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# Outsourcing Corporate Accountability

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# OUTSOURCING CORPORATE ACCOUNTABILITY

Kishanthi Parella\*

*Abstract:* This Article addresses the problem of preventing human rights violations abroad that result from the globalization of business. It specifically explores the challenge of improving labor standards in global value chains. The modern business has changed dramatically and has “gone global” in order to court foreign markets and secure resources, including labor. Familiar household names, such as Nike and Apple, have “outsourced” many of their functions to suppliers overseas. As multinational buyers, they dominate one end of the global value chain. At the opposite end of the value chain are the local managers and owners of the factories and workhouses where tablets are assembled, running shoes are made, and gowns are sown. These facilities are often the sites of serious human rights violations, such as forced labor and child labor.

Some actors have attempted to rein in transnational corporate misconduct through litigation in domestic courts regarding the corporation’s actions abroad. However, after *Kiobel v. Royal Dutch Petroleum*, it is unclear how successful such strategies will prove in the future. This Article takes a different approach and focuses on preventing these human rights violations by improving labor practices in global value chains. Unfortunately, current approaches focus on encouraging better due diligence regarding the behavior of their suppliers. These approaches rely on auditing, monitoring, and disclosures and have dominated international (UN’s Protect, Respect, and Remedy Framework), national (Danish Act on Financial Statement), and sub-state (California’s Transparency in Supply Chains Act of 2010) efforts to combat human rights violations. However, this Article explains that these and similar efforts will have limited effects because of the problem of misaligned incentives between buyers and suppliers in global value chains. Suppliers have different business profiles, interests, and constraints compared to their multinational buyers. Therefore, conventional drivers for better labor practices that rely on reputational risks and consumer boycotts will not work for suppliers. Instead, public actors and other stakeholders must identify incentives that are appropriate for suppliers. Second, they must also adopt a reflexive law governance approach in order to transmit these incentives effectively in global value chains. This Article concludes by offering examples of strategies that public actors should adopt in order to prevent another Foxconn or Rana Plaza tragedy.

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## INTRODUCTION

The key problem for international business law in this new millennium is the effective regulation of the global, fragmented firm.<sup>1</sup> Globalization has enabled corporate entities to span continents and establish dominions previously reserved for kings and statesmen. But whereas rules of international law evolved to curb the excesses of these latter types of actors, there is today a lack of similar rules to contend with this century's new titans. This is the reason that many global firms operate in this unregulated space between national borders.

Although a variety of national laws and corporate policies may speak to environmental and labor standards that businesses should abide by, these businesses enjoy a multitude of options regarding the structure of their operations. Their functions—from product concept, development, manufacturing, sales, shipping, and customer service—can be distributed across a variety of actors and several continents so that no two functions occur in the same place. This freedom allows businesses to escape the dictates of national regulation in favor of a less regulated space. As a result, headlines are filled with stories of corporate wrongdoing, including the tragedies at Rana Plaza in Bangladesh and Foxconn in China. According to the U.N. Special Representative for Business and Human Rights John Ruggie,

The root cause of the business and human rights predicament today lies in the governance gaps created by globalization - between the scope and impact of economic forces and actors, and the capacity of societies to manage their adverse consequences. These governance gaps provide the permissive environment for wrongful acts by companies of all kinds without adequate sanctioning or reparation.<sup>2</sup>

As a result, public actors and other stakeholders around the world have been confounded as to how to respond when the causes and effects of such crises are separated by an ocean.

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1. See Kenneth W. Abbott & Duncan Snidal, *Strengthening International Regulation Through Transnational New Governance: Overcoming the Orchestration Deficit*, 42 VAND. J. TRANSNAT'L L. 501 (2009); Charles Sabel et al., *Ratcheting Labor Standards: Regulation for Continuous Improvement in the Global Workplace* (Columbia Law Sch. Pub. Law & Legal Theory Research Paper Grp., Paper No. 21, 2000), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=262178](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=262178).

2. U.N. Secretary-General's Special Representative 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: Protect, Respect and Remedy: A Framework for Business and Human Rights*, U.N. Human Rights Council, 189 U.N. Doc. A/HRC/8/5 (Apr. 7, 2008) (by John Ruggie) [hereinafter *Framework*].

This Article argues that the solution to the “governance gap” is for stakeholders to adopt the very strategy at the root of the transnational governance challenge: outsource. The advantage of outsourcing for the business sector is that it allows companies to delegate and distribute roles among several actors in a manner that avoids duplication of efforts, capitalizes on the functional advantages of the actors, and adds value through a progression of steps. Firms like Nike and Apple chose to focus on a narrower set of core competencies that better reflected their specialized skills and the activities they believed would garner the most value. This outsourcing also made it more difficult for government actors to control giants like Nike and Apple because of geographic constraints, jurisdictional limitations, capacity, resources, and proximity. The solution, therefore, may be for government actors and other stakeholders to adopt the approach that businesses followed when faced with similar constraints: fragmentation according to functional specialization where the efforts of stakeholders are sequentially aligned in a series of value-adding activities.

The effective governance of transnational business activities requires that actors match the outsourced structure of the modern firm with an outsourced approach to regulating the fragmented firm. “Outsourced regulation” requires decentralization along two key dimensions: incentives and governance. The *first* dimension of decentralization relates to the model of the firm that stakeholders aim to regulate: unitary-actor model or fragmented-firm model. Decentralization along this dimension requires acknowledging that not all the actors in the global value chain are the same. In fact, these actors have different interests, business profiles, and constraints. Incentives for cooperation, therefore, must speak to this diversity in the value chain.<sup>3</sup>

However, designing incentives for all the actors in the value chain is not enough. Stakeholders must also have an effective way of transmitting those incentives to the relevant actors. The *second* dimension of decentralization, therefore, relates to the governance choices stakeholders face regarding how to transmit incentives in the value chain. One significant reason that current laws and standards speak to the interests of some, but not all, of the actors in the value chain is because of the challenge of transmitting incentives across a diverse group of actors who are geographically separated, culturally distinct, and often have very different business profiles. Any government actor will

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3. George S. Geis, *An Empirical Examination of Business Outsourcing Transactions*, 96 VA. L. REV. 241, 267 (2010) (examining the problem of aligning incentives in outsourced relationships).

be severely limited in their ability to offer incentives to such a diverse group. As a consequence, many government actors simply target one end of the value chain because it is within their jurisdictional reach. However, this is a more significant problem for “centralized” forms of governance, such as command and control regulation, that rely on one dominant actor, such as the state. This problem can be overcome by shifting to a decentralized approach to governance that involves a variety of stakeholders.

There are two main “decentralized” options for transmitting incentives in the global value chain: network coordination or reflexive coordination. Transnational regulatory networks have arisen as a forum for actors—usually from the sub-state level—to interact with one another to share information, harmonize standards, and improve enforcement efforts.<sup>4</sup> These networks have tackled issues such as securities regulation, banking supervision, insurance, and the environment.<sup>5</sup> However, a number of features of networks make this an inappropriate setting for government actors and other stakeholders to develop strategies for enforcing Corporate Social Responsibility (CSR) norms in global value chains.

Instead, government actors should consider using reflexive law as a way to coordinate their activities. Reflexive law is an approach to regulation that avoids direct intervention in favor of establishing procedures and policies that are intended to encourage the target industry to adopt a socially desirable course of conduct.<sup>6</sup> The significance of this approach for current practices is that public actors should differentiate between target and intermediate actors. If they cannot directly incentivize a target actor (such as a factory manager located overseas), they should identify an intermediate actor who possesses leverage over the target actor and exercise their leverage over that intermediary actor. Reflexive law approaches are part of a broader strategy of new

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4. Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257, 290–91 (2011); Anne-Marie Slaughter, *Sovereignty and Power in a Networked World Order*, 40 STAN. J. INT'L L. 283, 290 (2004) [hereinafter Slaughter, *Sovereignty and Power*]; Anne-Marie Slaughter, *Global Government Networks, Global Information Agencies, and Disaggregated Democracy*, 24 MICH. J. INT'L L. 1041, 1053 (2003) [hereinafter Slaughter, *Global Government Networks*]; see also David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281, 284–85 (1998).

5. Zaring, *supra* note 4, at 282; see also Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 12 (2002).

6. David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41, 48–51 (1999); Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227, 1264 (1995).

approaches to governing the modern firm, including encouraging government actors to persuade indirectly where before they commanded directly.<sup>7</sup>

The critical insight offered by this Article is that responses to tragedies like Foxconn and Rana Plaza will fail if they do not decentralize along both of these dimensions. This insight is intended for those government actors who are championing a new generation of CSR strategies that seek to reform the value chain through heightened transparency.<sup>8</sup> For example, in California, the Transparency in Supply Chains Act of 2010 requires that covered firms publicly disclose the nature and extent of their supplier monitoring.<sup>9</sup> California's approach is part of a broader strategy to address human rights violations in value chains by forcing corporations to disclose in the hope that such disclosures will encourage them to know and act regarding what goes on in their value chains.<sup>10</sup> Denmark, for example, has also mandated similar social reporting,<sup>11</sup> and the European Commission is considering adopting similar standards.<sup>12</sup> The United Nations also introduced the Guiding Principles that are intended to implement the Protect, Respect, Remedy Framework, including the corporate responsibility to respect.<sup>13</sup> All these initiatives attempt to improve transparency and consumer knowledge of the value chain and thereby increase monitoring and

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7. See Abbott & Snidal, *supra* note 1, at 520–21; David Hess, *The Three Pillars of Corporate Social Reporting as New Governance Regulation: Disclosure, Dialogue and Development*, 18 BUS. ETHICS Q. 447, 450 (2008). See generally Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004); Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458 (2001).

8. See Meredith R. Miller, *Corporate Codes of Conduct and Working Conditions in the Global Supply Chain: Accountability Through Transparency in Private Ordering* (October 20, 2013) (forthcoming), available at <http://ssrn.com/abstract=2342756>.

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

10. See Sabel, et al., *supra* note 1, at 16–17.

11. See Karin Buhmann, *The Danish CSR Reporting Requirement as Reflexive Law: Employing CSR as a Modality to Promote Public Policy* (Univ. of Oslo Faculty of Law Legal Studies Research Paper Series, Paper No. 2011-36, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1964220](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1964220).

12. European Commission, Environmental OREP, *Commission to Propose Mandatory Company Reporting of Environmental and Social Performance* (Aug. 8, 2013), [http://ec.europa.eu/environment/resource\\_efficiency/news/up-to-date\\_news/08032013\\_en.htm](http://ec.europa.eu/environment/resource_efficiency/news/up-to-date_news/08032013_en.htm).

13. U.N. Secretary-General's Special Representative 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: Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect, and Remedy" Framework*, U.N. Human Rights Council, U.N. Doc. A/HRC/17/31 (Mar. 21, 2011) (by John Ruggie).

oversight by businesses of the practices of their suppliers.

This Article illustrates the weaknesses of these approaches by illustrating the problem of misaligned incentives between buyers and suppliers in the value chain. Current due diligence standards concerning the value chain offer incentives that are more appropriate for the model of a single, integrated firm rather than the present reality of a diversity of actors operating in a global value chain. These approaches privilege the interests of one end of this value chain (the end in the developed world) to the neglect of the other actors in the chain. The assumption is that the business that the government is targeting is in a position to determine outcome (achieve compliance) and therefore the government tailors the incentives for cooperation to these actors. But the global value chain for a U.S. business can now involve several layers of suppliers. At one end is a multinational buyer, such as a large brand-name firm. At the opposite end of the value chain are the local managers and owners of the factories and work-houses where tablets are assembled, running shoes are made, and gowns are sewn. These facilities are often the sites of serious human rights violations, such as forced labor, child labor, and environmental contamination.<sup>14</sup> Effective CSR strategies require acknowledging the interests and constraints of buyers *and* suppliers in these global value chains.

It is true that the California approach acknowledges the global value chain structure by requiring firms to perform due diligence on their suppliers and disclose their efforts.<sup>15</sup> But the incentives for cooperation with California's mandate are suited to the firms within their jurisdiction but not the other actors in the value chain. As a result, the incentives offered in these approaches do not apply equally to all the parties in the chain and therefore exert limited "pull" on all the different actors. Admittedly, firms that operate in California, such as multinational brand and retail firms, often enjoy more power in the value chain than other actors and therefore may be in a better position to influence cooperation from their suppliers. But even if their suppliers do not have much power, they are not completely powerless. In fact, they often possess just enough power to resist these top-down approaches to corporate social responsibility. This resistance takes many forms. Some suppliers respond to more robust standards by further "outsourcing" their workforce in favor of temporary, contract labor who receive less legal

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14. See CHARLES KERNAGHAN, THE NAT'L LABOR COMM., CHILD LABOR IS BACK: CHILDREN ARE AGAIN SEWING CLOTHING FOR MAJOR U.S. COMPANIES 1 (2006), *available at* <http://www.globallabourrights.org/reports/child-labor-is-back>.

15. See *supra* note 12 and accompanying text.



protection. The ability of suppliers to hide their transgressions is facilitated by the willing ignorance of many of their multinational buyers. When on-site inspections do occur, suppliers counteract this threat by orchestrating the process to provide a false image of compliance. Through these and similar strategies, suppliers continue to maintain current practices and display little motivation to improve conditions. These are among the reasons that increased monitoring and auditing by corporate actors will not lead to the results desired.

Supplier audit evasion is a product of the subordination of supplier interests in the incentive structures of international, national, and private CSR initiatives. In these various approaches, there is an underlying assumption of harmony of interests among the variety of actors who operate in the modern global value chain. However, we are no longer dealing with a vertically integrated business. The different firms that operate in the global value chain have varying—even conflicting—interests and differ in location, size, capacity, and functional specialties. It is these interests and the resulting cost/benefit calculations that determine these actors' receptivity or resistance to improving CSR. Disproportionate attention to multinational buyers (such as large brand name retailers in the developed world) foster conclusions that media exposure, consumer boycotts, and other forms of reputational risks can secure better practices in global value chains. However, suppliers (such as local factory owners and managers in overseas facilities) are motivated by other sets of factors. The incentives that would secure their cooperation in improving standards vary from those of their multinational customers. Moreover, they are the parties who are "on the ground" and can determine the degree of implementation of improved CSR.<sup>16</sup> The real challenge is adequately incentivizing them to adopt better practices, and that requires formulating an incentive structure that speaks to all actors in the chain and not just one end. Failure to do so results in tension along the value chain, whereby downstream consumers and retail firms demand better production methods but upstream suppliers resist changes and simply hide the extent of their violations.

This Article makes the following significant contributions. First, it examines the largely understudied phenomena in legal scholarship of global value chains and the challenges of the global, fragmented firm that has outsourced and off-shored many of its functions. This is a significant project because the problem studied in this Article—labor

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16. Stephanie Barrientos & Sally Smith, *Do Workers Benefit from Ethical Trade? Assessing Codes of Labour Practice in Global Production Systems*, 28 *THIRD WORLD Q.* 713, 720 (2007).

standards in global value chains—is a manifestation of a greater problem confronting business law: devising an incentive structure that is applicable to the modern, transnational business. As such, the problems diagnosed in this Article, and the solutions offered, apply not only to the issue of improving corporate social responsibility but also to issues surrounding governance of a business that has outsourced many of its functions.

This Article's second contribution is the explanation of why the new wave of CSR strategies, which emphasize disclosure, monitoring, and audits will have limited effect. This is an important insight because a number of jurisdictions (such as California and Denmark) have already adopted this approach and it may become the template for future public responses in Europe and the United States.<sup>17</sup> This Article seeks to reform these strategies by clarifying the reasons why human rights abuses occur in the value chain. Section II distinguishes between asymmetries of information and asymmetries in rent and risk. This distinction is significant because it identifies the limitations of the current CSR strategies that seek to improve monitoring and disclosure and, therefore, only address the first problematic asymmetry. By providing an alternative explanation of the problem and exploring the understudied issue of supplier interests, it highlights the weaknesses of current incentives and offers suggestions on the types of incentives that would improve CSR strategies.

Finally, this Article begins a normative conversation regarding the types of approaches that public actors should support in order to reform problematic value chains. It does not claim to provide a solution for eliminating all abuses from all value chains. Instead, its objective is more modest: identify the flaws of the current approaches and explain the importance of decentralization in response to value chain problems. Section III introduces the two dimensions of decentralization— incentives and governance—and explains the importance of each and the problems that arise when one or more dimensions are centralized as opposed to decentralized. Although it will not eliminate all abuses, decentralization will improve the effectiveness of CSR initiatives, especially those involving brand firms. Section IV sketches the types of CSR strategies that emerge from a decentralized approach. This section also reveals that a decentralized approach to CSR resembles the fragmentation of industries that public actors are attempting to regulate.

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17. See *supra* notes 12, 14 and accompanying text; Hess, *supra* note 7, at 447 (“Overall, social reporting is on the verge of becoming a mainstream phenomenon.”).

The organizational mirroring of the regulators and the regulated aids the former in overcoming many of the challenges of regulating a fragmented, heterogeneous, transnational value chain.

## I. THE AGE OF OUTSOURCING

Many readers own an Apple iPhone, iPad, or similar gadget. However, most people do not know where these products are made. At one end of Apple's value chain are the "upstream suppliers," such as local managers and factory owners, who manufacture the iPhones, iPods, and iPads. They are "upstream" in the global value chain because they are the ones who supply the goods that are destined for Apple and consumers later down in the chain. At the other end of the value chain are the "downstream buyers," such as Apple, who purchase the goods manufactured by the suppliers and, in turn, sell them to consumers. The following Section provides an overview of global value chains that is useful for understanding the interests and attitudes of Apple's suppliers. Section A describes the shift to outsourced production, and Section B provides an example of the types of human rights problems that outsourcing can cause.

### A. *Rise of the Fragmented Firm*

Apple is a corporate behemoth. It became so, in part, by mastering the global value chain.<sup>18</sup> It is one of many American firms that abandoned vertical integration of their production in favor of a model that connects multiple tiers of firms of varying sizes, specialties, and geographic locations.<sup>19</sup> Previously, vertical integration of production occurred when a firm assumed the tasks associated with taking a product from concept to the end-user—including design, manufacturing, testing, packaging, and marketing. Although this form of organization had dominated the early part of the past century, it has been steadily challenged by an alternative model that largely externalizes manufacturing tasks (as well as an increasing array of functions) to outside firms (either domestically or internationally).<sup>20</sup> Under this alternative approach, product innovation is separated from product manufacturing, so that those who design the

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18. Charles Duhigg & David Barboza, *In China, Human Costs Are Built into an iPad*, N.Y. TIMES (Jan. 25, 2012), [http://www.nytimes.com/2012/01/26/business/ieconomy-apples-ipad-and-the-human-costs-for-workers-in-china.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/01/26/business/ieconomy-apples-ipad-and-the-human-costs-for-workers-in-china.html?pagewanted=all&_r=0).

19. See Gerald F. Davis, *After the Corporation*, 41 POL. & SOC'Y 283, 294–95 (2013).

20. Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 434 (2009).

products are seldom the same parties who actually assemble them.<sup>21</sup> Instead, a growing class of “contract manufacturers” take over the production tasks for firms so that firms can focus on other activities that are better suited to their skill set or result in higher returns. Broad swaths of industry have shifted to this outsourced model as familiar household names divest their production facilities and increasingly rely on overseas suppliers.

Why do firms choose to outsource and send abroad what they used to do at home? Answering this question harks back to Ronald Coase’s theory of firm organization in *The Nature of the Firm*.<sup>22</sup> All firms—whether they are globally oriented or not—confront the same dilemma: do they internally produce their own inputs or contract with external parties to do the same work? According to Coase, transaction costs help firms answer this question and, consequently, demarcate the boundary of the firm.<sup>23</sup> The transaction costs involved with contracting (negotiation, coordination, etc.) lead firms to produce internally what they can outsource externally.<sup>24</sup> However, internal production is not free from transaction costs either. Instead, firms face declining returns to management that result from higher production costs and internal inefficiencies.<sup>25</sup> Firms navigate these competing risks so that the “optimal location of economic activity is the result of a careful balance between production cost savings from using markets, and transaction cost savings (again, broadly defined) from using firms.”<sup>26</sup> Further complicating this calibration is the reality that transaction and production costs are not fixed but fluctuate according to many factors, such as new technologies.<sup>27</sup> As a result, “the borders of a firm will continue to change as the underlying tension between production costs and transaction costs oscillates.”<sup>28</sup>

These considerations mean that firms confront several choices regarding the organization of their production when they court foreign

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21. Victoria Curzon Price, *Some Causes and Consequences of Fragmentation*, in FRAGMENTATION 88, 88 (Sven Arndt & Henry Kierzkowski eds., 2001) (“‘Fragmentation’ refers to the growing complexity of the modern chain of production, which divides and redivides previously integrated systems into ever more specialized and distinguishable units.”).

22. R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

23. *Id.* at 390.

24. *Id.* at 390–91.

25. *Id.* at 394; Geis, *supra* note 3, at 245–46.

26. George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 *NOTRE DAME L. REV.* 955, 971 (2007).

27. *Id.*

28. *Id.* at 970–71.

markets and labor pools. They may choose to establish their own production plants in overseas locations for a number of perceived advantages. For example, they may prefer to control production out of a desire to protect proprietary technology and knowledge or due to other business advantages that may be compromised through too much decentralization.<sup>29</sup> For such reasons, firms may decide to retain all the economic activities “under one ownership roof” even if these processes could be subcontracted and despite the fact that production occurs in more than one country.<sup>30</sup> The inability to separate production into discrete tasks or to communicate production knowledge to a supplier also precludes such externalization.<sup>31</sup>

Alternatively, firms may prefer not to own the facilities in which their products are made or assembled and may instead opt to work with various independent actors in the production process through a series of market transactions. The choice to do this is facilitated by decreasing transaction costs that result from lower transportation costs, improved electronic communication, and trade liberalization.<sup>32</sup> Due to the internet, “[a] business executive will know, as never before, what is available, at what price, in what quantity, to what quality, when and where—at a click of a button.”<sup>33</sup> These declining market costs may therefore “reduce the advantage of internalizing activities within the firm, and therefore reduce its size, forcing it to ‘outsource’ all but its core activities.”<sup>34</sup> Novel contracting arrangements also lead to new possibilities for cooperation at the boundary of the firm.<sup>35</sup> These two possibilities

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29. Price, *supra* note 21, at 95.

30. *Id.* at 95.

31. Peter Lund-Thomsen & Khalid Nadvi, *Clusters, Chains and Compliance: Corporate Social Responsibility and Governance in Football Manufacturing in South Asia*, 93 J. BUS. ETHICS 201, 204 (2010) (explaining that in the literature on global value chains, “the specific governance outcome in a given value chain is determined by the capability of suppliers, the nature and complexity of the transaction involved, and the ability to which information can be codified”).

32. Geis, *supra* note 26, at 960–62 (“Relatively high transaction costs have historically prevented firms from tapping into the global supply of labor. As these costs drop, however—through improvements in communication, digitization, standardization, and the like—it becomes economical for firms to embrace overseas production. In essence, falling interaction costs have unlocked a massive supply of labor, driving down the price of economic inputs, realigning business processes, and tempting (or forcing) managers to move production outside the firm.” (citations omitted)).

33. Price, *supra* note 21, at 100.

34. *Id.*

35. See Geis, *supra* note 26, at 962 (“[B]usiness outsourcing has thrived in recent years not only because globalization has unlocked inexpensive production markets, but also because it is becoming easier for firms to monitor and prevent the agency costs of outsourcing.”); Gilson et al., *supra* note 20, at 435.

constitute opposite poles of a spectrum upon which a firm can arrange its level of integration with those who manufacture its products.<sup>36</sup>

Apple eventually chose to go with the second route (or close to it)<sup>37</sup> and this production model has contributed to Apple's emergence as one of the world's most successful corporate giants. The product that helped get Apple to that enviable pinnacle is the iconic iPhone: a pretty, usable, affordable piece of the future that allows the user to access every mode of communication—all within the convenience of their own palm. This product defined the “smartphone” industry, which in turn defined a generation of texters, tweeters, and social-networking aficionados. Although the iPhone and its peer smartphones rest within the hands of many in the United States, these products are not made here. Instead, the components are sourced from a number of countries and many hands—mostly foreign—help build each individual iPhone. Apple's success is partially due to its ability to coordinate the manufacture of such a sophisticated product in an even more sophisticated value chain involving various actors and several continents. This value chain has many characteristics, each of which will be discussed in turn below.

### 1. *Spatial Dispersion*

Most of the components of an iPhone are not made in the United States.<sup>38</sup> Instead, an estimated ninety percent of iPhone components are manufactured abroad:<sup>39</sup> Germany and Taiwan supply the advanced semiconductors, Korea and Japan supply the memory, Korea and Taiwan provide the display panels and circuitry, Europe provides the chipsets, and Africa and Asia supply the rare metals.<sup>40</sup> China does the rest and puts it all together.<sup>41</sup> Apple does employ 43,000 workers in the United States,<sup>42</sup> but this figure does not reflect Apple's true work force—the one that produces the millions of Apple iPods, iPhones, and

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36. See Lund-Thomsen & Nadvi, *supra* note 31, at 204.

37. Marcelo Prince & Willa Plank, *A Short History of Apple's Manufacturing in the U.S.*, WALL STREET J. (Dec. 6, 2012), <http://blogs.wsj.com/digits/2012/12/06/a-short-history-of-apples-manufacturing-in-the-u-s/>.

38. P.K., *Slicing an Apple*, THE ECONOMIST (Aug. 10, 2011), <http://www.economist.com/blogs/dailychart/2011/08/apple-and-samsungs-symbiotic-relationship> [hereinafter *Slicing an Apple*].

39. Charles Duhigg & Keith Bradsher, *How the U.S. Lost Out on iPhone Work*, N.Y. TIMES (Jan. 21, 2012), <http://www.nytimes.com/2012/01/22/business/apple-america-and-a-squeezed-middle-class.html?pagewanted=all>.

40. *Id.*

41. *Id.*

42. *Id.*

other products that Apple sells annually. Instead, a staggering 700,000 additional foreign workers are employed by Apple's contractors, such as Foxconn.<sup>43</sup>

Why are Apple's products made overseas and not in the United States? Most Americans believe that the location of manufacturing abroad is due to wage differences between American workers and their foreign counterparts. This is only a part of the truth. Labor costs are only a small fraction of the cost in technology manufacturing.<sup>44</sup> In theory, therefore, Apple could pay American wages and still secure considerable rewarding margins.<sup>45</sup> What it cannot find in the United States are the scale and flexibility offered by foreign plants.<sup>46</sup> A story relating to Apple's former leadership, Steve Jobs, is revealing. In 2007, Mr. Jobs demanded an unscratchable glass screen for the iPhone.<sup>47</sup> And he wanted it in six weeks.<sup>48</sup> There was only one location that could deliver on Mr. Jobs' demand: China. In China, subsidies from the government had aided the glass-cutting factories so that the factories could offer Apple warehouses filled with glass samples and skilled engineers.<sup>49</sup> And they offered it all to Apple for free or next to free.<sup>50</sup> The owners of the Chinese factories had also built dormitories on site so that "employees would be available 24 hours a day."<sup>51</sup> How could Apple say no? According to a former Apple executive,

The first truckloads of cut glass arrived at Foxconn City in the dead of night . . . . That's when managers woke thousands of workers, who crawled into their uniforms — white and black shirts for men, red for women — and quickly lined up to assemble, by hand, the phones. Within three months, Apple had sold one million iPhones. Since then, Foxconn has assembled

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43. *Id.*

44. *Id.* ("In part, Asia was attractive because the semiskilled workers there were cheaper. *But that wasn't driving Apple.* For technology companies, the cost of labor is minimal compared with the expense of buying parts and managing supply chains that bring together components and services from hundreds of companies." (emphasis added)).

45. *Id.*

46. *Id.* ("It isn't just that workers are cheaper abroad. Rather, Apple's executives believe the vast scale of overseas factories as well as the flexibility, diligence and industrial skills of foreign workers have so outpaced their American counterparts that 'Made in the U.S.A.' is no longer a viable option for most Apple products.").

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

over 200 million more.<sup>52</sup>

The ability to scale up and down quickly was especially important for Apple because it had experienced difficulties in the past with responding to changes in consumer demands.<sup>53</sup>

Additionally, Apple could not find the pool of skilled workers that it needed for its assembly lines. The company had projected a need for 8,700 industrial engineers to supervise the staff of 200,000 assembly line workers needed for making the iPhones.<sup>54</sup> Apple's analysts "forecast[ed] it would take as long as nine months to find that many qualified engineers in the United States. In China, it took 15 days."<sup>55</sup> Additionally, regulatory competition tends to favor Chinese markets. China boasts "flexible land-use, labour, and environmental rules" so that "China can erect a massive operation in no time at all, staffed with compliant labour and with little concern about the impact of the factory on watersheds, air quality, and traffic."<sup>56</sup> This contributes to one of China's chief advantages: the ability for Apple to scale its production up and down rapidly.<sup>57</sup>

Re-shoring Apple's manufacturing work back to the United States would therefore require significant changes in both national and global economies.<sup>58</sup> Securing a reliable pool of the relevant skilled labor is only part of the challenge. Another challenge is that supply chains for consumer electronics are concentrated in Asia.<sup>59</sup> A U.S. firm, therefore, must decide between manufacturing in the United States and shipping the component to its customers in Asia—an option that involves long delays and considerable cost—or constructing an overseas plant next to its customers in Asia. It is not a surprise that many U.S. firms choose the

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52. *Id.*

53. Gilson et al., *supra* note 20, at 464. After registering a \$740 million quarterly loss, Apple sold its largest U.S. production facility to SCI, an electronics contract manufacturer. SCI used the former Apple plant and Apple workers to manufacture Apple's products, as well as products made by other firms. This arrangement freed Apple from carrying unnecessary overhead and inventory costs. The electronics industry could be characterized by a great deal of volatility in consumer demand, which meant that production scheduling was difficult. Out-sourcing manufacturing meant that retailers and brand firms no longer had to internalize the costs associated with rapid changes in demand. Timothy J. Sturgeon, *Modular Production Networks: A New American Model of Industrial Organization*, 11 *IND. & CORP. CHANGE* 451, 456–58 (2002).

54. Duhigg & Bradsher, *supra* note 39.

55. *Id.*

56. R.A., *Supply Chains: Apple and the American Economy*, *THE ECONOMIST* (Jan. 23, 2012), <http://www.economist.com/blogs/freexchange/2012/01/supply-chains> [hereinafter *Supply Chains*].

57. See Duhigg & Bradsher, *supra* note 39 (discussing the benefits of Asian supply chains).

58. *Id.*

59. *Supply Chains*, *supra* note 56.



second option:

It's possible to coordinate a supply chain that's draped across an archipelago of Asian economies. To maximise the return to this chain, however, it's still necessary to keep plants reasonably close together. A plant located in America is too distant from Asia to make much economic sense . . . Changing transportation and communication technologies facilitated a shift in manufacturing to Asia, then reinforced its presence there.<sup>60</sup>

## 2. *Functional Specialization and Value Added*

Globalization of production does not only mean that production occurs in many countries. It also refers to the functional specialization of actors in different locations and the integration of these disparate economic activities into a cohesive production plan. Industrial "fragmentation" is based upon division of labor among a variety of actors, and the product cycle for the iPhone is distributed across a variety of different firms.

Each step in the production of an Apple iPhone 4 may be undertaken by different companies in different countries.<sup>61</sup> The "value added" at each step of the production process is the difference between the cost of the inputs and the value of the outputs.<sup>62</sup> In Apple's value chains, "each producer purchases inputs and then adds value, which becomes a cost of the next stage of production. The sum of the value added by everyone in the chain equals the final product price."<sup>63</sup>

The value chain for another Apple product, the iPod, involves *component suppliers* who produce low-value parts, such as capacitors and resistors.<sup>64</sup> They account for a small share of the total value in the value chain and the risk of close substitution leads to fierce competition that exerts a downward pressure on the prices they can charge and the profit margins they can secure.<sup>65</sup> Some of the components are high-value, such as visual displays, hard drives, and key integrated circuits.<sup>66</sup>

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60. *Id.*

61. *Slicing an Apple*, *supra* note 38.

62. Hal R. Varian, *Who Really Makes the iPod?*, N.Y. TIMES (June 28, 2007), <http://www.nytimes.com/2007/06/28/technology/28iht-ipod.1.6378095.html>.

63. JASON DEDRICK ET AL., ALFRED P. SLOAN FOUNDATION INDUSTRY STUDIES CONFERENCE, WHO PROFITS FROM INNOVATION IN GLOBAL VALUE CHAINS?: A STUDY OF THE IPOD AND NOTEBOOK PCs 1, 6 (2008), *available at* [http://web.mit.edu/is08/pdf/Dedrick\\_Kraemer\\_Linden.pdf](http://web.mit.edu/is08/pdf/Dedrick_Kraemer_Linden.pdf).

64. *Id.* at 7–8.

65. *Id.* at 7.

66. *Id.*

These components garner a significant share of the value added because they “are the most likely to embody proprietary knowledge that helps to differentiate the final product and to command a commensurately high margin.”<sup>67</sup> These various components are assembled into a final product by an original design manufacturer (ODM) or a contract manufacturer (CM), such as Foxconn, Flextronics, Solectron, Quanta, and Compal.<sup>68</sup> These assembly firms also compete fiercely for high-volume orders and this competition limits the margins they can secure.<sup>69</sup>

Brand-name vendors, such as Apple, supply the lion’s share of the value added to the value chain. They undertake high-value tasks such as product concept, branding, and marketing.<sup>70</sup> As the lead firm in the iPod value chain, Apple “contribute[s] market knowledge, intellectual property, system integration and cost management skills, and a brand name whose value reflects its reputation for quality, innovation, and customer service.”<sup>71</sup> Finally, global wholesalers and national and local distributors undertake distribution services, while large retail chains and general retailers sell the final products to consumers.<sup>72</sup>

Firms choose to divide up labor because, first, it allows them to focus on what they do best. Nike, an early architect of this model of global production, chose to leave the manufacturing to its external suppliers because, in the words of one of its executive, “[w]e don’t know the first thing about manufacturing.”<sup>73</sup> Instead, Nike’s strength was in branding and marketing, “entail[ing] the construction of a convincing world of symbols, ideas, and values harnessing the desires of individuals to the consumption of athletic shoes.”<sup>74</sup> Similarly, Apple does not manufacture or assemble the components of its iPod, iPhone, or iPad. Instead, it focuses on strategy, product design, branding, and marketing.<sup>75</sup> The result of this configuration of the global value chain is that the higher profit margins are generally found at the consumption end of the value

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67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. Miguel Korzeniewicz, *Commodity Chains and Marketing Strategies: Nike and the Global Athletic Footwear Industry*, in *COMMODITY CHAINS & GLOBAL CAPITALISM* 247, 252 (Gary Gereffi & Miguel Korzeniewicz eds., 1994).

74. *Id.* at 251; *see also id.* at 260.

75. Dedrick et al., *supra* note 63, at 7.

chain and not in the manufacturing process.<sup>76</sup>

Second, and critically, the reason that market leaders like Apple and Nike decided to focus on certain tasks and outsource the rest is because this division of labor allowed these firms to focus on “higher-returns” segments of global production. For example,

[t]he real value of the [Apple] iPod doesn't lie in its parts or even in putting those parts together. The bulk of the iPod's value is in the conception and design of the iPod. That is why Apple gets \$80 for each of these video iPods it sells, which is by far the largest piece of value added in the entire supply chain. Those clever folks at Apple figured out how to combine 451 mostly generic parts into a valuable product. They may not make the iPod, but they created it. In the end, that's what really matters.<sup>77</sup>

Finally, division of labor allowed Nike and Apple to adapt their sourcing strategies depending on changing labor costs and skill-level needed for their different products.<sup>78</sup> For example, the manufacture of an iPhone depends on several discrete tasks, but not all the tasks may require the same skill level. Apple, therefore, could source the low-skill, low-cost components from one location but ensure that the few high-value components are manufactured by higher-skill, high-cost workers.<sup>79</sup>

### 3. *Separation of Ownership and Control*

Although retailers and brand firms in North America may no longer own the means of production, this does not mean that they have relinquished control over the global value chain or the other actors in the

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76. *Supply Chains*, *supra* note 56 (“[A]s one scales up production of Apple products, there are vastly different employment needs across the supply chain. So, it doesn't take lots more designers and programmers to sell 50m iPhones than it does to sell 10m. You have roughly the same number of brains involved, and much more profit per brain. On the manufacturing side, by contrast, employment soars as scale grows. So as the iPhone becomes more popular, you get huge returns to the ideas produced in Cupertino, and small returns but hundreds of thousands of jobs in China.” (emphasis added)); see also Dong-Sook S. Gills, *Globalization of Production and Women in Asia*, 581 ANNALS OF THE AM. ACAD. OF POL. & SOC. SCI. 106, 108 (2002); 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 (2012).

77. Varian, *supra* note 62; see also *Supply Chains*, *supra* note 56.

78. Korzeniewicz, *supra* note 73 at 260.

79. The fragmentation of large, U.S.-based firms has also affected the evolution of suppliers in foreign countries. As the former shed functions, the latter developed competencies in these areas and often expanded in order to match the skill and scale of production required by their buyer firms. Sturgeon, *supra* note 53. This reactionary growth facilitates greater fragmentation because firms may be tempted to outsource more of their functions as the quality of an industry's supplier base increases. *Id.* at 455.

process. Instead, buying firms exercise tremendous power over suppliers despite their lack of direct ownership.<sup>80</sup> For example, as the lead firm in the iPod value chain, Apple is the dominant player.<sup>81</sup> Apple is the “only company that bargains with all other actors in the value chain” and “[i]n every relationship with its suppliers, Apple has the greater market power.”<sup>82</sup>

Like many other multinational buying firms, Apple’s power derives from a combination of large volume orders, retail concentration, and substitution possibilities. A high concentration of buyers gives these firms the ability to dictate favorable conditions to their suppliers, including exerting a strong downward pressure on prices and demanding greater turnaround times.<sup>83</sup> The threat of substitution looms over the various tiers of Apple’s value chain and not even the high-value component manufacturers are invulnerable to this risk. For example, U.S. company PortalPlayer made the primary microchip that managed the iPod’s functionality.<sup>84</sup> The component was valuable enough to the iPod that PortalPlayer secured a gross margin of 44.8 percent in 2005.<sup>85</sup> However, as important as PortalPlayer was to Apple, Apple was even more important to PortalPlayer: “In 2005, Apple’s subcontractors for iPod assembly accounted for 93 percent of PortalPlayer’s sales.”<sup>86</sup> PortalPlayer’s vulnerability was further compounded because “Apple [was] no more than one product revision (about 18 months) from being able to replace even a key supplier like PortalPlayer with acceptable switching costs.”<sup>87</sup> In fact, that is what Apple did. In 2006, “Apple began designing iPods without PortalPlayer’s processors in them. The chip company fell on hard times and was acquired by Nvidia, another chip company.”<sup>88</sup> If the supplier of a high-value component confronted such substitution risks, imagine the substitution risks faced by the various suppliers who produce low-value components for the iPod. Even

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80. 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).

81. Dedrick et al., *supra* note 63, at 15.

82. *Id.* at 16; see also Gary Gereffi, *Commodity Chains and Regional Divisions of Labor in East Asia*, 12 J. ASIAN BUS. 75, 83 (1996).

83. Stephanie Barrientos, *Contract Labour: The ‘Achilles Heel’ of Corporate Codes in Commercial Value Chains*, 39 DEV. & CHANGE 977, 982 (2008).

84. Dedrick et al., *supra* note 63, at 13.

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

large contract manufacturers like Foxconn, who assemble the Apple products, are not immune: “As with key components, Apple would incur some switching costs to change manufacturing service providers. However, these costs can be minimized by synchronizing them with a product revision, hence the power in the relationship is once again mostly on Apple’s side.”<sup>89</sup>

The power wielded by Apple and other powerful multinational buyers allow them to demand lower costs and faster turnaround times. Both of these factors are important for understanding the conditions at Foxconn and other overseas production sites. Most suppliers in Apple’s value chain are only permitted a slim profit margin; therefore, the managers at these suppliers “push their employees to work longer and faster.”<sup>90</sup> However, low costs are only part of the story. The rest is due to consumer preferences and the business model that it cultivates. In the United States and other developed economies, consumers demand new electronics on an annual basis.<sup>91</sup> This means that a company’s success depends upon its ability to satisfy consumer preferences for the next shiny bauble:

Apple lost billions of dollars in market value [in 2012] because it couldn’t produce enough handsets to meet record demand, one of several factors that precipitated a 20 percent decline in its share price at the end of last year. That only underscored the importance of speed in the supply chain to Apple executives . . . .<sup>92</sup>

Apple responds, therefore, by pushing Foxconn and its other suppliers to churn out newer models in significant volume and in record time.<sup>93</sup> According to critics of Apple’s value chain,

[c]ompliance will not be easy as long as Apple’s existing business model remains unchanged. The evidence from other big consumer brands suggest that most abuses of workers—particularly when it comes to overtime—occur when a factory is

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89. *Id.* at 15.

90. Duhigg & Barboza, *supra* note 18.

91. *Id.*; see also *Apple’s China Supply Chain Exposed: Interview by Kai Ryssdal with Charles Duhigg*, MARKETPLACE (Jan. 26, 2012), <http://www.marketplace.org/topics/tech/apple-economy/apples-china-supply-chain-exposed> (“Ryssdal: If change is going to come, where is change going to come from? Duhigg: . . . We live in a time when there’s a brand-new device, it seems like, every couple of months. And they’re amazing and wonderful – but there’s a price to that.”).

92. Cam Simpson, *An iPhone Tester Caught in Apple’s Supply Chain*, BLOOMBERG BUSINESSWEEK (Nov. 7, 2013), <http://www.businessweek.com/articles/2013-11-07/an-iphone-tester-caught-in-apples-supply-chain>.

93. Duhigg & Barboza, *supra* note 18.

under pressure to meet a sudden surge in demand, often around product launches.<sup>94</sup>

For example, when Apple's marketing chief unveiled the iPhone 5 on September 12, 2012, few units had been produced.<sup>95</sup> However, the phone was scheduled to become available for sale in nine different markets in nine days.<sup>96</sup> Apple's aggressive "production-and-launch schedule" meant that its supplier—Flextronics—had to intensify its own value chain to meet Apple's scheduling and volume demands.<sup>97</sup>

The result of this cost pressure and time pressure is the grueling environment reported in "sweatshops" around the world, including at Foxconn's large contract manufacturing facility near Shenzhen, China.

### B. *The Tragedy at Foxconn*

Foxconn Technology Group ("Foxconn") is the world's leading contract manufacturer of electronics.<sup>98</sup> Its customers include Apple, Dell, Sony, and Nokia.<sup>99</sup> However, it is now better known for the series of suicides that occurred at its facilities in 2010. During 2010, several workers leapt off buildings at Foxconn's site near Shenzhen.<sup>100</sup> This Foxconn facility is possibly the world's largest production facility with over 300,000 workers.<sup>101</sup> The facilities that Foxconn maintains in China are not like average production sites. Its workers eat and sleep at these facilities. This business model of taking over the lives of the workers is not unusual and is instead the usual practice for many of China's low-cost manufacturers.<sup>102</sup> Due to features of Chinese law, migrant workers are at the mercy of their employers, and not the government, for housing and services. Citizenship in China is linked to birthplace and so the local governments in the manufacturing districts in China often deny needed

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94. M.B., *Apple and Foxconn: iAudit*, THE ECONOMIST (Mar. 30, 2012), <http://www.economist.com/blogs/schumpeter/2012/03/apple-and-foxconn>.

95. Simpson, *supra* note 92.

96. *Id.*

97. *Id.*

98. Pun Ngai & Jenny Chan, *Global Capital, the State, and Chinese Workers: The Foxconn Experience*, 38 MODERN CHINA 383, 385–86 (2012).

99. Kathrin Hille, *Suicides Put Foxconn Model Under Scrutiny*, FIN. TIMES (May 23, 2010), <http://www.ft.com/intl/cms/s/0/a4d15856-66ca-11df-aeb1-00144feab49a.html#axzz2jsMkzDbI>.

100. Jason Dean & Ting-I Tsai, *Suicides Spark Inquiries*, WALL STREET J. (May 27, 2010), <http://online.wsj.com/news/articles/SB10001424052748704026204575267603576594936>.

101. Hille, *supra* note 99.

102. Richard Appelbaum & Nelson Lichtenstein, *A New World of Retail Supremacy: Supply Chains and Workers' Chains in the Age of Wal-Mart*, 70 INT'L LAB. & WORKING-CLASS HIST. 106, 110 (2006).

services to the migrant workers.<sup>103</sup> Therefore, migrant workers are dependent upon their employers for housing and that is why large dormitories are often situated adjacent to working facilities in these areas.<sup>104</sup> Of course, this dynamic only exacerbates the power of the factory owners and managers, who resort to tactics such as withholding a worker's identity papers until the worker fulfills the contract with the employer.<sup>105</sup>

One contributing factor to Foxconn worker exhaustion was Foxconn's drive to deliver orders in short delivery times.<sup>106</sup> The quick turn-around was part of Foxconn's strategy to compete and claim business away from its more established competitors.<sup>107</sup> It was also an adaptation to the production schedules demanded by their customers—including Apple and Nokia—who wanted their products quickly in order to satisfy global demand for their products: "The corporations pressure Foxconn so that they can compete against each other on price, quality, and delivery. To fulfill the requirement of speedy production and shipment deadlines, Foxconn transfers the work pressure to the frontline workers."<sup>108</sup> The Longhua factory could produce more than ninety iPhones per minute.<sup>109</sup> These production feats were achieved due to conditions like the following: "Management used stop-watches and computerized industrial engineering devices to test the capacity of the workers and if workers being tested were able to meet the quota, the target would be increased day by day until the capacity of the workers reached the maximum."<sup>110</sup> Unfortunately, this also had the effect of pushing its workers to and past their breaking point.

In the wake of public scrutiny, Apple joined the Fair Labor Association (FLA) in 2012 and promised to align its compliance program with FLA obligations.<sup>111</sup> Apple also terminated its relationship with a supplier that employed underage workers in violation of Apple's

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103. *Id.*

104. *Id.*

105. *Id.*

106. Ngai & Chan, *supra* note 98, at 388.

107. *Id.* at 387, 400.

108. *Id.* at 400.

109. *Id.*

110. *Id.*

111. *Apple Joins FLA*, FAIR LAB. ASS'N (Jan. 13, 2012), <http://www.fairlabor.org/blog/entry/apple-joins-fla>. The FLA conducted an independent investigation of Foxconn's facilities in China and reported a completion rate of approximately ninety-nine percent on remediation items. *Final Foxconn Verification Status Report*, FAIR LAB. ASS'N (Dec. 12, 2013), <http://www.fairlabor.org/report/final-foxconn-verification-status-report>.

code of conduct.<sup>112</sup> In 2013, Apple even decided to break Foxconn's monopoly over iPhone assembly and include a different supplier, Pegatron Corp., more prominently in its value chain.<sup>113</sup> Apple's reasons for doing so were at least partially informed by pricing decisions. Public scrutiny of Foxconn led the supplier to improve working conditions and therefore reduce its cost advantages from scale.<sup>114</sup> Some analysts speculate that the supplier change may be motivated by Pegatron's willingness to accept thinner margins, which will likely lead to downward pressure on wages and conditions for Pegatron's workers.<sup>115</sup> Finally, Foxconn decided to change the composition of its assembly-line workers by including up to 10,000 new robots on its factory floor in order to meet new iPhone production quotas.<sup>116</sup>

## II. IDENTIFYING THE PROBLEM: TWO COMPETING TALES OF CAUSATION

Identifying the solutions to problems like Foxconn requires that stakeholders first understand the problem accurately. There is a temptation in developed economies—from buyers to politicians to media—to diagnose tragedies such as Rana Plaza and Foxconn as consequences of asymmetries of information in the value chain: These abuses occur because the multinational buyer is often unaware of the choices and conduct of its overseas supplier. This leads to the familiar challenge of managing the agency-cost problem in corporate activity. This implicit or explicit diagnosis of the problem has led to reliance on monitoring and audits as means of discouraging suppliers from engaging in human rights abuses, such as the initiatives adopted in California and Denmark.<sup>117</sup> This diagnosis of the problem is prevalent because it accords with the buyer's perspective on value chain abuses: "it's them, not us." Given the relative power of buyer voices over their suppliers, it

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112. Connie Guglielmo, *Apple's Supplier Labor Practices in China Scrutinized After Foxconn, Pegatron Reviews*, FORBES (Dec. 12, 2013, 7:15 PM), <http://www.forbes.com/sites/connieguglielmo/2013/12/12/apples-labor-practices-in-china-scrutinized-after-foxconn-pegatron-reviewed/>.

113. Eva Dou, *Apple Shifts Supply Chain Away from Foxconn to Pegatron*, WALL STREET J. (May 29, 2013), <http://online.wsj.com/news/articles/SB10001424127887323855804578511122734340726>.

114. *Id.*

115. *Id.*

116. Michael Coffey, *Foxconn May Soon Rely on Robots Over Humans for Apple's iPhone 6*, MARKET WATCH (July 7, 2014, 12:37 PM), <http://blogs.marketwatch.com/thetell/2014/07/07/foxconn-may-soon-rely-on-robots-over-humans-for-apples-iphone-6/>.

117. *See supra* notes 12, 14 and accompanying text.



is not surprising that the problem is presented as one relating to control of supplier conduct in the value chain. Section A elaborates on this viewpoint and explains why the CSR strategies that it inspires will be unsuccessful.

However, as discussed in Section B, asymmetries of information are only a part of the problem. From the perspective of the suppliers, they fall short of human rights standards because of asymmetries in rent and risk that characterize many value chains: The value gained in the chain is directed toward the buying end while the risks involved are directed to the suppliers. This results in a situation where suppliers cannot simultaneously satisfy the sourcing demands and CSR standards of buyers. As a consequence, therefore, suppliers will frustrate buyers' attempts at monitoring and resist efforts at improvement. The solution to addressing this challenge is not to engage in more auditing. Instead, it depends on appealing to the interests of the suppliers and incentivizing them to cooperate.

A. *Explaining Foxconn—The Buyer's Tale: Asymmetries in Information*

One way to understand the events at Foxconn is to attribute them to the lack of information that the buyer, Apple, and other stakeholders have regarding what occurs at overseas sites such as Foxconn. The danger of this lack of information is that it contributes to the agency-cost problem that plagues many areas of corporate activity: "The agency cost problem arises whenever one party (the agent) has discretionary power to make decisions that affect the wealth of another (the principal)."<sup>118</sup> The challenge is that the "very act of deputizing someone else to run your affairs raises incentives for suboptimal behavior."<sup>119</sup>

The agency-cost problem also plagues the global value chain. The chain is based on one party, such as a multinational buyer, contracting with another firm to perform activity that the buyer previously performed within its own firm. When it does so, it creates a situation where the "outsourcing vendor controls the activity, while the outsourcing firm 'owns' the result."<sup>120</sup> In other words, Apple is in a situation where Foxconn controls production activities and related functions—including the treatment of the workers who produce Apple's goods—but the backlash against Foxconn's practices are directed at

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118. Geis, *supra* note 26, at 974.

119. *Id.* at 973.

120. *Id.* at 962.

Apple, who faces the consequences of Foxconn's choices.

1. *Addressing the Agency-Cost Problem: Monitoring*

A significant cause of the agency-cost problem is asymmetrical information between the agent (supplier) and the principal (multinational buyer).<sup>121</sup> It is difficult for the principal to adequately protect itself against the agent's behavior because the principal may have limited means to become aware of it.<sup>122</sup> It is no surprise, therefore, that one method that outsourcing firms have adopted to address the agency-cost problem is to contractually require vendors to subject themselves to monitoring performed by the outsourcing firm (buyer) or a third party designated by the outsourcing firm.<sup>123</sup>

Some of the most well-known contractual codes of conduct are those included in supply contracts between a company based in the United States and its overseas manufacturers. For example, HP's Supplier Social & Environmental Responsibility Agreement states that suppliers are "responsible for identifying any areas of its operations that do not conform to HP's Supplier Code of Conduct and HP's General Specification for the Environment," as well as "implementing and monitoring improvement programs designed to achieve" these standards.<sup>124</sup> The agreement also gives HP the right to progress reports and the right to records for verification of the information in the supplier's reports.<sup>125</sup>

One significant limitation of private codes of conduct is that downstream firms did not adequately monitor compliance with their own codes.<sup>126</sup> Ineffective monitoring meant that there was little motivation for upstream suppliers to change current practices.

Due to this limitation, public actors attempted to increase the monitoring and oversight responsibilities of upstream firms towards their downstream partners. For example, the Securities & Exchange Commission adopted a rule mandated by the Dodd-Frank Wall Street

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121. *Id.* at 974.

122. *Id.* at 979.

123. *Id.* at 993.

124. *HP Supplier Social and Environmental Responsibility Agreement*, HEWLET-PACKARD (Oct. 22, 2008), <http://www.hp.com/hpinfo/globalcitizenship/environment/pdf/supagree.pdf>.

125. *Id.*

126. In a study of 246 codes, only ten percent had a formal complaint body and less than fifty percent had any type of penalty or consequence for violation. Mark B. Baker, *Promises and Platitudes: Towards a New 21st Century Paradigm for Corporate Codes of Conduct?*, 23 CONN. J. INT'L L. 123, 133 (2007).

Reform and Consumer Protection Act that requires firms to “disclose their use of conflict minerals that originated in the Democratic Republic of Congo (DRC) or an adjoining country.”<sup>127</sup> Examples of such conflict minerals include gold, tungsten, and tin.<sup>128</sup> If the conflict minerals originated in the DRC or one of its neighbors, the firm must “undertake due diligence on the source and chain of custody of its conflict minerals” and must also file a Conflict Minerals Report.<sup>129</sup> Firms subject to this rule must not only provide the required information to the SEC but must also make their disclosures available to the public on their website.<sup>130</sup>

Another example is the 2012 executive order issued by President Obama that is intended to prevent human trafficking and forced labor in federal contracting.<sup>131</sup> Federal contracting regulations will be amended in order to ban certain “trafficking-related” activities by federal contractors, subcontractors, and their employees.<sup>132</sup> Examples of prohibited activities include “misleading or fraudulent recruitment practices; charging employees recruitment fees; and destroying or confiscating an employee’s identity documents, such as a passport or a driver’s license.”<sup>133</sup> Compliance programs are also mandatory for federal contractors and subcontractors working under larger contracts abroad.<sup>134</sup>

Sub-state actors have also been active in attempting to address supply chain issues. Under the California Transparency in Supply Chains Act of 2010,

Every retail seller and manufacturer doing business in this state and having annual worldwide gross receipts that exceed one hundred million dollars (\$100,000,000) shall disclose, as set forth in subdivision (c), its efforts to eradicate slavery and human trafficking from its direct supply chain for tangible goods

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127. Press Release, U.S. Sec. & Exch. Comm’n, SEC Adopts Rule for Disclosing Use of Conflict Minerals (Aug. 22, 2012), available at <http://www.sec.gov/news/press/2012/2012-163.htm> [hereinafter SEC Press Release].

128. *Id.*

129. *Fact Sheet: Disclosing the Use of Conflict Minerals*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/News/Article/Detail/Article/1365171562058#.VAd7PGMVM4g>.

130. *Id.*

131. Exec. Order No. 13627, 77 Fed. Reg. 60029 (Sept. 25, 2012).

132. *Fact Sheet: Executive Order Strengthening Protections Against Trafficking in Persons in Federal Contracts*, THE WHITE HOUSE, OFFICE OF THE PRESS SEC’Y (Sept. 25, 2012), <http://www.whitehouse.gov/the-press-office/2012/09/25/fact-sheet-executive-order-strengthening-protections-against-trafficking>.

133. *Id.*

134. *Id.*

offered for sale.<sup>135</sup>

Specifically, firms covered by the law must disclose the extent to which it (1) verifies product supply chains “to evaluate and address risks of human trafficking and slavery,”<sup>136</sup> (2) audits suppliers to evaluate compliance with firm standards regarding trafficking and slavery,<sup>137</sup> (3) “[r]equires direct suppliers to certify that materials incorporated into the product comply with the laws regarding slavery and human trafficking of the country or countries in which they are doing business,”<sup>138</sup> (4) “[m]aintains internal accountability standards and procedures,”<sup>139</sup> and (5) trains employees and management on human trafficking and slavery.<sup>140</sup> These disclosures must be available on the seller or manufacturer’s website.<sup>141</sup> If the firm does not maintain a website, it must provide a written disclosure within thirty days of receiving a written request for disclosure from a consumer.<sup>142</sup>

At the international level, the United Nations has also reinforced the importance of monitoring as a means to address abuses by suppliers in the value chain. For example, the most recent U.N. effort to combat corporate misconduct is the Protect, Respect and Remedy Framework proposed by U.N. Special Representative for Business and Human Rights John Ruggie.<sup>143</sup> Perhaps the most novel contribution of this framework is the recognition of the “corporate responsibility to respect,” which requires that companies refrain from infringing on the rights of others.<sup>144</sup> The foundation of this responsibility is due diligence, understood as “a process whereby companies not only ensure compliance with national laws but also manage the risk of human rights harm with a view to avoiding it.”<sup>145</sup>

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

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135. CAL. CIV. CODE § 1714.43(a)(1) (West 2012).

136. *Id.* § 1714.43(c)(1).

137. *Id.* § 1714.43(c)(2).

138. *Id.* § 1714.43(c)(3).

139. *Id.* § 1714.43(c)(4).

140. *Id.* § 1714.43(c)(5).

141. *Id.* § 1714.43(b).

142. *Id.*

143. *Framework, supra* note 2, at 9.

144. *Id.* at 8.

145. *Id.*

- 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.”<sup>146</sup> According to the “Ruggie Framework,” appropriate due diligence should include 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.<sup>147</sup>

The overarching theme of these diverse efforts is to increase the due diligence responsibilities of downstream firms regarding their sourcing practices.<sup>148</sup>

## 2. *The Limits of Monitoring: Resistance and Tension Along the Value Chain*

The problem with the monitoring efforts described above is that they do not overcome the problem of asymmetric information that characterizes the agency-cost problem. This is because upstream suppliers engage in a variety of practices that undermine the effectiveness of oversight by downstream buyers.

First, many workers do not know what is being evaluated when social auditors inspect the sites. In one study, although eighty percent of respondents knew of external auditor inspections, a very small number knew that the purpose of the auditor’s visits was to evaluate labor standards and work conditions.<sup>149</sup> The rest did not know the purpose or believed that the audits were related to production safety and quality.<sup>150</sup> Managers themselves may be unaware of the objectives of factory audits or the benefits of improved conditions and this lack of awareness reduces the likelihood that they will be willing to invest in change.<sup>151</sup>

Second, upstream suppliers manipulate the auditing process, thereby

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146. *Id.* at 17.

147. *Id.* at 18.

148. Marcia Narine, *From Kansas to the Congo: Why Naming and Shaming Corporations Through the Dodd-Frank Act’s Corporate Governance Disclosure Won’t Solve a Human Rights Crisis*, 25 REGENT U. L. REV. 351, 371 (2012).

149. Anita Chan & Kaxton Siu, *Wal-Mart’s CSR and Labor Standards in China* 20 (The Int’l Research Network on Bus., Dev. & Soc’y, Working Paper No. 4, 2009), available at [http://bdsnetwork.cbs.dk/publications/Working%20Papers/bsd\\_working\\_paper\\_\(paper4\).pdf](http://bdsnetwork.cbs.dk/publications/Working%20Papers/bsd_working_paper_(paper4).pdf).

150. *Id.*

151. Daniella Gould, *The Problem with Supplier Audits: Understanding How and Why Chinese Factories Circumvent Codes of Conduct*, 2 CORP. RESP. MGMT. 24, 25–26 (2005).

giving a false appearance of compliance. A social audit occurs when a firm submits its corporate accountability standards to verification. The auditors use a combination of interviews, document review, and visual inspection in order to evaluate the firm's compliance with its own standards.<sup>152</sup> One concern with private codes is that downstream firms do not actually monitor compliance with their codes, leading to continued violations and little incentive for change.<sup>153</sup>

A number of the world's most prominent brand names now proudly advertise the fact that they regularly audit their suppliers. However, this increased monitoring function may not actually identify violations or improve conditions. The following story from Bangladesh illustrates some of the limitations of external monitoring. Walmart and JC Penney were among several companies that were criticized for their use of child laborers in a Bangladesh factory known as Harvest Rich.<sup>154</sup> Some of the children used in this factory were as young as eleven years old and were routinely assaulted and forced to work shifts exceeding twelve hours.<sup>155</sup> Even more unfortunate than the conditions at Harvest Rich was the fact that *the factory had been inspected*. In fact, not only was Harvest Rich inspected but it had been certified by the Worldwide Responsible Apparel Production Group (WRAP).<sup>156</sup> A WRAP certification signifies that the factory is "in 'full compliance' with all human and worker rights laws and international standards."<sup>157</sup> So, how did WRAP miss the fact that 200–300 children were exploited at the factory, including routine beatings and substandard pay? In the words of one of the young girls who worked at Harvest Rich: "'When buyers come, we [the child workers] are kept in the bathroom.' They make us hide 'because we are little, because we are kids.'"<sup>158</sup>

Upstream suppliers are able to manipulate the auditing process for a number of reasons. Audits are often announced in advance and this provides local owners and managers with time to give the appearance of compliance to the visiting auditors.<sup>159</sup> Higher quality social audits can

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152. Sasha Courville, *Social Accountability Audits: Challenging or Defending Democratic Governance?*, 25 L. & POL'Y 269, 273 (2003).

153. Baker, *supra* note 126, at 133–34.

154. KERNAGAHN, *supra* note 14, at 1.

155. *Id.*

156. *Id.* at 37.

157. *Id.*

158. *Id.* at 12.

159. Gould, *supra* note 151, at 28; Peter Lund-Thomsen, *The Global Sourcing and Codes of Conduct Debate: Five Myths and Five Recommendations*, 39 DEV. & CHANGE 1005, 1013 (2008).

also be time intensive, involving interviews with several varieties of stakeholders (management, workers, worker representatives, health and safety officers).<sup>160</sup> The preference of some workers for off-site interviews also increases the time required for audits.<sup>161</sup> Despite this need for time, auditors may only stay for periods of time short enough for managers to maintain the façade.<sup>162</sup> Some suppliers even erect walls to hide non-compliance or ensure that production occurs off-site at facilities that will not be inspected.<sup>163</sup>

Local management also controls communication between workers and social auditors by prohibiting open conversation, selecting which workers will provide information, and even coaching workers in their answers.<sup>164</sup> A prevalent “management-bias” in the industry ensures that most information is obtained from managers as opposed to their workers.<sup>165</sup> Double book keeping also prevents auditors from making an accurate assessment because they only receive the set of records that local management wants them to see.<sup>166</sup> Suppliers keep false sets of records and logs to “hide evidence of actual excessive overtime, improper payment of wages, and otherwise adverse working conditions.”<sup>167</sup> Additionally, suppliers have improved their ability to maintain duplicitous practices and are further assisted by professional consultants who advise on such deception.<sup>168</sup>

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160. Courville, *supra* note 152, at 276.

161. *Id.*

162. *See id.*

163. Erica L. Plambeck & Terry A. Taylor, *Supplier Evasion of a Buyer's Audit: Implications for Auditing and Compliance with Labor and Environmental Standards* 3 (Draft Working Paper, 2014).

164. Chan & Siu, *supra* note 149, at 5; Ngai-Ling Sum & Pun Ngai, *Globalization and Paradoxes of Ethical Transnational Production: Code of Conduct in a Chinese Workplace*, 9 *Competition & Change* 181, 194 (2005); Plambeck & Taylor, *supra* note 163, at 3; *see also* Timothy Bartley, *Standards for Sweatshops: The Power and Limits of Club Theory for Explaining Voluntary Labor Standards Programs*, in 110 *VOLUNTARY PROGRAMS: A CLUB THEORY APPROACH* 128 (Matthew Potoski & Aseem Prakash eds., 2009).

165. Barrientos & Smith, *supra* note 16, at 716; Courville, *supra* note 152, at 275.

166. Barrientos, *supra* note 83, at 980; Michael E. Blowfield & Catherine S. Dolan, *Stewards of Virtue? The Ethical Dilemma of CSR in African Agriculture*, 39 *DEV. & CHANGE* 1, 13–14 (2008); Bin Jiang, *Implementing Supplier Codes of Conduct in Global Supply Chains: Process Explanations from Theoretic and Empirical Perspectives*, 85 *J. BUS. ETHICS* 77, 88 (2008).

167. Dexter Roberts et al., *Secrets, Lies, and Sweatshops*, *BLOOMBERG BUSINESSWEEK* (Nov. 26, 2006), available at <http://www.businessweek.com/stories/2006-11-26/secrets-lies-and-sweatshops> (according to one compliance manager, “the percentage of Chinese suppliers caught submitting false payroll records has risen from 46% to 75% in the past four years” and “estimates that only 20% of Chinese suppliers comply with wage rules, while just 5% obey hour limitations”); Plambeck & Taylor, *supra* note 163, at 3.

168. Gould, *supra* note 151, at 25, 27–28; Plambeck & Taylor, *supra* note 163, at 3; Roberts et

The result is that “an imperative for transparency and accountability can instead produce secrecy and deception.”<sup>169</sup> Auditing issues are further compounded when auditors are not trained in the necessary skills for social auditing or do not even speak the same language as the workers at the audited factories.<sup>170</sup> Increasing the costs of deceptive behavior can be an important improvement, but the result may just be that suppliers ultimately fail the audit if they cannot hide their violations. Failing an audit exposes them to the risk of termination, which results in a situation where the workers who were previously exploited are now unemployed. Furthermore, the risk of termination, and the economic results for workers, can result in a problematic alliance between management and workers to present an appearance of compliance with corporate codes.<sup>171</sup> Such a situation makes it even more difficult for the lead firm and external auditors to determine the situation on the ground.

Third, suppliers often turn to workers who enjoy little to no protection under national laws or corporate standards.<sup>172</sup> In order to contend with downward pricing and increasingly fluctuating demand for products, contract manufacturers have tended to employ women, minorities, and migrant labor because individuals from these groups are less likely or able to assert their rights.<sup>173</sup> Contract manufacturers have also turned to contract labor in order to reduce overhead and to hire and fire as needed based on demand.<sup>174</sup> Contract laborers receive far less protection from public actors (national employment legislation) and private actors (corporate codes of conduct).<sup>175</sup> The conditions of contract laborers escape the notice of social auditors because of the short duration of the auditor visits, unfamiliarity with local employment practices, and a failure to consult with contract labor.<sup>176</sup>

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al., *supra* note 167.

169. Blowfield & Dolan, *supra* note 166, at 14.

170. *Id.*; Courville, *supra* note 152, at 276.

171. Sum & Ngai, *supra* note 164, at 197–98; Plambeck & Taylor, *supra* note 163, at 3.

172. Stephanie Barrientos & Andrietta Kritzing, *Squaring the Circle: Global Production and the Informalization of Work in South African Fruit Exports*, 16 J. INT’L DEV. 81, 85 (2004).

173. See Barrientos & Smith, *supra* note 16, at 722–23; Locke et al., *supra* note 76, at 526; Ngai & Chan, *supra* note 98, at 386 (“As migrant workers, Foxconn workers enjoy little labor protection in the society at large and suffer from a heightened work pressure and desperation in the workplace that lead to suicides on the one hand but also daily and collective resistance on the other hand.”).

174. Locke et al., *supra* note 76, at 526.

175. Blowfield & Dolan, *supra* note 166, at 6–7; see also Barrientos, *supra* note 83, at 982–83; Locke et al., *supra* note 76, at 532 (explaining how many national laws do not protect contract laborers and, consequently, how suppliers structure their employment practices to prevent workers from becoming full-time).

176. Barrientos, *supra* note 83, at 980.



Contract laborers are less likely to assert their rights because they are often staffed from different agencies, rendering it more difficult for union organizers to coordinate the efforts of these workers.<sup>177</sup> Thus, although a corporate code may proclaim a lead firm's commitment to freedom of association, the increasing majority of that firm's workforce is not entitled to that right or cannot effectively exercise it. Contract laborers are also less likely to organize given that they can be easily terminated because of the short-term and contractual nature of their employment.<sup>178</sup> As supplier workforces are concentrated outside the supplier and in temporary staffing agencies, it becomes important to include these agencies in the CSR compliance monitoring. However, there is a risk that downstream suppliers will either not supply the agencies staffing their production lines with compliance codes or will not ensure that the agencies conform to the codes.<sup>179</sup> A number of local governments in China have also taken to dispatching students to "intern" at Foxconn factories.<sup>180</sup> This pool of labor "has become an enormous worker community in Foxconn factories across the country."<sup>181</sup> By formatting this working arrangement as an internship (and not employment), the students are not protected under China's Labor Law, not entitled to trade union membership, and any resulting disputes are not treated as labor disputes.<sup>182</sup>

It is important to remember that a number of corporate codes of conduct take national laws as their substantive standard and simply require that their suppliers adhere to those laws in their operation. This results in a double-negative effect when workers—such as students—do not fall within the protection of those national laws. When these workers fall outside the protection of the law, private codes simply reinforce this exclusion.

Although this Article focuses on the limitations of monitoring caused by resistance from upstream suppliers, the auditing model has been criticized for other weaknesses as well. One concern is that auditing—as a form of "regulation by numbers"—prioritizes a quantitative approach to public values that may be inappropriate for social issues such as

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177. Locke et al., *supra* note 76, at 526.

178. *Id.*

179. *Id.* at 534.

180. Lance Whitney, *Apple's Chinese Suppliers Still Exploiting Workers, Says Report*, CBSNEWS.COM (Feb. 27, 2013, 11:48 AM), <http://www.cbsnews.com/news/apples-chinese-suppliers-still-exploiting-workers-says-report/>.

181. Ngai & Chan, *supra* note 98, at 391.

182. *Id.*

human rights. This is because of a risk that indicators may lead to better performance on issues that are easier to quantify, thereby neglecting other equally significant issues because of the difficulties involved in measuring the latter.<sup>183</sup> Secondly, the use of indicators encourages a “box-ticking” approach to compliance that leads to a prioritization of the number of disclosures as opposed to their accuracy or role in promoting actual improvement.<sup>184</sup> Finally, there are concerns regarding the quality and conflict of interests of many of the firms performing auditing services.<sup>185</sup>

*B. Explaining Foxconn—The Supplier’s Tale: Asymmetries in Rent and Risk*

As the previous section explained, increasing the number of audits does not reduce the number of tragedies. After all, Apple increased the number of facilities it audited between 2007 and 2010 from thirty-nine to 102,<sup>186</sup> but this rise did not prevent the series of suicides that occurred in 2010. The reason that monitoring efforts oftentimes have limited success is because the asymmetrical flow of information is only a partial explanation of events such as the suicides at Foxconn. Instead, human rights abuses at overseas sites are also explained as a result of asymmetrical flows in rent and risks that are not addressed by monitoring efforts. This is why the current wave of corporate social responsibility reforms—heavily based on increased monitoring and due diligence—will have a limited impact on the lives of overseas workers.

*1. Caught in the Middle: The Tension Between Corporate Social Responsibility Policies and Procurement Practices*

The tenth suicide at Foxconn in 2010 occurred days before Apple’s global launch of its iPad to countries other than the United States.<sup>187</sup> Apple’s response was to reaffirm its “commit[ment] to ensuring that conditions throughout our supply chain are safe and workers are treated

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183. Galit A. Sarfaty, *Regulating Through Numbers: A Case Study of Corporate Sustainability Reporting*, 53 VA. J. INT’L L. 575, 611 (2013).

184. *Id.* at 581, 606–08.

185. *Id.* at 610.

186. *Business: Core and Periphery; Supply Chains in China*, ECONOMIST, Mar. 6, 2010, at 83.

187. *Workers Urged Not to Kill Themselves; Asked to Sign Contracts with Promise*, WINDSOR STAR (May 27, 2010), <http://www2.canada.com/windsorstar/news/story.html?id=19ffdd5-40ee-4b51-9dfb-04fe8d083ab4>.

with respect and dignity.”<sup>188</sup> The problem is the tension between this professed commitment and the business model that Apple adopts. Apple relies on a “lean and flexible” supply chain.<sup>189</sup> This results in more production per worker being required on a fluctuating timeline. As a consequence, “suppliers often try to cut corners, replace expensive chemicals with less costly alternatives, or push their employees to work faster and longer.”<sup>190</sup> According to an executive whose company assisted with bringing the Apple iPad to market, “[t]he only way you make money working for Apple is figuring out how to do things more efficiently or cheaper.”<sup>191</sup> But the problem for the suppliers, according to the same executive, is that Apple will “come back the next year, and force a 10 percent price cut.”<sup>192</sup> Much of supplier resistance, therefore, is fueled by the inability of upstream suppliers to meet the purchasing demands of multinational buyers while also adhering to the CSR practices espoused by these same buyers. According to a former Apple executive, “You can set all the rules you want, but they’re meaningless if you don’t give suppliers enough profit to treat workers well . . . . If you squeeze margins, you’re forcing them to cut safety.”<sup>193</sup>

The value chain is skewed in favor of Apple and other multinational buyers so that the benefits of the arrangement accrue to one end—in the developed economies—while the risks are relegated to the other end.<sup>194</sup> After all, Apple secured significant profits from its product launch of the iPhone in 2007. These profits were helped by the mystery that shrouded the iPhone prior to its launch and the significant scale-up that allowed

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188. *Id.*

189. Stephen Foley, *Apple Admits It Has a Human Rights Problem*, INDEPENDENT (Feb. 14, 2012), <http://www.independent.co.uk/news/world/asia/apple-admits-it-has-a-human-rights-problem-6898617.html>.

190. Duhigg & Barboza, *supra* note 18.

191. *Id.*

192. *Id.*; see also Bartley, *supra* note 164, at 127–28 (discussing similar issues in the apparel industry); Xiaomin Yu, *Impacts of Corporate Code of Conduct on Labor Standards: A Case Study of Reebok’s Athletic Footwear Supplier Factory in China*, 81 J. BUS. ETHICS 513, 523 (2007) (discussing similar issues with Reebok’s procurement practices).

193. Duhigg & Barboza, *supra* note 18.

194. See, e.g., Barrientos, *supra* note 83, at 982 (“Suppliers are thus caught in a Catch 22 situation, where they have to deliver on quality (and associated value) which is passed up the value chain, whilst cost and risk is being passed down the chain. These risks and costs are often passed down to workers—particularly casual and contract labour who are the weakest link in the chain.”); Barrientos & Kritzinger, *supra* note 172, at 83 (“Hence, within global value chains, risk and uncertainty are passed downwards, whilst economic rents are passed upwards. This has important implications for labour.”); Suk-Jun Lim & Joe Phillips, *Embedding CSR Values: The Global Footwear Industry’s Evolving Governance Structure*, 81 J. BUS. ETHICS 143, 144 (2008).

Apple to meet consumer demand for the products.<sup>195</sup>

But this marketing technique has a price. It was obtained because hundreds of Chinese workers staffed assembly lines in long shifts. The pay-off for this strategy was not evenly distributed as the lion's share of the value from the chain was secured by Apple.<sup>196</sup> However, the risks associated with this marketing strategy—meeting a large volume of orders in a short time period while meeting quality standards—were borne by overseas suppliers and their assembly line workers. Instantaneous communications between retailer buyers and their suppliers mean that the former pressure the latter to meet fluctuating and demanding production and shipping schedules. In the words of one of the managers at a Dongguan company, “We are forced to apply the labor codes . . . but we can judge from our intuition that when production and codes clash, which side we can cling to.”<sup>197</sup> One reporter commenting on another tragedy—this one at Rana Plaza in Bangladesh—diagnosed the problem aptly: “Every player has motives to look the other way. The retailers ignore the subcontracting because they would rather manage fewer big contracts, and the per-piece price of garments falls with bigger orders. Suppliers don't turn down giant orders because they fear they will be shut out of future jobs.”<sup>198</sup> This is the tension in the global value chain that leads to the forms of supplier resistance discussed above and that jeopardizes corporate social responsibility objectives.

The gains from fragmentation have not been shared equally among all the actors who participate in global value chains. The prospect of lower costs, greater responsiveness to demand, and short production schedules are some of the key attractions of fragmentation for multinational buying firms such as Apple. However, these same characteristics extract a high cost from the workers who labor at the other end of the value chain. Significant downward pressure on pricing decreases the margins that upstream suppliers can recover, leading them to pay their workers less and work them more. According to one critic, voluntary codes of conduct “involve[] a tension between buyers and retailers simultaneously striving to maximize the value they extract from the

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195. See Charles Duigg & Keith Bradsher, *How the U.S. Lost Out on iPhone Work*, N.Y. TIMES, Jan. 21, 2012, at A1.

196. See *Slicing an Apple*, *supra* note 38; Dedrick et al., *supra* note 63.

197. Appelbaum & Lichtenstein, *supra* note 102, at 120.

198. Vikas Bajaj, *Doing Business in Bangladesh*, N.Y. TIMES (Sept. 14, 2013), <http://www.nytimes.com/2013/09/15/opinion/sunday/doing-business-in-bangladesh.html>; see also Lim & Phillips, *supra* note 194, at 148 (“As long as Nike used purely economic standards for selecting and maintaining supplier relationships, the resulting fragile buyer–manufacturer link would not support the CSR goals.”).

chain, whilst selling competitively priced goods that meet high specifications in relation to both product and social standards.”<sup>199</sup> This reluctance to absorb the cost of compliance means that upstream suppliers will be the ones who will ultimately pay for improving conditions.<sup>200</sup> Given that a number of them already find it difficult to secure a satisfactory profit margin, it is unlikely that they will cut further into their margin by investing in CSR. Instead, they will more likely continue to find loopholes in existing initiatives and maintain current practices or they will fail their audits, exposing themselves and their workers to unemployment.

## 2. *Addressing Asymmetries in Rent and Risk*

A significant reason for the limitations of monitoring and disclosure efforts is that they are intended to address asymmetries in information but not to ameliorate the asymmetries in rent and risk discussed above. The failure to address this latter category of asymmetries encourages suppliers to frustrate attempts at auditing and other efforts to address asymmetries of information. The end result is that practices do not change.

It is important for public actors to recognize the different varieties of asymmetries that characterize the global value chain. This is because the identified asymmetries give rise to the solutions that these public actors adopt to reform the value chain. Disproportionate attention to only one type—asymmetries of information—has led California and other jurisdictions to encourage increased monitoring through audits. Unfortunately, given the dynamics of value chain discussed above, these steps will not necessarily increase the buyer’s access to accurate information or improve the supplier’s actual practices.

In order to improve conditions in the value chain, public and other actors must address asymmetries in information as well as asymmetries in rent and risk. The shift in focus from the former to the latter signifies a parallel shift from auditing suppliers to engaging suppliers by creating incentives for cooperation. After all, incentives are another way to address asymmetries of information and ameliorate the resulting agency-cost problem.<sup>201</sup> Although not the exclusive type of incentive, the most

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199. Barrientos, *supra* note 83, at 981–82; *see also* Miller, *supra* note 8, at 41–42.

200. Sum & Ngai, *supra* note 164, at 195.

201. Geis, *supra* note 26, at 991 (“A third strategy for mitigating outsourcing agency risk is to set a compensation scheme that seeks to align vendors’ economic interests with those of the principal.”).

effective incentives may be the ones that enable suppliers to comply with CSR standards and reward them for doing so.<sup>202</sup>

The incorporation of supplier incentives will likely determine the success of CSR initiatives adopted. For example, in the wake of the tragedy at Rana Plaza, two different CSR initiatives were adopted: the Bangladesh Accords and the Alliance for Bangladesh Worker Safety. The Accords were created by apparel companies, NGOs, and labor unions in order to improve fire and building safety in the Bangladeshi garment industry. What is distinctive about the Accords is the role of the apparel company in achieving the Accords' objectives. Specifically, the Accords contains a section entitled "Supplier Incentives" that contains both sticks and carrots that apparel companies should use in order to cajole their suppliers into compliance.<sup>203</sup>

For example, the Accords require that apparel companies finance the cost of improved standards in their production sites, although they are given latitude in designing the precise form of financing.<sup>204</sup> This is an important step because it reduces the temptation for suppliers to cheat if the apparel companies are "ensur[ing] that it is financially feasible for the factories to maintain safe workplaces"<sup>205</sup> and helping to finance the upgrading and remediation process. Additionally, under Article 24, signatory firms also financially contribute to the Accords' programs.<sup>206</sup> However, under the Accords, apparel companies do not only share costs with their suppliers. Governance of this program is shared between representatives of the signatory firms and signatory unions, and capacity-building is also a shared responsibility. The Accords also include important changes in sourcing practices. Signatory companies commit to source at least sixty-five percent of their production volume

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202. Duhigg & Barboza, *supra* note 18 (reporting that Hewlett Packard "allowed [suppliers] slightly more profits and other allowances if they were used to improve worker conditions"); *see also* Yu, *supra* note 192, at 526.

203. ACCORD ON FIRE AND BUILDING SAFETY IN BANGLADESH 6 (May 13, 2013), [http://bangladeshaccord.org/wp-content/uploads/2013/10/the\\_accord.pdf](http://bangladeshaccord.org/wp-content/uploads/2013/10/the_accord.pdf) [hereinafter BANGLADESH ACCORD].

204. *Id.* ("In order to induce Tier 1 and Tier 2 factories to comply with upgrade and remediation requirements of the program, *participating brands and retailers will negotiate commercial terms with their suppliers which ensure that it is financially feasible* for the factories to maintain safe workplaces and comply with upgrade and remediation requirements instituted by the Safety Inspector. Each signatory company may, at its option, use alternative means to ensure factories have the financial capacity to comply with remediation requirements, *including but not limited to joint investments, providing loans, accessing donor or government support, through offering business incentives or through paying for renovations directly.*" (emphasis added)).

205. *Id.*

206. *Id.*

from Tier 1 or Tier 2 firms, which are firms characterized by significant orders and long-term supply relationships.<sup>207</sup> Finally, Article 23 helps to prevent flight by retailers in response to improved standards and increased costs.<sup>208</sup>

However, many firms—mostly American—have opted for another route for addressing the tragedy at Rana Plaza. The Alliance for Bangladesh Worker Safety began with a group of North American brands and retailers who also wanted to improve conditions in the garment industry in Bangladesh. Initially, the Alliance’s approach appears very similar to the approach taken under the Accords. Although the Alliance’s plan includes some commitments to improving training and provision of funding, it appears to replicate more of the same by relying on auditing and verification. Unlike the Accords, the Alliance approach does not provide the same opportunities for worker representation and it is not binding.<sup>209</sup> Additionally, under the Accords, brand firms will guarantee the availability of funds for upgrading unsafe factories.<sup>210</sup> By contrast, even if loans are made available under the Alliance, “there is no obligation to create commercial terms that would allow factory owners to repay.”<sup>211</sup> The key differences between the two approaches, therefore, concern the types of incentives that each offers the Bangladeshi suppliers to change their practices and improve safety conditions. The Accords partner suppliers and buyers regarding governance, capacity-building, financing, and sourcing behavior and therefore necessitate changes in behavior at both ends of the global value chain.

The Alliance appears to favor a top-down approach applied by the buyers that does not seem to resolve tension points in the global value chain that led to crises like Rana Plaza. In other words, it has not offered key incentives to suppliers in order to get them to cooperate.

### III. ADDRESSING THE PROBLEM: DIMENSIONS OF DECENTRALIZATION

The fragmented firm poses two important challenges for public actors

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207. *Id.* at 1–2 (Articles 1–3).

208. *Id.* at 6.

209. *Walmart/Gap Bangladesh Safety Plan: Pale Imitation of Accord*, INDUS. GLOBAL UNION (Jul. 10, 2013), <http://www.industrial-union.org/walmart-gap-bangladesh-safety-plan-pale-imitation-of-accord>.

210. *Id.*

211. *Id.*

and other stakeholders who are concerned about labor standards in globalized value chains. The first challenge involves identifying the relevant actors and designing incentives that are effective for securing their compliance with the desired labor standards. As explained in Section I, many of the drawbacks to the current CSR initiatives is that these approaches are based on the view that the buying end of the value chain contains the only key actors.<sup>212</sup> That is why many of the incentives are targeted towards actors who have the profile of a large, multinational retailer or brand name. The neglect of other actors in the value chain, therefore, reinforces a belief in the unitary nature of the firm without acknowledging its fragmented, dispersed, and conflicted characteristics. In order to be effective, public actors must resist the urge to offer incentives to only one type of actor in the value chain (unitary model of firm) and instead design incentives for the diverse range of actors actually operating in the value chain (fragmented model of firm). As explained above, the most effective incentives for suppliers are those that alleviate asymmetries in rent and risk.<sup>213</sup>

The second challenge relates to how incentives are transmitted in the value chain. One reason that California targeted its legislation to multinational buyers is because it is easier for California to regulate directly those actors found in its jurisdiction. It is far more difficult for it to reach actors located across borders due to limitations relating to jurisdiction, information, legitimacy, and capacity. Therefore, it is important that California and other stakeholders organize their activities into a form of governance that will allow them to transmit incentives to key actors in the value chain, even if they are located far away. This would allow stakeholders to aggregate their leverage by expanding the toolkit of incentives that they can offer collectively. This objective requires that California, Denmark, and other public actors substitute the traditional state-dominated forms of regulation (command and control) for a decentralized approach that involves a diversity of stakeholders (reflexive law). Figure 1 below provides an illustration of these two dimensions.

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212. *See supra* notes 118–84 and accompanying text.

213. *See supra* notes 201–11 and accompanying text.



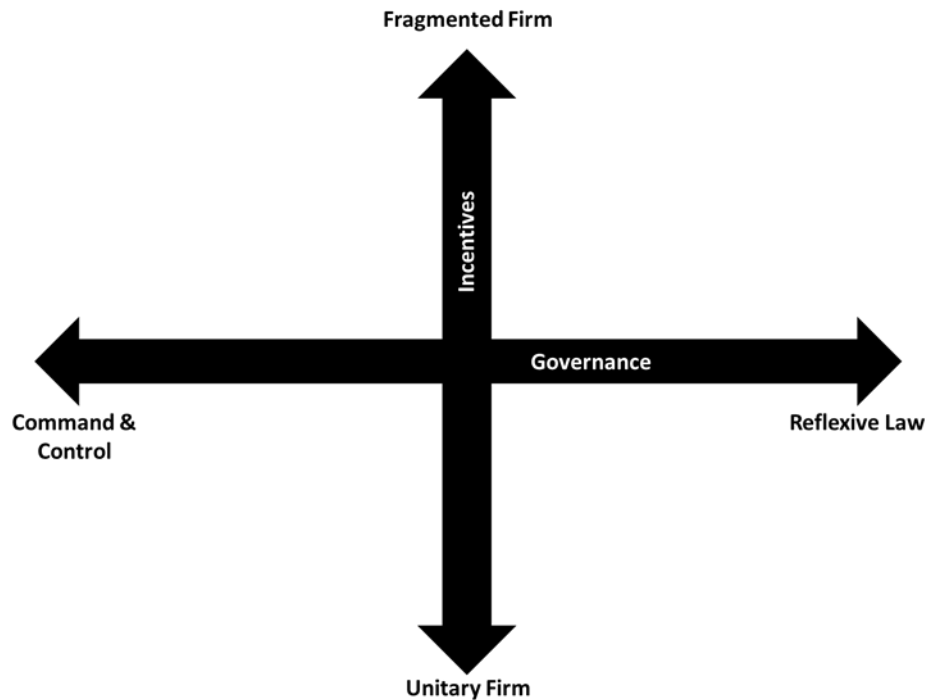


Figure 1: Dimensions of Decentralization

The Section below describes the importance of decentralization along *both* of these dimensions. Lack of decentralization along the incentive dimension results in a situation where the incentives produced are appropriate for only one segment of the value chain. Part A below outlines a number of these incentives that are more appropriate for securing supplier cooperation.

However, designing supplier incentives will be ineffective if these incentives are still transmitted under a traditional approach to regulation: command and control. Decentralized incentives require a decentralized approach to governance as well. This requires a form of regulation that involves a variety of stakeholders instead of the lead of one actor, such as the state. Section B explores the limitation of command and control regulation to transmit “decentralized” incentives. It also explains the limitation of current approaches to multi-stakeholder coordination that relies on networks. It concludes by advocating for governance using a reflexive law approach to coordination.

A. *Incentives Dimension: Designing Incentives for the Fragmented Firm*

Current approaches to improving CSR are limited by the failure of those approaches to offer the types of incentives that can win supplier cooperation. This is because these efforts do not adequately distinguish between the interests of upstream and downstream firms in the value chain. These approaches assume a harmony of interests between the two ends of the value chain and neglect points of tension. It is this tension, however, that leads to resistance from the lower-tiers of the value chain to CSR initiatives. Such resistance can take several forms, including supplier manipulation of the auditing process, reliance on contract labor, and continued violations in overseas facilities. These result in the limitations to current CSR initiatives that rely on disclosures and monitoring.

In order to effectively reform the global value chain, public actors must stop assuming that the only relevant interests are those of a downstream firm. Such assumptions produce CSR initiatives that primarily address the interests and cost-benefit calculations of a downstream buyer but have limited relevance for upstream suppliers.<sup>214</sup> Reputational damage, for example, is a powerful driver for brand name buyers but not for unknown suppliers who do not sell directly to a broad consumer base. This distinction is important because, as influential as downstream firms may be in the global value chain, they are unable or unwilling to secure compliance without the “buy-in” of suppliers.<sup>215</sup> Reform of the global value chain therefore requires acknowledging the full spectrum of interests involved and designing incentives that speak to the various segments of the value chain.

1. *Sanctioning Audit Manipulation*

Overseas factory managers and other local actors are in the best position to determine the accuracy of the monitoring of labor practices. Unfortunately, they currently have a strong incentive to provide positive, but inaccurate, representations in order to retain an American firm’s business without having to actually alter their operations.<sup>216</sup> One approach to discouraging this form of supplier behavior, therefore, is to increase the cost of these activities. The nature of the costs involved may

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214. See *supra* notes 118–84 and accompanying text.

215. See *supra* notes 146–84 and accompanying text.

216. See Plambeck & Taylor, *supra* note 163, at 2–3.

vary but the idea is to increase costs so that suppliers shift resources from hiding to compliance.<sup>217</sup> Public actors can also encourage firms to increase both the quantity and quality of their monitoring activities. Mandatory social reporting does not accomplish much if the information gathered is inaccurate. Notified of the risks of audit evasion, public actors should now ensure that firms guard themselves against these risks in their monitoring activities.

The problem with imposing costs on upstream suppliers is that although it may discourage audit manipulation, it will not improve conditions. In other words, reducing audit manipulation is an intermediate goal but is not the ultimate objective for those who want to improve conditions in global value chains. Removing audit manipulation will not accomplish the ultimate objective of reducing the risk of labor violations. The reason relates to the asymmetry of risk and rent that was discussed in Section II.B.<sup>218</sup> Current global value chains are generally skewed in favor of downstream buyers, who extract a disproportionately greater share of the benefits of the value chain while offloading a disproportionately large share of the risk to the upstream suppliers.<sup>219</sup>

A study commissioned by the World Bank found that many suppliers distrust the motivations of buyers because of this tension between corporate codes of conduct they promote and the substantial pressure that suppliers experience to lower prices and increase turnaround times.<sup>220</sup> The study found that many supplier complaints “stem from an overall sense of powerlessness that is underpinned by a perception that suppliers are asked to shoulder the costs of compliance, whereas buyers receive the benefits.”<sup>221</sup> This tension between the twin goals presented by buyers leads to mistrust by suppliers and decreases their likelihood for cooperation. Increased auditing may even compound this mistrust

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217. *Id.* at 21.

218. *See supra* notes 197–209 and accompanying text.

219. *See supra* notes 197–209 and accompanying text.

220. HELLE BANK JØRGENSEN ET AL., THE WORLD BANK, STRENGTHENING IMPLEMENTATION OF CORPORATE SOCIAL RESPONSIBILITY IN GLOBAL SUPPLY CHAINS (2003), available at [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2005/12/19/000090341\\_20051219093957/Rendered/PDF/346640StrengtheningImplementation.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2005/12/19/000090341_20051219093957/Rendered/PDF/346640StrengtheningImplementation.pdf) [hereinafter *Strengthening Implementation*].

221. *Id.* at 25; Barrientos & Smith, *supra* note 16, at 725–26; Lund-Thomsen & Nadvi, *supra* note 31, at 204; Chan & Siu, *supra* note 149 (“In the latter half of the 1990s, as Wal-Mart sourced more and more from China, doubling its imports between 1997 and 2002 . . . it became one of the engines that drove down prices, and in turn migrant wages in the export sector. The price pressure on other MNCs was so great that, by quickly following suit, they plunged Chinese suppliers into an intense competition among themselves to acquire orders by squeezing as much out of Chinese workers as they possibly could.” (citations omitted)).

because it sends external signals to suppliers regarding the buyer's lack of trust in them.<sup>222</sup>

The slim profit margins of upstream suppliers and the high competition among them means that there are not enough resources at the upstream end of the supply chain to implement the types of changes that Western consumers and their governments demand. Improving conditions requires money and the cost of this implementation is often imposed on upstream suppliers (except for the cost of the auditing process). Given slim profit margins, upstream suppliers opt to provide the appearance of compliance rather than invest in actual compliance because many claim that they cannot afford to do otherwise. Sanctioning, therefore, will have limited effect. It may improve transparency and the effectiveness of monitoring; however, removing audit manipulation may reveal only grim results from genuine audits as suppliers cannot afford to conform to the codes imposed by multinational buyers. In such a situation, a supplier will repeatedly fail the audits and likely be subject to termination. Termination is a problematic outcome because it negatively affects the welfare of the workers and, as a result, may incentivize them to hide the true conditions at the overseas sites.<sup>223</sup>

If change is to occur, therefore, the costs of compliance cannot be relegated to the upstream end of the supply network. Instead, they must be transmitted downstream. Imposing costs on audit manipulation will depend on the relative skill and expertise of the monitor compared to the supplier. Suppliers—situated in the territory and social, political, and cultural context of the facility and workers—may be better at hiding their infractions than external monitors are at discovering these infractions. Additionally, auditing is still an infrequent phenomenon. Even if a facility is audited several times annually, who is watching on all of the other days of the year? The increased quality demands on auditing due to audit manipulation may increase the costs of auditing and result in even less frequent audits. Therefore, a better way to incentivize suppliers to improve the global value chain is by taking away their incentive to cheat by giving them a feasible path to compliance. Such a path is not offered under the current approach of auditing suppliers and threatening sanctions for infractions; instead, it depends on offering suppliers benefits for cooperation.

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222. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1809 (2000).

223. See Sum & Ngai, *supra* note 164, at 198.

## 2. *Rewarding Compliance*

Suppliers claim that there is a strong tension between the stated goals of buyers regarding improvement and their sourcing practices in favor of ever decreasing prices, shorter lead times, and temporary contracts. For example, local 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.<sup>224</sup> Unauthorized subcontracting appears to be a prevalent practice in Bangladesh and is a “primary reason safety guidelines that apply to bigger contractors have not prevented the hundreds of worker deaths in fires and building collapses in facilities like Rana Plaza.”<sup>225</sup>

In order for suppliers to implement better practices, suppliers need to overcome these asymmetries by transmitting the cost of compliance downstream to the multinational buyer. Given the considerable costs and issues associated with auditing, a more reliable path forward is to incentivize cooperation from upstream suppliers so that they adhere to better practices even without the looming threat of monitoring and possible termination. Currently, the bulk of the financial burden for implementation costs falls upon upstream suppliers.<sup>226</sup> This results in a strong incentive for suppliers to cheat because “[i]f the buyers do not reward the socially responsible suppliers by purchasing products with prices reflecting the increase in production costs, the suppliers, in order to survive, will likely create the appearance of social responsibility without actually making any improvements.”<sup>227</sup> Analysts of CSR practices in China have claimed that Chinese suppliers face a strong incentive to cheat and misrepresent factory conditions because of tension between improving working conditions (requiring raising costs) and maintaining low prices in order to remain competitive and retain contracts with firms from the developed countries.<sup>228</sup>

In order to encourage upstream suppliers to actually implement good practices—and not simply hide their violations—these suppliers should be relieved of bearing the costs of compliance alone. Instead, they

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224. See Bajaj, *supra* note 198.

225. *Id.*

226. Gould, *supra* note 151, at 25; Lund-Thomsen, *supra* note 159, at 1014.

227. Li-Wen Lin, *Corporate Social Accountability Standards in the Global Supply Chain: Resistance, Reconsideration, and Resolution in China*, 15 CARDOZO J. INT’L & COMP. L. 321, 335–36 (2007).

228. *Id.* at 335; Roberts et al., *supra* note 167 (“But factory managers in China complain in interviews that U.S. price pressure creates a powerful incentive to cheat on labor standards that American companies promote as a badge of responsible capitalism.”).

should be allowed to transmit the costs of compliance downstream and without fear that increasing the cost of their prices will terminate their business with their customers in the developed countries. The challenge, of course, is to identify who will absorb the increased costs of compliance. Improved working conditions come at a price and the tension along the value chain arises from the dispute over who will pay for these improvements.

*B. Governance Dimension: Transmitting Incentives in a Global Value Chain*

Designing incentives that are “decentralized” and appropriate for buyers as well as suppliers is only part of the solution. Public actors also need an effective system for transmitting those incentives to suppliers. This is a challenge in this age of the fragmented firm that spans multiple continents. Transmitting incentives to suppliers therefore depends on the governance used; governance choices determine whether incentives designed for suppliers can reach suppliers. There are three main governance options that are discussed here: command and control, network coordination, and reflexive coordination. As discussed in Section III.B.1 below, command and control regulation is inadequate to transmit incentives because of constraints experienced by public actors at either ends of the value chain: home states and host states. Network coordination has been advocated as a way to counteract the constraints of state actors by involving non-traditional actors, such as sub-state actors and even other stakeholders. However, as explained in Section III.B.2 below, this form of governance is also not up to the task of transmitting incentives in the value chain because of the conflicts of interests between the potential network participants. By contrast, reflexive law offers a novel approach to governance that allows public actors and other stakeholders to maximize the incentives that they can offer suppliers but without the difficulties of bargaining and negotiating with each other. Section III.B.3 explains the decentralized turn in governance, illustrated by reflexive law, and proposes a novel application of reflexive law as an approach to multi-stakeholder coordination.

*1. The Limits of Command and Control Regulation*

Denmark and California may soon be joined by other governments of multinational buyers that attempt to improve monitoring and disclosure

requirements, thereby hoping to exert an upward pressure on compliance standards in global value chains.<sup>229</sup> The limitation of this strategy is that the weaknesses in the value chain occur beyond the legislative reach of these states. Requiring greater due diligence and disclosure from multinational buying firms is a positive development, but the benefits are limited by the types of upstream responses discussed in Section II.A. These abuses occur in factories and facilities overseas so that the willing sovereign is unable to regulate directly the offensive practices or practitioners. For example, following the collapse at Rana Plaza, the U.S. and the European Union pressured Bangladesh to change its labor laws and safety regulations.<sup>230</sup> However, the response by Bangladesh was to look for alternative markets for their garment exports in order to reduce their dependence on U.S. and European Union markets.<sup>231</sup>

Host States often suffer from weak or non-existent regulatory capacity that prevents them from enforcing standards and ensuring compliance.<sup>232</sup> Private regulation through corporate codes of conduct and monitoring may actually be the only way that labor and environmental conditions are addressed in some developing countries.<sup>233</sup> China has environmental and labor laws in place, but only attaches moderate fines to violations because of corruption, lack of resources, and importance of economic objectives.<sup>234</sup>

This weak regulatory capacity can also result in an inability to perform audits on the local supplier's facilities.<sup>235</sup> Bolstering environmental and labor standards may not be viewed as a priority by host state regulators who may fear that such regulations may compromise the achievement of economic objectives.<sup>236</sup> For example, the Bangladeshi government is encountering significant opposition from

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229. Hess, *supra* note 7, at 450.

230. Amrutha Gayathri, *Bangladesh's Garment Exports Surge in July; U.S., Canadian Retailers Due to Meet to Implement Factory Safety Plan*, INT'L BUS. TIMES (Aug. 20, 2013, 6:22 AM), <http://www.ibtimes.com/bangladeshs-garment-exports-surge-july-us-canadian-retailers-due-meet-implement-factory-safety-plan>.

231. *Id.*

232. See *Framework*, *supra* note 2, at 5; Abbott & Snidal, *supra* note 1, at 538–39 (lack of capacity and willingness to regulate); Natasha A. Affolder, *The Private Life of Environmental Treaties*, 103 AM. J. INT'L L. 510, 513–14 (2009); Brittany T. Cragg, *Home Is Where the Halt Is: Mandating Corporate Social Responsibility Through Home State Regulation and Social Disclosure*, 24 EMORY INT'L L. REV. 735, 752 (2010).

233. Locke et al., *supra* note 76, at 523.

234. Plambeck & Taylor, *supra* note 164, at 19.

235. Locke et al., *supra* note 76, at 541.

236. Abbott & Snidal, *supra* note 1, at 538.

factory owners regarding raising the wage level beyond a certain point.<sup>237</sup> Host state government officials' willingness to censure suppliers is further reduced when those same government officials are personally connected with the supplier and its operations in the host state. Many suppliers are supported by government investment, leading one analyst to remark that "Wal-mart in China is therefore a virtual 'joint venture' between the company and the Chinese government."<sup>238</sup>

Host states (and their sub-units) also encounter significant difficulties in controlling the behavior of upstream suppliers—like contract manufacturers—operating within their territories because of national and sub-national competition for the business of these suppliers. In pursuit of economic growth, local governments, for example, will compromise the enforcement of labor and environmental laws in order to compete for the business of suppliers.<sup>239</sup> Local governments vying for Foxconn's business offer a full spectrum of resources at their disposal, including labor. Some township and village governments have provided Foxconn with free labor recruitment services, while others have imposed a recruitment quota on their officials.<sup>240</sup> Foxconn is also able to secure waivers of rent and taxes and to secure these facilities at prices below market rate.<sup>241</sup> Given this level of solicitation, it is doubtful whether these same local government officials are willing or able to monitor compliance with laws and standards that they sacrifice for the sake of a business relationship with suppliers like Foxconn. As a result of this dynamic, suppliers exercise a great deal of influence over host state regulators and policymakers and can impede efforts to change their practices.

## 2. *The Limits of Network Coordination*

Regulatory networks have dominated contemporary imagination on how to coordinate activities of actors dispersed across the globe. These networks are "informal multilateral forums that bring together representatives from national regulatory agencies or departments to facilitate multilateral cooperation on issues of mutual interest within the

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237. Arun Devnath, *Bangladesh Raises Minimum Wage for Garment Workers After Unrest*, BLOOMBERG (Nov. 14, 2013, 11:59 PM), <http://www.bloomberg.com/news/print/2013-11-13/bangladesh-garment-factories-to-stay-shut-amid-worker-protests.html>; Gayathri, *supra* note 230 (noting that wage rates did ultimately improve following the collapse at Rana Plaza).

238. Appelbaum & Lichtenstein, *supra* note 102, at 109.

239. Ngai & Chan, *supra* note 98, at 392.

240. *Id.* at 390–91.

241. *Id.* at 391.



authority of participants.”<sup>242</sup> Cooperation through networks provides its members greater access to information sharing across borders, thereby improving enforcement efforts.<sup>243</sup> Networks also serve as a forum for promoting uniformity of standards in order to discourage regulatory competition between actors.<sup>244</sup> Networks have tackled issues relating to securities regulation, banking supervision, and insurance.<sup>245</sup>

A network approach to enforcement of labor standards in value chains could offer a productive environment for information sharing, brainstorming, bargaining, and delegating functions among different actors. If network regulation of value chains operated similarly to network coordination of securities regulations and banking supervision, we would expect to see frequent meetings between governmental officials of the different states implicated in value chains, such as home states of multinational buyers and host states of production. Such meetings could involve agency representatives from departments of trade or labor who come together to harmonize standards, share information, and improve enforcement efforts. Network meetings between sub-state legislators could also provide a fruitful setting for progress. As discussed in previous sections, the sites of regulatory competition are increasingly local or regional.<sup>246</sup> Chinese municipalities compete against each other to woo business to their territory.<sup>247</sup> For these reasons, the relevant host state legislator is more likely found at the regional or local level.

Similarly, one of the most robust approaches to regulation of multinational buyers has also originated from a sub-state legislator: California. As in the case of host state regulators, sub-state legislators located in the home state may be a more significant group than national legislators because legislative movement may be more likely at the sub-national level as opposed to the national arena.<sup>248</sup> Therefore, network

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242. Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 *YALE J. INT'L L.* 113, 118 (2009).

243. See Slaughter, *Sovereignty and Power*, *supra* note 4, at 290.

244. See Raustiala, *supra* note 5, at 29.

245. See, e.g., Zaring, *supra* note 4, at 287–301 (discussing the Basle Committee on Banking Supervision, International Organization of Securities Commissions, and International Association of Insurance Supervisors).

246. See *supra* notes 239–241 and accompanying text.

247. See *supra* notes 239–241 and accompanying text; Lin, *supra* note 227, at 362–63.

248. The Business Transparency on Trafficking and Slavery Act (H.R. 2759) was introduced by Representative Carolyn Maloney to the 112th Congress on August 1, 2011 and was meant to achieve the following objective: “To require companies to include in their annual reports to the Securities and Exchange Commission a disclosure describing any measures the company has taken

meetings between sub-state legislators from home states and host states might serve as productive settings for convergence on labor standards and cooperation on enforcement. Labor abuses in value chains are facilitated by regulatory competition among jurisdictions. This competition encourages downward pressure on labor standards, especially by host state regulators desperate to court international business.<sup>249</sup> Sub-state actors are therefore reluctant to introduce or enforce adequate labor standards due to a fear that such action might precipitate business flight from its borders in favor of the country—or municipality—“next door” that might offer more lax standards.<sup>250</sup> Harmonization of labor standards, therefore, and cooperation and commitments regarding enforcement might offer a way to limit this race-to-the-bottom situation. The enforcement of comparable labor laws globally could discourage forum-shopping by multinational buyers and relieve host states from having to sacrifice labor standards.

However, such a network is compromised by several factors. First, many networks operate based on voluntary compliance by their members because of the difficulties with monitoring and enforcement.<sup>251</sup> Harmonization of standards within a network is a product of such consensus and is unlikely to occur between host state and home state regulators. This is because labor regulation can serve as a form of competitive advantage for economies, especially in the developing world. By harmonizing their labor standards with those found in developed economies, host states in the developing world reduce or lose this perceived competitive advantage. They will therefore be resistant to harmonizing their labor standards with competitors.<sup>252</sup>

Of course, networks are also sites of power dynamics. One member’s

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during the year to identify and address conditions of forced labor, slavery, human trafficking, and the worst forms of child labor within the company’s supply chains.” Business Transparency on Trafficking and Slavery Act, H.R. 2759, 112th Cong. (2011). Congress failed to enact H.R. 2759. *H.R. 2759 (112th)*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/112/hr2759> (last visited June 4, 2013).

249. See Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 HARV. INT’L L.J. 47, 51–52 (1993) (discussing horizontal regulatory competition and the risk of “race for the bottom” scenarios).

250. *Id.* at 58.

251. Verdier, *supra* note 242, at 118, 130, 163; see also Brummer, *supra* note 4, at 290–91.

252. See Brummer, *supra* note 4, at 269–70 (discussing differences in regulatory preferences because of adjustment costs); David J. Doorey, *Who Made That?: Influencing Foreign Labor Practices Through Reflexive Domestic Disclosure Regulation*, 43 OSGOODE HALL L.J. 353, 360–61 (2005) (discussing the risk of race to the bottom regulations); Verdier, *supra* note 242, at 124, 129 (discussing the distributive problems of harmonizing standards).

reluctance can be overcome by another member's influence.<sup>253</sup> Networks can be so susceptible to soft power that U.S. participants in transnational regulatory networks have viewed these networks as conduits for the export of U.S.-styled regulation to other jurisdictions.<sup>254</sup> However, this may be less true at the sub-national setting where sub-state legislators have a more limited set of sticks and carrots to offer uncooperative members.<sup>255</sup> Analysts have also observed that the independence and efficacy of regulatory networks arise from the nature of issues that are addressed within network settings. Specifically, networks tend to confront technical rather than political issues.<sup>256</sup> However, labor standards, which impact economic performance and job prospects for workers in host and home states, are unlikely to be perceived as a purely technical matter. Instead, it will be viewed as a significant political issue that—at least in the United States—must be subjected to democratic checks. Setting labor standards within networks may also be politically unpopular because networks are not transparent; instead, networks are exclusive arrangements that are often secretive.<sup>257</sup> The combination of exclusivity and secrecy limit access to these networks to a narrow class of actors and limit participation by other stakeholders.<sup>258</sup> These reasons help explain why networks also usually address economic or environmental issues rather than social issues.<sup>259</sup>

In addition to these constraints, any regulations produced within networks of sub-state actors would be limited because of a noticeable absence from the negotiating table: multinational companies. Effective reform of the value chain cannot be based solely on public actor action because these actors' consolidated leverage does not include the types of incentives that a multinational buyer could offer suppliers. Importantly, the latter's set of incentives may be a necessary condition for securing supplier compliance.

Of course, one solution could simply be to expand the table to include representatives from the private sector and even other stakeholders.

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253. See Raustiala, *supra* note 5, at 27.

254. See *id.* at 32.

255. See Verdier, *supra* note 242, at 128.

256. See Raustiala, *supra* note 5, at 24 (“[P]olitical deference to agency actions in international affairs appears justified by a sense that the issues are narrowly technical—and thus appropriately controlled by a domestic agency—rather than broadly political, and thus best guided by the foreign affairs bureaucracy.”).

257. See Zaring, *supra* note 4, at 303.

258. Raustiala, *supra* note 5, at 25.

259. *Id.*

However, transnational regulatory networks are overwhelmingly composed of sub-state actors, such as representatives from different state agencies.<sup>260</sup> This may be due to the fact that counterparts are better able to understand common issues and interests and therefore better able to reach consensus. Introducing greater heterogeneity among actors may impede consensus within networks. Networks are voluntary arrangements. Multinational buyers may not be willing to participate within networks. Even if they do so, they might pose a “hold-out” problem unless they receive satisfactory concessions. As a result, any resulting regulation may be diluted and ineffective.

The U.N. Protect, Respect, and Remedy Framework can be understood as such an attempt to expand coordination among a greater spectrum of actors.<sup>261</sup> As such, it offers an illustration of the strengths and weaknesses of pursuing CSR goals through a network model. The U.N. Special Representative for Business and Human Rights, John Ruggie, developed the Guiding Principles on Business and Human Rights. The Guiding Principles identify the different responsibilities of states and corporations regarding human rights.<sup>262</sup> Although these Principles were developed by the U.N. Special Representative, he did so only after extensive consultations with a broad range of stakeholders.<sup>263</sup>

The distributive problems of network coordination compromise even the least controversial principle of the U.N. Special Representative’s approach that addresses the duty of states to protect human rights. Convergence of state practice on this point is unlikely because many states—usually those found in the developing world—will face higher adjustment costs with conforming to more stringent standards. Their fear that more stringent standards will compromise their global competitiveness will compromise their cooperation and encourage similar reluctance by developed economies that do not want their economies to suffer from asymmetrical enforcement.<sup>264</sup>

One of the characteristics of the U.N. Special Representative’s approach was its transparency and the multiple opportunities that a range

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260. Zaring, *supra* note 4, at 301.

261. *See supra* notes 143–147 and accompanying text.

262. Special Representative of the U.N. Secretary-General, *Guiding Principles on Business and Human Rights: Implementing the United Nations “Protect, Respect and Remedy” Framework*, U.N. Doc. HR/PUB/11/04 (Jun. 16, 2011), available at [http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR\\_EN.pdf](http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf).

263. Human Rights Council Res. 17/4, ch. 1, 17th Sess., U.N. Doc. A/HRC/RES/17/4 (Jul. 6, 2011).

264. Surya Deva, *Guiding Principles on Business and Human Rights: Implications for Companies*, 9 EUR. COMPANY L. 101, 103 (2012).

of actors had to contribute to the Special Representative's work.<sup>265</sup> The Principles seemed to enjoy the support of many businesses and industry groups.<sup>266</sup> This support, however, may have come at a high price. Critics of the Principles take issue with the aspirational language used, which they claim should have been replaced with more specific directions to states and businesses.<sup>267</sup> Others criticize the Principles for failing to provide monitoring mechanisms or attach any legal accountability to businesses.<sup>268</sup> It is therefore unlikely that business practices will significantly improve.

### 3. *Toward Reflexive Coordination*

The effectiveness of command and control or network coordination is limited because these rely solely on state actors and state based leverage is insufficient to offer the types of incentives needed for both buyers and suppliers in value chains.

The limits of state power—either in its command or networked form—necessitate the need for an alternative approach to regulation that harnesses the leverage possessed by non-state actors. After all, actors obey the law for a variety of reasons that may have little to do with the coercive power of the state. Other institutions and actors reinforce the proscriptions of the law and the commands of state authority. What is needed is a form of regulation that explicitly and intentionally aggregates these non-state forms of leverage in order to achieve the state's policy objectives.

Reflexive regulation may be the answer to the recognized limits of state power. Humility is the origin of reflexive law: Reflexive law is based on acceptance of the limits of the state alone to achieve all socially desirable goals.<sup>269</sup> Under reflexive law, the state no longer monopolizes, or even dominates, regulatory activity. Instead, public actors adopting a

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265. Jenna Martin Amerson, "The End of the Beginning?": A Comprehensive Look at the U.N.'s Business and Human Rights Agenda from a Bystander Perspective, 17 *FORDHAM J. CORP. & FIN. L.* 871, 914–15 (2012).

266. *Id.* at 915.

267. See, e.g., *Joint Civil Society Statement on the Draft Guiding Principles on Business and Human Rights*, INT'L FED'N FOR HUM. RTS. (Jan. 2011), [http://www.fidh.org/IMG/pdf/Joint\\_CSOS\\_Statement\\_on\\_GPs.pdf](http://www.fidh.org/IMG/pdf/Joint_CSOS_Statement_on_GPs.pdf).

268. See Amerson, *supra* note 265, at 916–17.

269. Doorey, *supra* note 252, at 370 ("Reflexive law recognizes law's limitations as a tool for controlling complex social behaviour. It focuses on the norm-producing potential of intermediate institutions between the state and markets and private actors and seeks ways to mobilize, to influence, to steer, to 'irritate' those institutions so that they create desirable norms and practices."); Orts, *supra* note 6, at 1265.

reflexive approach recognize the varied and considerable pressure points offered by other actors—consumers, shareholders, media, labor groups, NGOs—that can encourage the targeted industry to make “voluntary adjustments in their behaviour that are consistent with the goals of the state.”<sup>270</sup> Reflexive regulation allows these other actors to participate with state actors in exercising leverage over the targeted industry.<sup>271</sup> This inclusiveness is the first characteristic of reflexive law that distinguishes it from command and control regulation.

The second important characteristic relates to how state power is exercised under reflexive law.<sup>272</sup> The fact that a non-state actor has the potential to wield leverage over the targeted industry does not mean that it possesses the means to do so effectively. A number of constraints may prevent a non-state actor from exercising the leverage that it possesses. One such example of a constraint is information. Asymmetrical information between consumers and brand firms, for example, prevents consumers from learning of firm behavior and sanctioning conduct “with their wallet.”

The role of the state is to convert the *potential* of non-state leverage into *realized* power by removing the constraints that prevent the effective exercise of that leverage. If non-state actors are prevented from exercising their leverage because of a lack of information regarding industry practices, the public actor steps into this void by mandating disclosures regarding firm practices or establishing a forum for dialogue on best practices. The public actor facilitates the exercise of leverage by consumers by improving the flow of information between industry and consumers.

For example, in the environmental context, environmental labeling is a reflexive strategy because it creates access to information for the consumer who can discriminate between products based on the “environmental friendliness” of the product.<sup>273</sup> The leverage exercised here is that of the consumer; it is the consumer who brings the pressure to bear on firms and encourages the latter to make more environmentally-sound products. The public actor’s only role is to facilitate the consumer’s ability to exercise her leverage. The public actors do this by creating a flow of information between private industry and the consumer so that the latter learns about the environmental

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270. Doorey, *supra* note 252, at 371; *see also* Abbott & Snidal, *supra* note 1, at 525.

271. *See* Doorey, *supra* note 252, at 366; Hess, *supra* note 7, at 458.

272. *See* Abbott & Snidal, *supra* note 1, at 520–21; Doorey, *supra* note 252, at 366 (2005); Hess, *supra* note 7, at 458.

273. Orts, *supra* note 6, at 1271–72.

policies of the different firms and can support or boycott their products accordingly.

The public actor's role has therefore changed from direct intervention and source of sanctions (command and control) to facilitate the ability of these other actors to consolidate their pressure over the targeted industry (reflexive law).<sup>274</sup> A public actor fulfills this facilitative role by establishing processes that guide actors toward socially desirable behavior: "In becoming reflexive the form of legal regulation changes from substantive to procedural law."<sup>275</sup>

Reflexive law's insight has already been applied to the field of corporate social responsibility by Danish and California requirements for social reporting by businesses. Social reporting is a form of reflexive law because "a social report would not mandate that certain predetermined outcomes be reached, but would instead require a corporation to reflect on how its practices impact society and to open up dialogues with the relevant stakeholders."<sup>276</sup> Like environmental labeling, the leverage comes from the public, especially consumers. This non-state form of leverage is particularly significant for value chains involving brand firms because of their visibility and consequent sensitivity to consumer preferences. It is the threat of consumer purchasing choices that encourages brand firms to improve their practices.<sup>277</sup> But consumers need information in order to wield the wallet effectively. The problem is that consumers have limited power to obtain that information from firms.<sup>278</sup> That is where the public actor enters. It is within the public actor's power to demand that firms make such information available to the public. This sets the wheels in motion for consumers and other stakeholders to respond to that information.<sup>279</sup>

This coordination between public and non-public actors demonstrates

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274. Doorey, *supra* note 252, at 366; Hess, *supra* note 7, at 458.

275. Ralf Rogowski & Ton Wilthagen, *Reflexive Labour Law: An Introduction*, in REFLEXIVE LABOUR LAW 1, 7 (Ralf Rogowski & Ton Wilthagen, eds., 1994); *see also* Hess, *supra* note 6, at 42–43; Orts, *supra* note 6, at 1264 ("Reflexive solutions offload some of the weight of social regulation from the legal system to other social actors. This is accomplished by *proceduralization*. Rather than detailed pronouncements of acceptable behavior, the law adopts procedures for regulated entities to follow. The procedures are adopted with a design in mind to encourage thinking and behavior in the right direction." (emphasis in original)).

276. Hess, *supra* note 6, at 46.

277. *See* Narine, *supra* note 148, at 360 (explaining that the Dodd-Frank conflict minerals reporting provision "depends on consumers and investors to pressure the firms . . . to change their business practices").

278. Hess, *supra* note 7, at 457.

279. *Id.*; Miller, *supra* note 8, at 44.

the capitalization of two forms of leverage over the target firm: the leverage to command disclosure of information (needed by the consumer but within the power of the public actor to obtain) and the leverage to pressure firms to improve practices (desired by the public actor but within the power of the consumer to demand). These reinforcing capabilities demonstrate that the strength of reflexive law is that it incorporates the participation of a variety of intermediaries—such as media, consumers, and NGOs—into efforts to improve corporate behavior. Each of these stakeholders has something unique to offer to recalcitrant actors in the value chain. A reflexive law approach aggregates the leverage that these combined actors can wield.

Despite these strengths, mandating social reporting—even as reflexive law—will still fail to achieve the outcomes that its proponents desire. This is because mandatory social reporting systems—like the ones in place in Denmark and California—are insufficiently sensitive to the variety of interests in the global value chain. Its incentives are tailored to the buying end of the value chain to the neglect of the suppliers. Disclosures are still dependent upon audits with all the attendant issues previously discussed.<sup>280</sup> As such, social reporting may demonstrate a decentralization of governance, but not decentralization of incentives.

Stakeholders must commit to decentralization in both the form of governance (reflexive law) and regulations (incentives). This second dimension of decentralization is what is missing from mandatory social reporting strategies to combat abuses in the value chain. Reflexive law is only one half of the solution. Its advantage is its ability to aggregate leverage from a variety of actors and, as such, it offers a superior form of governance of transnational CSR norms compared to traditional command and control regulation. Its limited success in the mandatory social reporting arena is due to the fact that it has been misapplied. Reflexive law is a conduit for transmitting incentives; it has failed so far with CSR because it has been transmitting the wrong types of incentives. Under social reporting, it has been transmitting incentives to multinational buyers while neglecting upstream suppliers. As such, it has succeeded along one dimension of decentralization, governance, but has failed along the other, incentives. The way to improve the use of reflexive law regarding CSR is to ensure that the incentives are addressed to suppliers as well as other actors in the value chain.

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280. *See supra* notes 158–85 and accompanying text (describing the social reporting requirements encouraged by international, national, and sub-national actors and the ways that suppliers undermine these efforts).



#### IV. GOVERNING AMIDST THE FRAGMENTS: A CHAIN SOLUTION TO A CHAIN PROBLEM

A fragmented firm requires fragmented regulation, but what does such regulation look like? It first requires that public actors decentralize the incentives they offer so that they can target a greater variety of actors in the value chain. It also requires a form of governance that allows them to transmit these incentives effectively. Reflexive law has the potential to achieve both these objectives.

This use of reflexive law results in a model for regulation that strongly resembles the value chains that it is meant to regulate:<sup>281</sup> fragmentation of regulation according to functional specialization in a sequence of value adding activities. After all, fragmentation was the approach that the regulated industries adopted when they faced constraints similar to those confronted by public actors who are attempting to regulate activities overseas.

This type of decentralized approach offers a range of benefits. First, reflexive coordination allows for spatial dispersion among participating actors and reduces issues arising from jurisdictional and geographic constraints. Second, one of the advantages of a global value chain is that it delegates and distributes roles among several actors in a manner that avoids duplication of efforts, capitalizes on the functional advantages of the actors, and adds value through a progression of steps.<sup>282</sup> Firms that abandoned vertical integration chose to focus on a narrower set of core competencies that better reflected their specialized skills. The lesson for stakeholders is to engage in a similar process of self-examination regarding their functional advantages in order to identify the best exercise of their regulatory activity. Indeed, reflexive law encourages this form of self-evaluation because it is intended to encourage actors to “contemplate the negative externalities associated with their conduct” and “make voluntary adjustments in their behavior that are consistent with the goals of the state.”<sup>283</sup> But this lesson is not meant only for the regulated private parties. It is also an important lesson for public actors. This requires recognition of one’s own limits and the advantages of other intermediaries to reach distant actors.

California’s problem is the one faced by many home state jurisdictions: inability to regulate suppliers directly.<sup>284</sup> The way that

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281. See Slaughter, *Sovereignty and Power*, *supra* note 4, at 288.

282. See *supra* notes 44–86 and accompanying text.

283. Doorey, *supra* note 252, at 371.

284. See Barrientos, *supra* note 83, at 981–82.

California transcends this limitation is by, first, distinguishing between target firms and intermediary stakeholders. A target firm refers to the actor that California wants to ultimately reach and whose behavior it is attempting to influence. For example, a target firm is a factory manager of a Bangladesh plant. An intermediary stakeholder is an actor who can impact factory conditions in Bangladesh and be impacted, in turn, by California's own actions. An example of such an intermediate stakeholder is a downstream buyer that is within the jurisdictional reach of California.

California has exercised its leverage over downstream firms by mandating social reporting.<sup>285</sup> However, its current failure is due to its relative inattention to the interests of suppliers. Changing the primary audience for reflexive law from buyer to supplier results in a significant change from how reflexive law is currently used by public actors like California or Denmark. Under the proper application of reflexive law, the corporate actor (buyer) is transformed from the target of regulation to one of many intermediary institutions that will influence the actual target—the supplier—to change their behavior.

It is important to remember what does and does not change under this alternative reflexive approach. Public actors, such as California, will still directly regulate the same actor: multinational buying firms within their jurisdiction. However, the objective of the regulation has now changed. It is not ultimately about targeting the buyer's behavior but incentivizing downstream buyers with the objective of getting those buyers—as intermediary stakeholders—to extend particular types of incentives to their upstream suppliers. This objective impacts the types of incentives that the public actor would offer in its legislation. This insight should guide how stakeholders “pull” on the stakeholders within their reach, such as multinational buyers, to get those actors, in turn, to nudge suppliers along the pathway to compliance. The following Section describes changes—from modest to considerable—that California and other public actors should consider to improve labor standards in global value chains.

#### A. *Due Diligence Requirements Regarding Counter-Manipulation*

Monitoring efforts by multinational buyers are only as good as the quality of their audits. The California Transparency in Supply Chains Act of 2010 (the “California Act” or the “Act”) increases the pressure on

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

buyers to perform due diligence along their value chains.<sup>286</sup> But this pressure will not result in improved conditions if the audits are simply manipulated. The weakness of the current Act is that it decentralized along only one dimension: governance. It adopts a reflexive law approach by not mandating what a firm must do regarding its due diligence of its suppliers. Instead, it only requires that the firm disclose the extent of its action or inaction.<sup>287</sup> The Act relies on non-state actors, such as consumers and NGOs, to exercise their respective forms of leverage to encourage firms to change practices.<sup>288</sup>

However, the Act is not sufficiently decentralized along the incentives dimension. It does not explicitly acknowledge the risks created by supplier audit manipulation.<sup>289</sup> The structure of these disclosure standards therefore encourages the view that incentivizing the buying-end of the global value chain is sufficient to achieve the changes that public actors desire. This faith placed in top-down originated auditing procedures perpetuates the neglect of other actors in the value chain, including their divergent interests, relative power in the chain, and the choices they confront.

One relatively direct way to change the Act so that it applies to suppliers more effectively is for public regulators to require firms to disclose their efforts to combat audit manipulation. Although the legislation improves the quantity of audits occurring, it does not do enough to safeguard the quality of such audits.<sup>290</sup> This is why California, and other actors considering similar legislation, should add a separate disclosure requirement mandating firms to disclose what steps they take to address risks specific to the auditing process, such as countering the various activities that suppliers engage in to skew the results. For example, California could amend the Act to include a sixth requirement that reads: “Performs quality control of its audits to ensure that its monitoring activities minimize risks of supplier or third-party manipulation of processes or results.”<sup>291</sup> This addition transforms the

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286. *Id.*

287. *Id.*

288. *See supra* notes 277–279 and accompanying text.

289. CAL. CIV. CODE § 1714.43.

290. Requiring firms to disclose whether the audit was announced or not is a step in the right direction so that suppliers cannot use advance warning to hide their infractions. However, even an unannounced visit is vulnerable to other forms of evasion, such as maintaining double-books, using uninspected factories, manager-bias, etc.

291. CAL. CIV. CODE § 1714.43(c)(2). This section of the California Civil Code requires that firms “specify if the verification was not an independent, unannounced audit.” This requirement ensures that suppliers do not use advance warning to hide their infractions. However, even an

Act so that it is decentralized along both dimensions and now impacts the decision-making of suppliers more effectively. This may appear as a modest change to the current status quo but that is its advantage. This reform capitalizes on the law that is already in place and, as such, offers a solution that will be more straightforward to implement. By contrast, the solutions discussed in the sections below outline suggestions for more significant structural change and therefore may take more time and resources to implement.

*B. Disclosures Beyond the Audit: Changing Governance in Global Value Chains*

As discussed above, asymmetries in rent and risk perpetuate supplier suspicions that buyers are not sincere about improving conditions.<sup>292</sup> The tension between corporate CSR policies, on the one hand, and procurement practices, on the other, only compound these suspicions and make it difficult for suppliers to comply. These frustrations experienced by suppliers may be a product of the approach to governance undertaken in global value chains. Under market governance, buyers tend to use the market to manage their suppliers and, consequently, it is based on competition among suppliers.<sup>293</sup> Market governance, therefore, perpetuates the tension between the sustainability practices demanded by buyers and their sourcing practices. For example, Nike experienced first-hand the effect of its governance structure on the implementation of its sustainability objectives. Despite its adoption of a corporate code of conduct, Nike's use of a market-oriented approach to governing its global value chain compromised the effect of such a code:

Though economically superlative, the arm's-length subcontracting system doomed Nike's first Code of Conduct. With the buyer threatening to sever the relationship if the supplier's pricing was too high, code compliance was secondary to contractors. Relentless price pressure had also forced final assembly factories to (re)subcontract parts, materials, and processes to as many as seven tiers of vendors, further inhibiting code enforcement. The parties' economic focus suppressed a more collaborative CSR partnership between buyer and supplier.

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unannounced visit is vulnerable to other forms of evasion, such as maintaining double-books, using uninspected factories, manager-bias, etc.

292. See Jiang, *supra* note 166, at 88 (“[S]uppliers’ main objective is to pass the audit, rather than address the substantive issues that are the focus of the audit.”).

293. See *id.* at 80.

Nike was concerned only with the fiscal bottom line and subcontracting factories were ready to switch to another buyer for a better economic deal. Due to this aloofness (“my-business-is-my-business; your-business-is-your-business”), neither had a serious commitment to improving working conditions.<sup>294</sup>

Nike saw improvement in the implementation of its code when it shifted from a market-oriented governance structure to a collaborative model with suppliers that was “characterized by a high level of interdependence underpinned by goodwill and trust.”<sup>295</sup> Under this new approach, contractors selected into its new governance model received an “exclusive production relationship and guaranteed minimum monthly orders . . . . This contracting model provided greater certainty that Nike and the [selected contractors] would maintain a relationship through good and bad times.”<sup>296</sup> This alternative governance structure was supported by information sharing on best practices between suppliers (previously precluded by high competition in market-based governance), access to Nike’s CSR experts, and shared responsibility for CSR among the different actors in the global value chain.<sup>297</sup>

The lesson from the Nike case is that changing supplier incentives may necessitate changing how multinational buyers govern their value chains. Consequently, the way to offer suppliers effective incentives for cooperation is to change governance patterns in value chains from market-based approaches to alternatives that are more collaborative. Under this reflexive law approach, the public actor should attempt to alter the behavior of the target firm (the supplier) by changing the conditions under which the supplier operates. The specific condition that the public actor is attempting to change is the governance structure in the value chain. In order to do so, the public actor needs to focus its attention on the actor who is in the best position to determine the governance choices in a value chain: the multinational buyer. The objective is to get the multinational buyer, as an intermediary stakeholder, to change its governance practices in order to subsequently affect the compliance rates of its suppliers.

A public actor confronts many difficulties in demanding that private industries change the way they do business and adopt a different management approach to their value chains. This is why it is important

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294. Lim & Phillips, *supra* note 194, at 146; *see also* Yu, *supra* note 192 (discussing Reebok’s procurement practices).

295. Lim & Phillips, *supra* note 194, at 148.

296. *Id.* at 149.

297. *Id.* at 148.

for public actors that adopt a reflexive law approach to identify a second group of intermediary stakeholders who can exercise leverage over the multinational buyers to get them to change governance patterns in value chains. The role of the public actor, as in all reflexive approaches, is to facilitate the use of this leverage by this second group of intermediary stakeholders.

One group of potential intermediary stakeholders is consumers. Mandatory social reporting can be adapted to encourage firms to change their governance approaches. However, consumers are not armed with knowledge regarding the differences and consequences of governance choices on the labor violations at Rana Plaza and Foxconn. Under the California Act, it is the behavior of the upstream end of the supply chain that is under scrutiny.<sup>298</sup> What is missing from these disclosure requirements is attention to the behavior of downstream firms and the effect of their sourcing practices on the possibility of abuse by upstream suppliers. Suppliers for Nike and other multinational buyers do not see the “business case” for CSR when their buyers do not reward compliance and prefer to award short-term contracts to those suppliers who can meet their demands on low cost and short lead times: two of the very factors that often contribute to violations of worker’s rights.<sup>299</sup>

This tension between stated goals and actual practices suggests a causal connection between downstream behavior and upstream effects that is thus far not reflected adequately in the dominant approaches to mandatory social reporting. One-sided disclosures reinforce the fear that the heightened requirements concerning due diligence are only illuminating the “effect” side of a causal connection between buyers and suppliers. To the extent that supplier violations are symptoms of sourcing practices, compliance will not change until the sourcing practices change.

Consequently, disclosure requirements should be amended to include information on sourcing practices that have been identified as contributing factors to violations of corporate codes of conduct.<sup>300</sup> These initiatives would resemble strategies such as Fair Trade initiatives that seek to inform discriminating consumers and concerned stakeholders about the business practices of the retailer and not just the compliance rate of the upstream supplier.<sup>301</sup>

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

299. See Bajaj, *supra* note 198.

300. See Miller, *supra* note 8, at 41–42; Yu, *supra* note 192, at 523.

301. *What is Fair Trade?*, FAIR TRADE USA, <http://fairtradeusa.org/what-is-fair-trade> (last visited Sep. 8, 2014).

One reform, therefore, is to change disclosure requirements in the California Act to include information on sourcing behavior by downstream firms. For example, downstream buyers could be required to disclose the following: (a) proportion of compliance costs funded by downstream buyer, (b) instances when improved compliance resulted in renewal of contract or other repeat business, and (c) average duration of contract with suppliers. The aim of these measures would be to improve transparency regarding the contributing role of downstream buyers to abuses in global value chains. The hope is that this improved transparency will lead to public pressure for reform similar to the design of current CSR disclosure standards. More comprehensive sustainability reporting is intended to change the focus of consumer attention (and discrimination) to evaluating the global value chain as a whole and not the isolated performance(s) of discrete actors in the chain.

### C. *Shifting From Unilateral to Bilateral CSR Strategies*

The World Bank commissioned a study in order to understand better the obstacles to improving social and environmental practices by suppliers.<sup>302</sup> Its study suggests that the resistance by upstream firms to current CSR practices can also be understood in terms of how CSR objectives are implemented in the value chain.<sup>303</sup> Many CSR policies of downstream buyers are implemented in a unilateral, top-down, buyer-driven manner.<sup>304</sup> This unilateral approach to CSR suffers from the following limitations. First, there is a concern with standard-setting with suppliers faulting a unilateral approach for its exclusion of them in the formulation and implementation of codes.<sup>305</sup>

Second, there is also a similar concern with capacity-building. Many buyers concentrate on setting standards (through corporate codes) and monitoring (through audits) but do not provide local managers with the support to implement the necessary changes.<sup>306</sup> The weakness of audits is that they measure non-compliance but they generally fail to provide local management with the tools to make the necessary improvements.<sup>307</sup> As a result, managers are often overwhelmed by the areas for

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302. *Strengthening Implementation*, *supra* note 220.

303. *Id.* at 23–26.

304. *See* Jiang, *supra* note 166, at 86.

305. *Strengthening Implementation*, *supra* note 220, at 26.

306. Gould, *supra* note 151, at 25–26.

307. *Id.* at 26.

improvement, claiming that they do not know where to begin.<sup>308</sup> Without the proper training and knowledge on how to improve conditions in fact, managers instead focus on improving the appearance of conditions.<sup>309</sup> This oversight is partially due to the buyers' mistaken belief that the corporate codes set standards with which a factory can easily comply.<sup>310</sup> However, there are often significant gaps between current factory conditions and the required standards and, without assistance, it is unlikely that managers will improve conditions.<sup>311</sup> Finally, there is also frustration from suppliers regarding the allocation of costs associated with the implementation of improved standards.<sup>312</sup> It is no surprise, therefore, that these limitations of the unilateral approach lead to resistance from suppliers.

The way to correct these incentives is to adopt an alternative model for corporate social responsibility that rejects a unilateral, buyer-driven, top-down approach in favor of a partnership model for improving CSR in the value chain. Such an approach caters to the interests of suppliers because, like the Bangladesh Accords, it focuses on increased dialogue between suppliers and buyers on achievable goals, collaborative action plans, rewards for incremental change, and measurements of continuous improvement rather than compliance.<sup>313</sup> The advantages of this alternative approach are significant. Some suppliers believed that codes that are negotiated “from the bottom up” have a greater chance of securing a “sense of shared ownership” from suppliers.<sup>314</sup> This could be a potential strategy for changing the current culture of non-compliance among suppliers.<sup>315</sup>

The model for a bottom-up approach to social responsibility may come from a domestic supply chain that is challenging the traditional

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308. *Id.*

309. Jiang, *supra* note 166, at 88 (“[S]uppliers’ main objective is to pass the audit, rather than address the substantive issues that are the focus of audit.”); *see also* Plambeck & Taylor, *supra* note 163, at 2–3.

310. Gould, *supra* note 151, at 26.

311. *Id.*; Joonkoo Lee et al., *Global Value Chains and Agrifood Standards: Challenges and Possibilities for Smallholders in Developing Countries*, 109 PROC. NAT’L ACAD. SCI. 12,326, 12,327 (2012).

312. *See* Jiang, *supra* note 166, at 88; Yu, *supra* note 192, at 523.

313. Gould, *supra* note 151, at 29.

314. *Strengthening Implementation*, *supra* note 220, at 24–25.

315. *Id.* Additionally, analysts are skeptical about the possibility of bottom-up approaches in the absence of long-term relationships between buyers and suppliers. *Id.* at 26. Hence, it may be necessary for disclosure of sourcing practices—and changes in those sourcing practices—to occur as a precondition to a bottom-up approach to CSR.



top-down, audit based approach to corporate social responsibility. The Coalition of Immokalee Workers (the “Coalition”) is a worker-driven community organization that represents low-wage workers in the tomato, and other harvest industries in Florida.<sup>316</sup> The Coalition has won several successes for its members and workers in the Florida agricultural industries, including industry-wide raises of thirteen to twenty-five percent for workers, assisting with government investigation, and prosecution of involuntary servitude in the industry.<sup>317</sup> Additionally, and as discussed below, it also made a serious contribution to improved labor conditions by starting the Fair Food Program.<sup>318</sup> Its successes have been so considerable that it has won accolades from the United Nations<sup>319</sup> and the White House.<sup>320</sup>

Part of the reason for the Coalition’s success was that it understood the economics of the supply chain. In its early years, the Coalition had unsuccessfully attempted to pressure Florida growers to increase tomato harvesting piece rates.<sup>321</sup> It began to see success when it realized that the problem did not begin and end with the Florida growers. Instead, the Florida growers occupied one tier in a more complex supply chain that ended with a consolidation of retail power at the top.<sup>322</sup> The combined buying power of the retail giants at the top of the food chain exerted significant downward pressure on supplier prices, which resulted in declining wages and working conditions for the workers at the bottom of the supply chain.<sup>323</sup>

This recognition of the economic reality of the supply chain led the Coalition to adopt a different strategy that aimed at structural change in the industry. The Coalition launched the Campaign for Fair Food in order to incentivize the actors at the top of the supply chain to change

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316. *About CIW*, COALITION OF IMMOKALEE WORKERS, <http://ciw-online.org/about/> (last visited Aug. 26, 2014).

317. *Id.*

318. *Id.*

319. Greg Asbed, *UN Working Group on Business and Human Rights ‘Impressed’ with Fair Food Program*, HUFFINGTON POST (May 16, 2013, 5:12 AM), [http://www.huffingtonpost.com/greg-asbed/un-working-group-on-busin\\_b\\_3222906.html](http://www.huffingtonpost.com/greg-asbed/un-working-group-on-busin_b_3222906.html).

320. *Fair Food Program*, COALITION OF IMMOKALEE WORKERS, <http://ciw-online.org/fair-food-program/> (last visited Aug. 26, 2014).

321. Greg Asbed & Sean Sellers, *The Fair Food Program: Comprehensive, Verifiable and Sustainable Change for Farmworkers*, 16 U. PA. J.L. & SOC. CHANGE 39, 43 (2013).

322. *Id.* at 43–45.

323. *Id.*; *Our Brands*, YUM!, <http://www.yum.com/brands/> (last visited Aug. 26, 2014); *see also* FAIR FOOD STANDARDS COUNCIL, FAIR FOOD PROGRAM: REPORT 2011–2013, at 7 (2013), available at [http://www.fairfoodstandards.org/reports/FFP\\_2011-13\\_web\\_v1.0.pdf](http://www.fairfoodstandards.org/reports/FFP_2011-13_web_v1.0.pdf).

their operations in a way that would produce beneficial trickle-down effects.<sup>324</sup> The Coalition successfully negotiated a series of binding legal agreements with food retail giants such as Yum Brands (Taco Bell, KFC, Pizza Hut), McDonald's Corporation, Burger King Corporation, Subway, Whole Foods, Trader Joe's, and Chipotle.<sup>325</sup> These fair food agreements commit the retailers to paying a "penny per pound" price premium for more fairly produced tomatoes.<sup>326</sup> Retailers also commit to purchasing tomatoes only from growers who comply with the Fair Food Code of Conduct.<sup>327</sup> This condition creates market incentives for growers to abide by the terms of the Code of Conduct.<sup>328</sup> The Fair Food Code of Conduct is distinguishable from many corporate codes of conduct because it "was born in discussions among workers in Immokalee, shared with consumers in churches and schools across the country, shaped in negotiations with participating retailers, and honed into the working document it is today in an intense loop of implementation, feedback, and modification in partnership with Florida tomato growers."<sup>329</sup>

The Code of Conduct is at the heart of the Fair Food Program, which covers over ninety percent of the Florida tomato industry and "is the only industry-wide social responsibility program" currently in U.S. agriculture.<sup>330</sup> The key elements of the Fair Food Program include (a) worker-to-worker education that informs workers of their rights and responsibilities so they can identify problematic practices, (b) 24-hour complaint line and complaint investigation and resolution process, (c) audits, and (d) enforcement through the market incentives in the fair food agreements whereby growers who do not abide by the terms of the Code of Conduct lose the business of the retailers who have signed agreements with the Coalition.<sup>331</sup>

At a surface level, the Fair Food Program (FFP) may resemble other corporate social responsibility programs because the FFP also includes a code of conduct and utilizes audits. But the FFP is an example of a

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324. Asbed & Sellers, *supra* note 321, at 44.

325. *Id.*; see also *Highlights: Selected National and International Recognition of the CIW and Its Members*, COALITION OF IMMOKALEE WORKERS, <http://ciw-online.org/highlights/> (last visited Aug. 26, 2014).

326. Asbed & Sellers, *supra* note 321, at 45.

327. *Id.*

328. *Id.*

329. *Id.*

330. *Id.*

331. *Id.* at 46; see also FAIR FOOD STANDARDS COUNCIL, *supra* note 323, at 10–12.

Worker-driven Social Responsibility Program (WSR) that is an alternative to the CSR programs that are generally designed by corporations.<sup>332</sup> The FFP's worker-led characteristic has important ramifications for the operation of the program and differs from CSR in the following critical ways:<sup>333</sup>

- *Re-definition of the problem from a public relations issue to a human rights issue;*<sup>334</sup>
- *Shift from generic "Vendor Standards" to specific codes of conduct that reflect the bad practices in an industry;*<sup>335</sup>
- *Shift from audit-based monitoring to participatory and complaint based monitoring.* The Fair Food Program's worker education informs workers of their rights and provides avenues for workers to notify other actors when those rights are infringed. The complaint line is staffed by the actors who investigate the complaints. The Program also relies on third-party audits but their auditors are required to speak with at least fifty percent of the workers on an audited farm and sometimes the percentage can be as high as ninety percent. These percentages are in stark contrast to regular CSR audits that only engage approximately ten to twenty percent of workers. The increased attention to workers should reduce the risk of audit evasion by growers. Under WSR, "workers are the lead actors in the monitoring of the Fair Food Program";<sup>336</sup>
- *Shift in enforcement by the creation of market incentives for compliance.*<sup>337</sup>

The Fair Food Program is successful because it utilizes the strengths of actors at each tier of the supply chain.<sup>338</sup> Through their large purchasing orders, retailers provide strong incentives for compliance by their growers.<sup>339</sup> Although the Fair Food Program initially sounds like a narrative between workers and retailers (the two ends of the supply

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332. Greg Asbed, *Worker-Driven Social Responsibility (WSR): A New Idea for a New Century*, HUFFINGTON POST (June 17, 2014, 3:25 PM), [http://www.huffingtonpost.com/greg-asbed/workerdriven-social-respo\\_b\\_5500104.html](http://www.huffingtonpost.com/greg-asbed/workerdriven-social-respo_b_5500104.html).

333. *Id.*

334. *Id.*

335. *Id.*

336. *Id.*

337. *Id.*

338. Asbed & Sellers, *supra* note 321, at 47.

339. *Id.*

chain), it is important to remember the value of the grower-suppliers who operate in the middle. These suppliers initially resisted the fair food initiatives and their resistance compromised the effectiveness of the program.<sup>340</sup> The Florida Tomato Growers Exchange represents ninety percent of Florida's tomato growers.<sup>341</sup> It threatened to impose significant fines against any member-grower who participated in the program.<sup>342</sup> As a result, the price premium that buyers paid had no way of getting to the workers because the buyers did not pay the premiums to the workers directly and the premiums did not pass through entities such as the Coalition that were outside the buyer's regular supply chain.<sup>343</sup> The premiums sat in escrow while the Exchange's members refused to cooperate.<sup>344</sup> The situation changed in 2010 when the Coalition and the Exchange reached an agreement to expand the Fair Food Program throughout the Florida tomato industry; the premiums began to flow to the workers.<sup>345</sup> One reason for the growers' eventual cooperation is that the Fair Food Program does not require that growers bear the entire cost of change.<sup>346</sup>

If public actors are to replicate the successes of the Coalition within other value chains, their first challenge will be to determine who is in the best position to encourage private firms to change their CSR strategies from unilateral to bilateral approaches. The public actor's first step toward adopting a reflexive law approach is to recognize its own limitations to achieving its objective. Second, the public actor needs to identify an intermediary stakeholder who may be in a better position to exercise leverage over multinational buyers to get them to change their CSR approaches. In the example of the Immokalee workers, the pressure for change at the top came from strategic alliances between farmworkers and consumers.<sup>347</sup> The public actor's efforts, therefore, should be spent in helping these intermediary stakeholders maximize their leverage over the buyer firms.

In the transnational context, suppliers, frustrated by the dominant approaches to implementing CSR, may be important intermediary

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340. Editorial, *One Penny More a Pound*, N.Y. TIMES, Dec. 4, 2010, at A22 [hereinafter *One Penny More a Pound*].

341. *Id.*

342. *Id.*

343. FAIR FOOD STANDARDS COUNCIL, *supra* note 323, at 39.

344. *One Penny More a Pound*, *supra* note 340.

345. FAIR FOOD STANDARDS COUNCIL, *supra* note 323, at 39.

346. *Id.* at 12.

347. *About CIW*, *supra* note 316.

stakeholders who may have potential to change CSR practices. After studying four case studies of CSR implementation in overseas facilities, one group of researchers concluded that “while governance pressures emanating from the global value chain were the leading drivers behind the adoption of collective action CSR initiatives in the four cases [studied], local institutions were instrumental in the effective implementation of collective action responses across all four cases.”<sup>348</sup> In particular, “[t]hese collective bodies were critical in the implementation of CSR monitoring schemes that could ensure compliance and improve their industry’s standing in the eyes of stakeholders in Northern-buyer markets.”<sup>349</sup>

The involvement of local actors brought several advantages to CSR implementation. In the Kenyan cut flower industry, for example, the involvement of leading local industry associations in the Horticultural and Ethical Business Initiative (HEBI) meant that some of the usual constraints of traditional monitoring could be overcome.<sup>350</sup> The issues “associated with tick-box approaches, little time spent in monitoring at local pack-houses and farms and the use of expensive auditors with limited knowledge of local contexts” were ameliorated with participatory social auditing that involved more participation by workers.<sup>351</sup> This participation was important because it “rais[ed] their awareness and uncover[ed] less visible issues such as gender discrimination and sexual harassment.”<sup>352</sup> Participation by local industry associations can also be important to secure the cooperation of the industry’s individual members.<sup>353</sup>

Improving CSR compliance in global value chains, therefore, may require empowerment of local actors. For example, in Cambodia, Pakistan, and Bangladesh, the funding for the responses by local industry was provided by international agencies, including the U.S. Department of Labor.<sup>354</sup> California and other public actors could similarly seek to empower local industry associations so that the latter may be able to counter-balance the influence of buyers and push for a

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348. Peter Lund-Thomsen & Khalid Nadvi, *Global Value Chains, Local Collective Action and Corporate Social Responsibility: A Review of Empirical Evidence*, 19 *BUS. STRATEGY & ENV'T.* 1, 7 (2010).

349. *Id.*

350. *Id.*

351. *Id.* at 7–8.

352. *Id.* at 8.

353. *Id.* at 7.

354. *Id.* at 6.

new approach to CSR strategies. Such an approach is consistent with a reflexive law strategy because reflexive law seeks to mediate key relationships between private parties with an eye to counter-balancing the distribution of power in those relationships: “[R]eflexive law encourages lawmakers to consider how to motivate and facilitate the creation of private networks of countervailing power to existing powerful economic interests. It . . . challenges regulators to explore possibilities to influence interactions between global capital and these burgeoning forces of private antagonistic actors.”<sup>355</sup>

#### *D. Summary*

The initiatives discussed above are suggestions for fully decentralized regulation that address the weaknesses of incentives and governance explained in this Article. Each of these initiatives attempts to correct misaligned incentives in the value chain. However, this goal could have been attempted through traditional command and control regulation. For example, California could have required that all covered entities eliminate audit manipulation in their value chains, but such a mandate may prove difficult to enforce because of limitations of proximity, resources, jurisdiction, and information. Alternatively, California could have mandated that covered entities change the governance of their value chains from market-based to relational forms of governance. Such a regulation is unlikely to occur because it would not be politically popular. Finally, California could have required that covered entities change their CSR strategies from unilateral approaches to bilateral partnerships. Such an approach seems similarly unlikely because public regulators that have required social reporting, such as California and Denmark, have opted to require that companies disclose their CSR policies but have not identified the substantive requirements of these policies or even required that a company adopt one if it has not already done so. It is for these reasons that a reflexive approach is necessary to correct misaligned incentives in the value chain.

Second, it is difficult to prescribe solutions that can be applied across industries. This is because the “value” in these value chains is derived from different sources depending on type of product, product life-cycle, and branded or non-branded nature of the firm. Rana Plaza and Foxconn share similar risks for worker abuse, but that is where the similarities end. The electronics made at Foxconn derive a significant portion of

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355. Doorey, *supra* note 252, at 371–72.

their value from the innovative concept and design.<sup>356</sup> The firms who sell these products make profits because they are offering consumers something new or something better. This is not the same story for the garments produced at Rana Plaza, where the garments derive their value from the brand name that is stitched on the label or by controlling the costs of making them. The firms who sell these products, therefore, generally make profit by keeping the cost of labor down. This distinction is informed by the following two qualifications.

Even within the electronics industry, value will shift from innovation to cost depending on the stage of the product's life-cycle and the number of competitors in the field. With new technology, the firm faces little to no competition and the value for the product is derived from innovation. As this technology becomes mundane and new firms enter the market, the value that the firm extracts will depend less on innovation and more on controlling costs.<sup>357</sup>

Finally, branded firms extract part of the value for their product from the premium that consumers pay for that brand name. Nike learned a long time ago that saving costs at the expense of its reputation is a hard bargain. It therefore invested in implementing its corporate code of conduct, even including on-site monitors.<sup>358</sup> But not all brand names have learned Nike's lesson. Apple is in the midst of its own painful education and may be more willing now to emulate the example of the branded shoe firms.<sup>359</sup> Similarly, a brand name clothing company whose garments are made at Rana Plaza may also be willing to invest in CSR policies and share that premium—albeit a small one—with its suppliers.

These drivers change, however, when we move from the branded market to the low-cost discount market where firms survive on beating price and not on their brand name. When the value from the value chain only comes from controlling cost in a competitive environment, there will be greater downward pressure on prices with all the attendant risks for the workers who operate under those conditions. More importantly, the drivers for reform will differ. In industries that rely on technology, a driver for better labor practices is access to a skilled labor force. In

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356. See Varian, *supra* note 62; *Supply Chains*, *supra* note 56.

357. For example, Toshiba-Matsushita Display supplied the display used in Apple's video iPod. Dedrick et al., *supra* note 63, at 12. This component was one of the few high-value items, allowing Toshiba-Matsushita to capture an average gross margin of approximately twenty-nine percent. However, competition from Korean and Taiwanese entrants reduced Toshiba-Matsushita's market rank and contributed to a business environment of "rapid price deterioration." *Id.*

358. Lim & Phillips, *supra* note 194, at 147.

359. See *supra* notes 98–100 and accompanying text.

branded markets, the firms will be sensitive to reputational damage. These drivers are absent when we shift to the non-branded, non-innovative industries where price is determinative of value.

Finally, the suggestions shared here are meant to improve currently prevailing practices. None of the suggestions will eradicate labor abuses in value chains. Moreover, like other CSR strategies, they may also be vulnerable to the problem of unintended consequences.<sup>360</sup> Although the objective is to improve the conditions of overseas workers, these suggested initiatives may have the effect of negatively impacting the welfare of some groups of workers. For example, effective implementation of CSR may necessitate re-organization of production in the value chain in order to facilitate improved monitoring and oversight. When Nike intensified its monitoring efforts in Sialkot, Pakistan, where many of Nike's hand-stitched soccer balls are produced, it also changed the organization of production.<sup>361</sup> Previously, this industry had trended towards decentralized production in rural, home-based sites that made it more difficult to monitor compliance with standards, especially involving child labor.<sup>362</sup> In order to improve monitoring of labor conditions, Nike required that all production occur within designated stitching centers.<sup>363</sup> Although such a change improved Nike's ability to monitor standards, it likely had an effect on the ability of workers—predominantly female—to earn an income while still performing household duties, such as childcare. The centralization of production precipitated by Nike's CSR strategy may have made such a balance more difficult for these female workers. Additionally, accompanying improved CSR is the looming threat of business flight from countries that begin to demand more from their Western clients.<sup>364</sup>

## CONCLUSION

This Article presents a framework for improving the effectiveness of efforts to reform the global value chain. The key advantage of this framework is the incentives that it offers to neglected segments of the

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360. See Sabel et al., *supra* note 1, at 14.

361. Lund-Thomsen & Nadvi, *supra* note 31, at 210.

362. See *id.* at 209–10.

363. Khalid Nadvi, *Global Standards, Global Governance and the Organization of Global Value Chains*, 8 J. ECON. GEOGRAPHY 323, 335–36 (2008).

364. See Narine, *supra* note 148, at 391–92 (explaining that opponents of the Dodd-Frank conflict minerals reporting provision fear that the law will lead firms to source their minerals from other locations and leave local artisanal miners without any form of livelihood).



value chain: upstream suppliers. Current CSR efforts are compromised by their failure to incentivize these actors to cooperate. As a result, efforts to improve transparency and, consequently, exert upward pressure on conditions will fail so long as suppliers fail to “buy-in” to these efforts. Improving the global value chain requires recognizing the diversity of actors and interests involved and offering incentives that apply throughout the chain and not just the buying end.

The failure to win supplier cooperation is a result of more than just a weakness in incentives. It also stems from limitations to transnational governance and the organization of multi-stakeholder activity. Individual stakeholders are limited in their ability to influence suppliers directly. That is why it is important for them to distinguish between target firms and intermediary stakeholders in order to transmit incentives effectively. The combination of improved incentives and greater coordination will not ensure an ideal value chain but it can reduce the likelihood that we will witness another Rana Plaza or Foxconn.