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## **Assurance Services as a Substitute for Law in Global Commerce**

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# Assurance Services as a Substitute for Law in Global Commerce

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## Introduction

The problem of organizing complex production has for the most part been analyzed by law and economics scholars in a dichotomous way: production can be accomplished either through a series of market transactions and contracts, or under the guidance and control of a hierarchical governance structure within a firm.<sup>2</sup> A rich and

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<sup>2</sup> The classics in this literature include Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 1 (Nov.1937), and Oliver E. Williamson, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975). For much of the last three decades, "law and economics" scholars have tried to analyze "firms" as little more than "nexuses", or devices through which a collection of contracts are coordinated, thus treating enforcement through organizational structure and authority as a subset of contract enforcement. But as Prof. Coase pointed out in *The Nature of the Firm*, firms are *substitutes* for contracts, *see* Coase, *supra*, at 4, a view that is reinforced by the reluctance of courts to get involved in settling disputes between two participants within a firm, whereas courts, or at least a credible threat of legal sanctions, are a standard enforcement mechanism for contracts between firms or between an individual and a firm.

well-developed literature has emerged in the last few decades analyzing these two modes (as well as some “hybrid” modes), and considering why one mode might be used in some circumstances, and the other in different circumstances.<sup>3</sup> A more recent, but rapidly growing, literature has explored how globalization seems to be leading to more “outsourcing,” in which activities that were once carried on within a single firm are now being organized by contracts, across multiple firms, perhaps in multiple countries.<sup>4</sup>

Nearly all of the economic literature on choice of organizational form, globalization, and the “outsourcing” phenomenon, however, assumes the existence of an institutional context in which rule of law is followed, minimum social standards and business norms are established and regulated (or are at least commonly accepted and followed within a given trade), and contracts can be enforced.<sup>5</sup> Given these characteristics of the institutional context, two firms that both operate in the United States or other developed countries, for example, can focus in their contracts with each other on the terms on which the subject of the contract will be carried out, without having to worry much about baseline or “default” terms. If firm A hires firm B to clean its offices and facilities, for example, A will not have to specify that B may not use child labor, may not dump its waste products in the municipal water system, and may not kidnap A’s

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<sup>3</sup> Some of the foundational literature here includes Williamson, *supra* note 2; and Benjamin Klein, Robert A. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, J. L. & Econ. (Oct. 1978).

<sup>4</sup> A variety of terms have been used by economists to refer to the phenomenon of outsourcing, including “vertical specialization,” “intra-product specialization,” and “global production sharing.” For excellent starting points to explore this literature, see Gene M. Grossman and Elhanan Helpman, *Outsourcing in a Global Economy*, 72 REV. ECON. STUD. 135 (2005); Robert C. Feenstra, *Integration of Trade and Disintegration of Production in the Global Economy*, 12 J. ECON. PERSPECTIVES 31 (1998).

<sup>5</sup> Certainly some of the international trade literature recognizes that the quality of foreign enforcement of contracts is an important factor in explaining whether a firm relies on international outsourcing to procure specialized inputs, rather than production within the firm, either domestically or through vertical integration. See Barbara J. Spencer, *International Outsourcing and Incomplete Contracts*, NBER Working Paper 11418 (2005), available at <http://www.nber.org/papers/w11418> (last visited Mar. 14, 2007). This literature focuses on the institutional conditions under which a country can attract global firms to enter into outsourcing contracts in that country, rather than focusing on decisions within the firm, as does the law and economics theory of the firm literature that we are describing here.

executives and hold them for ransom in order to get higher pay than the contract provides. Nor will the contract have to specify that either firm A or firm B can call the other into court to settle any future dispute over terms of the contract.<sup>6</sup> Those things are properly taken for granted, because both A and B will be subject to law, regulation, and customary norms operating in their respective countries.

By contrast, firms that organize production through a long chain of suppliers in a global marketplace might have to be concerned about such problems, as well as numerous other problems that arise in the absence of a sophisticated and well-developed legal and regulatory infrastructure. At least three different literatures have touched on these problems: a literature in law and economics has considered the importance of rule of law and property rights protection generally to economic development<sup>7</sup>; another literature has focused on the problem of regulating environmental and social behavior of corporations in the global context<sup>8</sup>; and the theories of the firm literature in law and

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<sup>6</sup> The contract may specify such things as which courts the parties will go to, which law will be applied, and whether the parties may have to submit to arbitration first. See, e.g., Erin Ann O'Hara & Larry E. Ribstein, *Corporations and the Market for Law*, Working Paper dated Feb. 22, 2007, available at <http://www.ssrn.org>. But as long as the parties are willing to accept the default rules, the contract may leave these details out.

<sup>7</sup> See DOUGLAS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990); for a good summary of this literature, plus classics such as Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *The Quality of Government*, 15(1) J. OF LAW, ECON. & ORG. 222 (Apr. 1999); Dani Rodrik, [\*Institutions For High-Quality Growth: What They Are And How To Acquire Them\*](#), 2370 C.E.P.R. Discussion Papers (2000).

<sup>8</sup> This literature began with discussions amongst academics in both law and business about corporate social responsibility and the difficulty of regulating corporate behavior across national boundaries. For some introductions to voluminous literature, see, e.g., R. Edward Freeman, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* (1984); David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979). Recently, attention has turned more broadly to what one group of scholars has called "global administrative law," which is the term coined by Profs. Benedict Kingsbury, Nico Krisch, Richard B. Stewart and Jonathan B. Wiener to describe the "rapidly changing pattern of transnational regulation and its administration." Benedict Kingsbury, Nico Krisch, Richard B. Stewart & Jonathan B. Wiener, *Foreword: Global Governance as Administration—National and Transnational Approaches to Global Administrative Law*, 68 L. & CONTEMP. PROBS. 1 (Summer/Autumn 2005). The conceptual construct of global administrative law includes both the development of new, pluralistic legal regimes, including regimes that regulate the social and environmental conditions of production, and also enforcement of these regimes. Moreover, the global administrative law project seeks to evaluate the

economics has considered the standard problems of coordination, communication, and incentive structures in the “make or buy” decision.<sup>9</sup> In the latter case, the literature has generally assumed that various parties contract with each other “in the shadow of the law.”<sup>10</sup> There is also a relevant literature on the development, outside the law, of norms, reputational constraints, and arbitration mechanisms that may substitute for law in some circumstances.<sup>11</sup>

In this article we examine the rapid emergence and expansion of a private-sector compliance and enforcement infrastructure that we believe may increasingly be providing a substitute for public legal and regulatory infrastructure in global commerce, especially in developing countries where rule of law is weak and court systems are absent or inadequate. This infrastructure is provided by a proliferation of performance codes and standards (some developed in collaborative processes by non-governmental organizations (NGOs) and business), and a rapidly-growing global army of privately-trained and authorized inspectors and certifiers that we call the “third-party assurance industry.”

Third-party assurance in some form or another has been used to facilitate commerce for centuries.<sup>12</sup> But its growth in very recent years has been phenomenal.<sup>13</sup>

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legitimacy of these new law-making regimes according to such fundamental values of democracy as accountability, transparency, consent, and participation of the governed.

<sup>9</sup> See Klein, Crawford & Alchian, *supra* note 3.

<sup>10</sup> Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L. J. 950 (1979); Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982).

<sup>11</sup> See generally Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328 (2004) (giving an overview of contract enforcement by firms, courts and reputation; establishing a model for choosing contract enforcement mechanisms); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Codes’s Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996); Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms and Institutions*, 99 MICH. L. REV. 1724 (2001); Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribu Traders*, 49 J. ECON. HIST. (1989).

<sup>12</sup> The earliest use of third party assurance services may have been the role played by several “boards of state accountants” in verifying state revenues and expenditures in ancient Athens, 500 to 300 B.C. See

Moreover, whereas the third-party assurance business first developed to facilitate the making and carrying out of private contracts, we claim that the activities of the assurance industry are rapidly being deployed for purposes that in the past would be considered “public” and “regulatory” in nature, and would previously have been left to the authority of government. Third-party assurance may thus be providing a substitute for both private and public law in a number of situations, and may even be providing a new institutional structure through which private commercial exchange may be regulated for essentially public purposes.

We examine the new prominence of this industry in international commerce and the reasons why it has exploded onto the scene in the last decade. We also consider whether the rapid deployment of third-party assurance in business is facilitating the transmission of global norms of acceptable business behavior to new parts of the world, or whether, by providing a substitute for law, it is undermining the indigenous development of sophisticated legal systems.

## **I. The third party assurance industry and evidence of its growth.**

Perhaps the most familiar type of third-party assurance service is the external auditor, who examines financial statements and the processes by which they were generated, and opines on whether the statements fairly and accurately reflect the underlying economic reality.<sup>14</sup> Independent external auditors have been critical to the

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George J Costouros, *Auditing in the Athenian State of the Golden Age (500-300 B.C.)*, ACCT. HISTORIAN’S J. 41, 41-50 (Spring 1978).

<sup>13</sup> See section I below for evidence of an explosion in recent years in demand for third-party assurance services, as well as for the development of quantifiable performance metrics by which such services can measure and report on performance by parties to actual and potential contracts.

<sup>14</sup> According to the Global Market Information Database by Euromonitor International, the size of the US market for accountants’ services has grown by 9.6% from 2000 to 2004, measured in the dollar value of

development of liquid financial markets in which individuals may invest in market-traded securities issued by the businesses with reasonable confidence that the information the company has provided is an accurate reflection of the condition of the underlying business.

Financial institutions that invest in or insure business ventures have also long made use of other kinds of assurance services, in addition to financial audits. The business of assuring and attesting to non-financial matters began at least 150 years ago, for example, when marine insurance companies in France, Britain, and Italy began hiring inspectors to make sure that ships being hired for international commerce were seaworthy.<sup>15</sup> And financial institutions generally, including insurance companies and lending institutions, continue to be among the most active users of a variety of third-party assurance services.<sup>16</sup>

A. *The impact of ISO.* A major contributor to the development of a global assurance service industry has been the widespread adoption since the mid-20<sup>th</sup> century of international standards and technical specifications for a vast array of products and processes. Since its founding in 1946, the International Organization for Standardization

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sales. Auditing and accounting services was the largest sector, accounting for 59.7% of sales in 2004. The UK market has grown by 12% from 2000 to 2004. As an indication of the explosion in demand for audit services in developing countries, by contrast, the Chinese market for accountants' services has grown by 304.5% over the years from 1999 to 2003. The market is predicted to expand by 149% to \$4,022 million by 2008. Auditing took the largest share in China in 2003, accounting for 66.2%. See <http://www.euromonitor.com/>.

<sup>15</sup> RINA (Registro Italiano Navale) is an assurance firm that has provided ship classification and certification services since its establishment in 1861. See <http://www.rina.it/>. Since global trade and insurance predated RINA, we suspect ship inspection services did too. Hence our claim that the business goes back "at least" that far. Intertek started its maritime survey business in 1885. See <http://www.intertek.com/>. <http://bpa.odu.edu/port/research/REGULATORYISSUES.doc>.) A number of firms that are currently active in international inspection and assurance services, including RINA, SGS, BVQI, the TÜVs (Technischer Überwachungsverein), Intertek, and DNV (Det Norske Veritas), had their origins as firms that inspected ships, and/or their cargo, for international trade. See discussion in Section II below.

<sup>16</sup> Familiar types of third-party assurance services used in financial transactions include auditing, credit rating, title services, inspections for hazardous materials such as asbestos, and appraisers.

(ISO) has promulgated thousands of technical standards.<sup>17</sup> ISO also disseminates information about dozens of accreditation bodies that, in turn, accredit hundreds of organizations that are in the business of carrying out various evaluations to determine if products or processes or management systems are in conformance with the specifications in ISO standards.

In 1987, the ISO embarked on a significant new path when it adopted the “ISO 9000” standards of quality management.<sup>18</sup> These were the first sets of international standards that applied to *management systems* that firms have in place to meet customer and applicable regulatory requirements, rather than to the characteristics of the products firms produce or to units and methods of measuring those characteristics.<sup>19</sup> Although certification is not a requirement of the ISO standards, many firms have chosen to have their systems independently audited and certified to them,<sup>20</sup> and certification rapidly “became a *de facto* requirement for doing business in Europe and other parts of the

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<sup>17</sup> “ISO”, from the Greek word for “equal,” was adopted as the “standardized” name for the organization whose English name is the International Organization for Standardization. ISO is a non-governmental organization whose member institutes are part of the governmental structure of their countries, or are mandated by their government. Typically, however, members have their roots in the private sector, having been set up by national partnerships of industry associations. ISO uses technical committees organized by subjects for standards development, and at this time has more than 200 such committees. Since its founding in 1947, ISO has published more than 16,000 product, technical, and performance standards for the characteristics and quality of raw materials and other tangible production inputs, ranging from agricultural products, grades of oil and gasoline, metals, ceramics and glues to electrical parts, nanotechnology, information processing, digital equipment, and so forth.. See <http://www.iso.org/iso/en/aboutiso/introduction/index.html> (last visited March 9, 2007). ISO standards often form the basis for trade treaties and agreements. For an excellent description of the role of ISO standards in international trade, and the process by which it promulgates standards, as well as an early recognition of what has come to be called new governance, see Naomi Roht-Arriaza, *Shifting the Point of Regulation: The International Organization for Standardization and Global Lawmaking on Trade and the Environment*, 22 *ECOLOGY L. Q.* 479, 489-491 (1995).

<sup>18</sup> Prior to publication of ISO 9000 standards, the ISO had focused largely on developing internationally applicable technical standards for products and materials. ISO 9000 was established under the Technical Committee No. 176 (TC176). The list of technical committees is available at <http://www.iso.org/iso/en/stdsdevelopment/tc/tclist/TechnicalCommitteeList.TechnicalCommitteeList> (last visited August 14, 2006).

<sup>19</sup> See Roht-Arriaza, *supra* note 17, at 499.

<sup>20</sup> See The ISO Survey 2004, available at <http://www.iso.org/iso/en/prods-services/otherpubs/pdf/survey2004.pdf> (last visited July 3, 2006.)

world,” as well as being actually required for certain products sold in Europe and the United States.<sup>21</sup>

The ISO 9000 idea of creating standards for management systems has greatly fueled the development of the assurance industry.<sup>22</sup> The organizations that were first qualified to certify ISO 9000 compliance were generally European organizations that were already providing quality inspection services for various products; more recently, accounting and audit firms have been expanding their business services portfolios to add capability to perform ISO 9000 certifications.<sup>23</sup>

Although we have so far not found data tracking growth in the third-party inspection and assurance industry, data collected by ISO show that the number of firms and facilities in the world that were ISO 9000 certified grew from 27,816, in 48 countries in 1993,<sup>24</sup> to 670,399 in 154 countries by 2004.<sup>25</sup> ISO's approach to compiling these totals involves surveying the certifying bodies, so these numbers represent the total number of firms and sites that the certifying bodies claim to have certified. ISO provides no comparable data on the number of active certifying bodies, but this dramatic expansion in the number of firms and plants that have been certified could only be accomplished if the number of people and firms doing certification work had also grown dramatically.

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<sup>21</sup> Roht-Arriaza, *supra* note 17, at 500.

<sup>22</sup> See Stepan Wood, *Voluntary Environmental Codes and Sustainability*, 229, 261, in ENVIRONMENTAL LAW FOR SUSTAINABILITY (Richardson & Wood, eds) (2006).

<sup>23</sup> Organizations originally in financial auditing, such as KPMG Performance Registra Inc., a wholly owned subsidiary in Canada of KPMG, LLP and PricewaterhouseCoopers in Canada, have extended their services to ISO certification. See <http://www.kpmg.ca/en/ms/performance/registrars/services.html> and <http://www.pwc.com/extweb/service.nsf/docid/5401765577527120852570CA001771D2> (last visited Aug. 10, 2006). However, most of the certification bodies providing ISO9000 certification, including BVQI, UL, SGS-ICS, and the like, were already in the quality inspection services sector when the ISO 9000 standards were developed and promulgated.

<sup>24</sup> See <http://www.iso.org/iso/en/iso9000-14000/pdf/survey10thcycle.pdf>; at p. 15.

<sup>25</sup> See <http://www.iso.org/iso/en/prods-services/otherpubs/pdf/survey2004.pdf>, at p. 10.

Once the demand for management quality certification had developed sufficiently to support a private sector infrastructure to certify management systems, it was only a small step for business, government, NGOs, and social activists to look to these same sorts of certifying organizations to provide assurance when asking companies to demonstrate that they are meeting specified criteria for social performance.<sup>26</sup> In 1996, the ISO adopted the ISO 14000 series of standards for evaluating environmental management systems.<sup>27</sup> By 2004, 90,569 facilities and firms, in 127 countries, had been certified as meeting these standards.<sup>28</sup> And ISO is currently developing standards for social responsibility as well, although ISO asserts that these standards are not intended to be the basis for third-party certifications.<sup>29</sup>

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<sup>26</sup> The American National Standards Institute (which is the U.S. organizational representative to the ISO) notes growing pressures toward social performance certification on its website. See [http://www.ansi.org/about\\_ansi/introduction/history.aspx?menuid=1](http://www.ansi.org/about_ansi/introduction/history.aspx?menuid=1) (“During the first years of the 21st Century, those involved in standards-setting activities clearly recognized a growing need for globally relevant standards and related conformity assessment mechanisms. ‘Market forces’ such as global trade and competition; societal issues such as health, safety and the environment; an enhanced focus on consumer needs and involvement and increasing interaction between public-sector and private-sector interests were significantly impacting standardization and conformity assessment programs. Standards themselves had expanded well beyond documents identifying product specifications to instead focus on performance issues and to also include processes, systems and personnel.”)

<sup>27</sup> See Reinhardt Peglau, *Applauding the success of ISO 14001 should not deafen us to the challenges, ISO Management Systems*, January/February, 2002, 15-16, available at [http://www.iso.org/iso/en/iso9000-14000/addressources/articles/pdf/viewpoint\\_1-02.pdf](http://www.iso.org/iso/en/iso9000-14000/addressources/articles/pdf/viewpoint_1-02.pdf)

<sup>28</sup> See <http://www.iso.org/iso/en/prods-services/otherpubs/pdf/survey2004.pdf>, at p. 20.

<sup>29</sup> See <http://isotc.iso.org/livelink/livelink/fetch/2000/2122/830949/3934883/3935096/home.html?nodeid=4451259&vernum=0> (“The guidance standard will be published in 2008 as ISO 26000 and be voluntary to use. It will not include requirements and will thus not be a certification standard.

“There is a range of many different opinions as to the right approach ranging from strict legislation at one end to complete freedom at the other. We are looking for a golden middle way that promotes respect and responsibility based on known reference documents without stifling creativity and development.

“Our work will aim to encourage voluntary commitment to social responsibility and will lead to common guidance on concepts, definitions and methods of evaluation.

“The need for organizations in both public and private sectors to behave in a socially responsible way is becoming a generalized requirement of society. It is shared by the stakeholder groups that are participating in the WG SR [Working Group on Social Responsibility] to develop ISO 26000: industry, government, labour, consumers, nongovernmental organizations and others, in addition to geographical and gender-based balance.

“ISO has chosen [SIS](#), Swedish Standards Institute and [ABNT](#), Brazilian Association of Technical Standards to provide the joint leadership of the ISO WG SR. The WG SR has been given the task of drafting an International Standard for social responsibility that will be published in 2008 as ISO 26000.”

## B. *An overview of assurance organizations*

In the past ten to fifteen years, as numerous corporations, NGOs, and other organizations have developed codes of practice for various industries, firms that have long been in the business of inspecting the quality, weight, and quantity of traded goods – especially those that evaluate and certify conformance with ISO standards – have quickly expanded to offer their services in auditing and certifying that firm operations satisfy other codes of practice. Firms such as SGS, Intertek, DNV (Det Norske Veritas), BVQI, RINA (Registro Italiano Navale), and the TÜVs (Technischer Überwachungsverein) have all been in business as inspectors of goods and ships in international trade since before 1900. They all operate globally and have had a quasi-official status as inspectors for customs officials or government agencies regulating products moving in international markets. All have recently expanded their business to do audits and inspections to verify compliance with social responsibility standards.<sup>30</sup>

In addition, dozens of new firms have entered the business as certification bodies, including firms like Cal Safety Compliance Corp. (CSCC), ALGI, and Hong Kong Quality Assurance Agency (HKQAA). CSCC, for example, is a division of Specialized Technology Resources, Inc. in Los Angeles. It was established in 1991 to provide social responsibility auditing services, initially in the garment sector and now in a broad range

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<sup>30</sup> BVQI was formed in 1988 in response to the demand for the independent certification of ISO 9000 Quality Management Systems, primarily providing management systems certification, product certification, and service certification. See <http://www.bvqi.com/>. DNV, established in 1864, primarily focuses on risk management certification and consulting, in particular for maritime, oil and gas, process and transportation industries. See <http://www.dnv.com/>. Intertek can be traced to three separate companies in 1885, including Thomas Edison's Lamp Testing Bureau. It initially provided maritime surveying and testing of electrical equipment; it now provides testing services and risk management for a wide range of businesses. See <http://www.intertek.com/>. RINA (Registro Italiano Navale), a company established in 1861 in Genova, has been providing ship classification and certification services since its establishment. See <http://www.rina.it/>. SGS, originally founded in 1878 in Rouen as a French grain shipment inspection house and later registered in Geneva in 1919, provides inspection services of traded goods, product testing services, and certification services for products, systems or services. See [www.sgs.com/](http://www.sgs.com/).

of industries including home furnishings, food and agriculture, cosmetics, toys, and high-tech products, and has operations in more than 110 countries. Similarly, ALGI, headquartered in Nyack, NY, was founded in 1994 by several former Department of Labor officials to do social accountability auditing. TransFair USA was launched in 1998 and began "fair trade" certification of coffee purchased from developing countries in 1999. It has since expanded to certification of other food products. HKQA was established in 1989 by the Hong Kong government to do social compliance audits.

*C. The "professionalization" of the inspection industry.*

The assurance business is itself largely unregulated, and there are no well-established and well-accepted training procedures or professional standards for those who "audit" non-financial performance indicators. Yet, by its nature it is a business that is rife with potential for abuse. This is because, as is true for financial audits, inspections and evaluations of systems and operating practices are usually arranged and purchased by a supplier company in order to provide assurance to a purchasing company that the supplier has met contract terms, or complied with certain norms and standards. And, as is true in the business of providing financial audits, individual auditors might have incentives to accept payoffs in exchange for approval by the auditors. Likewise, the client firms whose facilities are being audited might have incentives to offer such payoffs if it is cheaper for them to make the side payments than it is to comply with the codes or standards. Indeed, factory owners in developing countries who are being asked by their developed-country customers to subject themselves to audit, frequently complain that the demands for audits are a form of extortion.<sup>31</sup>

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<sup>31</sup> See, e.g., Dexter Roberts, Pete Engardio, Aaron Bernstein, Stanley Holmes, & Xiang Ji, *Secrets, Lies, and Sweatshops*, BUS. WK., Nov. 27, 2006, at 42 (Opening paragraphs tell the story of Tang Yinghong, a

Suppliers of financial auditing services long ago figured out that there are two basic mechanisms for addressing this problem: professionalization of the providers of the service, and investments by the providers in reputations for honesty. Professional accountants are now required to go through formal training and licensing by organizations representing accountants, and they typically organize themselves into large, high-visibility firms with substantial interest in maintaining a reputation for honesty, independence, and competence. Those firms, in turn, have incentives to see to it that their auditors are competent, disciplined and behave in professional ways.

These things are only beginning to happen in the nonfinancial assurance business. Although the leading international firms in the business, such as SGS, Intertek, DNV, BVQI, RINA, and the TÜVs, mentioned above, have substantial reputational capital at risk, many smaller, newer assurance firms are in the business that may not yet have established reputations. Moreover, there is only one significant professional organization that offers any standardization and assurance of the assurance professionals themselves. This is the International Register of Certificated Auditors (IRCA), a UK organization based in London that was founded in 1984 as part of a UK government initiative to establish and certify quality standards.<sup>32</sup> IRCA certifies auditors of management systems, and approves training organizations and certifies their auditor training courses, and claims to have certified more than 13,750 auditors in over 120 countries worldwide.<sup>33</sup> Generally, however, there is “very little oversight” over the assurance industry.<sup>34</sup>

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manager at a Chinese factory that was due to be inspected for Wal-Mart, when an alleged inspector from an organization calling itself “Shanghai Corporate Responsibility Management & Consulting Co. called the manager and said that “for a \$5000 fee, he’d take care of Tang’s Wal-Mart problem. ‘He promised us he could definitely get us a pass for the audit,’ Tang said.”)

<sup>32</sup> See <http://www.irca.org/about/> (last visited March 9, 2007).

<sup>33</sup> Id.

<sup>34</sup> Wood, *supra* note 22, at 199 n. 173.

## **II. Factors causing a rapid growth in demand for third party assurance services.**

A number of different factors seem to be at work that, together, are driving the extraordinary growth in demand for assurance services, and in the supply of businesses that are offering their services as inspectors and auditors to meet this demand.

*A. The rapid opening of international markets in the last two decades, accompanied by increased reliance on outsourcing, the lengthening of supply chains, and the extension of supply chains into all parts of the globe.*

Other scholars have written at length about the growth in international commerce in the last few decades,<sup>35</sup> and the extent to which corporations in developed countries now contract with developing country firms for parts manufacturing, assembly, testing, and even sales (e.g., call centers) and record-keeping.<sup>36</sup> When products are made in factories owned by, and under the immediate supervision of managerial employees of a large firm, that firm can directly implement its own quality, timely delivery, labor, and environmental operating norms and standards. When the same firm contracts with a factory owner in Bangladesh, or Vietnam, or Costa Rica to make the products, the parties to the contract will probably need to develop alternative mechanisms, other than direct managerial control, to make certain that the products are still made according to the hiring firm's specifications (both as to product characteristics and quality, and as to the

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<sup>35</sup> The international trade literature in particular tracks this growth. *See e.g.*, International Monetary Fund and World Bank, *Market Access for Developing Countries' Exports*, (2001) (discussing the international trade growth from 1960s to 2000), available at <http://www.imf.org/external/np/madc/eng/042701.htm>; OECD, *OECD Statistics on International Trade in Services: Detailed by Partner Country 2000-2003* (2006).

<sup>36</sup> *See, e.g.*, George S. Geis, *Business Outsourcing and the Agency Cost Problem*, working draft dated Aug. 6, 2006, available at <http://www.ssrn.org> (last visited Feb. 14, 2007); Steve Lohr, *Outsourcing Is Climbing Skills Ladder*, N.Y. TIMES, Feb.16, 2006.

processes used). These mechanisms may range from the hiring firm having its own inspectors in the contractor's plant at all times, to having third party inspectors check the plant's operations from time to time, to relying solely on inspection of the final product at the time the hiring firm takes possession of it. This last mechanism may be widely-used for simple commodity-type products made in uncontroversial ways. But, as we discuss below, such products represent a decreasing share of total trade.

*B. The growing complexity of products and increased division of labor within supply chains.*

More of the products being exchanged between firms in international markets are intermediate products that must meet strict specifications as inputs or components of other products, or are made utilizing processes that are controversial (e.g., strip mining, farming with patented seeds and fertilizers and pest control chemicals, or labor-intensive assembly potentially involving sweatshop conditions or child labor).<sup>37</sup> It is common, for example, for products to be designed in one country, components to be purchased from suppliers in other countries, assembly work done in yet another country, all for shipment to markets in a number of other countries.<sup>38</sup>

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<sup>37</sup> See FRAGMENTATION: NEW PRODUCTION PATTERNS IN THE WORLD ECONOMY (Sven W. Arndt & Henryk Kierzkowski, eds) (2001). For a thoughtful analysis of various controversies involving the processes by which products are made and the implications of those controversies for various bodies of law (such as international trade law; domestic environmental, health and safety regulations; and constitutional analysis of companies' statements about how their products are made), see Douglas A. Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. 525 (2004).

<sup>38</sup> See Grossman & Helpman, *supra* note 13, at 136. Quoting an example from the 1998 Annual Report of the WTO concerning the production of a particular "American" car, Grossman and Helpman state: Thirty per cent of the car's value goes to Korea for assembly, 17.5% to Japan for components and advanced technology, 7.5% to Germany for design, 4% to Taiwan and Singapore for minor parts, 2.5% to the United Kingdom for advertising and marketing services and 1.5% to Ireland for data processing. This means that only 37% of the production value ...is generated in the United States (p.36)).

At each step of the way, the corporations that are organizing all of this productive activity need to be able to control for quality, conformance to specifications, timely delivery of intermediate products to final assembly plants, and safety in both the manufacturing and use of the product. Throughout this process, inventories must be managed for cost-efficiency, and to provide required levels of customer service.<sup>39</sup> For such products, the purchasing company may have compelling reason to want to monitor steps in the production process in one way or another.

*C. The growing need by global corporations for assurance that firms they are contracting with can meet requirements for quality, and timely delivery.*

The surge in demand from global corporations for third party assurance has grown out of the need on the part of global buyers to be sure that, if they were going to outsource an activity to smaller, less-experienced firms in distant countries, those firms could meet quality standards and timely delivery commitments. That need was the impetus for the development of the ISO 9000 standards for assuring that organizations could meet product quality expectations, discussed above.<sup>40</sup>

The growth of the third-party assurance industry based on ISO standard-setting was further fueled by developments in the regulation of international trade. Efforts in Europe to facilitate intra-European trade by harmonizing regulatory requirements initially emphasized compliance with European technical standards as a necessary condition for selling any goods in Europe.<sup>41</sup> Thus, the standards developed by the European standard-setting agency, the Comite Europeen de Normalization (CEN), were

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<sup>39</sup> See e.g., PHILIP B. SCHARY AND TAGE SKJOTT-LARSEN, *MANAGING THE GLOBAL SUPPLY CHAIN* (1998); BIRGIT DAM JESPERSEN, TAGE SKJOTT-LARSEN, *SUPPLY CHAIN MANAGEMENT: IN THEORY AND PRACTICE* (2005); JAMES B. AYRES, *HANDBOOK OF SUPPLY CHAIN MANAGEMENT* (2001).

<sup>40</sup> Since the publication of the original ISO 9000 standards, subsequent updates have been published as ISO 9001,9002, and so forth.

<sup>41</sup> See Roht-Arriaza, *supra* note 17, at 492.

applied to any goods sold in Europe. This led non-European companies to argue that technical and other standards, such as for quality and product safety, should be developed by the international standard-setting process of the ISO, rather than through a European process.<sup>42</sup> That position was persuasive to negotiators developing the GATT 1994/WTO Agreement on Technical Barriers to Trade, which thus provides that where international standards for technical requirements exist, member states should use those standards as the basis for their own technical requirements.<sup>43</sup> As a consequence, ISO certification became necessary for a growing number of products, and as ISO standards expanded beyond technical specifications to quality and environmental management systems, a “huge industry of auditors, certifiers and accreditation bodies has emerged to serve these expanding certification needs.”<sup>44</sup>

*D. The growing need by global corporations for assurance that firms they are contracting with can meet requirements for workplace safety, acceptable labor and human rights performance, and acceptable environmental standards, as well as quality and on-time delivery.*

In the last decade, for reasons we discuss below, many global corporations have begun seeking assurance that firms they do business with can meet social and environmental standards, in addition to technical and quality standards.<sup>45</sup> This focus on

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<sup>42</sup> *See id.*

<sup>43</sup> *See id.* at 494-95, *citing* the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement on Technical Barriers to Trade, . Apr. 15, 1994, art. 2.4, *reprinted in* H.R. Doc. No. 316, 103d Cong., 2d Sess. 1428 (1994).

<sup>44</sup> Wood, *supra* note 22, at 261. Prof. Wood includes companies’ interests in demonstrating conformance with various voluntary codes of environmental performance and negotiated standards involving governments and polluters; as well as ISO 14001 environmental management systems, as having provided the impetus for the rapid expansion of the “huge industry” of third-party certifiers, auditors and accreditation bodies.

<sup>45</sup> One indication of the new attention by business firms to social and environmental performance is the publication in early 2007 of the first edition of the CSR PROFESSIONAL SERVICES DIRECTORY, which lists 443 organizations worldwide under 49 different service categories, with contact details and summaries of

social and environmental standards is being driven partly by pressure on companies by some investors. Certain sectors of the investment community, such as public pension funds and self-described “SRI investors” (for “socially responsible investors”) in the EU, UK and US, and insurance investors in the UK, are increasingly looking at the social and environmental performance of their portfolio companies and those companies’ trading partners in an attempt to identify risks associated with the portfolio firms as well as their trading partners out in the supply chain.<sup>46</sup> This development, in turn, is causing corporations in developing countries that may be suppliers to more well-known global corporations to insist that their suppliers, in turn, also meet certain standards.

In this way, multinational firms may be drawing more small and local firms in more countries into their orbit. As this happens, we are observing a movement toward global standard setting and the associated use of third-party assurance firms to certify that standards are being met, even by supplier firms that still operate and sell primarily in their home country.<sup>47</sup> As we discuss at greater length below, we suspect this chain of

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the services they offer to assist corporations in meeting so-called “corporate social responsibility” (CSR) norms and standards. See <http://www.ethicalperformance.com/csrdirectory/index.php?PHPSESSID=c78e0151641014186bd7a2fa9d305c49> (last visited Jan. 19, 2007).

<sup>46</sup> See, e.g., Daniel Brooksbank, *Norwegian Government Fund Excludes Wal-Mart*, IPE.com, June 6, 2006 (Reporting on announcement by Norwegian Government Pension Fund that it had divested its holdings in Wal-Mart on the grounds that the fund would “incur an unacceptable risk of contributing to serious or systematic violations of human rights by maintaining its investments in the company.”). Another example is the Association of British Insurers in London, which represents 94% of UK insurers. Insurance companies in the UK offer savings and investment products in addition to insurance, and control 17% of all UK company publicly-listed equity. See [http://www.abi.org.uk/BookShop/ResearchReports/Key%20facts%202005\\_LR.pdf](http://www.abi.org.uk/BookShop/ResearchReports/Key%20facts%202005_LR.pdf) (last visited Feb. 14, 2007) The ABI published guidelines in 2002, 2005, and 2007 identifying the kinds of social and environmental management systems and factual disclosure that its members expect to see discussed on an annual basis so that, as investors, they can mitigate the risks in their investment portfolios. See text accompanying notes 73-75, *infra*.

<sup>47</sup> Suzanne Konzelmann, Frank Wilkinson, Charles Craypo and Rabih Aridi, *The Export of National Varieties of Capitalism: The Cases of Wal-Mart and IKEA*, Centre for Business Research, University of Cambridge, Working Paper No. 314, September, 2005, at 18, argue that IKEA, for example, is transferring its standards for quality, efficiency, and socially responsible behavior “globally to the mutual benefit of all the system’s stakeholder groups” by implementing its “IKEA Way on Purchasing Home Furnishing Products (IWAY) throughout its global supply chain.” To implement its standards, “IKEA contracts with

events is becoming an important mechanism by which developed-country business standards and norms are being propagated worldwide.<sup>48</sup>

1. *Recognition of the risks to global brands from problems in the supply chains.*

Global corporations are also more inclined in the last two decades to insist that suppliers, as well as their own facilities, meet certain social standards because they recognize that each link in the supply chain potentially exposes the whole operation to risks associated with that link.

The experience of companies in the chemical industry (especially companies operating in Canada), illustrate the pattern. Canadian chemical firms recognized as long ago as 1983 that risks in the handling of hazardous wastes in foreign operations can affect reputation and profitability of their worldwide organizations. To address these risks, a group of chemical companies led by Dow Canada and the Canadian Chemical Producers Association (CCPA), with encouragement from the Canadian government, agreed to develop a set of safe operating principles.<sup>49</sup> The 1984 explosion of a Union Carbide plant in Bhopal, India, accelerated the development and adoption of these principles, which

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independent auditors to inspect and monitor all suppliers with whom the company does business on an ongoing basis,” according to Konzelmann, et. al., at 19.

<sup>48</sup> British Petroleum and Shell, for example, are imposing requirements on smaller companies that provide maritime services to raise their standards for health, environment and safety and to secure certification of having met those higher standards. Interview with Anne-Maree O’Connor, Core Ratings (Member of the DNV Group), London, June 26, 2006 (notes on file with authors). See also Michael P. Vandenberg, *The Wal-Mart Effect: The Role of Private Contracting in Global Governance*, Vanderbilt University Law School Working Paper (2006), available at <http://www.ssrn.org>.

That supply chain pressures can affect the standards of conduct expected of companies is consistent with the legal transplant literature. See, e.g., Johnathan M. Miller, *A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process*, 51 AM. J. COMP. L. 839 (2003)(categorizing types of legal transplants; one of which is the externally-dictated transplant; where a foreign individual or entity may require adoption of certain laws as a condition for doing business).

<sup>49</sup> See J. Arthur O’Conner, *Responsible Care: Doing the Right Thing, Canada’s Chemical Producers: Chemistry – a part of everyday life/Responsible Care*, [http://www.ccpa.ca/files/Library/Documents/RC/Doing\\_the\\_Right\\_Thing\\_history\\_of\\_RC.doc](http://www.ccpa.ca/files/Library/Documents/RC/Doing_the_Right_Thing_history_of_RC.doc) (last visited June 22, 2006).

came to be called the Responsible Care Initiative (RCI), as other chemical companies joined the initiative in an effort to improve the industry's reputation.<sup>50</sup>

The initiative originally included six standards for safe practice in chemical production, transport and control.<sup>51</sup> Although the standards had been adopted by numerous chemical companies by 1988,<sup>52</sup> by 1993, chemical firms were learning, as Responsible Care executive Brian Wastle explained to us, that the mere fact that "CEOs stated they had met their commitment meant nothing to an untrusting public."<sup>53</sup> So the standards were expanded to include provision for verification and ongoing improvement of performance.<sup>54</sup>

Responsible Care executive Wastle reports that the standards now require that "teams of industry experts, public advocates and local citizens," review each company every three years, and "write a consensus report summarizing the verification process and players, opportunities for improvement, findings, required corrective action and successful practices," with verification certificates awarded once the work is completed.<sup>55</sup>

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<sup>50</sup> See Jean M. Bélanger, *Responsible Care in Canada: The Evolution of an Ethic and a Commitment*, 27 CHEM. INT'L. 2, March-April, 2005, [http://www.iupac.org/publications/ci/2005/2702/1\\_belanger.html](http://www.iupac.org/publications/ci/2005/2702/1_belanger.html) (last visited June 22, 2006).

<sup>51</sup> The six categories of the original standards included 1) Community awareness and emergency response; 2) Research and development; 3) Manufacturing; 4) Transportation; 5) Distribution; and 6) Hazardous waste management. See Canada's Chemical Producers: Chemistry – a part of everyday life/Responsible Care, <http://www.ccpa.ca/ResponsibleCare/> (last visited June 22, 2006).

<sup>52</sup> Chemical companies that were part of the original Responsible Care Initiative include Dow Chemical Canada, ICI subsidiary CIL, Union Carbide Canada, Imperial Oil Chemicals, H.L. Blachford, Rhone-Poulenc Canada, Ethyl Canada, Rohm & Haas Canada, Hoescht Celanese, General Chemical, Allied Chemicals, Shell (chemical division), Cyanamide Canada, and Polysar. Email from Brian Wastle, Vice President, Responsible Care®, Canadian Chemical Producers' Association, Ottawa Ontario, June 22, 2006.

<sup>53</sup> *Id.*

<sup>54</sup> Under the heading "Other Aspects of Responsible Care," the RC code now includes the following: "The ultimate test of Responsible Care is whether it delivers improved performance. On an ongoing basis, CCPA member companies must track, improve and report to their publics how they are performing in all the aspects of health, safety, environmental and social performance that are important to those publics. CCPA collects, collates and publishes data from all companies that our critics have told us they are particularly interested in. These include chemical emissions and wastes, with five-year projections, employee injuries and illnesses, chemical process spills and fires and transportation accidents." *Id.*

<sup>55</sup> *Id.*

Similarly, firms that use highly labor-intensive manufacturing and assembly processes, such as apparel and toy manufacturers, have responded to media attacks on firms whose products were allegedly made in "sweatshop" conditions<sup>56</sup> by developing codes of practice for their own factories and for supplier factories. But these firms have also learned that announcing codes of practice is not sufficient to solve the problem<sup>57</sup> – they must also develop implementation strategies and arrange for inspection and certification to be sure the codes are in fact implemented.

To enhance brand protection by tackling the implementation problem in one industry, for example, a group of corporations in the apparel and “sewn products” industries, together with industry trade associations,<sup>58</sup> provided seed money and technical support to form a third-party standard-setting organization called WRAP (Worldwide Responsible Apparel Production) in the late 1990s, with the goal of establishing worker

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<sup>56</sup> The iconic examples here include the negative publicity in the late 1990’s surrounding sweatshop working conditions in manufacturing plants making Nike products and Kathy Lee Gifford brand apparel for Wal-Mart. See Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1285-86 & fns. 441-3 (1999) (discussing press concerning Nike and Kathy Lee Gifford examples). See also KARL SCHOENBERGER, *LEVI’S CHILDREN: COMING TO TERMS WITH HUMAN RIGHTS IN THE GLOBAL MARKETPLACE* 58-65 (2000) (discussing sweatshop allegations concerning Nike, Kathy Lee Gifford and Wal-Mart and the resulting negative press).

<sup>57</sup> Wal-Mart has posted 10 "Guiding Ethical Principles" on its website, and states that it periodically inspects its factories for implementation, and yet continues to come under fire for tolerating poor working conditions in supplier factories. See, e.g., Konzelmann, et.al., *supra* note 47, at 21-22 (reporting on studies of Wal-Mart’s labor practices, state-level sanctions for “repeated violations of child safety ordinances, wage and hour regulations and anti-discrimination mandates,” and lawsuits alleging wide-spread practice of forced “off-the-clock” work). See also Brooksbank, *supra* note 46 (expressing the Norwegian Government Pension Fund’s view that continued investment in WalMart would “contribute to serious or systematic violations of human rights”); and Steven Greenhouse and Michael Barbaro, *An Ugly Side of Free Trade: Sweatshops in Jordan*, N. Y. TIMES, May 3, 2006, at C1 (reporting on a study by the National Labor Committee finding substandard conditions and abuse of employees at more than 25 out of 100 apparel factories in Jordan, including factories that supply Wal-Mart and Jones Apparel). Immediately after the National Labor Committee study findings were released Democrats in Congress pledged to introduce legislation to prohibit import or sale of goods made under conditions that violate core International Labor Organization worker rights standards, illustrating one of the risks global corporations face if they do not successfully enforce adequate labor practices at factories from which they buy product. See Kristi Ellis, *House Democrats Ask Bush to Investigate Jordan Abuse*, WWD.COM, May 4, 2006.

<sup>58</sup> In 1998, several prominent U.S. apparel producers approached the American Apparel Manufacturers Association (which subsequently merged with the Footwear Industries of American and the Fashion Association to form the American Apparel and Footwear Association) to work collaboratively to develop and implement labor, health, safety and environmental standards at the factory level. See WRAP website at <http://www.wrapapparel.org/> (last visited June 21, 2006).

safety and human rights performance standards to be applied at the factory level, and to implement inspection and certification procedures.<sup>59</sup> WRAP is now formally an independent non-profit organization, governed by a board of directors of which, by the organization's bylaws, more than half must be unaffiliated with the apparel industry.<sup>60</sup> Factory certification by WRAP requires that the facilities meet initial standards, as certified by an approved independent monitor, and be subject to unannounced audits, and annual renewal.<sup>61</sup>

The awareness of supply-chain risks is amplified by recognition on the part of corporations and their investors that a large share of the economic value that firms create is tied to their "brand value."<sup>62</sup> But, as discussed above, brand value is only as good as its weakest link because expansion in international travel and communications makes it harder for firms to hide their "dirty laundry." Wal-Mart, for example, has undertaken a massive public-relations campaign, including drawing attention to its new code of ethics, to attempt to respond to critics who charge that its suppliers violate international labor

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<sup>59</sup> The first result of the AAMA initiative was the twelve Worldwide Responsible Apparel Production Principles -- standards of labor practices, factory conditions, and environmental and customs compliance. The AAMA Board of Directors publicly endorsed these principles in 1998. For the next two years, the Association worked with producers, public interest groups, and development agencies to "design a process and develop an organization to monitor and certify factories for compliance—in hundreds of details—with the principles." Statement of AAMA Board of Directors, *available at*

<http://www.wrapapparel.org/modules.php?name=Congent&pa=whowpage&pid=26> (last visited June 21, 2006) The fruit of this work was the incorporation of WRAP in 2000 as a "501 [c] 6" organization. *Id.*

<sup>60</sup> See <http://www.wrapapparel.org/modules.php?name=Content&pa=showpage&pid=5>. One of us (Blair) has served as an independent board member of WRAP since 2005.

<sup>61</sup> The organization is working to obtain commitments from apparel firms and retailers that products that carry certain brands must be made in factories that are certified. Dara O'Rourke, Global Economic Governance Programme Working Paper 2005/16, Dept. of Politics and International Relations, Oxford University, describes and compares six major international programs that provide what he calls "non-governmental regulation" in the apparel and sewn products industries, including WRAP, Social Accountability International (SA8000) (discussed below), Fair Labor Association, Ethical Trading Initiative, Fair Wear Foundation, and Worker Rights Consortium.

<sup>62</sup> A 1999 study by Stanford economist Robert Hall found that less than one-third of the market value of corporate financial claims in that year could be attributed to the value of physical assets owned by corporations, suggesting that the rest of the value was tied to intangible assets such as brand value. See Robert E. Hall, *E-Capital: The Link between the Stock Market and the Labor Market in the 1990s*, Brookings Papers on Economic Activity, 2 (2000).

norms.<sup>63</sup> Although its code notably lacks both specifics about standards of treatment for workers, and enforcement mechanisms, Wal-Mart may very well not be the worst offender among U.S. retailers in its tolerance of labor abuses in supplier factories. But because of the high visibility of its brand, it is believed to be very influential in establishing industry norms, and hence may be targeted more intensely by NGOs and other activists than smaller, less well-known firms.

*2. The increasing sophistication of non-governmental organizations (NGOs), activists, and institutional investors in pressuring corporations to pay attention to environmental issues or human rights or labor concerns, and in publicizing failures in these areas.*

As corporations find themselves in the glare of the NGO spotlight for their social and environmental practices, a growing number of firms are looking for better ways to make sure they know what is actually happening out in their supply chains. Moreover, activists and investors are increasingly asking corporations to provide information about their social performance. This, in turn, has created demand for services of firms that can

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<sup>63</sup> Wal-Mart's website notes that its "Global Ethics Office" was established in June, 2004, and, on June 4, 2004, according to the website, "Wal-Mart released a revised Global Statement of Ethics to communicate our ethical standards to all Wal-Mart facilities and stakeholders. The Global Ethics Office provides guidance in making ethical decisions based on the Global Statement of Ethics and a process for anonymous reporting of suspected ethics violation. . . ." Wal-Mart's principles are:

1. Follow the law at all times.
2. Be honest and fair
3. Never manipulate, misrepresent, abuse or conceal information
4. Avoid conflicts of interest between work and personal affairs
5. Never discriminate against anyone
6. Never act unethically – even if someone else instructs you to do so
7. Never ask someone to act unethically
8. Seek assistance if you have questions about the Statement of Ethics or if you face an ethical dilemma
9. Cooperate with any investigation of a possible ethics violation
10. Report ethics violations or suspected violations

audit the quality of the non-financial information being produced. Some major accounting firms, such as KPMG and PricewaterhouseCoopers, have recently established global sustainability practice groups, for example, with the specialized expertise necessary to attest to environmental and social data.<sup>64</sup>

The activism of NGOs is accompanied by a proliferation of social and environmental responsibility standards over the past ten years,. These initiatives have been developed by states; public/private partnerships; multi-stakeholder negotiation processes; industries and companies; institutional investors; functional groups such as accountancy firms and social assurance consulting groups (many of which did not exist more than about five years ago); NGOs; and non-financial ratings agencies.<sup>65</sup>

One example (among many) is Social Accountability 8000 ("SA 8000"), a project of Social Accountability International. SA 8000 is an auditable certification standard based on international labor and human rights standards.<sup>66</sup> SA8000 also provides a social accountability management system to guide firms in implementing standards and to demonstrate ongoing conformance with the standards. In particular, to

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<sup>64</sup> See KPMG Sustainability Services, available at <http://www.kpmg.nl/site.asp?Id=40378> (last visited Feb. 5, 2007); Price Waterhouse/Coopers Sustainability Practice Website, available at <http://www.pwc.com/extweb/challenges.nsf/docid/58E92287890B5314852570980064ACC2> (last visited Feb. 5, 2007).

<sup>65</sup> The implications of these standards for theories of corporate governance, regulation, and economic development are profound, some of which one of the authors has explored in prior work. See John M. Conley & Cynthia A. Williams, *Engage, Embed and Embellish: The Theory and Practice of Corporate Social Responsibility*, 31 J. CORP. L. 1 (2005); Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORN. INT'L. J. J. 493(2005); Cynthia A. Williams, *Civil Society Initiatives and "Soft Law" in the Oil and Gas Industry*, 36 J. OF INT'L. L. & POLITICS 457 (2004).

<sup>66</sup> This standard is a voluntary, universal standard for companies interested in auditing and certifying labor practices in their facilities and those of their suppliers and vendors, based on the principles of international human rights norms as described in International Labour Organisation conventions, the United Nations Convention on the Rights of the Child and the Universal Declaration of Human Rights. It measures the performance of companies in eight key areas: child labor, forced labor, health and safety, free association and collective bargaining, discrimination, disciplinary practices, working hours and compensation. See Overview of SA8000, available at <http://www.sa-intl.org/index.cfm?fuseaction=Page.viewPage&pageId=473> (last visited August 10, 2006).

meet SA 8000 standards requires third-party certification of individual production facilities such as factories or farms, based upon an inspection by SAI-approved inspectors and other third party inspectors. Corporations that seek SA 8000 stamp of approval must stipulate in written purchase contracts with all suppliers that those suppliers conform to the SA 8000 standards.<sup>67</sup>

In addition to apparel and chemicals, discussed above, a number of other industries have promulgated voluntary corporate social responsibility standards that incorporate third-party certification that products being sold have been produced, harvested or extracted according to the standards, such as certification of conflict-free diamonds;<sup>68</sup> sustainable fisheries<sup>69</sup> and forestry;<sup>70</sup> and fair-trade goods such as coffee,

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<sup>67</sup> Social Accountability 8000: 2001, International Standards, *available at* <http://ce35.citysoft.com/index.cfm?fuseaction=document.showDocumentByID&nodeID=1&DocumentID=136> (last visited July 2, 2006).

<sup>68</sup> *See* The Kimberly Process, *available at* <http://www.kimberlyprocess.com:8080>. The Kimberly Process is a joint government, international diamond industry and civil society initiative to ensure that shipments of diamonds are free of “conflict diamonds” that have been sold to support wars in such countries as Angola, Cote d’Ivoire, the Democratic Republic of Congo and Sierra Leone. *Id.* The Kimberly Process Certification Scheme requires participating governments to implement import/export controls and systems to track diamonds from mining through export. Rough diamonds exported with a Kimberly Process Certificate must be in sealed containers, and participating countries must set up systems to ensure that rough diamonds cannot be exported except in sealed containers with Certificates. *See* [http://www.kimberlyprocess.com:8080/site/www\\_docs/related\\_docs1/kp\\_review\\_final\\_report\\_-\\_english\\_\(jan\\_31\).pdf](http://www.kimberlyprocess.com:8080/site/www_docs/related_docs1/kp_review_final_report_-_english_(jan_31).pdf) (last visited Feb. 13, 2007). All significant diamond producing and trading centers, with the exception of Liberia, are now operating within the framework of the Kimberly Process. *Id.* at 19. Review of the systems countries have implemented is delegated to multi-stakeholder teams composed of industry, government and civil society participants, with results being delivered to the Kimberly Process Working Group on Monitoring.

<sup>69</sup> *See, e.g.,* the Marine Stewardship Council certification process, *available at* <http://www.msc.org>: The Marine Stewardship Council is a global non-profit that has created an environmental standard for well-managed fisheries, according to which third-party certifiers can grant labels that assure that fish have been grown in well-managed fisheries, or caught according to environmentally sustainable principles. *See* [http://www.msc.org/html/content\\_462.htm](http://www.msc.org/html/content_462.htm) (last visited Feb. 16, 2007). As with many of the certification schemes for products, an important part of the certification is of “chain of custody” procedures that attempt to ensure the value of the certified label. *See id.* The third-party certifiers that have been accredited are Scientific Certification Systems, SGS Product and Process Certifiers, Moody Marine Ltd., and OIA.

<sup>70</sup> *See* Forest Stewardship Council: Principles and Criteria for Forest Stewardship, *available at* <http://www1.umn.edu/humanrts/links/fscprinciples.html>. The Forest Stewardship Council (FSC) is an international body composed of industry participants, transnational environmental NGOs and social justice NGOs, strongly influenced by international standard setting processes at the ISO, and which accredits organizations to certify timber and forest products as meeting the FSC standard for sustainable forest management. *See* Errol Meidinger, *The Administrative Law of Global Private-Public Regulation: the Case*

tea, cocoa and cotton.<sup>71</sup> Thousands of individual companies have adopted voluntary codes of conduct establishing their standards for responsible business behavior, and some companies then engage third-party certifiers to ensure that their suppliers and subsidiaries are meeting those codes.<sup>72</sup> The development of codes and standards and the increasing expectation that global firms take responsibility for implementing and enforcing these standards throughout their supply chains have greatly expanded the role of third-party assurance in global business, even though demand for quality, speed, timely-delivery and cost control may have provided the initial impetus for this expansion.

*E. The growing demands for transparency (as well as quality and social responsibility).*

Institutional investor networks are also asking for improved quality and quantity of information from their portfolio companies. Investors in the UK have been leaders in this development. In 2002, for example, the Association of British Insurers (“ABI”), which represents insurers that control 17% of stocks listed in the UK, issued its Disclosure Guidelines on Social Responsibility.<sup>73</sup> In those guidelines, which it updated in 2005 and 2007,<sup>74</sup> the ABI stated that it expects portfolio companies to provide information on an annual basis about how boards of directors evaluate and are addressing

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*of Forestry*, 17 EUR. J. OF INT’L L. 47, 51 (2006) (analysis of the competition between forestry certification regimes and implications for global governance). The FSC accredits certifying organizations, and there are currently 12 accredited certification organizations, including SGS, Eurocertifor, KPMG FSCI (Forest Certification Services Inc), Swiss Association for Quality and Managements Systems (SQS), Smartwood Program, and others. See *id.* at 74, citing [http://www.fscus.org/faqs/what\\_is\\_certification.php](http://www.fscus.org/faqs/what_is_certification.php)

<sup>71</sup> See [http://www.fairtrade.net/certification\\_mark.html](http://www.fairtrade.net/certification_mark.html) for an overview of the fair trade requirements.

<sup>72</sup> The University of Minnesota Law School, under the leadership of international human rights scholar Prof. David Weissbrodt, has an extensive collection of human rights materials on-line, including copies of hundreds of firms’ codes of conduct. See <http://www1.umn.edu/humanrts/business/sicc.html>.

<sup>73</sup> See <http://www.abi.org.uk/Newsreleases/viewNewsRelease.asp?nrid=3676>.

<sup>74</sup> See [http://www.politics.co.uk/press-releases/domestic-policy/environment/environment/abi-publishes-responsible-investment-disclosure-guidelines-\\$464874.htm](http://www.politics.co.uk/press-releases/domestic-policy/environment/environment/abi-publishes-responsible-investment-disclosure-guidelines-$464874.htm) (last visited Feb. 14, 2007).

environmental, social, and governance risks, in the context of the entire range of risks and opportunities facing the company.<sup>75</sup>

Climate change has become a particularly salient environmental risk that U.K. investor networks target in their disclosure requests. One example is the Carbon Disclosure Project (“CDP”), a process by a group now comprised of 284 British, European and American institutional investors, with \$41 trillion of money under management.<sup>76</sup> The CDP elicits information on an annual basis from companies worldwide about the financial risks to the companies from the physical effects of climate change or from regulatory efforts to mitigate those physical changes, and about company actions to manage and reduce greenhouse gas emissions.<sup>77</sup> In 2007, CDP sought information from 2,400 of the world’s largest quoted companies, by market capitalization, expanding its requests beyond the Global 500 to include the largest companies in various developed and rapidly developing markets, as well as the largest companies in transport and utilities. These pressures from institutional investors in the UK and Europe have been an important impetus for new requirements in those jurisdictions for companies to discuss future risks to the business from social, environmental and community matters in their Annual Reports.<sup>78</sup>

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<sup>75</sup> *See id.*

<sup>76</sup> *See* Carbon Disclosure Website and Reports, available at <http://www.cdproject.net>.

<sup>77</sup> *See* Carbon Disclosure Website and Reports, available at <http://www.cdproject.net>. In 2004, 70% of the Global 500 firms provided information that Innovest analyzed. (Innovest is a specialized investment research and advisement firm that analyzes firm-specific risk from social, environmental and strategic governance issues.).

<sup>78</sup> As of 2005, companies in Europe are required to include “a fair review of the development and performance of the company’s business and of its position, together with a description of the principal risks and uncertainties that it faces.” In addition, “to the extent necessary for an understanding of the company’s development, performance or position, the analysis shall include both financial and where appropriate, nonfinancial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.” Directive of Parliament 2003/51, art. 1, 14(a), 2003 O.J. (L 178), at 18. For a further discussion of these requirements, *see* Williams & Conley, *supra* note 65.

At the same time, firms and investors increasingly recognize that traditional financial measures fail to capture the value within companies from such intangible factors as employees' knowledge, training and development.<sup>79</sup> The recognition that such factors are important is driving a search by corporations, consultants, auditors and institutional investors for auditable non-financial metrics that can be used to measure and report on company performance in developing and protecting important intangible assets such as employee capabilities, brand, and reputation.

The pressure on companies to collect and disclose more relevant non-financial information, has been accompanied by pressure to have their approach to assembling such data subject to third-party review. In 2005, 52% of Global 250 companies issued non-financial, sustainability reports, including social, environmental and economic data,<sup>80</sup> and of these, 30% included independent, third-party assurance of the quality and accuracy of the underlying data.<sup>81</sup> Major accounting firms currently dominate the non-financial assurance and attestation market, issuing attestation statements [CHECK distinction between attestation and assurance] for 60% of those sustainability reports that are independently verified.<sup>82</sup>

Two global standards are under development for the assurance of non-financial reports. In March, 2003, the UK based AccountAbility organization issued AA 1000AS, which focuses on evaluating the materiality, completeness and responsiveness of a

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<sup>79</sup> See, e.g., Margaret M. Blair & Steven M.H. Wallman, *Unseen Wealth: Report of the Brookings Task Force on Intangibles*, Brookings, 2001; Baruch Lev, *Intangibles: Management, Measurement, and Reporting*, Brookings, 2001; Robert G. Eccles, et. al., *The Value Reporting Revolution*, 2001; Institute of Chartered Accountants in Australia, *Extended Performance Reporting: A Review of Empirical Studies*, 2006; and other studies documenting the growing importance of intangible assets in the value of corporate securities.

<sup>80</sup> See KPMG Global Sustainability Services, *KPMG International Survey of Corporate Responsibility Reporting, 2005(2005)*, available at <http://www.kpmg.com/NR/rdonlyres/66422F7F-35AD-4256-9BF8-F36FACCA9164/0/KPMGIntlCRSurvey2005.pdf> (last visited 7/3/2006).

<sup>81</sup> See *id.* at 5, 30.

<sup>82</sup> See *id.*

company's reporting to its various stakeholder groups.<sup>83</sup> In December, 2003, the International Federation of Accountants (IFAC)'s International Auditing and Assurance Standards Board (IAASB), which is the body responsible for issuing international accounting and auditing standards, issued guidance for accounting firms to use in order to guide their assurance work for non-financial reports.<sup>84</sup> This standard is applicable to any assurance work by accountants after January 1, 2005, and was needed, according to the IFAC, to meet the increasing demand for assurance reports on "[e]nvironmental, social and sustainability reports, information systems, internal control, corporate governance processes and compliance with grant conditions, contracts and regulations."<sup>85</sup>

### **III. An examination of these developments: China as a case study**

In both the short run, and possibly in the long run, the developments surveyed above point toward a rapidly developing shift in the sources of regulatory authority towards private standard setting,<sup>86</sup> and private enforcement through inspection, monitoring and certification services by third party assurance service organizations. The increasing reliance by global corporations on third party assurance services in lieu of either direct control of production in facilities owned by the corporations, or court enforcement of contracts entered into with locally-owned businesses, raises questions about how corporations may be influencing the development of law and legal institutions

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<sup>83</sup> See <http://www.accountability.org.uk/news/default.asp?id=158> for a description of AA 1000AS and related technical materials.

<sup>84</sup> See International Standard on Assurance Engagements (ISAE) 3000: Assurance Engagements other than Audits or Reviews of Historical Financial Information See IFAC Press Release, *IAASB Issues a New Framework and Standard for Assurance Engagement*, Jan.23, 2004, available at <http://www.ifac.org/News/LatestReleases.tmpl?NID=10748895832047605>.

<sup>85</sup> See *id.*

<sup>86</sup> See Nico Krisch & Benedict Kingsbury, *Introduction: Global Governance and Global Administrative Law in the International Legal Order*, 17 EUR. J. OF INT'L LAW 1 (2006).

in developing countries. It seems possible, for example, that when industries and civil society bypass government to develop standards and private mechanisms of enforcement, they implicitly demonstrate the benefits to a society from having clear legal rules and sophisticated, independent courts that can enforce those rules. This may help foster an interest on the part of middle class entrepreneurs and business people in rule of law institutions, thereby hastening their establishment in developing countries.

Business people who are under pressure to meet numerous different codes and standards may also begin to support regulation and enforcement by local governments to avoid multiple inspections and fees and possibly conflicting standards. Moreover, once some businesses are required to meet higher standards, they often find that it is in their interest that the same regulatory requirements be imposed on their *competitors*. For these reasons we might expect that widespread use of third party assurance services to help implement business norms and enforce contracts will hasten the movement toward rule of law.

On the other hand, to the extent that private-sector arrangements provide a satisfactory substitute for government-provided local legal institutions, they may take pressure off governments to build independent uncorrupted legal institutions, and thereby slow down the movement toward rule of law. For example, some critics of efforts by NGOs to act as watchdogs in enforcing agreements about labor protections in factories have argued that local governments are “ceding some of their sovereignty to consumers” and that NGOs may thereby “ultimately undermine traditional regulatory processes.”<sup>87</sup>

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<sup>87</sup> O’Rourke, *supra* note 61, at 13.

Whether we observe either outcome is likely to vary from country, to country. It may also vary as between enforcing contract terms having to do with quality and timely delivery, versus enforcing terms established to meet social performance expectations.<sup>88</sup>

We do not have clear answers to these questions yet, but a telling case is the debate currently under way among Chinese factory owners, their corporate customers from developed countries, human rights and labor advocates, and Chinese government officials about whether Chinese firms should accept standards imposed on them by outsiders and submit to private third-party inspectors to ensure those standards are met. China's case is interesting because the emergence of a network of firms attempting to do inspection and certification work in China was initially driven by the demand by developed country apparel firms and retailers that supplier firms in China meet social standards, especially for workplace safety and fair labor practices. But it is now rapidly spreading to other industries, and, more importantly, the Chinese appear to be trying to take responsibility themselves for creating social standards and for certifying that factories meet those standards.

The story of China's amazing rush to industrialize and compete in the global economy in the last two decades is now fairly well known. China began opening up its markets and encouraging production of goods for foreign markets in the 1980s, and by the mid- to late-1990s had become one of the world's largest suppliers of textile and apparel products, toys, and other labor-intensive, relatively low-technology products.<sup>89</sup> Early on in this process, little attention was paid either by Chinese factory managers or by

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<sup>88</sup> The latter may also be imposed on local firm suppliers through compliance clauses in contracts with global customers.

<sup>89</sup> It was also rapidly becoming a supplier of more technologically-intensive products, but apparel products and toys were the first industries where global corporations began trying to impose social responsibility requirements on the Chinese suppliers.

their global customers to *how* such products were made. Buyers were focused mainly on price, delivery speed, quality, and reliability. These are factors that buyers can observe for themselves with simple goods like apparel and toys, and they consequently did not worry about the conditions under which the products were being made.

By the early 1990s, however, the international press began writing stories about the appalling conditions in factories where branded products were being made.<sup>90</sup> By 1995 and 1996, a few high-visibility corporations, including Nike, The Gap, and Kathy Lee Gifford's apparel line for Wal-Mart, were being targeted relentlessly by news reports and social activists for operating sweatshops in developing countries. In response, some firms adopted their own codes of practice for their vendors.<sup>91</sup> But that didn't end the drumbeat of bad publicity, so the industry began working with NGOs, labor organizations and other groups to develop codes of best practice and to figure out how to get their supplier firms to implement them. (See discussion above in Section II (D)) The SA 8000 standards were among the first such codes,<sup>92</sup> Since 2000, numerous international companies that have Chinese factories in their supply chains have been attempting to require that the Chinese factories meet a variety of social responsibility standards,

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<sup>90</sup> See e.g. Philip Shenon, *Made in the U.S.A.? Hard Labor on a Pacific Island/A Special Report: Saipan Sweatshops are No American Dream*, N.Y. Times, July 18, 1993 (describing sweatshop practices at factories that supplied Arrow, Liz Claiborne, The Gap, Montgomery Ward, Geoffrey Been, Eddie Bauer, and Levi Strauss).

<sup>91</sup> Levi Strauss adopted "Global Sourcing Guidelines" in 1992; Reebok adopted "Human Rights Protection Standards" and Wal-Mart published Standards for Vender Partners in 1993, The Gap first adopted a Code of Vender Conduct in 1993. See Schoenberger, *supra* note 56, at 58-65.

<sup>92</sup> This code was actually developed by the Council on Economic Priorities Accreditation Association (CEPAA) in 1997, but CEPAA changed its name to Social Accountability International in 2000, and the code has since been called SA 8000. See Overview of SA 8000 on the website of SAI, available at <http://www.sa-intl.org/index.cfm?fuseaction=Page.viewPage&pageId=473>.

including SA 8000, WRAP, and ICTII (toy manufacturers) and some codes developed internally by certain large buyers.<sup>93</sup>

Just telling factories that they must meet certain standards does not make it happen in practice, however.<sup>94</sup> The mechanism that global customers have used to pressure supplier factories to meet standards is the requirement in their contracts with Chinese companies that the factories be inspected and certified either by inspectors from the buyer corporation, or by third party inspectors and certifiers.<sup>95</sup>

The initial reaction of Chinese manufacturing companies (as well as some Chinese scholars, policy analysts and businessmen) to customer pressures to meet social standards such as SA8000 was surprise, hostility to the standards, and panic because meeting the standards would require higher costs and make it more difficult, factory owners believed, for Chinese firms to win contracts with big buyers.<sup>96</sup> Some went so far

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<sup>93</sup> One article in a Chinese publication estimates that eighty percent of the 95 surveyed export factories in southeast China have experienced various forms of factory inspection demanded by their western clients. See Shenzhen Ni Tui Xing Qi Ye She Hui Ze Ren Ren Zheng [Shenzhen Is Planning To Carry Out CSR Certification], available at <http://www.yfzs.gov.cn/gb/info/wtoyz/LTXX/2005-10/04/1137250995.html> (last visited June 13, 2006). This does not mean that these factories have all been subject to third party inspection and certification, though. As the Chinese suppliers reported in other surveys, many buyers conduct some kind of social inspections either by themselves or by independent auditors. As of September 30, 2005, only 106 Chinese companies had obtained SA8000 certification, while a survey conducted by researchers at Tsinghua University and supported by the Ford Foundation revealed that until 2002 there had been at least 8000 factories in the coastal area subject to some kind of social inspections by their buyers. This indicates that many social inspections are not formal third party inspections.

<sup>94</sup> Levi-Strauss, Reebok, Wal-Mart and the Gap have all had vendor codes of conduct since the early 1990s, see *supra* note 91, and yet adopting the codes and getting them implemented are different things.

<sup>95</sup> Wal-Mart, for example, claims that it requires that plants from which it buys products must submit to periodic inspections either by Wal-Mart employees, or by third-party inspectors. See <http://www.walmart.com/corporatesocialresponsibility> (last visited Mar. 15, 2007).

<sup>96</sup> The discussion of the controversy over factory inspection and corporate social responsibility in China is adapted from Li-Wen Lin, *Corporate Social Accountability Standards in the Global Supply Chain: Resistance, Reconsideration and Resolution in China*, U Illinois Law & Economics Research Paper No. LE06-018 (2006), available at SSRN: <http://ssrn.com/abstract=916929>. Ms. Lin's research has been supplemented and largely confirmed by internet-based research by research assistants Bixuan Wu, Lily Huang, and Tracy Dry Kane. Mr. Wu searched Chinese websites beginning with the phrase "Corporate Social Responsibility" in Chinese, and found more than 250,000 hits in late spring, 2006. See, e.g., <http://www.google.com/search?hl=en&lr=&rls=GGLG%2CGGLG%3A2006-05%2CGGLG%3Aen&q=%22%E4%BC%81%E4%B8%9A%E7%A4%BE%E4%BC%9A%E8%B4%A3>

as to charge that the requirement was a new form of non-tariff barrier,<sup>97</sup> a protectionist measure designed to “undercut competitiveness of developing countries.”<sup>98</sup> For reasons that aren't entirely clear, the SA8000 certification program has been the most controversial and in the last few years, in fact, has become a lightning rod for widespread resentment and distrust among owners and operators of Chinese facilities that are asked to meet the standards by their big-name global customers.

Chinese critics of social responsibility standards have further challenged the purpose of the SA8000 requirements on the grounds that few facilities in developed countries have been required to meet SA8000 standards, and that, while SA8000 requires that certified facilities must protect freedom of association, the rate of unionization in the United States, where SA8000 standards were developed, is very low.<sup>99</sup> And critics have expressed resentment about meeting SA8000 requirements because the SA8000 process is costly, often requiring that fees be paid to certification bodies not only for the certification itself, but for consulting assistance required to meet the standards. It is widely believed in China that the high consulting fees are products of the unregulated

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[%E4%BB%BB%22](#) (last visited July 3, 2006). As of July 3, Google found 230,000 entries under the search term "企业社会责任".

<sup>97</sup> See, e.g., *She hui zhe ren ren zheng kao yan Zhong Guo chu kou qi ye [Corporate Social Certification Challenges Chinese Exporting Companies]*, available at <http://www.nanfangdaily.com.cn/zm/20040624/jj/qz/200406240034.asp> (last visited June 13, 2006).

<sup>98</sup> *Zhongguo zu hao zhun bei ying tiao zhan [China Gets Ready to Take Challenges]*, People Daily [sic], 2004.10.22 (reporting that the U.S., EU and Japan will continue to use technical trade barriers, intellectual property rights and SA8000 to increase the China textile production costs and curtail China's competitiveness.); *Fa da guo jia wu qiang zing tui zing SA8000 biao zhun ren zheng [Developed Countries Want to Impose the SA8000 Certification]*, Market Post, 2004.5.14; *Zhen zheng de kao yan dao le [The Real Challenge Comes]*, People Daily (Overseas edition), 2004.1.02 (asserting that SA8000 is a non-tariff trade barrier).

<sup>99</sup> The U.S. Department of Labor's Bureau of Labor Statistics reported that 12.5 % of wage and salary workers were union members in 2005. See <http://www.bls.gov/news.release/union2.nr0.htm> (last visited Apr. 11, 2006)

certification markets.<sup>100</sup> Moreover, the unwillingness of buyer corporations to absorb the additional cost of meeting social standards, plus the lack of training and unprofessional behavior by auditors for the certifying firms, have led Chinese firms to believe that the certification process is not taken seriously by buyer firms, and, in practice, certification is more or less an extortion scheme, in which certifying organizations will certify manufacturing facilities that adequately pay off the certifier.<sup>101</sup> Not surprisingly, some Chinese suppliers have found ways to falsify their records and satisfy the auditors with superficial changes.<sup>102</sup>

Participants in the debate over SA 8000 in China have also charged that, while imposition of social accountability standards by multinational companies may please the customers of those companies, this amounts to "value imperialism" by western society.<sup>103</sup> Factories that supply products for China's domestic market are not being required to meet similar standards, they note. The reality behind this complaint, however, is more complicated. China's own labor protection laws are in fact very similar to the requirements of SA8000, though, in practice, they are typically not enforced for lack of

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<sup>100</sup> See Li You-Huan, *SA8000 wu Zhongguo qu ye she hui zhe ren jian she [SA8000 and the Construction of Chinese Corporate Social Responsibility]* 178 (2004), at 265 (reporting that a typical facility with 300 workers would have to pay the equivalent of \$6,000 for the certification, but more than \$60,000 once the consulting fees are added in. ). Note that SA8000 certifications are good for three years as long as no major violations are found during occasional inspections.

<sup>101</sup> Wang Lin, the Chief Technical Advisor to the ILO in China, complained that SAI is a consulting firm, setting up its own standards and then trying to sell them. See *Bei kua de le de SA8000 ren zheng [The Exaggerated SA8000 Certification]*, ECONOMIC OBSERVER, Aug. 9, 2004 No 172.

<sup>102</sup> See Tan Shen & Liu Kaiming ed., *Kua guo gong si de she hui ze ren yu Zhongguo she hui [Social Responsibility of Transnational Corporations & the Chinese Society]* 14 (2003), at 186, and Helle Bank Jørgensen et. al., *Strengthening Implementation of Corporate Social Responsibility in Global Supply Chains*, prepared for the Corporate Social Responsibility Practice in the Investment Climate Department of the World Bank Group, p. 20 (reporting that some apparel suppliers confessed that they skillfully had developed the art of seeming to be in compliance without making changes). See also *Secrets, Lies and Sweatshops*, BUS. WK. Nov. 27, 2006.

<sup>103</sup> See Lin, *supra* note 93.

resources and other factors.<sup>104</sup> By contrast, multinational firms with the help of the inspection/certification firms, can enforce the SA8000 requirements, by threatening to cancel orders if plants fail to meet standards as reported by the certifying firms.<sup>105</sup> This suggests that the multinational corporations who are insisting on third party inspection to enforce social norms in Chinese factories are, in fact, merely implementing standards that China's own leaders have articulated in Chinese law.

Moreover, recent developments in China suggest that resistance to the social performance standards implied by SA 8000 and other internationally imposed standards may be softening, that China may even be moving to embrace and implement such standards on their own. One surprising development is the fact that job growth in the industrial regions of China has actually exceeded the pace at which potential workers are

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<sup>104</sup> The contents of SA8000 are not very different from the requirements of China's labor law. SA8000 provides criteria for limiting child labor or forced labor, for health and safety standards, for freedom of association and rights to collective bargaining, prohibiting discrimination, identifying permissible discipline, defining working hours, compensation and management systems. Article 15 of the PRC Labor Law likewise prohibits hiring persons under the age of 16, while Articles 17 and 32(2) address forced labor. Article 52 requires employers to set up health and safety protections for employees. Article 7 states that employees have rights to participate and establish unions. Article 8 deals with collective bargaining. Article 12 bans discrimination. Article 36 requires that working hours not exceed 8 hours per day, or 44 hours per week. Article 41 requires that overtime hours not exceed 3 hours per day, or 36 hours per month. Articles 48 and 49 set forth minimum wages. Note that as to the working hours, SA8000 has a less strict standard (48 hours per week) than the Labor Law (44 hours per week). The differences between SA8000 and the Labor Law are therefore minimal, but SA8000 has more detailed implementation guidelines and the potential for actual enforcement. The inspections by local governments in China are perfunctory, however, and imprisonment for labor activism notorious. See Stephen F. Diamond, *The "Race to the Bottom" Returns: China's Challenge to the International Labor Movement*, 10 U.C. DAVIS INT'L L. & POL'Y 39 (2003); See also Li Li-Qing & Li Yan-Ling, *Qi ye she hui ze ren yan jiu [Studies on Enterprise's Social Accountability]* 229 (2005).

<sup>105</sup> There are frequent reports in Chinese media of orders from multinational companies being cancelled because of low wages, long working hours and poor working conditions. See, e.g., *Shehui zheren renzheng kauyan Zhongguo chukou qiye [Corporate Social Certification Challenges Chinese Exporting Companies]*, NANFANG DAILY, June 24, 2004 (reporting that a toy company having 4 factories and nearly 8000 workers in Shenzhen, lost business from its multinational buyers and closed down in 2002 because of wages below acceptable minima, long working hours and poor working conditions); *Qiye shehui zheren pinggu puo ju shashangli [Corporate Social Accountability Assessment Has Lethality]* (reporting that a shoe factory with about 500 workers in Zhongshan City of the Guangdong Provinces had orders cancelled by its buyers in September 2002, idling it for two months, because of non-compliance of the legal minimum wages requirement), available at <http://www.people.com.cn/GB/paper49/11305/1021009.html> (last visited August 12, 2006).

flowing into those regions from rural areas, creating some actual shortages of skilled or experienced labor in some areas.<sup>106</sup> The shortages are blamed in part on "low wages and poor working conditions,"<sup>107</sup> but may also be due to migration policies in China designed to slow the movement of people out of the countryside into the urban industrial centers.<sup>108</sup>

The second development is the growing unrest in China over the widening gap between rich and poor, between interior areas and coastal regions, as well as between urban and rural regions, and the dissatisfaction of lower-income groups over low pay and the appalling standards at factories that serve only domestic markets.<sup>109</sup> These two factors have led China's own working classes and intellectual elite to begin demanding that factories that serve only the domestic market should also be required to meet higher standards for safety and worker protection.<sup>110</sup>

In response to these problems, there has been a subtle change in attitude toward "corporate social responsibility" standards among scholars, officials, and the general public in China. For example, derogatory words such as "stick" (Da Bang), and "non-tariff barrier" are being used less frequently.<sup>111</sup> Moreover, the Chinese central

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<sup>106</sup> See David Barboza, *Sharp Labor Shortage in China May Lead to World Trade Shift*, N. Y. Times, April 3, 2006, at A1, and Report on Labor Shortage (2004), released by the Ministry of Labor and Social Security of China, available at <http://www.gd.lss.gov.cn/gb/molss/bzyw/news/view.asp?id=787>.

<sup>107</sup> See *supra* note 106, Report on Labor Shortage.

<sup>108</sup> See Xe Frank He, *Regulating Rural-Urban Migrants in Beijing: Institutional Conflict and Ineffective Campaigns*, 39 STAN. J. INT'L L. 177 (2003).

<sup>109</sup> See China's Parliament to Begin Annual Session, available at [http://news.xinhuanet.com/english/2005-03/03/content\\_2642667.htm](http://news.xinhuanet.com/english/2005-03/03/content_2642667.htm) (last visited June 13, 2006).

<sup>110</sup> See China Prime Minister Wen Jiabao's Government Work Report at the opening meeting of the annual session of the National People's Congress on March 5, 2007, the official Chinese full-text version available at [http://www.gov.cn/ztl/2006-03/15/content\\_227782.htm](http://www.gov.cn/ztl/2006-03/15/content_227782.htm) Cites.

<sup>111</sup> See e.g., Mei Yu Xiang Wo Tui SA8000 Da Bang, *San Jiao Kong Cheng Zhai Qu [The United States Wants to Use the Stick of SA8000, the Pearl Delta is Likely to be a Disaster Zone]*, available at <http://big5.china.com.cn/chinese/zhuanti/zgqy/925860.htm> (last visited June 13, 2006), and *Zhong Guo Qi Ye Zao Yu Yin Xin Mao Yi Bi Lei [Chinese Corporations Encountered Invisible Trade Barrier]*, available at <http://www.mie168.com/manage/2006-06/160439.htm> (last visited June 13, 2006).

government has explicitly endorsed a number of goals related to corporate social responsibility. In its Five Year Plan for National Economic & Social Development of the People's Republic of China adopted in March, 2006, by the National People's Congress, two of the twelve national priorities listed in the Plan relate directly to improving the standards of social responsibility to which Chinese firms are held. These are "building a socialist harmonious society," and "building a resource-conserving and environment-friendly society."<sup>112</sup> It has become widely accepted among scholars and officials that the implementation of socially responsible norms by business is an integral part of what the phrase building a "harmonious socialist society" means.<sup>113</sup>

China's new embrace of the idea of requiring socially responsible behavior by business firms, however, may not, in the long run, translate into more business for western inspection and certification services. Within the last year, the Chinese government in Beijing has authorized the Ministry of Commerce to work with seven other Chinese agencies to develop "corporate social responsibility" standards, and the

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<sup>112</sup> See *Report on the Implementation of the 2005 Plan for National Economic and Social Development And on the 2006 Draft Plan for National Economic and Social Development*, delivered at the Fourth Session of the 10th National People's Congress on March 5, 2006, ("III. Principal Tasks and Measures for Economic and Social Development in 2006. . . . 10. We will conscientiously work to resolve problems that affect the vital interests of the people and pay very close attention to safeguarding social stability. We will promote the building of a harmonious society, focusing on increasing employment, improving the social security system, distributing wealth more equitably and safeguarding social stability. -- 1) We will continue to follow a vigorous employment policy . . . . 2) We will speed up development of the social security system . . . . 3) We will make appropriate adjustments in income distribution . . . . 4) We will help needy urban and rural residents in their work and lives . . . . 5) We will further strengthen production safety management. . . . 6) We will safeguard and promote social stability . . . ."), available at <http://www.china.org.cn/english/2006lh/161917.htm> (last visited June 13, 2006).

<sup>113</sup> See *Qiang Hua Qi Ye She Hui Ze Ren Shi Jian He Xie She Hui De Zhong Yao Nei Rong [Strengthening of Corporate Social Responsibility is an Important Part of Building a Harmonious Society]*, available at <http://www.sa8000.org.cn/TNC/2186.html> (last visited June 13, 2006); *Gou Jian He Xie She Bi Xu Qiang Hua Qi Ye She Hui Ze Ren [To Build a Harmonious Society, Strengthening of Corporate Social Responsibility is a Must]*, available at <http://www.china.org.cn/chinese/zhuanti/gjhxsh/1054890.htm> (last visited June 13, 2006); *Lu Xing Qi Ye She Hui Ze Ren Cu Jin He Xie She Hui Jian She [Discharge Corporate Social Responsibility, Facilitate Building a Harmonious Society]*, available at <http://www.sa8000.org.cn/TNC/712.html> (last visited June 13, 2006).

China National Textile and Apparel Council has created the Committee for the Promotion of Corporate Social Accountability System for Chinese Textile Enterprises. This set of standards has been given the title "CSC9000T" (in obvious imitation of the "ISO9000" and "SA8000" models<sup>114</sup>), and bears a strong resemblance to standards developed by WRAP and SAI for apparel and textile manufacturing facilities. CSC9000T is defined as "a social responsibility management system based on the Chinese laws and regulations, international conventions and practices, as well as China's special needs."<sup>115</sup> A special committee, the Responsible Supply Chain Association, has been established by the China National Textile and Apparel Council (CNTAC) to promote the implementation of CSC9000T.<sup>116</sup>

Both the English and Chinese versions of the CSC9000T website make clear, though, that "[t]he CSC9000T is not intended for the purpose of audit and certification."<sup>117</sup> Instead of following the certification model developed in western countries, CSC9000T invents a so-called "third-party evaluation model" structured with Chinese characteristics. CSC9000T is described as a management model based on a "Plan-Do-Check-Act" system. "Check" means evaluating systems of production, identifying problems and finding solutions. The process is aided by third party evaluation organizations. The evaluation reports by the third party organizations are subject to the final approval by the Responsible Supply Chain Association (RSCA), which is a group of

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<sup>114</sup> According to the Chinese language version of the website regarding CSC 9000T, the numbering system for these corporate behavior and certification models is intended to imitate ISO14000.

<sup>115</sup> Information regarding CSC9000T is available at <http://www.CSC9000TT.org.cn/en/FAQ.asp?ID=80&More=2&ID2=99&More2=0&MoreLink=true&LID=8&i=2&EndList=11> (last visited June 13, 2006).

<sup>116</sup> *Id.*

<sup>117</sup> *See* <http://www.csc9000.org.cn/en/FAQ.asp?ID=80&More=2&ID2=99&More2=0&MoreLink=true&LID=10&i=2&EndList=11#6> (last visited Feb. 22, 2007)

companies doing business in China with a commitment to CSC9000T. Firms then develop plans to address problems identified in the evaluation, and their efforts to implement these plans will eventually be rated by the third party evaluation organization. The ratings are either defensive, complaint, managerial, strategic or civil. It is claimed by the CSC9000T that these ratings are basically the five stages of constructing corporate social responsibility. The evaluation reports and ratings will not be available to the public, however. According to the CSC9000T Principles, a firm can demonstrate its compliance with the CSC Principles to its stakeholders, buyers or other third parties by voluntarily disclosing the results of the evaluation, but that is not a required part of the process.

RSCA is, in principle, responsible for ensuring the independence of the so-called “third party evaluation organizations” by evaluating the capacity of the organizations, the training of evaluators, monitoring of the evaluation process conducted by the third party evaluation organizations and handling of disputes over ratings and reports. Currently there are 168 members of RSCA, including state-owned enterprises, joint ventures, wholly foreign enterprises, and Chinese firms, although most are domestic Chinese firms. There are two non-Chinese domestic companies – Hudson’s Bay Company, a large department store group in Canada; and Linmark Group, a Hong-Kong Based company – that have endorsed CSC9000T by being cooperative partners with RSCA.

Substantively, CSC9000T is more like ISO14000 than SA8000 with regard to the underlying philosophy being used. That is, the standards set forth in the CSC9000T are long-term goals or commitments rather than immediately applicable substantive standards. CSC9000T is a management tool to help a firm manage its social

responsibility risk, as well as improve its performance, rather than a standard by which to certify performance. The function of the CSC9000T is said to be to promote *continual improvement* in labor protection, without an explicit substantive end-point that has been defined. Procedurally, CSC9000T provides for “third party evaluation organizations,” but these organizations’ functions are limited and their independence is questionable. RSCA controls the process, from deciding the eligibility of evaluating organizations and monitoring the process of evaluations to approving the actual reports that the evaluators generate. Since the members of the RSCA are the same firms that are subject to CSC9000T evaluation – Chinese domestic companies – there is the obvious potential for conflicts of interest, and for the process to be used to promote the appearance but not the reality of improving labor and other social conditions. Moreover, since the evaluation reports and ratings will not be available to the public, the pressure from buyers in the supply chain may still be the only mechanism for ensuring these firms actually improve their labor standards. And, so far as we can tell, there are no global customers accepting CSC9000T evaluations instead of certification to SA8000, or WRAP, or to the customers’ codes of conduct.

What effect of CSC9000T will have on the development of law and norms in China is not yet known, of course, and it is too soon to be entirely confident about its likely effect. While CSC9000T does not, in principle, have the force of law, it may nonetheless be useful in helping local government officials develop the capacity to evaluate manufacturing facilities. To the extent that CSC9000T embodies the existing requirements of Chinese law, it would be appropriate for local governments to develop this capability. In fact, local government officials might well view the development of CSC9000T by the quasi-official National Textile and Apparel Council as encouragement

from China's central government for them to be more proactive in enforcing existing law. To the extent that such evaluations generate income (from inspection fees, for example, or perhaps from fines for violations of legal codes), local governments may have a financial incentive to become more proactive in enforcing labor law as written.

#### **IV. Theoretical and policy implications.**

This article bridges two previously distinct fields of law, one that has to do with the institutions and mechanisms by which private contracts are drafted and enforced, and the other which has to do with how corporate behavior is policed, especially in the international arena.

*A. The contractual role of third party assurance.* On the contract side, the role being played by third-party assurance in global commerce can be understood as a mechanism for solving a number of common contracting problems.<sup>118</sup>

First, we can think of the relationship between a manufacturing firm in a developing country and a global corporation that contracts to buy the output of the manufacturer as an “agency” relationship, in which the manufacturer is making specialized goods on behalf of the global corporation. In any agency relationship we would expect to find problems arising from “asymmetric information” (The agent has knowledge about his performance that the principal does not have.) and from misalignment of incentives (The agent doesn’t always have an incentive to perform in a way that is in the principal’s best interest.).

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<sup>118</sup> See, e.g., Oliver Hart and Bengt Holmstrom, *The Theory of Contracts*, Ch.3, at 88, in *ADVANCES IN ECONOMIC THEORY, FIFTH WORLD CONGRESS (1987)*(Truman F. Bewley, ed.)(“agency relationships create a demand for monitoring.”).

Employing third-party assurance services can help address both problems by monitoring the agent's activities on behalf of the principal. On one hand, using a third-party assurance service might increase agency costs by engaging yet another agent – with all the associated information asymmetry and incentive problems. On the other, the third-party assurance organization may in many instances have several monitoring advantages relative to the cost of the principal either doing its own monitoring or simply living with the discrepancy between what the global corporation wants and what the manufacturing firm actually does. Relying on the assurance firm may also save costs for the principal because they specialize in monitoring certain kinds of problems, and thereby bring certain expertise to bear in gathering and interpreting the necessary information.

Second, contracts between global corporation and a developing country supplier may inevitably be incomplete in some ways.<sup>119</sup> In parts of the world where legal systems are well-developed, contracting parties can have access to courts if they get into a dispute about some aspect of the relationship, and courts can generally be relied upon to decide the dispute by imputing terms that may be missing in the formal contract. If courts are regarded by both parties to the contract as neutral, independent and reasonably sophisticated, the parties are likely to be comfortable with this approach to dispute resolution. But where contracting parties do not have a high level of confidence in courts of law, we might expect to find alternative arrangements that involve appeals to neutral, but sophisticated third parties such as arbitrators and assurance firms. Recognizing this issue, China, for example, established a quasi-governmental organization, CIETAC,

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<sup>119</sup> We will not even attempt to summarize that work here, and will certainly not cite all the scholarship on the subject. But see Hart and Holmstrom, *supra* note 118, for a useful discussion of the implications of incomplete contracts. See also PAUL MILGROM AND JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 133 (1992) for a brief and accessible introduction to the economic theories of incomplete contracts.

whose roots go back to the 1950s for the purpose of arbitrating disputes between Chinese firms and foreign companies doing business with China. Third-party assurance organizations of the type we are considering in this article do not handle complex contract disputes, but they may be able to resolve relatively simple questions about contractual performance, such as whether the manufacturing contractor maintains a “safe” workplace and does not employ child labor.

Third, it is a well-understood phenomenon in contract theory that performance problems in contractual relationships can be substantially reduced if both parties to the contract have reputational capital at risk in the relationship.<sup>120</sup> Parties that have a reputation for honesty, competence, and fair-dealing can reduce their costs of contracting because their contractual partners know that the advantages of cheating in a particular relationship are likely to be more than offset by the costs to the firm from reputational damage. In the relationship between a large, globally-recognized corporation and a local manufacturing firm in a developing country, the global company is likely to have more reputational capital at stake to constrain its behavior and bond its commitments, at least initially. The supplier firm may have strong incentives to develop a reputation as an honest and reliable trading partner over time, but may initially need to expend resources to build that reputation. Employing third-party assurance services may serve that function by acting as a “reputational intermediary.” This may work because the assurance firm has little in the way of assets except its reputation, and it has no direct stake in the outcome of any evaluation it performs. It may therefore be more credible in how it evaluates the supplier-firm’s performance.

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<sup>120</sup> See, e.g., Michael Trebilcock & Jing Leng, *The Role of Formal Contract Law and Enforcement in Economic Development*, 92 Va. L. Rev. 1517 (2006)

In recent years, economists and legal scholars interested in economic development have begun focusing on another type of contractual problem, which is the problem that arises when the legal system is weak, corrupt or unsophisticated, so that the contracting parties cannot count on courts and officers of the law for fair and independent adjudication and enforcement of contracts. Such circumstances are common in many developing countries, and a growing literature argues that the resulting lack of reliable property or contract enforcement may be a major factor impeding economic development.<sup>121</sup> In such situations, the parties may be able to anticipate and specify in fairly fine detail who is to do what under what circumstances, but that may be of small comfort if there is no authority available who can enforce the terms.

One might expect that the same institutional arrangements that make a contract “self-enforcing” might also be used extensively to govern business relationships when enforcement authorities are weak, corrupt, or unsophisticated. An alternative, however, might be for the contracting parties to develop systems of private contract enforcement, such as agreements to rely on the assessments of third party inspectors and verifiers for a determination of whether contract terms were satisfied. It appears to us that this is what is happening now in many contexts around the world. In the interaction between global corporations and local firms in developing countries, the parties may, in effect be importing resources for private law enforcement to interpret contract terms and determine whether they have been met.

Third-part assurance firms may thus supply certain contract facilitating and enforcing functions in developing countries that might be supplied by formal legal

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<sup>121</sup> See e.g., Douglass North, *supra* note 7; Donald C. Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 AM. J. COMP. L. 90 (2003).

institutions in developed countries. In performing these functions, the assurance service can perhaps be understood to be importing “rule of law” procedural norms into countries where legal institutions are weak.

*B. The regulatory role of third-party assurance.* On the question of how the behavior of global corporations is to be regulated and policed, the phenomenon of third-party assurance can be examined in light of so-called “new governance” theories,<sup>122</sup> or “global administrative law” theories,<sup>123</sup> which have been exploring the role of private actors in public “law-making.” These theories recognize that today we observe an accelerating diffusion of regulatory power among networks of state and non-state actors that transcend national boundaries<sup>124</sup> A central premise of these theories is that in the global economy, “regulatory governance function[s] in a manner not dependent on state law or in which state law is not central,” that there is “ a loosening of the sharp distinction between states and markets and between the public and the private.”<sup>125</sup> Thus, transnational regulation is now understood to encompass:

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<sup>122</sup> A central contributor to the development of new governance theories is Prof. Colin Scott, Research Associate in the London School of Economics’ Center for Regulation and Risk, and Professor of EU Regulation and Governance, University College, Dublin. For an introduction to Prof. Scott’s work, see Colin Scott, *Regulation in the Age of Governance: The Rise of the Post-Regulatory State*, Austrl. Nat’l Univ., Nat’l Europe Centre Paper No. 100 (2003), available at <http://www.lse.ac.uk/scott>. For a thoughtful overview of new governance theories, see Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004).

<sup>123</sup> See Kingsbury, Krisch, Stewart & Wiener, *supra* note 8, introducing the concept of “global administrative law.”

<sup>124</sup> It can be argued that self-regulatory, private initiatives within various industries are hardly new developments either. One can think of guilds or *lex mercatoria* regimes in the Middle Ages in Europe as historical examples of such self-regulation. This may simply indicate that law scholars have generally tended to define the term “regulation” too narrowly, and that focusing attention on the “new” regulatory regimes engendered by economic globalization has led many scholars to more clearly recognize the regulatory implications of private action—implications that could have been observed more systematically previously, but that are now getting sustained academic attention. See Orly Lobel, *The Paradox of Extralegal Activism: Critical Legal Consciousness and Transformative Politics*, 120 HARV. L. REV. 937, 979 (2007) (asserting that “today, the lines between private and public functions are increasingly blurred,” but that legal scholars often too sharply emphasize the distinction between regulatory and deregulatory regimes.)

<sup>125</sup> Scott, *supra* note 122, at 2-3.

“regulation by non-regulation (*laissez-faire*), through formal self-regulation (such as by some industry associations), hybrid private-private regulation (for example, business-NGO partnerships in the Fair Labor Association), hybrid public-private regulation (for instance, in mutual recognition arrangements where a private agency in one country tests products to certify compliance with governmental standards of another country), network governance by state officials (as in the work of the Organization for Economic Cooperation and Development (OECD) on environmental policies to be followed by national export credit agencies), inter-governmental organizations with direct governance powers (as with determinations by the Office of the U.N. High Commissioner for Refugees of individuals’ refugee status, or the WTO dispute resolution system for trade conflicts).<sup>126</sup>

The phenomenon we study in this paper points to an emerging alternative mechanism of regulation that is tied to private contractual relationships. As we noted above, global, branded companies are exposed to ever greater risks as their supply chains lengthen, as production is moved outside of the firm, and as companies increasingly come under pressure to demonstrate that the conditions of production in their supply chains meet international standards. Given these pressures, companies are including “regulatory” standards for health, safety, conditions of employment and environmental management in their supply-chain contracts,<sup>127</sup> and then engaging various certifying organizations to provide assurance that the standards have been met.

Thus, the role being played by third-party assurance may be a merging of private law contractual mechanisms for organizing production with public law activities of standard setting and enforcement.

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<sup>126</sup> Kingsbury et al., *supra* note 8, at 2.

<sup>127</sup> Supply contracts are usually confidential and not accessible to the public. Certain companies’ contracts are filed as part of their annual or quarterly securities reports, however, and thus available in the EDGARPlus(R) database of LexisNexis. By using the keywords “supplier code of conduct” and “material contract,” we found companies, such as Tommy Hilfiger Corp. (Exhibit 10 to 10-K, filed on June 26, 2001), Warnoco Group (Exhibit 10 to 10-K, filed on March 18, 2004), Phoenix Footware Group (Exhibit 10 to 10-Q, filed on Nov. 15, 2005) and Global Beverage Solutions (Exhibit 10 to 8-K, filed on June 7, 2006), incorporated such regulatory standards into their supply contracts.

## V. Conclusions.

We have suggested in this paper that a new private sector mechanism is emerging and operating globally that may provide a substitute for law and formal legal structures both in contract enforcement and in policing the social behavior of firms. The third-party assurance industry, which came to sudden prominence in international commerce in recent years initially to provide expert evaluations of product qualities for purposes of enforcing private contracts, is now being deployed globally to implement and enforce social standards. In the process, the activities of these organizations may be having the effect of promulgating international business norms and standards of human rights, labor protection, and social responsibility.

Even where local law as written is consistent with such international standards (such as seems to be true at least for labor protection in China), third party assurance provides an enforcement mechanism would otherwise be lacking in many countries. Moreover, as we have seen in the Chinese case study, importing international standards and private sector enforcers may have the effect of hastening the development of formal legal institutions that have the potential to implement and enforce for those standards.

This is clearly not the only possible interpretation of these developments. Commercial interests have long established parallel institutions for the arbitration of commercial disputes that do not depend on local judicial systems, and do not necessarily have any positive effect on those judicial systems.<sup>128</sup> Some commentators have even suggested that arbitration of commercial disputes can *undermine* public law developments by allowing firms to contract around public law, even the laws of

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<sup>128</sup> Reference here merchant guild courts.

developed economies such as the EU or US.<sup>129</sup> So we recognize the need for us to do further theoretical work to determine what aspects of “rule of law” are more amenable to influence by the developments described in this paper, and then test those theories by evaluating in detail the effect that strengthening commercial substitutes for local judicial enforcement has on public judicial and legal establishments.

We want to know more, for example, about the political dynamic that has given rise to, and that is now responding to third party assurance regimes as enforcers of social standards. It seems likely, for example, that the new Chinese social responsibility standard, CSC9000T, will not replace third party assurance unless foreign buyers treat a CSC9000T evaluation as the substantial equivalent of an audit and certification, to a Western standard or code of conduct, by an independent third party. For the reasons identified above, however, foreign buyers will undoubtedly be cautious about embracing CSC9000T—in significant part because it neither provides public acknowledgement nor credible assurance that suppliers have actually met acceptable social standards for production.

This suggests an interesting Catch-22 for NGOs, activists, business people and financial institutions who want to see social and political reform in developing countries. The importation of Western standards and third-party certification may, in the short run, help to impose norms and rule of law values such as transparency and accountability in developing economies, including in China. These standards may require more stringent human rights or labor protections than those offered by the law *as enforced*, as in China,

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<sup>129</sup> See, e.g., Philip J. McConaughay, *Rethinking the Role of Law and Contracts in East-West Commercial Relationships*, 41 VA. J. INT’L LAW 427 (2001). On balance, Prof. McConaughay thinks that transfer of authority to arbitral institutions is a net positive for commercial predictability in Asia, but a net negative when companies can “contract out of” developed economy law by transferring their disputes to arbitral institutions.

but may be consistent with the protections some Chinese political reformers and intellectuals advocate. In some enterprises, such as toys, apparel and sports equipment manufacturers, for example, it appears to us that the existence of external pressures from foreign buyers has allowed some Chinese citizens greater degree of freedom so that they have been able to advocate for reforms such as expanded labor rights and better human rights protection.<sup>130</sup> To the extent that participants in and around Chinese enterprise participate in developing business norms and social assurance standards and procedures modeled on Western variants, then, they are essentially engaging in type of political action in a context that is likely to be less threatening to the government than other types of political activity. Such a development may ultimately be a powerful lever for political liberalization in China.

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Of course it may also be that China's experience is atypical. While it is certainly the case that the assurance service business has grown dramatically in size and in importance in China in the last decade, it has also become extremely important around the world, from Mexico to India to Thailand and Vietnam, to Turkey and Eastern Europe and South Africa. And, just as in China, the industry seems to be playing both a contract enforcement role, and a role in introducing and enforcing social norms and standards wherever it is operating. We are unaware, however, of local governments outside of China that are attempting to create their own regulatory and inspection regimes in response to the activities of the private sector assurance organizations. These are all questions that await further research.

<sup>130</sup> In interviews of company executives in large retail firms in the United States with responsibility for supply chain management, conducted with Prof. John Conley as part of projects to explore the CSR trend in business, we have heard this point made: that by coming in with their CSR requirements, companies give Chinese managers and government officials who want reform a safe rationale to use to argue for such reform. See Conley & Williams, *supra* note 65, at 8, fn. 49 for a description of the research methodology.