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# Sustainability and the Contractual Organization of Production

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Transcript of the intervention of Jaakko Salminen in the webinar on Corporate Due Diligence in Contract and Company Law organised by the Nova Centre on Business, Human Rights and the Environment with the support of the Portuguese Presidency of the Council of the European Union in partnership with the British Institute of International and Comparative Law, the Portuguese Ombudsman (Provedor de Justiça), the Teaching Business and Human Rights Forum, and NOVA 4 The Globe on the 25th of March 2021.

***Q1: Many studies including the*** Study for the European Commission on Due Diligence through the Supply Chain ***found that contractual clauses are still the most utilized tool, for supply chain due diligence, however there's also evidence that contractual clauses often undermine human rights in practice. Could you elaborate on the status quo of contracts in the value chain within this context?***

To start with, I really enjoyed the previous presentations, such as Stephen on historical developments related to the corporation and Rachel on corporate groups. Of course, the other means for organizing production apart from corporation and corporate groups is by sourcing from others by contract.

We have to some extent come to grips with multinational corporate groups composed of parent companies and various tiers of subsidiaries. For one example, I refer to the picture on page 28 of Richard Meeran's article 'Tort Litigation against Multinational Corporations for Violation of Human Rights: An Overview of the Position Outside the United States'. The basic gist of the picture is that you have the parent company, RTZ Corporation, on top. Connected to the parent company you have several tiers of subsidiaries situated in different countries. In many cases the previous tier has full equity ownership of the next tier subsidiary and, if not, then you see a percentage between the lines linking the different companies which identifies how much equity one company owns in another.

These kinds of pictures of corporate structure are something that multinational corporations readily have at hand so that they know exactly the structure of the corporate group and how they best might govern it. But from the outside, it may be very difficult to discern how the group is organized: who owns what and who controls what. This is because in principle each of these companies should be an independent company: that is why they have the benefit of limited liability, and it is important for parent companies to maintain this aura of independence for legal reasons. So parent companies try to balance the active governance and relative independence of their subsidiaries. This is depicted to for example by Lord Briggs in § 51 of the recent UK Supreme Court decision *Lungowe* v *Vedanta*: *At one end, the parent may be no more than a passive investor in separate businesses carried out by its various direct and indirect subsidiaries. At the other extreme, the parent may carry out a thoroughgoing vertical reorganisation of the group's businesses so that they are, in management terms, carried on as if they were a single commercial undertaking, with boundaries of legal personality and ownership within the group becoming irrelevant, until the onset of insolvency, as happened within the Lehman Brothers group.*

The same balancing between coordination and independence is very much true of contractual organization. The main difference is that instead of an underlying foundation of equity ownership, a lead firm's contractually organized "value chain" consists of seemingly independent corporations connected through contractual relationships. An illustrative picture, a "value chain flow chart", is available on page 188 of Peter Kajüter and Harri Kulmala's article 'Open-book accounting in networks: Potential achievements and reasons for failures'. The picture looks in many ways similar to the one of a multinational group, except that it is standing on its head in comparison. At the bottom you have the lead firm and above it several tiers of suppliers to which it has a contractual relationship. Instead of using equity ownership as a foundational organizational principle, you have a value chain organized around the principle of contractual relationships.

A similar history as Stephen's in relation to the development of corporate form could be drawn in relation to contract. In short, there is a very particular historical development behind how contract has shaped into a mechanism for limiting liability. Basically, the doctrine of privity of contract means that a contract is from a legal perspective seen to have effects primarily on its parties, but this concept of privity and what it means in practice has evolved and continues to evolve over time. From a traditional, classical contract law perspective, the lead firm should not have the kind of a picture as we see in the value chain flow chart depicted by Kajüter and Kulmala. Contract law, as it is taught today, is not calibrated to dealing with actors gaining such a bird's eye view of the internal workings of several tiers of contractual suppliers, their cost structures, and how they organize the transportation of goods between one another. From a legal perspective it might even be said that such contractually organized and nonetheless centrally coordinated value chains do not exist. While they are daily bread in management and logistics practice and theory, in contract law such pictures are not discussed. In comparison to corporate groups, which we still struggle to meaningfully tackle through law, contractually organized value chains are even more in the dark of the night (see The IGLP Law and Global Production Working Group 2016).

From a governance perspective, I would argue that for big corporations there is very little difference in governing production under corporate law principles of equity ownership or contractual relationships. We have companies such as BMW with a global supplier network of 12,000 suppliers in 70 different countries. Most probably BMW ensures the value-chain-wide operation and efficiency of this global complex of suppliers through mechanisms such as the value chain flow chart described by Kajüter and Kulmala in the context of German automotive manufacturing. And then we have other companies, like the global transport giant Mærsk, who use the transparency afforded by contractual governance mechanisms, such as the open books mechanism described by Kajüter and Kulmala, to develop transport logistics between BMWs 12,000 suppliers in 70 different countries in a way that can reduce carbon emissions. Or we have broad sectoral alliances of garment lead firms coming together under the Accord for Fire and Building Safety in Bangladesh to organize a contractual mechanism that connects lead firms to the employees of several tiers of Bangladeshi suppliers in order to develop safe working conditions (the Accord is publicly available; for one analysis see Salminen 2018).

Thus from a governance perspective there is little difference in whether we are dealing with corporate groups or contractually organized value chains. The same continuum of governance as mentioned by Lord Briggs in *Vedanta*, from passivity to what in practice is a single entity, can take place in either form of organization. From a practical perspective, of course, there is a very big difference due to much more focus having been given to corporate groups to date than to contractually organized value chains. If we take the example of reporting, group level corporate reporting is something of an established standard, but value chain wide reporting lags far behind. For example, while the Greenhouse Gas Protocol has in 2011 expanded from corporate-group-focused greenhouse gas reporting (so-called 'scope 1 emissions') towards value chain wide reporting (so-called 'scope 3 emissions'), the first is still seen as the core of the GHG protocol's corporate standard while the latter is an "optional" reporting category (see the Revised Edition of the Greenhouse Gas Protocol).

The problem is clear. Companies can outsource production contractually to gain competitive advantage. At the same time, they outsource the negative externalities of production, for example by outsourcing resource-intensive aspects of production to countries without access to clean electricity or renewable resources, or by outsourcing labour-intensive aspects of production to countries where social or labour standards are not comparable to those in the lead firm's own jurisdiction. Our lacking understanding of contractual value chains and how to tackle them means that this part of the global sustainability problem is much more in the dark than in relation to corporate groups.

How do lead firms govern their contractually organized value chains? Most companies today have codes of conduct that establish standards that they expect their suppliers to follow, for example in relation to labour conditions or the environment. These codes of conduct are to various degrees integrated into supply contracts and may give lead firms a right to terminate the supply contract if they are not followed. But in many cases codes of conduct are not enough. For example, if suppliers are located in other jurisdictions, they typically operate under very different standards than the lead firm. They may not have the financial, technical, or processual means of putting in place standards that lead firms require. If lead firms want to have a value chain functioning effectively in relation to its standards, the lead firm will also need transparency over the relevant actors of the chain. The lead firm needs to know what the different tiers of suppliers are capable of to identify problems in relation to putting in place the required standards. Only once they know what the problems are can they start tackling those problems together with affected suppliers, for example by providing financial, technical, or processual support. This applies in the same way to maintaining logistics, R&D, and cost management, as in Kajüter and Kulmala's example above, as it does to different forms of sustainability, such as the Carbon Pacts and the Accord on Fire and Building Safety in Bangladesh (for an overview of approaches to governance through contract, see Salminen 2020).

Many of the transnational sustainability laws that have sprouted up in the recent decade and, for example, the proposed due diligence directive included in the European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability, try to tackle this reality of contractual value chains (generally on the relationship of value chains and current regulation, see Salminen and Rajavuori 2019). But we are still very much trying to come to grips with the contractual form of organization. There is much work left to do in relation to broadening our understanding of contractual organization and developing knowledge about what kinds of mechanisms could best enable their sustainability.

***Q2: How would you anticipate that these organizational structures and contracts will change if there's a mandatory due diligence duty?***

I was just about to mention that in addition to regulatory developments, many of the legal cases we have been talking about today, for example *Lungowe* v *Vedanta*, are based in the tort of negligence. Basically, similar principles could be applicable in contractual contexts as well, even if there are of course differences between equity-based and contractual organization and the situation in relation to private law liability for inadequate value chain governance is still highly unclear.

At the same time, we have clear examples where lead firms, without regard to size or sector, are generally liable for their contractually organized chains, with product liability being one prominent example.

If we were to have a similar, generally applicable regulatory approach to due diligence as we have in relation to product liability, how would things change? Let's say we take the French *loi vigilance* as a starting point, and let's say that it would be extended to cover also small and medium sized enterprises, so that it would extend the requirement of due diligence not only to the current handful of big corporations but also to a much larger group of small and medium sized corporations. The directive proposed by the European Parliament seems to be going a bit more towards this kind of an expansive approach.

From the perspective of big corporations, I do not see this would be a problem in any way. They already have transparency over their contractually organized value chains and the means to develop due diligence further, as we know from various examples such as the open books accounting practices described by Kajüter and Kulmala, the Carbon Pacts, and the Bangladesh Accord.

For smaller companies this could be problematic. However, we can imagine different kinds of solutions. One is joining together in broader sectoral instruments, such as the Bangladesh Accord, which is a collective of actors working together to govern the use of contractual suppliers. Actors could naturally also turn to sourcing in jurisdictions where standards of operation are generally adequate: this is no doubt one aim of the recent regulatory initiatives, and if all actors are similarly affected then the effects on comparative competitiveness should be manageable. And if local sourcing were not possible, companies might instead emphasize relationships with their external suppliers more than today and focus on building stable supply relationships through transparency and capability building to ensure that externalities are taken care of. All this would no doubt lead to something of a recalibration of transnational trade.

Of course, there are other layers to the problem of sustainable production. One of the things that we should definitely consider is that for example consumers can already now source directly from extraterritorially located digital platforms, thus avoiding companies established in the EU and any regulatory initiatives aimed at them. Whatever approach we take to regulating value chains through lead firms located within the EU, we will need to also account for the fact that consumers can source and are currently to a great extent already sourcing production directly from extra-territorially located platforms. Doing otherwise might move today's sustainability challenges increasingly to consumer transactions on digital platforms that are not covered by our current approaches to the sustainability of contractual organization.

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