2021

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Recommended Citation
Kishanthi Parella, Protecting Third Parties in Contracts, 58 Am. Bus. L.J. 327 (2021).

American Business Law Journal

American Business Law Journal
Volume 58, Issue 2, 327–386, Summer 2021

Protecting Third Parties in Contracts

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Corporations routinely impose externalities on a broad range of non-shareholders, as illustrated by several unsuccessful lawsuits against corporations involving forced labor, human trafficking, child labor, and environmental harms in global supply chains. Lack of legal accountability subsequently translates into low legal risk for corporate misconduct, which reduces the likelihood of prevention. Corporate misconduct toward non-shareholders arises from a fundamental inconsistency within contract law regarding the status of third parties: On the one hand, we know that it takes a community to contract. Contracting parties often rely on multiple third parties—not signatories to the contract—to play important roles in facilitating exchange, such as reducing market transaction costs, improving information flows, and decreasing the risk of opportunism. On the other hand, we deny this community protection from the externalities that contracting parties impose on them. This article examines a corporation's duties to others in its role as a contracting party. Normatively, this article proposes an alternative view of contracts as an ecosystem with three attendant principles that result from this view: (a) third-party protections from negative externalities, (b) contract design obligations of contracting parties, and (c) recourse to legal remedies for third parties. On a policy level, this article proposes the following duty to contract in order to translate theory into practice: Contracting parties are required to take into account negative externalities to third parties when the contracting parties could reasonably foresee that performance of the contract would create a risk of physical harm to these third parties.

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Introduction

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

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[1] *See, e.g.*, Katherine Pistor, Yoram Keinan & Jan Kleinheisterkamp, *Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries*, 18 The World Bank Res. Observer 89, 92 (2003); Stewart Macaulay, *Non-contractual Relations in Business: A Preliminary Study*, 28 Am. Soc. Rev. 55, 56 (1963); Ian R. Macneil, *Values in Contract: Internal and External*, 78 Nw. U. L. Rev. 340, 344 (1983) ("[I]t is important to stress the highly relational character of all contracts in real life. Exchange of any importance is impossible outside a society."); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 Colum. L. Rev. 1377, 1386, 1402–04 (2010); Cathy Hwang, *Faux Contracts*, 105 Va. L. Rev. 1025, 1030 (2019). For a discussion of systems approaches to corporate law, *see* Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. Pa. L. Rev. 579, 583 (2018).

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

[3] Lisa Bernstein, *Contract Governance in Small-World Networks: The Case of the Maghribi Traders*, 113 Nw. U. L. Rev. 1009, 1022–23 (2019); Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 Am. Econ. Rev. 525, 526 (1991).

[4] Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 Mich. L. Rev. 1724, 1782 (2001); Barak D. Richman, *How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 Law & Soc. Inquiry 383, 384 (2006).

[5] *See generally* Robert C. Ellickson, Order Without Law: How Neighbors Settle Disputes (1991) (describing several social norms that provide order in property disputes); Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. Legal Stud. 349, 352 (1981).

[6] *See* Bernstein, *supra* note 3, at 1022–23; Greif, *supra* note 3, at 526.

by enabling exchanges—even those that might not otherwise occur but for the contract ecosystems that third parties provide.

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

Unfortunately, third parties remain hidden parties in exchanges. They are not hidden because they disguise themselves, but because we choose not to see them. And this oversight has real consequences in our legal system. Contracts do not endanger signatories only; they also pose risk of harm to third parties through a variety of externalities.[8] These externalities are particularly evident in global supply chain contracts that govern the "full range of activities that firms, farmers and workers carry out to bring a product or service from its conception to its end use, recycling or reuse."[9] In the supply chain context, a variety of externalities arise implicating environmental, labor, and human rights harms.

This article focuses on the latter type of harm because human rights abuses in supply chains are an increasingly important policy issue, nationally and internationally. In July 2020 alone, a new Senate bill was introduced[10] that addresses human rights in supply chains, as well as new executive advisories and sanctions concerning supply chains in China that may involve the use of forced labor.[11] On July 1, 2020, the United States Department of State, along with the U.S. Department of the

[7]*See* Belinfanti & Stout, *supra* note 1, at 600 (describing how the elements of a public company, such as human, financial, and physical capital, "are interconnected, influencing each other in ways that allow them to operate as a unified whole, separate and apart from their individual selves").

[8]*See, e.g.*, Aditi Bagchi, *Other People's Contracts*, 32 YALE J. REG. 211, 212 (2015); David A. Hoffman & Erik Lampmann, *Hushing Contracts*, 97 WASH. U. L. REV. 165, 199 (2019); Andrew Johnston, *Governing Externalities: The Potential of Reflexive Corporate Social Responsibility* 1 (Univ. of Cambridge Ctr. for Bus. Research, Working Paper No. 436, 2012) [hereinafter Johnston, *Governing Externalities*]; Cathy Hwang & David Hoffman, *The Social Cost of Contract*, COLUMBIA L. REV. (forthcoming 2020) (manuscript at 6); Andrew Johnston, *Facing Up to Social Cost: The Real Meaning of Corporate Social Responsibility*, 20 GRIFFITH L. REV. 221, 222 (2011) [hereinafter Johnston, *Facing Up to Social Cost*].

[9]Stefano Ponte, Gary Gereffi & Gale Raj-Reichert, HANDBOOK ON GLOBAL VALUE CHAINS 1 (2019).

[10]Slave-Free Business Certification Act of 2020, S. 4241, 116th Cong. (2020).

[11]*See infra* notes 12–16 and accompanying text.

Treasury, the U.S. Department of Commerce, and the U.S. Department of Homeland Security, issued a business advisory to companies with this warning:

> Businesses with potential exposure in their supply chain to the Xinjiang Uyghur Autonomous Region (Xinjiang) or to facilities outside Xinjiang that use labor or goods from Xinjiang should be aware of the reputational, economic, and legal risks of involvement with entities that engage in human rights abuses, including but not limited to forced labor in the manufacture of goods intended for domestic and international distribution.[12]

The advisory recommended that, in order to manage these risks, "businesses should apply *industry human rights due diligence policies and procedures* to address risks."[13] This advisory highlighted how supply chain exposure could arise through "relying on labor or goods sourced in Xinjiang, or from factories elsewhere in China implicated in the forced labor of individuals from Xinjiang in their supply chains[.]"[14] This warning is particularly relevant for many American and foreign companies that may have supply chain contacts in Xinjiang.[15]

On July 20, 2020, the Department of Commerce followed up on the advisory by adding eleven Chinese companies to the Entity List because they are "implicated in human rights violations and abuses in the implementation of the People's Republic of China's (PRC) campaign of repression, mass arbitrary detention, forced labor, involuntary collection of biometric data, and genetic analyses targeted at Muslim minority groups from the Xinjiang Uyghur Autonomous Region (XUAR)."[16]

These actions will hopefully incentivize those companies with supply chains in China to consider human rights risks. But what about the companies that do not maintain supply chains in China? What incentives are present to encourage them to examine their own supply chains? After

[12]U.S. Dept't of State, Risk and Consideration for Businesses with Supply Chain Exposure to Entities Engaged in Forced Labor and Other Human Rights Abuse in Xinjiang (2020), https://www.dhs.gov/sites/default/files/publications/20_0701_xinjiang-supply-chain-business-advisory.pdf.

[13]*Id*. at 1 (emphasis added).

[14]*Id*. at 3.

[15]Dan Strumpf & Liza Lin, *Blacklisting of Chinese Firms Rattles American Supply Chains*, Wall Street J., July 21, 2020, https://www.wsj.com/articles/blacklisting-of-chinese-firms-rattles-american-supply-chains-11595343494.

[16]Press Release, U.S. Dep't of Commerce, Commerce Department Adds Eleven Chinese Entities Implicated in Human Rights Abuses in Xinjiang to the Entity List (July 20, 2020), https://www.commerce.gov/news/press-releases/2020/07/commerce-department-adds-eleven-chinese-entities-implicated-human.

all, the risks of forced labor and other human rights violations are not unique to supply chains in China but also characterize supply chains all over the world.[17] This article develops a framework for understanding the origins of human rights risks and recommends additional policy options to encourage other companies similarly to adopt human rights due diligence practices or to invest in other prevention strategies.

This article begins by exploring the problem of why human rights abuses arise in supply chains. Certainly, political and economic conditions in different countries cause or contribute to these human rights violations; however, these public dimensions to human rights abuses in supply chains—focusing on government acts—are beyond the scope of this article. Instead, this article focuses on the lesser-known side to human rights violations that arise because of externalities created by private parties when they contract with each other.

This article explains that third parties—such as consumers, employees of suppliers, and local communities, for example—are at risk from two different types of externalities. Type I externalities are harms that result from contract performance when contracting parties perform as expected; contract terms concerning price, volume, and delivery times can exacerbate risk of third-party harms, such as forced labor and human trafficking, because these risks are inherent in the contract as designed.[18] In order to address these risks, multinational companies usually enter into a second set of contracts—codes of conduct—with their overseas suppliers. But suppliers often violate these codes, resulting in Type II externalities that result from contractual breach. Unfortunately, despite these risks, third parties are unable to address either externality because they do not participate in contract design (Type I externality) and cannot assert rights under supply contracts (Type II externality).

Recent litigation provides ample illustrations of the severity of third-party externalities that these supply contracts produce and the inability of third parties to address them. For example, in December 2019, an international advocacy group filed a lawsuit in federal district court on behalf of a group of

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[17] *See generally* U.S. DEP'T OF STATE, TRAFFICKING IN PERSONS REPORT (2020), https://www.state.gov/wp-content/uploads/2020/06/2020-TIP-Report-Complete-062420-FINAL.pdf.

[18] *See, e.g.*, HOUSE OF LORDS HOUSE OF COMMONS JOINT COMMITTEE ON HUMAN RIGHTS, HUMAN RIGHTS AND BUSINESS 2017: PROMOTING RESPONSIBILITY AND ENSURING ACCOUNTABILITY, 2016-17, HL 153, at 13 (UK); NIKOLAUS HAMMER & REKA PLUGOR, A NEW INDUSTRY ON A SKEWED PLAYING FIELD, SUPPLY CHAIN RELATIONS AND WORKING CONDITIONS IN UK GARMENT MANUFACTURING 42 (2015) (discussing supply chain practices in Fast Fashion industry that lead to human rights risks in the UK garment industry).

children against a number of tech giants—Apple, Microsoft, Alphabet, Dell, and Tesla—for "knowingly benefiting from and aiding and abetting the cruel and brutal use of young children in Democratic Republic of Congo ("DRC") to mine cobalt, a key component of every rechargeable lithium-ion battery used in the electronic devices these companies manufacture."[19] Plaintiffs allege that "young children mining Defendants' cobalt are not merely being forced to work full-time, extremely dangerous mining jobs at the expense their educations and futures; they are being regularly maimed and killed by tunnel collapses and other known hazards common to cobalt mining in the DRC."[20]

This lawsuit is one of several concerning externalities produced by supply chain contracts. Litigation involving different human rights abuses (child labor, forced labor, human trafficking, and extrajudicial killing, among others) by different corporations (Mars, Costco, Wal-Mart, and Royal Dutch Petroleum, among others) in different countries (Thailand, Nigeria, the Ivory Coast, and Bangladesh, among others) has been brought by a variety of corporate stakeholders (laborers, consumers, and local communities) before both federal and state courts alleging causes of action based in international law, consumer protection laws, contract law, and tort law.[21] However, almost all of these cases share a common fate: dismissal.[22] The outcomes in these cases result from a lack of judicial recognition of duties that contracting parties owe to various third parties: no duty to monitor supply chains, no duty of care to laborers in supply chains, and no duty to disclose information to consumers about child labor or forced labor in supply chains.[23]

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[19]Class Action Complaint for Injunctive Relief and Damages at 1, Doe v. Apple, Inc., No. 1:19-cv-03737 (D.D.C. Dec. 16, 2019).

[20]*Id.* at 1–2.

[21]*See, e.g.*, Doe I v. Wal-Mart Stores, Inc., 572 F.3d 677, 680 (9th Cir. 2009) (alleging violations of codes of conduct contained in the supply contracts); Rahaman v. J.C. Penney Corp., Inc., CA. No. N15C-07-0174, 2016 WL 2616375, at *1 (Del. Super. Ct. May 4, 2016) (alleging negligence and wrongful death claims arising from the collapse of Rana Plaza in Bangladesh in 2013); Doe v. Nestle, S.A., 906 F.3d 1120, 1122 (9th Cir. 2018) (alleging claims for aiding and abetting slave labor).

[22]*See, e.g.*, *Wal-Mart Stores*, 572 F.3d at 685 (affirming the motion to dismiss); *Rahaman*, 2016 WL 2616375, at *10 (granting defendants' motion to dismiss).

[23]*See, e.g.*, *Wal-Mart Stores*, 572 F.3d at 685 ("[W]e conclude that Plaintiffs have not stated a claim against Wal-Mart…. Wal-Mart had no legal duty under the Standards or common law negligence principles to monitor its suppliers or to protect Plaintiffs from the suppliers' alleged substandard labor practices. Wal-Mart is not Plaintiffs' employer, and the relationship between Wal-Mart …. and Plaintiffs is too attenuated to support restitution under an unjust enrichment theory.") (internal citations and footnotes omitted); *Rahaman*, 2016 WL 2616375, at *10 ("Just as in *Doe I v. Wal-Mart*, Plaintiffs in this case have failed to allege facts to establish that Defendants owed Plaintiffs a duty of care.").

The juxtaposition of third-party contributions with third-party harms sheds light on how we still imagine contracts in the twenty-first century. Namely, despite the multilateral nature of contracting—in which multiple third parties nourish contract exchanges—many courts still adhere to a bilateral model of contracting in which a contract is imagined as an agreement between two or more parties that is both isolated and insulated from the broader society.[24] This view perpetuates the notion that those most at risk of harm in contracts are counterparties; it also influences our diagnoses of the types of harms that may result from a contract, such as opportunism, which, once again, are harms that most threaten counterparties.[25]

We can come up with a variety of reasons for why we should revise this view and account for third-party interests in contracts. Some are moral: it's the right thing to do. Others are economic: doing so provides long-term value for the company. Some situations foster compliance considerations: the law commands it. Others foster strategic ones: it's good for brand value and marketing. But the reason that this article highlights originates from the concept of contract itself and the fundamental tension within it. While we may continue to view contracts as bilateral arrangements when it comes to assessing harms, we have known for a long time that contracts are multilateral when it comes to the benefits third parties confer on contracting ones. Contracts do not occur in a vacuum. We rely on institutions and organizations developed by a variety of third parties to support those contracting relationships even while contract signatories continue to impose a variety of externalities on those same parties. We need to close the loop.[26]

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[24] *See* Bagchi, *supra* note 8, at 219 ("For different reasons, scholars from both philosophical and economic perspectives are drawn to an insular picture of contract interpretation focused exclusively on the parties to contract. The result is that, although everyone would acknowledge the legitimate interests of third parties, courts do not assign any formal and systematic role to those interests in the exercise of interpretation.").

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

[26] *See* Hoffman & Lampmann, *supra* note 8, at 199–201 (discussing the ways that contract parties externalize costs to third parties while enjoying the benefits).

Currently, the incentive structure for CEOs and corporate directors does not encourage these corporate leaders to consider the interests of third parties in their decision making.[27] Instead, "[t]hey can be expected to protect other stakeholders only to the extent that doing so would not hurt share value."[28] Many corporate law scholars seek to address this gap by arguing that fiduciary duties should incentivize corporate regard for employees, local communities, and other stakeholders.[29] Other scholars have turned to negligence theories and advocated for the judicial recognition of a common law duty of care of businesses to respect human rights

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[27]Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, CORNELL L. REV., (forthcoming 2020) (manuscript at 3), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3544978 (noting that director and CEO compensation practices are designed to align the interests of these actors with shareholders, not stakeholders).

[28]Lucian A. Bebchuk & Roberto Tallarita, *'Stakeholder' Capitalism Seems Mostly for Show*, WALL STREET J. (Aug. 6, 2020) https://www.wsj.com/articles/stakeholder-capitalism-seems-mostly-for-show-11596755220.

[29]*See* Leo E. Strine Jr., Kirby M. Smith & Reilly S. Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, IOWA LAW REV. (forthcoming 2020) (manuscript at 1) (arguing that "EESG is best understood as an extension of the board's duty to implement and monitor a compliance program under Caremark"); Matthew T. Bodie, *Employment as Fiduciary Relationship*, 105 GEO. L. J. 819, 821 (2017) (arguing that employers owe fiduciary and quasi-fiduciary duties to employees); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N. C. L. REV. 1189, 1194 (1991) (proposing a "stakeholder model of corporate social responsibility" which "expands directorial fiduciary duties to encompass actions that shield workers from disruptions brought about by plant closings and other corporate changes. Such fiduciary duties toward workers would require directors to provide adequate severance payments, job retraining, and other appropriate relief to displaced workers."); Kent Greenfield, *The Third Way*, 37 SEATTLE U. L. REV. 749, 751 (2014) (arguing that it would be a violation of fiduciary duties "to prioritize one stakeholder over others consistently and persistently or to fail to consider the interests of all stakeholders in significant corporate decisions"); Johnston, *Facing Up to Social Cost, supra* note 8, at 236 (arguing that the directors' duty of good faith "should be reformed to require the directors to take action that is capable of producing returns for the shareholders while internalizing the externalities of which they become aware in the course of management."); Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1459 (2020) (arguing that "that courts should recognize ESG as an essential part of boards' monitoring mission"); Veronica Root Martinez, *More Meaningful Ethics* 1 (U. Chi. L. R. Online, Notre Dame Legal Studies Paper No. 191023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3474344 (advocating for the development of company policies that "(i) protect the dignity of, (ii) promote the flourishing of, and (iii) advance the interests of various stakeholders of firms within firms as a baseline to be used for establishing the ethics components of their ethics and compliance programs.").

and other environmental, social, and governance (ESG) concerns.[30] This article shares this same objective but takes a different path by examining a corporation's duties to others in its role as a contracting party. Contracts are the primary means through which corporations interact in the world. By reimagining contracts we also reimagine corporations and their duties to others.[31]

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

[31]*See, e.g.*, E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Tamara C. Belinfanti, *Forget Roger Rabbit—Is Corporate Purpose Being Framed?*, 58 N.Y.L. SCH. L. REV. 675, 678 (2014); Katherine Van Wezel Stone, *Employees as Stakeholders under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 45–47 (1991); Anita Ramasastry, *Corporate Social Responsibility Versus Business and Human Rights: Bridging the Gap Between Responsibility and Accountability*, 14 J. HUM. RTS. 237, 238 (2015); Lyman Johnson, *Reclaiming an Ethic of Corporate Responsibility*, 70 GEO. WASH. L. REV. 957, 964–66 (2002); Robert C. Hockett & Saule T. Omarova, *'Special,' Vestigial, or Visionary? What Bank Regulation Tells Us about the Corporation–and Vice Versa*, 39 SEATTLE U. L. REV. 453, 487–95 (2016); David Millon, *Theories of the Corporation*, 1990 DUKE L. J. 201, 240–51 (1990); Elizabeth Pollman, *Corporate Social Responsibility, ESG, and Compliance*, CAMBRIDGE HANDBOOK OF COMPLIANCE (D. Daniel Sokol & Benjamin van Rooij eds., forthcoming), https://ssrn.com/abstract=3479723; *see also* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L J. 923, 929 (2019) (proposing a "Sustainability Discussion and Analysis" that would "require an issuer to disclose, at a minimum, the three sustainability issues that are most significant for the firm's operations, to explain the basis for that selection, and to explain the impact of those issues on firm performance"); Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 653 (2016) (explaining the economic rationales for risk-related activism); Ann Lipton, *Not Everything Is about Investors: The Case for Mandatory Stakeholder Disclosure*, YALE J. REG. (forthcoming 2020) (manuscript at 5), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3435578 (recommending a disclosure system that produces information for non-shareholder audiences), https://bit.ly/2NzJd6o.

In order to protect third parties, we need to recognize contract obligations that flow to those beyond contract signatories. This article suggests a number of legislative and judicial reforms that can help to protect third parties in contracts. In the supply chain context, academics and legislators have proposed due diligence requirements that would force corporate actors to consider the human rights impacts of their conduct on a variety of third parties and to take steps to address and mitigate them. For example, in October 2019, the French Corporate Duty of Vigilance Law[32] was the basis of a suit against Total, the multinational energy giant.[33] This law "requires companies to create and implement publicly-available vigilance plans for which they can be held accountable"[34] and is "designed to improve the corporate social responsibility programs of the companies in scope, as well as aid the victims of these crimes in achieving justice."[35] Using this law, six environmental groups sued Total for its planned oil operations in a national park in Uganda that they allege would create substantial human rights and environmental risks—risks inadequately addressed by Total in its vigilance plans under the law.[36] However, many legislators around the world remain reluctant to go that route. By highlighting contract's fundamental inconsistency, this article offers another justification to support mandatory due diligence requirements.

But this article goes even further by proposing a new duty that borrows elements from both contract and tort law. Under this duty,

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[32]Loi 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre [Law 2017-399 of March 27, 2017 Relating to the Duty of Care of Parent Companies and Contractors], Journal Officiel De La République Française [J.O.] [Official Gazette of France], Mar. 28, 2017 (Fr.), https://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000034290626&categorieLien=id [hereinafter French Corporate Duty of Vigilance Law].

[33]*Total Sued Under France's New Duty of Vigilance Law*, Env't News Serv. (Oct. 23, 2019), https://ens-newswire.com/2019/10/23/total-sued-under-frances-new-duty-of-vigilance-law/.

[34]*Regulatory Resource Center: What Is the French Corporate Duty of Vigilance Law?*, Assent, https://www.assentcompliance.com/assentu/resources/article/french-corporate-duty-of-vigilance-law/?PF_Corporate_Social_Responsibility__c=true.

[35]*Id.*

[36]*Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, Business Roundtable (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

contracting parties must take into account negative externalities to third parties when the contracting parties could reasonably foresee that performance of the contract would create a risk of physical harm to these third parties. The standard of care is satisfied by reasonable contract design. Many of the lawsuits alleging third-party externalities sound in either contract law or negligence law independently.[37] However, each falls short because of the status of third parties in these supply chains. Under contract law, third parties in supply chains are not beneficiaries of promises exchanged in supply chain codes of conduct. Under negligence law, corporations do not owe a general duty of care to employees of their suppliers. The proposed duty addresses the gap between these two areas of law by providing incentives for contracting parties to account for third-party externalities while providing the parties with significant latitude in addressing those externalities. As such, it preserves the traditional features of contract law, such as flexibility and autonomy, but curtails the freedom of contract by situating it against the background of negligence law.[38] While some scholars have advocated for the protection of third-party interests through third-party liability,[39] contract interpretation,[40] or public policy,[41] this article argues that some externalities are grave enough to warrant obligations at the *ex ante* contract design stage.

This article proceeds as follows: Part I traces the roots of corporate misconduct in the supply chain to contract design and the distinction between Type I and Type II externalities, including examining the reasons why these externalities arise and remain inadequately addressed. It also provides an overview of recent litigation concerning harms to third parties in supply chains. Part II proposes a duty to contract that requires

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[37]*See, e.g.*, Rahaman v. J.C. Penney Corp., Inc., CA. No. N15C-07-0174,2016 WL 2616375, at *7–8 (Del. Super. Ct. May 4, 2016) (relying upon negligence principles); *see also* Doe v. Wal-Mart, Inc., 572 F.3d 677, 681–83 (9th Cir. 2009)

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

[39]Brishen Rogers, *Toward Third-Party Liability for Wage Theft*, 31 Berkeley J. Emp. & Lab. L. 1, 47–54 (2010).

[40]Bagchi, *supra* note 8, at 242 ("When an ambiguous agreement would adversely affect the legal interests of third parties if interpreted one way but not if interpreted another way, courts should prefer the interpretation that generates fewer negative externalities.").

[41]Hoffman & Lampmann, *supra* note 8, at 213.

contracting parties to account for third-party externalities that are reasonably foreseeable as a consequence of contractual performance. It also discusses the various advantages that this contract duty offers to the current regulatory environment, including targeting Type I externalities, incentivizing prevention, addressing weaknesses of market mechanisms and transparency laws, and offering a judicial basis for human rights due diligence. Part III provides a normative basis supporting this contractual duty for supply chain contracts and beyond. It begins by providing an overview of the role that third parties undertake in contracts by briefly reviewing the institutional research on private ordering that highlights the various institutions that third parties build and maintain. An explanation of functional advantages that these institutions offer to contracting parties, such as reducing the transaction costs associated with search and information gathering, negotiating and drafting complete contracts, or providing for legal enforcement is also provided. It concludes by articulating a view of contracts as ecosystems with particular normative principles that result from this view: (a) third-party protections from negative externalities, (b) contract design obligations of contracting parties, and (c) recourse to legal remedies for third parties.

I. The Contractual Roots of Corporate Misconduct

Many of the harms that corporations impose on society arise from the contracts that they design, negotiate, and perform. While contracts primarily benefit the contract's signatories, they can create a risk of harms to a variety of actors who are not formally part of the contract. Part I.A explains that Type I externalities are harms that result from *contract performance* when contracting parties perform as expected; in contrast, Type II externalities result from *contractual breach*. Part I.B explains that while various parties suffer these risks, they are powerless to do much about it. As nonsignatories to the contracts, they have no role at the bargaining table when the contract is designed and negotiated and no remedy from the courts when the contract results in injury to them. Part I.C explains the types of third-party harms that can result from both types of externalities, including harms to laborers, consumers, and communities.

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

International economic production is organized through a vast array of supply chains that connect individuals and companies in various countries to each other.[42] Each of these supply chains is created and maintained by a variety of supply contracts. Supply contracts can vary in length, objective, terms, parties, duration, and so forth. For the purpose of the following discussion, this section focuses on two features of the supply contract: the master agreement and supply contract ("master agreement") and supplier code of conduct ("code"). Each of these contracts creates the risk of negative externalities for noncontracting parties, or third parties.

What is an externality? Quite simply, it is a cost that one or more parties does not bear.[43] Another feature of negative externalities is that those creating them are usually not inclined to account for them in their decision making because the costs are borne by others and not themselves; "corporations that produce externalities gain all the benefits of their economic activity, but do not bear all the costs."[44] The result is that "[s]ince corporations take no account of these costs, their private costs of engaging in the productive activity are lower than the social costs, and so there will be more production than is optimal from the perspective of society as a whole."[45]

A contract creates third-party externalities in two different ways: *Performance* results in a Type I externality, while *breach* results in a Type

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[42]*See, e.g.*, Gary Gereffi & Karina Fernandez-Stark, Global Value Chain Analysis: A Primer 7 (2d ed. 2016) ("The value chain describes the full range of activities that firms and workers perform to bring a product from its conception to end use and beyond. This includes activities such as research and development (R&D), design, production, marketing, distribution and support to the final consumer. The activities that comprise a value chain can be contained within a single firm or divided among different firms.").

[43]Lisa Grow Sun & Brigham Daniels, *Mirrored Externalities*, 90 Notre Dame L. Rev. 135, 137 (2014). For the purpose of this article, I use the term "externalities" to refer exclusively to negative externalities or costs imposed on third parties, as distinct from positive externalities that are benefits conferred on third parties. *Id*; *see also* Johnston, *Governing Externalities*, *supra* note 8, at 1 ("A negative externality occurs where a decision is taken that results in an event which has adverse, uncompensated effects on another party who does not consent to it.")

[44]Johnston, *Facing Up to Social Cost, supra* note 8, at 221; *see also* Grow Sun & Daniels, *supra* note 43, at 137.

[45]Johnston, *Facing Up to Social Cost, supra* note 8, at 221–22.

II externality. Type I externalities do not occur when things go wrong but when parties perform exactly as expected under the supply agreements.[46] Specifically, the very terms of the supply contract create the risk of externalities for third parties; performance of these contractual terms is often the root cause of the externalities that third parties encounter.[47] Terms such as purchase price, delivery schedule, and volume of orders may place a heavy burden on suppliers to perform.[48] In certain industries, suppliers may be reluctant to push back against buyers regarding these terms because of fear of losing the buyer's business.[49] For example, if a supplier does not have an exclusive supply relationship with a buyer, it is under pressure to agree to the buyer's demands regarding pricing and delivery because there may be multiple other suppliers to whom the buyer may turn if the supplier cannot comply.[50] Additionally, if these supply contracts are short-term, then the supplier is constantly under pressure to acquiesce to the buyer so that it may continue to obtain the buyer's business in the future.[51]

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

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[46]In this discussion, I keep separate the terms of the Master Agreement and Codes of Conduct to identify the unique risks of externalities that each creates.

[47]*See, e.g.*, Justine Nolan & Martijn Boersma, Addressing Modern Slavery 41–42 (2019) (discussing the labor implications for production that relies on just-in-time production and lean manufacturing).

[48]*Id*. at 41–42, 54; Stephanie Barrientos, *Contract Labour: The 'Achilles Heel' of Corporate Codes in Commercial Value Chains*, 39 Dev. & Change 977, 980–82 (2008); Pun Ngai & Jenny Chan, *Global Capital, the State, and Chinese Workers: The Foxconn Experience*, 38 Modern China 383, 385–86 (2012).

[49]*See* Nolan & Boersma, *supra* note 47, at 158 (referencing a study by the International Labor Organization that "reported that 39% of suppliers surveyed accepted orders 'whose price did not allow them to cover production costs.'").

[50]Suk-Jun Lim & Joe Phillips, *Embedding CSR Values: The Global Footwear Industry's Evolving Governance Structure*, 81 J. Bus. Ethics 143, 144 (2008); Richard M. Locke, Ben A. Rissing & Timea Pal, *Complements or Substitutes? Private Codes, State Regulation and the Enforcement of Labour Standards in Global Supply Chains*, 51 British J. Indus. Rel. 519, 526 (2012); Bin Jiang, *Implementing Supplier Codes of Conduct in Global Supply Chains: Process Explanations from Theoretic and Empirical Perspectives*, 85 J. Bus. Ethics 77, 80 (2009).

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

subcontracting from the supplier to another party.[52] Subcontracting relationships are fraught with risks because (a) subcontractors may not be bound to the buyer's standards and policies, (b) buyer may be unaware of the identity of the subcontractor and its production sites and so cannot send its representatives to monitor or audit those facilities, and (c) subcontractors may not be approved by buyers and are selected by suppliers only because the subcontractor can meet production demands and not for social compliance quality reasons.[53] It is therefore unsurprising that many incidents of publicized wrongdoing in supply chains occur at subcontracting sites. It is the performance of the contract that creates Type I externalities and leads to many of the lawsuits.[54]

Given that the terms of supply contracts may create Type I externalities for third parties, many supply contracts include a supplier code of conduct, as reflected in this hypothetical supply contract code of conduct for the fictional company ACME:

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

An accompanying schedule ("Schedule [X]") to the contract may add further obligations of suppliers, such as ensuring that (a) sub-suppliers and other subcontractors also comply with the code, and (b) suppliers agree to provide ACME and its representatives with audit and assessment rights of supplier facilities to ensure compliance with the code of conduct.

These codes of conduct appear to address Type I externalities to third parties through a variety of contract terms. First, the risks associated with subcontracting are addressed by putting ACME's suppliers "on the hook"

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[52]University of Leicester & Centre for Sustainable Work and Employment Futures, New Industry on a skewed Playing Field: Supply Chain Relations and Working Conditions in UK garment Manufacturing, Centre for Sustainable Work and Employment Futures, 22–25 (2015).

[53]Locke, *supra* note 50, at 526; Michael E. Blowfield & Catherine S. Dolan, *Stewards of Virtue? The Ethical Dilemma of CSR in African Agriculture*, 39 Dev. & Change 1, 6–7 (2008); Sarah Dadush, *Contracting for Human Rights: Looking to Version 2.0 of the ABA Model Clauses*, 68 Am. U. L. Rev. 1519, 1525, 1540–41 (2019).

[54]*See infra* Part 2.3

for the actions of their subcontractors; the code states that the latter are also bound to their terms and policies and that noncompliance by the latter may have negative consequences for ACME's suppliers. In this way, the code incentivizes suppliers to choose their subcontractors with compliance considerations in mind and to take action to support subcontractors' compliance with the code's terms. The code also provides ACME (and its representatives) with audit rights, including the right to interview workers and inspect documents to assess compliance with the code.

Why would multinational buyers include such provisions in their supply agreements? One driver is reputational risk: misconduct by suppliers or sub-suppliers may expose the buyer to unwelcome media attention, consumer boycotts, shareholder activism, and even lawsuits. Therefore, buyers may want to reduce the risk of labor abuses, such as child labor and forced labor, by including contractual terms that obligate their suppliers to abide by standards and policies covering social compliance. A second driver may be the availability of model clauses addressing social compliance risks, such as those recently drafted by the Working Group to Draft Human Rights Protections in International Supply Contracts (Working Group) of the Business Law Section of the American Bar Association.[55] Finally, companies may want to include these clauses as a means to manage a variety of compliance concerns, such as compliance with national laws addressing disclosures and human rights in supply chains.[56] The problem, of course, is that suppliers may not always comply with these terms; when they breach them, they create Type II externalities that lead to many of the lawsuits discussed in Part 2.3.

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

Despite the externalities that they encounter, third parties are unable to manage these risks as are contracting parties. Contracting parties are

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[55]David V. Snyder & Susan A. Maslow, *Human Rights Protections in International Supply Chains—Protecting Workers and Managing Company Risk*: *2018 Report and Model Contract Clauses from the Working Group to Draft Human Rights Protections in International Supply Contracts, ABA Section of Business Law*, 73 Bus. Law. 1093, 1096-1103 (2018) (setting forth proposed clauses); Jonathan C. Lipson, *Promising Justice: Contract (As) Social Responsibility*, 2019 Wisconsin L. Rev. 1109, 1117 (2019) ("Unlike the conventional bilateral contract, KSR terms deliberately contemplate the welfare of persons not parties to the contract, or conditions such as environmental sustainability, that are directed at society in general.").

[56]Snyder & Maslow, *supra* note 55, at 1096; Lipson, *supra* note 55, at 17–23.

Table 1: Challenges with Addressing Third-Party Externalities in Supply Chains

Type	*Issue*	*Risk Management*	*Third-Party Limitation*
I	Performance	Contract design	No role *ex ante*
II	Breach	Judicial remedy	No rights *ex post*

provided two opportunities to address risks to themselves: *ex ante* contract design and *ex post* legal liability. As discussed below, and reflected in Table 1, third parties are not afforded either opportunity.

When contracting parties encounter potential risks from the agreement, they minimize these risks to themselves through contract design.[57] The contract agreement also creates risks for third parties, but, unlike contracting parties, they are not in a position to participate in contract design. Third parties, such as laborers, consumers, and local communities, do not have a seat at the bargaining table when the buyers and suppliers negotiate and execute supply agreements. Therefore, they cannot directly influence the drafting of contract terms that may minimize risks to themselves. And the contracting parties at the negotiating table may have little incentive to consider third-party interests when negotiating the contract unless they are obligated to do so because of mandatory law, private governance arrangements, or fear of reputational risks.[58] As a result, third parties often find themselves in the unfortunate situation that they may suffer Type I externalities but may have limited or nonexistent means to address these risks through contract design.

Third parties are similarly limited in their ability to control Type II externalities, which result from a breach of a code of conduct. Third parties are not signatories to these codes of conduct so are not in a position to sue multinational buyers for a breach of contract. The inability to impose *ex post* legal sanctions in the future means that buyers may have little incentive to consider the welfare of third parties in the present.

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[57]*See, e.g.*, Alan Schwartz, *Keynote Address: Modern Supply Chains and Outmoded Contract Law,* 68 Am. U. L. Rev. 1503, 1511 (2019).

[58]Lipson, *supra* note 55, at 17–23.

C. Consequences of Third-Party Externalities

The risks of Type I and Type II externalities, and the inability to control them through contract design or legal enforcement, lead to a variety of harms to third parties. This part provides illustrative examples of the variety of harms that corporations can cause to different individuals around the world through their supply contracts, and how the legal system is complicit in these harms by failing to recognize these legal claims and denying the victims remedies.

1. Laborers

Some of the most painful externalities of supply chain contracts fall upon the laborers at the overseas production sites for goods that are produced for American companies. While supply contracts govern obligations between the retailer, for example, and the supplier, the terms of those contracts—such as tight price competition, high volume, and quick turnaround times—can create significant externalities for the men and women who work for those suppliers.[59]

In *Doe v. Wal-Mart*,[60] employees of Wal-Mart's foreign suppliers in countries including China, Bangladesh, Indonesia, Swaziland, and Nicaragua brought a lawsuit against Wal-Mart regarding the working conditions at those suppliers' sites.[61] Critically, they pointed out that Wal-Mart included a supplier code of conduct ("Standards for Suppliers") in each of its contracts with its suppliers.[62] The code "require[s] foreign suppliers to adhere to local laws and local industry standards regarding working conditions like pay, hours, forced labor, child labor, and

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[59]*See, e.g.*, Verité, Strengthening Protections Against Trafficking in Persons in Federal and Corporate Supply Chains 8–9 (2015) ("Industries that are characterized by sharp seasonal or product life-cycle fluctuations in labor demand are also at risk …. The need for a large number of workers for short periods of time leads many employers to turn to labor brokers for assistance with recruitment …. In addition, employers in industries with sharp spikes in labor demand sometimes seek to intensify production by temporarily increasing pressure on their existing workforce through the use of compulsory overtime or other forced labor practices.").

[60]Doe I v. Wal-Mart Stores, 572 F.3d 677 (9th Cir. 2009).

[61]*Id.* at 683.

[62]*Id.*

discrimination."[63] The code also provided Wal-Mart with important inspection rights regarding the enforcement of the code.[64] The plaintiffs blamed Wal-Mart for not exercising the inspection rights that it possessed by virtue of its contracts with its foreign suppliers.[65] Specifically, they alleged that "Wal-Mart does not adequately monitor its suppliers"[66] and that "in 2004, only eight % of audits were unannounced, and that workers are [ ] often coached on how to respond to auditors."[67] Plaintiffs also alleged that "the short deadlines and low prices in Wal-Mart's supply contracts forced suppliers to violate the Standards in order to satisfy the terms of the contracts."[68]

Plaintiffs claimed that they were third-party beneficiaries of the promises exchanged between Wal-Mart and its suppliers regarding the code and that Wal-Mart promised the suppliers that "it would monitor the suppliers' compliance with the Standards, and that Plaintiffs are third-party beneficiaries of that promise to monitor."[69] The United States Court of Appeals for the Ninth Circuit did not agree, finding the code provided Wal-Mart with rights but not duties to exercise those rights: "Because, as we view the supply contracts, Wal-Mart made no promise to monitor the suppliers, no such promise flows to Plaintiffs as third-party beneficiaries."[70] Plaintiffs also alleged a variety of other theories of liability that proved unsuccessful, including a claim for negligence.[71]

The Ninth Circuit is not alone in addressing the issue of harms to laborers in supply chains. In 2016, the Delaware Superior Court addressed the issue of whether a retailer can be liable in negligence for

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[63]*Id.*

[64]*Id.*

[65]*Id.*

[66]*Id.*

[67]*Id.*

[68]*Id.*

[69]*Id.* at 681.

[70]*Id.* at 681–82 ("The language and structure of the agreement show that Wal-Mart reserved the right to inspect the suppliers, but did not adopt a duty to inspect them.")

[71]*Id.* at 683.

harms suffered by employees of its suppliers. In *Rahaman v. J.C. Penney*,[72] plaintiffs brought claims for wrongful death and negligence against J.C. Penney, The Children's Place, and Wal-Mart on behalf of those who died in the collapse of Rana Plaza in 2013, which killed 1100 individuals and injured approximately 2500 more.[73] The Superior Court rejected the negligence claim, explaining that in "negligence cases alleging non-feasance, or omission to act, there is no general duty to others in the absence of a 'special relationship' between the parties.[74] Plaintiffs also attempted to establish a duty of care based on the ethical sourcing statements made by defendants. However, the court was not convinced: "These statements by Defendants do not, by themselves, create a duty to employees of independent contractors where a duty does not otherwise exist."[75]

2. Consumers

Consumers have brought lawsuits against large manufacturers and retailers, claiming that conditions in the supply chain have harmed their interests.[76] For example, in *National Consumers League v. J.C. Penney*

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[72]Rahaman v. J.C. Penney Corp., Inc., CA. No. N15C-07-0174, 2016 WL 2616375 (Del. Super. Ct., May 4, 2016).

[73]*Id*. at *1.

[74]*Id*. at *8.

[75]*Id*. at *9.

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

et al.,[77] the National Consumers League (NCL) brought claims against J.C. Penney, The Children's Place, and Wal-Mart for violating the District of Columbia Consumer Protection Procedures Act.[78] The lawsuit was based on statements that each of the defendant retailers had posted on their websites concerning their policies and practices regarding conduct in their supply chains.[79] Plaintiffs highlighted two features of company statements regarding their supply chains: (a) supplier codes of conduct, and (b) auditing practices. They claimed that these retailers promised NCL and the "general public that their suppliers will ensure safe and healthy working conditions for their workers and will not utilize child labor," and that the resulting harms suffered at Rana Plaza are evidence of a breach of those promises.[80]

The court, however, was unconvinced. It found that "the majority of statements referenced by NCL are aspirational statements. The statements were not false on their face and were general in nature, outlining the expectations of each retailer and efforts by each retailer to place pressure on its suppliers to be more socially responsible."[81] The court engaged in a textual analysis of the corporate statements to show how these statements were aspirational and did not convey promises: "The usage of the qualifying terms 'expect', 'goal', and 'ask' is demonstrative of the aspirational nature of the statements and further demonstrates that the statements are not promises to consumers, as NCL alleges in its Amended Complaint. In these Corporate Statements, the defendants did not use qualifying terms binding Retailers such as 'ensure', 'promise' or 'forbid.'"[82] Based on this textual analysis, the court concluded that "the language of the defendants does not convey a promise" and that "NCL goes too far by recasting the retailers' aspirational statements" as such.[83]

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[77]Nat. Consumers League v. Wal-Mart Stores, Inc., No. 2015 CA 007731 B, 2016 WL 4080541 (D.C. Super. Ct.).

[78]*Id*. at *1.

[79]*Id*.

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

[81]*Id*. at *5.

[82]*Id*. at *6.

[83]*Id*. at *6.

However, the court found that that the retailers' statements regarding their auditing practices are distinguishable because these "auditing statements are more specific and contain verifiable facts that may be material to a consumer's purchasing decisions."[84]

In *Hodsdon v. Mars, Inc.*,[85] plaintiff brought a lawsuit on behalf of himself and other similarly situated consumers against Mars, Inc. and Mars Chocolate North America, LLC (collectively, "Mars") for violations of California's consumer protection laws and sought restitution and injunctive relief.[86] Plaintiff claimed that they would not have purchased these chocolate products had they known about the conditions in the supply chain or, at the least, would not have paid as much for these products.[87]

Plaintiff drew particular attention to the inconsistency between what Mars professed in its corporate statements and policies and the conditions that plaintiff claimed characterized Mars's supply chains. Specifically, its human rights policy referenced the United Nations Guiding Principles on Business and Human Rights and expressed Mars's intent to perform human rights due diligence in their cocoa supply chains.[88] The complaint also referenced Mars's supplier code of conduct that prohibits child labor, forced labor, and human trafficking and reserves the right to audit suppliers' facilities.[89] Plaintiff argued that "although Mars recognizes that the use of child and/or slave labor in its supply chain is wrong and its corporate business principles and supplier code explicitly forbid child and slave labor by its suppliers, it materially omits to disclose to consumers at the point of purchase the likelihood that its Chocolate Products are made from cocoa beans produced by Ivorian children engaged in the Worst Forms of Child Labor."[90]

First, the court found that there was no violation of false advertising laws because the claims are based on omissions regarding Mars's failure

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[84]*Id.* at *7.

[85]Hodsdon v. Mars, Inc., 162 F. Supp. 3d 1016 (N.D. Cal. 2016).

[86]Class Action Complaint at 23–27, Hodsdon v. Mars, Inc., 162 F. Supp. 3d 1016 (N.D. Cal. Sept. 28, 2015) (No. 15-CV-04450)

[87]*Id.* at ¶ 10.

[88]*Id.* at ¶ 49.

[89]*Id.*

[90]*Id.* at ¶ 53, ¶ 10.

to issue statements regarding child labor and forced labor in its supply chains.[91] Similarly, the court dismissed the claims based on unfair competition and legal remedies acts because it found that Mars did not have a duty to disclose information regarding child labor and forced labor in its supply chain.[92]

3. Communities

Finally, individuals residing in the countries in which these multinational companies operate have also brought claims alleging significant violations of their human rights. Perhaps the most famous is *Chevron v. Ecuador*[93] that concerns Texaco's oil operations in previous decades, which plaintiffs allege resulted in environmental damage and harm to the health of those who live in the region.[94] The facts of the case led to litigation or requests for review before multiple courts and tribunals.[95]

In 2013, the United States Supreme Court considered a case involving human rights abuses by multinational corporations in *Kiobel v. Royal Dutch Petroleum*.[96] The "[p]etitioners were residents of Ogoniland, an area of 250 square miles located in the Niger delta area of Nigeria."[97] The petitioners brought claims under the Alien Tort Statute (ATS),[98] which provides that "[t]he district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."[99] Petitioners brought claims under the ATS for violations of "the law of nations concerning aiding and abetting … (1) extrajudicial killings; (2) crimes against humanity; (3) torture and cruel treatment; (4) arbitrary arrest and detention; (5) violations of the rights to life, liberty,

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[91]Order Granting Mars Inc.'s Motion to Dismiss the Complaint at 7, Hodsdon v. Mars, Inc., 162 F. Supp. 3d 1016 (N.D. Cal. Feb. 17, 2016) (No. 15-CV-04450) ("[W]hen the defendant has not made any statements at all, a plaintiff cannot assert a claim under the FAL.").

[92]*Id*. at 8–11.

[93]Chevron v. Ecuador, 795 F.3d 200 (D.C. Cir. 2015).

[94]*Texaco/Chevron lawsuits (re Ecuador)*, Business and Human Rights Resource Centre, https://www.business-humanrights.org/en/latest-news/texacochevron-lawsuits-re-ecuador-1/.

[95]See *id*.

[96]Kiobel v. Royal Dutch Petroleum, 569 U.S. 108, 108 (2013).

[97]*Id*. at 113.

[98]28 U.S.C. § 1350 (2018).

[99]*Kiobel*, 569 U.S. at 113–14 (quoting 28 U.S.C. § 1350 (2018)).

security, and association; (6) forced exile; and (7) property destruction."[100] The Supreme Court took up the issue of whether a claim brought under the ATS may reach conduct occurring in the territory of a foreign sovereign.[101] It affirmed the Second Circuit's dismissal of the case because it concluded that "[t]he presumption against extraterritoriality applies to claims under the ATS, and that nothing in the statute rebuts that presumption."[102]

In *Doe v. Nestle*,[103] the third parties were "former child slaves who were kidnapped and forced to work on cocoa farms in the Ivory Coast for up to fourteen hours a day without pay."[104] Defendants were large manufacturers, purchasers, processors, and retail sellers of cocoa beans, such as Nestle, Cargill, and Archer Daniels.[105] In their complaint, plaintiffs raised claims for aiding and abetting slave labor under the ATS. The district court had dismissed the case because it involved an impermissible extraterritorial application of the ATS.[106] However, the Ninth Circuit disagreed because the facts alleged claimed that the defendants provided personal spending money to farms and cooperatives, which is "outside the ordinary business contract and given with the purpose to maintain ongoing relations with the farms so that defendants could continue receiving cocoa at a price that would not be obtainable without employing child slave labor."[107] Additionally, "[d]efendants also had employees from their United States headquarters regularly inspect operations in the Ivory Coast and report back to the United States offices, where these financing decisions, or 'financing arrangements,' originated."[108] The Ninth Circuit concluded that "the allegations paint a picture of overseas slave labor that defendants perpetuated from headquarters in the United States."[109] However, following the Supreme Court's

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[100] *Id*. at 114.

[101] *Id*.

[102] *Id*. at 108.

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

[104] *Id*. at 1122.

[105] *Id*.

[106] *Id*.

[107] *Id*. at 1126.

[108] *Id*.

[109] *Id*.

clarification of corporate liability under ATS in *Jesner v. Arab Bank, PLC*,[110] the Ninth Circuit clarified that the ATS does not support claims against foreign corporations and that, on remand, plaintiffs would need to "specify whether aiding and abetting conduct that took place in the United States is attributable to the domestic corporations in the case."[111]

II. Advantages of a Corporate Duty to Contract for Addressing Supply Chain Harms

This part introduces and discusses some of the advantages that a corporate duty to contract offers for the current regulatory environment. The first advantage is that it offers a means to address Type I externalities in addition to bolstering efforts to reduce Type II externalities. The second advantage is that it can incentivize corporations to invest in prevention by potentially triggering *Caremark* oversight obligations. The third advantage is that it can incentivize corporations to take specific steps that they may not take under a mandatory reporting regime. Finally, this duty may offer a judicial basis for human rights due diligence when a legislative basis may seem unlikely.

A. Proposing a New Duty to Consider Third-Party Harms in Contract Design

Given the difficulties that third parties encounter in protecting themselves through contract design and enforcement, what we need is a regard for others at the bargaining table, especially when those others are not present to advocate for their own interests. The contract contemplated may create significant externalities for third parties besides the contracting parties.[112] These externalities will manifest themselves following the conclusion of the contract and during performance; in this way, these are *ex post* externalities. However, the parties suffering from these externalities are not present during *ex ante* contract design to address the risk of externalities through negotiating and drafting contract clauses. And the contracting parties may have little incentive

[110] Jesner v. Arab Bank, PLC, 138 S. Ct. 1386, 1436 (U.S. 2018).

[111] *Nestle*, 906 F.3d at 1127.

[112] *See* Johnston, *Facing Up to Social Cost, supra* note 8, at 222–23 ("[F]or a variety of reasons, many externalities are not dealt with by law, regulation or taxation …. Where the law fails to require corporations to take their externalities into account, corporations rarely take account of their social costs voluntarily.").

to consider those externalities. This tracks the familiar problem that negligence law often addresses: incentivizing parties to have some concern for the welfare of others who may be injured by their own actions. Here, the action is contracting, which can have significant consequences for the welfare of others not at the bargaining table. We need to similarly incentivize contracting parties to take these externalities into account.[113] In order to do so, this article proposes the following basic idea for a new duty: *Contracting parties must take into account the interests of third parties when they could reasonably foresee that performance of the contract would create a risk of physical harm to third parties*. Reasonable contract provisions would satisfy the standard of care.

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

There is little question that economic activity in supply chains creates a risk of physical harm to many individuals, especially laborers in those chains.[114] The

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[113]Johnston, *Facing Up to Social Cost, supra* note 8, at 223.

[114]Rogers, *supra* note 39, at 46–47. In *Rahaman*, defendants focused on the omissions that illustrated the *breach of a duty* rather than on the conduct that *created the duty* in the first place (terms of supply contract). The Superior Court of Delaware accepted these allegations as involving nonfeasance in which defendants are under no duty to act unless there is a special relationship between the parties, or an exception applies. Rahaman v. J.C. Penny Corp., No. N15C-07-174, 2016 WL 2616375, at *7–8 (Del. Super. Ct. May 4, 2016). However, one could also argue that by creating specific terms of exchange, multinational buyers affirmatively act in the world and create risks of harm to others. This is not nonfeasance but misfeasance. According to comment *c* to § 37 of the Restatement (Third) of Torts, "[t]he proper question is not whether an actor's specific failure to exercise reasonable care is an error of commission or omission. Instead, it is whether the actor's entire conduct created a risk of physical harm." As an illustration, the Restatement explains, "[A] failure to employ an automobile's brakes or a failure to warn about a latent danger in one's product is not a case of nonfeasance governed by the rules in this Chapter, because in these cases the entirety of the actor's conduct (driving an automobile or selling a product) created a risk of harm. This is so even though the specific conduct alleged to be a *breach* of the duty of reasonable care was itself an omission." Restatement (Third) Torts: Liability for Physical and Emotional Harm § 37 (2012); Restatement (Third) Torts: Liability for Physical and Emotional Harm § 37 (2012) ("It would be necessary to ask hypothetically what would have happened if the actor had not engaged in the conduct to determine whether a duty exists."). The Restatement's explanation further clarifies that multinational buyers' actions constitute misfeasance warranting a duty of reasonable care. The terms of supply contracts that relate to volume, price, and delivery times create the risk of subcontracting and oversourcing, with all the attendant labor abuses. These are the predictable consequences of the supply contracts that multinational buyers routinely write. As such, the course of the entire "conduct create[s] a risk of harm."

multiple lawsuits brought by laborers in these supply chains provide graphic details of the abuse they have suffered from corporations and their suppliers.[115] And these conditions are often a product of the terms of the supply contract (Type I externality) or a failure of the supplier code of conduct (Type II externality). Therefore, under a negligence framework, the act of contract design creates a risk of physical harm to these parties such that the contracting parties have a duty to exercise reasonable care.[116]

Second, parties satisfy the duty with adequate contract design. All this duty asks of the parties is that they consider whether contractual performance would create the risk of physical harm to parties not present at the negotiating table. If so, this duty requires that contracting parties control what they can control: contract design.

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

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

Because this standard of care depends on knowledge, what constitutes "reasonable contract design" under this duty varies with time. Imagine a hypothetical where Buyer and Supplier are aware of media

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[115] *See, e.g.*, First Amended Class Action Complaint for Injunctive Relief and Damages at ¶¶ 20–31, Doe I v. Wal-Mart Stores, Inc., (No. 05-7307), 2007 U.S. Dist. LEXIS 98102 (describing conditions inducing fatigue, situations of physical assault); *Nestle*, 906 F.3d at 1122 ("While being forced to work on the cocoa farms, plaintiffs witnessed the beating and torture of other child slaves who attempted to escape.").

[116] Restatement (Third) Torts: Liability for Physical and Emotional Harm § 77 (2005).

coverage of forced labor conditions in the supply chains for the goods they are planning to exchange. To combat this risk, they adopt a standard model clause promoted by an industry association of which they are members. This clause provides for monitoring and inspection rights of Buyer and establishes a "hotline" for grievances. However, eight months later, Buyer learns of a number of instances of forced labor in its supply chain involving Supplier. Buyer promptly terminates its contract with Supplier. An internal audit by Buyer reveals that one reason the forced labor occurred is because Buyer announced its visits to Supplier's work sites, thereby enabling the latter to hide the forced laborers and present Buyer with a fake set of records.[117] Another reason for the abuse is because the forced laborers did not have access to the means to utilize the "hotline" that Buyer provided for in its code of conduct with Supplier. In its new supply contract with Supplier's replacement, Supplier 2, Buyer cannot satisfy the standard of care by using the exact same language it used in its previous contract with Supplier. It now knows that announced visits will not work and that hotlines are ineffective. It must therefore use its increased knowledge to design more effective clauses in its new contract with Supplier 2.[118] Whereas the initial contract clause could have satisfied the standard of care with Supplier, the same clause does not satisfy the standard in Buyer's new contract with Supplier 2 because the latter knows more; therefore, it must do more by incorporating that new knowledge in its contract design going forward.

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

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[117]*See, e.g.*, Kishanthi Parella, *Outsourcing Corporate Accountability*, 89 Wash. L. Rev. 747, 774–79 (2014) (describing various strategies of audit evasion).

[118]Johnston, *Facing Up to Social Cost, supra* note 8, at 223.

business operations.[119] This duty may also encourage buyer companies to engage meaningfully in stakeholder engagement with those who may be potentially harmed in order to draft clauses that are appropriate.

B. Targeting Type I Externalities

The first advantage of the proposed contractual duty is that it addresses Type I externalities. This article argues that human rights abuses often arise not only from the breach of contractual provisions (Type II externalities) but also as foreseeable consequences of the contract as designed. That is why the harms result from contract performance as much as from contract breach. The proposed duty would require that contracting parties consider the effects of the contract as envisioned on third parties and to alter the contract accordingly. It is *this* act of contract modification that allows contracting parties to address Type I externalities. Otherwise, contracting parties will design their contracts only to *manage* the risks they create, not to eliminate them.

While helpful, many contractual reforms of supply chain contracts focus on addressing Type II externalities but may not do enough to address Type I externalities. For example, the model clauses proposed by the Working Group of the Business Law Section (WGBLS) of the American Bar Association offer contracting parties clauses ready to insert into their supply contracts and other agreements to reduce the risks of human rights abuses.[120] But the addition of these contractual clauses may not necessarily cause contracting parties to rethink or redraft the other parts of the transaction that give rise to the harms that the clauses are meant to address. At worst, it may encourage a "tick the box" approach.[121] The motivation to include these provisions is to reduce legal risk or reputational risk. But these provisions may not be adapted to the particularities of the company's operations or the

[119]*See* Special Representative of U.N. Secretary General, *Protect, Respect and Remedy: A Framework for Business and Human Rights*, 14–21, U.N. Doc. A/HRC/8/5 (Apr. 7, 2008). *See* Working Grp. on Business and Human Rights, *Corporate Human Rights Due Diligence: Emerging Practices, Challenges and Ways Forward*, U.N. Doc. A/73/163 (October 2018); OECD, GUIDELINES FOR MULTINATIONAL ENTERPRISES (2011) http://www.oecd.org/daf/inv/mne/48004323.pdf (introducing a new chapter on human rights); INTERNATIONAL BAR ASSOCIATION, IBA PRACTICAL GUIDE ON BUSINESS AND HUMAN RIGHTS FOR BUSINESS LAWYERS 19–21 (2016); IPIECA, HUMAN RIGHTS DUE DILIGENCE PROCESS 4 (2012).

[120]*See generally* Snyder & Maslow, *supra* note 55.

[121]*See generally* David Hess, *Social Reporting and New Governance Regulation: The Prospect of Achieving Corporate Accountability Through Transparency*, 17 BUS. ETHICS Q. 453 (2017).

unique Type I externalities that these operations may create; as such, the clauses do not speak to the unique risks of the transaction and are therefore limited as a contractual tool. More critically, they provide less opportunity for the company's managers to reflect on the risks of the transaction.[122] In other words, what incentives do these contract clauses offer company managers to revisit the parts of the contract that do not specifically address Type II externalities?

If company managers do not reflect, it is very unlikely that they will change. As scholars have noted, "the resistance to a culture of compliance is often via scripts, and so much of the compliance effort must be to rewrite them."[123] Regulation should include opportunities for companies to create new habituation practices that may counterbalance other powerful behavioral scripts within the company.[124]

Additionally, many model clauses still restrict duties on the part of buyers.[125] These restrictions mean that third parties cannot sue buyers who fail to exercise the rights that these contract clauses give them. So even though a referenced appendix of supplier obligations gives buyers the right to inspect facilities, interview employees, review documents, and perform other audit functions, buyers are under no contractual obligation to exercise those rights. And if buyers do not exercise those rights, then suppliers face very little incentive to change their practices. They may get the impression that these clauses, policies, and codes of conduct are empty words that buyers do not intend to enforce and therefore will maintain the status quo. It is understandable why the Working Group decided to include these disclaimers regarding buyers' duties. Otherwise, buyers, fearful of legal liability, may hesitate to include such clauses in their contracts—clauses that are nonmandatory and are included only if

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[122] *See id.* at 457 (describing the "paradox of compliance problem" in which "[f]irms adopt compliance programs as insurance against prosecution; but because the effectiveness of a program is difficult to determine, a firm can simply adopt the appearance of a program and actually take less care to prevent wrongdoing. The end result is more wrongful behavior.").

[123] Donald C. Langevoort, *Cultures of Compliance*, 54 Am. Crim. L. Rev. 933, 966 (2017).

[124] *Id.* at 965 ("Compliance norms threaten the beliefs, behaviors and cultural tropes that are instinctively success-producing.").

[125] Snyder & Maslow, *supra* note 55, at 1105 (describing Section 5.7 Disclaimer Clause).

buyers and suppliers voluntarily decide to include them.[126] The prospect of legal liability may make it less likely that buyers would choose to do so.

C. Incentivizing Prevention Under Caremark

A second advantage of the corporate duty to contract is that it may offer an incentive for corporations to adopt supply chain compliance programs that prevent harms to third parties.[127] One mechanism that can encourage better compliance practices is directors' oversight responsibility under *In re Caremark International Inc. Derivative Litigation*[128] and, more recently, *Marchand v. Barnhill*[129] and *In re Clovis Oncology*.[130] But before there can be compliance, there must first be risk—often framed in legal terms. The absence of a duty to third parties means that there is minimal legal risk to corporations for their misconduct in the supply chain; lack of duty leads to a lack of legal risk.[131] Due to this lack of legal risk, *Caremark* and its subsequent cases may not impose much of an

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[126]Snyder & Maslow, *supra* note 55, at 1096–97 ("The drafters have crafted the text this way because some buyers may have the leverage to use the proposed text, and in any case, these clauses are aimed primarily at companies in the role of buyer.").

[127]*See, e.g.*, David Millon, *Human Rights and Delaware Corporate Law*, 25 Pac. McGeorge Global Bus. & Dev. L.J. 173, 182–86 (2012) (discussing potential legal and reputational risk associated with human rights violations abroad and the risk management responsibility of the board of directors); Ramasastry, *supra* note 31, at 238 (explaining that business and human rights "grows out of a quest for corporate accountability to mitigate or prevent the adverse impacts of business activity on individuals and communities and out of expectations grounded in a specific core set of human rights obligations").

[128]In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996); Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369–70 (Del. 2006); Strine, *supra* note 29; *see generally* Donald C. Langevoort, *Caremark and Compliance: A Twenty-Year Lookback*, 90 Temp. L. Rev. 727, 731 (2018); Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 Del. J. Corp. L. 719, 734 (2007).

[129]Marchand v. Barnhill, 212 A.3d 805, 809 (Del. 2019).

[130]In re Clovis Oncology, Inc. Derivative Litig., Consol. C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *12–15 (Del. Ch. Oct. 1, 2019).

[131]*See* Nolan & Boersma, *supra* note 47, at 135; *see also* Ramona L. Lampley, *Mitigating Risk, Eradicating Slavery*, 68 Am. U. L. Rev. 1707 (2019).

incentive to develop compliance programs that can serve a preventative function in the supply chain.[132]

The unfortunate consequence is that third parties are wounded three times over: *first*, through the initial misconduct; *second*, through a denial of justice in the courts; and, *third*, by facing the prospect of recurrence of the earlier misconduct due to inadequate compliance or other preventative corporate policies. The proposed duty addresses the *Caremark* problem by creating an incentive for those present at the bargaining table to consider these third-party externalities when contracting. Much of the

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[132]*See, e.g.*, Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y. L. Sch. L. Rev. 717, 719–20 (2009) (explaining that under *Stone v. Ritter*, the "board is responsible only for preventing wrongful or illegal acts. The board has no responsibility to prevent acts that are legal, but that lead to harmful business results."); Charles M. Elson & Christopher J. Gyves, *In Re Caremark: Good Intentions, Unintended Consequences*, 39 Wake Forest L. Rev. 691, 701 (2004) ("For directors, increasingly concerned about personal financial liability, the goal became liability avoidance rather than the prevention of corporate misconduct …. As the motivation for these actions was primarily liability-driven, their actual impact on corporate activities was questionable. It was the mere existence of these procedures that mattered-whether or not they would have any actual impact on corporate compliance with law was of secondary concern."); *see also* James A. Fanto, *The Governing Authority's Responsibilities in Compliance and Risk Management, as Seen in the American Law Institute's Draft Principles of Compliance, Risk Management, and Enforcement*, 90 Temp. L. Rev. 699, 705–06, 709 (2018) (discussing the prospect of legal liability to the company as a driver of corporate compliance programs); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 Wash. U. L.Q. 487, 491 (2003) (discussing the ineffectiveness of "paper compliance programs"); Todd Haugh, *Caremark's Behavioral Legacy*, 90 Temp. L. Rev. 611, 634 (2018) (discussing behavioral incentives and compliance initiatives). However, some have argued that *Caremark*'s penumbra may also extend to ESG and reputational risks to the company and, therefore, is not limited only to acts that may trigger legal liability. *See* Claire A. Hill, *Caremark as Soft Law*, 90 Temp. L. Rev. 681, 684–85 (2018) ("[W]hat directors and officers apparently think they should do to abide by their *Caremark* duties is much more than what they have to do to avoid liability …. But what boards do to abide by their *Caremark* duties extends to activities or omissions that are not illegal."); *id*. at 689 ("[A]t least part of the story is an obligation for the company to be mindful of the harm it can do to third parties beyond anything that might be legally actionable."); Millon, *Human Rights and Delaware Corporate Law*, *supra* note 127, at 185–86 ("[R]isk management extends beyond avoidance of litigation to the broader challenge of avoiding behavior that is likely to be condemned in the court of public opinion."); Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. Corp. L. 967, 978 (2009) (discussing the application of *Caremark* to failures in risk management). However, as discussed later, the reputational damage to a corporation from misconduct in the supply chain may depend on some predicate legal action that publicizes and disseminates the information. Here, legal sanctions and reputational costs work together with the former influencing the magnitude and effectiveness of the latter. *See* Kishanthi Parella, *Reputational Regulation*, 67 Duke L.J. 907, 913 (2018); Roy Shapira, *Reputation Through Litigation: How the Legal System Shapes Behavior by Producing Information*, 91 Wash. L. Rev. 1194, 1196 (2016).

current legislation addressing supply chains—in the United States and abroad—focuses on transparency measures and mandatory information disclosures.[133] These approaches do not impose fines or penalties on corporations for their performance. As such, there is no legal leverage to get the compliance process going from a legal risk perspective.[134]

The challenges with curtailing supply chain externalities are familiar ones associated with encouraging better compliance by corporate actors; namely, how to encourage corporate actors to adopt a socially optimal compliance program that "'a rational, profit-maximizing firm would establish if it faced an expected sanction equal to the social cost of the violation.'"[135] Scholars have noted the limitations of legal risk to incentivize corporations to adopt a socially optimal compliance program, including "limited regulatory resources, detection difficulties, legal uncertainties and procedural obstacles, conflicts of interest, [and] political pressure."[136]

These problems are further compounded when it comes to human rights compliance in supply chains because enforcement action is absent. Most of the laws addressing supply chains rely on information disclosure without recourse to legal fines or penalties. As a result, at present, human rights abuses do not create many legal risks for companies. While these abuses are unlawful, corporations are rarely held liable for these acts because many of the legal rules prohibiting these acts are based in international law that is addressed to state actors and not corporations.[137] The low probability of corporate accountability for these acts translates into low legal risk from a *Caremark* calculus. To avert a human rights crisis, a corporation must, at minimum, have adequate human rights compliance policies and practices in place. The incentive to

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[133] *See* Michael R. Littenberg & Nellie V. Binder, *Corporate Social Responsibility Disclosure and Compliance: An Overview of Selected Legislation, Guidance and Voluntary Initiatives*, Ropes & Gray (October 2019), https://www.ropesgray.com/en/newsroom/alerts/2019/10/Corporate-Social-Responsibility-Disclosure-and-Compliance.

[134] *See* Nolan & Boersma, *supra* note 47, at 149.

[135] Donald C. Langevoort, *Cultures of Compliance*, 54 Am. Crim. L. Rev. 933, 936–38 (2017) (quoting Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, in Jennifer Arlen, Ed., Research Handbook on Corporate Crime and Financial Misdealing (2017)).

[136] *Id*. at 938.

[137] *See* Jesner v. Arab Bank, PLC, 138 S. Ct. 1386, 1389 (U.S. 2018).

do so, however, may rest upon the legal consequences to a corporation from such a crisis. When there are minimal legal consequences, *Caremark* may provide little incentive to adopt such a compliance program.

The duty to contract can help to address these shortcomings in a number of ways. First, it alters the *Caremark* calculus by recognizing duties that may recalibrate the compliance calculation by offering the prospect of legal accountability that is otherwise absent.[138] This response not only offers access to justice for those harmed by the corporate misconduct but also gets the issues on the radar of corporate officers and directors so that the misconduct may be averted in the future through adequate compliance efforts. After all, compliance is not a profit center within a corporation; there is competition for those dollars from those parts of those organizations that are more profitable or from compliance areas that present more of a legal risk.[139] Second, increased legal accountability may shift the internal importance of these issues and transform them from departments devoted to procurement or quality control into a matter for the legal department.[140]

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[138]In re Clovis Oncology, Inc. Derivative Litig., Consol. C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *12–13 (Del. Ch. Oct. 1, 2019) ("Our Supreme Court's recent decision in *Marchand v. Barnhill* underscores the importance of the board's oversight function when the company is operating in the midst of "mission critical" regulatory compliance risk .... As *Marchand* makes clear, when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised.").

[139]*See* Langevoort, *supra* note 128, at 730; Eugene Soltes, *Evaluating the Effectiveness of Corporate Compliance Programs: Establishing a Model for Prosecutors, Courts, and Firms*, 14 N.Y.-U. J. L. & Bus. 3, 965, 1005 (2018); Assent Compliance, Budgeting for Compliance in 2020 35 (2019) ("Between 2016 and 2019, companies reported increases of 16 to 25% in time spent on labor; compliance professionals project that an increase of 11 to 15% more time will be needed for compliance by 2022.").

[140]Irene Pietropaoli, Lise Smit, Julianne Hughes-Jennett & Peter Hood, A UK Failure to Prevent Mechanism for Corporate Human Rights Harms 17–18 (contrasting the comparing the departments tasked with compliance with bribery as compared to human rights due diligence and arguing that "[i]f a regulation for human rights based on section 7 of the Bribery Act is introduced, primary responsibility for human rights due diligence may similarly move away from corporate social responsibility to the compliance and legal departments."). *But see* Mariam H. Baer, *Compliance Elites*, 88 Fordham L. Rev. 1599, 1624 (2020) (discussing the drawbacks of "performance blind spots" of compliance officers).

D. Addressing Weaknesses of Mandatory Reporting Requirements

Another advantage of the corporate duty to contract is that it may motivate companies to take steps that transparency laws fail to incentivize. Many jurisdictions that have adopted supply chain laws relating to human rights have adopted an information disclosure approach that requires that companies tell the public about their human rights policies and practices, for example, but does not require that they adopt one or that it accord with a particular standard.

For example, the California Transparency in Supply Chains Act[141] requires covered corporations to disclose their efforts to ensure that their supply chains are free from slavery and human trafficking, including information about their practices concerning verification, audits, certifications, internal accountability standards and procedures, and training.[142] The law requires that covered companies publish this information on their website if they have one.[143]

Similarly, the UK Modern Slavery Act[144] requires that covered companies provide an annual statement of the measures they take to eradicate slavery from their supply chains.[145] Specifically, Section 54 of the Act[146] requires that the statement, "if the organisation is a body corporate other than a limited liability partnership, must be approved by the board of directors (or equivalent management body) and signed by a director (or equivalent)."[147] The company must also publish the statement on its website in a prominent place if the company maintains a website.[148] Section 54 also recommended a number of topics that a statement should include, such as "its due diligence processes in relation to slavery and

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141 Cal. Civ. Code § 1714.43 (West 2012).

142 *Id.*

143 *Id.*

144 Modern Slavery Act 2015 (U.K.), https://www.legislation.gov.uk/ukpga/2015/30/contents/enacted.

145 Virginia Mantouvalou, *The UK Modern Slavery Act 2015 Three Years On*, 81 The Modern Law Review 1017, 1038 (2018).

146 Modern Slavery Act of 2015, c. 30, § 54 (UK).

147 *Id.* § 54(6)(a).

148 *Id.* § 54(7).

human trafficking in its business and supply chains" and "the parts of its business and supply chains where there is a risk of slavery and human trafficking taking place, and the steps it has taken to assess and manage that risk."[149] The problem is that many companies provided insufficient information in many of these reporting categories because Section 54 did not *require* that a company statement include this information.[150]

Another problem is that mandatory reporting requirements don't seem to work well to improve corporate behavior.[151] A significant number of companies are still not complying with the disclosure requirements in place—an outcome that is not surprising given the weak sanctions available for noncompliance.[152] And even if companies are improving their *reporting*, they are *not* improving their underlying *practices*, which is the goal of the reporting regime. According to the Corporate Human Rights Benchmark (CHRB), nearly one-half of the 200 global companies assessed in 2019 scored zero across all indicators related to human rights due diligence.[153] The CHRB report also found that many companies are not improving their practices over time, thus "indicating that there have been insufficient incentives for them to change."[154]

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[149]*Id.* § 54(5).

[150]Business & Human Rights Resource Centre, FTSE 100: At The Starting Line 4–5 (2016), https://media.business-humanrights.org/media/documents/files/documents/FTSE_100_Modern_Slavery_Act.pdf (noting inadequate disclosures among company statements provided by FTSE 100 companies); Business & Human Rights Resource Centre, FTSE 100 & the UK Modern Slavery Act: From Disclosure to Action 14 (2018), https://media.business-humanrights.org/media/documents/files/FTSE_100_Briefing_2018.pdf (also noting inadequate disclosures among company statements provided by FTSE 100 companies).

[151]Policy Brief from the Clean Clothes Campaign et al. (Oct. 3, 2019).

[152]*See, e.g.*, Business & Human Rights Resource Centre, Modern Slavery in Company Operation and Supply Chains 13 (Sept. 2017), https://media.business-humanrights.org/media/documents/fb7a2e03e33bcec2611655db2276b4a6a086c36c.pdf (compiling summaries of analyses of company statements under mandatory disclosure laws).

[153]Corporate Human Rights Benchmark, 2019 Key Findings 6 (Nov. 2019).

[154]*Id*. at 8. (finding that a number of companies did improve practices, especially when they have been repeatedly assessed.); *see also* Working Grp. on Bus. & Human Rights, s*upra* note 119, at 8–9; British Inst. Int'l & Comparative Law et al., Study on Due Diligence Requirements Through the Supply Chain 63-67 (Lise Smit et al. eds., 2020).

One explanation for this failure is that the UK and California laws neglected to include a number of features that would enable reputational markets to work effectively. For example, the California supply chain law did not provide a public list of the companies that were covered by the law. This gap made it difficult for those—such as NGOs—who wish to "name and shame" noncompliant companies because there was no public list that identified which companies are required to report.[155] Another criticism is the lack of a central repository for company statements provided under the reporting laws.[156] A central repository is important to facilitate comparisons between companies so that stakeholders can identify "leaders and laggards" and provide the appropriate market response.[157] Finally, critics also noted the lack of sanctions for noncompliance that undermines the effectiveness of the reporting regime.[158] The Australian government had the benefit of learning from experiences in these other jurisdictions and addressed many of these shortcomings when designing their own supply chain law.[159] For example, Australia's Commonwealth Modern Slavery Act of 2018[160] mandates specific topics for disclosure.[161]

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[155]Know The Chain, Five Years of the California Transparency in Supply Chains Act 5 (Sept. 30, 2015).

[156]*See, e.g.*, Joint Standing Committee on Foreign Affairs, Defence, and Trade, Parliament of the Commonwealth of Australia, Modern Slavery and Global Supply Chains: Interim Report of the Joint Standing Committee on Foreign Affairs, Defence, and Trade's inquiry into establishing a Modern Slavery Act in Australia § 2.28 (Aug. 2017).

[157]*See id.*; *see also The Australian Modern Slavery Act 2018 – will it live up to expectations?* Bus. & Hum. Rights Resource Ctr. (Jan. 12, 2018), https://www.business-humanrights.org/en/blog/the-australian-modern-slavery-act-2018-will-it-live-up-to-expectations/.

[158]Secretary of State for the Home Department, Independent Review of the Modern Slavery Act 2015: Final Report, 2019, at 35–36 (UK).

[159]Joint Standing Committee on Foreign Affairs, Defence, and Trade, Parliament of the Commonwealth of Australia, Hidden in Plain Sight: An inquiry into establishing a Modern Slavery Act in Australia § 1.10 (Dec. 2019) ("[A] key question for this inquiry was to examine the effectiveness of the UK's *Modern Slavery Act 2015* (UK Act) and assess whether similar or improved measures could be introduced in Australia.").

[160]Modern Slavery Bill 2018 (Cth.) (Austl.).

[161]*See, e.g.*, Modern Slavery Business Engagement Unit, Australian Government, Commonwealth Modern Slavery Act 2018: Guidance for Reporting Entities 39–61, (Sept. 26, 2019).

These reforms certainly improve the design of reporting requirements.[162] But reporting requirements may get us only so far. These changes do not eliminate fundamental limitations of reputational mechanisms that impede their ability to improve corporate behavior in the supply chain. These mandatory disclosure laws seek to change corporate behavior through reputational mechanisms.[163] The idea is that the government actors mandate disclosure of information that corporations would not otherwise share. Stakeholders, such as consumers, who now possess this information discriminate in the market between corporations based on the information that is reported, thereby providing financial penalties (or rewards) for superior or inferior corporate behavior.[164]

The issue is whether the audience for the information that is reported under these laws—most prominently, consumers—cares enough to impose market sanctions or rewards. Some research into reputational markets suggests not. While there is no doubt that reputational sanctions can levy significant financial costs for corporate misconduct,[165]

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[162]For example, the proposed Washington State Transparency in Agricultural Supply Chain Act offers a number of improvements, such as mandating reporting along the supply chain from supplier to retailer, public disclosure, and legal sanctions. But the bill also appears to suffer from a number of the weaknesses of the California law by not providing for a public list of covered companies or a central repository of company statements for comparison. Finally, the bill applies only to agricultural supply chains and does not impose reporting requirements on a broader base of companies. S.B. 5693, 66th Leg., Reg. Sess. (Wash. 2019). Another approach is the Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019 that would require issuers to perform an annual analysis to identify any human rights risks or impacts in their operations and supply chains “that are known or should be known” and to rank those risks or impacts based on severity. In addition to mandating information disclosure on human rights due diligence processes, it also mandates disclosures on outcomes. Issuers are required to share information on the ranked list of risks and impacts, as well as their responses and the effectiveness of those responses. 116 Cong., 1st Session §3 (2019).

[163]*See* Nolan & Boersma, *supra* note 47, at 133.

[164]*See, e.g.*, United Kingdom Home Office, Transparency in Supply Chains, A Practical Guide 6 (“[A] failure to comply with the provision, or a statement that an organisation has taken no steps, may damage the reputation of the business. It will be for consumers, investors and Non-Governmental Organisations to engage and/or apply pressure where they believe a business has not taken sufficient steps.”).

[165]*See* Soltes, *supra* note 139, at 1005.

companies engaging in environmental violations do not suffer similar reputational losses.[166] One explanation for this is the divergence between interest and leverage: corporations suffer reputational losses when their exchange partners, such as consumers or investors, alter the terms of the exchange, often because of a fear of opportunism. Under this explanation, the reputational sanction is wielded only by these exchange partners. Environmental harms, however, "impose costs on parties other than those with whom the polluting firm does business."[167] Exchange partners are not directly affected by the firm's misconduct and are therefore less likely to sanction the firm.[168] This insight raises concerns not only about the efficacy of "naming and shaming" relating to environmental misconduct but also about other types of social impact, such as human rights abuses in the supply chain. In these situations, those wielding the reputational sanctions—often consumers—do not internalize the costs of wrongdoing; the identities, and therefore interests, of the injured and the sanctioner diverge, unlike in situations of financial misconduct in which reputational sanctions are high since the party who internalizes the cost of wrongdoing is also the party who wields the sanction.

E. Increasing Prospects for Mandatory Due Diligence

Due to the disadvantages of mandatory reporting laws, a number of countries are considering or implementing mandatory due diligence laws that require that companies take specific due diligence steps; reporting on what they do (and do not do) is not enough. While these legislative steps are promising, we do not yet know how far these steps may go to address Type I externalities. Additionally, and more fundamentally, it may be unlikely that general mandatory human rights due diligence laws will be implemented in the United States. Specifically, it may be difficult to mandate general and broad human rights due diligence in the United States through legislation. However, a corporate duty to contract may provide a judicial basis for human rights due

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[166] *Id.*

[167] Jonathan M. Karpoff, John R. Lott & Eric W. Wehrly, *The Reputational Penalties for Environmental Violations: Empirical Evidence*, 48 J.L. & Econ. 653, 656 (2005).

[168] *Id.*

diligence,[169] among additional steps that contracting parties may take.

Much of the basis for legislative action on human rights due diligence traces back to the United Nations Guiding Principles on Business & Human Rights, which states that businesses have a "responsibility to respect human rights,"[170] and, as part of that responsibility, businesses should have in place a "human rights due diligence process to identify, prevent, mitigate and account for how they address their impacts on human rights."[171] A company's responsibility for due diligence includes evaluating (a) "the country contexts in which their business activities take place, to highlight any specific human rights challenges they may pose [,]" (b) the "human rights impacts their own activities may have within that context—for example, in their capacity as producers, service providers, employers, and neighbours[,]" and (c) "whether they might contribute to abuse through the relationships connected to their activities, such as with business partners, suppliers, State agencies, and other non-State actors."[172] Appropriate due diligence requires formulating a firm-specific human rights policy, impact assessments, integration of the human rights policy throughout the firm, and tracking performance through monitoring and auditing.[173] These UN guidelines have, in turn,

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[169]Some scholars have argued for the recognition of a business common law duty of care that includes human rights due diligence. *See, e.g.*, Cassel, *supra* note 30, at 179; *see also* Salminen, *supra* note 30, at 422; Palombo, *supra* note 30, at 266. For example, parent companies would need to undertake due diligence for all activities undertaken by the entities in the enterprise, and victims could bring claims under negligence so long as their "injuries were of the kind reasonably foreseeable by the exercise of due diligence." Cassel, *supra* note 30, at 179–80. According to one scholar, "[a] company would not be liable for breach of its duty of care if it proved that it reasonably exercised due diligence as set forth in the [UNGPs], … On the other hand, a company's failure to exercise due diligence—its negligence—would create a rebuttable presumption of causation and hence liability." *Id.* at 180. In situations in which a "plaintiff proves that a business activity adversely affected her human rights, causing injury and resulting in damages, a company could then avoid liability for breach of its duty of care, or mitigate the amount of damages, only by carrying its burden to prove that the risk of the human rights violation was not reasonably foreseeable, or that the damages would have resulted even if the company had exercised due diligence." *Id.*

[170]*See* U.N. Human Rights Office of the High Comm'r, Guiding Principles on Business and Human Rights 7 (2011).

[171]*Id.* at 15–16.

[172]*See* Special Representative of U.N. Secretary General, *supra* note 119, at 17.

[173]*Id.* at 59–63; *see also* Working Grp. on Bus. & Human Rights, *supra* note 119 at 4–6.

influenced best practices and manuals produced by the OECD,[174] the International Bar Association,[175] and the American Bar Association,[176] among other organizations.

The French Corporate Duty of Vigilance[177] provides an example of this approach and establishes "a legally binding obligation for parent companies to identify and prevent adverse human rights and environmental impacts resulting from their own activities, from activities of companies they control, and from activities of their subcontractors and suppliers, with whom they have an established commercial relationship."[178] Soon, France may not be alone. Similar mandatory due diligence laws have been proposed or considered in at least thirteen other countries, and the European Commission is also considering an EU-wide equivalent.[179] In 2019, the Netherlands Child Labor Due Diligence Act[180] introduced "a duty of care for companies to prevent the supply of goods or services which have come into existence using child labor, to Dutch end-users."[181] According to legal commentary, "[t]he Act imposes three main obligations on companies: (i) a duty to investigate by means of due diligence whether there is a 'reasonable suspicion' that goods or services to be supplied have been created using child labor; (ii) a duty to

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[174]OECD, OECD Guidelines for Multinational Enterprises 3 (2011).

[175]*See* International Bar Association, *supra* note 119, at 7.

[176]Debra Cassens Weiss, *ABA House Considers Human Rights Responsibilities of Corporations*, ABA Journal (Feb. 6, 2012), https://www.abajournal.com/news/article/aba_house_considers_human_rights_responsibilities_of_corporations.

[177]French Corporate Duty of Vigilance Law, *supra* note 32.

[178]European Coalition for Corporate Justice, French Corporate Duty of Vigilance Law: Frequently Asked Questions (2017), https://respect.international/wp-content/uploads/2017/10/french-corporate-duty-of-vigilance-law-faq.pdf.

[179]British Inst. Int'l & Comparative Law et al., *supra* note 154, at 17, 41.

[180]Wet van 24 oktober 2019 houdende de invoering van een zorgplicht ter voorkoming van de levering van goederen en diensten die met behulp van kinderarbeid tot stand zijn gekomen (Wet zorgplicht kinderarbeid) [Law of 24 October 2019 on the introduction of a duty of care to prevent the delivery of goods and services that have been established with the help of child labor (Child Labor Due Diligence Act)], Stb. 2019 401, https://zoek.officielebekendmakingen.nl/stb-2019-401.pdf.

[181]Rick van 'T Hullenaar & Kornel Olsthoorn, *The Netherlands Adopts Business and Human Rights Legislation to Combat Child Labor*, Jones Day Commentaries (Feb. 2020), https://www.jonesday.com/en/insights/2020/02/the-netherlands-tackling-child-labor-with-new-act.

develop and execute a plan of action in case there is a reasonable suspicion of child labor; and (iii) a duty to issue a statement to the supervising authority that it observes the aforementioned due diligence requirements."[182] The Act also authorizes fines in the event of noncompliance and, "[w]hile the Act's criminal provision is ambiguous, it appears that individual directors of a company may face up to two years of imprisonment or a criminal fine of up to EUR 21,750." [183]

A second issue is whether we can expect comparable mandatory due diligence legislation at the state or federal level in the United States. The current human rights due diligence laws seem circumscribed in their application to specific types of actors or specific types of goods from specific locations. For example, the Federal Acquisition Regulations includes specific requirements regarding compliance programs addressing human trafficking.[184] Additionally, the 2012 US Conflict Minerals Rule requires that "[i]f tin, tantalum, tungsten or gold is necessary to the functionality or production of a product manufactured or contracted to be manufactured by a U.S. public company registrant, it must conduct a 'reasonable country of origin inquiry' to determine whether the necessary 3TG minerals in the product originated in the Democratic Republic of the Congo or an adjoining country."[185] In situations where "the minerals originated outside of the DRC region or are from recycled or scrap sources, the registrant is required to disclose on Form SD its determination and describe its reasonable country of origin inquiry and the related results."[186] "If the registrant knows or has reason to believe that necessary 3TG minerals are from the DRC region, it must conduct enhanced due diligence and file a separate Conflict Minerals Report exhibit to its Form SD, detailing the measures taken to exercise due diligence on the source and chain of custody of the minerals and information concerning the processing facilities, the country of origin and the efforts to determine the mine or location of origin."[187]

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[182]*Id.*

[183]*Id.*

[184]Lyndsey Conrad *et al.*, *Mandated Corporate Responsibility for Human Trafficking: New Federal Acquisition Regulation Steps Up Supply Chain Accountability*, 60 St. Louis U. L. J. 73, 87 (2015); Assent Compliance, Human Trafficking, Slavery, and Your Supply Chain 8.

[185]Littenberg & Binder, *supra* note 133, at 1.

[186]Littenberg & Binder, *supra* note 133, at 1.

[187]Littenberg & Binder, *supra* note 133, at 1.

III. Beyond Supply Chains: The Normative Basis for Protecting Third Parties

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

The proposed contract duty can similarly encourage contracting parties to revisit contract design and reduce the risks of these harms to third parties. But the extension of this duty beyond the supply chain requires a normative examination of why third-party interests should matter—within the supply chain and beyond. Part II explored the practical policy reasons for a duty to contract; this part examines the normative basis for that duty.

Specifically, Part III.A illustrates how the "outsider" status of third parties is inappropriate given the multiple benefits they bring to exchanges, such as by reducing search and information costs, improving information flows, and magnifying and redistributing losses. Part III.B discusses the normative implications that result from recognizing a contract as an ecosystem and identifies three contracting principles that contracting parties should honor: (a) third-party protections from negative externalities, (b) contract design obligations of contracting parties, and (c) recourse to legal remedies for third parties.

A. Contracts as Ecosystems: Recognizing the Roles of Third Parties in Exchanges

What follows is an illustrative but not exhaustive discussion of the many institutions that third parties create and the functions these institutions provide. Institutions constrain human behavior and interactions, and such constraints broadly "include any form of constraint that human beings devise to shape human interaction."[188] Institutions can consist of formal rules, such as laws, as well as informal ones, such as codes of conduct.[189] The purpose of an institution is to provide guidance on how to behave when we interact with other people.[190]

Institutions are often confused with a related but distinct concept: *organizations*. If institutions are the rules, then organizations are the players or "groups of individuals bound together by some common objective [ ]."[191] The combination of institutions and organizations around us structures the choices we make daily, encouraging us toward some forms of behavior while deterring us from others.[192] For the purpose of this part, a "third-party institution" refers to "rules of the game" established, maintained, and enforced by parties other than the participants in an exchange relationship; in the familiar contracts setting, third parties are nonsignatories to the contracts. A "third-party organization" is a grouping of individuals who are not participants in the exchange.

The dividing line between exchange participants or contract signatories, on the one hand, and third parties, on the other, is not clear or fixed. After all, exchange participants are also members of our society, so they help to maintain the "third-party institutions." The point is that while exchange participants may contribute to the operation of these institutions, they cannot maintain these institutions alone; instead, they need the assistance of parties not a part of their exchange to maintain these institutions. As discussed in Table 2, these institutional functions discussed below are some of the major contributions that third parties provide to contracting ones, which generally fall into two categories: *lowering transaction costs ex ante*, and (or because of) *lowering risk of opportunism ex post*.[193]

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[188] Douglass C. North, Institutions, Institutional Change and Economic Performance 4 (1990).

[189] *Id*. at 5.

[190] *Id*. at 6.

[191] Douglass C. North, Understanding the Process of Economic Change 59–60 (2005).

[192] *Id*.

[193] *See, e.g.*, Ronald Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1, 15 (1960).

1. Lowering Transaction Costs *Ex Ante*

Consider the risks associated with contractual uncertainty when two parties are strangers to each other. To proceed with the exchange, a party will likely engage in at least two types of costly activities to protect itself against the risk of breach or other misconduct by the other: *information gathering* regarding the other's propensity for opportunism,[194] and *negotiating and drafting* a more complicated contract sufficiently detailed to identify noncompliance and provide remedies and other protections.[195] Third-party institutions assist both of these functions by lowering *ex ante* information costs through organizations, networks, and norms that improve both the production and accuracy of information regarding potential exchange partners. Third-party institutions also provide background rules against which parties contract.

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

Kinship networks help to reduce these costs by providing low-cost credible information regarding risk of opportunism by different parties at varying levels of social distance.[196] These predictions are based on

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[194] *See, e.g.*, EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS 52 (Univ. Mich. Press, 2d ed. 2005) ("[P]otential traders must search each other out, and, once such interested parties have made contact, they must try to find out more about each other. Specifically, each has to determine who the other party is and whether he is willing and able to live up to any agreement that may be reached.").

[195] *Id.*

[196] Landa, *supra* note 5, at 359–60.

Table 2: Advantages of Third-Party Institutions for Contracting Parties

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

shared norms and values, such as a code of ethics, that govern those traders. For example, in a study of ethnically homogeneous middlemen, the standard of conduct was provided by the Confucian code of ethics.[197] This code allowed traders to form reliable expectations about the risks of exchanging with different types of partners at varying levels of social distance from themselves: near and distant kin, clan, village, ethnicity, and nationality.[198] These expectations are provided by the shared code of ethics that established guidance regarding how one trader would treat another based on social distance.[199] Kinship institutions thereby facilitate exchange in situations in which they might not otherwise occur because of the high level of contract uncertainty, on the one hand, and an ineffective legal framework, on the other.[200] Associational membership also serves as a screening device that parties may use when searching for another party with whom they may want to exchange.[201]

Third parties develop certain types of social preferences that can help reduce information costs by decreasing the likelihood that individuals will crowd the marketplace for information with misinformation.[202] Third parties also develop social preferences for trustworthiness,[203] fairness,[204] and reciprocity that are advantageous to the activity of exchanging.[205] For example, the preference for trustworthiness reduces the risk that a party sharing that preference will engage in opportunism because they will experience some level of loss by engaging in that action. Similarly, parties often value reciprocity independent of outcomes

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[197]Landa, *supra* note 5, at 358.

[198]Landa, *supra* note 5, at 352.

[199]Landa, *supra* note 5, at 352.

[200]Landa, *supra* note 5, at 349.

[201]Landa, *supra* note 5, at 349; Bernstein, *supra* note 4, at 1765.

[202]Richman, *supra* note 4, at 402.

[203]W. Bentley MacLeod, *Can Contract Theory Explain Social Preferences?*, 97 Am. Econ. Rev. 187, 187 (2007).

[204]*See* Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 Colum. L. Rev. 1641, 1667 (2003).

[205]Linda D. Molm, Gretchen Peterson & Nobuyuki Takahashi, *In the Eye of the Beholder: Procedural Justice in Social Exchange*, 68 Am. Soc. Rev. 128, 150 (2003); Elizabeth Hoffman, Kevin Mccabe & Vernon L. Smith, *Behavioral Foundations of Reciprocity: Experimental Economics and Evolutionary Psychology*, 36 Econ. Inquiry 335, 350 (1998).

because of the qualities that reciprocity reveals about the character of the exchange parties; these perceived qualities can then help one exchange partner predict how the other will treat them in the future.[206]

Next, third parties developed institutions that allowed contracting parties to utilize incomplete contracts and thereby economize on contract drafting costs *ex ante*. The merchant law developed by trade associations can help to reduce the burden to create detailed contracts between parties.[207] In a historical example, the Maghrebi traders of the eleventh century faced high negotiation costs given the poor state of technology and vast distances of trade.[208] The use of the merchant law reduced these costs because it provided a significant baseline of norms and expectations upon which the parties exchanged, reducing the need to rely on detailed contracts.[209] Not only did this law facilitate the use of incomplete contracts; it also provided the traders with a means of identifying cheaters despite the use of incomplete contracts.[210] Without the aid of the merchant law, it would have proven difficult to differentiate between cheaters and honest traders because incomplete contracts did not specify sufficient details to ascertain breach.[211]

2. Lowering Risk of Opportunism *Ex Post*

Third-party institutions discourage parties from engaging opportunistically *ex post* by improving information flows between individuals; therefore, potential cheaters know that future exchange partners will learn about their conduct. When such information is accompanied by coordinated punishment, potential defectors will likely resist the temptation to act opportunistically because of the prospect of losing future exchanges with other parties. Through such coordinated punishment, third-party organizations magnify the potential losses from noncompliance. They also magnify the potential losses by binding business relationships with

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[206]*See* Molm et al., *supra* note 205, at 148–49; Scott, *supra* note 204, at 1667.

[207]Greif, *supra* note 3, at 542–43; Bernstein, *supra* note 4, at 1726.

[208]Greif, *supra* note 3, at 542.

[209]Greif, *supra* note 3, at 530.

[210]Greif, *supra* note 3, at 530.

[211]Greif, *supra* note 3, at 530.

social position, so that misconduct in one sphere of a merchant's life has consequences for another. Finally, third-party institutions redistribute losses from the potential cheater to those in their social circles, thereby providing additional inducements for cooperation.

First, third-party institutions deter opportunism by magnifying losses from noncompliance. For example, problems can arise when the temptation of short-term gains from cheating exceed the value of profits from future exchanges with a particular exchange partner. In some situations, that exchange partner may be unable to surmount the gains from cheating by themselves. However, third parties acting collectively can increase the losses associated with cheating through coordinated punishment, binding social and business lives, and redistributing losses.

Coordinated punishment occurs when third parties respond collectively to acts of cheating against one of their members. In a simple example, consider an exchange between parties X and Y in a situation where X's short-term gains from cheating are greater than the present value of long-term gains from exchanging with Y in the future. Even though the prospect of losing Y's future business may not be enough to deter X from cheating in the present, the cost-benefit analysis changes when the other members of the trade coalition or association also threaten to refrain from exchanging with X if X cheats Y. By threatening to ostracize X, the other trade members add the value of future exchanges with them to the cost-benefit analysis, thereby magnifying the losses associated with cheating and outweighing the short-term gains from cheating.[212]

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

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

[212]Greif, *supra* note 3, at 537; Richman, *supra* note 4, at 400; Bernstein, *supra* note 4, at 1764.

private dispute panel reveals.[213] For example, in the diamond industry, the New York Diamond Dealers Club's (DDC) private arbitration system "is wholly incapable of enforcing agreements on its own and is toothless in punishing diamond theft."[214] Instead, "the DDC's role is purely informational, and the power of its dispute resolution system rests on the degree to which it supports trust-based exchange and can foreclose future transactions to uncooperative merchants. The DDC fulfills this role by facilitating information exchange and publicizing individual reputations."[215]

Private dispute resolution is valuable not only for information production but also for verification. Information revealed through dispute mechanisms tends to be viewed as more accurate, thereby reducing the need for independent verification processes and additional information gathering.[216]

Information production is only part of the challenge; once the information is gathered, how is it transmitted across the distances in which exchanges may occur? Here, third-party institutions also operate to facilitate exchanges by creating *information networks*. Specifically, connections between communities and trade groups in different areas can aid in the transmission of reputation-relevant information.[217] Finally, the prospect for magnification and redistribution of losses depends on information flows. Private dispute resolution mechanisms can both generate and publicize information regarding a merchant's misconduct. These institutions do not need to supply the sanctions; instead, they trigger them by invoking certain responses from the broader community or trade organizations.[218] Even informal institutions play an important role through

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

[214] Richman, *supra* note 4, at 396.

[215] Richman, *supra* note 4, at 397 ("The DDC's system of arbitration and information exchange thus sets the stage for other family and community-based institutions to enforce the industry's executory contracts; if the DDC announces the verdict, then these complementary institutions are the sheriffs that enforce it.").

[216] Bernstein, *supra* note 4, at 1768–89.

[217] Bernstein, *supra* note 4, at 1022–23.

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

information networks like clubs or interpersonal ties that can transmit information across distances both modest and great.

These information networks deter opportunism by making the threat of sanctions credible. Otherwise, a potential cheater engaging in opportunism that is difficult to detect, verify, or publicize may think: "Yes, but you have to learn of it first to punish me." Without information, there is no punishment; and without punishment, there is a higher risk of cheating. Information networks counteract the temptation to cheat by allowing parties to know that their acts of opportunism will be detected and broadcast to all of their potential future trading partners. Thereby, by cheating, a party risks their relationship not only with the merchant they are cheating but with all the other merchants as well.

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

Community club goods also magnify the losses associated with noncompliance.[219] Communities may confer status upon individuals that the latter would not jeopardize through noncompliance. For example, in New York's diamond industry, actors who would normally pose a significant threat to exchange because of the significant short-term gains of opportunism (high value of diamonds), high level of informalities in exchange, and limited future returns from future exchanges given their low wages do not flee with the diamonds because of the value of excludable community goods that would be denied to them following opportunism.[220] Membership may also provide a sense of belonging and identity to an association's participants such that they would not risk breaching the association's relevant institutions—religious norms, Confucian ethics, merchant law—if such behavior would result in ostracism or expulsion. Through these various means, community institutions

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[219]Richman, *supra* note 4, at 405 ("Club goods are available only in the club, only club members can consume club goods, and each member of the club experiences externalities from every other member's behavior. Consequently, club members strive to obtain club goods just as they would standard goods, and relatedly, the club (or community) will manipulate the consumption of club goods in order to induce behavior that is desirable to the club.").

[220]Richman, *supra* note 4, at 408.

increase the losses resulting from noncompliance and thereby deter opportunism; the interdependence between social and business institutions increased the risk that conduct within one arena may reverberate in the other.

The bonding of social and business relationships also leads to the creation of inter-generational reputational capital, which deters opportunism by redistributing losses from noncompliance. If reputational capital belonged only to the individual merchant (with no transferability prospects), then that reputational capital would incentivize only the merchant's good behavior for the duration of the merchant's career. This creates the risk that merchants may engage in opportunism near the end of their careers when they do not anticipate future exchanges.[221] However, the time horizon for the value of reputational capital is extended through transferability of that capital to the merchant's familial or social circles, thereby redistributing the potential gains and losses from opportunism to the merchant's family members.[222]

B. *Contracting Principles under an Ecosystem Approach*

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

(a) *Principle 1*: If third parties are insiders within a contract ecosystem, they should be *protected from the types of harms* that other contract insiders—contracting parties—choose to address.
(b) *Principle 2*: If third parties are insiders within contract ecosystems who should be protected from harm, then we must incentivize those who are agents of those harms—contracting parties—to avoid those actions through *contract design* by asking: What would the contracting parties have bargained for in the contract if *they* were the ones who confronted the risks of harm?

[221] Richman, *supra* note 4, at 403.

[222] Greif, *supra* note 3, at 533; Richman, *supra* note 4, at 403; Bernstein, *supra* note 4, at 1770.

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

The following three subsections expand on these three principles to explain how each results from a vision of contracts as ecosystems.

1. Principle 1: Protection from Harm

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

If both groups of actors are present within contract ecosystems, it is difficult to justify a situation in which one group (contracting parties) is empowered to protect itself from the harms of contract activities while the other (third parties) is not. What normative lens justifies this differentiation that results in us prioritizing the vulnerabilities of some but not others? Certainly, the latter have the ability to address these risks while the former do not (as yet); however, this is an observation of current realities and does not reflect a normative evaluation of their status within contract ecosystems. The fact that third parties *cannot* protect themselves from harm does not mean that they *should* not be able to do so. This gap illustrates only the limitations of the law.[223] For this observation to serve as a guide on the moral equality of the parties or the priorities of their harms is to doubly wound those marginalized in contracts: First, the law ignores their plight, and second, our imagination constricts to reflect those same limitations. Encouraging this view creates the danger that those legal limitations may be viewed as parameters for possibilities. For those reasons, our views on the rights of third parties should

[223] *See, e.g.*, Bagchi, *supra* note 8, at 226–28 (arguing that contracts should protect the legally protected interests of third parties).

acknowledge the roles they perform in contracts and not simply focus on the realities that the law currently reflects.

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

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

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

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

Conversely, donor third parties may suffer externalities from exchanges. For example, communities may create club goods that are available only to their members and, consequently, serve as an incentive for contractual cooperation.[224] Club goods not only induce a trader to keep their promise but also create a community interest in the trader doing so: "The credibility of its members certainly brings wealth to the community, ensuring sustained income for its current workers and its younger members, but it also reflects an adherence to values that have religious significance to the community and, according to the club good model, add to each members' utility."[225] As such, certain externalities may destroy the institutions that donor third parties build, thereby causing harms to the latter.

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

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[224]Richman, *supra* note 4, at 406.

[225]Richman, *supra* note 4, at 406–07.

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

2. Principle 2: Protection from Externalities—*Ex Ante* Contract Design

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

One approach is through contract design. Here, we might ask: What would the contracting parties have bargained for in the contract if *they* had been the ones vulnerable to these externalities? First, contracting parties may modify contractual obligations to minimize the risk of externalities posed by the contract. For example, corporations may modify production schedules and volume expectations to minimize the risk of labor violations in the supply chain. Second, contracting parties may introduce new contract obligations to address the potential externalities that could result from contract performance. Supplier codes of conduct are one such contract mechanism, but given the externalities that remain unaddressed, contracting parties may upgrade these contract provisions with enhanced obligations.

Third, contracting parties may realize that some contract requirements create the risk of externalities that may be too difficult to address through contract provisions and, as a consequence, eliminate those obligations wholly from the contract. By placing the contracting party in the position of the third party, we may expect the elimination of problematic provisions that would not have been within contract ecosystems if third parties had a voice at the bargaining table. Fourth, it is also possible that the entire contract may be immune to redemption. Here, the thought exercise does not eliminate specific contract provisions but forecloses the possibility of the contract as a whole because the contract is one that creates externalities to third parties grave enough that contracting parties should ask: Is this a contract that should be performed? This is an important question because not every imagined contract is a socially desirable one. Some contracts may create the risk of harms that are so grave that if third parties had a voice, they would prohibit the contract. Or, if contracting parties suffered the risk of harm, they would never sanction its performance.

All these thought exercises unite the *risks* faced by third parties with the *power* enjoyed by contracting parties by asking how the latter would act if they confronted the same risks as the former. However, imagination can get us only so far. Contracting parties can only imagine what third parties may prefer. This may lead to inaccurate beliefs and suboptimal contracting choices. Therefore, the last response from this thought exercise is *consultation*: contracting parties may be better off if they stopped imagining what third parties would want and instead asked them directly through consultations or a role in the bargaining process. These are all natural consequences from the thought exercise described above. They may not be plausible consequences; however, this section is intended to explore how externalities in the supply chain may be addressed.

3. Principle 3: Protection from Externalities—*Ex Post* Legal Remedies

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

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

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

This leads to the second justification for *ex post* legal remedies: incentives for compliance. Ideally, the law would incentivize prevention of harms to third parties, but contracting parties may not invest in preventative compliance measures without the prospect of a legal sanction for a failure to do so. Therefore, by providing legal remedies *ex post*, the law also achieves the added advantage of potentially decreasing the risks of similar harms in the future.

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

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

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

Conclusion

This article explores the issue of third-party externalities in the global supply chains in which many of our familiar products are created and valued services rendered. The men, women, and children who work in these supply chains—or are otherwise affected by them—have very little voice in designing the contracts that these supply chains support. However, it is often they who suffer from physical harm that results from the performance of these contracts or breaches of the codes that are meant to address these risks.

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

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