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Regulating in a Transnational Context: Three Foundational Principles

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This brief puts forward three foundational principles that explain the difficulties in regulating global value chains and multinational enterprises (MNEs). This has implications on whether more or less coercive strategies could be pursued to ensure responsible business conduct. Targeting the top of the value chain – parent companies and lead firms – is not be as straightforward as it might appear at first sight. For the time being, there is no treaty on corporate human rights accountability, and national laws in home countries have limitations. These regulatory gaps allow businesses to externalize costs with impunity through their cross-border operations. Can these gaps be explained as mere lack of political will of home states and pro-business bias? If not, what are the difficulties that hinder the adoption of such coercive legal strategies at international and home state levels?

The brief maintains that the task of regulating MNEs (lead firms) should remain mindful of three 'first order' principles in the transnational business context. These principles are fundamental considerations of corporate law (legal separation of entities), international law (national sovereignty) and human rights law (leverage for rightholders).

SPECTER OF REDIRECTING GLOBAL VALUE CHAINS

The corporate accountability movement sends out a compelling message: outsourcing activities does not mean outsourcing responsibility. Outsourcing production, distribution or other business functions in settings where human rights are at high risk of infringement and non-remediation does not mean the company becomes insulated from abuses 'tainting' its goods and services. On the one hand, the company (lead firm) might be blameworthy for its harmful decisions that have rippling effects on suppliers' operations, such as when setting up a subsidiary in a high risk zone without precautions, or setting contractual terms on suppliers that result in exploitative working conditions. On the other hand, the company might be blameworthy when it stands by as its business partners infringe the rights of workers or local communities. In short, lead firms in MNEs might be blameworthy for their culpable actions and omissions, for contributing or just being linked to rights abuses.

The 2011 UN Guiding Principles (UNGPs) establish a responsibility for the company to act in both situations. Consequently, human rights due diligence (HRDD) should be used to identify and address adverse impacts when a business causes, contributes or is linked to such impacts. Some argue that states should turn this responsibility to act into a legal obligation, backed by sanctions and offering remediation for victims. The counterargument is that businesses are legally separated from their subsidiaries and contractors, a bedrock principle of company law and foundational to 'shareholder capitalism'. Legislating some version of a HRDD obligation on parent companies (lead firms) reduces the protection from liability offered by this principle. How will this affect the compliance strategy of such companies coordinating global value chains?

Companies can comply by strengthening their human rights efforts, or by redirecting their value chains away from high risk partners and countries. Concretely, in deciding how to comply with the new regulations, companies remain free to sell a subsidiary or chose less problematic suppliers from safer zones. If they are deprived of the protection offered by

Note: This brief draws on R. Mares, 'Legalizing human rights due diligence and the separation of entities principle', in Surya Deva and David Bilchitz (eds.), Building a Treaty on Business and Human Rights: Context and Contours (CUP, 2017) pp. 266-296, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3054492 legal separation, companies contemplating international trade or investment decisions will ponder whether the risks and costs of compliance are worth taking. Simply disengaging from partners in high risk zones remains a legitimate compliance strategy. Such compliance would have significant ramifications.

The basic argument herein is that regulating in a transnational setting is evolving under the specter of redirection of global value chains: legal pressure on the lead firm creates liability risks and compliance burdens that may result in a compliance strategy to redirect the value chain away from high risk zones. Such redirection has implications for both host states and rightholders therein. Indeed host states have sovereign interests in pursuing development by integrating in global markets. Moreover, rightholders in exporting countries seek opportunities to escape poverty; having the chance to participate in global value chains is such an opportunity. In sum, turning HRDD into a legal obligation creates frictions with the legal separation of entities principle, which in turn can generate frictions with the sovereignty of host states and with the imperative of realizing human rights in an economically integrating world. Therefore proposals to regulate lead firms should be mindful of fundamental considerations of business law (legal separation of entities), international law (national sovereignty), and human rights (leverage for the benefit of rightholders).

It might be appealing to think of imposing a HRDD obligation on lead firms as merely pushing back against a business-friendly principle, of ranking human rights imperatives over profitability of large companies. It would be tempting to regard the principle of legal separation of entities as merely a legal technicality or a lasting pro-business bias that new regulations could and should simply reverse under sustained advocacy and moral weight of human rights imperatives. Rather the legal separation principle must be seen as a foundational aspect for any discussion about ending MNE impunity. The emphasis herein is that one should not lose sight of the policy considerations lying behind this principle and its ramifications in the transnational business context.

Indeed, domestic and transnational regulatory contexts to end corporate impunity are not similar. The specter of relocation is real and should not be excluded out of hand. Requires factual analysis of the specific supply chains before regulatory proposals are advanced with full force. Regulations imposing HRDD come in different shades; the more coercive the laws hitting at the top of the value chain, the stronger the frictions with the three foundational principles. Therefore, one should account for the specificity of the transnational context, frictions should be acknowledged, and legalization proposals should be designed to keep such frictions at manageable levels. The three foundational principles will reassert themselves in any international treaty making process on corporate accountability, as well as domestically in home states contemplating laws with extraterritorial effects.

The three first order principles are presented below and followed by a discussions of potential objections.

THREE FOUNDATIONAL PRINCIPLES

Legal Separation Principle (Company Law)

The principle of legal separation of entities is well recognised in most jurisdictions. As a general rule, one is not liable for the harms created by third parties. Originally meant to limit the exposure of individuals from the liabilities of the company they invested in, the principle has evolved to offer protection also to companies that operate through subsidiaries and contractors. Although such business enterprises are economically coordinated, the multitude of entities involved in the enterprise remain legally separated with their own assets and liabilities. The public policy explanation has to do with efficiency considerations and stimulation of large scale economic activity.

This legal separation of entities principle creates opportunities to increase efficiency in legitimate ways but also to accidentally or even deliberately externalize costs on society. Far from a developing country problem only, the limited liability privilege has come under sustained attack in developed countries with advanced rule of law systems. The protection offered to parent companies places victims at a severe disadvantage by denying them reparations for damage suffered if the subsidiary cannot compensate them. There have been sophisticated arguments challenging the limited liability privilege in tort law; they raised both economic and moral considerations, but proved unsuccessful in reshaping the law. A hard look at history serves as a reminder about the staying power of this principle. It allows to size up this major obstacle for current regulatory proposals on corporate human rights responsibilities.

The legal separation of entities principle is widely seen as the bedrock of company law[2]. Exceptions to it can and have been created. Indeed, abuses of legal separation such as fraud or alter ego resulted in courts 'piercing the corporate veil', but these are of narrow application leaving little space for expansion. There are also precedents in several fields of law where due diligence obligations have been imposed on parent companies. It would be

[2] H Hansmann and R Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 Yale Law Journal 1897; Nina A. Mendelson, A Controller-Based Approach to Shareholder Liability for Corporate Torts (2002), 102 Columbia Law Review 1203.

mistaken to maintain that the legal principle is an immutable, outright, formal obstacle for lawmakers and courts. However, the risk-management and public policy considerations behind the principle do not become irrelevant. The principle is not crumbling. Despite exceptions and precedents, the space for maneuver remains restricted. This is particularly so regarding liability aspects (tort law), which is at the core of providing remediation for victims. Recent case law and legislative initiatives substantiate this cautionary standpoint.

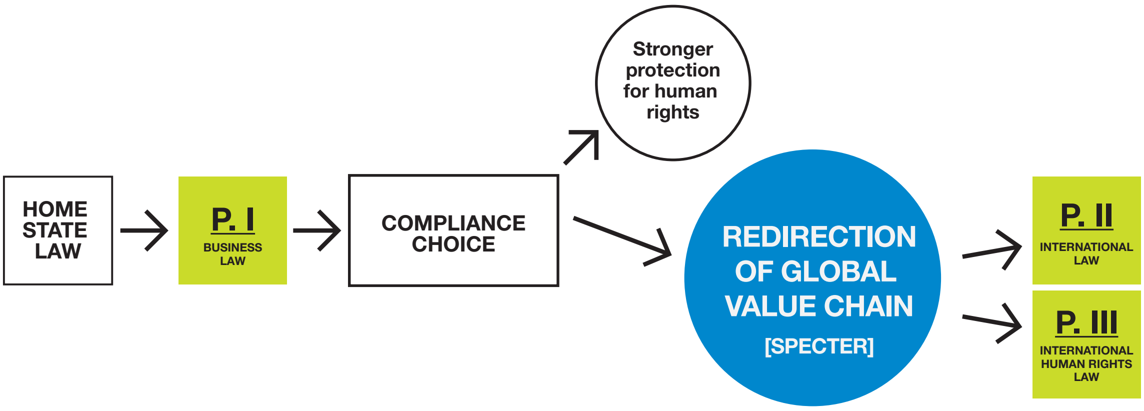
State Sovereignty (International Law)
State sovereignty is a foundational principle in international law. Regulating lead firms in MNEs that might comply by diverting their value chains away from the host state denies it the opportunities from participating in the global economy according to its own sovereign developmental path. Coercive regulations of lead firms or trade bans can be seen in host states as protectionist moves. Some developing countries could see this as illegitimately linking trade and human rights; they explicitly rejected this attempt when the World Trade Organization was set up (1994).

Proposals to regulate the lead firms cannot overlook a global development, trade, investment context where sovereign states prize highly their integration in global value chains. Some might argue that sovereignty is a myth. However, concerns of national sovereignty are not misplaced particularly now as developing countries show an ever growing desire for increased international trade and investment as witnessed by the multitude of free trade agreements being negotiated in recent years. A disaggregated and fact-based approach to host countries is warranted to assess their potential objections to regulations with transnational effects.

Leverage Principle (International Human Rights Law)
International human rights law emphasizes that states should take a wide variety of legislative and other measures to protect the rightholders. In the transnational commercial context scarred by deep governance gaps, this variety of measures translates into the overriding aim to mobilize all forms of private and public leverage to systematically increase the protection of rightholders harmed by business operations. This ‘leverage principle’ can be discerned in the UNGPs which clarify that the responsible course of action for a business that does not cause or contribute to infringements is, first, to exercise leverage and, second, to disengage from its abusive suppliers. This sequencing reflects the imperative that rightholders should be supported through all sources of leverage possible. To achieve that, the UNGPs seek to mobilize public, corporate and civil governance systems to bring corporate impunity to an end (the ‘polycentric governance’ model – Brief 1/2017).

The possibility of value chains redirecting as a response to coercively legalizing HRDD at the top of the value chain is immediately problematic for the UNGPs: it severs transnational channels of exercising leverage. Civil society groups also see redirecting value chains away from high risk zones as unproductive and desirable only as a last resort.

While harvesting leverage from as many sources as possible is desirable, legalizing such leverage is not a straightforward task. The legislatures seeking MNEs’ accountability have a delicate balancing task in not setting the bar too low – making then the regulatory effort less consequential – or too high – risking thus redirecting the value chains away from high risk zones. Legalizing leverage in too coercive of a way may result in destroying the leverage altogether as companies will consider reorienting their value chains to escape the compliance burden and liability risks. That has implications for how we assess coercive and less coercive legal strategies in a transnational setting.



OBJECTIONS

This analysis posits that three first order principles are at play and interacting in the transnational business context, and that the difficulty for regulating lead firms comes from the possibility that being subjected to coercive regulation in their home states lead firms could comply by redirecting global supply chains away from high risk zones. Some objections could be raised regarding all aspects: the specter is not real, the sovereignty concerns are overstated, and the legal separation principle is fading away.

1. Specter of Redirection is Not Real Because Lead Firms Will Not Necessarily Redirect Their Value Chains

It is possible that lead firms will not redirect their value chains. For instance, such companies might have no feasible alternative but to stay and comply, and thus to bear the costs of compliance or pass them to consumers. If value chains are not redirected, then the interactions of the foundational principles will not really unfold: there will be no sovereignty objections and the rightholders will only benefit from the added safeguards.

A case by case analysis of value chains is required to identify where the risk of redirecting is significant and where not, given the specificities of each supply chain. Accepting the costs of respecting human rights is not the only consideration going into relocation calculations. However one would be hard pressed by reality to deny that relocation occurs. This brief raises the possibility that the specter exists and it should not be assumed away for convenience.

2. Sovereignty Concerns are not Warranted Because Host States Would Not Object to Home State Regulations

It is possible that host states will not object to home states' regulating coercively the lead firms. After all, it is developing countries that have been driving the UN corporate accountability treaty process since 2014 (Brief 1/2017). With no objections from host states, a home state could push back against the legal separation principle and impose more coercive HRDD obligations on lead firms under its jurisdiction. Furthermore, a broadly ratified treaty would see the specter not materialize as lead firms would have less space to redirect their value chains. Then the choice could simply be reduced to human rights against the legal separation of entities principle.

The reality however is that developing countries compete fiercely in the global market place. They also have varying commitments to human rights. Thus some states pursue a path to development and integration in the global economy that builds on social and environmental safeguards. For example, such host states are willing to agree to free trade agreements that incorporate labour and human rights protections (Brief 3/2017). However some other states pursue accelerated economic growth and development uncluttered by human rights sensitivities. They seek to grasp the opportunities economic globalization and liberalized global markets offer without getting bogged down in protracted debates, dissent and individual complaints that respect for human rights enables. In short, the position of host states cannot be assumed as favourable or neutral to home state regulating their MNEs should the specter of redirection arise.

3. Legal Separation is Not Sacrosanct Because Exceptions and Precedents Exist
Some might argue that the legal separation principle should give way to human rights considerations, or at a closer look that it actually is crumbling following recent judicial and legislative developments. Therefore this principle should not be seen as immutable. Not only are legislation and case law in flux but they are also fully aligned with the idea of HRDD enshrined in the widely endorsed UNGPs. With an eye to such recent developments, one might legitimately wonder whether caution and emphasis on the legal separation of entities principle are misplaced now that this business law principle is coming under attack from so many directions and seemingly losing ground on so many fronts. Such precedents in case law and statutory law are noteworthy, but they should be carefully read for how they refer to the separation principle and how coercive they actually are.

Judicial precedents supporting a HRDD obligation come from two recent notable English and Canadian cases in tort law.These cases discuss a parent company's duty of care leading to liability for a subsidiary's harmful operations. However, in both cases the courts wrote explicitly and at length that this was not a challenge to the legal separation principle. Parent companies are not liable by default when their affiliates infringe human rights. The judgement should not be construed as a vindication of 'enterprise liability' reasoning but as instances of liability derived from the parent's own faulty conduct, from its own involvement in harmful activities of subsidiaries. Instead of being downplayed, the legal separation of entities principle is reaffirmed in strongest terms.

> 'I would emphatically reject any suggestion that this court is in any way concerned with what is usually referred to as piercing the corporate veil. A subsidiary and its company are separate entities. There is no imposition or assumption of responsibility by reason only that a company is the parent company of another company.'
> 'There is in general no duty to prevent third parties causing damage to another.' (Chandler v Cape [2012] EWCA (Civ) 525)

A legislative precedent was set by France, when in February 2017 it created a HRDD obligation for French MNEs with subsidiaries and suppliers abroad. Large companies now

[3] Chandler v Cape [2012] EWCA (Civ) 525 and Choc v. Hudbay Minerals Inc., 2013 ONSC 1414 (Ontario Superior Court).

have a ‘duty of vigilance’ that requires them to prepare, publish and implement a management plan. The process began in 2013 drawing on the momentum created by the UNGPs and the shocking factory collapse at Rana Plaza, Bangladesh. The gradual narrowing of the legislative proposal demonstrated lawmakers’ preoccupation to proceed carefully in moving liability up the value chain. The initially-planned reversal of the burden of proof has been abandoned in order to exclude the possibility that the law in practice would result in vicarious liability. The initial proposal also explicitly excluded calling for strict or vicarious liability, which would have made the parent company liable by default.

Soft law instruments are meant to clarify the corporate responsibilities. While by their nature these instruments do not create legal obligations and can therefore be silent on legal separation, neither are they oblivious to legal realities. The OECD has been most clear, and consistently so, on the friction with legal separation.

In 2011 the OECD updated its CSR Guidelines and brought them in line with the UNGPs, but with a meaningful addition: ‘This is not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship.’ (OECD Guidelines, 2011)

‘The question whether parent companies should assume responsibility for certain financial obligations of subsidiaries as part of good management practice raises complex problems in view of the limited liability principle embodied in adhering countries’ national laws. The Guidelines cannot supersede or substitute for national laws governing corporate liability. They do not therefore imply an unqualified principle of parent company responsibility.’ (Annex to OECD Guidelines, 2000)

This analysis emphasized the gravity of the ramifications of the legal separation principle. The legalization discussion should not be reduced to one about overcoming the legal separation principle through hard laws that would ‘legalize HRDD’ and ‘hold MNEs accountable’. Awareness of the three foundational principles makes it clear why not succumbing to a simplistic and sweeping narrative is necessary. The way forward cannot simply be reduced to a relentless push for more coercive obligations directed at the top of the value chain. The legalization task is way more complex: proponents have to navigate a course around first order principles of international law, business law, and human rights law that interact in the transnational value chain context. The alternative is to confine themselves to direct involvement cases where coercive laws are not objectionable and the legal separation principle does not play a role (Brief 4/2017).

Implication 1: The transnational context is different from the domestic context and can be explained by the specter of redirection of value chains and three foundational principles.

Implication 2: The legal separation principle is not a legal technicality but a foundational aspect in itself. Additionally, in the transnational context carries ramifications that bring two other foundational principles into play. Therefore the regulation of lead firms cannot be reduced in all situations to a simple choice between a pro-business principle and human rights imperatives.

Implication 3: Using coercive laws to strengthen HRDD is not as straightforward and unproblematic a task as might appear. To reduce frictions with the three foundational principles, the legalization of HRDD should on the one hand, distinguish between the direct or indirect involvement of the lead firm, and on the other hand reassess the continuum of coercive to less coercive legalization options (Brief 4/2017).

Implication 4: These foundational principles come into play only for cases of indirect involvement in harm ('linkages' in UNGPs) and not direct involvement situations ('cause' or 'contribute' in UNGPs). In the latter situation, the separation principle is not relevant as liability builds on the own wrongful conduct of the lead firm.

Implication 5: Less coercive legalization of corporate responsibilities can be explained not as a symptom of a persistent lack of political will to get tough on multinationals, although that clearly can be a factor, but as a way of reducing frictions with first order principles revolving around the redirection of value chains.

The specter of value chains being redirected away from high risk zones hovers above attempts to regulating MNEs. Faced with coercive laws that remove the protection offered by the legal separation principle, lead firms can comply by increasing protections for human rights or by redirecting value chains. Such potential redirection triggers profound national interests of states not willing to forfeit their integration in the global economy and furthermore raises unintended effects for rightholders. Three first order principles shape legalization options: the legal separation of entities (business law), national sovereignty (international law), and rightholders' interest in maximum leverage being mobilized (human rights).

To succeed, regulation of MNEs should be designed in a way that minimizes the frictions with these three principles. It follows that transposing HRDD into law is not simply about pushing relentlessly for more coercive laws targeting lead firms. Instead, in many situations the task is to conceive policy mixes adapted to the mobility of global value chains and thus deliver a regulatory regime able to account for and navigate a course around foundational principles specific to the transnational business and human rights area.