

INNOVATIONS IN GOVERNANCE: A FUNCTIONAL TYPOLOGY OF PRIVATE GOVERNANCE INSTITUTIONS

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INTRODUCTION

Biodiversity loss, fishery collapse, deforestation, climate change, conflicts over natural resources, economic migration, and increasing inequality threaten economic and social stability throughout the world. These negative externalities have accompanied the economic gains that globalization has brought to many countries. Recent advances in communications technology have allowed communities to overcome geographic limits and act collectively to address those impacts. Communities are meeting their demand for governance not only through formal government and legislative and regulatory processes, but also through direct negotiations with other interested parties. Increasingly, groups are turning to private governance, rather than formal government, to address their needs.

Private governance institutions provide governance without government. They are rules and structures by which individuals, communities, firms, civic organizations, and other entities govern their interests without the direct involvement of the state or its subsidiaries. Private governance institutions are limitless in their variety. Political science, sociology, law, and economics literature describes hundreds of variations of private governance institutions throughout the world that have developed their own community-based rules for resource management and conflict resolution.¹ This

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1. See Charlotte Hess & Elinor Ostrom, *Introduction* to UNDERSTANDING KNOWLEDGE AS A COMMONS: FROM THEORY TO PRACTICE 3, 8–9 (Charlotte Hess & Elinor Ostrom eds.,

article will only examine a few that have been developed in the last two decades or adapted in recent years to address significant social costs and environmental externalities arising from globalized trade: education and mobilization initiatives, firm contractual arrangements, corporate social responsibility programs, socially responsible investment, codes of conduct, environmental management systems, disclosure and reporting initiatives, learning initiatives, models and meta-standards, cooperatives, and voluntary standards, certification, and labeling mechanisms.²

This article advances the private governance literature in three ways. First, the article outlines the descriptive and analytical shortcomings of existing taxonomies used to classify private governance institutions. Second, the article examines public demand for governance and the ways private governance institutions meet that demand.³ The article argues that private governance institutions arise in response to government failure at one or more stages of the regulatory process. This government failure may result, for example, from collective action problems, public choice dilemmas, rent-seeking

2008); *see also* Indiana University's Digital Library of the Commons, *available at* <http://dlc.dlib.indiana.edu/dlc/> (compiling the existing literature on common-pool resources, including governance issues).

2. While this article may have implications for formal government, it does not specifically examine or address the variety of hybrid forms or other "new governance" systems that have recently been initiated and developed by formal government, such as public voluntary programs and negotiated agreements. New governance diverges from traditional command-and-control forms of governmental regulation to include experimental programs, framework agreements, stakeholder developed rules, revisable standards, benchmarks for improvement, and public and peer participation mechanisms to ensure accountability. *See* David M. Trubek & Louise G. Trubek, *New Governance & Legal Regulation: Complementarity, Rivalry, and Transformation*, 13 COLUM. J. EUR. L. 539, 541–42 (2007). While many of the new governance processes and forms may be similar to those we see in private governance institutions, formal government generally provides the framework for their initiation, development, and support in most studies of these systems. *See id.*; Gainne de Burca, *New Governance and Experimentalism: An Introduction*, 2010 WIS. L. REV. 227, 228 (2010). *But see* Jason M. Solomon, *New Governance, Preemptive Self-regulation, and the Blurring of Boundaries in Regulatory Theory and Practice*, 2010 WIS. L. REV. 591 (2010) (diverging from the common usage to identify "new governance" as an approach, regulatory strategy, or tool for both public and private contexts which "blurs the boundaries between state-centered and self-regulatory, public and private" distinctions).

3. Thomas P. Lyon, *Environmental Governance: An Economic Perspective*, in GOVERNANCE FOR THE ENVIRONMENT 43, 43 (Magali A. Delmas & Oran R. Young eds., 2009) (suggesting that, from an economic point of view, demand for governance may arise from consumers seeking products or services from companies that have a record of fair treatment of their workers, fair payment to their agricultural suppliers, or environmentally sound operations); Walter Mattli & Ngaire Woods, *In Whose Benefit? Explaining Regulatory Change in Global Politics*, in THE POLITICS OF GLOBAL REGULATION 1, 29, 33 (Walter Mattli & Ngaire Woods eds., 2009).

behavior, regulatory capture risks, and the challenge of funding public goods. The article also identifies the institutions' innovative responses to market failures, including transaction costs, information asymmetries, agency problems, moral hazard, anti-competitive behavior, and externalities, all of which create the need for regulation in the first place.

Finally, the article identifies a number of insights that a functional typology of private governance institutions yields. First, a functional typology clarifies the strengths of each type of private governance institution, thereby revealing key structures needed at each stage of the regulatory process, and suggesting improvements for both private governance and formal government. Second, the functional typology suggests that effective governance does not require that a single institution substitute for formal government at all stages of the regulatory process. Private governance institutions may complement formal government at key junctures, or they may coordinate and collaborate with each other to create network or ensemble regimes with the capacity to substitute formal government entirely. In fact, collaboration may be preferred, based on the complexities of the social and ecological systems that private governance and formal government are attempting to manage, as well as considerations associated with the theory of the firm. On the other hand, private governance institutions may compete with formal government through preemption and other crowding-out effects. Private governance institutions may also compete with one another through free-riding, dilution, and confusion. Sorting the institutions by function clarifies what each institution brings to the regulatory process, what each institution lacks, and how the institution may be supported or improved.

The sorting process also underscores the importance of funding mechanisms in an institution's overall effectiveness as a regulator. Efforts to analyze private governance institutions alongside institutions in which government plays a significant role, such as negotiated agreements, public voluntary programs, and other forms of new governance,⁴ have obscured the roles that funding mechanisms play in private governance because these functions are supplied largely by the tax system and the budgetary process in formal government contexts. Finally, the analysis identifies one type of private governance institution that currently attempts to substitute for

4. *See supra* note 2.

government at all stages of the regulatory process: voluntary standards, certification, and labeling systems.

The article is organized as follows. Part I describes existing taxonomies and their shortcomings. Part II describes the circumstances that give rise to a demand for private governance at each stage of the regulatory process and the barriers and hazards that block effective regulation by formal government at each stage. Part II also organizes private governance institutions according to the functions they serve in overcoming these barriers and hazards. The article then identifies the key characteristics or structures needed at each stage of the regulatory process to ensure effectiveness. Part III describes how certain private governance institutions also compete with formal government and other private governance institutions for regulatory space.

I. THE DESCRIPTIVE AND ANALYTICAL LIMITS OF THE EXISTING TAXONOMIES

Identifying what makes private governance institutions reliable, effective regulators is a meaningful exercise for a number of reasons. Parties that generate negative externalities⁵ may use private governance to avoid formal regulation. Private governance institutions not only complement formal government as well as other private governance institutions in order to meet demands for governance, they can also preempt formal regulation and compete with one another for participants, consumers, investors, and regulatory space.⁶ Consequences include “greenwashing”⁷ or

5. As long as the total benefits to society from the activity outweigh the total harms caused by the activity, society enjoys a net gain in welfare. However, the individuals who enjoy the benefits of an activity or transaction may not be the only parties who bear the costs of that activity or transaction. When the costs associated with an activity or transaction are borne by third parties or by society at large, these costs are said to have been “externalized” and the harm is regarded as an “externality.” NATHANIEL O. KEOHANE & SHEILA M. OLMSTEAD, *MARKETS AND THE ENVIRONMENT* 66 (2007) (“An externality results when the actions of one individual (or firm) have a direct, unintentional, and uncompensated effect on the well-being of other individuals or the profits of other firms.”).

6. These activities are described in more detail in Part III, *infra*.

7. Greenwashing is a term used to describe the concealment of an organization’s environmental harms while advertising that the organization is acting to protect the environment. See Andrew Hoffman & Stephanie Bertels, *Who Is Part of the Environmental Movement?*, in *GOOD COP, BAD COP: ENVIRONMENTAL NGOS AND THEIR STRATEGIES TOWARD BUSINESS* 48, 62 (Thomas P. Lyon ed., 2010) (“[G]reenwashing [is] a term that implies presenting misleading information to conceal an organization’s abuse of the environment and present a positive public image.”). The term appears to have come into use with accusations that firms were “whitewashing” their “green” credentials or performance.

misinformation and fraud in meeting consumers' and investors' social and environmental preferences.⁸

Previously, scholars have attempted to classify the diverse array of private governance institutions by their dominant stakeholder constituencies, based on whether those groups are primarily (1) firms and business groups, (2) nongovernmental organizations (NGOs) and civic participants or community actors, (3) a hybrid of business groups and NGOs or civic participants, (4) formal government partnering with business, non-governmental, or civic participants, or (5) a combination of all these constituents.⁹

Using this sectoral approach, scholars criticize certain institutions, suggesting that they will fail to serve the public interest because the stakeholders are not drawn broadly from all sectors.¹⁰ This strategy draws on a normative or prescriptive form of stakeholder theory where more equitable outcomes are achieved by including all parties with a stake in those outcomes.¹¹ Other scholars suggest that the regulatory regime will fail because stakeholder groups lack all of the required institutional competencies to function properly.¹² Kenneth Abbott and Duncan Snidal refine the stakeholder analysis, arguing that for private governance institutions to regulate in the public interest, the stakeholders must (1) address all stages of the regulatory process, and (2) collectively possess certain competencies to address the various stages of regulation such as independence, representativeness, expertise, and operational capacity.¹³ Abbott and Snidal explain that because businesses, NGOs, and government have

8. Eric L. Lane, *Consumer Protection in the Eco-Mark Era: A Preliminary Survey and Assessment of Anti-Greenwashing Activity and Eco-Mark Enforcement*, 9 J. MARSHALL REV. INT'L PROP. L. 742 (2010).

9. Graeme Auld et al., *The New Corporate Social Responsibility*, 33 ANN. REV. ENV'T & RESOURCES 413 (2008); see also Kenneth W. Abbott & Duncan Snidal, *The Governance Triangle: Regulatory Standards Institutions and the Shadow of the Law*, in THE POLITICS OF GLOBAL REGULATION 44, 46–57 (Walter Mattli & Ngaire Woods eds., 2009); Maria Carmen Lemos & Arun Agrawal, *Environmental Governance and Political Science*, in GOVERNANCE FOR THE ENVIRONMENT 69, 77–80 (Magali A. Delmas & Oran R. Young eds., 2009); Magali A. Delmas & Oran R. Young, *Introduction to GOVERNANCE FOR THE ENVIRONMENT* 3, 8 (Magali A. Delmas & Oran R. Young eds., 2009).

10. See Abbott & Snidal, *supra* note 9, at 64.

11. R. EDWARD FREEMAN ET AL., STAKEHOLDER THEORY 170 (2010) (identifying the use of stakeholder theory by scholars as a normative and prescriptive goal to permit indigenous populations to have their interests taken into account by corporate decision-makers, and as an ideal method for reaching solutions that accommodate environmental equity, economic development, and broader environmental objectives).

12. See Abbott & Snidal, *supra* note 9, at 46.

13. *Id.* at 46, 64.

different competencies, “it is difficult, if not impossible” for private governance institutions to have all of the necessary competencies to contribute to all stages of the regulatory process.¹⁴ They conclude that the institutions most likely to provide regulation in the public interest are those that have stakeholder participation from each sector.¹⁵

First, as a descriptive matter, institutions and their constituents do not always fit neatly into the business, civic, or government categories. There are frequently degrees of involvement of all three interests in each type of private governance institution.¹⁶ Second, private governance institutions may appear to be the same in terms of stakeholder composition and competencies, but have different rules and function in very different ways.¹⁷ Similar institutional structures may be used by business or by purely civic institutions.¹⁸ Furthermore,

14. *Id.* at 46.

15. *Id.*

16. Abbott and Snidal develop a map that identifies the location of specific organizations within a “Governance Triangle” based on the extent to which states, firms, and NGOs participate directly in the management and operation of a particular organization or regulatory regime, recognizing the diversity in institutional forms and variation in sector control. *See id.* at 46–57.

17. *See generally* Benjamin Cashore et al., *Legitimizing Political Consumerism: The Case of Forest Certification in North America and Europe*, in *POLITICS, PRODUCTS, AND MARKETS* 181 (Michele Micheletti et al. eds., 2003). For example, Forest Stewardship Council (FSC), an organization developed by environmental organizations, timber traders, indigenous groups, forest laborer organizations, and other stakeholders in 1993, created a certification and labeling system for forest products and their retailers to encourage sustainable management of forests globally. Graeme Auld et al., *Certification Schemes and the Impacts on Forests and Forestry*, 33 *ANN. REV. ENV'T & RESOURCES* 187, 189–90 (2008). The Sustainable Forestry Initiative (SFI), created by the American Forest and Paper Association, an industry trade association, developed a certification and labeling scheme for forestry products to compete with the system created by FSC. *Id.* at 191. SFI's standards are process-oriented rather than prescriptive, and consequently, less stringent than those of FSC. *Id.* at 192. Initially, the public could differentiate the standards of the two organizations based on the identity of their participants. FSC was a nonprofit organization and SFI was business firm, a subsidiary of the American Forest and Paper Association. SFI was later converted into a tax-exempt nonprofit organization with tripartite governance that includes environmental organizations and government members as well as business and industrial interests. SFI now bears the same indicia of civic representation and the organizational structure reflects the same capacity for “representativeness” as FSC; however, the actual standards behind the two organizations remain significantly different. Here, despite an appearance of “representativeness,” the composition of the institution is not an accurate signal as to whether the institution is undertaking voluntary regulation that will have an overall beneficial effect on the greater community. *See Abbott & Snidal, supra* note 9, at 76, 78. In such cases, the public cannot discern whether an institution is meeting their demand for regulation by looking at the relative participation by NGOs, business, and government in the governing structure.

18. Some socially responsible investors, such as Domini Social Investments and Pax World, are for-profit organizations, which were developed to provide a return to their investors on a portfolio of investments that meet certain environmental and social criteria. Others, such as

while the rules that private governance institution constituents develop may be evenhanded initially, these rules may change over time to favor the interests of one group over another.¹⁹ In addition, private governance institutions may fall prey to internal conflicts of interest that belie their organizational status.²⁰ Third, formal organization may not reflect underlying control of the private governance institution. Parties from each sector may be involved directly or indirectly, making it difficult to discern which sector is actually in control.²¹ For some private governance structures, government plays a significant role even though it is not a direct stakeholder or participant in the development of the institution. Governments interact with private firms in a variety of ways to coordinate regulatory activity.²² Legislators may consult with firms during the legislative process. Government agencies may consult with private firms when they develop regulations pursuant to legislative authority,²³ and agencies may delegate certain aspects of regulatory

the Acumen Fund are nonprofit organizations that provide no monetary return on investment to investors, but devote 100% of their net profits to further their social causes. *Compare Sustainable & Responsible Investing*, CALVERT INVESTMENTS, <http://www.calvert.com/sri.html> (last visited Oct. 4, 2011), *DOMINI SOCIAL INVESTMENTS*, <http://www.domini.com> (last visited Oct. 4, 2011), and *PAX WORLD*, <http://www.paxworld.com> (last visited Oct. 8, 2011), with *About Us*, ACUMEN FUND, <http://www.acumenfund.org/about-us.html> (last visited Oct. 4, 2011).

19. See *infra* Part III.

20. For example, the Nature Conservancy has had organizational structures in place to avoid conflicts of interest for many years, including specific written policies and a broad-based board of directors; it nevertheless became entangled in scandals associated with rent-seeking by its members and trustees in 2003. In 2003 the Washington Post disclosed that the organization had engaged in a number of questionable transactions with the organization's trustees and board members and had begun resource extraction activities on one of its nature preserves. See Joe Stephens & David B. Ottaway, *Charity's Land Deals to Be Scrutinized; Senators Send Letter to Nature Conservancy*, WASH. POST, May 10, 2003, at A2. The organization was required to submit to an audit by the Internal Revenue Service and they received Congressional requests to attend public hearings. Joe Stephens & David B. Ottaway, *IRS Toughens Scrutiny of Land Gifts*, WASH. POST, July 1, 2004, at A1; Joe Stephens & David B. Ottaway, *Nature Conservancy Faces Panel Review*, WASH. POST, July 17, 2003, at A19. The organization responded by suspending land sales and reviewing its governing documents and practices. *Conservation Group Alters Rules After Criticism Over Its Practices*, N.Y. TIMES, June 15, 2003, at N17.

21. Some scholars have begun to raise questions about whether institutions developed by NGOs funded with private resources accurately represent the interests of the public or civil sector. See Thomas P. Lyon, *Introduction to GOOD COP, BAD COP: ENVIRONMENTAL NGOS AND THEIR STRATEGIES TOWARD BUSINESS* 1, 5 (Thomas P. Lyon ed., 2010).

22. Auld et al., *supra* note 9, at 420; see also Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 545-49 (2000).

23. Auld et al., *supra* note 9, at 420.

authority to private firms.²⁴ Firms and government authorities may jointly negotiate standards and implementation processes.²⁵

Governments now offer voluntary programs and negotiated agreements as new hybrid forms of regulation²⁶ and have begun to incorporate “soft law”²⁷ and “reflexive law” elements into regulatory regimes.²⁸ Many private governance institutions mimic programs developed and funded by government.²⁹ Some private governance structures exist in the shadow of the law.³⁰ In some instances, it is the threat of future government regulation that causes private actors with vested interests to develop private governance structures in the first place.³¹ Private firms would not have developed other private governance institutions if the courts were not available to enforce

24. *Id.*

25. *Id.*

26. See Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 33–37 (1997).

27. See John J. Kirton & Michael J. Trebilcock, *Introduction to HARD CHOICES, SOFT LAW: VOLUNTARY STANDARDS IN GLOBAL TRADE, ENVIRONMENT AND SOCIAL GOVERNANCE* 3, 5 (John J. Kirton & Michael J. Trebilcock eds., 2004); Jason M. Solomon, *New Governance, Preemptive Self-Regulation, and the Blurring of Boundaries in Regulatory Theory and Practice*, 2010 WIS. L. REV. 591, 594 (2010); David M. Trubek & Louise Trubek, *New Governance & Legal Regulation: Complementarity, Rivalry, and Transformation*, 13 COLUMB. J. EUR. L. 539, 542 (2007); Neil Walker & Grainne de Burca, *Reconceiving Law & New Governance*, 13 COLUM. J. EUR. L. 519, 531 (2007).

28. See Trubek & Trubek, *supra* note 27, at 548; Walker & de Burca, *supra* note 27, at 527 (describing the shift from command-and-control regulation to these new forms).

29. For example, following the success of the Toxic Release Inventory, a number of firms and organizations began to employ voluntary disclosure and reporting requirements to signal market differentiation. See generally Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 GEO. L.J. 257, 367 (2001).

30. Margaret M. Blair et al., *The New Role for Assurance Services in Global Commerce*, 33 J. CORP. L. 325, 329 (2008) (citing Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225, 225 (1982); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); and Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms and Institutions*, 99 MICH. L. REV. 1724 (2001)).

31. The chemical industry, for example, developed the Responsible Care Program following the Union Carbide disaster in Bhopal with the goal of avoiding the institution of regulations upon the chemical industry, and in 1992, following the Rio Summit, the Chamber of Commerce developed a Business Charter for Sustainable Development to deflect possible global environmental regulation. David Vogel, *The Private Regulation of Global Corporate Conduct*, in *THE POLITICS OF GLOBAL REGULATION* 151, 159, 167–68 (Walter Mattli & Ngaire Woods eds., 2009).

obligations under contract law and the Uniform Commercial Code or to impose common law or statutory tort liability against those firms.³²

Other scholars focus, in part, on stakeholder intent or motive, suggesting that regulatory failure in the private governance context is the result of mixed or compromised motives.³³ However, stakeholders have a wide variety of motives for undertaking voluntary regulation. Firms undertake corporate social responsibility (CSR) programs primarily to reduce waste, improve efficiency, increase profits,³⁴ achieve market differentiation,³⁵ adapt to shifting business norms and values,³⁶ and enhance firm reputation with investors, markets, and consumers.³⁷ Firms use contracts to regulate suppliers, reduce risks from contract and tort liability,³⁸ and shift the risk of loss in transactions.³⁹ Collectively, firms develop industry-wide codes of conduct to level the playing field among competitors and reduce the costs of compliance.⁴⁰ Firms create and adhere to voluntary

32. For instance, firms use contracts to control the quality of products being delivered through their supply chains to maintain quality standards. When the goods they sell are credence goods (goods for which neither they nor their consumers can tell the quality prior to purchase), firms are motivated by the risks associated with breach of contract claims and potential tort liability to set up private regulatory mechanisms.

33. See Auld et al., *supra* note 9, at 416.

34. *Id.* at 415; David Vogel, *Private Global Business Regulation*, 11 ANN. REV. POL. SCI. 261, 268–69 (2008) (suggesting that much of the business literature exaggerates the cost-savings or other “win-win” benefits from shifting to more sustainable practices, and indicating that studies have shown little correlation between financial performance and performance along social and environmental parameters).

35. Auld et al., *supra* note 9, at 415; Lyon, *supra* note 3, at 29; Mattli & Woods, *supra* note 3, at 56; see also Abbott & Snidal, *supra* note 9, at 70. The need for market differentiation may arise from a disaster within the industry that has widespread negative impacts on public perception of the industry as a whole and could potentially lead to regulation. Vogel, *supra* note 34, at 268.

36. *Id.* at 269 (suggesting that changes in business mores have contributed significantly to the shift in business practices, and attributing this change to an expansion of firm accountability not only to shareholders but to other communities that are impacted by their decisions); Vogel, *supra* note 31, at 170; see also Benjamin Cashore et al., *Can Non-State Global Governance Be Legitimate? An Analytical Framework*, 1 REG. & GOV. 347 (2007). *But see* Abbott & Snidal, *supra* note 9, at 70 (suggesting that while these kinds of responses to the logic of appropriateness may have long-term impacts, competition drives firms to reduce and externalize costs).

37. Vogel, *supra* note 31, at 169. A firm’s desire to enhance its reputation may arise in response to activities by NGOs to shame and blame the firm or the industry through media exposes, protests, and boycotts.

38. See Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029, 2033–34 (2005).

39. *Id.* at 2046–47.

40. Vogel, *supra* note 31, at 169; Mattli & Woods, *supra* note 3, at 35.

regulations to seek favor with regulatory authorities and to insert themselves in the regulatory process.⁴¹ They also do so to reduce the degree of government monitoring that currently occurs,⁴² and to preempt proposed governmental regulation.⁴³ Firms undertake hybrid approaches to governance when facing potential regulation,⁴⁴ preferring to negotiate standards and regulatory solutions over typical forms of state intervention.⁴⁵ In addition, investor pressures⁴⁶ and efforts by NGOs to hold companies responsible for the environmental and social impacts of their activities and the activities of their supply chains have driven participation in private governance regimes.⁴⁷

Government entities also have a broad array of reasons for collaborating with business and nonprofit entities in voluntary regulatory schemes. Governmental entities may decide to support these alternatives because (1) a given governmental entity lacks authority to develop a mandatory program,⁴⁸ (2) a voluntary program may offer an opportunity to test new approaches through pilot projects,⁴⁹ (3) a voluntary program may reduce the costs of obtaining environmental improvement compared to traditional command-and-

41. Lyon, *supra* note 3, at 58.

42. *Id.*

43. *Id.* An increased threat of governmental regulation will increase firm attempts at corporate self-regulation. Lyon suggests that regulatory preemption may decrease political transaction costs and leaves open the possibility that consumers will organize if preemption measures do not result in sufficient environmental improvement. *See also* Vogel, *supra* note 34, at 268 (“In some cases, business self-regulation represents a political strategy for avoiding additional government regulation.”)

44. *Id.* at 57. The choice to engage is thought to follow a nonlinear model. *Id.* at 66. Some voluntary mechanisms, such as public voluntary programs, are undertaken when the threat of regulation is weak, and others, such as negotiated agreements, when the threat is stronger. *Id.* at 57. Firms would tend to pursue voluntary abatement if the threat of government regulation is low or if the threat of governmental regulation is high. *Id.* at 66. Intermediate threats of regulation would not appear to prompt firms to take action. *Id.*

45. Auld et al., *supra* note 9, at 420.

46. Philipp Pattberg, *The Institutionalization of Private Governance: How Business and Nonprofit Organizations Agree on Transnational Rules*, 18 GOVERNANCE 589, 598–602 (2005) (describing the development of a global reporting initiative from demands by investors for information on firm environmental performance to permit investors to assess the risk of their investments).

47. Vogel, *supra* note 34, at 268 (noting that the top reason for firms accepting private governance is that NGOs make global brands and global supply networks into a source of vulnerability through “name and shame campaigns”).

48. *See* Lyon, *supra* note 3, at 60–61.

49. *See id.* at 60.

control regulation,⁵⁰ or (4) a voluntary program may improve government–business relationships.⁵¹

Regardless of which sector or set of stakeholders develops the standards, and no matter their motives for doing so, some structures are effective and beneficial to society while others are not. Correlations between stakeholder intent and effectiveness may not be consistent. Voluntary standards promulgated by NGOs that are neither strict nor enforceable will not abate risks or internalize potential costs into the price of the goods—the risk of loss will remain with the general public. On the other hand, voluntary efforts by firms that involve a shift to new technology may guarantee improved environmental performance and save the government and the taxpayer significant costs associated with monitoring. The lines drawn between public and business interests obscure important structures needed for effective regulation.

In summary, classifying governance systems based on the composition of their constituents misses the point; the purpose of classification is to predict which private governance institutions will meet public demand for governance and which will not. Because the conventional taxonomy is limited in descriptive and analytical capacity, a new paradigm for examining private governance institutions is needed. The next section formulates a new typology based on the functions that private governance institutions serve in addressing government and market failures.

II. HOW PRIVATE GOVERNANCE INSTITUTIONS OVERCOME GOVERNMENT FAILURES THAT OCCUR AT EACH STAGE OF REGULATION AND ADDRESS MARKET FAILURE

Abbott and Snidal identify five stages of regulatory activity captured by the acronym “ANIME”: (1) agenda-setting, (2) negotiation of standards, (3) implementation, (4) monitoring, and (5) enforcement.⁵² At each stage, the process may break down, undermining the purpose for which the regulations are being promulgated. Formal governments fail to regulate successfully for a number of reasons: (1) lack of authority, resources, or political will to regulate at all; (2) inability to coordinate and collaborate across jurisdictional boundaries; (3) inability to generate regulation that sets

50. *See id.*

51. *See id.*

52. Abbott & Snidal, *supra* note 9, at 46.

enforceable standards; (4) inability to monitor and enforce the standards that they have set;⁵³ and (5) diversion of the regulatory process by interested actors to their own purposes. In addition, the allocation of responsibility and the costs associated with developing, implementing, monitoring, and enforcing the rules can also give rise to a breakdown in the regulatory process.⁵⁴

This section describes the different stages of regulation and the kinds of barriers and hazards that prevent formal government from regulating or cause public regulation to fail to serve the public interest. Because demand for governance remains unmet, a regulatory gap exists that private governance systems can fill. This section, therefore, also describes how private governance institutions address these governance deficits.

A. *Agenda-Setting Institutions*

At the initial stage of the governmental regulatory process, public interest, industry, or business groups identify an agenda they would like to have their legislative or regulatory bodies meet. Parties bearing externalized social costs articulate their concerns, investigate activities that cause those harms, identify the parties engaging in those activities, and appeal to government actors to regulate those activities. Abbott and Snidal identify this stage as the “Agenda-Setting” stage.⁵⁵

Before any regulation can occur, legislators or regulatory bodies must be aware of social costs. Because ecological systems behave in nonlinear ways, many social costs, such as those associated with environmental harm,⁵⁶ are not readily apparent.⁵⁷ In addition,

53. Vogel, *supra* note 31, at 160.

54. ELINOR OSTROM, UNDERSTANDING INSTITUTIONAL DIVERSITY 262–63 (2009) [hereinafter UNDERSTANDING INSTITUTIONAL DIVERSITY] (“When the rules related to the distribution of benefits are made broadly consistent with the distribution of costs, participants are more willing to pitch in to keep a resource well-maintained and sustainable. Relating user inputs to the benefits they obtain is a crucial element of establishing a fair system. If some users get all the benefits and pay few of the costs, others are not willing to follow rules over time. Thus, fairness is a crucial attribute of the rules of robust systems.” (citations omitted)).

55. Abbott & Snidal, *supra* note 8, at 63–64.

56. For those concerned about natural resources and ecological systems, the damage suffered by these systems may be difficult to discern or estimate. Oran R. Young, *Institutions and Environmental Change: The Scientific Legacy of a Decade of IDGEC Research*, in INSTITUTIONS AND ENVIRONMENTAL CHANGE 3 (Oran R. Young et al. eds., 2008) [hereinafter Young, *Institutions and Environmental Change*]. Biological systems frequently behave in nonlinear ways, and are subject to thresholds and tipping points. *Id.* Collapse may be imminent, but the signs may not be readily apparent. *Id.* Ecological systems also behave in a non-linear

globalization has shifted manufacturing from developed to developing nations, making social harms borne by residents in developing countries less visible to those enjoying lower prices that result from externalizing those costs.⁵⁸ Proponents of regulation must also identify the parties responsible for those social harms and persuade legislative bodies to take action. However, effective oversight requires information, and gathering information can be costly and difficult.⁵⁹ In addition, identifying affected parties and coordinating them to engage across vast geographic distances, thereby bridging cultural, technological, and language barriers, is challenging. A number of private governance institutions have arisen to address this need.

In recent years, NGOs, church groups, and other advocacy organizations have begun to identify social and environmental costs and disseminate information to spur action by legislative bodies. These education and mobilization initiatives, however, are not the source of all private regulatory activity. Insurance companies now lobby regulatory bodies for new regulation and mandate certain practices among their insured parties that will reduce the companies' risk of loss. Socially responsible investment (SRI) firms use capital markets and screening programs to incentivize firm management to shift firm practices into alignment with their investors' social and environmental concerns. Voluntary standards, certification, and labeling mechanisms cultivate consumer markets to select products from firms that conform to specified social and environmental practices.

manner: they are frequently subject to thresholds and tipping points, and collapse can occur quickly after a long period of what appears to be incremental change. Oran R. Young, *Governance for Sustainable Development in a World of Rising Interdependencies*, in GOVERNANCE FOR THE ENVIRONMENT 12, 39 (Magali A. Delmas & Oran R. Young eds., 2009) [hereinafter Young, *Governance for Sustainable Development*].

57. Occasionally, catastrophic events, such as the Bhopal disaster, coffee collapse, labor scandals, or human rights scandals will bring these social costs to public attention.

58. See Vogel, *supra* note 31, at 159.

59. Mattli & Woods, *supra* note 3, at 28; see, e.g., Leslie Kaufman, *Tracking Flow of Oil on His Own*, N.Y. TIMES, Apr. 19, 2011, at A17 (describing efforts of a conservationist to gather and disseminate information on the environmental impact of the Deepwater Horizon oil spill after being frustrated with government efforts to do so). While technology has advanced communication to a level that government censorship becomes less feasible on a global scale, some governments are still able to exert control over information either by limiting media access or through disinformation campaigns. See, e.g., William Yong & Robert F. Worth, *Iran Clamps Down on Reporting on Protest Leaders*, N.Y. TIMES, Aug. 26, 2010, at A4; Andrew Jacobs & Miguel Helft, *Google, Citing Attack, Threatens to Exit China*, N.Y. TIMES, Jan. 13, 2010, at A1.

1. Education and Mobilization Initiatives

Increasingly, civic organizations have taken an entrepreneurial role in exposing social costs by communicating them to the public and galvanizing action with respect to environmental and social concerns.⁶⁰ Since the 1980s, NGOs, churches, and other groups have developed civil society campaigns to draw into question the activities of certain high-profile business entities and groups.⁶¹ The groups have assumed the costs associated with gathering information about firm performance,⁶² and used media campaigns to disseminate information about the environmental and social impacts of firm activities.⁶³ Civic organizations, in addition to disclosing social costs and identifying the parties that have contributed to the problem, may also communicate this information to the public in a way that will prompt action.⁶⁴ They may offer a plan for action to empower the public to overcome collective action problems and call for institutional change either in the form of legislation, enforcement of existing regulations, or, if those needs will not be met by formal government, by galvanizing interest groups to develop private governance institutions.⁶⁵

60. Mattli & Woods, *supra* note 3, at 29 (describing the efforts of Greenpeace, Amnesty International, and the Sierra Club in seeking a regulatory response to the Union Carbide disaster in Bhopal, India); Vogel, *supra* note 31, at 168–70 (describing the name and shame campaigns directed against unhealthy working conditions and the employment of child laborers by textile and clothing manufacturers, human rights violations and environmental harms by mining companies, and sourcing of illegally and unsustainably harvested wood by lumber retailers). For example, in 1997 the Rainforest Action Network undertook a highly visible campaign against Home Depot to urge the company to stop purchasing wood and paper products from old growth forests and substitute sustainably harvested wood sources. Jennifer Krill, *Rainforest Action Network*, in *GOOD COP, BAD COP: ENVIRONMENTAL NGOs AND THEIR STRATEGIES TOWARD BUSINESS* 208, 218–19 (Thomas P. Lyon ed., 2010).

61. Sasha Courville, *Social Accountability Audits: Challenging or Defending Democratic Governance?*, 25 *LAW & POL’Y* 269, 271 (2003).

62. Mattli & Woods, *supra* note 3, at 28–29 (attributing this phenomenon, in part, to the availability of the Internet, which reduced the costs of communication and information gathering).

63. Courville, *supra* note 61, at 271.

64. Abbott & Snidal, *supra* note 9, at 64; Vogel, *supra* note 31, at 168–69 (name-and-shame campaigns directed at prominent firms identify shortfalls in corporate responsibility).

65. Vogel, *supra* note 31, at 171 (“[A] critical role has been played by NGOs whose anti-corporate campaigns have creatively taken advantage of the vulnerability of global firms to threats to their public reputation and the value of their brands. . . . [T]hese organizations have effectively mobilized the diffuse interests of those adversely affected by the shortcomings of existing regulatory mechanisms. Their efforts to create new forms of business regulation have been often supported by foundations, trade unions, social movements, and in some cases, governments.”); *see also* Mattli & Woods, *supra* note 3, at 28–29 (describing the emergence of NGOs as policy entrepreneurs).

As a result of these campaigns, targeted companies are shifting their practices to reduce their negative environmental and social impacts through private governance initiatives, such as adoption of CSR programs,⁶⁶ codes of conduct, environmental management systems, and through participation in government-based hybrid efforts, such as public voluntary programs and negotiated agreements.⁶⁷ Corporate involvement in these programs stems from the desire to upgrade the firm image,⁶⁸ to reduce financial risks associated with education and mobilization initiatives and “name and shame” campaigns, and generally to restore the firm’s social license to operate.⁶⁹

2. Insurance Contracts

Insurance companies are also acting as regulatory entrepreneurs.⁷⁰ Insurance agreements generally enhance efficiency by permitting parties to spread compliance risks and create economies of scale in managing remediation costs.⁷¹ Facing increased exposure to higher risk, insurance firms have also begun to demand additional regulation.⁷² For example, in the shipping industry, traffic on navigable waters has risen from expanded trade and increased tanker size.⁷³ This has increased the likelihood of accidents, leading to larger payouts associated with lost cargo and environmental and other harms to natural resources and human communities.⁷⁴ In response to increased risk and higher payouts, insurance firms have taken a more active role in lobbying for regulation of the shipping

66. Auld et al., *supra* note 9, at 417.

67. Lyon, *supra* note 3, at 56–63. Because formal governments initiate and fund hybrid programs, such as public voluntary programs and negotiated agreements, this article does not cover them to any degree.

68. See Robert Kagan et al., *Explaining Corporate Environmental Performance: How Does Regulation Matter?*, 37 *LAW & SOC’Y REV.* 51, 69 (2003) (noting that some managers seek to avoid negative publicity and maintain their social license with their communities by going beyond compliance with mandatory environmental standards).

69. Auld et al., *supra* note 9, at 417.

70. Mattli & Woods, *supra* note 3, at 33.

71. See Vandenberg, *supra* note 38, at 2063 (noting that, among other things, these policies can cover past liabilities, costs associated with future requirements for compliance, and cost overruns on projects to clean up an environmentally damaged property).

72. Mattli & Woods, *supra* note 3, at 33.

73. Samuel Barrows, *Racing to the Top . . . at Last: The Regulation of Safety in Shipping*, in *THE POLITICS OF GLOBAL REGULATION* 189, 202–06 (Walter Mattli & Ngaire Woods eds., 2009).

74. *Id.*

industry⁷⁵ and in enforcing regulations through their contracts.⁷⁶ While individual insurers could impose additional requirements or decline to insure firms that failed to meet their standards, these insurance companies and their clients would face a competitive disadvantage. By seeking government regulation, insurance companies level the playing field for themselves and their clients.

3. Socially Responsible Investment

Investors also harness the market to pressure firms to manage their environmental and other risks.⁷⁷ Focusing primarily on publicly-held firms, SRI firms direct investors to companies that achieve their financial goals in a socially and environmentally responsible manner.⁷⁸ By offering early recognition and the advantages associated with expanded access to capital, SRI firms provide economic incentives for companies to undertake social and environmental harm abatement or other activities associated with meeting investor preferences. While some institutional investors support particular governmental or intergovernmental initiatives,⁷⁹ others have developed programs to screen firms based on their performance across a number of social parameters, going beyond firm profitability or return on investment.⁸⁰ SRIs provide information to investors about the environmental and social performance of firms, primarily publicly held firms.⁸¹ SRI research organizations may collect information by sending questionnaires to companies to self-report their activities, or SRI research organizations may pull information provided by reporting and disclosure initiatives or certification programs.⁸² The information is rarely verified independently.⁸³ SRI firms screen companies to assemble portfolios of investments, and select investments that meet

75. *Id.* at 203.

76. *Id.* at 202.

77. Kagan et al., *supra* note 68, at 82.

78. Courville, *supra* note 61, at 274.

79. See Cynthia Williams, *Civil Society Initiatives and "Soft Law" in the Oil and Gas Industry*, 36 N.Y.U. J. INT'L L. & POL. 457, 488–89 (2003) (describing the involvement of institutional investors managing \$3 trillion in assets in the Extractive Industry Transparency Initiative, designed to require extractive industry companies to disclose amounts paid to foreign governments for rights to extract natural resources).

80. These programs may employ an array of approaches, including screens for positive qualities, screens against negative qualities, and screens to identify the best of a class of investments without regard to any minimum criteria. Courville, *supra* note 61, at 274.

81. *See id.*

82. *Id.*

83. *Id.*

positive investor preferences or screen investments to exclude firms that engage in activities that investors have elected to avoid.⁸⁴ SRI firms may also assemble portfolios by identifying the best performing firms in each sector without identifying a minimum threshold for performance.⁸⁵ While initial participants were individual investors and thus the size of funds under management was small, recent entry of institutional investors such as state pension funds, universities, and foundations has increased the funds under management dramatically.⁸⁶

It is unclear whether investment in socially responsible firms produces desired environmental and social outcomes. If a firm's standards are not sufficiently prescriptive or stringent, they may have little impact. Because no information verification systems exist regarding firms' self-reported information, the effectiveness of the selection and screening process has yet to be determined. Given that social and environmental performance are "credence qualities,"⁸⁷ firms may not provide accurate reports of their performance unless there is some method to monitor activity, verify self-reported performance, and provide a credible threat of sanction. In addition, leakage⁸⁸ remains a problem: as long as noncompliant businesses may

84. *Id.*

85. *Id.*

86. *Performance and Socially Responsible Investments*, FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTMENT, <http://www.ussif.org/resources/performance.cfm> (last visited Oct. 7, 2011) (indicating a 480% increase in funds under professionally managed SRIs from 1995 to 2010). A number of studies have shown that SRI funds perform comparably to non-SRI mutual funds. *See, e.g., id.*; Meir Statman & Denys Glushkov, *The Wages of Social Responsibility* (Dec. 2008) (unpublished manuscript) (on file with DUKE ENVTL. L. & POL'Y F.); Center for Responsible Business, University of California (Berkeley) Haas School of Business, *Key Studies*, STUDIES OF SOCIALLY RESPONSIBLE INVESTING, <http://www.sristudies.org/Key+Studies> (last visited Oct. 7, 2011). Some SRI funds are benchmarked against non-SRI indices, such as the S&P 500 and the Dow Jones Industrial Average, and in some instances have outperformed these standard indices. FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTMENT, *supra*.

87. Credence qualities cannot easily be evaluated before, during, or after normal use. To determine whether the good has the properties or qualities that a consumer prefers, the consumer would be required to undertake expensive studies to acquire additional information. In some instances, it may not be possible for the consumer to learn whether the good has preferred qualities. Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 68–69 (1973).

88. Leakage occurs when a market responds to the imposition of a regulation by shifting demand to goods that are manufactured in jurisdictions where the regulation is not imposed. When prices increase as a result of regulation, consumers continue to seek lower priced goods and purchase the goods from jurisdictions where production of the goods are not subject to regulations and can therefore be manufactured and sold at a lower price.

obtain capital from alternate sources on similar terms, they may retain a competitive advantage over compliant firms by continuing to externalize the social costs.⁸⁹

4. Voluntary Standards, Certification, and Labeling Systems

Voluntary standards, certification, and labeling systems are private governance institutions that set minimum standards for firms, products, or facilities to meet one or more consumer preferences.⁹⁰ They designate a process to verify whether the standards have been met, provide training for individuals who will inspect the goods or facilities to verify whether they are in compliance with the standards, certify the goods or firms that have met the standards, and develop labels to identify the compliant goods and firms.⁹¹ These regimes use

89. Note, however, that social costs may impact a firm's risk profile. To the extent that a firm's activities give rise to grave environmental impacts, civil unrest, work stoppages, media attention, and injunctive relief or regulatory activity, economic risks to investors increase. Public awareness of these risks can result in a shift of capital away from these firms. *See, e.g.,* Michael P. Vandenbergh, *The New Wal-Mart Effect: The Role of Private Contracting in Global Governance*, 54 UCLA L. REV. 913, 943–44 (2007) (stating disclosure of environmental release information through the mandatory Toxic Release Inventory affected the stock prices for firms with the worst records).

90. These systems go by many names in the different literature. Some scholars call these institutions non-state market-driven (NMSD) systems. *See* Benjamin Cashore et al., *Can Non-State Governance 'Ratchet Up' Global Environmental Standards? Lessons from the Forest Sector*, 16 REV. EUR. COMMUNITY & INT'L ENVTL. L. 158, 162–66 (2007). Others have identified them as regulatory standards setting (RSS) forms of private governance. *See* Abbott & Snidal, *supra* note 9, at 44–45. Others, in the business world refer to all forms of private governance as "civil regulation." *See* Vogel, *supra* note 31, at 151. One example of a voluntary standards, certification, and labeling institution is the Forest Stewardship Council. Following recognition of the tragedy of the commons dynamic with respect to forests in the 1960s, many governments elected to privatize their forests. *See* ELINOR OSTROM, *GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION* 23 (1990) [hereinafter *GOVERNING THE COMMONS*]. In some cases, government ownership of the forests has not made them less susceptible to illegal logging, but more so where governments have lacked the capacity to monitor and enforce the law. *Id.* In an attempt to reverse this trend, the Forest Stewardship Council has developed a system to help enforce existing national laws against illegal logging by encouraging the logging industry, forest owners, and indigenous populations to adopt sustainable forest management practices and deter illegal logging by joining the certification program. *See FSC Policy and Standards*, FOREST STEWARDSHIP COUNCIL, http://www.fsc.org/policy_standards.html (last visited Dec. 10, 2011). The organization certifies and labels forests, forest products, and firms that sell those products. In exchange for their participation, forest owners and managers and retailers that sell certified forest products may receive a premium on products they sell. This market premium has not always eventuated. Michael Richards, *Certification in Complex Socio-political Settings: Looking Forward to the Next Decade*, in *FOREST TRENDS* 26 (2004).

91. Errol Meidinger, *Competitive Supragovernmental Regulation: How Could It Be Democratic?*, 8 CHICAGO J. INT'L L. 513, 515 (2008); Cashore et al., *supra* note 90, at 162–66.

the supply chain to create financial incentives for performance.⁹² Voluntary standards, certification, and labeling systems may create or capitalize on activist pressure directed toward supply chain anchor firms in the form of media campaigns, protests, and actual or threatened boycotts.⁹³ Firms committing to become members of the certification and labeling system or committing to purchase certified goods avoid these pressures.⁹⁴

In addition, voluntary standards, certification, and labeling systems are thought to shape public perception of social or environmental problems by shifting the discourse around social and environmental goods.⁹⁵ When the dominant discourse changes, institutional change occurs.⁹⁶ Voluntary standards, certification, and labeling systems target consumer demand by activating norms associated with consumption.⁹⁷ By using labels to make externalities more visible, voluntary standards, certification, and labeling systems also enhance efficiency; when consumers confront the environmental impacts of their consumption choices and have the opportunity to pay a premium to internalize the externality, they may choose the good with a lower environmental or other social cost.⁹⁸ These systems not only enable customers to express existing preferences, but they also shift those preferences by providing information, rankings, and third-party certification. Voluntary standards, certification, and labeling systems engender and strengthen norms associated with fair trade, fair wage and labor practices, sustainable harvesting, and the avoidance of environmental harm.⁹⁹ By educating and informing consumers about the consequences of their purchases, these institutions seek to inculcate certain values and encourage consumers to internalize standards and set boundaries on what they will and will not consume.

Table 1 summarizes the hazards that arise at the agenda-setting stage, the private governance institutions that address those hazards,

92. Auld et al., *supra* note 9, at 424–25.

93. *Id.*

94. *Id.*

95. See Young, *Institutions and Environmental Change*, *supra* note 56, at 8.

96. *Id.*

97. Norms are internalized rules; individuals who fail to observe norms experience mental discomfort and may be shunned within their community. Michael A. Livermore, *Reviving Environmental Protection: Preference Directed Regulation and Regulatory Ossification*, 25 VA. ENVTL. L.J. 311, 332–33 (2007).

98. *Id.* at 330.

99. *Id.* at 326–28.

what they supply, and the characteristics required for the institutions to be effective.

Table 1. Agenda-Setting Institutions

| Barrier or Hazard | Suppliers | Structure Supplied | Keys for Effectiveness |
|---|---|--|--|
| Information problem: lack of information about problem or cause of problem | Education and mobilization initiatives Voluntary standards, certification, and labeling systems Socially responsible investment firms | Information about problem Information about cause Network for communication with the public and key stakeholders | Independence (organizational and financial) from entity causing problem |
| Collective action problems: communication problems, coordination problems | Education and mobilization initiatives Voluntary standards, certification, and labeling systems Socially responsible investment | Convening stakeholders or shareholders | Structures to convene groups and to permit stakeholder or shareholder engagement |
| Race to the bottom dynamics: government incentives are against regulation | Voluntary standards, certification, and labeling systems | Market incentives to counteract race to the bottom dynamics Creation of club goods | Marketing Sufficiently broad consumer participation for market incentive to be created Ability to exclude noncompliant parties from club |

B. Standards-Setting Institutions

At the second stage of the regulatory process, legislative and regulatory bodies and stakeholders negotiate and set standards and develop a regulatory scheme for monitoring compliance and

enforcing those standards.¹⁰⁰ However, even when private business incentives and the public will to regulate exist, a number of barriers may impede the legislative process, such as collective action problems, regulatory capture, and rent seeking activity. Businesses regulate internally to improve their performance along social and environmental lines, to enhance their image among investors and lenders, to regain their social license to operate, and to differentiate themselves in the market so as to achieve a “green” or socially responsible premium. Supply chain contracts import standards into jurisdictions where democratic and legal institutions are weak. Voluntary standards, certification, and labeling mechanisms create market incentives and lower transaction costs to overcome regulatory capture, regulatory fragmentation, and the “race to the bottom.”

1. Business Firm Programs

Business firms often engage in a particular self-regulatory activity commonly described as CSR.¹⁰¹ Firms generally set their own policies without input from other parties,¹⁰² employ existing management structures to implement those policies, use internal hierarchies to obtain feedback about policy impacts, and incentivize compliance through compensation, honors, and other perquisites.¹⁰³ In general, firms that undertake CSR seek a win-win situation; they hope to increase efficiency and firm profits by reducing waste and unnecessary costs, and by developing new markets through differentiation to generate premium prices.¹⁰⁴

2. Supply Chain Contracts

A number of scholars now focus on supply chain contracts as a source of environmental and social regulation.¹⁰⁵ Firms experience pressures to control suppliers from a variety of sources, including the

100. At the rulemaking stage of the regulatory process, formal governments have begun to draw on the types of innovations that have arisen in private governance. In setting standards and developing new rules, governments have begun to require that firms network with and share information with stakeholders, and include stakeholders in the deliberative regulatory processes. Trubek & Trubek, *supra* note 27, at 555.

101. Auld et al., *supra* note 9, at 414.

102. Abbott & Snidal, *supra* note 9, at 67.

103. *Id.* at 65.

104. Auld et al., *supra* note 9, at 422.

105. See Vandenbergh, *supra* note 89, at 925–26; Michael P. Vandenbergh & Mark A. Cohen, *Climate Change Governance: Boundaries and Leakage*, 18 N.Y.U. ENVTL. L.J. 221, 226–29 (2010); Lyon, *supra* note 21, at 22.

threat of contract or tort liability,¹⁰⁶ consumer demand, targeting by name and shame campaigns and boycotts,¹⁰⁷ and pressures from socially responsible investors,¹⁰⁸ firm managers, and owners. Because investors are also concerned with the long-term supply of the raw materials and products used in their business, investors have begun to pressure firms to control firm suppliers' operations and activities to ensure that the raw materials and harvested products will be available for the future.¹⁰⁹

Supply chain contracts and operations permit anchor firms to transfer technology and management skills to countries where the rule of law and the regulatory apparatus is weak.¹¹⁰ When retail firms are subject to regulatory controls in one jurisdiction but their supply chain contractors reside in jurisdictions where regulatory standards either do not exist or are not enforced, the retail firms use contractual arrangements to ensure that their contractors comply with firm quality control requirements. While common law or statutory tort or contract law establishes the regulatory agenda in the jurisdiction of the anchor firm, these laws have no effect in foreign jurisdictions. Anchor firms must therefore use contracts to set and enforce the standards within foreign jurisdictions. In such cases, global supply chain contracts have been described as “transplanting” social and environmental standards in foreign countries.¹¹¹ While the corporate goal may simply be to meet government, investor, and consumer demands, a corporation's exercise of bargaining power and contractual enforcement benefits the residents of countries in which environmental and labor regulation has been precluded because of democracy deficits or race to the bottom dynamics.¹¹²

106. Vandenbergh, *supra* note 38, at 2031.

107. Vandenbergh, *supra* note 89, at 947.

108. *Id.*

109. *Id.* at 949.

110. *See id.* at 942–56. In general, these requirements extend only to first-tier suppliers and would have little impact on suppliers further up the manufacturing chain. *Id.* As an empirical matter, countries with strong supply chains also tend to have fair labor practices and improved environmental performance. *See e.g.*, Thomas P. Lyon & Bart van Hoof, Evaluating Mexico's Green Supply Chains Program (2010) (unpublished report to the Commission for Environmental Cooperation), <http://webuser.bus.umich.edu/tplyon/PDF/Working%20Papers/Lyon%20Van%20Hoof%20GSC%20Paper%20Sep%2013%202010.pdf>.

111. Blair et al., *supra* note 30, at 337–38; *see also* Li-Wen Lin, *Legal Transplants Through Private Contracting: Codes of Vendor Conduct in Global Supply Chains as an Example*, 57 AM. J. COMP. L. 711, 714–16 (2009); Vandenbergh, *supra* note 89.

112. *Cf.* Lin, *supra* note 111, at 716. (describing how private contracting exports the political considerations of the “home” country to the country of the supplier). While the low levels of

3. Voluntary Standards, Certification, and Labeling Systems

Legislative and regulatory bodies may fail to regulate for a number of reasons despite public demand for regulation. First, legislative and regulatory bodies may be concerned about conflicting policies,¹¹³ and may be uncertain about the impacts of regulation.¹¹⁴ Second, regulatory authorities may be fragmented¹¹⁵ or engaged in race to the bottom dynamics.¹¹⁶ And finally, legislative and regulatory authorities may also be subject to capture or corruption. A number of private governance institutions meet the demand for regulation through alternative structures that resist these hazards.

Private governance institutions are sometimes developed in situations where legislators face uncertainty about the most efficient

implementation may not yet result in substantial environmental and social benefits, the influx appears to have prompted the consideration, and in some circumstances, the adoption of certain legal reforms. *Id.* at 737 (noting that the ISO 14001 standards have become legal measures in China).

113. Abbott & Snidal, *supra* note 9, at 57–58 (noting that regulation may be seen as conflicting with economic growth). For instance, at the international level, the World Trade Organization (WTO) Technical Barriers to Trade Agreement prohibits trade discrimination against “like goods.” Vogel, *supra* note 31, at 161. Governments may post regulations that make “product distinctions” based on characteristics that inhere in the goods, but they are barred from making “process distinctions” that relate to the process by which the goods are made. Douglas A. Kysar, *Preferences for Processes: The Product/Process Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. 525, 531 (2004). Process distinctions, such as whether distinctions based on labor standards, human rights conditions, or the environmental impacts associated with the manufacture and distribution of products, may be challenged as non-tariff barriers to trade. *See* Vogel, *supra* note 31, at 161. If states maintain these kinds of regulatory standards in the face of a challenge, they may subject the state to retaliatory trade sanctions. While the law remains somewhat uncertain because cases before the WTO lack precedential value and because there are a number of exceptions to the doctrine, the product–process distinction generally bars governments from imposing these kinds of regulatory standards. There are limits to the reach of the WTO Technical Barriers to Trade Agreement, however. In general, international treaties apply only to the nation–states that are signatories to the agreements. They do not apply to corporate or individual actors or to multinational organizations. Nor do they extend to the activities of private parties unless those actions may be attributed to the states. *See* David A. Wirth, *The International Organization for Standardization: Private Voluntary Standards as Swords and Shields*, 36 B.C. ENVTL. AFF. L. REV. 79, 95 (2009); Williams, *supra* note 79, at 481. Consequently, there is an opening for private governance to meet public demand.

114. Abbott & Snidal, *supra* note 9, at 58 (noting that regulators often lack information, resources, and technical competence).

115. *See* William W. Buzbee, *Recognizing the Regulatory Commons: A Theory of Regulatory Gaps*, 89 IOWA L. REV. 1, 49–51 (2003). In such circumstances, agencies vie with one another for authority. Examples of regulatory fragmentation include authority over regional land use decisions, control of genetically modified organizations, and control over the release of toxic substances into the environment under the Toxic Substances Control Act.

116. *See* Abbott & Snidal, *supra* note 9, at 58.

allocation of entitlements. Voluntary standards, certification, and labeling are institutions that facilitate the operation of “Rule Four,”¹¹⁷ as contemplated by Guido Calabresi and Douglas Melamed in their seminal article, *Property Rules, Liability Rules and Inalienability Rules: One View of the Cathedral*.¹¹⁸ These institutions allow parties to overcome an existing allocation of entitlements through trade by reducing the transaction costs associated with finding willing buyers and sellers, coordinating an exchange, negotiating a price, and verifying that the purchased goods are what they claim to be.¹¹⁹

While legislators may occasionally allocate entitlements inefficiently because of uncertainty, an improper allocation of rights may also occur because of legislative or agency capture. In these situations, legislators or bureaucrats promulgate regulations that are more favorable to targeted industries than to the public.¹²⁰ Regulatory capture frequently occurs in countries where there are democracy deficits.¹²¹ Voluntary standards, certification, and labeling systems

117. Tracey M. Roberts, *The Rise of Rule Four Institutions: Voluntary Standards, Certification and Labeling Systems* (unpublished manuscript, University of Louisville Working Papers), at 3–5, available at <http://ssrn.com/abstract=1934274>.

118. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability Rules: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). In this article, Calabresi and Melamed summarize certain rules that Calabresi developed in his previous writings for governments to allocate entitlements in the presence of transaction costs. *Id.* at 1096–97; see GUIDO CALABRESI, *THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* (1970). In the case of pollution, legislators must make a choice between two opposing entitlements: they may grant a firm the right to pollute or grant the public the right to be free of pollution. Sometimes there is uncertainty about the costs and benefits associated with regulation and failure to regulate. There may also be uncertainty about the distributional impacts of regulation versus the status quo. Because of these kinds of uncertainty, an incorrect or inefficient allocation of entitlements may occur. Under Rule Three, Calabresi and Melamed suggest that if legislators are uncertain about whether a legal entitlement is worth its cost to society, they should allocate the costs to the party that will be able to avoid the social cost most cheaply (the “cheapest cost avoider”). Calabresi & Melamed, *supra*, at 1096–97. If legislators are uncertain about which party would be the cheapest cost avoider, they should allocate the costs to the party that can most cheaply (a) locate the cheapest cost avoider and (b) pay them to avoid those costs. *Id.* at 1097. In *THE COST OF ACCIDENTS*, Calabresi describes this party as “the best briber.” CALABRESI, *supra*, at 150.

119. Roberts, *supra* note 117, at 5–6.

120. Buzbee, *supra* note 115, at 44–45 (“Most significantly the path-breaking early work of Professors Stigler, Becker, and Petzman is primarily concerned with how diverse interest groups will compete for regulatory spoils. The result of this competition is typically not excessively burdensome regulation addressing social ills, but regulation favoring regulatory targets, weak regulation or no regulation at all.”). See generally Mancur Olson, *THE LOGIC OF COLLECTIVE ACTION* (1965).

121. Abbott & Snidal, *supra* note 9, at 66–67; Mattli & Woods, *supra* note 3, at 15 (noting that a lack of “relative inclusiveness, openness, transparency, fairness, and accessibility of regulatory institutions” will correlate with regulatory capture); Vogel, *supra* note 31, at 160 (“It

avoid capture through a number of structures. First, they frequently split membership and voting rights into three groups: (1) private firm or industry representatives, (2) government representatives, officials, and agencies, and (3) NGOs and other public interest and civic groups.¹²² This division allows each interest to participate in the deliberative process, but limits the power of any one group to dominate the institution.¹²³ Second, decentralization deters capture.¹²⁴ Voluntary standards, certification, and labeling systems employ substantive rules that reflect broader legal and social norms, and include structures that provide for transparency and procedural due process and encourage inclusive and broad participation by various interest groups.¹²⁵ Many of these systems permit participation by any “interested party” and some provide structures and funding to support participation by underrepresented groups.¹²⁶

Even when entitlements have been allocated appropriately and legislative and administrative bodies have not been captured, commons dynamics may deter government action in redressing adverse distributional impacts. Regulatory fragmentation—a split in government authority over persons, places, or regulatory subject matter—situates agencies in an anti-commons¹²⁷ dynamic with respect

is the inability or unwillingness of states to adopt or enforce [government controls over global firms and markets] that has contributed to the development and growth of non-state-based governance institutions.”); Vogel, *supra* note 34, at 266 (“Underlying virtually every scholarly and popular discussion of global civil regulation is the claim that the global economy suffers from a democratic governance deficit, often attributed to the constraints posed by global competitive pressures on the willingness and capacity of states to effectively regulate both global and domestic firms.”).

122. For example, the Forest Stewardship Council has a global “general assembly” made up of three chambers—economic, environmental, and social—with equal voting power. Meidinger, *supra* note 91, at 523.

123. *Id.* at 519. Many of these institutions follow the guidelines developed by the ISEAL Alliance for developing standards, measuring and evaluating performance, and accrediting auditors. See *List of Full Members*, ISEAL ALLIANCE, http://www.isealalliance.org/organisation/full_members (last visited Sept. 17, 2011).

124. See Mattli & Woods, *supra* note 3, at 11 n.31; Abbott & Snidal, *supra* note 9, at 79.

125. See Meidinger, *supra* note 91, at 532–33; see also UNDERSTANDING INSTITUTIONAL DIVERSITY, *supra* note 54, at 263–64 (noting that when rules have been made by a local elite or a government agency, research reveals higher levels of theft and free-riding; in contrast, when those that are governed by the rules have made the rules, participants show increased cooperation).

126. Meidinger, *supra* note 91, at 526–27. Some institutions provide resources to permit low-income individuals and those representing minority interests to participate.

127. See generally Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998); Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L. REV. 1163 (1999) (describing the dangers of

to regulatory turf.¹²⁸ Examples of regulatory fragmentation include splits in authority over regional land use decisions between states, counties, and municipalities, and division of control of genetically modified organisms between the U.S. Department of Agriculture, the Environmental Protection Agency, and the Food and Drug Administration. When multiple agencies are involved in a regulatory issue, they must communicate, coordinate, and potentially cede authority to regulate effectively. Transaction costs associated with communicating and collaborating increase as the number of parties required for consensus increases. Agencies may resist ceding authority or sharing information that could undermine that authority.¹²⁹ The political benefits to an agency from hold-out¹³⁰ are higher than the political rewards of regulation, which are split among the participating agencies.¹³¹ Furthermore, a regulatory breakdown is less visible and therefore less costly because the public cannot identify any one agency as the source of failure.¹³² Voluntary standards, certification, and labeling mechanisms overcome regulatory fragmentation by taking the conflict outside of the legal and regulatory system. These institutions bring all stakeholders together to resolve issues outside of government venues and without appeal to government authority.¹³³

Institutional dynamics may also lead to a tragedy of the commons¹³⁴ at the regulatory level, creating incentives to deregulate.¹³⁵ Nations, states, counties, and municipalities frequently compete with one another to attract businesses and new residents. Competition between these jurisdictions to reduce taxes, exempt industries from regulation, and provide subsidies may result in a regulatory race to

fragmentation of private property rights and interests). Buzbee extends this analysis to the fragmentation of regulation over land use and environmental matters. *See* Buzbee, *supra* note 115, at 49–51. In such circumstances, agencies refuse to use their authority or spend resources to regulate because of communication, coordination, and collaboration problems and because the costs of regulation to the agency outweigh the benefits the agency will receive.

128. *See* Buzbee, *supra* note 115, at 49–51.

129. *See id.* at 50.

130. Hold-out occurs when a necessary party to an agreement withholds consent, stymieing further progress.

131. *See* Buzbee, *supra* note 115, at 33.

132. *Id.* at 47.

133. Note that frequently there is no government authority to which the stakeholders could appeal because of democracy deficits at the international level. *See* Vogel, *supra* note 34, at 266.

134. *See* Buzbee, *supra* note 115, at 49–51 (2003). In such circumstances, agencies vie with one another for authority.

135. *See id.* at 26; Abbott & Snidal, *supra* note 9, at 58.

the bottom.¹³⁶ Voluntary standards, certification, and labeling systems counter the race to the bottom by creating market incentives for stakeholders to eliminate, reduce, or internalize social costs. These systems generate countervailing subsidies to encourage stakeholders to reduce environmental and social harms and promote positive externalities.¹³⁷

Table 2 summarizes the challenges that arise at the negotiation of standards stage of the regulatory process, the private governance institutions that address those challenges, what they supply, and the characteristics private governance institutions must have to be effective.

Table 2. Standards-Setting Institutions

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|--|---|--|--|
| Market economics or competitive disadvantage | Firm corporate social responsibility programs | Corporate directive and internal structures for implementation | Information about cost savings Market for green, socially responsible activities Prescriptive standards Transparency for monitoring and enforcement |

136. Abbott & Snidal, *supra* note 9, at 58.

137. For instance, state and local governments often fail to perform regional planning. They compete for commercial, industrial, and residential developments in order to expand their tax bases, resulting in a race to the bottom. William W. Buzbee, *The Regulatory Fragmentation Continuum, Westway and the Challenges of Regional Growth*, 21 J. L. & POL. 323, 351 (2005). The consequences include sprawl, traffic, loss of agricultural lands and wildlife habitat to commercial use, hollowing out of cities, urban blight and brownfields, heat island effects, groundwater pollution, flooding, and exposure to sewage wastes because of failure to separate and upgrade storm water infrastructure. In response to these social costs, members of the design, construction, and development industries; environmental organizations; and urban planners have developed the U.S. Green Building Council. See U.S. GREEN BUILDING COUNCIL, <http://www.usgbc.org/Default.aspx> (last visited Sept. 29, 2011). The Council addresses not only issues associated with poor land use planning, but also wasteful building design and construction practices through its Leadership in Energy and Environmental Design (LEED) standards. The LEED rating system addresses these social costs by rewarding land use planning that avoids or internalizes these social costs. See Sustainable Sites Requirements, LEED for New Construction Rating System, *in* LEED REFERENCE GUIDE FOR GREEN BUILDING DESIGN AND CONSTRUCTION (2009).

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|---|--|--|---|
| Regulatory capture | Voluntary standards, certification, and labeling systems | Alternative avenue for regulation | Tripartite or other structures to ensure representation of different stakeholders to prevent domination by one group Open, transparent structures to provide informational access and avoid secrecy Deliberative, consensus structures for inclusive participation and to prevent capture by narrow interests |
| Misallocation of entitlements from uncertainty or mistake | Voluntary standards, certification, and labeling systems | Structures to reduce transaction costs in trade of entitlements (identification of parties, negotiation of price, mechanism to identify compliant goods) | Prescriptive standards Effective monitors Protection of label against dilution, confusion, and fraud |
| Democracy deficits in foreign jurisdictions | Supply chain anchors | Supply standards via contract (based on tort law in jurisdiction of anchor firm) | Mechanisms to monitor compliance with standards Mechanisms to enforce standards, contracts |

C. Implementation Facilitators

To the extent firms agree to comply with voluntary regulatory requirements, they may find the process of implementing the regulations burdensome.¹³⁸ Small firms with fewer resources may find

138. In the context of governmental regulation, firms that are the targets of regulation generally underwrite the costs of implementation and compliance with command-and-control regulations. These costs may vary widely among firms and are generally higher for older facilities with older technology, resulting in higher costs per unit of environmental improvement. These costs of implementation and compliance may also ultimately be passed forward to consumers or back to suppliers, shareholders, and employees. Governments have begun to look for more efficient ways to regulate. By shifting to market mechanisms, such as taxes, subsidies and cap-and-trade programs, governments have permitted the costs of compliance to be shared among all of the regulatory targets. To reduce these inefficiencies, governments have begun to incorporate a number of innovations developed by private governance institutions to reduce costs and accelerate the speed of adoption and implementation of new standards. These innovations are often referred to as the “new

the process prohibitively expensive. A number of private governance mechanisms have arisen to facilitate implementation of regulatory standards and lower the costs of compliance. These include models and meta-standards, learning initiatives, environmental management systems, and codes of conduct. These institutions reduce costs associated with compliance with both governmental and private standards and address market uncertainties that may impact voluntary efforts to internalize externalities.

1. Models and Meta-Standards

A number of institutions have arisen to assist in the development of private governance by creating model structures and outlining procedures and criteria for the development of standards (“models” and “meta-standards”). Models, such as ISO 14001, provide general templates for firms to develop environmental management systems.¹³⁹ Models permit firms to implement these systems without having to construct the systems from scratch. The models thereby lower cost barriers and accelerate implementation of rules and structures. To the extent models provide guidelines for data collection and documentation, they also permit those concerned with compliance to compare the records of different firms or organizations. Meta-standards (rules for setting rules) such as those developed by the ISEAL Alliance¹⁴⁰ for voluntary standards, certification, and labeling

governance.” To increase adoption and implementation of standards, they have also begun to include managerial style mechanisms. Pattberg, *supra* note 46. These include providing non-mandatory guidelines and protocols; requiring firms to develop management plans, set benchmarks for performance, and use various metrics for measuring progress; and requesting that the firms share best practices with other regulated parties. *See, e.g.*, Trubek & Trubek, *supra* note 27, at 555–57 (describing the European Water Development Framework and related Common Implementation Strategy). These mechanisms foster innovation, increase flexibility, and improve participation. *Id.*

139. The International Organization for Standardization (ISO) has expanded its role as a standards-setting institution for products and has begun to provide models for management systems, including environmental management systems. *See, e.g., ISO 9000: Quality Management*, ISO: INTERNATIONAL ORGANIZATION FOR STANDARDIZATION, http://www.iso.org/iso/iso_catalogue/management_and_leadership_standards/quality_management.htm (last visited Oct. 8, 2011).

140. For example, the ISEAL Alliance provides guidance and models for voluntary standards, certification and labeling mechanisms. The organization shares best practices to help member organizations improve their effectiveness, increase their positive impacts, and maintain their credibility. *See The ISEAL Alliance in 100 Words*, ISEAL ALLIANCE, <http://www.isealalliance.org/content/the-iseal-alliance-in-100-words> (last visited Sept. 29, 2011). ISEAL Alliance establishes process requirements by which organizations develop, structure, and revise standards that provide for the process to be open, transparent, and broadly participatory. *See ISEAL Codes of Good Practices*, ISEAL ALLIANCE,

systems, provide guidance about how to develop effective rules and regulatory structures. These institutions reduce the costs of developing effective regulatory rules and structures by providing models, disseminating information about best practices, and providing a locus for their members to share information.

Without models and meta-standards, the development of private governance institutions would be more expensive and less effective. Stakeholders would be forced to generate rules themselves or modify rules and structures from other industries. Models and meta-standards also improve regulatory effectiveness. If standards fail to be sufficiently prescriptive or to include appropriate metrics for measuring improvement,¹⁴¹ the process of promulgating the standards may be seen as purely symbolic,¹⁴² increasing costs without procuring actual changes in social and environmental conditions. By identifying best practices to address the needs of particular industries, sectors, and stakeholders, models and meta-standards accelerate learning and facilitate institutional effectiveness.

2. Learning Initiatives

Learning initiatives are programs designed to increase capacity within a firm to evaluate and improve social and environmental performance.¹⁴³ Learning initiatives provide training to firm employees to facilitate the development and operation of

<http://www.isealalliance.org/content/codes-good-practice> (last visited Sept 29, 2011). The organization also sets standards for measuring and evaluating the social and environmental impacts of the member organizations and the effectiveness of their systems. *Id.* Finally, the organization has accreditation and process requirements for the individuals or bodies that will audit and certify whether participants are in compliance with the organization's standards with a view to ensuring that they are credible and accessible. *See id.* ISEAL Alliance provides training, tools, and technical support to its members. *Members*, ISEAL ALLIANCE, <http://www.isealalliance.org/content/members> (last visited Sept. 29, 2011). The ISEAL Alliance follows its own guidelines and procedures in setting standards for its member organizations. *Code Development*, ISEAL ALLIANCE, <http://www.isealalliance.org/content/code-development> (last visited Sept. 29, 2011).

141. *See* Courville, *supra* note 61, at 280. Without concrete performance benchmarks, it is difficult to measure whether a firm is improving over time or to make comparisons to other firms, which impacts the credibility of the system. *Id.* at 283.

142. *Id.* at 287–88; Andrew King et al., *The Strategic Use of Decentralized Institutions: Exploring Certification with ISO 14001 Management Standard*, 48 ACAD. MGMT J. 1091, 1092–94 (2005).

143. *See* Courville, *supra* note 61, at 273–74. For example, the Ethical Trading Initiative assists firms in adopting management and reporting systems associated with labor practices and facilitates dispute resolution. *Training*, ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org/training> (last visited Jan. 19, 2012).

accountability, auditing, and reporting systems.¹⁴⁴ Firms generally participate in learning initiatives to receive reputational benefits and to reduce risks associated with name and shame campaigns, tort actions, labor disputes, and other events that reduce firm profitability. Firms may also be motivated to enroll in these programs to improve employee relationships and align their practices with the norms and values of senior management.¹⁴⁵ Firms sometimes enroll in learning initiatives to receive reputational benefits, but fail to achieve compliance after enrolling in the program.¹⁴⁶

3. Environmental Management Systems

Firms have employed management systems for many years to improve firm operations and efficiency.¹⁴⁷ More recently, firms have

144. *Id.* at 273. The primary non-governmental example of a learning initiative is the Ethical Trading Initiative (ETI). *See generally* ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org> (last visited Oct. 8, 2011). ETI targets supply chains to improve labor practices throughout the world. *About ETI*, ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org/about-eti> (last visited Oct. 8, 2011). The organization's membership is comprised of firms, trade union organizations, and nonprofit organizations or voluntary civic institutions. *Our Members*, ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org/about-eti/our-members> (last visited Oct. 8, 2011). ETI helps firms evaluate their trade performance and set benchmarks to improve their performance over time. *What We Do*, ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org/about-eti/what-we-do> (last visited Oct. 8, 2011). The organization identifies best practices, provides training on implementation of those practices, initiates pilot projects, and brokers resolutions between companies, suppliers, and workers. *Id.* The organization also raises awareness among consumers, and provides training to firms on integrating ethical buying practices. *Id.* Finally, ETI requires firms to submit annual reports of their progress and conducts random validation visits to approximately twenty percent of its membership each year to validate the data and information contained in the report. *What Companies Sign Up To*, ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org/about-eti/what-companies-sign-up-to> (last visited Jan. 19, 2012). The organization provides a disciplinary procedure for companies that fail to implement the management systems and data collection processes within the benchmarked timeframes. The ultimate sanction is removal from the organization's membership list. ETHICAL TRADING INITIATIVE, PROCEDURE TO ENFORCE MEMBERSHIP OBLIGATION: CORPORATE MEMBERS (2009), available at <http://www.ethicaltrade.org/resources/key-eti-resources/eti-disciplinary-procedure>. The organization is supported through membership fees and grants from government agencies. Firms join the organization to benefit from the support structures and mediation processes to reduce the risk of strikes and work stoppage and to rehabilitate their reputations following adverse media exposure. *Join ETI*, ETHICAL TRADING INITIATIVE, <http://www.ethicaltrade.org/get-involved/join-eti> (last visited Jan. 19, 2012).

145. Courville, *supra* note 61, at 271.

146. *See id.* at 274.

147. *See, e.g., ISO 9001: 2008*, ISO: INTERNATIONAL ORGANIZATION FOR STANDARDIZATION, http://www.iso.org/iso/iso_catalogue/management_and_leadership_standards/quality_management/iso_9001_2008.htm (last visited Jan. 19, 2012); PHILIP B. CROSBY, LET'S TALK QUALITY: 96 QUESTIONS YOU ALWAYS WANTED TO ASK PHIL CROSBY (1989); KAORU ISHIKAWA, WHAT IS TOTAL QUALITY CONTROL? (David J. Lu trans., 1985).

begun to employ environmental management systems that focus specifically on firm environmental performance and the impacts of firm operations.¹⁴⁸ The systems may include evaluation processes to determine the environmental impacts of a firm's operations, policies designed to reduce those environmental impacts, plans for allocating resources and responsibility for implementing those policies, timelines for implementation, and organizational structures and hierarchies to assign responsibility for evaluating and reporting compliance. The systems help firms identify environmental problems and build capacity for change.¹⁴⁹ The systems may, but do not necessarily, provide specific goals for the firm to accomplish, benchmarks to measure progress in meeting those goals, and timelines for meeting those benchmarks and tracking improvement. Firms may develop their own systems or they may reduce the time and resources that they must invest by using models and meta-standards, which identify programs and processes that have already been tried, tested, and distilled into best practices.¹⁵⁰ Environmental management systems also facilitate the inculcation of values and a shift in firm norms through the logic of appropriateness.¹⁵¹

Because each firm may develop its own standards, environmental management systems are thought to lower the barriers to entry to environmental improvement, thereby increasing participation in the systems. By stressing continual improvement, the systems are thought

148. For example, ISO 14001 provides a standardized set of guidelines that firms may follow in instituting an environmental management system. ISO 14001:2004 provides a general template for developing an environmental management system for use by all firms. This meets the ISO's organizational goal—to standardize systems, to increase interoperability, to reduce the cost of obtaining knowledge, and to assure those that rely on the system that the essential elements of environmental management have been considered and addressed. Because the operations of businesses differ from one another, their environmental impacts vary. For this reason, ISO has provided a general template that may be modified by each business based on their initial evaluation of their environmental impacts. See *ISO 14000 Essentials*, ISO: INTERNATIONAL ORGANIZATION FOR STANDARDIZATION, http://www.iso.org/iso/iso_catalogue/management_and_leadership_standards/environmental_management/iso_14000_essentials.htm (last visited Dec. 10, 2011).

149. See Courville, *supra* note 61, at 288.

150. Auld et al., *supra* note 9, at 422.

151. Young, *Institutions and Environmental Change*, *supra* note 56, at 7; see also Vogel, *supra* note 31, at 170 (describing norm-shifting and a “herd effect” to the decision to adopt voluntary standards); Stephen Bernstein & Benjamin Cashore, *Can Non-State Global Governance be Legitimate?: An Analytical Framework*, 1 REG. & GOVERNANCE 347, 349–50 (2007) (explaining that social systems provide a basis for understanding what institutional goals are worthwhile and justified, what institutional structures are legitimate, and what actions are appropriate or inappropriate, and that certain private governance systems may be a source of change for existing rules and norms).

to incentivize firms at all levels to improve their level of environmental performance, but this encourages firms to set their initial standards low so that they will be able to demonstrate continual improvement over time.¹⁵² Furthermore, because compliance is costly, firms have an incentive to avoid setting prescriptive requirements and specific benchmarks.¹⁵³ Consequently, the employment of environmental management systems may obscure the fact that the changes firms are making are minor.¹⁵⁴

4. Codes of Conduct

In general, codes of conduct are developed by members of an industry to reduce risk in industry operations.¹⁵⁵ When the members

152. King et al., *supra* note 142, at 1101.

153. See Courville, *supra* note 61, at 288–89. Prescriptive requirements might include maximum emissions during a set time frame. Procedural requirements, in contrast, might include plans to take measurements at set intervals and to report them to firm management using specific forms of communication.

154. Auld et al., *supra* note 9, at 422–23.

155. See, e.g., Auld et al., *supra* note 9, at 423 (discussing the Equator Principles). The Equator Principles were developed in 2003 by a number of private banking firms, including Citigroup, ABN Amro, and Barclays. *History of the Equator Principles*, EQUATOR PRINCIPLES, <http://www.equator-principles.com/index.php/about-the-equator-principles/38-about/about/17> (last visited Oct. 8, 2011). The project sets industry-wide social and environmental standards for project finance, applying across all industry sectors to projects with capital costs in excess of \$10 million. *About the Equator Principles*, EQUATOR PRINCIPLES, <http://www.equator-principles.com/index.php/about-the-equator-principles> (last visited Oct. 8, 2011). The standards are based, in part, on the social and environmental sustainability performance standards developed by the International Finance Corporation and on the World Bank's Environmental, Health, and Safety general guidelines. *Id.* Project developers are required to avoid, reduce, mitigate, or provide restitution for the negative impacts of their projects on ecosystems and communities. *Id.* In July 2010 an association was created to govern the institution; the organization is comprised of participating financial institutions that are active in public finance and have adopted the principles and associates (banking institutions that are not active in public finance). *The Equator Principles Association*, EQUATOR PRINCIPLES, <http://www.equator-principles.com/index.php/about-the-equator-principles/38-about/about/12> (last visited Oct. 8, 2011). The association obtains input from various steering committees and working groups, including three stakeholder engagement working groups comprised of NGOs, industry-based groups, and SRI firms. *About the Equator Principles*, EQUATOR PRINCIPLES, <http://www.equator-principles.com/index.php/about-the-equator-principles> (last visited Oct. 8, 2011). Signatories are required to report annually on their lending activities. *Reporting Requirements*, EQUATOR PRINCIPLES, <http://www.equator-principles.com/index.php/members-reporting/reporting-requirements> (last visited Oct. 8, 2011). At times, NGOs have raised questions about the degree to which signatory banks have enforced the Equator Principles and held project developers accountable. See, e.g., *WWF Urges Commercial Banks Not to Fund Controversial Pipeline*, WORLD WILDLIFE FUND (Nov. 11, 2003), http://wwf.panda.org/wwf_news/press_releases/?9722/WWF-urges-commercial-banks-not-to-fund-controversial-pipeline. While this code of conduct has extended to lenders, the main risks here are from

of an industry share a collective reputation, all industry members are exposed to economic harm when one member causes injury.¹⁵⁶ Codes of conduct encourage industry members to undertake similar obligations, thereby reducing the competitive disadvantage faced by any one firm that is subject to the regulatory standards of a particular jurisdiction or the costs of complying with differing standards in multiple jurisdictions. In a voluntary context in which no public regulation has been developed, codes of conduct facilitate voluntary adoption of industry standards by reducing the competitive risks associated with implementing labor and working condition standards, paying fair wages or fair prices for commodities, adopting new technologies or limits to prevent over-harvesting or environmental harms. The more firms that participate in a voluntary regulatory program, the less competitive disadvantage any single firm faces from incurring the costs associated with complying with that program.

Similarly, in the context of existing regulation, codes of conduct may facilitate standards implementation by reducing leakage. Even where regulatory standards have been imposed and are properly enforced, compliant firms face a competitive disadvantage from firms that flee a jurisdiction to avoid the costs associated with regulation.¹⁵⁷ When production and supply networks cross jurisdictional boundaries, it becomes more difficult for governments to enforce standards.¹⁵⁸ Firms may avoid the costs of compliance by subcontracting to other companies, by outsourcing risky behavior to companies that do not meet size or jurisdictional thresholds,¹⁵⁹ and by entering into private contracts that mandate conditions that skirt the technical parameters of existing regulations.¹⁶⁰

Codes of conduct are usually funded solely by industry or industry trade groups and are developed by industry without input from other stakeholders, such as potentially impacted parties, regulators, or the general public. Consequently, they may not contain prescriptive requirements that would improve environmental or social outcomes. In fact, they may not supply effective regulatory

leakage—companies turning to other lenders, such as sovereign wealth funds, that do not require these kinds of criteria.

156. Auld et al., *supra* note 9, at 423.

157. In a related practice, firms sometimes create subsidiaries outside of the regulating jurisdiction and execute a subcontract with that entity to outsource the offending activity. Vandenberg, *supra* note 38, at 2034.

158. See Vogel, *supra* note 31, at 159–60.

159. Vandenberg, *supra* note 38, at 2088.

160. *Id.*

standards at all. Frequently, codes of conduct lack structures for implementation or procedures for monitoring and enforcement.¹⁶¹ In general, firms have an incentive to enjoy the advantages of the appearance of improvement without making any actual effort to improve. Unless there are effective monitoring and enforcement systems in place to ensure compliance, the regime may be marked by significant free-riding; this incentive grows as the number of members in the industry group increases.¹⁶²

5. Voluntary Standards, Certification, and Labeling Systems

Voluntary standards, certification, and labeling systems provide a number of resources to facilitate implementation of social and environmental standards. They train and accredit consultants to advise participants in the certification process on program requirements and to provide technical assistance to firms in implementing management systems. They also market the standards and label products, firms, and facilities for consumers to generate premium prices that incentivize and reward firms to adopt the standards and implement the certification process.

Table 3 summarizes the challenges that arise at the implementation stage, the structures institutions supply to address those challenges, and the characteristics needed be effective at that stage.

Table 3. Implementation Facilitators

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|---|---------------------------|---|---|
| Market uncertainties Costs of implementation | Models and meta-standards | Reduce costs by providing templates, best practices | General models have greater interoperability; particularized models have better application to specific problems Requirement of prescriptive standards |

161. Auld et al., *supra* note 9, at 423.

162. Lyon, *supra* note 3, at 59.

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|--|--|---|---|
| Costs of implementation | Learning initiatives | Reduce costs by providing technical support for implementation | Knowledge of industry and industry practices Feedback mechanism for best practices Mechanism to verify implementation |
| Costs of implementation | Environmental management systems | Systematizes implementation | Prescriptive standards Monitoring Transparency |
| Competitive disadvantage from acting alone | Codes of conduct | Levels the playing field for participants in industry | Prescriptive standards for club membership Monitoring is necessary to prevent free-riding Enforcement against free-riders |
| Market uncertainties | Socially responsible investment Voluntary standards, certification, and labeling institutions | Market incentives through price premiums to induce parties to participate | Marketing to consumers and investors Sufficiently broad consumer or investor participation for market incentive to be created Ability to exclude noncompliant parties from club |
| Costs of implementation | Voluntary standards, certification, and labeling institutions | Provides technical assistance, management systems, and trains consultants to advise participants on program requirements and implementation | Prescriptive standards must be clearly delineated Complementary monitoring and enforcement devices are needed to ensure compliance |

D. Monitoring

A demand for private governance at the monitoring stage arises when governments have failed to create adequate requirements for monitoring, when too few funds are allocated to develop the infrastructure required for monitoring, and when corruption or other factors render monitoring ineffective. An economic model of the

deterrence effect of sanctions predicts that parties will comply with regulation to the extent that the penalties for noncompliance, when multiplied by the risk of getting caught, exceed the benefits from cheating.¹⁶³ In other words, the efforts a firm will make and the funds the firm will invest to comply with regulations depend on the risk of getting caught cheating, the benefits to be gained from cheating, the penalty for cheating, and the benefits of compliance.¹⁶⁴ The higher the risks and costs of noncompliance and the higher the benefits of compliance, the more likely a party is to adhere to the rules. This suggests four options to improve compliance with the rules: (1) increase the likelihood of detecting cheating, (2) reduce the benefits from cheating, (3) increase the sanctions against cheaters, and (4) increase the rewards for compliance. Private governance institutions have taken all four approaches. The first and second options are discussed in this section and the third and fourth options are discussed in section E *infra*.

Most businesses have focused on option one, increasing the likelihood of detecting cheaters either by paying for monitoring, providing infrastructure to improve monitoring, or expanding the number of monitors. However, cooperatives have employed option three, reducing the benefits of cheating by eliminating the principal-agent problem.

1. Contractual Approaches

Much environmental and labor regulatory compliance may be attributed to contractual arrangements between private parties.¹⁶⁵ Equity investors condition their investment of capital, lenders

163. JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 128–38 (2005). From an economic point of view, firms would comply with regulations when the value to be gained from cheating is less than the amount of penalty multiplied by the risk of getting caught out of compliance. If the penalty multiplied by the risk of getting caught is greater than the value of cheating, then a firm will comply with the regulations. However, if the costs of monitoring are high, such as when there are many sources of environmental harm, then monitoring will not occur as frequently. If monitoring is done less frequently or less comprehensively, the risk of getting caught is low and firms will be incentivized to cheat.

164. See Williams, *supra* note 79, at 493 (citing Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968)). This analysis derives from the “logic of consequences” used primarily in law, economics, and political science. Sociology would interpret compliance activities somewhat differently, from the “logic of appropriateness” where compliance activities communicate to shareholders, future investors, lenders, insurers, regulators, and the general public a commitment that is inculcated through socialization into a shared culture. See Abbott & Snidal, *supra* note 9, at 63–64 (describing how the ANIME framework can accommodate both the logic of appropriateness and the logic of consequences).

165. See Vandenberg, *supra* note 38, at 2034.

condition their lending,¹⁶⁶ and insurance companies condition their commitment to insure on the outcome of their due diligence or underwriting investigations. In general, investors, acquisition parties, lenders, and insurers all identify their risks of loss by performing preliminary investigations. As an alternative, or in conjunction with these investigations, investors, purchasers, lenders, and insurers may also require that the counterparty make representations and warranties about past activity and make covenants promising to undertake certain beneficial actions and to avoid actions that would increase risks during the term of the contract. The counterparty discloses in a set of schedules all of the known risks and costs that the investors, purchasers, lenders, and insurers identify as areas of concern.

In the context of an acquisition or investment, the risks and costs that the acquisition target identifies may be reflected in a lower purchase price, in post-closing agreements, in indemnity provisions, and in insurance products covering post-closing risks.¹⁶⁷ These kinds of contractual arrangements enhance efficiency by permitting the parties to allocate those burdens to the parties most likely to manage those costs most effectively and cheaply.¹⁶⁸ They also incentivize firms seeking debt or equity investments to reduce sources of risk before seeking capital.

Lenders may include provisions in their loan documents that grant the lender private rights of enforcement when environmental problems or risks such as labor strikes or work stoppages arise; in doing so, lenders add themselves to the number of parties monitoring compliance.¹⁶⁹ While lenders may have added these provisions to their loan agreements primarily to provide lenders with a counterclaim in the context of potential regulatory liability,¹⁷⁰ lender imposition of a

166. *Id.* at 2051–56.

167. *Id.* at 2046–47.

168. *See id.* at 2050. In addition, private dispute resolution mechanisms in the contracts permit parties to preserve confidentiality and to avoid costs associated with court delays and unreliability. *Id.* at 2051.

169. *Id.* at 2053.

170. Following the imposition of liability against a lender for environmental torts under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601–9675 (2006), in *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990), lenders began to perform more extensive due diligence to remain within the safe harbor regulations promulgated by the EPA and to include additional contractual provisions to provide additional defenses against liability. William G. Murray, *What to Do About the Problem Project*, SS049 ALI-ABA 121, 135–36 (2011) (outlining the history of lender liability for environmental contamination and the subsequent development of guidance by the EPA to allow lenders to

Phase I Environmental Report, for example, in the standard underwriting process may not only have availed lenders of the safe harbor rules and a number of defenses under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),¹⁷¹ but also improved environmental management.¹⁷²

Insurers perform due diligence investigations to determine the risk profile of the insured. Insurers set rates and identify exclusions from coverage based on what they uncover, and they may offer incentives, such as lower premiums, for safe operations and actions that reduce risk. Insurers may also mandate that the insured employ certain equipment or implement certain procedures prior to granting coverage. Finally, insurance companies may conduct inspections to verify whether the matters a firm has reported are correct.

2. Audits and Third Party Assurance Services

Third-party auditing processes arose initially as an extension of the financial audits that accounting firms performed.¹⁷³ Globalized firms now outsource manufacturing processes and other services to foreign firms.¹⁷⁴ Products have also grown more complex; supply firms manufacture components in different countries, making it more difficult to monitor and control quality, conformity to specifications, and timely delivery.¹⁷⁵ Because manufacturing standards, regulatory infrastructure, and cultural practices differ throughout the world, firms now hire third-party auditors to verify whether goods manufactured by foreign contractors meet the contracting firm's specifications.¹⁷⁶

avail themselves of safe harbors and employ other defenses under CERCLA by undertaking "all appropriate inquiries" including a Phase I Environmental Site Assessment before taking title through a foreclosure action).

171. 42 U.S.C. §§ 9601–9675.

172. Recently Brazil has expanded their rules for environmental liability to include lenders in the array of potentially responsible parties in an apparent attempt to use lender due diligence and monitoring as a mechanism to enforce environmental laws and to substitute for an ineffective public administration regime. See Bianca Zambao, *Brazil's Launch of Lender Environmental Liability as a Tool to Manage Environmental Impacts*, 18 U. MIAMI INT'L COMP. L. REV 47 (2010).

173. Blair et al., *supra* note 30, at 330.

174. *Id.* at 329, 335.

175. *See id.* at 329.

176. *Id.* Social, cultural, and institutional differences and geographic distance reduce the frequency of interaction and information transfers, impacting accuracy of the information flows. See King et al., *supra* note 142, at 1093, 1096.

Third-party audits have expanded to include social parameters relating to labor standards, environmental impacts, and other matters.¹⁷⁷ As firms have begun to expand into new markets for environmentally friendly or socially responsible goods or services, they have begun making claims that they have taken effective actions to reduce their negative environmental or social impacts, or that their products are better for the environment than comparable products. Frequently, in response to environmental NGO accusations that firms are misrepresenting their green credentials or greenwashing their environmental performance, these firms have begun to employ third-party audits to prove their environmental claims are true.¹⁷⁸ Social audits verify whether or not a firm or facility is adhering to pledges it has made to follow certain production processes, use certain management systems, or otherwise meet the benchmarks or environmental or social standards to which it has committed. Social audits may be aimed at firm products, facilities, services, or processes.¹⁷⁹ They may include performance assessments to determine whether production standards have been met, or may simply verify whether a firm is following prescribed processes.¹⁸⁰ Companies may hire either private firms, including the accounting firms that are performing other auditing services,¹⁸¹ civic organizations,¹⁸² or some hybrid to perform the audits. Some institutions set guidelines and provide training for auditors to ensure that firm performance is accurately measured.¹⁸³

As auditing has grown into a separate industry,¹⁸⁴ private commercial auditors have sometimes been criticized as ineffective.¹⁸⁵ Conflicts of interest arise when the party being audited pays for the audit.¹⁸⁶ Consequently, some private governance institutions require

177. Courville, *supra* note 61, at 272; Blair et al., *supra* note 30, at 329, 337.

178. Courville, *supra* note 61, at 271–72 (noting that studies have shown that false environmental claims are widespread).

179. *Id.*

180. *Id.*

181. Blair et al., *supra* note 30, at 345. Major accounting firms are responsible for providing sixty percent of the reports where firms seek third-party verification.

182. Courville, *supra* note 61, at 272.

183. *See id.* at 276–77.

184. Blair et al., *supra* note 30, at 342.

185. Michael J. Hiscox et al., *Evaluating the Impact of SA 8000 Certification*, in *SA 8000: THE FIRST DECADE 147–48* (Deborah Leipziger ed., 2008).

186. *See* Courville, *supra* note 61, at 275 (noting that financial relationships can weaken auditor independence).

the party closest to the consumer in the supply chain pay for the audit.¹⁸⁷ In addition, stakeholders question whether monitoring agencies are sufficiently independent so as to fairly assess compliance when these same monitoring agencies are paid by their regulatory targets, are hired to assist with implementation, or are imbedded in the organizations that set the standards.¹⁸⁸ To maintain legitimacy, a number of these institutions have separated the standards-setting and implementation activity from the monitoring functions by transferring those functions to newly created organizations or business entities.¹⁸⁹ This practice eliminates the potential conflict of interest that may arise when monitors also set and improve standards or have business interests in standards implementation assistance.¹⁹⁰

Some scholars have suggested that the enforcement of environmental and social provisions would be improved through widespread adoption of more explicit and effective standards and by disclosure of existing implementation and enforcement practices, possibly through a clearinghouse relating to supply contracts that would include detailed information about firm supplier procurement policies, environmental provisions in the contracts, other materials about implementation, and the extent of enforcement by the supply chain anchor or retailer.¹⁹¹ These changes would expand the number of monitors by permitting consumers and NGOs to evaluate firm and supply chain performance.¹⁹² However, firms are unlikely to voluntarily share such information because it would reduce their competitiveness generally.

3. Voluntary Standards, Certification, and Labeling Systems

In general, consumers concerned with the environmental impacts of goods they consider buying can seldom discern whether the goods were produced sustainably and without use of toxins just by

187. For example, the Fairtrade Labeling Organization solves this problem in a unique way by charging the final packaging company in the supply chain a license fee to pay for the cost of the auditing process. *Id.* This allocates the audit costs to the entity in the supply chain that is closest to the consumer—the party that most values the audit. While the actual cost of the audit may ultimately be passed forward or backward (through higher coffee prices to consumers or reduced prices for farmers) based on market dynamics, it solves the conflict of interest dilemmas that arise from producers paying directly for their own audits.

188. *Id.* at 283.

189. *Id.* at 287–88.

190. *Id.* at 283.

191. Vandenberg, *supra* note 89, at 967.

192. *See id.* at 969.

examining the goods. Similarly, consumers concerned about the social conditions under which goods were manufactured or produced cannot tell through inspection whether the goods were produced under hazardous or unfair working conditions, traded under monopolistic terms, or extracted at the cost of human life.¹⁹³ When a consumer cannot discern the quality of the good before, during, or after use, those goods are known as “credence goods.”¹⁹⁴ Consumer criteria relating to environmental sustainability and social impacts are credence qualities.¹⁹⁵ Credence goods create monitoring and selection problems.¹⁹⁶

Because the goods are credence goods, consumers and investors have difficulty identifying the goods that meet their preferences. In these situations investors and consumers must generally rely on the reputation or assurances of other parties.¹⁹⁷ SRI firms screen investments to meet investor standards. Voluntary standards, certification, and labeling systems create structures to ensure that a firm, facility, or set of goods complies with and conforms to their standards.¹⁹⁸ These systems solve the monitoring problem by training and accrediting monitors and by requiring all products, facilities, or firms that receive the certification label to go through a process in which their activities are monitored to ensure that they conform to the standards. To the extent monitors fail to apply standards uniformly, they are subject to negative reputational costs and may be subject to having their accreditation revoked. Voluntary standards, certification, and labeling systems assist consumers in differentiating and selecting compliant goods by labeling them.¹⁹⁹

193. Whether or not resources have been extracted as a result of exploitative practices or a product has been manufactured using slave labor, and whether these items are transferred up the supply chain for less than their fair market value because of the exercise of power, is not visible to the consumer.

194. Darby & Karni, *supra* note 87, at 68–69 (“Credence qualities are those which, although worthwhile, cannot be evaluated in normal use. Instead the assessment of their value requires additional costly information.”).

195. Ostensibly, consumers with concerns about the presence of toxins may detect them through chemical testing processes, but such tests can be exorbitantly expensive and are not readily available.

196. King et al., *supra* note 142, at 1092.

197. See Darby & Karni, *supra* note 87, at 69 (discussing the issue in the context of repair services, where consumers often must rely on the claims of the service provider).

198. See Vogel, *supra* note 31, at 183.

199. For example, the Forest Stewardship Council certifies and labels forest products so that consumers may avoid illegally and unsustainably harvested wood and instead choose products that have been sustainably harvested. Similarly, the Marine Stewardship Council, through their certification and labeling of fish and marine products, seeks to increase consumer

4. Disclosure and Reporting Initiatives

Disclosure and reporting initiatives increase the risks to noncompliant firms of getting caught by expanding the number of monitors. They recruit firms to self-report information about their activities across a range of social and environmental parameters.²⁰⁰ Reporting initiatives multiply the effects of both governmental regulation and private governance by increasing the number of monitors and by rewarding firms with positive recognition and reputational benefits for reducing the negative impacts of the manufacture and distribution processes.²⁰¹ Reporting initiatives also shift public norms, including management norms,²⁰² facilitate environmental activism,²⁰³ and signal investment choices for socially responsible investors and underwriting choices for insurance companies.²⁰⁴ By providing more information about whether firms are

awareness about illegal, unreported, and unregulated fishing and shift consumption toward more sustainable harvesting.

200. The Global Reporting Initiative (GRI) is one of the most well-known of these types of programs. CERES, a nonprofit organization created following the Exxon Valdez oil spill, partnered with the United Nations Environmental Programme to develop a corporate code of conduct—the CERES principles—to be used by private investors in evaluating firm performance. These principles and their reporting requirements later developed into the GRI. Pattberg, *supra* note 138, at 598–602. The GRI is a network-based organization that has developed a sustainability reporting framework that reduces the transaction costs firms face in gathering and reporting information relating to the environmental and social impacts of their operations. The framework helps firms determine what to report and how to gather reliable, high-quality data about their operations, and facilitates the compilation of credible, consistent reports that permit investors to compare firms. *See generally* GRI, <http://www.globalreporting.org/Home> (last visited Sept. 17, 2011).

201. *See* Michael P. Vandenbergh, *Climate Change: The China Problem*, 81 S. CAL. L. REV. 905, 943 (2008).

202. Vogel, *supra* note 34, at 269 (“The literature . . . frequently claims that business acceptance of [corporate social responsibility] in general and civil regulation in particular both reflect and reinforce a shift in norms for acceptable global business behavior.”); *see also* Pattberg, *supra* note 46, at 598–602 (describing development of the GRI as arising, in part, from demands of investors seeking information about risks associated with companies’ environmental performance and the subsequent responsiveness of firms in participating in the GRI to secure brand reputation and profits amidst a hostile public environment following the Exxon Valdez oil spill).

203. *See id.* at 955.

204. *See id.* at 956. Formal government has also employed periodic reporting and transparency requirements to facilitate surveillance by multiple parties, including the general public. Vandenbergh, *supra* note 38, at 2072. Mandatory public disclosure requirements—such as those in Resource Conservation and Recovery Act of 1976 (RCRA), 42 U.S.C. §§ 6929–6939 (2006), the Emergency Planning and Community Right-to-Know Act of 1986, 42 U.S.C. §§ 11021–11023 (2006), and the Pollution Prevention Act of 1990, 42 U.S.C. § 13106 (2006), which are reported in the Toxic Release Inventory—have been effective in shifting firms to reduce their environmental impacts. The Toxic Release Inventory, established shortly after the 1984

performing across a range of environmental and social parameters, disclosure and reporting initiatives educate the public about risks, permit investors to make socially conscious decisions about their investments, permit consumers to make thoughtful choices about their purchases, and permit regulators, insurance companies, and other interested parties to compare risks between firms.

Monitoring the supply of credence goods is inherently problematic. Where voluntary standards, certification, and labeling systems face difficulties in verifying that goods are legally harvested, organic, traded fairly, produced in a sustainable, ecosystem-friendly manner, investors face similar difficulties in discerning whether their investments are supporting their investment goals. Consequently, to the extent that any of these private governance institutions rely on self-reported information from firms without employing a monitoring or verification system, private governance institutions have no way to tell whether the reports are accurate. However, by affirmatively reporting firm activities, practices, and other performance metrics, firms invite additional scrutiny by employees, investors, consumers, concerned public interest groups, the news media, and the markets.

Economic modeling suggests that firm participation in reporting initiatives will be low compared to participation under mandatory government disclosure programs, particularly among the firms that perform most poorly along the reported parameters.²⁰⁵ However, when compared to situations in which there is no clear governing authority and where government has failed to act, any movement by firms to address social costs can improve outcomes, particularly when the risks associated with inaction are high.²⁰⁶ In addition, movement

Union Carbide disaster in Bhopal India, has been seen as particularly effective. It requires large industrial firms to disclose information to the public each year about chemical releases that have occurred at their facilities. Vandenberg, *supra* note 201, at 943–44. Empirical studies have shown that markets have responded to this information by penalizing the highest emitters with reductions in stock value. *Id.* As a consequence, high-emitting firms reduced their emissions more rapidly and to a greater extent than lower-emitting companies, even when emissions reductions were not required by law. *Id.*

205. Lyon, *supra* note 3, at 61 (discussing incentives for firm to disclose or to avoid disclosure).

206. For instance, in response to the risks associated with climate change, nearly 3000 of the largest corporations submitted voluntary reports in 2009 on their carbon emissions to the Carbon Disclosure Project, which provides the information to over 500 institutional investors, with over \$71 trillion in assets under management, and approximately 60 supply chain anchors, such as Wal-Mart. *What We Do: Overview*, CARBON DISCLOSURE PROJECT, <https://www.cdproject.net/en-US/WhatWeDo/Pages/overview.aspx> (last visited Nov. 21, 2011). The data is also available to policymakers, government bodies, NGOs, universities, and the general public. The Carbon Disclosure Project was developed to identify the financial risks

toward disclosure by a few firms could eventually lead to the development of industry-wide codes of conduct that would shift adoption and implementation rates upward.

5. Environmental Management Systems

Firms employing environmental management systems generally use internal control systems to monitor firm performance.²⁰⁷ These firms may supplement internal audits with external auditing, disclosure, and reporting programs.²⁰⁸ Environmental management systems also generally provide a framework for generating documentation to demonstrate compliance. To the extent that a firm discloses this information to the public, the report may be used to provide assurance to employees, customers, and the general public about risk, safety, and environmental performance, to confirm with investors, lenders, and suppliers that the firm is operating in conformity with their requirements, and to show regulatory agencies that the firm is in compliance with the law. Environmental management systems may therefore reduce the frequency and costs of external monitoring by government regulators.²⁰⁹ To the extent that

companies face from climate change and companies' efforts to decrease carbon emissions, with the understanding that in the business world "what gets measured gets managed." Blair et al., *supra* note 30, at 345; *Industry Viewpoints: What Does Business Want from a Global Deal?*, CARBON DISCLOSURE PROJECT, <https://www.cdproject.net/en-us/WhatWeDo/Pages/Industry-viewpoints-What-does-business-want-from-a-Global-Deal.aspx> (last visited Sept. 29, 2011). Nevertheless, if reporting initiatives only require firms to self-report and lack systems to verify whether the reports correctly reflect the firm environmental impacts, their usefulness to investors and consumers may be limited.

207. See Courville, *supra* note 61, at 288.

208. *Id.* In addition to mandatory governmental programs and due diligence and compliance information requests by contracting parties, firms may report their data to disclosure and reporting initiatives such as The Global Reporting Initiative or the Carbon Disclosure Project. See *What is GRI?*, GLOBAL REPORTING INITIATIVE, <http://www.globalreporting.org/AboutGRI/WhatIsGRI> (last visited Oct. 7, 2011); *What We Do*, CARBON DISCLOSURE PROJECT, <https://www.cdproject.net/en-US/WhatWeDo/Pages/overview.aspx> (last visited Sept. 29, 2011).

209. Courville, *supra* note 61, at 288–89 (“As one of the expectation gaps in social auditing is the inability of the external auditor and certification system to constantly monitor performance of the producer company, internal control systems or management systems can provide a critical tool of more regular monitoring of performance. This is then complemented by periodic planned and surprise checks by external auditors. However, where internal auditing is used as a vehicle to reduce the external audit to less than 100 percent coverage, the difficulty is in finding the right balance between internal and external auditing, balancing capacity building, and ownership with inspectability to a consistent interpretation of the standards.”).

internal auditing is used to reduce the comprehensiveness of an external audit, however, the value of the auditing process declines.²¹⁰

6. Cooperatives

In contrast to the mechanisms outlined above, which improve compliance by expanding monitoring, cooperatives reduce the benefits a firm might receive from cheating. Cooperatives form when groups of individuals or firms voluntarily decide to work together to meet their collective needs or to share the profits from their enterprise.²¹¹ Cooperatives are mutual benefit organizations; those who use the enterprise control it, and control rights are exercised on a one-person, one-vote basis.²¹²

Cooperatives may take the form of business organizations that are owned by employees in equal shares, such as trade cooperatives,²¹³ or organizations that are owned by the individuals that actually use its services, such as electrical utility cooperatives.²¹⁴ While competition in

210. *Id.*

211. Morris Altman, *History and Theories of Cooperatives*, in INTERNATIONAL ENCYCLOPEDIA OF CIVIL SOCIETY 563 (Helmut K. Anheir et al. eds., 2010). There are nearly 30,000 cooperatives in the U.S., owning more than \$3 trillion in assets. They generate over \$500 billion in revenue and \$25 billion in wages. UNIV. OF WISCONSIN CTR. FOR COOPS., RESEARCH ON THE ECONOMIC IMPACT OF COOPERATIVES 2 (2009), available at http://reic.uwcc.wisc.edu/sites/all/REIC_FINAL.pdf. They are not prominent in the scholarly literature, however. Some scholars attribute this to a decline in coverage of institutions in economics textbooks which has shifted toward neoclassical economics, and the changing role of the economist as a social engineer that seeks optimal solutions. Panu Kalmi, *The Disappearance of Co-operatives from Economic Textbooks*, 31 CAMBRIDGE J. ECON. 625, 639 (2007).

212. See Kalmi, *supra* note 211, at 627.

213. For example, fair trade certification and labeling programs often have a cooperative element. Farmers that participate in the Fairtrade Labeling Organization are required to participate in cooperatives designed to assist producers in developing and accessing new markets and in building trading relationships. See Courville, *supra* note 61, at 279. The fair trade premium garnered by the program is delivered to the cooperative and the cooperative members, a joint body of workers and management, to decide how it is to be used. *Id.* at 280. They may elect to remit the proceeds to the cooperative members or to use the money to make other investments that will allow the group to enhance their operations and improve their profitability. See *id.* at 281. Cooperatives also often seek to achieve social goals as well as serve their members' needs, such as promoting equality, recognizing human rights, and protecting the environment. Kalmi, *supra* note 211, at 627.

214. During the Great Depression the extension of public utility services was seen to be a key factor in reducing poverty and improving employment and interstate trade. Because the costs of extending electricity to rural areas would likely exceed the benefits for many years, few local and state governments were willing to make these investments. The Rural Electrification Administration was created under the New Deal to make loans to rural electrification cooperatives so that they could build lines and other infrastructure to transmit electricity to rural residents. Exec. Order No. 7037 (May 11, 1935).

a free market with full information and low transaction costs would theoretically produce the greatest social welfare for both buyers and purchasers,²¹⁵ exercises of market power, hold-up problems, lack of easy access to complete information, principal-agent problems, moral hazard, and uncertainty may inhibit trade.²¹⁶ Cooperatives address problems associated with unfair competition and monopolistic use of power either upstream or downstream²¹⁷ by permitting individuals to act collectively to obtain discounts and other benefits granted to market actors that engage in larger and more regular transactions.²¹⁸ Cooperatives use vertical integration to address problems of hold-up,²¹⁹ which may occur in processing agricultural or other products requiring time-sensitive processing or delivery.²²⁰ By purchasing and managing the processing equipment or delivery mechanism, cooperative members eliminate the parties in the supply chain that may reduce the value of their goods by delay and force them to relinquish price premiums for those goods.²²¹ While vertical integration through merger is also possible, the cooperative form permits decentralized decision-making and allows firms to capitalize on time-based or location-specific knowledge.²²² Cooperative

215. See Ronald Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). Coase theorizes that, with perfect information and in the absence of transaction costs, trade will give rise to an economically efficient allocation of entitlements, regardless of how the entitlements are originally allocated. If there is no cost associated with making an exchange, parties will exchange entitlements until a Pareto optimal allocation occurs; trade will continue to occur until no one can be made better off without making another party worse off.

216. GRUBER, *supra* note 163, at 126–28.

217. Michael Sykuta & Michael L. Cook, *A New Institutional Economics Approach to Contracts and Cooperatives*, 83 AM. J. AGRIC. ECON. 1273, 1276 (2001).

218. Altman, *supra* note 211, at 564–65.

219. The problem of hold-up occurs when two parties agree to cooperate to make a profit and one party makes a significant investment in an asset whose use, economic productivity, and therefore value, will depend on the cooperation of the other party. The first party's sunk costs in the asset put him at a disadvantage and gives the other party significant bargaining power. After the first party makes the investment, the second party could demand a significantly higher proportion of the profits—a change the first party will be forced to accept or otherwise face the loss of his initial investment altogether.

220. Helmut M. Dietl & Martin Grossman, *The Knowledge Economics of Cooperatives* (2006) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017844. For example, dairy farmers that need to get milk to market face hold-up problems from distributors to whom they sell the milk. Failure to get the milk to market in time will cause it to spoil. By creating their own cooperative distribution system, farmers eliminate the principal-agent problem and the incentive to hold-up.

221. See *id.* at 16 (discussing vertically integrated dairy cooperatives as a manner by which producers can avoid the hold-up problem).

222. *Id.* When general knowledge is more important, vertical integration through merger solves the hold-up problem and the centralized decision-making that results from merger will

structures, therefore, also permit individuals or entities that otherwise compete with each other to coordinate successfully without reducing their incentives to compete or make decisions independently.²²³ In the context of the theory of the firm,²²⁴ the decision to make (yielding protection from opportunistic behavior at the expense of additional coordination costs from centralized decision-making)²²⁵ or buy, if opportunistic behavior and hold-out are less likely or less costly and external transaction costs are relatively low, is expanded to include a third option: cooperate.

not create additional inefficiencies. *Id.* When specific knowledge is needed, however, the centralized decision-making may not allow the company to capitalize on time- or location-specific knowledge of the merged entities. *See generally* Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 524 (1945) (“If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. We cannot expect that this problem will be solved by first communicating all this knowledge to the central board which, after integrating *all* knowledge, issues its orders. . . . We need decentralization because only thus can we ensure that the knowledge of particular circumstances of time and place will be promptly used.”). If decentralized decision-making processes remain in place to accommodate and allow the company to benefit from idiosyncratic knowledge, the company will need to spend additional resources to communicate and coordinate among the segments of the merged entity.

223. *See, e.g.*, Dielt & Grossman, *supra* note 220, at 16–17. Most professional sports leagues are organized as cooperatives. Individual sports teams would lose much of their value if they did not use common rules, referees, scheduling, and marketing. *Id.* at 17. As Dielt and Grossman note, refusal by any team to play according to common rules and schedules (an example of the hold-up problem) would undermine the entire league. *Id.* However, they state that the common market solution to hold-up problems—vertical integration through merger—would also undermine league value, because fans could no longer trust that the individual teams were sufficiently independent for real competition to occur. *Id.* Cooperative organization permits the teams to maintain decentralized decision-making while participating in a binding structure that eliminates the uncertainty associated with hold-up. *Id.* at 17

224. Ronald Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937) (hypothesizing that firms begin to organize production inside a firm when the costs associated with that production are lower than the transaction costs of bargaining to purchase goods from outside of the firm, under knowledge constraints).

225. Peter G. Klein, *The Make-or-Buy Decisions: Lessons from Empirical Studies*, in *HANDBOOK OF NEW INSTITUTIONAL ECONOMICS* 436 (Claude Menard & Mary M. Shirley eds., 2005) (“In the Coasian framework, the decision to organize transactions within the firm as opposed to on the open market—the “make or buy” decision—depends on the relative costs of internal versus external exchange. The market mechanism entails certain costs: discovering the relevant prices, negotiating and enforcing contracts, and so on. Within the firm, the entrepreneur may be able to reduce these ‘transaction costs’ by coordinating these activities himself. However, internal organization brings other kinds of transaction costs, namely problems of information flow, incentives, monitoring and performance evaluation. The boundary of the firm, then, is determined by the tradeoff, at the margin, between the relative transaction costs of external and internal exchange.”)

Cooperatives also address agency problems.²²⁶ When an individual hires an agent to conduct business or enter into a transaction on the individual's behalf, a number of problems may arise. First, the agent may have a conflict of interest: the principal may not be able to tell whether the agent is serving the interests of the principal or pursuing the agent's own interests—a "moral hazard" problem.²²⁷ Second, the agent may withhold information that the principal would otherwise use to negotiate a fair price with the agent if the principal had access to the information.²²⁸ Two ways that market participants use contract law to solve the asymmetrical information problem are to perform research before the transaction or to monitor and enforce rules after the transaction.²²⁹ Both of these solutions can be expensive. Cooperatives eliminate the agency and asymmetrical information problems by allowing a market actor (such as the consumer) to be involved on both sides of the transaction.²³⁰ Additional profits to be gained from an agent succumbing to moral hazard or using asymmetrical information to the detriment of the person who hired them will accrue as a surplus not to the agent, but to the cooperative as a whole.²³¹ Surpluses are then distributed to cooperative members in accordance with their relative contribution to that surplus.²³² The cooperative structure changes the incentives; if consumers ultimately reap the profits from withholding information, there is little reason for agents to withhold the information from consumers in the first place.²³³ In times of legislative gridlock and

226. Sykuta & Cook, *supra* note 217, at 1274.

227. *Id.*

228. *Id.* at 1276.

229. *Id.* at 1277.

230. *Id.*

231. Altman, *supra* note 211, at 538. In this hypothetical the individual would likely receive a percentage of the surplus equivalent to the amount of his investment.

232. A trade cooperative rewards its members according to the members' relative production, a work cooperative according to the members' labor, and a purchasing cooperative according to the members' patronage.

233. Sykuta & Cook, *supra* note 217, at 1279. Ultimately, the problem of monitoring managers is addressed by internalizing the monitoring within the firm structure. Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777-78 (1972). While an employee may act adversely to both the customer's interest and the employer's interest, employee activities are more readily and regularly monitored, self-interested actions are more easily detected, and their activities are less likely to cause as extensive or widespread harm. As an empirical matter, regulation permits investor-owned firms to proliferate where there would otherwise be significant problems with asymmetric information, such as in the banking and insurance industries. HENRY HANSMANN, THE

limited administrative budgets, it is therefore not surprising that communities are turning again to cooperative structures to address their own banking, consumer, and employment needs.²³⁴

Table 4 identifies the challenges that arise at the monitoring stage, the private governance institutions that address those challenges, what they supply, and the characteristics the institutions must have to be effective.

Table 4. Monitoring Institutions

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|---|--|--|---|
| Information asymmetries | Acquisition and investor contracts Lending contracts Insurance contracts | Due diligence and underwriting investigations Contractual shift of risk of loss | Well-trained, independent investigators |
| Information asymmetries and credence problems | Audit firms and third party assurance arrangements | Monitoring and reporting device | Well-trained, independent investigators Accurate reporting to interested parties |

OWNERSHIP OF ENTERPRISE 294 (1996). Where regulation has been ineffective, however, cooperative ownership is an obvious response.

234. See, e.g., Kevin Roose, *Amid Wall Street Protests, Smaller Banks Gain Favor*, N.Y. TIMES, Nov. 4, 2011, at B5 (describing the shift to community banks, credit unions and banking cooperatives to avoid new fees charged by larger banking institutions and to support investment in local communities); Lee Romney, *They're Owning This Cooperation*, L.A. TIMES (Nov. 28, 2011), <http://articles.latimes.com/2011/nov/28/local/la-me-richmond-20111128> (describing the resurgence of cooperatives during the recession and efforts by cities such as Cleveland, Ohio; Washington, D.C.; Amarillo, Texas; Atlanta, Georgia; and Richmond, Virginia to develop or partner with cooperatives to increase employment and reduce poverty); Stuart Pfeifer & E. Scott Reckard, *One Facebook Post Becomes National Movement to Abandon Big Banks*, L.A. TIMES (Nov. 4, 2011), <http://articles.latimes.com/2011/nov/04/business/la-fi-bank-transfer-20111105> (describing the impetus behind Bank Transfer Day).

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|--|---|---|---|
| Information asymmetries and credence problems | Disclosure and reporting initiatives | Supplies information on firm compliance to investors, insurers, lenders, supply chain partners, stakeholders, regulatory bodies, and general public | Prescriptive standards Comparable standards (within an industry or practice) Independent verification of compliance with standards |
| Credence problem: selection signaling | Voluntary standards, certification, and labeling institutions | Provide labels to signal whether standards have been met | Auditor training and accreditation so goods accurately and consistently labeled Checks on conflicts of interest: independence of monitors from standards setting groups, from private contractors assisting with implementation, and from participants Accessible dispute resolution mechanisms |
| Information asymmetries Agency problems Moral hazard | Cooperatives | Eliminates economic incentives to cheat by placing consumer on both sides of transaction | |

E. Enforcement Institutions

As mentioned above, institutions may improve compliance with rules by improving monitoring systems that increase the likelihood that cheaters will be caught, by reducing the benefits of cheating, by posing a credible threat of sanctions, and by increasing the penalties of getting caught. This section discusses the innovative mechanisms that private governance institutions have developed to pursue the latter two strategies, including increasing the number of parties with the power to enforce the rules, the benefits associated with compliance, and the costs of noncompliance.

1. Regulation by Contract

Firms have employed a number of contract mechanisms to incentivize regulatory compliance from firms.²³⁵ Acquisition and equity investors manage concerns about risk by refusing to contract, negotiating lower purchase prices, shifting risk to the target companies and their owners through indemnities and insurance requirements, and requiring risk reduction and remediation efforts as a funding contingency. They reward firms with lower risk profiles with higher investments, higher purchase prices, more favorable deal terms, and promises of additional contracts.

Similarly, following underwriting investigations, lenders may refuse to lend, or they may include additional provisions in loan agreements and ancillary documents that provide for continued oversight, expanded default triggers, and contingencies for funding. The additional rights that lenders may exercise if firms fail to comply, such as declaring default, accelerating the repayment of the loan, and controlling the use of loan proceeds, make the threat of sanctions more immediate and credible.²³⁶ Note that the goal of these contractual provisions may simply be to give the lender a defense when there is a threat of tort liability or a competing claim on the use of loan proceeds if regulatory fines are imposed or remediation efforts are required.²³⁷ Insurance premium rate structures also promote compliance, since insurance companies may inspect insured parties to monitor their behavior and offer reductions in premiums if firms remain compliant over time.²³⁸ If inspections reveal that the insured party has misrepresented risk or broken covenants, the insurer may also deny coverage. On the other hand, lenders may reward compliant borrowers with lower rates, better terms, and additional loans.

Supply chain anchors use third party assurance services to verify compliance with quality control standards. They punish noncompliance by withholding payments and terminating contracts,

235. See Vandenberg, *supra* note 38, at 2044.

236. *Id.* at 2055. Lenders with private rights of enforcement sometimes create more stringent standards. *Id.* at 2055–56.

237. *Id.* at 2052. Following the *Fleet Factors* case and the EPA's development of certain safe harbors that lenders may use to avoid liability for environmental torts, lenders may use these kinds of provisions primarily for defensive purposes. In the event that the borrower is subject to damages, fees, or fines as a result of tort liability or noncompliance, the lender retains the right to control loan proceeds and may prevent them from being used to pay those liabilities or to redress environmental impacts.

238. See *id.* at 2063.

and they reward compliant suppliers with continued future contracts and more favorable prices or terms.

2. Education and Mobilization Initiatives

Civic organizations investigate firm activities and sometimes employ name and shame tactics that alert the public by identifying firms responsible for environmental or social harms or by exposing false claims of environmental or social responsibility. They enforce public regulation and private governance regimes with threats of boycotts, negative news media reports, the potential loss of market share and investors, and the costs associated with new regulation. When combined with the desire of firm owners, managers, and employees to maintain an image of public integrity, these mechanisms provide credible sanctions that pressure firms to reduce risk, remediate adverse impacts, and keep their practices in alignment with their claims and societal norms.²³⁹ Firms that can demonstrate they meet or exceed the standards set by societal norms can also receive positive attention and increased investment.²⁴⁰

3. Conservation Land Trusts

Land conservancies, or conservation land trusts, are nonprofit organizations that acquire rights to ecologically, environmentally, or historically important properties.²⁴¹ Land conservancies are commonly developed to preserve open space, ranchland, farmland, environmentally sensitive areas, water rights, and riparian zones.²⁴² These institutions pose an innovative solution to enforcement problems by expanding the number of parties with property interests and legal standing to enforce contractual rights. They may acquire property in fee, obtain conservation easement rights, or purchase the development or resource extraction rights associated with the property.²⁴³ Sometimes land conservancies transfer the acquired rights to federal or state governments for management and enforcement, especially if the acquired rights are to lands adjacent to other publicly held lands. But land conservancies may also hold the property rights

239. See Livermore, *supra* note 97, at 330–31 (describing how reputational forces can motivate firms to avoid harmful environmental practices).

240. See *id.* at 331.

241. Zachary Bray, *Reconciling Development and Natural Beauty, The Promise and Dilemma of Conservation Easements*, 34 HARV. ENVTL. L. REV. 119, 121–22 (2010).

242. *Id.*

243. *Id.*

in perpetuity, privately enforcing the land use restrictions in conservation easements to prevent heirs from developing property subject to the easement.²⁴⁴ Policymakers are increasingly considering conservancies not only for managing ecologically sensitive and historically important lands, but for preserving the relationships with indigenous people who rely on those lands.²⁴⁵

4. Voluntary Standards, Certification, and Labeling Systems

While other institutions enhance enforcement by increasing sanctions or deter capture by expanding the number of enforcement parties, voluntary standards, certification, and labeling systems use markets to incentivize compliance. In general, voluntary standards, certification, and labeling institutions market labeled goods and facilities to the public so that they may offer firms positive reputational benefits or retail price premiums to incentivize adoption of the standards and implementation of the certification program.²⁴⁶ By using a label to justify higher prices and generate goodwill, the systems reduce the relative benefits of non-adoption. To the extent that the programs determine that member firms have not continued to conform to the certification standards, they may discipline the firms through fines or other penalties and may ultimately bar the firms from using the system's label.

Note that unfair or unequal enforcement poses a challenge for the institution. When participants allege that the enforcement

244. One example of a well-recognized land conservation trust is The Nature Conservancy. The organization works throughout the United States and in thirty-one other countries to identify and preserve the ecological resources that they identify as most important, including forest, marine, and freshwater resources. The organization's conservation work includes obtaining property rights and transferring them to state and federal governments for management, acquiring conservation easements over private properties, managing its own private nature preserves, performing conservation services, and improving management practices for millions of acres of land and water. *See generally* THE NATURE CONSERVANCY, <http://www.nature.org> (last visited Jan. 19, 2012). In 2009, the Nature Conservancy had \$4.6 billion in assets and an annual operating budget of \$448 million. It received over \$400 million in member dues and donations and over \$300 million in land sales and gifts that year. THE NATURE CONSERVANCY, 2009 ANNUAL REPORT (2009), *available at* <http://www.nature.org/aboutus/ouraccountability/annualreport/Annual-Report-2009.xml?src=araboutus>.

245. *See, e.g.*, Mary Christina Wood & Zachary Welcker, *Tribes as Trustees Again (Part I): The Emerging Tribal Role in the Conservation Trust Movement*, 32 HARV. ENVTL. L. REV. 373 (2008); Mary Christina Wood & Matthew O'Brien, *Tribes as Trustees Again (Part II): Evaluating Four Models of Tribal Participation in The Conservation Trust Movement*, 27 STAN. ENVTL. L. REV. 477 (2008); Karol Bourdreaux, *A New Call of the Wild: Community-Based Resource Management in Namibia*, 20 GEO. INT'L ENVTL. L. REV. 297 (2008).

246. Cashore et al., *supra* note 17, at 186–87.

processes are being applied unfairly or unequally, the system can undergo a loss of credibility and legitimacy.²⁴⁷ This may result in increased cheating by the participants²⁴⁸ and potentially withdrawal from the private governance scheme.²⁴⁹ One of the key distinctions between private governance and formal government is that state criminal and civil sanction are available to keep residents from refusing to comply with the law and from opting out when formal government is engaged.²⁵⁰ In contrast, private governance institutions are maintained through the continuing agreement of their participants and are more sensitive to disputes and opt-outs, which can destabilize the regime. Voluntary standards, certification, and labeling mechanisms avoid this problem by supplying conflict resolution mechanisms that allow participants to resolve their disputes cheaply and quickly.²⁵¹ By requiring participation in dispute resolution procedures, private governance institutions allow participants to air grievances and resolve conflicts. Dispute resolution mechanisms improve the likelihood of long-term success by reducing their members' need for and their opportunity to resort to exit.²⁵² Private governance institutions that include dispute resolution mechanisms tend to be more stable and robust in the face of challenges as well as resilient to external changes that occur over time.²⁵³

Independent of the market incentives to encourage participation by producers and the enforcement and dispute resolution mechanisms aimed at sustaining their participation, voluntary standards, certification, and labeling systems also encourage continued participation among consumers. Sociological literature suggests that individuals are thought to take action based on the logic of appropriateness rather than the result of a conscious cost-benefit

247. Courville, *supra* note 61, at 290.

248. *Id.* at 290.

249. Cashore et al., *supra* note 17, at 186–87.

250. *Id.* at 184.

251. UNDERSTANDING INSTITUTIONAL DIVERSITY, *supra* note 54, at 267–68 (noting that (1) all rules are subject to interpretation, (2) conflicts arise between participants even when they have made the rules jointly, (3) low-cost conflict resolution mechanisms not only address immediate conflicts, but reduce conflicts as the community becomes aware of the way the conflicts have been resolved and the rules have been interpreted, and (4) such mechanisms also deter capture by local elites).

252. *Id.*

253. *Id.*

analysis.²⁵⁴ Institutions are viewed as social practices as individuals' identities are shaped by their membership in groups, and they comply with rules as a matter of habit.²⁵⁵ To the extent that a community's belief systems, norms, culture, and sense of connectedness create a culture of compliance, it reduces the need to develop complex systems for monitoring and enforcement and reduces the costs of enforcement.²⁵⁶ On the other hand, if the parties participating in the governance system share no common norms or share norms of noncompliance, the costs associated with enforcing the regime will be higher.²⁵⁷ Voluntary standards, certification, and labeling mechanisms have often been developed by groups with a shared set of values²⁵⁸ or a common mission.²⁵⁹ In turn, the groups have used their networks to expand the market for certified goods, providing an avenue for group

254. Abbott & Snidal, *supra* note 9, at 63, 70; Young, *Governance for Sustainable Development*, *supra* note 56, at 31; *see also* Lemos & Agrawal, *supra* note 9, at 76 (describing an emerging literature focusing on popularity, responsiveness, legitimacy, transparency, and accountability in the context of private governance).

255. *See id.*

256. Young, *Institutions and Environmental Change*, *supra* note 56, at 7 (contrasting the collective action perspective with the social practices perspective). The collective action perspective "assumes that individuals have preferences that are exogenous to their membership in groups, that they act on the basis of some sort of utilitarian calculation, and that they endeavor to maximize payoffs to themselves as individuals. Institutions form through a process—explicit or implicit—of developing social contracts. The prisoner's dilemma, the free-rider problem, and more generally problems of burden sharing and compliance loom as critical concerns among collective-action thinkers. The social practices perspective, by contrast, assumes that the identities of individuals are shaped in part by group membership, that actors are influenced by what is known as the logic of appropriateness as opposed to the logic of consequences, and that compliance with institutional rights and rules often become a matter of second nature or habit." *Id.* *See also* Elinor Ostrom, *Toward a Behavioral Theory Linking Trust, Reciprocity, and Reputation*, in *TRUST AND RECIPROCITY: INTERDISCIPLINARY LESSONS FROM EXPERIMENTAL RESEARCH* 19, 26, 33–34, 42–43, 48–49 (Elinor Ostrom & James Walker eds., 2003) (discussing the lack of empirical support for predictions of behavior in less structured situations than situations where the stakes are high and the numbers are low, such as competitive market situations (p. 26), and discussing the positive impacts of in-person communication (pp. 33–34) and reciprocity norms (pp. 42–43) on cooperation, and the positive feedback loop between reciprocity norms, reputation for trustworthiness, and levels of trust (pp. 48–49)).

257. *See* Young, *Institutions and Environmental Change*, *supra* note 56, at 15; *see also* Livermore, *supra* note 97, at 333.

258. Fair trade labeling activities were initially instituted by church groups and spread through support of church networks, for example.

259. The Forest Stewardship Council was developed from an alliance between World Wide Fund for Nature and a number of British firms following the breakdown of efforts to negotiate a forestry treaty at the Rio Summit in 1992. *About Us*, FOREST STEWARDSHIP COUNCIL, http://www.fsc.org/about_us (last visited Oct. 7, 2011); Cashore et al., *supra* note 17, at 182.

and network members to express their values and mission through their consumption choices.²⁶⁰

Furthermore, under post-structuralist theory, political scientists see individuals as shaped by the ways that governments exercise power.²⁶¹ Governments are thought to achieve their ends less by forcing people to comply with state-mandated goals than by making them allies and confederates.²⁶² The mere existence of a known rule may influence behavior.²⁶³ In a coordination game, knowledge of the law may change behavior, even without the threat of sanctions.²⁶⁴ Similarly, the opportunity for citizens to make consumer choices based on labels invites consumers to see themselves as citizen-consumers, and enables them to take action through their consumption choices and purchasing power.²⁶⁵ To the extent consumers use self-restraint in their consumption, they have internalized the enforcement process.

Table 5 identifies the challenges that arise at the enforcement stage, the private governance institutions that address those challenges, what they supply, and the characteristics required for effective enforcement.

260. Kysar, *supra* note 113, at 624–25; Cashore et al., *supra* note 17, at 181.

261. Lemos & Agrawal, *supra* note 9, at 84–86 (noting that an individual's understanding and governance of themselves are shaped through scientific inquiries that identify them and their behaviors as targets of inquiry, through disciplinary practices that make distinctions between types of individuals, and through modes of thought that make certain practices seem more reasonable than others).

262. *Id.* at 84–85. These theories suggested that individuals' private lives and actions are also shaped by the way that knowledge is represented. In the process of following certain modes of thought, or "discourses," and engaging in certain practices, individuals posit themselves as subjects and take actions consistent with that subjectivity. When the dominant discourse changes, institutional change occurs. This line of inquiry is thought to be relevant particularly for market-based forms of governance that posit individuals as global citizens and consumers, those that label goods for consumption and for socially responsible investment, and the kinds of programs that shape the information reported by firms along with their investment parameters.

263. See Williams, *supra* note 79, at 494 (citing Richard H. McAdams & Janice Nadler, *Testing the Focal Point Theory of Legal Compliance: Expressive Influence in an Experimental Hawk/Dove Game 2* (2003) (Northwestern Law Legal Working Paper Series, Law and Economics Papers Working Paper no. 29), available at <http://law.bepress.com/nwwps/lep/art29>).

264. See *id.* at 482.

265. Kysar, *supra* note 113, at 624–25.

Table 5. Enforcement

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|--------------------------|--|---|--|
| Incentives to cheat | Education and mobilization initiatives | Public name and shame campaigns | Independence from target |
| Incentives to cheat | Supply chain anchors | Contractual enforcement mechanisms for breach and default, nonpayment and reduced payment, termination of contract | Complementary monitoring devices and credible threat of enforcement |
| Incentives to cheat | Insurance contracts | Refusal to insure after underwriting, refusal to pay claims, offer of reduced premiums for compliance, increased premiums for noncompliance | Underwriting review, complementary monitoring devices, and credible threat of enforcement |
| Incentives to cheat | Lending contracts | Refusal to loan after underwriting; loan enforcement mechanisms: stop payment, default interest rates, fines, acceleration of debt; decision-making rights of use of loan proceeds; calls on collateral and cross-collateralized debt | Due diligence review, complementary monitoring devices, and credible threat of enforcement |
| Incentives to cheat | Equity investment contracts | Refusal to contract following due diligence review, enforcement of indemnification agreements, calls on private collateral | Due diligence review, complementary monitoring devices, and credible threat of enforcement |
| Incentives to cheat | Socially responsible investment | Refusal to invest and divestment | Complementary monitoring and reporting devices |

| Barrier or Hazard | Suppliers | Structure Supplied | Keys to Effectiveness |
|--------------------------|---|---|--|
| Incentives to cheat | Voluntary standards, certification, and labeling mechanisms | Fines, sanctions, exclusion from club (remove participant from membership in label scheme) Education and soft or reflexive enforcement | Checks on conflicts of interest: independent monitors separate from standards setting groups, implementation experts, and participants Accessible dispute resolution mechanisms |
| Incentives to cheat | Land conservancies | Expands number of parties available to enforce bar on development of private lands | Court system to enforce contracts |

F. Funding Governance, a Public Good

Rules, and the institutions developed to enforce them, are public goods,²⁶⁶ and the process of developing rules and effectuating them can be expensive. Public goods are by definition non-rival. If public goods are provided to anyone, everyone can enjoy their benefit without diminishing others' enjoyment of them. Public goods are also non-exclusive—those who pay for the goods cannot exclude others from their enjoyment.²⁶⁷ In general, not everyone will contribute to the creation and maintenance of public goods to the extent of their enjoyment of those goods because they may free-ride on the efforts of others. Consequently, the private market will supply less of the public goods than would be socially optimal.²⁶⁸

Formal governments regulating within their own jurisdictional boundaries have several advantages in funding, most particularly, the latter stages of the regulatory process: implementation, monitoring, and enforcement. As many have noted, formal governments have the authority and the power to coerce implementation and compliance through threat of criminal sanction or monetary fines.²⁶⁹ More importantly, governments use their taxing power to overcome the

266. Edela Schlager, *Rationality, Cooperation and Common Pool Resources*, 45 *AM. BEHAV. SCIENTIST* 801, 804 (2002).

267. See GRUBER, *supra* note 163, at 170.

268. *Id.* at 176–77.

269. Vogel, *supra* note 31, at 153; Abbott & Snidal, *supra* note 9, at 57; Cashore et al., *supra* note 17, at 284.

free-rider problem and cover the costs of developing, effectuating, and enforcing new rules. Unlike governmental regulation, private governance institutions may not rely on state authority to cover the costs of the implementation, monitoring, enforcement, and conflict resolution processes.²⁷⁰ In addition, they must overcome free-rider problems.²⁷¹

This has important consequences for institutional stability. In a representative democracy, the tensions between interest groups tend to occur primarily in the initial stages of the regulatory process: when the agenda is set, when the standards are negotiated, and when the programs are funded through the budgetary process. Firms must bear the costs of implementing the regulation or suffer government sanctions. The state bears the costs of monitoring, enforcement, and dispute resolution through the courts and the state funds those activities through tax revenues. In contrast, in private governance institutions, participants must find resources to cover costs at each of the regulatory stages; consequently, internal tensions among participating interest groups may continue to occur throughout the regulatory process.

To develop private governance institutions, most of the participants must accept the rules at each stage; otherwise, they may opt out. If the parties fail to reach an agreement, no institution develops and no regulation occurs.²⁷² If parties reach an initial agreement but lack sufficient means or incentives to implement that agreement, the policy will not be implemented.²⁷³ Incentives to cheat remain unchecked if there are no monitoring or enforcement mechanisms.²⁷⁴ If monitoring and enforcement are not performed in a

270. UNDERSTANDING INSTITUTIONAL DIVERSITY, *supra* note 54, at 262–63 (describing the importance of fair allocation of the cost and benefits of a regime to the regime’s long term institutional stability).

271. Young, *Governance for the Environment*, *supra* note 56, at 16 (“The ‘free-rider’ problem . . . occurs in situations where the social benefits accruing from a public good exceed the cost of supply, but individual members of the group would prefer to enjoy the good without shouldering a share of the cost.”).

272. *Id.* at 21 (outlining the challenges of governance, including ignorance, high transaction cost, and massive free-rider problems, that impede resolution of socio-environmental problems).

273. *Id.* at 36 (“Bargaining processes can make governance systems incoherent, and problems of implementation can turn them into dead letters.”).

274. UNDERSTANDING INSTITUTIONAL DIVERSITY, *supra* note 54, at 265–67 (describing the importance of monitoring and enforcement); Stepan Wood, *Voluntary Environmental Codes and Sustainability*, in ENVIRONMENTAL LAW FOR SUSTAINABILITY 229, 260–62 (Benjamin J. Richardson & Stepan Wood eds., 2006).

fair manner and there are no systems to permit participants to appeal decisions or resolve disputes, participants may refuse to comply with the rules.²⁷⁵ The participants in private governance institutions must find resources to fund or otherwise support each stage of the regulatory process themselves. Furthermore, the way the costs of these burdens are allocated among the participants can have a significant impact on the effectiveness of the regulation.²⁷⁶

In smaller self-governing communities, Elinor Ostrom has observed that the costs and benefits associated with successful regulatory regimes tend to be proportionate for the participants.²⁷⁷ If participants' costs bear no relation to their benefits, they may either opt out or cheat, causing the system to unravel.²⁷⁸ The same dynamic is observed at the international level. States must come to an agreement that is collectively acceptable; there is no coercive power to ensure compliance.²⁷⁹ To the extent that certain states disproportionately bear the burdens from change and others reap the benefits, a mechanism is required to permit costs to be shared or the agreement will be unstable.²⁸⁰

Sources of financial support may also shape the behavior of private governance institutions.²⁸¹ Institutions that are funded by membership dues may be more likely to take actions that align with member interests and the public interest than those that receive funds

275. UNDERSTANDING INSTITUTIONAL DIVERSITY, *supra* note 54, at 267–68 (describing the importance of dispute resolution mechanisms to the regime's long term institutional stability).

276. *See id.* at 262; GOVERNING THE COMMONS, *supra* note 90, at 92 (explaining that in robust institutions, there is congruence between appropriation and provision rules and local conditions).

277. UNDERSTANDING INSTITUTIONAL DIVERSITY, *supra* note 54, at 262–63.

278. *Id.* at 263.

279. *See generally* Robert O. Keohane & Elinor Ostrom, *Introduction to LOCAL COMMONS AND GLOBAL INTERDEPENDENCE* (Robert O. Keohane & Elinor Ostrom eds., 1995).

280. Note that this phenomenon has been observed in the common pool resource context and is the basis in part for caution against using any particular governing approach as a panacea. Following recognition of the extent to which the earth's ecosystems were subject to a tragedy of the commons problem, many governments began to privatize forests and other natural resources, following the approach suggested by Garrett Hardin. Because many governments failed to allocate adequate resources to monitoring and enforcing restrictions on harvesting, the rate at which harvesting occurred accelerated, exacerbating the problem. In contrast, forests governed by local communities that assigned monitoring duties to individuals that would benefit directly from enforcement of the harvesting limits, fared well. *See* GOVERNING THE COMMONS, *supra* note 90, at 23.

281. Lyon, *supra* note 21, at 2.

primarily from foundations or private industry.²⁸² On the other hand, scholars have noted that while civic institutions are effective in pointing out failures, they may be limited in what they can achieve without the aid of regulatory institutions.²⁸³ The activities that membership organizations pursue may also reflect the limitations of member involvement.²⁸⁴ Membership-based organizations rely primarily on annual membership fees to cover the costs of their activities. They therefore have incentives to focus on activities in which they may garner media attention and attract new members.²⁸⁵ Media-worthy activities, such as exposing harmful practices, identifying bad actors, and initiating educational campaigns, tend to occur at the beginning of the regulatory process when the regulatory agenda is set, and at the end of the process, when the rules must be enforced.²⁸⁶ Members may find it more difficult to engage during rule negotiations when the standards are set and statutory language is drafted, particularly if technical expertise is required.²⁸⁷ Public

282. Robert J. Brulle & J. Craig Jenkins, *Civil Society and the Environment: Understanding the Dynamics and Impacts of the U.S. Environmental Movement*, in *GOOD COP, BAD COP: ENVIRONMENTAL NGOS AND THEIR STRATEGIES TOWARD BUSINESS* 73, 77, 92 (Thomas P. Lyon ed., 2010) (describing the discussion in the literature of impacts of foundation funding as shifting environmental nonprofits away from protest and grassroots mobilization and toward professionalized, centralized, nondemocratic structures with more moderate agendas); Lyon, *supra* note 21, at 5 (“Indeed, critics charge that instead of being governed by citizens, the environmental movement has become increasingly controlled by foundations that represent large corporate wealth and rationalized power in the American political economy. This, they say, blunts the potential impact of the movement, promotes nonparticipatory civic organizations, and limits the range of viewpoints represented in the public arena.”).

283. See Vogel, *supra* note 31, at 153, 165–66, 181–84. For example, the Rainforest Action Network is a well-known example of a civic organization that engages in grassroots activism and direct action focused on well-recognized leaders in industry and commerce to achieve its goals to protect rainforests and to defend the rights of rainforest inhabitants. Krill, *supra* note 60, at 208, 210. Factors that NGOs examine in determining which businesses they will target include the market share of the corporation, its reputation, and the distance that activists must travel to reach the corporation’s headquarters. Vogel, *supra* note 34, at 268. The organization derives its \$4 million budget equally from membership dues, major donations, and foundation support—a proportion the organization tries to maintain. Krill, *supra* note 60, at 213. The organization has approximately 13,000 members, 100,000 online supporters, and 1000 activists that participate regularly. *Id.* The organization engages in street protests, initiates advertising campaigns, develops shareholder resolutions, negotiates directly with corporate boards, and generally tries to coordinate with other organizations that work on the same or similar issues to attack the concern from a different angle. *Id.* at 213, 217.

284. See Vandenberg, *supra* note 89, at 960.

285. Mattli & Woods, *supra* note 3, at 29.

286. Abbott & Snidal, *supra* note 9, at 63–64.

287. *Id.* at 67–69. To the extent that the standards setting process is technical, the nuances may be difficult to explain, complicating any advocacy role that members may play. See *id.*

participation in the implementation and monitoring stages may also be challenging given firm interests in protecting trade secrets and in maintaining operational efficiency and security.²⁸⁸ For this reason, membership organizations that rely on the financial support of members and grassroots fundraising events may tend to focus on media-intensive activities that raise awareness and shift public debate²⁸⁹—activities that support the agenda-setting and enforcement stages of regulation.

In contrast, organizations funded by private foundations and corporate entities often undertake projects that more strongly resemble traditional government activities, such as including the monitoring and regulation of firm behavior and the truthfulness of firm claims, and funding and developing public goods, such as conservation of endangered habitat.²⁹⁰ They may also undertake market-enhancing activities, such as the creation of exchanges to facilitate the trade of environmental goods, or the development of new markets and branding systems to direct public attention to alternative goods that meet consumer social and environmental preferences.²⁹¹ The kinds of projects that these institutions undertake may simply reflect the availability of stable sources of funding. Long-term, ambitious projects are less interesting in terms of confrontational activity and media interest, but may be more effective in addressing the social and environmental problems. On the other hand, these projects give rise to fewer conflicts with corporate interests, raising questions about whether firm interests are steering

288. Because implementation, monitoring, and enforcement may occur where the public lacks the access (because firm security bars access), geographic location, or technical skills to assist in any meaningful way, members are unlikely to be able to play any direct role. Consequently, they may not be as ready to provide funding to support endeavors when they cannot participate or see the impacts directly.

289. Vogel, *supra* note 31, at 169; *see also* Mattli & Woods, *supra* note 3, at 29 (“[T]here are strong incentives for NGOs to focus their attention on the first phase of regulation—agenda-setting. The immediate benefits to NGOs of mobilizing campaigns are likely to be high: media attention brings them funding, new members, and public support. By contrast, engagement in the detailed elaboration of regulations or closely monitoring their enforcement is more time-consuming, more resource-intensive, and less easily effective or noticed.”).

290. Lyon, *supra* note 21, at 5; Vogel, *supra* note 31, at 154–55; Hoffman & Bertels, *supra* note 7, at 59–62 (showing the growing schism between (1) environmental organizations with corporate and foundation support that define themselves in conjunction with business and capitalist systems and take more moderate stances and enter into collaborative agreements with organizations such as the Environmental Defense Fund and The Nature Conservancy, and (2) organizations that avoid such ties and define themselves in opposition to corporations and their activities, such as Greenpeace and the Rainforest Action Network).

291. Hoffman & Bertels, *supra* note 7, at 59–62, 64.

NGOs' activities through foundation-based and corporate funding.²⁹² Some organizations have developed structures to maintain a balance of funding from a variety of sources to avoid conflicts of interest that may arise between their mission and the interests of those that provide significant funding.²⁹³

Given these tensions, private governance institutions have developed a number of innovative mechanisms to generate higher prices and other forms of funding, including some forms of corporate social responsibility, SRI firms, voluntary standards, certification, and labeling mechanisms, and producer cooperatives. Other institutions lower costs, such as some forms of CSR programs, environmental management systems, codes of conduct, and buyer cooperatives. Some programs play a facilitative role in increasing prices or reducing costs, including models and meta-standards, learning initiatives, and disclosure and reporting initiatives.

For firms seeking capital, loans, supply contracts, or insurance, meeting the demands and addressing the concerns of counterparties to their contracts are simply a cost of doing business. For equity investors, lenders, or insurance companies, due diligence investigations and contract requirements reduce risk and increase rewards for investments made. To the extent the costs of managing their supply chains are not immediately expensed in the year incurred, supply chain anchors and retailers may pass the costs forward to consumers or back to suppliers.²⁹⁴

To the extent that voluntary regulatory activities require investments to produce firm savings, firms will decide whether or not to make an investment based on the time frame in which they are able to recover the costs of their investment. Cost recovery is accelerated when income tax provisions permit deductions for the full

292. Lyon, *supra* note 21, at 5; Hoffman & Bertels, *supra* note 7, at 56 (“Board interlocks are mechanisms for gaining access to critical resources such as information and, of particular importance to NGOs, funding, both because individual board members will influence their corporations’ giving and because the closer connections they have to others will also raise overall giving levels. But they also become mechanisms for influence by incorporating representatives from other institutions in the NGOs’ decision-making processes or advisory structures” (internal quotations and citations omitted)). Note that some studies have shown that the existence of a confrontational environmental NGO to place pressure on corporate entities has had both a positive flanking effect (by providing a contrast) and a negative flanking effect (from the risk of being associated with the more radical groups and experiencing backlash). *Id.* at 63–66.

293. Krill, *supra* note 60, at 213 (describing the funding structure of Rainforest Action Network and its rationale).

294. The actual incidence and distribution of these costs has not yet been modeled.

expense of activities associated with voluntary regulatory regimes in the year they are incurred. When significant capital investments are involved, such as technological changes, firms may be required to capitalize the investment and recover the costs through depreciation deductions over time. Cost savings and capital recovery enjoyed immediately following implementation make investments more attractive.

Voluntary standards, certification, and labeling systems address a portion of the costs of governance by charging fees to their members. They also market the certification and labeling program to generate market demand and procure a price premium for certified goods. Certification participants may use these premiums to cover the costs of participating in the certification process. SRI firms, like other investment firms, charge their clients fees to meet their clients' preferences.

Funding sources for many private governance institutions may include charitable donations from individuals, firms, and foundations and grants from governmental entities. Conservation land trusts benefit from tax exempt status as charities and may also receive donated property or funds to purchase property rights and manage them. They may also receive royalties from leases of resource extraction rights. Donors benefit from tax deductions that are available for donations or below-market sales to public charities.²⁹⁵

Table 6 below identifies the main sources of funding for the various types of private governance institutions.

Table 6. Funding Sources and Economic Incentives

| Institution | Funding Sources |
|----------------------------------|---|
| Firm Programs | Green and social premium; savings from increase in efficiency, lower costs, less waste |
| Codes of Conduct | Reduction in competitive risk from competitors; benefits of preempting regulation |
| Environmental Management Systems | Cost savings from coordination within firm, increased compliance, reduced costs from monitoring |

295. See 26 U.S.C. § 170 (2006). A number of concerns have arisen about fraudulent activity associated with valuation of the conservation easements, the value of the properties to which they are subject, and the tax benefits that accrue to the individuals who participate in these transactions. There are also concerns about whether conservation easements will be enforced over time. See generally Bray, *supra* note 241.

| Institution | Funding Sources |
|--|---|
| Acquisition and Investment Contracts | Reduced risk of loss and shifting of risk of loss following due diligence investigations through contractual arrangements |
| Lending Contracts | Reduced risk of loss and shifting of risk of loss following due diligence investigations through contractual arrangements |
| Supply Chain Contracts | Green and social premium; reduced risk of loss from unstable supply, contract claims, tort liability |
| Insurance Contracts | Reduced risk of loss and shifting of risk of loss following underwriting investigations through exclusions from coverage |
| Cooperatives | Reduction of risk of loss from information asymmetries and moral hazard; increased profits from increased bargaining power and economies of scale in sales and purchase |
| Education and Mobilization Initiatives | Private donations, foundation funding, grants |
| Learning Initiatives | Private donations, foundation funding, grants, fees for services |
| Reporting Initiatives | Private donations, foundation funding, grants, fees for services |
| Models and Meta-Standards | Private donations, foundation funding, grants, fees for services |
| Third-Party Audits | Fees for services |
| Socially Responsible Investment | Investment fees |
| Land Conservancies | Private donations; foundation funding; sales, rents, royalties from lands; tax incentives to donors; tax exempt status of nonprofit and state property tax exemption |
| Certification and Labeling Systems | Price premium for certified goods; membership fees; foundation funding; private donors |

As noted above in part I, *supra*, each type of private governance system has something to contribute to the regulatory process. Table 6 identifies each stage of regulation and the types of private governance institutions that bring resources to bear at each stage. Not every institution has all of the structures needed to produce regulation that is in the public interest at every stage. In fact, as Table 7 shows, only voluntary standards, certification, and labeling systems and cooperatives attempt to address governance needs at every stage of the regulatory process.

Table 7. Private Governance Institution Supply at Each Stage of Governance

| Institution | Agenda-Setting | Negotiation; Setting of Standards | Implementation | Monitoring | Enforcement |
|--|----------------|-----------------------------------|----------------|------------|-------------|
| Education and Mobilization Initiatives | X | | | | X |
| Supply Chain Contracts | X | | | | X |
| Insurance Contracts | X | | | (X) | X |
| Firm CSR Programs | | X | X | (X) | (X) |
| Socially Responsible Investment | | X | | (X) | X |
| Codes of Conduct | | X | X | | |
| Environmental Management Systems | | | X | (X) | |
| Learning Initiatives | | | X | | |
| Reporting Initiatives | | | | (X) | X |
| Models and Meta-Standards | | (X) | X | | |
| Acquisition and Investment Contracts | | | | (X) | X |
| Lending Contracts | | | | (X) | X |
| Audits | | | | X | |
| Voluntary standards, certification, and labeling systems | X | X | X | X | X |
| Cooperatives | X* | X* | X* | X* | X* |

X = Provides (X) = Varies X* = Stage internalized

However, private governance institutions frequently operate as part of a network or an ensemble regime.²⁹⁶ Consequently, they may complement one another and, potentially, produce synergistic effects.²⁹⁷

For example, one possible sequence may proceed as follows. At the agenda-setting stage, NGOs educate consumers about lead contamination in toys sold by a leading retailer. At the negotiation of standards stage, the retailer, under threat of tort litigation, sets substantive requirements for its suppliers to exclude lead and similar substances in the manufacturing of products. To implement the retailer standards, suppliers employ management systems designed to

296. See generally Abbott & Snidal, *supra* note 9; Oren Perez, *Private Environmental Governance as Ensemble Regulation: A Critical Exploration of Sustainability Indexes and the New Ensemble Politics*, 12 THEORETICAL INQUIRIES L. 543 (2011).

297. See generally Abbott & Snidal, *supra* note 9.

avoid the use of lead and similar substances in the manufacture and assembly of the products and require their secondary suppliers to exclude those substances in the manufacture of component parts. To monitor and enforce the contract, the retailer includes provisions for periodic inspections and hires an auditing firm to verify that its requirements are being met. Based on the audits, the retailer sanctions suppliers that fail to adhere to its standards through contract or by withholding repeat business. The retailer funds the process by increased consumer prices, but the price increase may be justified as a premium for safety assurances.²⁹⁸

In fact, this shift to decentralized, multi-modal, networked forms of governance may be necessary to address the kinds of complex environmental problems that have resisted solution by centralized governmental regulation.²⁹⁹ Private governance may provide

298. Another possible sequence may involve additional participants. NGOs increase awareness about sweatshop labor conditions in apparel manufacturers in Southeast Asia and identify particular companies that employ child laborers and have poor safety records. They may also engage in name and shame campaigns and institute boycotts of the products of the specific companies identified. SRI firms screen those manufacturers from their list of investments and sell stock from those companies. To rehabilitate its reputation and restore its market share, the company becomes a member of a learning initiative and employs a management system. By implementing new management processes, the company improves conditions. The company employs a third-party audit to confirm to the learning initiative and the reporting initiative that it has made improvements. The reporting initiative in turn provides information about these changes to investors, retail chain suppliers, and the general public. The company covers the costs associated with engagement of the learning initiative and the reporting initiative and employing the environmental management system, but passes the costs forward in the price of its apparel and gains market share from an improved reputation. SRI firms again include the stock of the company in their portfolios and consumers again purchase the goods following confirmation that the firm's labor practices have improved and are being monitored.

299. See Craig Anthony Arnold, *Fourth-Generation Environmental Law: Integrationist and Multimodal*, 35 WM. & MARY ENVTL. L. & POL'Y REV. 771 (2011) (arguing that both monolithic and fragmented approaches to environmental problems are proving inadequate, that environmental law is evolving toward use of multiple methods to manage complex environmental problems, and that those methods require some level of coordination for success in addressing the complexities of social ecological systems); J.B. Ruhl & James E. Salzman, *Climate Change, Dead Zones, and Massive Problems in the Administrative State: A Guide for Whittling Away*, 98 CAL. L. REV. 59 (2010) (describing problems resistant to any one policy response, such as problems that aggregate proportionally, problems in which responses to one source can exacerbate another source, problems with feedback loops in which policy responses may have extensive spill-over hazards, and problems with significant discontinuities in which the impacts are felt far from the source of the problem or at some point in the distant future). Similarly, Elinor Ostrom, writing in the political science literature, suggests that there are no panaceas in addressing complex social ecological systems, and offers an expanded version of her IAD framework to analyze the rules, institutions, networks, and nested enterprises developed to manage these systems. See Elinor Ostrom, *A Diagnostic Approach for Going Beyond Panaceas*, 104 PROC. NAT'L ACAD. SCI. 15,181 (2007).

additional, independent cuts at problems that may not otherwise be amenable to “whittling away” by formal government responses.³⁰⁰ Furthermore, concerns associated with the theory of the firm may determine whether an organization performs all aspects of the regulatory process or relies on other institutions to perform them.³⁰¹ Note, however, that a number of voluntary standards, certification, and labeling systems have identified credibility costs associated with having the monitoring functions housed within the same entity that performs standards-setting and implementation functions.³⁰²

III. CONFLICT AND COMPETITION AMONG PRIVATE GOVERNANCE INSTITUTIONS

While combinations of private governance institutions may collaborate to produce effective regulation, private governance systems also conflict with formal government and with one another. First, they may compete for regulatory space and support.³⁰³ Trade association codes of conduct³⁰⁴ and CSR efforts³⁰⁵ may disarm education and mobilization initiatives that are making a case for

300. *Cf.* Ruhl & Salzman, *supra* note 299, at 120 (concluding that a single government agency is often incapable of combatting complex problems caused by multiple actors).

301. *See* Klein, *supra* note 225. Under a transaction-cost analysis, whether a firm performs functions itself or outsources those functions may depend on whether the internal costs of information flow, incentives, monitoring, and performance evaluation of employees outweigh, at the margin, the external transaction costs associated with relying on other entities to perform parts of the regulatory process. In addition, private governance institutions are often developed to address government failures. To the extent that the courts are not functioning as the source of enforcement of contracts, private governance institutions may choose instead to internalize these activities.

302. *See* Courville, *supra* note 61, at 283, 287–88.

303. Abbott & Snidal, *supra* note 9, at 78–79.

304. Auld et al., *supra* note 9, at 423. Trade associations have often developed codes of conduct in the wake of an industry disaster, with the goal of deterring government regulation. *Id.* For example, following the Union Carbide disaster in Bhopal, the chemical industry was successful in deflecting the threat of regulation by developing a code of conduct called the Responsible Care Program. *Id.* Subsequent studies have shown that Responsible Care participants showed worse environmental performance than firms that did not join program. *See id.*; Vogel, *supra* note 31, at 167–68 (providing as examples the pharmaceutical industry’s adoption of the International Code of Pharmaceutical Marketing Practices to ward off threat of regulation by the World Health Organization, and the International Chamber of Commerce’s development of a Business Charter for Sustainable Development to forestall environmental regulation following the 1992 Rio Earth Summit).

305. *See* Vogel, *supra* note 31, at 167–68 (describing how in 1992, following the Rio Summit, the Chamber of Commerce developed a Business Charter for Sustainable Development to deflect possible global environmental regulation).

regulation and preempt other public or private regulatory activity.³⁰⁶ They may undermine coalitions by splitting them into factions supporting greater or lesser regulatory stringencies.³⁰⁷ They may also divert the attention away from firms that would otherwise be targets for activism and toward programs that would not otherwise be primary targets.³⁰⁸

Second, private governance regimes are sometimes used in an anti-competitive manner against other firms within a common industry. Anchor firm requirements that their supply chains implement environmental controls may have significant anti-competitive impacts. By requiring their supply chain contractors to invest in expensive technology, anchor firms may spread the costs of their own regulatory compliance. When a firm requires its supplier to make a regulatory change, the supplier may raise the price of its goods for all of its customers to cover the costs associated with change; thus, a portion of the financial burden of change shifts to the firm's competitors.³⁰⁹ When the competitors are sensitive to price changes on their inputs, the increase in price may drive them out of business,³¹⁰ revealing a potential anti-competitive motive behind the requirement. Firms promoting codes of conduct within their industries may also have an anti-competitive motive in promulgating new rules and requirements for their competitors. If they have lower costs of compliance compared to their competitors, the new rules will put them at an advantage.

While competition for regime participants has at times caused private governance institutions to ratchet up their standards³¹¹ and

306. Abbott & Snidal, *supra* note 9, at 75.

307. *Id.* at 76.

308. *Id.* This data may indicate that codes of conduct only shield industry from regulation, and are ineffective in improving environmental performance because of weak standards and significant free-riding. However, some scholars have suggested that the comparatively poor performance of members of the Responsible Care Program could be the result of a shift in the focus of education and mobilization initiatives away from Responsible Care participants and toward other firms that did not sign up for the program. *See* Lyon, *supra* note 3, at 59.

309. Vandenbergh, *supra* note 89, at 950.

310. *See id.*

311. Abbott & Snidal, *supra* note 9, at 78 (“Implicit bargaining takes the form of competition among parallel schemes to control the regulatory space. In some cases, competition exerts pressure toward higher standards.”). *See also* Auld et al., *supra* note 17, at 192 (explaining how “comparative reports in the United States [between the standards of Forest Stewardship Council and the Sustainable Forestry Initiative] were used to pressure the SFI to continually change, narrowing the gap between its approach and that of the FSC”).

implement more democratic structures and procedures,³¹² more frequently it has forced civic institutions to water down their standards.³¹³ SRI programs compete for investors,³¹⁴ while labeling systems compete for both consumers and participants.³¹⁵ Institutions with lower minimum standards attract more participants because, in general, the participants have to incur fewer costs to participate. Higher standards may be more attractive to consumers to the extent that they more closely align with consumer preferences for risk.

Trade associations have often used the second mover advantage³¹⁶ to develop alternate schemes that resemble stringent

312. Abbott & Snidal, *supra* note 9, at 78 (“Industry schemes . . . which may have been created with the aim of preemption but must compete with NGO and multi-stakeholder schemes for legitimacy and public support—have over time strengthened their substantive standards, procedures . . . and governance (e.g., adding stakeholder advisory or supervisory boards).”).

313. For instance, the Forest Stewardship Council, an organization developed with input from business, government, and environmental organizations, has created a certification and labeling system for forest management and forest products to encourage sustainable harvesting. The organization has been criticized as having allowed its standards to be compromised in order to increase the participation by large retail firms in the United States and the European Union.

314. For examples of eco-friendly investments attempting to attract participants, see *Sustainable & Responsible Investing*, CALVERT INVESTMENTS, <http://www.calvert.com/sri.html> (last visited Oct. 4, 2011); DOMINI SOCIAL INVESTMENTS, <http://www.domini.com> (last visited Oct. 4, 2011); *About Us*, ACUMEN FUND, <http://www.acumenfund.org/about-us.html> (last visited Oct. 4, 2011).

315. Abbott & Snidal, *supra* note 9, at 76 (“In a variety of sectors, once an NGO-based or collaborative scheme has been created and begins to press firms to sign on, the relevant industry association creates a competing, business-friendly scheme. Examples include SFI and PEFC, forest industry schemes created in response to the FSC, and WRAP, an apparel industry labor rights scheme created in response to the FLA.”). The Fair Labor Association (FLA) was developed in the late 1990s as the monitoring and certification branch of the Apparel Industry Partnership formed to address sweatshop labor practices by the Clinton administration, the Union of Needletrades, Industrial, and Textile Employees, NGOs such as the Lawyers Committee for Human Rights and International Labor Rights Fund, and apparel manufacturers. Tim Bartley, *Certifying Forests and Factories: States, Social Movements, and the Rise of Private Regulation in the Apparel and Forest Products Fields*, 31 POL. & SOC’Y 433, 449–50 (2003). FLA certifies apparel industry supply chains. Errol Meidinger, *Beyond Westphalia: Competitive Legalization in Emerging Transnational Regulatory Systems* 18 (2006) (Buffalo Legal Studies Research Paper No. 2006-019), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917952. In contrast, Worldwide Responsible Apparel Production (WRAP) was founded by the apparel industry and certifies individual factories. *Id.* “The competition among the programs has been intense and contentious at times.” *Id.*

316. While “first movers” face high costs associated with research, development, implementation, and educating the public to develop a market for their goods, second movers may take advantage of what the first movers have done. Second movers face lower costs because they may use the first mover as a model, learning from first mover successes and failures, and enjoying the market that the first mover developed. See Michael Abramowicz & John F. Duffy, *Intellectual Property for Market Experimentation*, 83 N.Y.U. L. REV. 337, 340 (2008) (describing the two advantages that late entrants have over early market experimenters

systems developed by civic institutions in structure, but contain only minimal requirements for compliance.³¹⁷ Asymmetric information creates an opportunity for opportunistic behavior.³¹⁸ Weak labels may attempt to free-ride on the goodwill associated with strong labels and capture a portion of the premiums generated through labeling green or socially responsible goods.³¹⁹ When a number of labels emerge in rapid succession, noise may overwhelm the signal that a labeling system sends.³²⁰

Multiple schemes in any sector may result in investor and consumer confusion.³²¹ When multiple certification systems govern the same industry or subject matter, consumers and investors may become concerned about whether the certification systems continue to signal environmental performance. To the extent that the public recognizes that there may be differences between labels, consumers and investors may demand more information.³²² Identifying, documenting, and segregating firms or products based on social and environmental criteria is expensive. Efficiency declines as consumers are required to spend more time and resources investigating labels.

Even where there are no competing labels, a certification process may decouple from the practices and performance that the certification process is supposed to reflect.³²³ Chain of custody and other verification systems are also vulnerable to cheating and fraud.³²⁴

as avoiding the expense of developing the market and copying the first entrant's market successes and avoiding its failures). Consequently, second movers may capture greater market share.

317. These organizations "adopt the trappings" of fair regulatory processes to develop guidelines without actually imposing prescriptive requirements. Abbott & Snidal, *supra* note 9, at 76; Auld et al., *supra* note 17, at 189–95 (comparing SFI to FSC). *See also* Auld, *supra* note 9, at 422 (describing ISO 14000, an NGO-developed model environmental management system, which certifies firms that develop internal management processes but does not require that the systems contain prescriptive standards or impose any benchmarks or requirements).

318. *See* King et al., *supra* note 142, at 1092.

319. Wood, *supra* note 274, at 259.

320. Abbott & Snidal, *supra* note 9, at 79–80.

321. There is some suggestion that this may be a form of intentional interplay. Creating a similar label allows a firm to free-ride on the goodwill and value associated with existing labels. This may substantiate the move by the Federal Trade Commission in 1992 to regulate green claims. *See* Michelle Diffenderfer & Keri-Ann C. Baker, *Greenwashing: What Your Client Should Know to Avoid Costly Litigation and Consumer Backlash*, 25 NAT. RESOURCES & ENV'T 21 (2011).

322. Darby & Karni, *supra* note 87, at 84.

323. King et al., *supra* note 142, at 1094.

324. *Id.* at 1094 ("The third-party audits required by certified management standards reduce the risk of decoupling, but as demonstrated by recent scandals in cost accounting, third-party certification does not guarantee honesty, nor does it prevent changes in practices after

This may cast doubt not only on the particular system in question, but also on the integrity of all certification processes.

Consequently, demand has grown for increased transparency and a means to evaluate the various certification and labeling programs.³²⁵ Again, private governance institutions have arisen to meet this demand. Some nonprofit organizations have begun to address label confusion by compiling lists of all known eco-labels and evaluating those institutions based on self-reported information from the organizations developing the labels.³²⁶ Consumers have also developed websites and blogs to expose false claims.³²⁷ In addition, private firms have also begun to respond to demand for information about social and environmental claims to prevent clients from losing market share from greenwashing and to keep competitors from free-riding on their development of markets for socially responsible and sustainable sourcing.³²⁸

Finally, in some cases, the federal government has intervened to protect consumer expectations and control labeling and advertising claims. The Federal Trade Commission Act authorized the Federal Trade Commission (FTC) to take direct action against the firms that

certification. If decoupling becomes too frequent, certification will no longer provide real information for differentiating underlying organizational attributes . . .”).

325. See, e.g., ECOLABEL INDEX, <http://www.ecolabelindex.com/ecolabels/> (last visited Oct. 5, 2011) (providing a database that lists and describes various ecolabels, with the aim of “increasing transparency and helping buyers and sellers use [ecolabels] more effectively”). As with all verification processes, the effectiveness of this endeavor is limited by the truthfulness of the organizations’ responses, whether the organizations are subject to having their submissions verified, and of course, the pertinence and clarity of the questions to which the organizations are asked to respond. Bibi van der Zee, *Listing the Green Labels*, GUARDIAN GREEN LIVING BLOG (Jan. 31, 2008, 5:22 AM), <http://www.guardian.co.uk/environment/ethicalivingblog/2008/jan/31/labelgeeks> (describing how the ecolabel index helps consumers understand otherwise “incomprehensible” ecolabels).

326. See, e.g., ECOLABEL INDEX, *supra* note 325.

327. Diffenderfer & Baker, *supra* note 321, at 21, 25; see also Lane, *supra* note 8, at 747–48.

328. TerraChoice Group, Inc., an environmental marketing firm, has begun to issue annual reports examining firm environmental and social claims, identifying seven “sins” of greenwashing: lack of proof, vagueness, irrelevance (advertising absence of substances already banned by law), hidden trade-offs, creating false impressions of third-party endorsements, distracting the consumer from broader impacts, and lying. See *The Seven Sins*, TERRACHOICE: SINS OF GREENWASHING, <http://sinsofgreenwashing.org/findings/the-seven-sins/> (last visited Oct. 2, 2011). EnviroMedia Social Marketing, Inc., a public relations and advertising firm, has in conjunction with the University of Oregon developed a website that allows consumers to post copies of advertisements that contain environmental and social claims and to rate the ads based on whether the ads mislead with words, visual, or graphic information, make claims that are vague or impossible to prove, overstate or exaggerate, or omit or mask key information. See *About Greenwashing*, GREENWASHING INDEX, <http://www.greenwashingindex.com/criteria.php> (last visited Oct. 2, 2011).

make unfair or deceptive advertising claims.³²⁹ Following consumer complaints about greenwashing, the FTC developed *Guides for the Use of Environmental Marketing Claims* (“Green Guides”) in 1992.³³⁰ The FTC has since revised the guides twice and a new version is due to be released this year.³³¹ The Green Guides provide firms with a safe harbor against claims for unfair or deceptive advertising under the Federal Trade Commission Act,³³² so long as the firms making environmental claims are specific and provide substantiation of those claims.³³³

CONCLUSION

The process of sorting private governance institutions by their function in addressing regulatory needs and meeting the challenges of government failure at each stage of the regulatory process has yielded a number of insights about what kinds of structures make private governance institutions effective and ways that networked institutions may work together to form a regulatory regime that is in the public interest.

First, it is not necessary for a single private governance institution to meet the governance demands of all stages of the regulatory process for private governance to be effective. Private governance institutions may work together through collaboration, cooperation, and contractual arrangements with other institutions and with formal government to achieve effective regulation through a networked or ensemble regime. There are, however, certain design features that strengthen regulatory regimes at the various stages. Supplemental structures, collaboration with other institutions, or specific forms of support from formal government may address weaknesses in existing regimes.

At the agenda-setting stage, private governance institutions that are independent of their regulatory targets can bring public awareness to social costs associated with firm activities and credibly identify the causes of social harm. If they are representative of

329. See 15 U.S.C. § 45 (2006) (authorizing the Federal Trade Commission to investigate unfair trade practices or unfair or deceptive acts or practices affecting commerce, to hold hearings and issue cease and desist orders, and to commence civil actions to recover civil penalties and equitable relief against parties that fail to comply with the orders.)

330. 16 C.F.R. §§ 260.1–260.8 (2012).

331. Diffenderfer & Baker, *supra* note 321, at 21.

332. *Id.* at 22.

333. See 16 C.F.R. § 260.5 (2012).

community interests and are not dominated by any one funding source, they may be able to garner sufficient public support to induce public officials to regulate or generate interest in private governance if the hazards and barriers to legislation appear to be too high. Trade association and industry codes of conduct have been allowed to crowd-out both public regulation and private governance institutions that are more representative of the public interest. While organizational structure may provide some insight about control and the capacity of the organization to regulate in the public interest, inquiry into the major funding sources for a proposed self-regulatory regime would be more revealing. Before governments waive their responsibility to regulate and before education and mobilization initiatives and other private governance institutions cede the field to institutions whose primary function is to lower the barriers to self-regulation within the targeted industry or to avoid formal regulation, they and the media should focus on the institutions' funding sources.

When standards are negotiated, private governance institutions that supply structures that make the regulatory process transparent, open, and inclusive are more effective in avoiding capture and developing regulation in the public interest. By including structures that foster broad public participation, transparency, and deliberative processes that give stakeholders the ability to contribute in a meaningful way, they allow constituents to overcome the regulatory capture that increasingly clouds the process in a representative democracy. As the number of parties involved at each stage of the regulatory process expands, the expense of influence increases, and capture becomes more difficult. Structures that provide for consensus decision-making, or include tripartite structures that limit the power of any one interest group to dominate, are more successful at producing regulation in the public interest.

At the implementation stage, the primary obstacle to adoption of the standards is the cost associated with change. Private governance institutions can offer firms flexibility, lower the cost associated with implementing the new rules, and level the playing field to reduce market uncertainties that arise from change. Institutions that provide price premiums and lower costs of capital investment or accelerate cost recovery expedite adoption and implementation of standards. Formal government may support implementation by protecting these price premiums through regulation of false advertising claims for credence goods or by providing tax benefits that permit more rapid recovery of costs that firms incur during the implementation process.

At the monitoring stage, a number of institutions address the demands of monitoring by expanding the number of monitors. By disclosing information and publicizing claims made by firms about their activities, monitoring institutions enroll and empower activists, shareholders, consumers, the media, competing firms, and the general public to participate in the monitoring process. Unfortunately, most institutions that relay firm-reported information about social and environmental performance lack monitoring or verification systems. In addition, except for employees, most of the additional “monitors” lack opportunities to watch firm practices and expose any deviation from what is set forth in the reports. Consequently, if the incentive to cheat is not checked, these programs will not enhance efficiency. Instead, they will direct consumption and investment flows to firms that do not accurately meet consumer or investor preferences, which reduces social welfare. Given that they rely primarily on the self-reported claims of industry, disclosure and reporting initiatives and SRI programs could benefit from a whistle-blowing platform that they either provide themselves or through collaboration with other institutions involved in improving firm performance along social and environmental parameters, such as learning initiatives. A whistle-blowing platform would facilitate information sharing about performance, noncompliance, and errors in the firm disclosure reports. To the extent that private governance systems use auditing systems to monitor compliance, they may avoid concerns about bias by ensuring that auditors are financially and functionally independent of both the advocacy organizations that developed the standards and the targets being regulated.

Separate analysis of private governance institutions from “hybrid” organizations that are instituted by formal government, such as public voluntary programs and negotiated agreements, reveals two key features that private governance institutions must provide to ensure that the institution is stable and resilient over time. First, dispute resolution structures support the enforcement stage. Because there is no threat of criminal or other sanction except those that the parties agree to and can impose on one another, private governance is always limited to a coalition of the willing. The tensions that gave rise to the development of a private governance institution in the first place continue to exist between stakeholders after the standards have been set and the program has been implemented. Disputes about fair enforcement of the rules can destabilize hard-won alliances because of the availability of exit.

Conflicts, if left untended, may devolve into cheating, opting-out, and institutional failure. Institutions that provide cheap, accessible dispute resolution mechanisms support fair enforcement of the rules and permit participants to resolve their conflicts quickly, thereby preserving alliances. Dispute resolution systems enhance the credibility of the institution and help to secure the long-term involvement of its participants.

The second key feature is a funding structure. Tax revenues fund much, if not all, of the governmental regulatory process, decoupling the costs of regulation from the process of regulating. In contrast, private governance institutions must not only satisfy the demands of each of the five stages of regulation, but they must also fund each stage of regulation. Free-riding may result in both instability and the under-funding of public goods—the institutions necessary to monitor compliance and enforce the rules. Allocation of the costs of regulation is a sensitive matter in the context of private governance because if participants perceive that the benefits and burdens of regulation are distributed unfairly, the coalition may fail. In addition, the source of funding may impact the forms the regulatory structures take, rendering them less effective. Therefore, organizations that generate sufficient value to cover their costs will be much more resilient to the outside pressures and inside tensions that occur throughout the regulatory process. Systems that include a market element can potentially generate a premium that will cover some portion of the governance process. Other institutional forms, such as cooperatives, may reduce the need for monitoring and enforcement by eliminating or reducing the incentives for agents to take advantage of their partners. In addition, when institutional structures eliminate the incentives to cheat, the need for and costs of monitoring are reduced.

Finally, the institutional sorting process shows that only one type of institution attempts to substitute for government at each stage of the regulatory process: voluntary standards, certification, and labeling systems. Voluntary standards, certification, and labeling systems educate the public about the impacts of their consumption decisions, activate consumer norms, and facilitate the internalization into the price of a good the costs associated with avoiding social or environmental harm. In addition, they address the transaction costs that consumers face in locating and negotiating with the “cheapest cost avoider” in global trade by creating structured links between those parties; they resolve both the information asymmetries and

search costs that consumers face in purchasing credence goods by identifying conforming goods; they use structures that invite broad participation and deliberation, reducing the risk of capture during the standards-setting process; they provide training to develop an expanding number of experts to assist firms in adopting and implementing the standards; they use consumer markets and labels to incentivize compliance; they generate their own financial support—an important factor in maintaining legitimacy and effectiveness over time; and finally, their certification processes ensure that participants adhere to those standards. These systems are therefore marked for more focused study, since they provide a unique solution to governmental void and to situations in which government exists and has authority to act but does not take action because of regulatory fragmentation or race to the bottom dynamics.

Sorting the institutions by the roles they play in the regulatory process also reveals the limits of a functional typology, since some private governance institutions accomplish similar ends without creating substitute regulatory regimes. For instance, cooperatives address demands for governance not by mimicking the governmental process, but by changing incentive structures. Cooperatives resolve the principal-agent problem by placing the party to be protected on both sides of the transaction, which reduces the need for monitoring. They also allow competitors to collaborate to achieve economies of scale and to compete with larger enterprises without losing the competitive advantages they possess from time- and location-specific knowledge. And finally, they accomplish these ends not by providing structures that set a regulatory agenda and negotiate, implement, monitor, and enforce those standards, but rather, by changing the incentives that make standards, monitoring, and enforcement necessary.