Paper #17

A FAREWELL TO ARM'S LENGTH IN VALUE CHAIN RESPONSIBILITIES

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Abstract: The trend toward increased levels of business interconnectedness in the value chain has clouded the issue of responsibility for business practices. Firms have historically denied responsibility for many questionable practices by suggesting that such acts were committed somewhere else in the value chain and that, because they are separated by an arm's length transaction, they are not responsible. Emerging evidence suggests that in light of the interconnected and networked business environment, the arm's length defense is growing less effective. We discuss the practical realities that firms are facing in the highly networked environment and offer examples of each. We also offer practical guidance about each example within a total responsibility management framework.

Keywords: value chain; corporate social responsibility; arm's length transaction; conflict of interest; network

We are told that the "new" business organization is becoming increasingly networked. The boundaries of the organization are becoming more blurry, permeable and difficult to discern as interactions with stakeholders become more thoroughly knit into the fabric of firms. Which stakeholders are internal and which are external to the organization is becoming an increasingly difficult question to answer. For today's firm, the boundaries are less clear and more permeable. The environment is less hostile in part because it is harder to distinguish inside from outside the firm. Firms have moved from an age of safety stock to just-in-time inventory management.

Beyond this, the age of the flexible, networked firm has brought change beyond reckoning to today's business organizations. Due in part to the nature of the networked firm, the power of business organizations has increased to rival that of many nations. Lagging this extraordinary increase in international power, however, has been the evolution of our conceptions of responsibility within such networks and value chains. When networks of organizations were less prevalent, responsibility was somewhat easier to attribute. How the products and services were created was the responsibility of the individual firms and not a matter of concern for other members of the value chain.

In this article we discuss the evolving conception of responsibility within value chains (i.e., value-chain responsibility or VCR). We will examine the recent managerial challenges to claims of arm's length transaction. We discuss the practical realities of this evolution and provide guidance for managers of firms operating under these new responsibilities. This guidance is sorted and systematized using a popular responsibility management framework.

Value Chains and Stakeholder Networks

Work that considers the firm's relationship with other organizations can be loosely categorized as value chain analysis (Porter, 1995) or stakeholder analysis (Freeman, 1984; Phillips, 2003). Despite different philosophical orientations, each of these literatures is interested in the interaction and coordination of the firm's relationships. Early work in value chain analysis viewed the value chain as a way to define discrete transactions and boundaries of the firm and was firmly supported by legal conceptualizations like arm's length transactions. Value chain analysis has evolved into a tool aimed at helping organizations understand how to better integrate interfirm activities (Nishiguchi, 1994). In this way, it recognizes the realities of the extended enterprise referred to earlier.

The work on value chains is voluminous. At its highest level of abstraction, the literature suggests that the value chain is a series of interconnected firms engaged in bringing value to a good or service as the good or service makes its way to end users. For a specific firm, value chain analysis is more focused on firm choices about which activities to perform (e.g., vertical integration) and which activities to outsource (e.g., make or buy decisions). Firms are told that they can achieve competitive advantage with unique and inimitable combinations of activities. For contemporary firms, value chain analysis has become a primary focus. Firms are constantly searching for ways to eliminate costs associated with activities that are not deemed critical to the delivery of a good or service. Activities that don't make the cut are outsourced to other providers as firms look to focus on only those tasks for which they have a particular talent. Firms have enthusiastically embraced this technique and there has been a commensurate increase in outsourcing activity. Because of the pervasiveness of outsourcing activity, there is far more firm interconnectedness.

Another potential source of insight on VCR is the literature on stakeholder management. Scholarship under the rubric of stakeholder theory has now for 20+ years examined the relationships between the firm and its constituencies - including suppliers and customers (Leap & Loughry, 2004; Clement, in press). Work by Post, Preston & Sachs (2002) describes the managerial activities of three major firms attempting to implement a stakeholder model that better recognizes the wealth creating potential of the extended enterprise. Failures to recognize and consider the relationships inherent in an extended enterprise are highlighted in the work of Spar & LaMure (2003). Rowley (1997) explicitly examines stakeholder relationships as a network and Frooman (1999) builds on this looking at how stakeholders use a variety of, often indirect, strategies to influence firms. Phillips (2003) examines the role of fairness in stakeholder analysis and to whom the organization has moral obligations. The effect of this increasing involvement between firms and stakeholders is nowhere more evident than in the firm's value chain.

However, the stakeholder literature has only recently recognized the importance of the value chain within the context of the firm/stakeholder relationship. Post, Preston & Sachs (2002) note Chrysler's use of the extended enterprise, a value chain concept, and relate it to the stakeholder experience. Although supply chains are starting to receive more specific attention in the stakeholder literature, we estimate that the vendors and the supply chain they represent have received the least attention among those Clarkson (1995) referred to as primary stakeholders: customers, employees, investors, and vendors.

Thus, we see that studies on value chains have paid scant systematic attention to notions of responsibility while studies of stakeholder obligation and responsibility have de-emphasized the particular challenges of networked value chains. This shortage of scholarly attention notwithstanding, managers are increasingly being held responsible for the actions of their customers and their suppliers. There are reasons to believe that this trend toward greater responsibility for actions within stakeholder value chains will accelerate.

We begin this examination by describing some of the emerging practical challenges that can arise within networked value chains. Rather than establish definitive ideas for how far a firm's value chain responsibility should extend, we are more interested in highlighting the practical realities that accompany the notion of extended VCR. We follow this by offering brief suggestions for managing these realities.

Reality #1

Changing Conceptions of Responsibility in Value Chains

Many stakeholders no longer accept the premise that the firm is an island or that it is incapable of influencing its value chain. As business activity has become more networked and extended, so too have stakeholders' expectations of responsibility. With firms like UPS integrating deep into the value chain tasks that have historically been conducted by their suppliers and customers (Salter, 2004), there is greater likelihood that these firms will have to shoulder more responsibility for externalities caused by value chain activity.

According to the traditional understanding, the various nodes in the value chain are independent of one another. Their borders are rigid and it is easy to distinguish among organizations. Producers of raw materials, distributors, retailers and final consumers are independent entities with no relationship between one another beyond the economic transaction by which the goods or services exchange hands. The emerging trend is that many companies are being scrutinized for the manner in which value is added to their products, as well as the circumstances under which the transactions themselves occur.

Examples of Changing Conceptions of VCR

No group has been more active in applying value chain pressure than People for the Ethical Treatment of Animals (PETA). Their tactics and targets have received extensive media coverage. For example, PETA's "Unhappy Meal" campaign is aimed at bringing suppliers of beef, chicken and eggs to McDonald's restaurants in the United States into line with the welfare standards used by suppliers of its European restaurants. In two years time, then CEO Jack Greenberg went from saying, perhaps correctly, that PETA, "will not be happy until we sell only beans and rice," (Guy, 2002) to the release in April of 2002 of its first social performance report. McDonald's has also issued a plan to stop the use of growth promoting antibiotics among its global meat suppliers including audits of suppliers. One financial analyst claims,

> "McDonald's has a huge amount of leverage in its global supply chain that can raise the bar for the whole industry through this kind of innovation." (Baue, 2003)

Reality #2

Challenges to Accepting Value Chain Responsibility

Firm claims about VCR typically take the form of social responsibility reports, outsourcing reports, supplier codes of conduct and the like. In these statements, firms describe their efforts to establish acceptable practices in their value chain or defend existing practices. While not a required disclosure for legal or regulatory purposes, firms often provide reports on VCR activity because of prior problems, or calls from activists and NGOs to do more.

The preparation and content of these reports have been subject to considerable criticism, an ironic outcome given that they are often prepared to help firms reduce criticism. The criticisms leveled by NGO's and similar organizations suggest that they are suspicious of the firm's motivations and have grave concerns over the accuracy of the reports. Social audits and other claims about VCR are receiving special scrutiny and legal status. Activists are using the courts to help establish the difference between genuine VCR efforts and corporate window dressing as we discuss later.

Much like taking a proactive environmental stance, issues of VCR present collective action and bootstrap problems. That is, it may be competitively harmful to be among the first to embrace greater VCR and transparency when others continue to reap the economic benefits of refusing to accept responsibility. Though we suspect that the extent of this competitive disadvantage may be overstated (again, as with improved environmental practices), recourse to some governing or enforcement body is a typical response to such challenges. Local, national or international laws as well as recourse to voluntary monitoring organizations are typical responses to such collective action issues.

Reality #3

Legal Challenges and VCR

In addition to the preceding difficulties, how a firm addresses issues of VCR may open it up to legal challenges as well. If pressure from activists, the media, and other stakeholders is not sufficient prompting to better manage VCR, perhaps the specter of legal sanctions on the horizon will provide additional justification. To date, court cases have come in the form of false advertising in social responsibility reports and accusations of human rights violations in foreign countries. We turn first to the case: social responsibility reports as false advertising.

Following Nike's acceptance of some level of VCR and the issuance of its social responsibility report came charges of false claims within the report. Not satisfied with the veracity of Nike's claims, Marc Kasky sued the company claiming that Nike's statements were inaccurate and constituted fraud. The California Supreme Court ruled that Nike's defense of its labor practices in the report may constitute commercial speech (i.e., it was designed to sell shoes rather than engage in the marketplace of ideas). As such, mistakes of fact come under scrutiny similar to that of false advertising with significant financial penalties for conviction (e.g., disgorgement of all profits in the state of California for the period covered). Nike ultimately settled the case for a $1.5 million donation to the monitoring group Fair Labor Association. (Kang, 2003) Nike dodged a potentially significant legal bullet – others may not be so lucky. Because of the way in which the case proceeded, the legal status of VCR claims and social responsibility reports remains unclear as of this writing. What is clear, however, is that managers need to show extra care not to simply window-dress company activities described in publicly available reports.

In addition to cases involving fraudulent claims, activists and attorneys are increasingly using lawsuits to hold firms responsible for acts committed in foreign countries. Many of these lawsuits are occurring under the 18th century Alien Tort Claims Act. This Federal law gives foreign citizens the right to sue in U.S. courts and was the subject of a 2004 U.S. Supreme Court case (Sosa v. Alvarez-Machain) – though the implications of that case for VCR are still unclear as well. There remain numerous other cases pending under this law. A former senior vice president of global affairs at Gap, Inc., Elliot Schrage, claims at least a dozen similar lawsuits are working their way through the judicial system against companies including Citigroup, Coca-Cola, Occidental Petroleum and Pfizer, though none have made it to trial or verdict. Mr. Schrage says,

> When a jury is asked to decide whether apparel retailers conspired with manufacturers to keep costs down by exploiting foreign workers in Saipan, how long before other global industries -- in manufacturing, agriculture and high technology -- face similar challenges? How will a U.S. court determine when the invisible hand of market forces becomes the iron fist of exploitation?
>
> Though courts still express reluctance to intervene if the challenged conduct is not egregious – creating conditions of torture or slave labor, for example – the safe bet is that the list of actionable abuses will grow over time. (Schrage, 2003)

All of these companies claimed an arm's length relationship with these contractors, suppliers and the local governments, but the courts disagreed and have allowed the suits to continue. While the U.S. State Department's assertions that the suits may hinder the war on terrorism may yet provide these companies with a further defense, the judicial shortening of an arm's length is a foregone conclusion.

Reality #4

More than Media and Activists

While pressure from media, activist groups, and lawyers is enough to keep executives up at night, sources of pressure are also likely to arise from sources much nearer to the hearts (and bottom lines) of many firms: customers and suppliers. While Nike and others may be seen as responding to the demands of activists, the media and the final consumer of their products, it is important that we also consider this question from the perspective of the companies' lower profile suppliers. In its public disclosures, Nike lays out its policy on subcontractor use of underage labor. This policy places a new responsibility on these subcontractors. As more and more high profile companies recognize these new responsibilities, a cascade effect of increased supplier responsibility will be become more pronounced.

Ken Larson, Worldwide Director of Social Responsibility for Hewlett-Packard, indicated to one of the authors that all of H-P's suppliers should be expecting a phone call regarding their production processes and labor standards. Miriam Rodriguez of Levi Strauss suggested that her company, along with managers from companies like Gap, Liz Claiborne and Nike are in discussions about collaborating to influence supplier practices.

Customer Involvement Examples

Labor practices in the manufacture of Nike products had a ripple effect among a number of important Nike customers. Universities across the country have faced high-profile protests over the issue of sweatshop labor and licensing the schools' name and logo. Among the protestors have been members of the universities' own student body, faculty and alumni. The methods of protest have included the occupation of administrative offices and resignation of athletic coaches among others.

Universities all over the country are paid substantial sums by the makers of athletic equipment and apparel (e.g., Nike and Adidas) including free clothing into the millions of dollars. The contract between Nike and the University of Michigan was thought to be about $8 million (Wall Street Journal, 2000). In return, the university's athletic programs agree to use the company's clothing and equipment as well as display more overt forms of advertising during events and in the athletic department's literature. Also among these arrangements, companies sell gear and apparel to the general public emblazoned with the name and logo of various universities. Protests at Georgetown, Duke and the University of Oregon among several others have forced these institutions to take a closer look at these licensing agreements.

The danger of failing to engage customers on issues of VCR is that they will begin to act on their own. The New York State Assembly passed a law in 2002 allowing the 83 public colleges to include considerations of labor standards in their procurement decisions rather than being forced to accept the lowest bid. Though the "Fair Labor Conditions and Procurement Act" is localized and provides no mandate upon the colleges, it may be a warning. The Minneapolis Board of Education has also signed a resolution to avoid buying apparel and equipment made in sweatshops.

Reality #5

Downstream Product Use

Yet another practical reality that a firm's managers must face is that the unintended use of the firm's products may open the firm to scrutiny. At the same time that we are seeing the shortening of the up-stream aspect of arm's length transactions, there is evidence that the down-stream arm is also being shortened. In the first case, firms are held responsible for how the value in the product is created. In the latter case, firms are held responsible for how their products are used.

Downstream Value Chain Examples
Since the success of lawsuits against companies in the firearms, casino and fast food industries, these industries have come in for critical media attention. Gun companies are being pressured for greater attention to safety of the product itself as well as the security of their distribution. Casinos have been criticized (and sued) for inadequately dealing with problem gamblers. McDonald's and others in the food industry have been recently the subject of documentary films (e.g., *Super Size Me*) and myriad news accounts of the harm done by the consumption of their products.

Glue maker HB Fuller was the subject of several national news accounts (and a widely used business ethics case) concerning the misuse of its product *Resistol* as an inhalant in Honduras and Guatemala. This product, made by Fuller subsidiary Kativo Chemical, was a favorite of the street children and it became so popular that these children became known as *Resistoleros*. In early January 1996, the family of a Honduran boy sued H.B. Fuller of St. Paul for wrongful death in civil court. This case posed a serious problem for H.B. Fuller due to the fact that it had the potential to expand into a class action lawsuit that could include over 15,000 Honduran street children claiming to be addicted to Resistol. In its defense, Fuller stated that it, "…neither manufactured nor sold Resistol." Further, Fuller stated that the allegations, "are nothing more than an attempt to hold Fuller liable for acts and omissions of its second tier Guatemalan subsidiary."

These statements are awkward for Fuller given that they spent years and millions of dollars trying to rectify this problem. From these and myriad other examples we can see that issues of responsibility in value chains are an increasingly important issue for managers up and down the value chain in an increasingly networked economy. And, the arm's length defense is a less and less viable one. What can be done to anticipate and manage these issues?

A Framework for Managing Value Chain Responsibility

A convincing way to address these challenges is what has been termed "total responsibility management" (or TRM). Recent work by Waddock & Bodwell (2003) offers a potential direction on how to systematize our guidance about VCR. These authors develop a framework of responsibility management that is based on the important work conducted under the aegis of total quality management (or TQM). Waddock & Bodwell offer three broad categories that are necessarily involved in responsibility management:

- *inspirational processes,*
- *integration processes* and
- *innovation/improvement/indicators*

Inspirational processes refer to an organization's ability to recognize that VCR is not a technique *du jour*, but rather, like TQM, a holistic system involving changes in managerial values. Integration processes refer to an organizational ability to weave processes that institutionalize TRM into the daily activity of the firm. Much as quality control can't be done at the end of the manufacturing line, TRM also requires integration throughout all activities of the firm. Innovation, improvement and indicator processes provide the feedback loop for an organization to assess its progress in TRM. This outcome oriented step is necessary for the firm to continue improving with respect to how it manages VCR issues.

The final section of the paper combines the realities discussed earlier with the TRM framework we just discussed. Table 1 summarizes the relationship between our VCR examples and the TRM framework.

Insert Table 1 Here

Managing Changing Conceptions of VCR
The critical guidance to managers with respect to this emerging reality is that it is important to understand both the firm's expectations of VCR and stakeholder notions of VCR. Managers adopting a stakeholder approach will be more likely to see the futility of proposing an arm's length defense (See Guidance Point #1). Critics are unmoved by claims of arm's length transactions and are quite skilled in convincing the public that firms bear responsibility for activities beyond traditional transactional boundaries. Using the arm's length transaction defense makes firms appear out-of-step with the practical realities of a highly networked business world.

One conclusion we draw from this changing conception of VCR is that it is often the most powerful value chain member who bears the greatest burden of responsibility. This is entirely consistent with the general moral principle that with great power comes great responsibility. However, if there is any question as to the firm's dominance, management should undertake to assess its position in the value chain (See Guidance Point #2).

One technique for exerting influence on the value chain network would be to identify and develop vendors whose policies and values mirror those of the dominant firm (See Guidance Point #3). These activities are always more likely to continue in a rigorously applied way if the dominant firm is willing to create a compliance program for its vendors.

Obviously, if an organization develops a policy about vendors, there is a need to monitor and enforce the policy to avoid charges of window dressing. Thus, the dominant firm in the network will have to implement a program whereby vendor compliance is evaluated (See Guidance Point #4).

Embracing Value Chain Responsibility
Clearly if a firm wishes to establish a good track record with respect to VCR, the accuracy of information provided is critical. Just as inaccurate financial information has negatively impacted investor trust in firm performance and the reputations of countless companies, inaccurate information of value chain activities can have an equally chilling effect on trust in firm claims (See Guidance Point #5).

But this reputational sword cuts both ways and care should be exercised in its use. The direction we can draw from this is that firms should avoid a half-hearted approach to VCR as it can be more damaging than ignoring VCR pressures (See Guidance Point #6).

Within the domain of self-sponsored audits we see two options for managers. First, they can use an external set of well recognized standards (e.g., Coalition for Environmentally Responsible Businesses (CERES) or Council on Economic Priorities (CEP)). By receiving a favorable assessment from an independent organization using these standards, a firm is more likely to convince critics that its intentions are good and the report is accurate and comparable to other similar reports.

For those firms wishing to conduct a self-sponsored social audit without using recognized standards, there is another option. Once the report is completed, the firm should provide complete transparency of the report's contents and data that build the conclusions in the report. In essence, criticism may be avoided by providing a level of detail that allows critics to reconstruct the report. This may not entirely satisfy critics, but time, integrity, transparency and good faith effort can often win over skeptics.

Customer Involvement

Clearly, one way to avoid involving your customers in controversies about VCR is to avoid such problems in the first place. However, this may not always be possible. Regardless of whether the firm is going to embrace calls for greater VCR, the firm's management would do well to prepare its major customers when it is apparent that activists will target them. Another approach to preparing customers is the creation of a VCR fluency program. In such a program, a firm might offer guidance to vendors and customers about hot-button VCR issues facing the industry (See Guidance Point #7).

The firm's managers may wish to preempt activist pressure by communicating its procurement policies as a way to prepare its customers. If the first contact a customer receives is from the activists and not their supplier, they will likely be unable to address the issue. If however, the customer is notified about the issue, they will have the opportunity to formulate a response to activist concerns and provide feedback to the dominant firm in the network (See Guidance Point #8).

Lawsuits

Starting with the realization that these kinds of lawsuits are possible, it is important for firms to recognize who is involved in its overseas operations and those of its suppliers. While some multi-national firms are sensitive to human rights issues, despots and poorly trained police forces are not. If the local authority's lack of sensitivity to human rights issues is a function of ignorance, the firm can play a role is providing training. Taking a lesson from Unocal, BP, Shell and other oil companies that have run into security problems in developing nations, Premier Oil of the UK has undertaken a training program on human rights for Burma's National Police College (See Guidance Point #9).

Such training raises yet another challenge in VCR. Firms should take steps to determine the qualifications needed to adequately perform the environmental, labor and human rights oversight and audits required of a company wishing to take more responsibility for its value chain. *Financial Times* correspondent Sarah Murray (2002a; 2002b) describes many of the obstacles to finding and training personnel in this area. A logical first question is whether a company should have a department of social responsibility or should the responsibility be diffused throughout the organization? Regardless of whether organizations utilize a diffusion or department approach, what is clear is that the process of managing VCR needs to be an integrated part of the value creation process (Guidance Point #10).

Downstream Value Chain Issues

The public is more easily convinced than courts that firms bear a responsibility in situations where the firm's product is being abused. The public asks managers to think more holistically about its product's lifecycle. Whereas traditional product lifecycle theories of marketing and strategy terminate with the product's sale to the consumer, external constituents demand attention to product use, abuse and disposal (See Guidance Point #11). William McDonough's ideas on making products so that they may better provide the raw materials for the next round of production (as in natural processes in which "waste=food") is an example of how downstream VCR can lead to innovation and commercial success (McDonough & Braungart, 2002).

Conclusion

The financial and economic benefits of having a global, networked value chain are impossible to ignore. The fuzziness of the boundaries around any given firm is a direct result of this inexorable move toward the "new" or "virtual" company. Attention to *responsibility* among the members of the value chain has lagged however. Due primarily to the idea that such networks are made up of discrete and independent economic entities, the idea of responsibility has relied on the historical notion of arm's length transactions. As the examples here have shown, this disavowal of responsibility is growing less viable and more dangerous to the financial and reputational well-being of the company.

Responsibility has always been partly a function of power. To say that something *ought* to be done presupposes the ability and capacity to do it. One thing that the companies described here have in common is that they are dominant in their value chains. This power, and the high profile and deep pockets that accompany it, are the reason these companies are the targets of critical attention. Customers, suppliers and supplier's suppliers may expect a call soon to discuss the ethics of your business practices. This is the promise and the peril of life in a networked economy.

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Table 1

VCR EXAMPLES	TOTAL RESPONSIBILITY FRAMEWORK		
	Inspiration/Vision	***Integration into Practice***	***Innovation/Improvement/ Indicators***
Changing Conceptions of VCR	1) Recognize the environmental changes that have occurred with respect to value chain responsibility	3) Establish policies for vendors that mirror the firm's policies and values	4) Monitor vendor compliance with firm's value chain responsibility practices
	2) Initiate and assess the firm's dominance in its network of suppliers, industry peers, and customers		
Embrace Value Chain Responsibility		6) Avoid value chain responsibility improvements that are less than 100% commitments to remedying the problem. Half measures will only serve to heighten responsibility	5) Provide accurate and verifiable claims about the firm's value chain responsibility efforts
Customer Involvement		7) Establish a program to ensure value chain responsibility fluency	8) Actively communicate firm value chain responsibility efforts and expectations to key customers
Lawsuits		9) Provide basic human rights training for any direct or indirect parties involved in overseas business activity where such knowledge is in question	
		10) Engage the totality of firms activities in working towards VCR: A separate department with access to all levels of the firm, or a set of VCR functions integrated into the firm's traditional activities.	
Downstream Value Chain Issues		11) Engage in product development that anticipates potential downstream abuse and views the product lifecycle more holistically	12) Be prepared to limit access to those customers who cannot offer assurances that products will not be abused