A Timely Analysis of Legal Developments

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The Ninth Circuit Court of Appeal in *Doe v. Wal-Mart Stores, Inc.*, recently held that a company's good faith requirement that foreign suppliers or sub-contractors follow ethical labor standards did not allow the employees of those foreign entities to sue the American company when their own employers failed to follow those standards.

Employees Alleging Labor Violations by Foreign Suppliers Cannot Proceed Against U.S. Companies Based on Code of Conduct Clause in Supply Contracts

By Eric A. Savage and Ian T. Wade

As companies headquartered in the United States and elsewhere in the developed world seek less expensive alternatives to producing manufactured goods in their homelands, the international community has gained a greater awareness of the labor law practices in lesser developed nations. From time to time, companies have been accused of engaging in practices relating to pay and/or work conditions that would not be allowed in the United States.

As part of their efforts to demonstrate that they are "best practices" companies, some American businesses have required suppliers to adhere to strict labor guidelines as part of the supply contracts. In *Doe v. Wal-Mart Stores, Inc.*,[1] the United States Court of Appeals for the Ninth Circuit considered whether a company's good faith requirement that foreign suppliers or sub-contractors follow ethical labor standards allowed the employees of those foreign entities to sue the American company when their own employers failed to follow those standards.

The Theories Behind the Foreign Workers' Claims

In *Doe*, workers of manufacturing companies in China, Bangladesh, Indonesia, Swaziland and Nicaragua alleged that Wal-Mart should be held liable for the failure of its suppliers to comply with local labor laws. The gravamen of the complaint was that Wal-Mart was required to protect the workers from labor law violations, due to its use of a contractual clause requiring that, in order to keep Wal-Mart's business, suppliers comply with local labor laws and industry standards. The clause included a "Right of Inspection" provision stating that Wal-Mart will undertake "affirmative measures, such as on-site inspections" to monitor compliance with the clause. The plaintiffs claimed that very few audit visits were unannounced, workers were coached on how to respond to auditors, that inspectors were pressured to produce positive reports even when factories were not in compliance with the standards, and that short deadlines and low prices in the supply contracts forced suppliers to violate the standards to satisfy the contractual terms.

The plaintiffs asserted that the retailer was liable under four theories, namely: (1) the foreign employees were third-party beneficiaries to the agreement between Wal-Mart and their employers, (2) Wal-Mart was their joint employer, (3) Wal-Mart negligently breached a duty owed to the foreign employees, and (4) unjust enrichment.

On July 10, 2009, the Ninth Circuit Court of Appeals affirmed the district court's decision dismissing the case, ruling that Wal-Mart was not liable to the foreign employees, either through its contractual dealings with their employer or under a joint employer theory. Although the decision is welcome news to American companies operating abroad, the court's analysis demonstrates that, under certain circumstances, similar claims might be allowed to proceed.

No Contractual Duty

Relying on the contractual clause entered into between Wal-Mart and its suppliers, the court determined that an American company's creation of a code of conduct for its suppliers (the "Standards"), even one that included a "Right of Inspection" by Wal-Mart to ensure compliance with the Standards, did not confer any right of action by the suppliers' employees for local labor violations.

First, the court found that, under the Restatement (Second) of Contracts, the employees were not third-party beneficiaries to the contract because the Standards did not create an enforceable duty upon the retailer to monitor the foreign suppliers' labor practices. Instead, the clause's plain language simply conferred on Wal-Mart an opportunity to inspect the foreign operations and, to the extent that the foreign company was not complying with the Standards, to rescind the contract. Accordingly, since there was no enforceable duty owed to the foreign employer, the foreign employees had no right to sue Wal-Mart under a third-party beneficiary theory.

Retailer Was Not a Joint Employer

Second, the court determined that Wal-Mart could not be considered the plaintiffs' employer under California's Joint Employer Doctrine. Specifically, although this doctrine includes a detailed list of possible factors that might allow the finding of a joint employee relationship, the Ninth Circuit focused on whether Wal-Mart had control over its suppliers' employees and held that that there was no evidence of any exercise of day-to-day control over the employees. The court found that establishing rules regarding "deadlines, quality of products, materials used, prices, and other common buyer-seller contract terms" did not rise to the level of day-to-day control necessary to fall within the joint employer analysis. Further, the court ruled that Wal-Mart's contractual right to monitor the suppliers' compliance with the Standards by itself did not establish any day-to-day control because no duty was created by this contractual right.

No Basis for Negligence Claims

This absence of a duty owed to the foreign employees also served as the court's basis for dismissing the employees' assertion that Wal-Mart was negligent in its failure to monitor and prevent violations of the Standards. The court determined that the four negligence claims - (1) third-party beneficiary negligence, (2) negligent retention of control and supervision, (3) negligent undertaking and (4) common law negligence - had no legal or factual support. Finally, the court determined that the lack of a prior relationship between Wal-Mart and the employees prevented the plaintiffs from succeeding on their unjust enrichment claims.

Lessons for Employers from this Decision

At first glance, this decision appears to create critical precedent shielding American companies from labor lawsuits by employees of suppliers abroad. However, companies should exercise caution when negotiating similar clauses in supplier contracts. The decision was clearly fact-specific and left open the possibility that differently worded contracts or more active involvement by the American company in the activities of its suppliers or contractors could serve as the basis for a suit.

The court's analysis involved careful scrutiny of the language of the Standards and ultimately relied on that language to show that Wal-Mart did not bargain for a duty to inspect, monitor operations, or protect employees. Nevertheless, it is possible to imagine a scenario where a contractual clause might cross the line and transform the simple "right" to inspect or oversee operations into an actual "duty" to act.

Finally, the court's analyses of the joint employer and negligence claims, and its focus on the actual level of Wal-Mart's control (or lack thereof) of suppliers' operations abroad, is equally important. This control inquiry should remind companies that too much oversight could potentially create an employment relationship where otherwise one might not exist.

Despite the court's fact-specific analysis and the potential that future claims with different facts could result in entirely different outcomes, this case provides a useful guide to consider when entering into contracts with foreign suppliers. As more and more companies seek economic advantage by looking abroad for manufacturing and product assembly services, they are likely to face criticism, public relations issues and legal challenges based on the activities of their foreign suppliers. Thus, while requiring foreign suppliers to comply with certain ethical employment standards is a valuable goal from many standpoints, if not done carefully, it could come with an unexpected price.

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[1] No. 08-55706 (9th Cir. July 10, 2009).