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Another Look at the Equator Principles: A Historical and Economic Perspective

A Comment on: "Corporate Social Responsibility: Towards a New Market-Embedded
Morality?" by Ronen Shamir.

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Another Look at the Equator Principles: A Historical and Economic Perspective

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Ronen Shamir's article¹ takes us to the cutting edge of the theoretical discourse on neo-liberalism, private regulation, and corporate social responsibility. It analyzes one of the most recent and interesting practices in the field, the introduction of the Equator Principles as a large-scale attempt at private regulation from above of environmentally risky infrastructure projects. The article is thoughtful and captivating.

I am not a sociologist. I examine Shamir's article from outside its discipline. I would like to offer external insights taken from my disciplinary and methodological toolkit, namely economics, history and empirical micro-studies. I will make four points, two of which relate to the theoretical framework and two of which concern the analysis of the Equator Principles themselves.

I. HISTORY

One of Shamir's main claims is that in the age of neo-liberalism we are witnessing an "epistemological dissolution of the distinction between society and the market" and "the emergence of political structures which are not external to, but rather embedded in, the market."² It is asserted that since Adam Smith's time, liberalism, or at least classical political economy, has conceived of two separate spheres, the market and the state, economy and society, business and the household. The advent of neo-liberalism triggered a

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1 Ronen Shamir, *Corporate Social Responsibility: Towards a New Market-Embedded Morality?*, 9 THEORETICAL INQUIRIES L. 371 (2008).

2 *Id.* at 389.

collapse of this separation, allowing an economization of the state and civil society and a socialization and moralization of the market.

The article alludes to two periods of time: the past, stretching from Adam Smith's time to the 1960s and 1970s, in which the two spheres were separate; and the present, in which one sphere is embedded in the other.³ Neo-liberalism for Shamir is not an economic policy or economic theory. Nor is it a political project. It is a set of practices or a discourse.⁴ Today's incoherent discourse is contrasted with a coherent economic theory in the past. Can practices and discourses be contrasted with a theory?

Further, was there indeed a coherent theory in the past? If we add next to Smith other past theorists, the asserted separation doesn't hold. Malthus, a political economist, stressed the connection, which has moral ramifications for both, between market prices and family behavior.⁵ Social Darwinist theories did not assert different logics for the economy and society.⁶ These theories have had an influence in neoclassical and institutional economics.

When comparing past economic practices to present practices the contrast is further blurred. For 250 years the East India Company was at the same time both a for-profit multinational corporation and a governmental body with sovereign powers and an army.⁷ The Bank of England was owned by private shareholders but exercised central banking functions.⁸ Adam Smith objected only to the monopoly of the EIC but not to its public role. He approved of the bank of England's dual status.⁹

In Germany and Japan banks are traditionally significant shareholders in industrial corporations and at the same time major creditors of the same corporations. Due to this dual status they cannot just sell their shares in the market and exit. They have a long-term interest in these corporations. Their directors on corporate boards tend to take into account a variety of stakeholders, not only the shareholders. They provide employment security to company workers. They maintain long-term relationships with suppliers

³ *Id.* at 374-78.

⁴ *Id.* at 373.

⁵ T.R. MALTHUS, *AN ESSAY ON THE PRINCIPLE OF POPULATION* (Donald Winch ed., Cambridge Univ. Press 1992) (1798).

⁶ E. Donald Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 COLUM. L. REV. 38 (1985).

⁷ Ron Harris, *The English East India Company and the History of Company Law*, in VOC 1602-2002: 400 YEARS OF COMPANY LAW 219 (Ella Gapken-Jager, Gerard van Solinge & Levinus Timmerman eds., 2005).

⁸ RON HARRIS, *INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844* (2000).

⁹ ADAM SMITH, *THE WEALTH OF NATIONS* (Bantam Classics 2003) (1776).

and local communities.¹⁰ In wartime they put their corporations at the service of the state.

Corporate social responsibility was exemplified by Robert Owen's New Lanark, by George Pullman's subsidized housing in company towns, and by Henry Ford's early 20th century maximum hours-minimum pay scheme. Berle and Means' canonic 1932 book, *The Modern Corporation and Private Property*, is a prime example of the call upon big corporations to assume state-like roles.¹¹ The Cold War military-industrial complex is another example of the blurring between the spheres of private profit and public purpose. Note that these are examples of sphere overlap, not of good intentions or consequences.

II. ECONOMICS

Shamir defines neo-liberalism as a set of practices or a discourse. This allows him — and most other sociologists, philosophers and others who critique neo-liberalism — to bypass economic theory.¹² All such approaches entail an implicit assumption that economic theory serves practices, projects and policies. Just as Smith's theory served classic economic liberalism and the Chicago School's theory served free-market economic policy, so modern economic theory serves neo-liberalism. But is economic theory just an instrument, a reflection, or does it have constitutive potential regarding policies, practices, imagination? Why did it celebrate a separation of the market from the state in the 1950s and 1960s, but by the 1990s was supporting dissolution of the separation? Economics has scientific aspirations. As a science it has its own paradigms and dynamics.

I would like to suggest two trends within economic theory that may be compatible with a collapse of the separation between market and society. Awareness of these two distinct trends may enrich our understanding of the collapse of the separation between the spheres. The first trend is the realization among economists that markets cannot function in a vacuum. They rely on the definition of property rights, on transactions and contracts, on dispute resolution and enforcement. This realization resulted at least

10 RANDALL K. MORCK, A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD (2005); CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

11 A.A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

12 Shamir, *supra* note 1, at 373.

in part from the inability of the science of economics to explain the economy. The rise of the transaction costs school, of the new institutional school, of the property rights school, has shifted economists' attention from markets to institutions and the state.¹³ This shift is in line with Shamir's sphere-embedding thesis. The second trend is the application of economic theory outside the sphere of the market. Economic theory in its price-theory form was applied to the state, to the law, to the family. Individuals outside the market were assumed to be rational maximizers.¹⁴ This trend was seen by other disciplines and by researchers of non-market phenomena as an aggressive and imperialist move.¹⁵ The distinct juncture of each of these two trends with the embedding of the social in the economic, with the economization of the state, and with the advance of corporate social responsibility, is worth considering. The history of economic theory should not be avoided altogether in an astute article like Shamir's. It may provide Shamir with insights as to the roles played by politics and ideology, by material developments and by the science of economics in the rise of neo-liberalism in general and in the blurring of the separation between the economic and the social-political.

III. ECONOMICS APPLIED

I would like to suggest, based on tools provided by economic theory, a view of the Equator Principle not as private regulation but as a cartel instead, one that creates a contract whose aim is to increase banks' profits. This speculative interpretation of the EP identifies them as a market transaction or a market commitment tool rather than a social governance device.

A lending bank cannot follow an environmentally friendly policy when its competitors do not follow that policy. Other banks will win the bid and provide loans to environmentally damaging projects. A bank can adopt a "green" policy only if its competitors do so as well. If the EP are adopted by all major banks they can credibly commit the banks to being environment-friendly. The damage to the reputation and business of a breaching bank may be large enough to deter the breach. The more specific,

13 Ron Harris, *The Encounters of Economic History and Legal History*, 21 LAW & HIST. REV. 297 (2003); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990).

14 GARY S. BECKER, A TREATISE ON THE FAMILY (1991); JAMES M. BUCHANAN, POLITICS AS PUBLIC CHOICE (2000).

15 Harris, *supra* note 13.

transparent and self- or NGO-enforced the EP are, the more likely the cartel is to be stable.

Since banks normally finance projects by granting loans and not by equity investment, their profits are not necessarily lower despite the costs of EP compliance. An EP-compliant project would require higher investments by the project company. The company will either need higher equity investment by its shareholders, or alternatively it will resort to borrowing more from banks. The creditors will not necessarily be exposed to higher risks. Compliance with the EP prevents equity holders from externalizing to the environment, thereby reducing their profits. But it also reduces the risks involved in mass tort liability. Higher risks normally suit the preferences of equity investors. Lower risks better fit the interests of creditors. Bigger and less risky loans are beneficial to banks. The benefits can materialize if other banks will not finance the same project without environmental compliance. In light of this analysis, I suggest we consider the possibility that the practice we observe is a market contract, not private regulation.

IV. AN EMPIRICAL MICRO-STUDY: SAKHALIN II

Sakhalin Island is located at the eastern end of Russia, just north of Japan.¹⁶ Its oil and gas reserves are equivalent to the remaining reserves in the North Sea. Sakhalin Energy is a company created to locate and produce oil and gas on Sakhalin Island and immediately offshore under a Production Sharing Agreement with the Russian Federation. The initial estimated investment in the project was \$10 billion. It has been updated to \$20 billion and is still rising. The company was formed by a consortium composed of Shell Oil (UK/Netherlands) 55%, Mitsui (Japan) 25%, and Mitsubishi (Japan) 20%.¹⁷ It was financed as a project finance scheme. This means that development banks and commercial banks provide non-recourse loans to the consortium. Many of these banks are subject to the Equator Principles. The huge investment made Sakhalin II one of the largest project finance schemes in the world and an excellent case study for the operation of the EP.

NGOs have concluded that Sakhalin II poses a major environmental hazard, threatening, among other things, the last remaining Western gray

¹⁶ *Sakhalin-II*, in WIKIPEDIA, <http://en.wikipedia.org/wiki/Sakhalin-II> (last visited Feb. 1, 2008).

¹⁷ Michael Bradshaw, *Prospects for Oil and Gas Exports to Northeast Asia from Siberia and the Russian Far East, with a Particular Focus on Sakhalin*, 3 SIBIRICA 64 (2003).

whales, and the island's fishermen and salmon rivers.¹⁸ They exerted pressure on financial institutions to conform to the EP and condition their loans on the consortium's acceptance of demands by the NGOs. Some banks, including the European Bank for Reconstruction and Development (EBRD), eventually yielded to the pressure, while others, such as the Japan Bank for International Cooperation, did not.¹⁹ Private regulation drafted from above serves, as Shamir observes, as self-imposed regulation for the banks and — by way of the banks — as a policing devise for disciplining oil and construction companies. A mixed success.

But what is more interesting in my view for the present article is what we can learn from the Sakhalin II case about the role of markets and states. The Russian Federation intervened in the project in 2005, alleging that the Shell-led consortium had violated Russian environmental regulations. But the pressure was not intended to stop the project or to make it more environment-friendly. Under heavy pressure from the Russian government, Shell and its partners were forced to sell a large block of shares to the Russian state-controlled company Gazprom. As of April 17, 2007, Gazprom holds 50% plus 1 share of the Sakhalin II company, Shell 27.5%, Mitsui 12.5%, and Mitsubishi 10%.²⁰

Shortly after the deal was concluded, Vladimir Putin declared that the environmental questions surrounding the Sakhalin II project had been settled. Alexander Medvedev, head of exports at Gazprom, said: "Despite the rhetoric of some politicians that Gazprom's price request is politically motivated, economic sense has prevailed and commercial companies have signed contracts."²¹ Britain's Conservative Shadow Secretary of Defence Liam Fox had a different interpretation: "While the West has been focused on the Middle East, we have seen the resurgence of Russian nationalism

18 ECA-WATCH, RACE TO THE BOTTOM, TAKE II (Sept. 2003), www.eca-watch.org/eca/race_bottom_take2.pdf.

19 Press Release, EBRD, EBRD No Longer Considers Current Financing Package for Sakhalin II (Jan. 11, 2007), <http://www.ebrd.com/new/pressrel/2007/070111.htm>; News Release, JBIC, Project Financing for Sakhalin Offshore Oil Development (Dec. 19, 1997), <http://www.jbic.go.jp/english/base/release/exim/1997-e/A15/nr97-sakhalin.php>.

20 BETS, About Sakhalin II Project, <http://www.betsbv.com/aboutsak.htm> (last visited Feb. 1, 2008).

21 Melissa Kite & Nicholas Holdsworth, *Russian Bullying over Oil Is 'a Wake-Up Call'*, TELEGRAPH, Dec. 24, 2006, <http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2006/12/24/noil24.xml>.

and a willingness to use natural resources as a political weapon."²² Sakhalin Energy's Shell-appointed CEO Ian Craig stated:

We welcome entry of [Gazprom] as a major shareholder. Gazprom brings extensive expertise to the Sakhalin II project which will be of great benefit in completing the remaining programme of work and in maximising the long term value of the venture. Our newly broadened shareholder base strengthens our ability to successfully deliver this gateway project for the benefit of the shareholders, Sakhalin Island, the Russian Federation and our customers in Asia and North America.²³

On April 24, 2007, the *Moscow Times* reported that ABN AMRO, a founding signatory of the EP, and Societe Generale, who refused to sign the EP, provided \$1 billion each to Gazprom for its purchase of a controlling share of Sakhalin II.

Global or national era? State regulation or private regulation? Corporate social responsibility or profit maximization? Economization of the state or moralization of the market? Real life surpasses theory. Empirical case studies can enrich even articles as insightful as Shamir's.

²² *Id.*

²³ BETS, *supra* note 20.