



Supply Chain Liability in the CSDDD Proposal: Law & Economics

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Outline

1. The rule establishing Supply Chain Liability (art 22 CSDD Directive proposal)
2. Function (Theoretical Law & Economics): curbing strategic use of limited liability
3. Function (Empirical Law & Economics): evidence of strategic use of limited liability
4. A missed opportunity: Supply Chain Liability very easy to avoid
5. Attention points for EU/national legislators

The rule (art 22 CSDD Directive proposal)

1. Companies in scope are liable if adverse environmental impact/adverse human rights impact → damage
2. Damage arising from (art 6):
 - a. Company's own operations
 - b. Company's subsidiaries
 - c. Company's "established business relationships" within the "value chain" → **Supply Chain Liability**
3. Lack of "due diligence" = failure to (art 7, 8):
 - a. Prevent/adequately mitigate *potential* adverse impact
 - b. Bring to an end/minimize *actual* adverse impact
4. Liability for damage by **indirect partners** excluded if contractual cascading/compliance verification (art 22)
5. Unless it is **unreasonable** to expect that they are **adequate** to pursue the goals of art 7, 8.

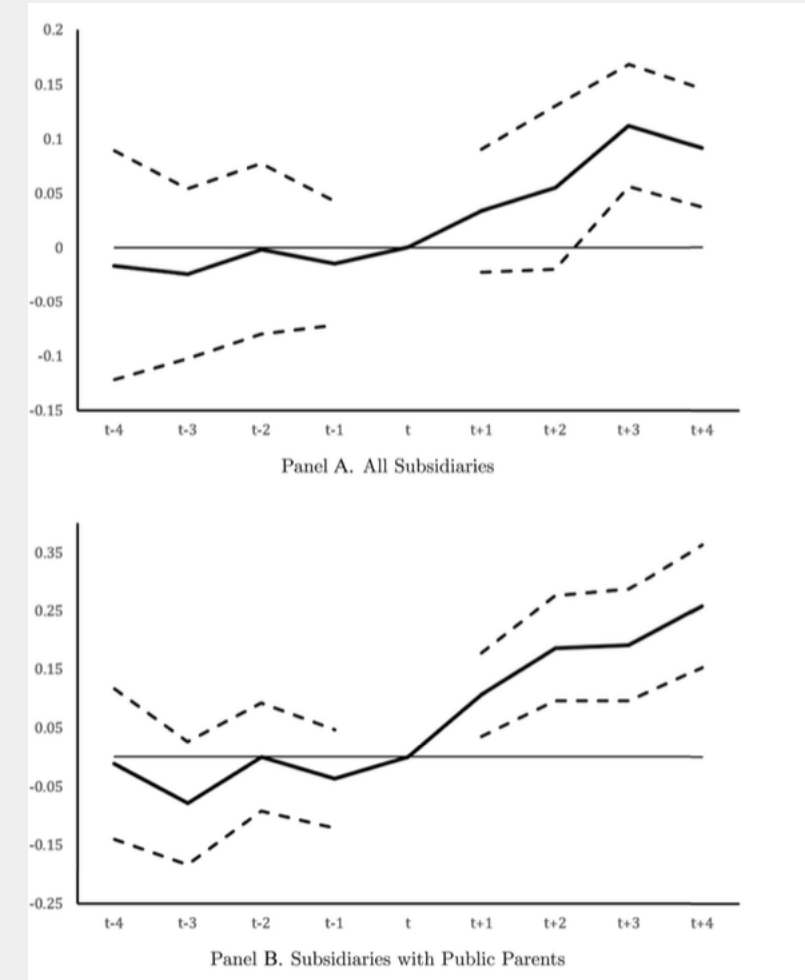
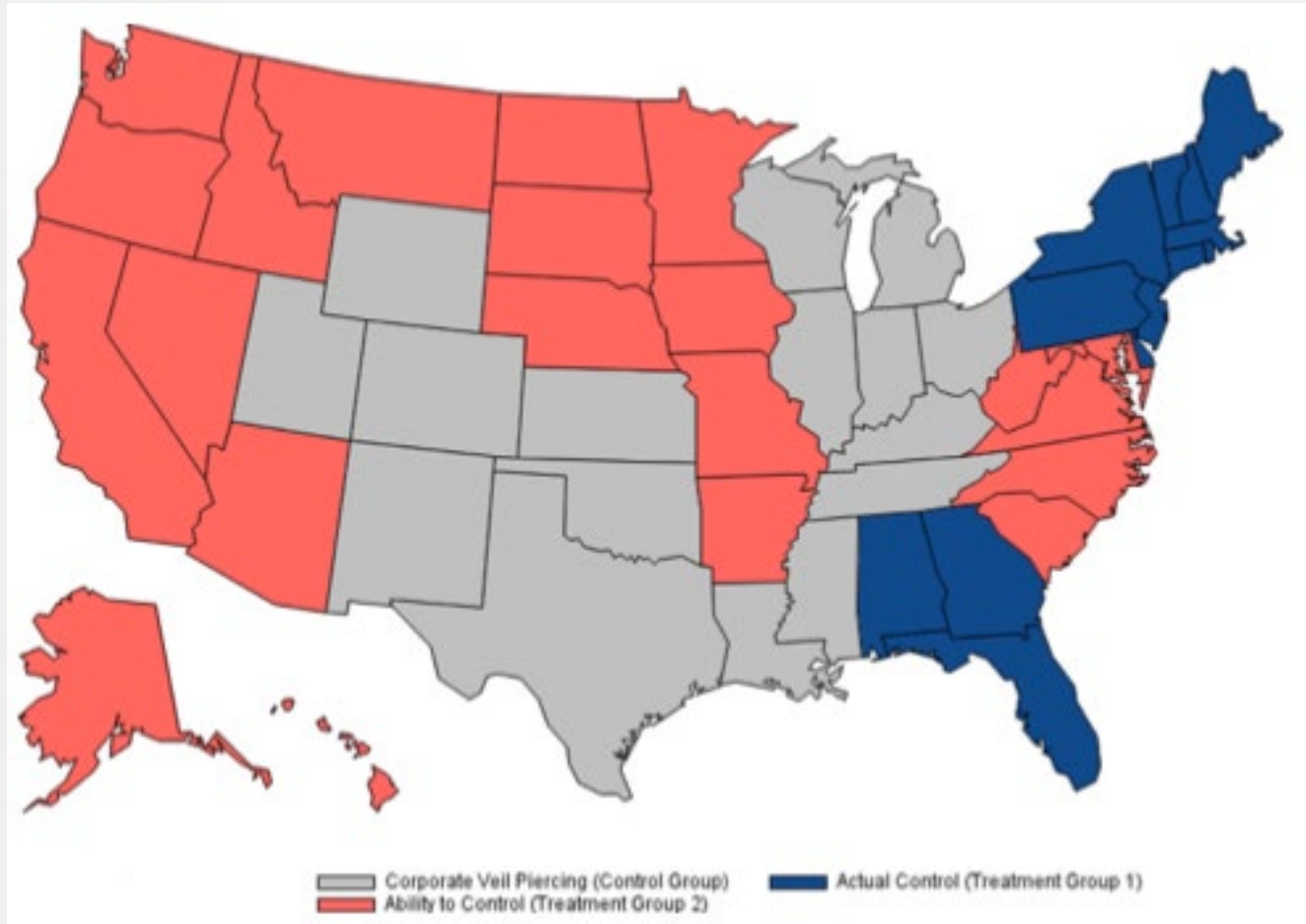
Law & Economics of Supply Chain Liability (theory)

1. Tort liability to correct negative externalities
 - Expected tort liability → **deterrence** → internalize cost of human and environmental degradation
2. Hansmann & Kraakman (1991): limited liability *undermines* deterrence
 - **Judgment proofness** → lower incentive to take care/monitor (environmental risk, labour conditions)
 - Incentive to concentrate (potentially) socially harmful activities in judgment-proof subsidiaries
3. Unlimited liability → Evasion → Supply Chain Liability
 - Companies may evade parent liability by *outsourcing*
 - MNCs may outsource (potentially) socially harmful activities to undercapitalized suppliers/buyers
 - **Supply chain liability** → victims can sue deep-pocket outsourcers → internalize externalities
4. It works in theory, but empirically?

Law & Economics of Supply Chain Liability (empirics) (1)

1. Do companies use subsidiaries strategically (i.e. to evade tort liability)?
2. Akey & Appel, “The Limits of Limited Liability”, *Journal of Finance* (2021)
 - A natural experiment: some US federal circuits supported parent liability in 1980 environmental statute
 - *Bestfoods* (1998) → parent liability protection in all US states
 - Diff-in-diff design → treatment = parent liability jurisdictions, control = no (never) parent liability
3. Results
 - Parent liability protection (post-*Bestfoods*) → 5% to 9% increase in pollutant emissions by subsidiaries
 - Impact is much higher when parent is publicly traded
 - Suggests pay-per-performance putting more pressure on subsidiaries

Main results of Akey & Appel (2021)



Law & Economics of Supply Chain Liability (empirics) (2)

1. Do companies design the supply chain strategically (i.e. to evade tort liability)?
2. Lam, “Do Health Risks Shape Firm Boundaries?” Working paper (2021)
 - Another natural experiment: US carcinogen designation every year
 - Designation increases liability risk (→ burden of proof)
 - Diff-in-diff design → carcinogen designation affects different firms/plants in different points in time
3. Results
 - a. After designation, using firms *increase asset sales* → pollution concentration (judgment-proofness)
 - b. After designation, using firms *outsource* carcinogen emissions
 - c. Increases \cong 4-fold if firms were sued before

Key result of Lam (2021)

Table 9: Health Risks, Litigation and Firm Boundaries

	(1) Log(Assets)	(2) Outsourcing Emissions
TREAT×POST×SUED	-0.142*** (0.053)	0.031* (0.019)
TREAT×POST	-0.042** (0.017)	0.008** (0.004)
TREAT×SUED	-	-
POST×SUED	0.055 (0.048)	-0.005 (0.008)
TREAT	-	-
POST	0.010 (0.011)	0.000 (0.002)
SUED	-	-
Observations	60,589	60,589
Firm-Cohort FE	Yes	Yes
Industry-Year-Cohort FE	Yes	Yes
Cluster	Firm	Firm
Adj. R-Sq.	0.971	0.608

Thus, CSDDD's liability welcome, unless companies can:

1. Avoid extraterritorial reach (EU & Non-EU > turnover threshold)
 - Liability does not carry on to Non-EU parent → may use judgement proofness of EU subsidiary
 - May still trigger US parent's director liability for the subsidiary's losses (Enriques & Gatti 2022)
2. Avoid “subsidiary” designation ← controlled undertaking (Directive 2004/109/EC)
 - majority of voting rights (also by agreement)/appoint majority of board members
 - “dominant influence”
3. Avoid Supply Chain Liability
 - “established business relationships” → large coverage
 - in direct contractual relationships: → “appropriate measures” to identify, prevent, mitigate ...
 - in indirect contractual relationships → **box ticking**
 - Contractual cascading
 - Compliance verification
 - *unless it is unreasonable to expect that these measures are adequate*

What should national/EU legislator worry about?

1. Who is to **prove** that contractual cascading and compliance verification “could be/be not reasonably expected to be adequate”?
 - a. The plaintiff (victim) → hard to do → liability = no bite
 - b. The (parent) company → incentive to take effective measures

2. Avoidance Supply Chain Liability → negative externalities (defies the CSDDD’s goal)
 - Burden of proving “unreasonableness” → national law (**Recital 58 CSDDD**)
 - *«The liability regime does not regulate who should prove that the company’s action was reasonably adequate under the circumstances of the case, therefore this question is left to national law»*
 - Even if some national laws puts it on parent, not all MS will do it → regulatory arbitrage (by parents, incorporating in friendly jurisdictions) → a case for EU law

Many thanks for listening!

**Questions?
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