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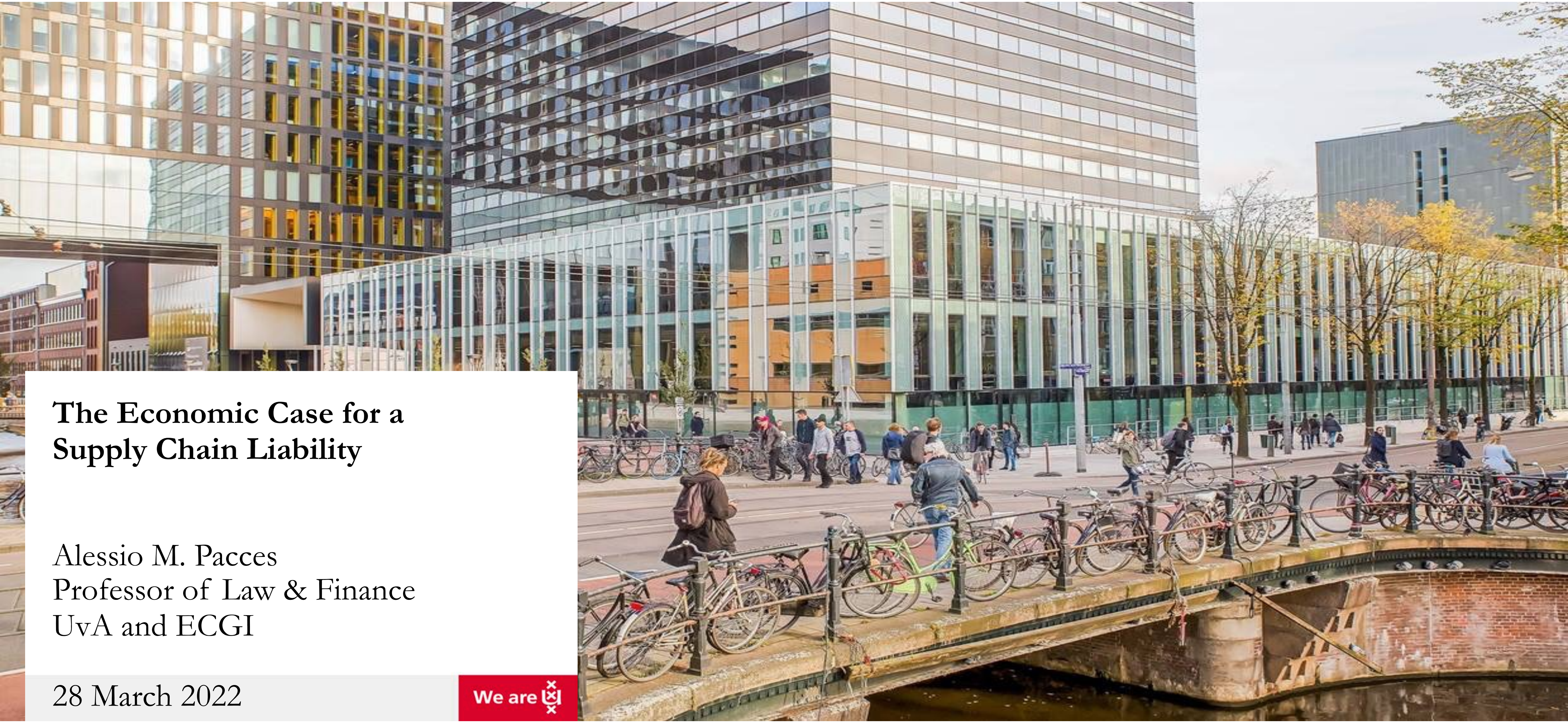

The Economic Case for a Supply Chain Liability

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We are

Outline

1. Does Supply Chain Liability make sense – in theory?
2. Does Supply Chain Liability make sense – empirical evidence?
3. Supply Chain Liability in the CSDD Directive proposal (art 22)
    a. For subsidiaries
    b. For "established business relations"
    c. Escaping liability
4. Limitations and Drawbacks

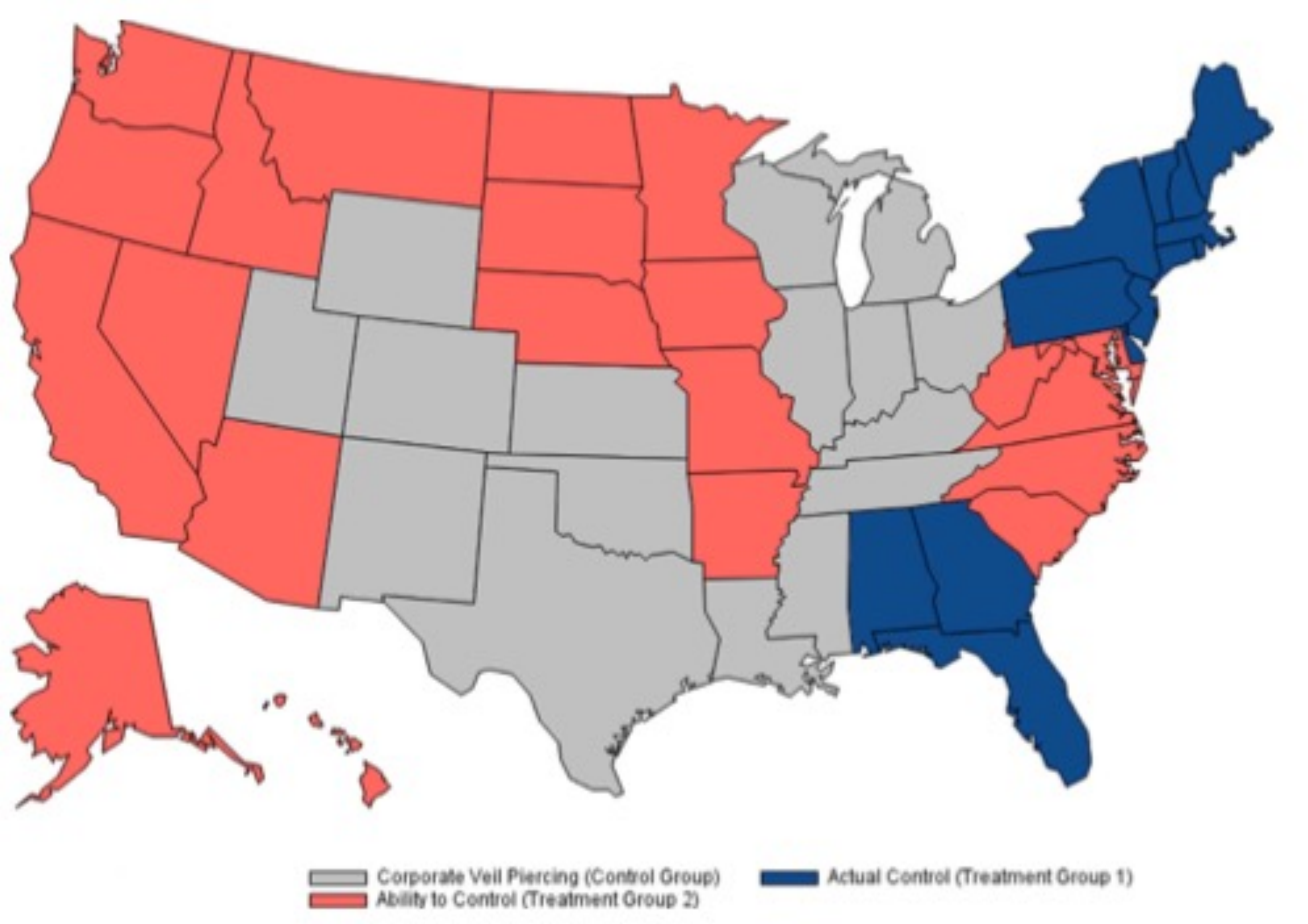
Does Supply Chain Liability Make Sense in Theory?

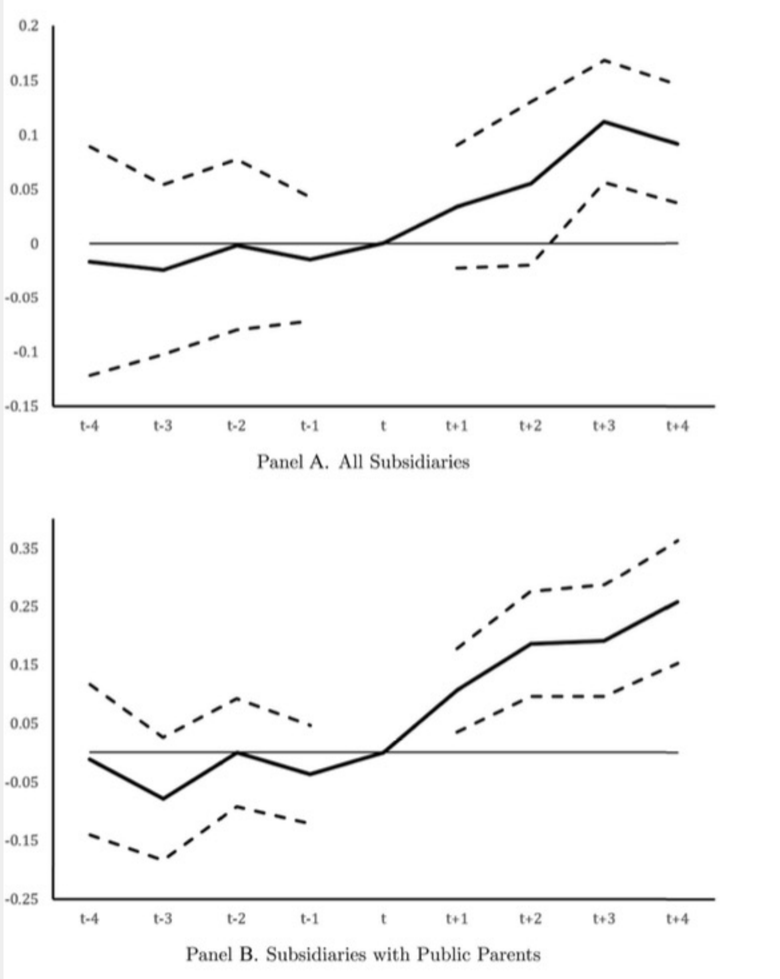
1. Tort liability to correct negative externalities
   - Expected tort liability → internalize cost of human and environmental degradation
   - Complements regulation, criminal law, and Pigouvian taxation
2. Hansmann & Kraakman (1991): limited liability undermines deterrence
   - Judgment proofness → 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 disaggregating
   - 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?

Does Supply Chain Liability Make Sense? Empirical evidence (1)

1. Do companies actually use subsidiaries 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) clarified that standard is 'veil piercing' → almost no parent liability
   - Diff-in-diff design → treatment = parent liability jurisdictions, control = no parent liability
3. Results
   - Parent liability protection (post-*Bestfoods*) → 5% to 9% increase in pollutant emissions by subsidiaries
   - Channel:
     - No increase in production/employment by polluting subsidiaries
     - However, **<u>subsidiaries cut on abatement costs</u>**
   - Impact is much higher when parent is publicly traded
     - Suggests pay-per-performance putting more pressure on subsidiaries

Main results of Akey & Appel (2021)





Does Supply Chain Liability Make Sense? Empirical evidence (2)

1. Do companies use the supply chain 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
   - After designation, using firms/plants increase abatement → Tort liability works!
   - However, carcinogen emissions at the national (US) level do not decrease → Evasion works too…
   - After designation, using firms increase asset sales by 4%
     - Emission concentration increases → big polluters (potentially judgment proof) become even bigger
   - After designation, using firms are 0,8% more likely to outsource the carcinogen emissions
   - Both selling assets and outsourcing increase ≅ 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***	0.031*
	(0.053)	(0.019)
TREAT×POST	-0.042**	0.008**
	(0.017)	(0.004)
TREAT×SUED	-	-
POST×SUED	0.055	-0.005
	(0.048)	(0.008)
TREAT	-	-
POST	0.010	0.000
	(0.011)	(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

Corporate Liability in the CSDD Directive Proposal

1. Firms in scope (EU & Non-EU > turnover threshold) are liable if they fail to:
   - "Identify", "prevent/mitigate", "bring to an end" adverse human rights/environmental impacts
2. Parent companies liable for operations of "subsidiaries" in which (Dir 2004/109/EC):
   - they exercise majority of voting rights (also by agreement)/appoint majority of board members
   - they exercise "dominant influence"
3. Companies liable for partner's operations in "established business relationships" unless:
   - In <u>direct</u> contractual relationships:
     - They have taken a host of actions, including terminating the relationship as last resort (severe harm)
   - **In <u>indirect</u> contractual relationships**:
     - Contractual cascading (assurance of compliance with company's code of conduct/prevention plan)
     - Compliance verification (eg via independent 3rd party)
   - Escaping liability
     - Companies may not be liable for the operations of indirect relations, unless it is **<u>unreasonable</u>** to expect that *contractual cascading* and *compliance verification* were **<u>adequate</u>** to implement due diligence.

Challenges & Drawbacks

1. Evading liability
   - Burden of proving "reasonable adequateness" → national law (recital 58) → regulatory arbitrage?
   - What kind of liability? Strict, vicarious, joint-and-several … ?
2. Distortions make-or-buy decisions

- Dealing with single oil tankers or with a fleet of oil tankers?
- Classic make-or-buy decision (transaction cost, economies of scale…)
- **Function of Supply Chain Liability (→ Directive's goal):**
  Make companies' liability risk invariant to make-or-buy

Looking forward to your questions

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