Civil Liability in the EU Corporate Sustainability Due Diligence Directive Proposal: A Law & Economics Analysis

Finance Working Paper N° 691/2023
March 2023

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ECGI Working Paper Series in Finance

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Keywords: European Union, negative externalities, corporate groups, due diligence, limited liability, supply chain, outsourcing, causation, burden of proof

JEL Classifications: K13, K22, K38, M14

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The EU Corporate Sustainability Due Diligence Directive (CSDDD) proposal can be interpreted as an attempt to cope with the under-deterrence of negative externalities on human rights and the environment depending on the strategic use of limited liability by corporate groups. This article reviews the civil liability proposals by the Commission, the European Parliament, and the Council from this law & economics perspective. The article finds that these liability rules fall short of making corporations internalize negative externalities by way of due diligence obligations in the group and the supply chains. It is relatively easy for companies that fail to carry out due diligence effectively to avoid the civil liability being considered by the EU legislature.

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1. Introduction

This article concerns the proposed EU Corporate Sustainability Due Diligence Directive (henceforth CSDDD).[2] It focuses on civil liability as a mechanism for companies to internalise negative externalities within their group and supply chains.[3] Therefore, this article analyses the CSDDD from a functional perspective, using economic analysis to identify the expected impact of the proposed legal rules on a company's conduct. The analysis focuses on the incentives created by the existing and the proposed rules governing liability for corporate damages. This analysis refers to the Commission's CSDDD proposal, although it will consider the more recent text proposed by the Council as Political Compromise in the negotiations with

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[2] Commission's Proposal for a Directive of the European Parliament and of the Council on the Duty of Business Diligence for Sustainability and amending Directive (EU) 2019/1937, No. 2022/0051 COD of 23 February 2022.

[3] Art. 20 of the CSDDD proposal also requires Member States to adopt administrative 'sanctions' ('penalties' in the Council's Political Compromise, see *infra*, note 4) for violations of the national provisions implementing the Directive. Although these sanctions contribute to deterrence, they are out of the scope of this article.

the European Parliament (hereinafter, EP).[4] At the moment of writing, the text which will form the basis of the so-called 'Trialogue' is not known.[5]

I have divided the remainder of this article into five parts. In Section 2, I will describe the operation of the rule establishing liability for damages in the value chain, i.e. Art. 22 of the CSDDD proposal. This is mainly, albeit not exclusively, a liability for damages occurring in the supply chain of Multi-National Corporations (MNCs).[6] In Section 3, I will discuss the economic aspects of this liability. I have chosen to take a functional approach to civil liability, based on economic analysis, to answer the question: what is the goal of a supply chain liability? In theory, such a liability aims to counter the strategic use of limited liability by corporations to avoid paying damages for their wrongdoings and, in such a way, avoid internalising the negative externalities of their operations. However, not all theories are good representations of reality. Therefore, in Section 4, I will discuss the empirical studies showing that the strategic use of limited liability is a reality, indeed, both in the context of groups of companies and in the construction of supply chains.

As the proposal to establish a supply chain liability seems to be well grounded in theory and empirically, the EU could play a leading role in making MNCs internalise the negative externalities they generate worldwide. However, as I will explain in Section 5, this liability does not work very well as currently designed. The Commission's original proposal was easy to circumvent. In overhauling the civil liability provision, with the aim to clarify its legal basis, the Council has arguably made supply chain liability even easier to get around. In Section 6, I will conclude that the current CSDDD proposal is a missed opportunity to make companies internalise their negative externalities on human rights and the environment.

2. Civil liability in the CSDDD proposal

[4] Council of the European Union, Proposal for a Directive of the European Parliament and of the Council on the Duty of Business Diligence for Sustainability and amending Directive (EU) 2019/1937 – General Approach, No 15024/1/22 REV1 of 30 November 2022 (hereinafter, Political Compromise). The European Parliament's Committee on Legal Affairs published a Draft Report, which is not yet final. Lara Wolters (Rapporteur), Draft Report on the proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 of 7 November 2022 (hereinafter, Wolters Report).

[5] Trialogue is the informal negotiation between the Council and the European Parliament preceding the approval of an identical text by the two EU institutions, as required by the ordinary legislative procedure. See Article 294 of the Treaty on the Functioning of the European Union (TFEU).

[6] A key provision to define the scope of the CSDDD is Art. 6, which requires companies to identify actual and potential adverse impacts on human rights and the environment from their own operations, that of their subsidiaries, and from the relevant business partners in the value chain. The Commission's proposal defined 'value chain' broadly (Art. 3(g)), though it restricted the relevant business partners to 'established business relationships' (Art. 3(f)). To accommodate divergent views of Member States on whether the CSDDD should cover the entire value chain or limit its scope to the supply chain, the Council's Political Compromise has adopted the term 'chain of activities', which focuses mainly on the supply chain. See Political Compromise, Accompanying Report p. 6. The Council's proposal has abandoned the concept of 'established business relationships' and applies to the operations of all direct and indirect business partners in the supply chain, but only to the direct downstream partners (Art. 3(g) in the Political Compromise).

Art. 22 of the CSSDD requires Member States to impose on the companies in scope civil liability for breach of the due diligence obligations established by the Directive.[7] Taking a functional approach, in this section I will focus on the key aspects of this liability rule.

Companies subject to the Directive will be liable for the damages resulting from adverse environmental or human rights impacts that occur in three contexts: i) in the company's own operations; ii) in the company's subsidiaries; and iii) in the operations of direct or indirect business partners in the value chain. In the Commission's proposal, 'value chain' was defined broadly although its relevance was confined to 'established business relationships.'[8] Reflecting the EP's stance, the Council's Political Compromise has scrapped the concept of 'established business relationships.'[9] Departing from the EP's approach,[10] however, the Council also replaced 'value chain' with a novel definition of value 'chain of activities', narrowing down the scope of the Directive to the upstream business partners and adding only the *direct* downstream partners.[11] Thus, the Council's version mainly results in a supply chain liability. The different opinions of the EP and the Council about the scope of the Directive are not surprising, because the inclusion of indirect business partners in the scope of a company's liability is a sensitive aspect of the CSDDD proposal.

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[7] According to Art. 4 CSDDD, the due diligence obligations of the companies are as follows:

a) « integrating due diligence into their policies and risk management systems in accordance with Article 5;
b) identifying actual or potential adverse impacts in accordance with Article 6;
c) preventing and mitigating potential adverse impacts, and bringing actual adverse impacts to an end and minimising their extent in accordance with Articles 7 and 8;
d) establishing and maintaining a complaints procedure in accordance with Article 9;
e) monitoring the effectiveness of their due diligence policy and measures in accordance with Article 10;
f) publicly communicating on due diligence in accordance with Article 11. »

[8] See Art. 3(f)(g) CSDDD, Commission's proposal (emphases added):

- « '**value chain**' means activities related to the production of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product as well as the related activities of *upstream* and *downstream* established business relationships of the company;
- '**established business relationship**' means a business relationship, whether *direct* or *indirect*, which is, or which is *expected to be lasting*, in view of its *intensity* or *duration* and which does not represent a negligible or merely ancillary part of the value chain. »

[9] According to Art. 3(e) in the Political Compromise (emphases added), « '**business partner**' means a legal entity:

i. with whom the company has a *commercial agreement* related to the operations, products or services of the company or to whom the company provides services pursuant to point (g) ('*direct* business partner'), or
ii. which is not a direct business partner but which performs *business operations related to the operations, products or services* of the company ('*indirect* business partner'). »

[10] See Amendment 74 Wolters Report (emphases added):

« '**value chain**' means *all upstream* and *downstream* activities, operations, including marketing and advertising related to, and entities involved in, the production and supply of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product. »

[11] See Recital 18 and Art. 3(g) in the Political Compromise, specifying that downstream activities are to be included in the '**chain of activities**' only "where the business partners carry out those activities for the company or on behalf of the company."

In any of these contexts – own operations, subsidiaries operations, and operations of direct and indirect business partners – a company is liable if it has failed to carry out the actions that qualify as 'due diligence' according to the Directive.[12] In the CSDDD, due diligence is not a mere standard of care in monitoring, but it means specific statutory obligations. The companies in scope must not only monitor their own operations, their subsidiaries, and the business partners in the supply chain through procedures, policies, and codes of conduct aiming to identify adverse impacts on the environment and human rights, as defined by the lists of international conventions in the Annex of the CSDDD proposal.[13] Most importantly, the companies must also prevent, or at least adequately mitigate, the potential adverse impacts (Art. 7) and bring to an end, or at least minimise the extent of the actual adverse impacts (Art. 8). If a company fails to comply with Art. 7 and Art. 8 of the CSDDD, it may be liable for the damages resulting from these adverse impacts, even if these are remote because, for example, the company's business partners in Asia or Africa pollute or use child labour in violation of the relevant international conventions.

The scope of the supply chain liability depends on the definition of business partners, especially the indirect ones. As in the above example, liability may arise from indirect partners who are very remote, both geographically and in contractual terms, from the MNC. In the Commission's proposal, the relevant partners were those falling within the definition of 'established business relationships' in the value chain.[14] The Wolters Report removed the restriction of established business relationships, effectively extending the scope of liability to *all* direct and indirect business partners.[15] The Council's Political Compromise is not only more restrictive as it excludes indirect downstream partners from the relevant definition of 'chain of activities',[16] but also explicitly defines business partners without reference to the duration or intensity of the relationship.[17] Although it is difficult to predict the outcome of the legislative process at this stage, it seems clear that the presence of an established business relationship will no longer be a precondition.

The different approaches to the value chain definition have important repercussions on the liability rule. Understandably, the EU legislature has been concerned about limiting the liability for damages caused by indirect partners, for not all these damages can be avoided, or limited, by the company's due diligence. Recital 15, which the EP and the Council left substantively unchanged, clarifies that due diligence must be understood as obligations of means, not of result. In the same vein, the EU legislature has identified situations in which the liability for damages caused by particularly indirect business is excluded. These exclusions differ in the Commission's and in the Council's text.

In the Commission's proposal, liability for indirect partners could be excluded under two conditions. The first was the presence of 'contractual cascading' by which

[12] Art. 22 CSDDD specifically attaches liability to the breach of Art. 7 and 8 CSDDD, which focus on the purpose of due diligence.
[13] Art. 4 to 11 CSDDD.
[14] *Supra*, note 8.
[15] *Supra*, note 10.
[16] *Supra*, note 11.
[17] *Supra*, note 9.

business partners are seeking contractual assurance from their own contract partners about compliance with the company's code of conduct and, as necessary, preventive action plans. The second condition was that the contractual cascades be accompanied by appropriate measures of 'compliance verification', including – but not necessarily – independent third-party verification.[18] Meeting these box-ticking conditions was, however, insufficient to exclude liability if "it was unreasonable […] to expect that the action actually taken […] would be adequate to prevent, mitigate, bring to an end or minimise the extent of the adverse impact."[19] With this structure, the enforcement of the liability rule critically depends on who has to prove that the action was unreasonable. Albeit eliminating reliance on contractual cascading as an exculpatory mechanism, the EP maintained the rule's structure. According to the Wolters Report, a company should be able to escape liability by demonstrating compliance with the due diligence obligations in general, "unless it was unreasonable […] to expect that the action actually taken […] would be an appropriate measure to prevent, mitigate, bring to an end or minimise the extent of the adverse impact."[20] Although the EP's language suggests that defendant companies must demonstrate compliance, the burden of proving the unreasonableness of the action is still open for discussion.[21]

The Council's Political Compromise completely overhauled the liability rule. Although it is unclear which approach will become final, it is interesting to compare the exclusions of liability. The Council's version of Art. 22 maintains that a company faces liability when: a) it breaches the due diligence obligations established by Art. 7-8; b) damage occurs because of this breach. However, the text is now explicit about two additional requirements. First, the breach of duty should be intentional or negligent. Second, there must be no break in the causation link, that is, liability is excluded if the damage was caused *only* by the business partner. Consequently, there is no additional exculpatory provision for the company. Although the Council presents these as mere legal clarifications, they will have an impact on the implementation by Member States, notably on the burden of proving the four conditions for liability, which by default lies with the plaintiff.[22] Moreover, as we have seen, the Council's text has limited the scope of due diligence obligations with regards to downstream indirect partners and has added an additional nuance: prioritisation.[23] In order for a company to be in breach of Art. 7-8, the failure must concern adverse impacts on human rights or the environment that are considered a priority in light of their 'severity' and 'likelihood', provided that it is 'unfeasible' for the particular company to address all adverse impacts at the same time. This vague language leaves companies plenty of room to escape liability.

[18] See Art. 22(1) and Art. 7(2)(4) and 8(3)(5) CSDDD.
[19] Art. 22(2) CSDDD.
[20] Amendment 198 Wolters Report.
[21] See *infra*, Section 5.
[22] Typically, in civil law jurisdictions, the plaintiff in a tort liability case must prove: 1) a damage; 2) a breach of duty; 3) the causal link between the breach and the damage; 4) the fault of the person in breach (intention or negligence). See e.g. Art. 162 BW6 Dutch Civil Code and Art. 2043 of the Italian Civil Code. See also Political Compromise, Accompanying Report.
[23] Art. 6a in the Political Compromise.

The conditions introduced by the Council's Political Compromise replace the explicit exclusions in the Commission's and the EP's proposals. Arguably, the Council's requirements are more demanding, making it harder for a company to face liability for damages occurring in its supply chain.

3. Economic function of civil liability: the problem of limited liability

To evaluate the different models of value/supply chain liability being considered by the EU, let me take a step back and look at the purpose of this type of liability. This can be understood based on the economic rationale for tort liability. From an economic standpoint, the main function of tort liability is deterrence.[24] Tortfeasors facing liability are deterred from imposing damages on other members of society. Put differently, tort liability incentivises tortfeasors to internalise the negative externalities of their activities on the victims. Think, for example, of car accidents: liability (as the no-claim bonuses of liability insurance) incentivises drivers to pay attention to other people's vehicles. Generally, whenever the social cost of an activity exceeds the private cost, liability aims to prevent private actors, who only bear the private cost, from creating excessive damage compared to the social optimum. The same logic applies to environmental damage and human rights violations. By requiring damage compensation equal to the social harm, liability bridges the gap between the social and private costs of environmental and human degradation. Although describing such degradations as negative externalities may sound odd, economists using this language aim to constrain these market failures as much as possible.[25]

In a 1991 seminal article, Hansmann and Kraakman identified a major shortcoming in tort liability's capacity to foster the internalisation of negative externalities: corporate limited liability.[26] Limited liability can undermine tort liability's deterrence because it allows corporations to be judgement proof.[27] The judgment proofness problem arises not so much because tortfeasors unexpectedly face liability for damages exceeding their net worth, but much more often because they strategically put themselves in this situation. It is easy for MNCs to concentrate on dangerous activities that can cause, for example, exorbitant environmental damage in tiny capitalised corporate vehicles. In this way, should the victims sue, the defendant company would not be able to pay damages. Judgment proofness results in under deterrence: when deciding whether to undertake a dangerous activity within the

[24] Steven Shavell, *Foundations of Economic Analysis of Law*, 2004, Harvard University Press, 175 ff.

[25] In economics, however, the optimal level of negative externalities is not zero. There are two reasons for this. First, even if all negative externalities were internalised, it would be efficient to carry out harmful activities so long as the social benefits (including the tortfeasor's private benefits) exceed the social costs. Secondly, because internalizing externalities is costly (for instance, due to the administrative cost of tort liability), it would not be in the public interest to bring negative externalities to zero. See Shavell, *supra* note 24, 80-83.

[26] Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts', *Yale Law Journal*, 1991, 1879-1934.

[27] Steven Shavell, 'The Judgment Proof Problem', *International Review of Law and Economics*, 6(1), 1986, 45-58.

corporate group, the parent company may disregard the negative externalities if tort liability is only faced by subsidiaries unable to pay damages.

To foster the internalisation of externalities via tort liability, Hansmann and Kraakman proposed to abolish corporate limited liability with regards to tort victims. If tort victims are able to claim damage compensation from the entire group's assets, the parent companies will internalise the externalities and have incentive to minimise the social harm of their activities wherever these are carried out in the group. However, unlimiting the limited liability of MNCs is complex because corporate law varies internationally. Anticipating a race-to-the-bottom competition between jurisdictions,[28] Hansmann and Kraakman also proposed that corporate unlimited liability towards tort victims has an extraterritorial effect. In particular, in applying tort law, the United States should disregard the limited liability conferred by other jurisdictions.[29]

Hansmann and Kraakman's article is a milestone in the economic analysis of corporate liability. Because of corporations' political clout, their proposal did not get much traction in legislatures or courts. It is worth noting that even unlimited liability would not completely disallow the circumvention of tort liability (hence the internalisation of externalities) by corporate groups. Even if parents were facing unlimited liability for their subsidiaries' actions, MNCs could still avoid liability risk by outsourcing the most dangerous activities to their business partners in the supply chain. Hansmann and Kraakman were aware of this problem, although this did not affect their proposal because it is impossible to predict whether outsourcing would increase or decrease in a counterfactual unlimited liability regime.[30]

From a law & economics standpoint, the CSDDD proposal can be interpreted as an attempt to cope with underdeterrence of environmental and human rights violations stemming from limited liability in corporate groups.[31] Functionally, the CSDDD extends corporate liability to the operations of subsidiaries and of business partners in the value chain. However, this liability is not constructed as tort liability for damages caused by subsidiaries or business partners, which would directly address the limited liability problem, but it is rather liability for breach of due diligence obligations in dealing with the subsidiaries and the business partners in scope.[32] In the Commission's proposal, the key concept defining the scope of liability was the presence of an 'established business relationship' with the business partners. As this concept was removed by the EP and the Council, and the two institutions' attitudes towards the scope of the CSSD Directive differ, it is impossible to predict what the scope of MNC liability will be. Yet, whichever definition the EU legislature will eventually adopt, companies will be liable for the damage caused by subsidiaries

[28] See e.g. Lucian A. Bebchuk, 'Federalism and The Corporation: The Desirable Limits on State Competition In Corporate Law', *Harvard Law Review*, 1992, 1435-1510.

[29] Hansmann & Kraakman, *supra* note 26, 1921-23.

[30] Hansmann & Kraakman, *supra* note 26, 1913-16. But see *infra*, text accompanying notes 37-38, for more recent empirical evidence on outsourcing.

[31] Interestingly, Recital 56 of the in the Political Compromise speaks against deterrence thorough damages, although that must be read in the context of the prohibition of punitive damages and other forms of overcompensation.

[32] See Anne Lafarre, 'Mandatory Corporate Sustainability Due Diligence in Europe: The Way Forward', *ECGI Blog*, 12 April 2022, https://ecgi.global/blog/mandatory-corporate-sustainability-due-diligence-europe-way-forward.

and some business partners, so long as these damages result from a breach of the due diligence obligations – a point on which I will return in Section 5.

4. Strategic use of limited liability: empirical evidence

A supply chain liability seems to be justified, in theory, to cope with the strategic use of limited liability by corporations. The question remains whether corporations actually use limited liability strategically. This is an empirical question. Recent empirical work in financial economics has answered this question in the affirmative, with regards to both groups of companies and the construction of supply chains.

As far as a group of companies are concerned, Akey and Appel have recently demonstrated that limited liability increases the corporation's incentive to externalise environmental damage. When corporations benefit from limited liability, they pollute more.[33] The challenge of empirical studies, especially studies of the impact of law on finance, is to identify causality. This is because two phenomena such as limited liability and environmental damage could be statistically correlated, but both depend on a variable omitted from the study which, in reality, determines the production of negative externalities.[34] Having published their study in the Journal of Finance, the world leading scientific journal in financial economics, the authors had a convincing strategy to prove causality.

Akey and Appel used a US Supreme Court case, the *Bestfoods* case from 1998, to tease out the causal impact of limited liability.[35] In empirical jargon, *Bestfoods* is a (quasi-)natural experiment, which alters the rule of law in certain jurisdictions leaving it unchanged in other, comparable jurisdictions. Similarly to the randomised controlled trials of medications, this setting allows for identifying the effect of legal change. Prior to *Bestfoods*, the US federal courts applied different standards to establish the parent's liability for the environmental damage caused by subsidiaries. Some courts held the parent company liable if it could *potentially* exercise control over the subsidiary. Others required that the parent exercised *actual* control. Others still applied state corporate law, which in the US allows piercing the corporate veil only in extreme cases of fraud or subsidiaries being the 'alter ego' of the owner.[36] In *Bestfoods*, the Supreme Court ruled that, in the US, parent companies can only be liable for the environmental damage by their subsidiaries if the conditions for veil piercing apply. This implied that some parent corporations suddenly enjoyed the protection of limited liability, which they did not have before. Figure 1 illustrates the situation before *Bestfoods*.

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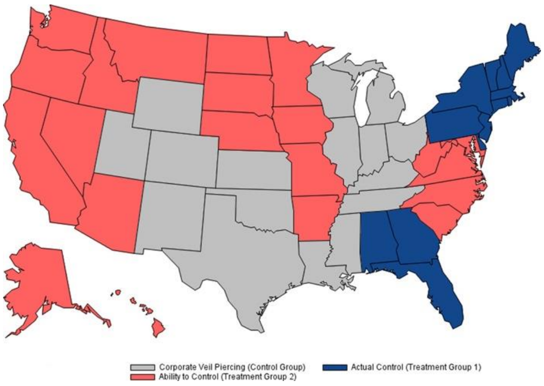
[33] Pat Akey and Ian Appel, 'The Limits of Limited Liability: Evidence from Industrial Pollution', *Journal of Finance*, 76(1), 2021, 5-55.

[34] Vladimir A. Atanasov and Bernard S. Black, 'Shock-Based Causal Inference in Corporate Finance and Accounting Research', *Critical Finance Review*, 5, 2016, 207-304.

[35] *United States v. Bestfoods*, 524 U.S. 51 (1998), https://supreme.justia.com/cases/federal/us/524/51/.

[36] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law*, 1996, Harvard University Press, 54-59.

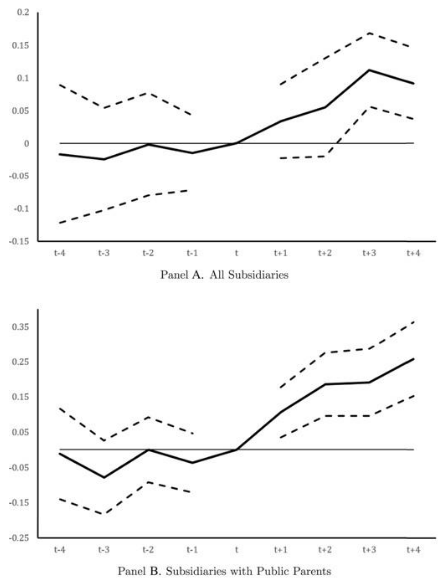
Figure 1



Source: Pat Akey and Ian Appel, 'The Limits of Limited Liability: Evidence from Industrial Pollution', *Journal of Finance*, 76(1), 2021, 12.

The grey states are those in which parent companies have always enjoyed limited liability, except for veil piercing under state law. The blue states disregarded limited liability also in case of actual control whereas, in the red states, the parent would be liable even if it could exercise control only potentially. After *Bestfoods*, all states suddenly become grey. Empirically, this is an opportunity to identify the causality of limited liability on pollution, which increased in the US after *Bestfoods*, but possibly due to other reasons. Analysing how subsidiaries with plants in blue or red states behave, after *Bestfoods*, in comparison with subsidiaries having plants in grey states allows identifying limited liability's impact on environmental damage, measured as change in pollutant emissions. According to Akey and Appel, the impact is significant: subsidiaries benefiting from limited liability increased pollutant emissions by 5% to 9%, on average, compared to subsidiaries which already enjoyed limited liability.

Figure 2



Source: Pat Akey and Ian Appel, 'The Limits of Limited Liability: Evidence from Industrial Pollution', *Journal of Finance*, 76(1), 2021, 28.

The graph in Figure 2 illustrates the increase in pollutant emissions from the year of Bestfoods (1998), indicated as time t. In the upper part of the graph, which concerns all subsidiaries affected by *Bestfoods*, one can see the significant increase in the curve's slope from time t. This shows that the subsidiaries affected by *Bestfoods* increased their emissions, year after year, up to time t + 3. In the lower part of the graph, the analysis is only about subsidiaries having a parent listed on the stock market. The increase in pollution (the curve's slope) is higher than for the universe of the subsidiaries affected by *Bestfoods*. When the parent company is listed, subsidiaries have a higher incentive to externalise environmental damage taking advantage of limited liability, probably because the managers of the parent company, who make decisions, are more sensitive to pay-per-performance.

As hinted in the previous section, companies may also make strategic use of limited liability by outsourcing dangerous activities to formally separate corporations in the supply chain. Because the study of supply chains in law & economics is relatively recent, the empirical analyses of this topic have not yet been published. However, there are two working papers showing, with a solid strategy to identify causality, that companies react to the increased liability risks from negative externalities, such as health damage or pollution, by outsourcing dangerous activities to their partners in the supply chain.

The first study by Professor Adrian Lam uses, as a natural experiment, the designation of a substance as carcinogen by the US National Toxicology Program.[37] From the moment of designation, it becomes clear that the use of the substance in the production process exacerbates health risk. Therefore, companies that use the substance face greater liability risk than companies that do not use it. By comparing the behaviour of these two types of companies, before and after the designation, causality can be established. Professor Lam's main result is that, after designation and presumably because of it, companies reduce the carcinogen's use, but the use of the substance does not decrease in the aggregate. While some companies reduce carcinogen use, others increase it, and the net impact on the negative externality is zero. Tort liability doesn't deter.

After the carcinogen designation, companies redraw their firm boundaries, and particularly their supply chains, to minimise liability risk. Firstly, companies sell assets using the designated substance. The second effect of the designation is that companies using carcinogens outsource more, that is, they stop using the carcinogen directly while buying more inputs from suppliers that may use them facing lower liability risk. This effect is, on average, statistically significant and economically large. The impact of carcinogen designation on the levels of outsourcing is four times higher if the company has already been sued for health damage.

The strategic use of supply chains to minimise liability risk is confirmed by another recent working paper by Professors Rand Duchin, Janet Gao, and Qiping Xu,

[37] Adrian Lam, 'Do Health Risks Shape Firm Boundaries?', *Working Paper* (July 2022), https://sites.google.com/view/adrianlam.

studying the asset market for industrial pollution.[38] The authors find that, following environmental risk incidents, companies divest polluting plants. While pollution does not decrease at the level of sold plants and in the aggregate, again revealing a failure of tort liability to deter negative externalities, divesting companies enjoy higher Environmental, Social, and Governance (ESG) ratings and face lower regulatory compliance costs, including liability risk. Interestingly, buyers of divested assets tend to be firms with pre-existing relationships or joint ventures with the sellers, allowing the latter to maintain their access to the sold assets.

The empirical evidence to date confirms that companies use limited liability strategically, not only in corporate groups, but also by reshaping the firm boundaries and supply chains to minimise liability risk. This strategic behaviour of corporations undermines tort liability's function to foster the internalisation of negative externalities.

5. Getting around civil liability in the CSDDD proposal

The foregoing discussion reveals that a supply chain liability is theoretically justified, as it would reduce the company's ability to externalise social harm by structuring corporate groups and supply chains strategically, to evade tort liability. This concern is also borne out by the empirical evidence. Armed with these insights, I come back to the CSDDD proposal to show that, as it stands, the liability established by Art. 22 is very easy to circumvent.

Firstly, any attempt to impose functionally unlimited liability on MNCs must reckon that limited liability is a privilege from national corporate law. For this reason, Hansmann and Kraakman's proposal included an element of extraterritoriality. Also, the CSDDD proposal seeks to impose due diligence obligations to companies outside the EU, but the effectiveness of this strategy is questionable. Companies incorporated outside the EU are subject to the Directive if they exceed a turnover threshold in the EU.[39] However, because the turnover is not consolidated, this provision can be circumvented by operating in the EU through many small companies. Most importantly, to avoid the CSDDD, it suffices for a third-country corporation to operate via subsidiaries incorporated in an EU Member State, as is normally the case. While the subsidiaries would be individually subject to the CSDDD, the CSDDD would not apply to the non-EU parent company, which might be the one where the group's net worth is concentrated.[40]

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[38] Duchin, Ran, Janet Gao, and Qiping Xu, 'Sustainability or Greenwashing: Evidence from the Asset Market for Industrial Pollution,'" *Working Paper* (October 2022), available at SSRN: http://dx.doi.org/10.2139/ssrn.4095885.

[39] See Art. 2(2) CSDDD, defining the EU turnover thresholds for high-risk sectors and in general.

[40] According to Professors Luca Enriques and Matteo Gatti, 'The Extraterritorial Impact of the Proposed EU Directive on Corporate Sustainability Due Diligence: Why Corporate America Should Pay Attention', *Oxford Business Law Blog*, 21 April 2022, https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/04/extraterritorial-impact- proposed-eu-directive-corporate, a US parent company incorporated in Delaware could be indirectly affected by the CSDDD. Under Delaware law, directors may face duty of care liability if they fail to monitor their subsidiaries. Thus, directors of a Delaware

There is another way to evade the CSDDD liability. To determine whether a company is a subsidiary, potentially exposing the parent company to liability, the CSDDD refers to the notion of 'controlled undertaking' in the Transparency Directive.[41] Thus, a company qualifies as a subsidiary for the purpose of due diligence obligations if the parent controls it, *de jure* or *de facto*, according to the Transparency Directive.[42] *De jure* control is straightforward as it stems from a majority of voting rights or the right to appoint the majority of directors. *De facto* control is defined by a vaguer notion of 'dominant influence'.[43] A simple way to get around the CSDDD is, therefore, to avoid the subsidiary designation by refraining from exercising a dominant influence on the company responsible for environmental or human rights violations, while maintaining effective control in some subtler way. This strategy would be ineffective, however, if the scope of the supply chain liability was broad enough to include the companies escaping the subsidiary designation as business partners of the parent company, which would still be subject to due diligence obligations and liable for failure to comply with them.

Ultimately, the CSDDD's ability to prevent companies from using limited liability to externalise social harm depends on the credibility of liability for the actions by business partners, i.e., of the supply chain liability. The Commission's proposal initially cast the net wide, relying on a broad definition of 'consolidated business relationships' to identify business partners and refraining from defining the 'appropriate measures' that would exclude liability, at least in the case of direct partners. The Commission's proposal was more restrictive with regards to indirect partners, for which liability could be excluded in the presence of contractual cascading and compliance verification, unless those measures were reasonably inadequate.[44] As discussed in Section 2, the EP has been sceptical about reliance on contractual cascading, but maintained the possibility for companies to escape liability by demonstrating compliance with the due diligence obligations, unless the due diligence measures were reasonably inappropriate. This approach makes the credibility of supply chain liability dependent on the burden of proof.

The Council's Political Compromise is completely different. As there are no exculpatory provisions, the credibility of supply chain liability depends on the plaintiff's ability to claim a breach of due diligence obligations and damages caused by it. Leaving aside the issue of mass claims, which is left to Member States,[45] the Council has taken quite a restrictive position on at least two conditions for liability, which may undermine effective deterrence. The first is causation: the company's

company may be liable towards their shareholders if the European subsidiaries do not comply with the EU due diligence obligations and must pay damages because of that.

[41] Art. 2(f) Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 (Transparency Directive).

[42] Art. 3(d) and Art. 6 CSDDD.

[43] Art 2(f)(iv) Transparency Directive.

[44] See *supra*, text accompanying notes 18-19.

[45] See Recital 58 in the Political Compromise:
"[T]his Directive does not regulate who can bring a claim before national courts and under which conditions the civil proceeding can be initiated, therefore this question is left to national law. For example, Member States can decide that it is only the victim who can bring the claim before national courts or that a civil society organisation, trade union or other legal entity can bring the claim on behalf of the victim."

liability is excluded when the damage is caused ‘only’ by the business partner. The second is the prioritisation of the due diligence actions whenever it is ‘not feasible’ to address all potential and actual adverse impacts. When an adverse impact on human rights or the environment may not be considered a priority, the company is not in breach of due diligence obligations and is not liable for the damages by business partners.

Not knowing which of these approaches to the liability rule will become final, I shall briefly discuss the major shortcomings of each model.

In the Commission’s and the EP’s models, the burden of proof is crucial. According to the original proposal, a company could avoid liability for the indirect partners’ actions by implementing contractual cascading, that is, requiring contractual partners to request compliance with the code of conduct from their contractual partners and so forth, provided that contractual cascading be accompanied by compliance verification. Because both cascading and compliance verification could be standardised, to prevent box-ticking the Commission added, as a ground for liability, the reasonable inadequacy of these measures to achieve the goals of due diligence. The question is who is to prove the inadequacy. If the burden of proof is on the victim, the liability for actions by indirect partners is effectively muted because the victim does not know or cannot easily learn about the company's procedures. Think of an NGO that wants to protect children being exploited in Africa by some indirect partner of a European manufacturing company. How could such an NGO provide evidence that the company procedures to deal with supply chain partners are inadequate? This rule would work better if the burden of proof was reversed. In this case, box-ticking would no longer be sufficient to avoid liability because the company should demonstrate that its due diligence procedures are reasonably adequate ‘to prevent, mitigate, bring to an end or minimise the extent of the adverse impact.’

The EP’s version of Art. 22 has a similar structure. It allows the defendant to escape liability by demonstrating compliance with all due diligence obligations, not just contractual cascading. Yet, the company would still be liable if it is unreasonable to expect that the action actually taken is an appropriate measure to achieve the goals of the Directive. Also this text doesn’t specify the burden of proof. However, the EP is aware that the victim typically lacks access to evidence and acknowledges that in the amended version of Recital 58 stating that “the company will be responsible for producing evidence to prove it complied with the Directive.”[46] This suggests that the defendant should prove the appropriateness of the measures actually taken, after “the claimant provides prima facie elements substantiating the likelihood of the defendant’s liability.”[47] This language and particularity Recital 58 are significantly different from the original CSDDD proposal. In the Commission’s version of Recital 58, the EU legislature basically washed its hands of the burden of proof issue, leaving to national law the question of who should prove the reasonable adequacy of

[46] Amendment 43 Wolters Report.
[47] Art. 22 CSSDD, Amendment 198 Wolters Report.

the measures. As I argued in the past,[48] this approach may be even worse than a uniform EU rule as it is likely to trigger a race-to-the-bottom among EU jurisdictions.

The Council's Political Compromise came up with a more structured EU liability rule, though that seems even easier to get around than the original Commission's rule. First of all, the Council reinstates the agnostic EU approach to the burden of proof.[49] Secondly, the new formulation of Art. 22 makes the burden of proof less relevant as it lines up four conditions for liability, which are typically for the plaintiff to show: i) a breach of duty; ii) a company's fault; iii) a damage; and iv) the causal link between the breach and the damage. On causation, Art. 22 now specifies that a company cannot be liable if the damage was caused only by the business partners in the value chain of activities, i.e., a direct or indirect upstream partner or a direct downstream partner of the company. This provision brings into play the doctrine of break of causation chain (*novus actus interveniens*), on which different jurisdictions have different approaches.[50] The relevant question is whether the failure to carry out due diligence is sufficient to cause the damage jointly with the business partner that did it, triggering the joint and several liabilities of the company as is now explicitly provided for.[51] Some jurisdictions will require that the company's failure is a *condicio sine qua non* of the damage by the partner, for others it will be sufficient that it is one of the contributing factors. This will likely create the regulatory arbitrage situation I hinted at before: companies will tend to locate where the causal link between the breach of due diligence and the damage done by the business partner is easier to exclude.

Limiting the scope of liability on the grounds of causation has always been criticised by the law & economics literature because this undermines the tortfeasors' incentive to internalise negative externalities, including contemplating the low-probability consequences of their actions (or inactions). In fact, the doctrine of foreseeability, which limits causation to the damages that can be reasonably foreseen and is tantamount to the break of causal link exception to supply chain liability, reduces the incentive to monitor and is economically justified only when foreseeing remote damages would be too expensive.[52] The Council's approach therefore defies the CSDDD's purpose to foster internalisation of externalities by MNCs to the extent that it undermines the deterrence of supply chain liability and the monitoring incentives stemming from it.

Moreover, the Council's Political Compromise confines the due diligence obligations to adverse impacts that should have been prioritised according to criteria that are currently very vague. Prioritisation is allowed when it is 'not feasible' to address all

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48 Alessio M. Pacces, 'Supply Chain Liability in the Corporate Sustainability Due Diligence Directive Proposal', *ECGI Blog*, 12 April 2022, https://www.ecgi.global/blog/supply-chain-liability-corporate-sustainability-due-diligence-directive-proposal.

49 See Recital 58 in the Political Compromise:
"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."

50 Penelope A. Bergkamp, 'Models of Corporate Supply Chain Liability', *Jura Falconis*, 55(2), 2018, 185.

51 Art. 22(3) in the Political Compromise.

52 Omri Ben-Shahar, 'Causation and foreseeability', in: Michael Faure, *Tort Law & Economics*, 2009, Edward Elgar, 100-101.

the adverse impacts.[53] Feasibility, however, is a matter of cost and the legislature is silent on what can be considered too expensive to address. The same criticism applies to actual prioritisation. Assuming that all adverse impacts can be ranked based on their severity and likelihood, as required by the Council's text, where should one draw the line above which the impacts are 'significant' and must be addressed 'in a reasonable time'? As a result, companies who are sued for breach of due diligence obligations will have an additional way to escape liability by arguing that the damage occurred in parts of their supply chains that couldn't be prioritised.[54]

6. Conclusion

Corporations have been using limited liability to avoid tort liability and externalise damages to society, as confirmed by economic theory and empirical evidence. In the context of environmental and human rights protection, the CSDDD proposal could potently ameliorate this situation by establishing civil liability for failure to carry out due diligence in the relationship with subsidiaries and business partners in the supply chain. Facing supply chain liability, companies could not get away with environmental harm or human rights violations simply by using subsidiaries or outsourcing harmful activities to remote business partners.

Unfortunately, the analysis of the CSDDD proposals currently on the table of EU institutions reveals important loopholes in the civil liability rule, which undermine its effectiveness. Companies seem to be able to evade liability either by choosing a favourable regime of the burden of proof, or by making it more difficult for victims to claim damage causation by due diligence failure through the choice of incorporation or the design of complex supply chains.

[53] Art. 6a in the Political Compromise.

[54] More along these lines could be said about the criteria laid down in the Council's text to determine whether the due diligence measures are 'appropriate', which indirectly define the fault requirement of the supply chain liability. I leave this discussion for another day. See Art. 7(1) and 8(1) in the Political Compromise.

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