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CAN THE THREAT OF COSTLY LITIGATION BE INCENTIVE
ENOUGH FOR COMPANIES TO ENGAGE IN CSR?

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Abstract

In 1970 Milton Friedman wrote “[t]he social responsibility of business is to increase profits” (p. 122). Today there are voices advocating that engaging in CSR is in the direction of increasing profits. It is also argued that engaging in CSR helps firms alleviate some of the risks associated with the uncertain environments in which they operate. This research aims to look at the question of whether the threat of costly litigation can provide an incentive to firms to engage in CSR. We built a model where a firm and an interested party engage in litigation. The firm operates in a market and earns profits and can engage in a level of CSR which will determine the probability that damage will be caused by the firm. An interested party affected by the damage claims compensation. The firm and interested party may settle out of court or the plaintiff may bring the case to court. We assume that besides damages, the firm’s investment in CSR affects the plaintiff’s probability of winning at trial. We find that investment in CSR reduces the amount of cases brought to court and at the same time increases the probability of a case settling out of court. We also find some ambiguity regarding the effect of CSR on settlement offers with the driving forces here being on the one hand the reduction in the probability of the plaintiff winning trial and the increase in the probability of settlement and the level of court costs on the other hand. We conclude that there is incentive for firms to invest in CSR in order to avoid costly litigation

Keywords

Corporate Social Responsibility, Litigation, Settlement, Incentives

Introduction

There is general consensus that Corporate Social Responsibility (CSR) is a voluntary engagement. The practice of CSR is not mandated and the choice to engage in it as well as the level of engagement is left to firms themselves to decide. According to Siegel and Vitaliano (2007, p.1) “CSR occurs when firms engage in activity that appears to advance a social agenda beyond that which is required by the law”. According to the Commission of the European Communities (2007, p. 5) “CSR is the voluntary integration of environmental and social considerations into business operations, over and above legal requirements and contractual obligations”. The focus of the Commission is on designing policies to promote and support socially responsible behaviour from the side of business. In the direction of identifying and promoting incentives for companies to engage in CSR the Commission suggests a set of “CSR instruments” (Commission of the European Communities, 2007), which include social and environmental reporting requirements, auditing and certification of responsible corporate behaviour, increasing the awareness of the public (with a specific mention to the role of consumers), communicating CSR initiatives by business, issuing a European Code of Conduct¹ to set common requirements for socially responsible corporate behaviour. In the same direction with the EU guidelines are the OECD Guidelines for Multinational Enterprises (OECD, 2000) as well as the UN Global Compact (UN, 2008), which stress the voluntary nature of CSR and at the same time aim at promoting and supporting CSR among business. So, if CSR is a voluntary engagement, what drives business to be socially responsible?

The public call that business shows a socially responsible face is increasingly persistent, and evidence shows that business does indeed make efforts to demonstrate a socially responsible face, to convince the public of its social engagement and its concern about society and the totality of stakeholders involved in or affected by its operations². In 1970 Milton Friedman wrote “[t]he social responsibility of business is to increase profits” (p. 122). Today there are voices advocating that engaging in CSR is in the direction of increasing profits. It is also argued that engaging in CSR helps firms alleviate some of the risks associated with the uncertain environments in which they operate.

A lot has been said by both academics and business people about the business case for CSR³, and about how firms’ incentives to do CSR are linked to their efforts to enhance their business. As Porter and Kramer (2006, p. 3) put it “CSR can be much more than a cost, a constraint of a charitable deed – it can be a source of opportunity, innovation and competitive advantage”. So CSR is described as a way to appeal to consumer preferences and to open new markets, as a way to maintain good relations with suppliers, partners and with the totality of stakeholders, and as a way to avoid the risks associated with boycotts and their adverse effects to firms’ operations and reputation.

In the direction of designing policies to promote and support CSR among business, one strand of the debate deals with the use of legal instruments and the facilitation of wider access to justice to promote incentives for CSR. As put by Williams and Conely (2005, p. 86) legal instruments and self-regulation (CSR) “may reinforce each other”. To this direction the Commission of the European Communities (2007, p. 9) “[b]elieves that CSR policies can be enhanced by better awareness and implementation of existing legal instruments” and makes a call “to implement a mechanism by which victims, including third-country nationals, can seek redress against European companies in the national courts of the Member States” (p. 8). Similarly, a case is made in favour of extending the use

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- 1 A code of conduct is one type of instrument that companies have resorted to, to demonstrate self-regulation and compliance to the demand for social responsibility.
 - 2 A few examples of this engagement are companies issuing codes of conduct where they make special references to their duties to society, or engaging in philanthropy, environmental projects, and taking part to community projects.
 - 3 See for example Cochran and Wood, (1984), Waddock and Graves, (1997), Baron, (2001), Feddersen and Gilgigan, (2001), Arora and Gangopadhyay, (1995), Innes, (2006) Porter and Kramer (2006).

of the Alien Tort Claims Act⁴ as a way to push for more CSR from the side of business (see for example, Williams and Conley (2005), Fried Frank (2007), Ruggie (2008)). In fact Shamir (2004) argues that there is a direct relationship between offering wider access to legal instruments and incentives to engage in CSR, as he argues that while corporations strongly oppose the use of the Alien Tort Claims Act at the same time they invest considerable resources to CSR to demonstrate that the use of the Alien Tort Claims Act is not necessary as they are being good corporate citizens respectful of society. In the direction of using legal instruments to foster CSR, some jurisdictions have examined whether corporations can be held liable for criminal liability based on their corporate culture⁵ (Allens Arthur Robinson, 2008; Ruggie, 2008). “Australia, in particular, has introduced provisions holding corporations directly liable for criminal offences in circumstances where features of a corporation, including its ‘corporate culture’, directed, encouraged, tolerated or led to the commission of the offence” (Allens Arthur Robinson, 2008, p. 2).

Regarding the link between the use of legal action and facilitating wider access to justice and firms’ incentives to engage in CSR, it has been argued in the literature that firms use self-regulation to avoid costly formal regulation (actual or potential) and legal costs (litigation). Levis (2006, p. 51) argues that “[l]itigation and not only public regulation may challenge corporate strategies and explain managers’ recent interest for CSR Codes of conduct.” In the same line of argument, Kolk et al (1999, p. 152) write, “[t]hus, codes of conduct are drawn up to anticipate or prevent mandatory regulation.” Finally, Maxwell et al (2000) present a model where companies engage in environmental self-regulation to preempt strict regulatory action.

Despite the interest in the matter of whether companies do indeed resort to self-regulation as a means to avoid litigation, or whether the threat of legal action can play the role of an incentive mechanism for companies to engage in CSR, a formal model examining the company’s choices of care in the form of CSR (like for example by issuing a code of conduct, or putting together an employee development programme, or investing in enhancing the quality of its product) or out of court settlement choices has not been developed. This research aims to look at the question of whether the threat of costly litigation can provide an incentive to firms to practice CSR. Existing literature on litigation has a lot to say about the effects of care levels on litigation, the probabilities of settlement, or the effects of different regimes of allocating litigation costs. For example, Landes (1971), Gould (1973), Posner (1973) and Shavell (1982) consider the question of incentives to suit, as well as terms of settlement, likelihood of settlement and the effects of different cost allocation rules on that. Issues of information asymmetries among parties have been dealt with, among others, in P’ng (1983), Bebchuk (1984), Reinganum and Wilde (1986), Farmer and Pecorino (1994).

With this research we are not aiming to expanding the current literature on litigation. Instead we are interested in applying lessons from that literature to the specific questions relating to CSR and firms’ incentives to be socially responsible. For this reason we base our research on the simple model of litigation developed in Gravelle (1993). We consider a case of a firm that operates in a market, produces a product and earns profits. The firm chooses to produce its product incorporating a level of CSR in its operations, where we assume that CSR can take any form the firm wishes⁶. Depending on the level of CSR a certain level of damage is caused (the higher the level of CSR the less likely that

4 According to the Alien Tort Claims Act cases can be brought to US federal courts by “an alien for a tort only, committed in violation of the law of nations or a treaty of the United States” (U.S.C., 1789).

5 “Corporate culture refers to the character of a company’s internal work climate – as shaped by its core values, beliefs, business principles, traditions, ingrained behaviors, work practices, and styles of operating” (Thompson et al, 2008).

6 We do not distinguish among the different forms that CSR can take. However, we acknowledge that different forms of CSR would appeal in a different way to different people and that similarly different forms of social irresponsibility would harm in different ways and to different extends different people. However, at this point adding different types of CSR to the model would only add complexity to the analysis without adding value to the study of the problem that is in the focus of this paper, namely the incentives of firms deriving from their effort to avoid costly litigation. Considering different types of CSR could be an extension to the model presented here.

damage will be caused). We assume there is an interested party which is affected by the damage and claims compensation for it. This interested party can be an individual or an interest group such as for example an NGO or a consumer organization. So we envisage a model with a plaintiff – the interested party – and a defendant – the firm – who engage in litigation. The timing is as follows. Once the damage is done and the claim is made, the defendant can make a settlement offer to settle the case. If the settlement is not accepted by the plaintiff then the firm is taken to court. At court we assume that the defendant may lose the case according to a probability distribution which is a function of the level of CSR care taken by the defendant – at this point our model differs from that of Gravelle (1993) where the likelihood of the plaintiff winning the case is not a function of the defendant’s care level. Also, although Gravelle (1993) considers the effects of different cost allocation rules to the outcomes of the litigation we are not interested in this question. We want to examine how the possibility of litigation affects the firm’s decision to engage in CSR. This we will see by examining the effect of care on the settlement offer, the probability of settlement, as well as the number of cases been taken to court. We would like to relate our conclusions to policy formation and examine whether, given that CSR in itself is not mandated, it would make sense to strengthen the courts’ rulings in cases of claims from irresponsible corporate behaviour. In the following section the litigation model is presented, post-accident and pre-accident choices are considered, and the effects of the firm’s choice of CSR are considered. In the final section of the paper the implications of the litigation process and the firm’s choice of CSR are discussed. Also, areas for further research are identified.

The Model

We assume a firm which operates in a market and makes profit and which can choose to engage in a level of CSR (of any form it wishes), which we call r . The choice of r determines whether some kind of damage will be caused according to a distribution function $f(r)$, for which we assume that $f'(r) < 0$, $f''(r) > 0$. Damage can take the form of an accident for example or the form of damage caused to the environment. Damage is in the range of $[0, \bar{d}]$ and follows a distribution function $Q(d)$. The defendant does not observe the level of damage d but knows the distribution function $Q(d)$. We assume that the damage affects an interested party which claims compensation. So we envisage a model with a plaintiff – the interested party – and a defendant – the firm. The defendant makes a settlement offer S to compensate the plaintiff for the damage. The plaintiff may accept or reject the offer. If the offer is rejected then the case goes to court, where the plaintiff wins the case with a probability $\phi(r)$, for which we assume $\phi'(r) < 0$, $\phi''(r) > 0$, so that higher engagement in CSR makes the plaintiff’s case weaker⁷, and is awarded full damages d . We assume that if the case goes to court the plaintiff pays a fraction α of the court costs while the defendant pays the remaining $1 - \alpha$ of the costs which are assumed to be F . Finally, we assume the plaintiff is risk neutral.

Post-accident

After the accident has occurred and the case has been filed the plaintiff will accept the settlement offer if $S \geq \phi(r)d - \alpha F$ where $\phi(r)d - \alpha F$ is the plaintiff’s payoff from trial. Indifference between accepting and rejecting the offer is characterized by the condition $S = \phi(r)d - \alpha F$ which determines a threshold point

$$\tilde{d} = \frac{S + \alpha F}{\phi(r)}$$

such that for $d \leq \tilde{d}$ the settlement is accepted while for $d > \tilde{d}$ the case goes to court, which means

⁷ This is in accordance with Allens Arthur Robinson (2008) and Ruggie (2008) according to whom features of a corporation such as corporate culture are being used to decide whether a corporation should be held liable for criminal liability and to determine the level and type of sentence to be imposed.

that the case will settle out of court with a probability $Q(\tilde{d})$.

The defendant chooses the settlement offer S to minimize post-accident costs

$$C = Q(d)S + (1 - Q(d))\phi(r)\int_d^{\bar{d}} DdQ + (1 - Q(d))(1 - \alpha)F$$

where $Q(d)S$ is the expected cost of settlement, the term

$$(1 - Q(d))\phi(r)\int_d^{\bar{d}} DdQ$$

is the level of expected damages that the defendant will be called to pay in case the case goes to court and the last term

$$(1 - Q(d))(1 - \alpha)F$$

is the level of the defendant's expected court costs.

The defendant's choice of S is determined by the first order condition

$$\frac{\partial C}{\partial S} = Q(d) + \frac{q(d)}{\phi(r)}S - q(d)\left[\frac{\bar{d}^2}{2} - \frac{((S + \alpha F)/\phi(r))^2}{2}\right] - (1 - Q(d))\frac{S + \alpha F}{\phi(r)} - \frac{q(d)}{\phi(r)}(1 - \alpha)F = 0$$

and the second order condition

$$\frac{\partial^2 C}{\partial S^2} = 2\frac{q(d)}{\phi(r)} + \frac{q'}{\phi(r)}\left[\frac{S - (1 - \alpha F)}{\phi(r)} + \frac{((S + \alpha F)/\phi(r))^2 - \bar{d}^2}{2}\right] + 2q(d)\frac{S + \alpha F}{(\phi(r))^2} - \frac{1 - Q(d)}{\phi(r)} > 0$$

We call the defendant's optimal choice of settlement $S^* = S(d, r, \alpha, F)$ which in turn determines the defendant's post-accident expected cost $C^* = C(S^*, d, \alpha, F, r)$ ⁸.

Pre-accident

Before the accident happens the defendant chooses the level of CSR to maximize pre-accident welfare which is given by

$$W_D = \pi^n - r - f(r)C^*$$

where the first term is the firm's net profit (which we assume to be independent of expenditure in CSR⁹) the second term is the investment in CSR and the third term is the minimized expected post-accident cost. The condition for maximizing pre-accident welfare with respect to r is

$$\frac{\partial W_D}{\partial r} = -1 - \frac{\partial f(r)}{\partial r}C^* - f(r)\frac{\partial C^*}{\partial r} = 0$$

This says that the marginal cost of CSR (which is equal to -1), should equal the marginal benefit from CSR. The marginal benefit is twofold, there is one direct benefit which results from reducing the potential post-accident costs and that is $f(r)\frac{\partial C^*}{\partial r}$, and an indirect benefit which results from reducing the probability of causing damage which is $\frac{\partial f(r)}{\partial r}C^*$. From this we get the defendant's optimal choice of CSR, $r^* = r(S^*, d, \alpha, F)$.

8 Note that as the choice of the settlement offer is endogenized a choice of $S = 0$ would imply that the defendant is better off not making any settlement offer and taking the case directly to court.

9 This assumption is to isolate the effect of potential litigation costs to the firms' choice of CSR abstracting from any demand consideration. We acknowledge that CSR may affect the sales of the firms products, however, at this stage we are interested in the role of CSR as a mechanism to avoid risks rather than to enhance business.

The effects of investing in CSR

In this section we will consider the effects of investing in CSR. More specifically we will look at the effect of CSR on settlement acceptance levels, on the probability of settlement and the on ex ante probability of trial. We will also look at the effect of investment in CSR on the level of the defendant's settlement offer and finally the effect of increasing post-accident costs on the defendant's decision to invest in CSR.

The immediate thing that we can say about the effect of CSR is that for a given level of settlement offer, investing in CSR increases settlement acceptance levels and the probability of settlement and decreases the ex ante probability of trial. Starting from acceptance levels, the threshold level for a certain settlement offer to be accepted is given by

$$d = \frac{S + \alpha F}{\phi(r)}$$

so that

$$\frac{\partial d}{\partial r} = \frac{-(S + \alpha F)\phi'(r)}{(\phi(r))^2} > 0$$

This says that, for a given settlement offer, when the level of CSR increases the threshold/acceptance level increases and thus it is more likely that the plaintiff's damages will be below the threshold level and that settlement will be accepted. In other words, for a given settlement offer, higher CSR increases the probability of settlement. Regarding the ex ante probability of trial, this is given by $f(r)(1 - Q(r))$. Differentiating this with respect to r yields

$$\frac{\partial [f(r)(1 - Q(d))]}{\partial r} = f'(r)(1 - Q(d)) - f(r) \frac{\partial Q(d)}{\partial r}.$$

This is negative because $f'(r) < 0$ and because higher investment in CSR increases the probability of settlement. What this means is that higher CSR will decrease the ex ante probability of a case going to trial. This will be done in two different ways. On one hand higher CSR will reduce the probability of an accident taking place ($f'(r) < 0$) and thus in this case less cases will be brought to court, and on the other hand higher CSR will increase the probability of settlement and thus again less cases will be brought to court. Of course the above do not capture the total effect of r on acceptance levels, probability of settlement and ex ante probability of trial, but only the effect of r for a given level of settlement. But, the settlement offer is a function of the level of CSR.

Unfortunately the effect of CSR on the level of the settlement offer is very difficult to determine even if we assume that damages follow a specific distribution function, for example a normal distribution. Assuming a normal distribution and using the first order condition for S we get

$$\frac{\partial S}{\partial r} \frac{\partial^2 C^*}{\partial S^2} = \phi'(r) \left[\frac{S + \alpha F}{\phi(r)} \frac{\partial^2 C^*}{\partial S^2} - \frac{q(d)}{\phi(r)} F \right]$$

In the above $\frac{\partial^2 C^*}{\partial S^2} > 0$, $\phi'(r) < 0$ and $\frac{S + \alpha F}{\phi(r)} = d$. So with respect to the effect of CSR on the settlement level there are two parallel forces into play. Higher r increases the acceptance level and thus increases the probability of a settlement offer being accepted (intuitively this should reduce the settlement level). At the same time a higher r decreases the probability of the plaintiff winning the case and thus decreases the expected trial costs for the defendant (in other words increases the defendant's incentives to go to trial and thus reduce the settlement offer). What seems to be determining the direction of S is the level of court costs. So for

$$\frac{S \frac{\partial^2 C^*}{\partial S^2}}{q(d) - \alpha \frac{\partial^2 C^*}{\partial S^2}} > F$$

or in other words for court costs that are small enough, the settlement offer is decreasing in the level of CSR. If on the other hand the court costs are high enough then the effects of CSR on acceptance levels and the plaintiff's probability of winning trial are offset by the fact that by going to court the defendant will have to pay the high costs and thus the settlement offer increases to avoid these costs.

Similarly it is difficult to determine the effect of increasing the defendant's post-accident costs on the level of care in the form of CSR that the defendant will choose to take. To see this, we use the first order condition of pre-accident welfare with respect to r and differentiate with respect to r to get

$$\frac{\partial r}{\partial C^*} = - \frac{2f'(r)}{f''(r)C^* + f(r) \frac{\partial^2 C^*}{\partial r^2}}$$

This says that the sign of $\frac{\partial r}{\partial C^*}$, and thus the effect of increasing post-accident costs on the level of CSR, is determined by the sign of

$$f''(r)C^* + f(r) \frac{\partial^2 C^*}{\partial r^2}$$

since the numerator of the fraction is negative. So for the effect of an increase of post-accident costs to lead to an increase in the level of investment in CSR by the firm it suffices that the above expression is positive. On the one hand increased post-accident costs cause the defendant not to want to cause an accident and thus to want to increase investment in CSR in order to reduce the likelihood of damages. However, increasing CSR decreases the probability of a case been brought to trial and the probability of the plaintiff winning at trial and thus pushes potential post-accident costs down. As a result, the effect of increasing post-accident costs on the firm's choice of CSR is ambiguous.

Discussion and Conclusions

CSR is defined as a voluntary engagement "over and above legal requirements and contractual obligations" (Commission of the European Communities, 2007, p. 5). However, there appears to be a role for legal instruments in the direction of providing incentives for firms to engage in CSR. This paper's aim was to examine whether the potential of being faced with costly litigation can provide incentives to firms to invest in CSR. We have developed a simple model of litigation following Gravelle (1993), with a defendant – a firm which operates in a market, earns profit and can cause damage depending on the level of CSR that it engages in – and a plaintiff – an interested party which is affected by the damage and claims compensation for it. Our model differs from that of Gravelle (1993) in that we endogenise the probability of the plaintiff winning the case in court, in accordance with literature which argues that the firms 'character' – the way it goes about doing its business – is used as a determinant to establish liability (Allens Arthur Robinson, 2008; Ruggie, 2008).

We find that for a given settlement offer the firm's investment in CSR increases the settlement acceptance level, and thus increases the probability of a case settling out of court. This is done through increasing the plaintiff's willingness to settle the case since an increase in the level of care from the side of the defendant in the form of CSR decreases the plaintiff's probability of winning the case in court. Also, we find that for a given level of settlement, more care from the side of the defendant in the form of CSR reduces the ex ante probability of a case going to court. This means that extra care in

CSR decreases the number of cases going to court. This is done both through decreasing the plaintiff's willingness to take a case to court but also through decreasing the likelihood of damages in the first place.

Although we cannot draw unambiguous conclusions about the effect of CSR on the defendant's settlement offer, we can provide intuition about the forces determining this effect. Higher CSR increases the probability of settlement which intuitively would imply that the settlement offer tends to be reduced. Reinforcing to this effect, higher CSR decreases the plaintiff's probability to win at trial which increases the defendant's incentives to go to trial and thus offer a lower settlement which the plaintiff will not accept and take the case to trial. However, what seems to play a decisive role is the level of court costs. If the court costs are low enough then the two forces described above dominate and higher investment in CSR decreases the settlement offer. If however, court costs are high, then these high court costs dominate over the two forces of CSR increasing settlement acceptance level and lowering plaintiff's probability of winning at trial and higher CSR increases the settlement offer.

The last thing that we examine is the effect of increasing the defendant's post-accident costs on the defendant's incentives to invest in CSR. Unfortunately we cannot derive unambiguous results but we can identify opposing forces affecting the defendant's choice. On the one hand increased post-accident costs cause the defendant not to want to cause an accident and thus to want to increase investment in CSR in order to reduce the likelihood of damages. However, increasing CSR decreases the probability of a case being brought to trial and the probability of the plaintiff winning at trial and thus pushes potential post-accident costs down. As a result, the effect of increasing post-accident costs on the firm's choice of CSR is ambiguous.

In terms of policy towards CSR, our research supports the idea that making use of legal instruments and making possible wider access to legal action can raise companies' incentives to practice CSR. As put by the Commission of the European Communities "CSR policies can be enhanced by better awareness and implementation of existing legal instruments" (2007, p. 9). and "implement[ing] a mechanism by which victims, including third-country nationals, can seek redress against European companies in the national courts of the Member States" (2007, p. 8) seems to be in the direction of increasing CSR engagement by business. As shown above, for the defendant the threat of having to stand before a court and defend its case increases its incentives to invest in CSR in order not to cause the damage in the first place but also in order to increase the probability of settlement. This incentive is increased if the court costs are substantially high.

Of course the strength of the use of legal instruments and of facilitating wider access to justice as a means to promote firms' incentives to engage in CSR is determined by whether interested parties choose to pursue their cases when damage occurs. However, the complications of the legal system, the inability of some mechanisms to resolve cases brought against corporations and to provide remedies, the cost of pursuing a legal case as well as ignorance among other factors mean that cases are often not pursued. This is one more argument in favour of facilitating wider access to justice and making legal instruments more effective.

One obvious way to extend the analysis in this paper is to take account of the effects of CSR on the firm's profit. In this paper we have ignored the effect of CSR investment on the profits of the firm by assuming that the firm's net profit is not a function of CSR and that CSR takes the form of a fixed cost equal to c . However, CSR may affect a firm's profit in so many ways. For example CSR may increase the per unit cost of the firm's product. Or it may increase the firm's sales by giving it a reputation among consumers that it is socially responsible. Alternatively it may increase the productivity of its employees who may feel rewarded to be more productive by taking pride from working in a socially responsible firm. Also, besides ignoring the effect of CSR on net profits, we have ignored other costs from causing damage for the firm besides litigation costs, such as for example damaged reputation costs. More interestingly, this paper should be extended to the direction of incorporating the costs of

allowing wider access to justice and of conducting a welfare analysis of promoting CSR as a response to the threat of litigation.

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