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 practicing 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 firms operate. This research aims to look at the question of whether the threat of costly litigation can provide an incentive to firms to practice CSR. We built a model where a firm and an interest group 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 interest group affected by the damage claims compensation. The firm and interest group 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 important forces there being on the one hand the reduction in the probability of the plaintiff winning trial and the increase in the probability of settlement. We conclude that there is incentive for firms to invest in CSR in order to avoid costly litigation.

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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 the EU (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 EU, is on designing policies to promote and support socially responsible behaviour from the part of business. In the direction of identifying and promoting incentives for companies to practice CSR the EU 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 (there is specific mention to the role of consumers), communicating CSR initiatives by business, issuing a European Code of Conduct to set common requirements for socially responsible corporate behaviour. A code of conduct is one type of instrument that companies have resorted to, to demonstrate self-regulation of CSR and compliance to the demand for social responsibility. In the same direction with the EU guidelines are the OECD Guidelines for Multinational Enterprises (OECD, 2000) as well as the UN Global Combat (UN, 2008), which stress the voluntary nature of CSR and at the same time aim at promoting CSR among business. So 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 operations. However, despite the common consensus from the public regarding the need for CSR and the popular trend among business to appear as socially responsible, Votav’s (1972, p. 25) words that “corporate social responsibility means something, but not always the same thing to everybody” are still valid in our days. In 1970 Milton Friedman wrote “[t]he social responsibility of business is to increase profits” (p. 122). Today there are voices advocating that practicing 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 firms operate.

A lot has been said by both academics and business people about the business case for CSR. As Porter and Kramer (2006, p. 3) put it “CSR can be much more than a cost, a constraint of a charitable deed – it

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can be a source of opportunity, innovation and competitive advantage”. However, it is quite often that the firms’ incentives to show a socially responsible behaviour have been questioned. For example, it has been argued in the literature that firms use self-regulation to avoid costly formal regulation and legal costs (litigation). For example, Maxwell et al (2000) present a model where companies engage in environmental self-regulation to preempt strict regulatory action. 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.” Referring to the Alien Tort Claims Act and the attempts made to use the act as a basis for their legal claims against multinational corporations Shamir (2004) argues that while corporations are more than happy to issue codes of conduct, they strongly oppose to the use of the act as a basis for legal action.

In the direction of making use of legal instruments and making possible wider access to legal action to raise companies incentives to practice CSR the EU “[b]elieves that CSR policies can be enhanced by better awareness and implementation of existing legal instruments” (Commission of the European Communities, 2007, p. 9) and “[c]alls on the Commission 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” (Commission of the European Communities, 2007, p. 8).

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 practice 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, 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). We are not interested in expanding the current literature on litigation. Instead we are interested in applying lessons from that literature to the specific questions relating to CSR and the incentives to practice it. For this reason we base our research to 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 wishes. Depending on the level of CSR a certain level of damage is caused (the higher the level of CSR the less likely that damage will be caused). We assume there is an interest group which is affected by the damage and claims compensation for it. So we envisage a model with a plaintiff – the interest group – 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 interest group 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 or CSR care taken by the defendant – this is the difference of our model with 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 Grevelle (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 settling as well as the number of cases being taken to court. We would like relate our conclusions to policy formation and examine whether, given that CSR in itself is not mandate, it would make sense to strengthen the courts’ rulings in cases of claims from irresponsible corporate behaviour.

THE MODEL

We assume a firm which operates in a market 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 interest group which claims compensation. So we envisage a model with a plaintiff – the interest group – 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 $\phi'(r) < 0, \phi''(r) > 0$, and is awarded full damages $d$. We assume that if the case goes to court the
plaintiff pays a fraction $\alpha$ of the court costs while the defendant pays the remaining $1 - \alpha$ of the costs which are assumed to be $F^4$. We assume that both the plaintiff and the defendant are risk neutral.

**Post-accident**

After the accident has occurred 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

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

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

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

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

$$(1 - Q(d))\phi(r)\int_{d}^{\tilde{d}} DdQ$$

is the 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 defendant’s expected court costs.

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

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

and the second order condition

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

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 $C^* = C(S^*, d, \alpha, F, r)$.

**Pre-accident**

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

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$^4$ I should say something here about the allocation of court costs.
\[ W_D = \pi^n - r - f(r)C^* \]

where the first term is the firm’s net profit (which we assume to be independent of expenditure in CSR) the second term is the investment in CSR and the third term is the minimized expected post-accident cost. The condition for minimizing pre-accident costs 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 \( r^* = r(S^*d, \alpha, F) \).

**The effects of investing in CSR**

Here we will consider what are the effects of investing on CSR. More specifically we will look at the effect of CSR on settlement acceptance levels, on the probability of settlement and the ex ante probability of trial. We will also look at the effect of investment on 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 on CSR.

The immediate thing that we can say about the effect of CSR is that for a given level of settlement offer, investing on CSR increases settlement acceptance levels and the probability of settlement and decreases the ex ante probability of trial. Stating 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. However, the settlement offer is a function of the level of CSR itself.

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. With a normal distribution and using the first order condition for \( S \) we get

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

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 opposing forces into play. On the one hand higher \( r \) increases the acceptance level and thus increases the probability of a settlement offer being accepted (intuitively this would reduce the settlement level) but 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).

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

\[
\frac{\partial W_D}{\partial r} = 0
\]

and differentiate with respect to \( r \) to get

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

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 no 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 post-accident costs down. As a result, the effect of increasing post-accident costs on the firm’s choice of CSR is ambiguous.

CONCLUSIONS

CSR is defined as a voluntary “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 the firm engages in – and a plaintiff – an interest group which is affected by the damage and claim compensation from it. The difference of our model from that of Gravelle (1993) is that we endogenise the probability of the plaintiff winning the case in court.

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 court. This means that extra care in CSR decreases the number of case 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 drive unambiguous conclusions about the effect of CSR on the defendant’s settlement offer, we can conclude that there are two forces determining this effect. On the one hand higher CSR increases the probability of settlement which intuitively would imply that the settlement offer tends to be reduced but on the other hand 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.

The last thing that we examine is the effect of increasing the defendant’s post-accident costs on the defendant’s incentives to invest on CSR. Unfortunately again 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.
been brought to trial and the probability of the plaintiff winning at trial and thus pushes 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 EU “CSR policies can be enhanced by better awareness and implementation of existing legal instruments” (Commission of the European Communities, 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” (Commission of the European Communities, 2007, p. 8) seems to be in the direction of increasing CSR engagement by business.

One obvious way to extend the analysis in this paper is to take account of the effects of CSR in the firm’s profit. In this paper we have ignored the effect of CSR investment in 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 \( r \). 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.
References


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