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# *The Plural -and Misleading- Notion of Economic Loss in Tort: A Law and Economics Perspective*

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## *Abstract*

The economic loss notion and its associated non-recovery rule have puzzled lawyers and courts in Common Law systems for a long time. Civil Law systems have also dealt with similar cases as those considered under the concept of economic loss, although using different doctrinal instruments. The paper analyses the consistency of the economic loss concept, and concludes that it has no normative value and very little, if any, descriptive and orientative value.

The major theories, both economically oriented and non-economical, in search for a unified rationale of the notion of economic loss, are reviewed and criticized. Finally, a pluralistic Law and Economics approach is presented and argued, on the basis of the subrogation principle, the search for social losses in foregone sales cases, the surrogate character of economic loss in failed contractual liability situations, and the liability of gatekeepers.


## *Summary*

## 1. Introduction

Tort Law operates through liability rules making injurers liable for harm caused to victims. Liability depends on the fulfillment of certain preconditions, referring, *inter alia*, to the injurer's behavior, the connection in causal terms between behavior and harm, the proximity of this causal connection (*imputación objetiva*, *objektive Zurechnung*), and, eventually, the nature of the harm. Along the latter dimension –that defining the boundaries of recoverable harm- one of the most relevant instruments to determine under what conditions a given harm would give rise to the injurer's liability is the so-called economic loss rule or purely pecuniary loss rule. Broadly speaking, the economic loss rule denies recovery –at least presumptively- of the harm suffered by a victim if it is purely economic or pecuniary. And a pure economic loss is one which is not the direct financial impact of personal or property injury, nor the consequential financial impact upon the victim of such personal or proprietary injuries.

The notion of economic loss as such, and the exclusionary rule based on it, are Common Law creatures. In the Common Law they still lie at the core of the uncertainties surrounding the boundaries of the duty of care and the contract-tort interplay[1]. In Civil Law legal systems, the issues underlying the economic loss notion and rule are usually dealt with using a different legal tool kit, but it is undeniable that many of the controversial cases under the Common Law approach also pose significant theoretical and practical concerns under the various Civil Law perspectives. In Germany, the subordination of harm which is not to person or property is clear according to § 823 I BGB, approximating the starting point in the German legal system to that in Common Law countries. But in the former, the problem has been addressed not through a specific rule –eventually accompanied by the appropriate exceptions- against economic losses but through a variety of other doctrinal means: the concept of "other right" in § 823 I BGB, the scope and goal of a protective Law under § 823 II BGB, the harm caused against *guten Sitten* in § 826 BGB, the enlargement of the area of *Vertrag mit Schutzwirkung für Dritte*, and the *Drittschadenliquidation* concept. In Italy, it has been the elusive notion of *danno ingiusto* which has allowed Courts and commentators to draw mobile frontiers in the field of non-physical and non-proprietary injury, particularly through the admissibility of the *lesione del credito da parte di terzi* as *danno ingiusto* under art. 2043 *Codice civile*. In France, apparently, it have been fault and causation considerations the ones carrying the primary burden of defining the limits of liability in this field. In Spain, Courts have tackled cases (and excluded liability in them) of the type usually considered under the heading of economic loss, using the principle of certainty and effectiveness of harm (*principio de la certeza y efectividad del daño*) plus proximate causation principles, such as the scope of the infringed upon rule.

[1] Some influential tort scholars consider that economic loss is the most controversial area of the Law of Torts, and is in the eye of the storm concerning the concept of duty of care: John FLEMING, *The Law of Torts*, 9th edition, LBC Information Services, Sydney, (1998), p. 194.

Moreover, in recent years, the interest raised by the economic loss problem among continental European legal academics[2] has been remarkable, and the influence of the Anglo-american literature dealing with this issue cannot be denied by any disinterested observer.

The economic loss rule has also produced a substantial amount of literature from the field of Law and Economics, inspired by the goal of finding a hidden economic logic in so prominent a rule in the Law of Torts[3]. My approach to the topic will also be economic in spirit, and I will analyze the desirability of imposing or excluding liability in a given set of circumstances with the goal of economic efficiency in mind. So I will assume the operational purpose of liability (or its denial) is the creation of adequate incentives for the potential injurer, and eventually, also for the potential victim, in terms of decisions concerning care or precaution, and concerning the level of (potentially harmful) activity. In this respect, I fully assume the adequacy of what is one of the basic (and also, one of the most intuitive) results of the economic analysis of accidents and Tort Law: that in order to achieve the socially desirable levels of activity and care, the potential injurer has to face liability payments (costs) that equal the actual losses, in social terms, resulting from his activity. We will see in section 3 below how this idea of confronting the real social losses

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[2] See, for instance, Mauro BUSSANI and Vernon PALMER, *The Frontiers of Tort Liability: Pure Economic Loss in Europe*, Cambridge University Press, Cambridge, (2002) (forthcoming); Jan van DUNNÉ, "Liability for Pure Economic Loss: Rule or Exception? A Comparatist's View of the Civil Law-common Law split on Compensation of Non-physical Damage in Tort Law, 4 *European Review of Private Law* (1999), p. 397; Efstathios BANAKAS (ed.), *Civil Liability for Pure Economic Loss*, Kluwer Law International, London-The Hague-Boston, (1996) (with contributions from Austria, France, Germany, Italy, and Switzerland).

[3] See William BISHOP, "Negligent Misrepresentation Through Economist's Eyes", 96 *Law Quarterly Review* (1980), p. 360; William BISHOP, "Economic Loss in Tort", 2 *Oxford Journal of Legal Studies* (1982), p. 1; Mario RIZZO, "The Economic Loss Problem: A Comment on Bishop", 2 *Oxford Journal of Legal Studies* (1982), p. 197; William BISHOP, "Economic Loss: A Reply to Professor Rizzo", 2 *Oxford Journal of Legal Studies* (1982), p. 207; Mario RIZZO, "A Theory of Economic Loss in the Law of Torts", 11 *Journal of Legal Studies* (1982), p. 281; Richard POSNER, *Tort Law: Cases and Economic Analysis*, Little Brown, Boston-Toronto, (1982), p. 467; William BISHOP and John SUTTON, "Efficiency and Justice in Tort damages: The Shortcomings of the Pecuniary Loss Rule", 15 *Journal of Legal Studies* (1986), p. 347; Donald HARRIS and Cento VELJANOVSKI, "Liability for economic loss in tort", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 45; William BISHOP, "Economic loss: economic theory and emerging doctrine", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 73; Steven SHAVELL, *Economic Analysis of Accident Law*, Harvard University Press, Cambridge (MA), (1987), p. 135; William LANDES and Richard POSNER, *The Economic Structure of Tort Law*, Harvard University Press, Cambridge (MA), (1987), p. 251; Victor GOLDBERG, "Recovery for Pure Economic Loss in Tort: Another Look at *Robins Dry Dock v. Flint*", 20 *Journal of Legal Studies* (1991), p. 249; Victor GOLDBERG, "Recovery for Economic Loss following the *Exxon Valdez* Oil Spill", 23 *Journal of Legal Studies* (1991), p. 1; Francesco PARISI, "Liability for Pure Financial Loss: Revisiting the Economic Foundations of a Legal Doctrine", George Mason University School of Law, Law and Economics Research Paper No. 01-21; Mauro BUSSANI, Vernon PALMER, and Francesco PARISI, "The Comparative Law and Economics of Pure Economic Loss", in Mauro BUSSANI and Vernon PALMER, *The Frontiers of Tort Liability: Pure Economic Loss in Europe*, Cambridge University Press, Cambridge, (2002) (forthcoming) (available at http://papers.ssrn.com/abstract=288091.)

caused is the guiding principle of most economic understandings of the economic loss rule[4]. Of course, when one speaks of accidents and liability, and parties are risk-averse, insurance is of great importance, and this dimension is also given its due space.

In this paper I will try to show that the notion of economic loss not only contains a multi-faceted and diverse set of issues and real cases[5] , but that as a single notion or reference point, it tends to obscure the radically different economic substance and efficient solutions to the various situations ordinarily grouped together under the economic loss concept. I will also argue that when one looks carefully into the economic structure of the problem concerned in each type of case, the exclusionary rule for so-called economic losses is not uniformly efficient. In some of the situations, the exclusionary rule makes no sense, whereas in others the non recovery solution will in general terms be a plausible alternative, though usually for reasons quite disparate from one set of cases to the other.

The paper will be organized as follows: in section 2, I will present the reasons supporting the heterogeneity of the cases, and how their conceptualization under a uniform economic loss heading is, on the one hand, misleading, and on the other, largely dependent upon the particular starting points and assumptions (explicitly or implicitly) dominant in a given legal system. In section 3, I will briefly review and criticize the current theories or rationales explaining the cogency of the economic loss notion, and the exclusionary rule affecting those purely economic losses. In section 4, I will present what I think are the economic rationales that leads us to efficient solutions for a given case, or at least, allows us to frame the issue in a much more theoretically sound and productive way. The purpose of this section is not to provide a full-fledge discussion of each of the major types of cases commonly grouped as economic loss cases, but rather to sketch the economic perspective that fits them. This sketchy character of the section particularly applies to the cases involving negligent provision of information causing financial losses. In section 5, I conclude.

## 2. The radical inconsistency of economic loss and related notions

The concept of economic loss attaches great importance to whether the plaintiff in the tort action claiming compensation of a given financial loss had suffered any harm in a personal or property interest at the hands of the defendant. If the financial damage were a consequence following the invasion of life, bodily integrity or other personal entitlement, or the invasion of property or a similar absolute right, the financial loss would be deemed,

[4] In section 4 we will also observe how this principle is, however, of little use in many sets of cases commonly grouped under the economic loss notion.

[5] Something that has already been widely noticed in the literature on the topic: Gary SCHWARTZ, "Economic Loss in American Tort Law: The Examples of *J'Aire* and of Products Liability", 23 *San Diego Law Review* (1986), p. 37; Gary SCHWARTZ, "The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience", in Efstathios BANAKAS (ed.), *Civil Liability for Pure Economic Loss*, Kluwer Law International, London-The Hague-Boston, (1996), p. 103.

in principle, consequential harm and not pure economic loss, and would be, thus, recoverable from the defendant. If, on the contrary, the financial loss had no claim to be the consequence of a personal or proprietary violation of the plaintiff –maybe it was the result of the harm to person or property to someone different from the plaintiff- the loss could not escape from being termed as financial and thus presumptively non-recoverable. To illustrate the idea with an example: if an employee, X, looses one month wages due to the inability to go to work resulting from a non-serious bodily injury produced by the negligent action of Y, X is entitled to sue Y for damages comprising the lost wages together with the medical costs, and eventually, the pain and suffering[6]. If an employee, X, looses one month wages due to the impossibility of going to work because the workplace (belonging to his employer) was destroyed by the negligent action of Y, X is not entitled to sue Y for damages covering the lost wages[7]. In the first situation, we have a consequential financial loss from a bodily injury; in the second, pure economic loss[8].

If one substitutes the employee for a commercial seller, and the lost wages for foregone sales, with an owner in the first situation[9] and a mere lessee in the second[10], one obtains a similar result: recoverable consequential loss in the former, and non-recoverable pecuniary loss in the latter.

So according to the economic loss notion, the plaintiffs in the first situation of both hypotheticals (the injured worker, the aggrieved owner) are grouped together and

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[6] This is a standard lost wages from bodily injury case. Legal regimes vary in practice due to the existence of employers' obligation to pay wages during temporary inability periods, or the possibility of collecting benefits in substitution of wages from a Social Security body. See further, note 8 below.

[7] These stylized facts correspond broadly to real cases such as those in the Spanish case STS, 1ª, 30.5.1986 (RJ 1986\2918), or in the American case *Stevenson v. East Ohio Gas Co*., 73 N.E., 20o (Ohio Ct. App. 1946). In the latter, the American Court, using the economic loss rule dismissed the action for damages, whereas the Spanish Court considered that the harm was certain and undisputable, and the action had been negligent, so the liability of defendant had to be affirmed.

[8] It is true that in some legal systems there are specific solutions to this problem, namely, to force the employer or a public body to pay the wages during the impossibility to work period (*Lohnfortzahlung* in Germany), and then allow them to recover the wages paid (without the corresponding services rendered) against the tortfeasor (*Regressrecht* in Germany). This is, for instance, the German solution (see, Hermann LANGE, *Schadensersatz*, 2nd ed., JCB Mohr, Tübingen, (1990). The argument does not loose force, though. Absent the specific rule, the general rules in tort Law would have recommended, on the basis of the economic loss or similar concepts, to allow recovery in the first case and to ban it in the second. But it is true that when a specific rule is in force, the issue seems to vanish from sight and from interest. Liability is settled by a particular rule, and no one thinks again of it as being or not an economic loss. This explains why in the German legal system the case is not considered problematic and potentially falling within the category of economic loss. In Spain (where there is *Lohnfortzahlung* under various forms for both private and public employees, but no legally established *Regressrecht*), or in some Common Law systems, where a specific rule is absent, these cases belong to the debated ones under economic loss or functionally similar notions.

[9] This would be a typical case of lost profits consequential on a direct harm to property.

[10] The facts correspond in a stylized way to those in cases such as STS, 1ª, 13.3.1976, STS, 3ª, 7.6.1985 (RJ1985\4823).

separated from the other two (the non-injured worker who nevertheless has lost wages, the aggrieved lessee) who, in turn, are also grouped together and labeled economic loss.

If one analyses the two examples through the lenses of simple economic theory, the impression is quite different. In the first example, both workers look substantially alike. In both cases, the issue seems to be, well, simply lost wages. In the second example, again both sellers look similar, and the problem, well, apparently just forgone sales in both cases. So similarities and disparities seem to run exactly opposite of what the economic loss concept would deliver.

The reason is that in economic theory there is no a priori restriction or ranking of interests, and, consequently, of harms. Only individuals (in the field of tort Law, victims themselves) are able to rank sources of welfare or satisfaction, according to their own preferences. And utility might arise from any source: whatever feature of the outside world, and one's own biological and psychological situation are candidates for producing welfare to an individual. There is no theoretically sound reason to establish general and *a priori* orderings among sources of welfare. One might be most sensibly more highly worried about the state of one's own purse and sales than about a particular piece of property, or even one's own body. In the end, for welfare economics, only preferences and, through them, human welfare, matters[11].

Of course, some empirical regularities can be established, and they should be taken into account, both in Economics and in Law. Most people tend to rank highest their own (and those of their most loved ones) life, and substantially higher than any piece of property or future stream of income. But to recognize this fact as a very useful piece of empirical evidence is one thing, and to arbitrarily draw a boundary between absolute rights in one's own body and tangible and intangible property, on the one side, and the rest of possible sources of human welfare, on the other, is a rather different story. Moreover, the empirically testable preeminence of personal interests does not carry over to the consequential losses arising from a direct harm to those personal interests. I very much doubt that a lost wage is more important for an employee if it were the result of a non-serious injury than if it were the product of a destroyed workplace. They look to me as very similar in the eyes of the victim. And I find unlikely that a seller would resent losing sales more bitterly if he is the owner of the shop than if he is only a lessee.

So economic loss as a normative notion seems at odds with basic results from economic theory. Even deprived of any normative pretensions, the notion of economic loss simply as a useful term allowing us to group together cases facing similar fundamental problems in terms of liability, or pointing towards an issue of relevance for the analysis of a given type of case, it is again a miserable failure. It would be a misleading catch-all term, covering a

[11] For accessible references to these and other issues of welfare economics, See Robert WILSON, "Value Maximization", in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, Vol. III, MacMillan, London, (1998), p. 655; Louis KAPLOW and Steven SHAVELL, *Fairness versus Welfare*, Harvard University Press, Cambridge (MA), (2002).

large range of cases that, as I will try to show in section 4, diverge substantially among themselves in terms of the economic issues involved. In what respects the liability for negligently killing a valuable employee[12], or negligently injuring a worker who will collect wages from the employer even during the disability period[13], or negligently destroying or damaging a leased asset[14], negligently blockading access to selling space[15], negligently drafting a will[16], or negligently certifying the financial situation of a company or a prospective borrower[17], share a common thread that will allow a legal system to take sensible decisions on efficiency terms concerning the imposition of liability? All of them are, at least potentially, candidates for the economic loss label, and in several legal systems, most notably Common Law ones, all of them have been termed, at one moment in time, economic losses. In my view, a common label for them all only obscures how the underlying efficiency issues widely differ across those types of cases[18].

Moreover, the mere notion of economic loss appears to underline that it is the nature of the harm and the legal interests involved the question we should look at to understand the proper place of those cases in the Law of torts. The nature of the harm is not, however, the right track. Of course, the nature of the harm is a crucial issue in many instances in tort Law. But what makes some of those cases special or problematic under widely accepted notions and rules of tort liability is never (and I mean never), the nature of the harm suffered by the plaintiff in connection with the direct interests injured by the defendant.

There is a strong impression that what might be considered under the heading of economic loss (or might raise similar uncertainties and, eventually, lead to a similar denial of liability) is heavily dependent upon specific features of a given legal system, notably the existence of apparent legal gaps due to the absence of a particular rule establishing or rejecting liability. Doctrines in this field seem *ad hoc* responses to what are perceived as

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12 The Italian Superga and Meroni (Cass. Sez. un. 26 gennaio 1971, n. 174, in Giur. it. 1971, 1, 681) cases are some of the most clear examples of this type of case.

13 Spanish cases such as those of STS, 1ª, 14.2.1980 (RJ 1980\516); STS, 1ª, 14.4.1981 (RJ 1981\1539); STS, 1ª, 25.6.1983 (RJ 1983\3685); STS, 2ª, 13.5.1975 (RJ 1975\2083); STS, 2º, 20.9.1982 (RJ 1982\4948); STS, 2ª,13.12.1983 (RJ 1983\6522).

14 For instance, *Robins Dry Dock v Flint* 275 US 303 (1927), or *East River SS v Transamerica* 476 US 858 (1986), or *Candlewood Navigation Corp. v Mitsui O. S. K. Lines Ltd.* [1986] A C 1 (P. C.), among other cases.

15 For instance, *Rickards v Sun Oil Co.* N. J. Msc. 89, 41 A. 2d 267 (1945), or *People Express Airlines, Inc. v Consolidated Rail Corp.* 495 A. 2d 107 (NJ 1985), or the Spanish case of STS, 1ª, 26.7.2001 (RJ 2001\8429), or the French case Cass. Civ. 2e, 28 Avril 1965, among many others.

16 *White v Jones* [1995] 2 AC 207, among others.

17 For instance, *Ultramares Corp. V Touche*, 174 N. E. 441 (N. Y. 1931), or *Credit Alliance Corp. v Arthur Andersen & Co.*, 483 N. E. 2d 110 (N. Y. 1985), among others.

18 From a non-economic perspective, others have also insisted on the pernicious effects of the economic loss notion: Bruce FELDTHUSEN, "The Recovery of Pure Economic Loss in Canada: Proximity, Justice, Rationality and Chaos", in Efstathios Banakas (ed.), *Civil Liability for Pure Economic Loss*, Kluwer Law International, London-The Hague-Boston, (1996), p. 132. One can also remember here the famous indictment against the economic loss rule by Lord Devlin in *Hedley Byrne v Heller* [1964] AC 465 , in the sense that there was neither logic nor common sense in it.

uncertainties affecting the boundaries of liability in Tort. And these responses are highly contingent and multiform. When the uncertainties are dispelled in a given situation by precise legislative action, all theoretical difficulties, and all relationship with fundamental issues of the scope of tort liability suddenly vanish. This explains, for instance, why certain cases that, in a given legal system, look problematic and are natural candidates for the economic loss category or parallel doctrines for drawing the boundaries of liability, are simply a non-problematic issue in other systems: the legislature has spoken, and its words still carry much weight. But the words of a historical and contingent legislator is just a practical question and carries little or non theoretical weight. From a theoretical point of view, of course, a word more or less from a law-making power does not change the nature of the problem in terms of the efficiency of the alternative solutions.

To conclude this section: the notion of economic loss bundles together situations and cases that raise essentially different issues as far as the efficient imposition or denial of liability are concerned. The notion itself is based on an unfounded and misleading understanding of what is relevant in harm, and what role the legal typology of protected interests should have in determining the limits of liability. The contours of the underlying problem from the legal perspective, moreover, are extremely contingent and variable, and heavily correlated (maybe naturally) with particular rules of a given legal system. This gives the notion an *ad hoc* flavor which seems at odds with theoretical rigor.

## 3. The rationales for limiting liability for economic loss: review and critique

In this section I will briefly present a review and critique of the most influential rationalizations of the economic loss notion and rule. Some of the theoretical rationales that I will examine are normative in purpose, trying to give support to the exclusionary nature of the rule. Others, in contrast, are merely positive interpretations of the rule, attempting to find a convincing explanation of the general basis for both the concept and the adoption of the rule. Some, in the end, pretend to be at the same time positive and normative. I will jointly deal with all three types of theories, commenting in due course on the nature and purpose of each. Given my economically oriented approach, I will separately address the non-economic and the economically-inspired theories.

### 3.1 Non-economic theories of the economic loss rule

a) The pre-eminence of personal and property rights over economic interests

Some commentators[19] argue that the harm against economic interests is and should be[20] less protected from negligent interference by others than life, limb, and tangible

[19] See FLEMING JAMES Jr. "Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal", 25 *Vanderbilt Law Review* (1972), p. 54; Erwin Deutsch, "Compensation for Pure Economic Loss in Germany", in Efstathios Banakas (ed.), *Civil Liability for Pure Economic Loss*, Kluwer Law International,

property. Negative physical impacts caused by third parties are more serious, and deserve more protection in the Law of Torts (probably, even in all areas of the Law as well) than negative impacts producing only non-tangible economic damage. There is a hierarchy of protected interests, and pure economic ones are placed at the bottom of the scale by legal systems, and things should remain that way.

Although there might be constitutional provisions in several legal systems apparently awarding to personal integrity and, to a lesser extent, to property, a particular place in the universe of the Law, to try to derive from constitutional recognition of rights to life and physical integrity and to private property, consequences in the operation of Tort Law, and notably in connection with the economic loss rule, is both groundless and misleading.

First, because the indiscriminate translation of constitutional status to every field of Law is unwarranted. Moreover, it is not actually observed in the operation of actual legal systems. For instance, it would imply giving absolute priority in bankruptcy to tort debtors with claims on physical damage over contractual debtors, who only have an economic interest supporting their claim. This absolute priority is something that, with good reason, legal systems have not introduced in their bankruptcy provisions.

In addition to this, and descending now to the economic loss rule, preeminence would mean just that, preeminence, but not exclusion of economic losses. A presumption of recovery for personal and property harm and a presumption of non-recovery for economic harm is simply unwarranted even if one places the former higher up in the scale of deserve and merit than the latter. Moreover, many losses that count as "personal" or "proprietary" under the economic loss rule are overtly economic in nature: as was shown in section 2, lost wages or profits are no different when the consequence of a previous direct damage on personal or property rights, and are conceptually and practically distinct from the antecedent harm of life, limb or tangible property.

Finally, the hierarchy theory is not very useful in giving us advice about how to proceed with economic interests. It groups all of them together and thus obscures the obvious differences within economic harms. No operational directives for approaching and solving the diverse range of economic loss cases observed in the real world can be deducted from the assertion of priority of personal and property rights.

b) The flood of litigation argument

Probably the unattractive image of a flood of claimants approaching the Courts with minuscule and disperse damage claims has been the most central and powerful

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London-The Hague-Boston, (1996), p. 73; Pedro DEL OLMO, "Responsabilidad por daño puramente económico causado al usuario de informaciones falsas", 54 *Anuario de Derecho civil* (2001), p. 297.

[20] This makes the claim both positive and normative.

rationale used, at least by Courts in Common Law jurisdictions, for the justification of the economic loss rule[21]. The economic loss rule, according to this vision of the rule, is a policy instrument in the hands of Courts necessary to achieve a pragmatic result which everyone would agree is highly desirable: avoiding an unlimited flow of tort claims arising of a tortious act that would no doubt swamp the Court system if recovery of economic losses were authorized. Given that most negligent actions do have unpredictable effects on economic interests of a potentially indeterminate number of affected victims, liability for pure financial losses without a direct connection with a personal or physical loss of the plaintiff would create a proliferation of claims by an unknowable number of victims in an unknowable amount. As Justice Cardozo expressed it in *Ultramares Corp. v Touche*: such a liability for pure economic losses may expose defendants to a "liability in an indeterminate amount for an indeterminate time to an indeterminate class".

The clearest illustration of this kind of danger from liability for pure pecuniary losses are the so-called cable cases[22]: if an assumedly minor negligence by a small construction firm damages an electricity or telephone line, a rule allowing recovery of losses by plaintiffs who had not suffered neither personal nor proprietary harm, would imply that the firm would be liable in front of all individuals and businesses who experienced a loss by the black-out or the interruption of communications. The amount and extent of these losses are completely indeterminate, and would constitute and unwanted flood of litigation arising from a minor lack of care during construction work.

Several criticisms have been raised along different lines against this pragmatic justification for denying liability for economic losses[23], and I will not reproduce them here. I will just mention several flaws in the argument, both from a positive and a normative perspective. No doubt the vision of an endless stream of Tort plaintiffs is a terrifying vision. But it should be much more scary to a 19th or early 20th century spectator, and not to one used to large product liability, environmental damage, or

[21] In the literature, the most fervent representative of this line of thinking is Robert RABIN, "Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment", 37 *Stanford Law Review* (1985), p. 1513.

[22] Examples of this kind of case are the British case *Spartan Steel and Alloys v Martin & Co.* [1973] Q. B. 27; the American case *Kaiser Alluminium & Chem C. v Marshland Dredging Co.* F. 2d 957 (1972); the German case BGHZ 41, 123; the Italian case Puddu (Cass. Sez. Un. 24 giugno 1972, n. 2135, Giur. It., 1973, 1, 1125); and the Spanish cases SAP Alicante 29.1.1996 (AC 1996\326) and SAP Barcelona 2.11.2000 (AC 2001\33).

[23] A thorough examination –and criticism- of the various elements present in the flood of litigation argument in Jane STAPLETON, "Duty of Care and Economic loss: A Wider Agenda" 107 *Law Quarterly Review* (1991), p. 253. See also Donald HARRIS and Cento VELJANOVSKI, "Liability for economic loss in tort", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 54; Jan van DUNNÉ, "Liability for Pure Economic Loss: Rule or Exception? A Comparatist's View of the Civil Law-common Law split on Compensation of Non-physical Damage in Tort Law, 4 *European Review of Private Law* (1999), p. 426; Eileen SILVERSTEIN, "On Recovery in Tort for Pure Economic Loss", 32 *University of Michigan Journal of Law Reform* (1999), p. 404.

financial fraud cases, involving hundreds of plaintiffs grouped together in a class action suit. Modern tort Law has already accepted, even welcomed, at least in certain circles, the possibility of large number of claimants arising out of a single tortious injury. So the prospect would not look as uninviting today as it may have appeared 100 or 150 years ago.

Additionally, the danger of a long stream of tort suits is exaggerated, when one takes into account that cases involving a potential very large number of claimants are rare occurrences[24]. If the risk (of litigation flood) is remote, so the corresponding benefit from avoiding the risk is small. More importantly, the depiction of all economic loss cases as cases potentially giving rise to an unlimited number of claims is a gross mischaracterization. As we will see in section 5, many, if not most of the cases traditionally considered under the economic loss rule involve a very small number of potentially damaged parties, typically only one, precisely the contracting partner of the victim who suffered the personal or proprietary harm. In this setting, the floodgates argument is simply misplaced: allowing recovery for pure financial harm will just give rise to a single tort suit, a number certainly not threatening enough for any legal system.

There is, however, some truth in the pragmatic argument in favor of liability denial for economic losses on the basis of avoiding excessive and indeterminate litigation. Administration and litigation costs are real social costs that have to be adequately taken into account in the search for efficient solutions to the cases.

c) The political interpretation: economic loss rule as a product of *laissez-faire*

Some have argued that the pure economic loss notion and rule are deeply rooted notions in a certain political vision of the Tort system, namely the one corresponding to pro-market *laissez-faire* ideological propensities. In historical and present terms, the exclusion of liability for pure pecuniary loss legitimizes market values and private orderings, barring the use of liability rules that might interfere with the private contractual arrangements that market participants would have chosen[25]. Some argue further that if Courts would allow recovery of pure economic losses, they would be in

[24] It is, however, an empirical question, and by no means totally clear in terms of the right answer, that in the cable cases we are facing low-probability events. Given repair equipment and training, maybe it would be more exact to speak of low-duration events. See Fernando GÓMEZ, "Comentario a la Sentencia de 29 de enero de 2001", 57 *Cuadernos Cívitas de Jurisprudencia civil* (2001), p. 567.

[25] John FLEMING, "Tort in a Contractual Matrix", 5 *Canterbury Law Journal* (1993), p. 277; Joanne CONAGHAN and Wade MANSELL, *The Wrongs of Tort*, 2nd ed., Pluto Press, London-Sterling (VA), (2000), p. 21. In a more positive tone, but remarking that the economic loss rule serves to preserve the domain of contracting, Gary Schwartz, "Economic Loss in American tort law: the examples of J' Aire and products liability", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 83; Gary SCHWARTZ, "Economic Loss in American Tort Law", in Efstathios Banakas (ed.), *Civil Liability for Pure Economic Loss*, Kluwer Law International, London-The Hague-Boston, (1996), p. 125.

trouble trying to justify why there should be no liability arising out of ordinary market exchanges, in which there are economic losses as well (some gain, even systematically, at the expense of others)[26].

Although I believe that the political theory of the economic loss rule is ultimately unconvincing, I will not try to refute it here, because it would involve a significant detour from the primary purpose of the paper. I will notice, however, that regardless of its positive (explanatory) accuracy, the political rationale does not allow us to derive criteria that usefully illuminate us in the task of understanding, and eventually solving, the relevant cases in an efficient way.

### 3.2 Economic theories of the economic loss rule

I will now turn the attention towards those rationales offered for the pecuniary loss treatment that have a more or less explicit economic theory component. The conclusion of this review can be easily anticipated: even though several of these economic theories do provide valuable insights on the nature of some of the issues involved, they fail to integrate under a single economic vision so heterogeneous a group of situations as that commonly considered under the economic loss heading. Only a pluralistic economic perspective can fruitfully serve to analyze a plural set of phenomena such as the pecuniary loss cases.

I will start by the most influential and widespread understanding of the pecuniary loss rule among the Law and Economics scholarly community: the private loss versus social loss argument.

a) The gap between private losses and social losses

The losses arising from a given action suffered by some victim (by the plaintiff claiming compensation in a tort suit) may sometimes differ from the net losses that society at large has incurred as a consequence of the action. More specifically, the private losses of a victim might be counterweighted by the private benefits of a beneficiary, leaving society as a whole as well-off in terms of overall welfare as it was before the action causing the harm and the benefit took place. Although this discrepancy between private losses (that a victim might try to recover in tort) and social losses, can happen in other situations, it is typically likely when economic loss is involved.

The clearest example is that of foregone sales. If through the tortious action of a party (let's say, causing damage to a public infrastructure giving access to its premises), a seller X is prevented from selling its merchandise for a given period of time, X (rightly) perceives the lost profits on the foregone sales as a loss meriting compensation. But the sales lost by X might very well have been made by a competitor selling the same

[26] See Eileen SILVERSTEIN, "On Recovery in Tort for Pure Economic Loss", 32 *University of Michigan Journal of Law Reform* (1999), p. 408.

product, Y, who has increased profits on the same amount as X has lost them. The net social loss from damaging the infrastructure (leaving aside repair costs, which affect the owner of it) is zero. Unless able to recover the increased sales by Y, forcing the negligent injurer of the infrastructure to pay the full amount of damages to X would actually overstate the social effects of his behavior, and would provide him with excessive incentives to increase precaution or adjust the level of activity that might result in harm to the infrastructure. The economic loss rule prevents precisely this inefficient result by denying recovery of the private losses of X, which are purely pecuniary. The wedge between private and social losses is typically the amount of the pure economic loss and they are rightfully excluded from the damage payments that the liable injurer will be forced to pay[27].

That a prospective injurer should face liabilities equal to (but not greater than) the real net social costs resulting from his activity is one of the basic and most intuitive propositions of the economic analysis of tort Law. It is therefore important to clearly identify which losses suffered by a victim actually translate in a net social cost that is not compensated in other ways (such as profits disgorgement, unjust enrichment and the like). But that this proposition is the only guiding principle for resolving the issues posed by the cases which are commonly considered under the pure economic loss heading, cannot be fully endorsed[28]. The private loss-social loss gap argument is very helpful to understand foregone sales[29], but it cannot illuminate other types of cases.

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[27] The idea that the gap between private and social loss was the driving force behind the economic loss notion and rule was first proposed by William BISHOP, "Economic Loss in Tort", 2 *Oxford Journal of Legal Studies* (1982), p. 4, and was later widely shared by most economic analysts of the issue. See Steven SHAVELL, *Economic Analysis of Accident Law*, Harvard University Press, Cambridge (MA), (1987), p. 136; William LANDES and Richard POSNER, *The Economic Structure of Tort Law*, Harvard University Press, Cambridge (MA), (1987), p. 251; Victor GOLDBERG, "Recovery for Economic Loss following the *Exxon Valdez* Oil Spill", 23 *Journal of Legal Studies* (1991), p. 31; Francesco PARISI, "Liability for Pure Financial Loss: Revisiting the Economic Foundations of a Legal Doctrine", George Mason University School of Law, Law and Economics Research Paper No. 01-21, p. 5; Mauro BUSSANI, Vernon PALMER, and Francesco PARISI, "The Comparative Law and Economics of Pure Economic Loss", in Mauro Bussani and Vernon Palmer, *The Frontiers of Tort Liability: Pure Economic Loss in Europe*, Cambridge University Press, p. 30 (the two latter ones discussing in full all possible relationships between private and social losses).

[28] Not all economic commentators hold the view that this is the only valid rationale for the economic loss rule. Bishop himself defends a more pluralistic economic approach in William BISHOP and John SUTTON, "Efficiency and Justice in Tort damages: The Shortcomings of the Pecuniary Loss Rule", 15 *Journal of Legal Studies* (1986), p. 347; William BISHOP, "Economic loss: economic theory and emerging doctrine", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 73. Goldberg, in turn, thinks that the economic loss rule incorporates substantial elements of moral hazard avoidance (incentives for the potential victim to engage in pre-accident precaution) and mitigation of damages (incentives for the victim to engage in post-accident harm reducing measures): Victor GOLDBERG, "Recovery for Economic Loss following the *Exxon Valdez* Oil Spill", 23 *Journal of Legal Studies* (1991), p. 16.

[29] As we will see in section 4, even those consequential upon an invasion of tangible property, which in all legal systems fall outside pure economic losses. This is an additional reason to confirm that the notion of pecuniary loss can be envisaged by a single rationale, even one as seemingly uncontestable as the private loss-social loss wedge.

Even more, if we were to apply this principle to lost wages, for instance, the most likely result would be that lost wages should never be compensated, regardless of whether they are or not the direct consequence of a bodily injury.

b) Channeling losses through contracts

A different economic justification of the economic loss concept and the subsequent exclusionary rule has been the one sponsored by Rizzo[30]. The core of the argument is as follows: given that economic losses tend to be widespread and compensating them with the use of the Tort system would involve very substantial litigation costs, it is best that those who might expect an economic loss from the action of a third party, shift the anticipated value of the loss to the party who might suffer the physical loss, and the latter would be the one who seeks compensation from the injurer. The incentive to channel through the physical victim can be achieved only by denying a direct cause of action for the economic loss against the injurer. The party suffering the economic loss would be *ex ante* or *ex post* compensated through the contract, and the injurer would actually face liability payments incorporating the economic loss, but with a very significant reduction in litigation costs, because instead of a multiplicity of suits, all is concentrated in a suit by the direct victim. The clearest example could be found in cable cases. Clients of the power or telephone company have no direct claim against the negligent injurer of the line, but get a lower price (or contractual compensation after the accident) from the company who, in turn, could obtain damages from the injurer that would cover the lower price or the extra compensation to economic loss victims.

The argument, though suggestive in some settings, cannot qualify as a general theory of economic loss in tort. First, some cases of economic loss (for instance, the cases of negligent information about someone else's creditworthiness) do not have a "direct victim" with whom those who might suffer pecuniary losses are able to strike a bargain to channel compensation. In other cases, as was mentioned in the critique addressed above to the flood of litigation argument, there is simply no risk of an excessive amount of litigation, because economic losses are as concentrated as personal or proprietary harms. Moreover, channeling contracts might also face significant transaction costs, particularly in areas in which the contractual process is heavily standardized (as with utilities or telephone companies), and introducing additional terms adjusted at the level of prospective economic losses of the client is almost unimaginable.

c) The victim of economic losses as the cheapest-cost insurer

Some[31] also claim that the economic loss rule expresses a preference for first-party insurance over liability insurance. The party that is in a position to expose herself to

[30] See Mario RIZZO, "A Theory of Economic Loss in the Law of Torts", 11 *Journal of Legal Studies* (1982), p. 281

[31] Most clearly Robert RABIN, "Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment", 37 *Stanford Law Review* (1985), p. 1531, but it is a kind of argument that permeates more or less explicitly,

pure financial loss is better placed to evaluate the probability of the event and also to foresee the likely amount of financial loss that might be caused. The prospective injurer, in contrast, finds himself in a position in which it is almost impossible to calculate the expected cost of the pure financial loss, given the potentially large number of parties affected, and the heterogeneity of the likely pecuniary losses that each of them might incur. This makes the victim a superior risk bearer, and therefore, from an efficiency point of view, the party who should bear the cost of the accident.

The claimed insurance advantage cannot explain, however, any preference for the economic loss rule. First, because first-party and third-party insurance are not mutually exclusive. The former is typically wider in scope, covering a broader range of events than the latter. The important thing is to coordinate them appropriately, so the incentives of the parties to take cares and to insure themselves if they are risk-averse, are not distorted by the joint presence of both forms of insurance. Second, because it is misleading to decide upon the imposition of liability only on the basis of insurability. This might be the preferred alternative when we are confident that imposing liability will not improve deterrence. If deterrence is not an issue, so could be said, at least let's achieve the best loss-spreading we can. But there is no indication that the issue of deterrence of harmful behavior is completely futile with regard to economic losses. Far from the truth, as we will see in section 4 below, in many cases the imposition of liability for economic losses might have a significant and positive deterrence effect. So the advantage in terms of insurability might be an acceptable criterion at the point in which our purpose of achieving optimal incentives for care and activity levels becomes moot, but not before.

## 4. The organizing economic principles behind the groups of cases

In this section I will present the key economic principles that, in my view, allow us to make sense of the most important groups of cases that are, across legal systems, commonly labeled as economic loss cases. This idea of a plurality of organizing principles will come as no surprise, given my position on the radical heterogeneity of the cases, and the lack of theoretical coherence and unity in the concept of economic loss, and the lack of sufficiently general explanatory power in the various theories aiming at understanding the rule excluding recovery for pure financial losses.

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hand in hand with the flood of litigation argument, the reasoning of many Common Law rejecting liability of the defendant in application of the economic loss rule. Others use a similar type of argument (although the defense they make of the economic loss rule is much less general) but do not limit its scope to insurance, extending the idea to all alternative means of protection available to the victim of economic loss: Jane STAPLETON, "Duty of Care: Peripheral Parties and Alternatives opportunities for Deterrence", 111 *Law Quarterly Review* (1995), p. 301.

In this respect, other economic analysts have advocated a pluralistic economic approach to the major groups of cases at hand[32]. My perspective shares this fundamental diversity of economic issues underlying the various situations, though the identification of the issues, and sometimes, also the implications of the analysis, differ markedly from theirs.

a) The subrogatory principle

Most legal systems explicitly recognize property insurers who have paid the insured party the indemnity contractually foreseen, a right of subrogation in the amount of the paid sum in the claim that the insured party would have against a liable third-party because of the insured event. If a house owned by X is destroyed by the negligent action of Y, the insurance company Z, having paid, according to the policy, the amount n to X , can exercise an action in subrogation against Y to obtain reimbursement of n[33].

It has already been shown that it is in the best interest of the parties to the insurance contract to introduce subrogatory provisions in the contract[34]. Moreover, it has been shown that subrogation is the most efficient solution among the plausible alternatives (cumullation by the victim of insurance benefits and the damage award, deduction of insurance benefits from the damage award, and subrogation) both for the incentives to take care and for the incentives of risk-averse parties to insure against harmful events[35].

In my view, many cases usually considered under the economic loss rule can be fruitfully understood in economic terms using the same logic as the one presiding subrogation in insurance contracts. The financial loss that a party not directly harmed in personal or property rights by the negligent action tries to bring against the injurer is very similar to a subrogation claim arising out of an insurance contract.

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[32] See particularly William BISHOP, "Economic loss: economic theory and emerging doctrine", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 73; William BISHOP and John SUTTON, "Efficiency and Justice in Tort damages: The Shortcomings of the Pecuniary Loss Rule", 15 *Journal of Legal Studies* (1986), p. 347; Donald HARRIS and Cento VELJANOVSKI, "Liability for economic loss in tort", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 45.

[33] Details of the subrogatory mechanism and scope differ across legal systems. For a discussion, see Fernando GÓMEZ, "Insurance Benefits, Insurance Subrogation, and Imperfect Liability Rules", *International Review of aw and Economics* (2002), forthcoming, text accompanying note 3.

[34] Steven SHAVELL, *Economic Analysis of Accident Law*, Harvard University Press, Cambridge (MA), (1987), p. 235.

[35] Fernando GÓMEZ, "Insurance Benefits, Insurance Subrogation, and Imperfect Liability Rules", *International Review of aw and Economics* (2002), forthcoming. See also, Alan SYKES, "Subrogation and Insolvency", 30 *Journal of Legal Studies* (2001), p. 383. I analyze the effects of the choice among the three legal instruments in a setting of imperfect liability rules (in a perfectly functioning liability system the choice does not make sense) along the two dimensions mentioned in the text. Sykes analyzes a more general model in a specific imperfect setting (that of bankruptcy) and exclusively on the decision to insure dimension.

The analogy is most visible in the following type of case that for some years puzzled the Spanish Courts: an employee is injured by a negligent injurer, and is disabled for a certain period of time. Either by Law (public employees) or by contract (private employees), the employer is bound to pay the employee's wages during the disability period. The employer then sues the injurer for reimbursement of the paid wages (without the corresponding employee's services). The Spanish Supreme Court, after a an initial period in the Second Chamber in which claims awards were granted[36], finally opted for rejecting liability of the injurer for the amount of the wages, on the basis of the principle of certainty and effectiveness of harm[37].

In economic terms, what the employer is doing by paying wages during the disability period is insuring the employee against a real social loss, a destruction, albeit temporary, of valuable social resources, in this case, human resources. The employer should be allowed to obtain compensation for the paid wages, because he is doing nothing else than claiming subrogation in the loss of wages by the direct victim. If the tort claim[38]is rejected, the injurer will not face part of the social cost of his harmful activity, and so the incentives to take care and to adjust the level of activity will be inefficiently small. This inefficiency might be deemed insignificant in a given case, but if one thinks of the number of accidents of this kind happening every year, and adds up the resulting inefficiencies, the overall picture is one of gross and worrisome inefficiency. Moreover, we can encounter in a setting like this a different source of inefficiency. If we assume that for the parties to the employment contract it is optimal to assign the cost (wages) of the risk of accident affecting the employee, to the employer (he is a superior risk-bearer), the rule denying recovery might induce the parties to adopt an inefficient distribution of risk, and thus eliminating the payment of wages during disability periods by the employer. The rule against recovery benefits the injurer at the expense of both the employer and the employee, and if this unwanted forced transfer is sufficiently high, the parties to the contract might rationally decide to introduce an inefficient clause (because it places risk on the side of the inferior risk-bearer) in it just for the sake of eliminating the forced subsidy to the injurer.

The subrogatory logic does not restrict its field of application to employment contracts and disability payments. It extends to all cases of apparent economic loss in which there is a contract between the direct victim and other party, and the contract allocates some risks that might be increased by the action of the injurer.

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[36] STS, 2ª, 13.5.1975 (RJ 1975\2083); STS, 2º, 20.9.1982 (RJ 1982\4948); STS, 2ª,13.12.1983 (RJ 1983\6522).

[37] STS, 1ª, 14.2.1980 (RJ 1980\516); STS, 1ª, 14.4.1981 (RJ 1981\1539); STS, 1ª, 25.6.1983 (RJ 1983\3685); STS, 1ª, 29.9.1986 (RJ1986\4922).

[38] Or reimbursement claim, as in Germany: the legally technical cause of action is immaterial in this respect.

This is the case of lease and charter contracts. When the parties to the contract sign it, they have to assign[39] the risk that the leased building or object, or the chartered ship or aircraft, might be destroyed or impaired (by the negligent action of a third party, or by fortuitous causes) during the life of the contract. If the charterer or lessee have to pay the lease or charter prices during the period in which the object of the lease or charter is out of order, they are, in economic terms, the insurers against such a risk[40], and they should be able to recover the amount paid without the corresponding use of the contract object. If the contract foresees that the lessee or charterer will not pay the price during the repair period, then it is the owner who assumes that risk. In this case, it is undisputed that the owner will be entitled to recover the lost rent: it will be considered a loss consequential on a proprietary harm, ad thus recoverable under the ordinary conditions of tort damages. But here, as well as in the lost wages case, no difference shall be made because there is an insurance provision in the contract. The party who suffers the loss should be entitled to claim the contract price or the lost wages against the injurer.

The same logic applies to those economic loss cases in which the injurer's action increased the cost of performing a contract. In the famous English case *Cattle v Stockton Waterworks Co*, the plaintiff in the tort suit was a builder who had contracted with a landowner the construction of a tunnel underneath the property, for a fixed price. The defendant negligently flooded the tunnel, significantly increasing the cost of completing the construction as agreed. In this case, the fixed price clause makes the contractor the economic insurer of the risks that might negatively affect the execution of the task. The increased cost of production reduces real resources in the economy, a negative uncertain event that the contractor has insured and for which he should be able to seek compensation under the broad subrogatory principle defended in this section. Similarly, in the Australian case *Caltex Oil v The Willemstad*, the defendant negligently injured a pipeline running underwater in a bay, which forced the plaintiff to send petrol by ship till the pipeline was repaired. Here again the increased cost of production are social costs, and whoever in the contract had insured the other party against this negative event should be allowed to recover increased costs of performance[41].

In the preceding paragraphs the subrogatory principle has been deployed in order to provide support for the compensation in tort of the market price of the resource negatively affected by the injurer (human labor, leased object, performance cost). The

[39] It is also possible that the Law sets default rules to regulate the issue if the parties leave it unresolved. For instance, the Spanish Law on Urban Leases (Ley de Arrendamientos Urbanos) forces the lessee to pay the rent, unless otherwise agreed by the parties, if the repair works prevent the use of the rented space for less than 20 days.

[40] All things equal, the owner should pay an insurance premium for this, however implicit. It will commonly take the form of lower contract price or better contract terms.

[41] Actually, in this case the Australian court allowed the recovery of the economic loss: John FLEMING, *The Law of Torts*, 9th edition, LBC Information Services, Sydney, (1998), p. 199.

subrogatory principle does not cover, however, the surplus that the insuring party -or the consumer- could have made had the negligent action not taken place. For instance, the employer of a difficult to replace employee (a football player or other star, as in the Italian Meroni case), could claim damages, under the subrogatory principle, for the wages or other sums paid to the injured employee. But subrogation does not apply to the surplus, if any, that the employer was making on the contract and that, if the employee were killed or permanently disabled, would be lost as a consequence of the injurer's action. Or, in the case of a lease or a charter, subrogation would cover the amount of the rent or charter, but not the profit that the lessee or charterer was making on the contract.

In both cases, the losses arise from foregone sales on the part of the contractual party not suffering personal or proprietary harm. And as foregone sales, they should be dealt with under the principle that will be examined in subsection 4 b) below[42].

Lost consumer surplus is also not affected by the subrogation analogy. Of course, this does not mean that there might be many cases in which substantial consume surplus might get lost through the injurer's action. Let's think, as paramount examples, of typical cable cases: an electric or telephone cable is damaged and the line is interrupted. Of course, the power and telephone companies forgo sales because of the interruption. Commercial customers of electricity and telephone companies will also forgo sales[43]. As before, foregone sales will be considered under the principle of private loss-social loss gap.

But the prices of electricity and telephone do not capture the full surplus that consumers place on light and telephone services. Non-commercial customers will be

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[42] Some economic commentators propose further reasons for denying recovery of lost profits or surplus in this case. In the star employee case, Mauro BUSSANI, Vernon PALMER, and Francesco PARISI, "The Comparative Law and Economics of Pure Economic Loss", in Mauro Bussani and Vernon Palmer, *The Frontiers of Tort Liability: Pure Economic Loss in Europe*, Cambridge University Press, (2002), think that the no recovery is justified because of the "star" type of employee: they have monopoly power given the non-fungible nature of their services, which allows them to earn rents that probably capture most of the surplus of the contract. So if lost wages are compensated (and they are, either directly to the employee or via subrogation to the employer), the contract surplus is actually being taken into account, and additional compensation for the employer will likely constitute overcompensation. Although there might be some truth to this, I still think that the best way to address this issue is simply as a particular case of foregone sales. In the lease and charter cases, Victor GOLDBERG, , "Recovery for Pure Economic Loss in Tort: Another Look at *Robins Dry Dock v. Flint*", 20 *Journal of Legal Studies* (1991), p. 262 thinks that allowing recovery of lost profits to the lessee or charterer would actually overcompensate them. In long-term contracts such as these, the contract price is the best estimate of the value of the services rendered (use of the building or ship) at he time of contracting. Of course, market price at any given future time might be higher (in which case the lessee or charterer is making profit) or lower than the contract price (in which case lessee or charterer are making a loss on the contract). Allowing compensation of the lost profits in the first case, without forcing them to disgorge the gain from putting an end or interrupting the contract in the second, would overall overcompensate the whole class of lessees and charterers.

[43] As in cases such as those cited in note 22 above.

deprived of the use of say, telephone, and this will eliminate consumer's surplus that enters the social welfare function[44]. Indisputably, there is a net social loss here that ideally should be reflected in the damage payments that a potential injurer should face when deciding activity and care levels. The problem is that this social loss is dispersed among a large number of uncoordinated agents, and moreover, those consumers holding a legitimate claim because they had suffered a reduction in consumer surplus are not easily distinguishable from those holding an spurious claim (for instance, they had no intention of using the phone during the interruption of the line). This is, I think, the proper space for a pragmatic non recovery rule based on legitimate concerns about the administrative cost of small and possibly frivolous claims, that is, the already examined fear of litigation overload.

b) Social losses and foregone sales

The problem with foregone sales is that the sales that a firm might lose may be the new sales that a competing firm have gained. In terms of the liability for harm done, the problem is, as was already presented in section 3, that private losses are not always converted into social losses, but in positive external effects for others, notably for firms producing substitute products of those of the affected firm.

The possible divergence between private and social losses does not only occur in areas commonly characterized as economic loss cases. Consequential harm, as long as it comes from lost profits or foregone sales, is afflicted by the same discrepancy. The efficient rule in Tort Law would thus be one that limits damages to those private losses that are not offset by gains of someone else and therefore actually constitute social losses. And this would be valid for consequential losses as much as for pure economic losses[45].

The proposed rule limiting damages to social losses is easier said than done. Private losses are, with all the unavoidable measurement problems, relatively easy to discern. The problem of how to assess the actual social losses is of a different order of

[44] In fact, the loss not only affects those consumers whose telephone lines had been interrupted. Telephone is the primary example of a good or service showing positive network externalities: the more people use the service, the more valuable the service is for every consumer. This means that when some consumers cannot use the phone, not only they suffer a loss in utility, but everyone with a phone experiences a decrease in utility, however small this might be. On network externalities generally, see the fascinating book by Oz SHY, *The Economics of Network Industries*, Cambridge University Press, Cambridge, (2001).

[45] Victor GOLDBERG, "Recovery for Economic Loss following the *Exxon Valdez* Oil Spill", 23 *Journal of Legal Studies* (1991), p. 33 thinks that although in theory the private versus social loss problem affect both consequential and purely pecuniary losses alike, in operational terms the distinction should be kept, and a rule for recovery should apply to the former, and a non-recovery rule should apply to the latter (that is, in general terms, the existing Law in the US). He claims that there is a clear correlation between the directness of the harm and the size of the private loss-social loss gap. Although he presents some general reasons for this empirical assertion (requirement of direct injury places a limit on liability, simplified measurement), I think the argument is largely unconvincing.

magnitude. One would need to trace whether there had been or not alternative sales (or postponed sales), whether the alternative or postponed sales had been made at an equal level of production cost, whether the degree of substitutability between foregone sales and alternative or postponed sales is perfect or not[46]. Elasticity of supply and demand in the industry would also play a role, because it influences the diminution in total quantity sold and thus, social surplus.

Market structure is also relevant, and apparently, able to provide us with clear indications about how private losses translate into social losses. If the foregone sales affect a firm in a perfectly competitive industry, there is no social loss. The conditions of a perfectly competitive market[47] guarantee that the elimination (permanent or temporary, total or partial) of the output from any single firm, does not affect market equilibrium, and thus, social surplus. The recommendation will then be simply to ignore those foregone sales and disallow any tort claim that concerns them. In contrast, if the firm suffering the foregone sales is a pure monopolist having complete control of the market, lost profits provide an estimate –actually, and underestimate, unless the monopolist successfully practices first-degree price discrimination- of the social losses caused. This implies that an efficient rule would impose liability for all foregone sales of the pure monopolist, because all lost profits in this case are real losses for society.

Unfortunately, neither perfect competition nor pure monopoly[48] actually describe many real-world markets. We should thus be very cautious about the use of these criteria based on market structure, and not adopt an extreme position favoring either universal refusal to award damages compensating profits from lost sales, or universal acceptance of tort liability for lost sales by firms.

Equally dubious in its practical application by courts is the argument favoring wider recovery of foregone sales based on second-best considerations. The argument runs as

[46] If the costs of serving customers through alternative or later sales is higher, there is a social loss (not for the whole extent of the foregone sale, just for the total amount of the cost increase).

[47] The standard assumptions in economic theory for a perfectly competitive market are the following: atomicity of producers (the number of producers is so large that no single producer has an impact on what others do); product homogeneity (the products by all different producers are perfect substitutes); perfect information (both producers and consumers have perfect knowledge of all relevant variables); equality of producers (all producers have the same technology and cost functions); free and unlimited entry (any producer may enter or exit the market as it wishes). Of course, this set of assumptions clearly shows that perfect competition is a theoretical construct, and that it is not something that we can derive by induction or observation from real-world markets. Still, it is an extremely useful benchmark to evaluate the performance and the possible corrective measures in real life markets.

[48] One could defend, however, that electric power local distribution even now, and telephone services before telecoms liberalization and the introduction of mobile phones, could be considered perfect monopolies, and thus qualify for full ad complete recovery of lost profits.

follows[49]: it is true that the first-best solution might be the one denying recovery of lost profits because they do not correspond to real social losses. But given that the victim of lost profits perceives them as real losses, the non-recovery rule will induce him to adopt measures that reduce the probability of the private loss. If those self-protection measures of the potential victim are socially more costly than excessive care measures by the injurer (remember, the losses are not social losses), it will be more efficient to impose liability in order to induce the latter and avoid the former , even if we are aware of the fact that liability is in excess of the social loss. In other words, it might be advisable to settle for second best (liability but no undesirable self-protection by the victim), than pursue the first best (no care measures and no self-protection) and end up with third-best (no liability and self-protection by the victim).

It is possible to create examples in which the argument works, and thus, liability for foregone is an imperfect but desirable second best. I am doubtful, though, that the practical implications of the argument can be helpful for courts. I am inclined to think rather the opposite: the assumptions for its workability are so strong that it might be better to let it go.

c) Surrogate[50] of contractual liability

In some cases, the real issue is that we have a clear contractual liability on the part of the injurer, but there are factors that impede this liability from providing the adequate incentives to the injurer. Tort liability apparently comprising economic losses might act as a surrogate of this malfunctioning contractual liability.

The most obvious example is the case of a lawyer who negligently fails to draft a will following the instructions of the testator, and as a consequence, the estate ends up not in the hands of the intended beneficiary, but in the hands of a different person. By definition, the other party to the contract with the lawyer cannot pursue any claims based on the obvious contractual liability of the lawyer. Affirming liability in tort[51] towards the intended beneficiary serves as a valuable surrogate of the failed contractual liability. Notice that here the private loss-social loss distinction would have led us astray, because the consequence of the lawyer's negligence is a pure transfer involving no social cost: what the intended beneficiary has not received is exactly what

[49] See William BISHOP, "Economic Loss in Tort", 2 *Oxford Journal of Legal Studies* (1982), p. 8; Donald HARRIS and Cento VELJANOVSKI, "Liability for economic loss in tort", in Michael Furmston (ed.), *The Law of Torts. Policies and Trends in Liability for Damage to Property and Economic Loss*, Duckworth, London, (1986), p. 50.

[50] Landes and Posner (William LANDES and Richard POSNER, *The Economic Structure of Tort Law*, Harvard University Press, Cambridge (MA), (1987), p. 252) use the term surrogate losses and liability with a completely different meaning in mind. They are thinking of harm to unowned natural resources, and refer to liability for economic losses to non-owners who make a living out of the resource as a valuable surrogate for liability to the non-existent owner. The clearest example would be that of marine pollution and liability towards local fishermen. For a coherent critique of this approach, Victor GOLDBERG, "Recovery for Economic Loss following the *Exxon Valdez* Oil Spill", 23 *Journal of Legal Studies* (1991), p. 8.

[51] In some legal systems this liability is specifically imposed by statute: art. 705 Spanish civil code.

the actual legatee has found herself with. But this forgets that the real loss is given by the violation of the testator's wishes. To estimate how much the testator valued respect for her wishes is notoriously hard, so a simple and effective surrogate (probably with some overestimation) is given by tort liability towards the failed inheritor.

Not very differently, liability might work in cases concerning negligently provided information about someone's financial reliability and solvency. To make the informant (usually, an institution knowledgeable of the financial situation of the person to whom the information refers because there is a contractual relationship between them) liable against those who have incurred losses by relying on the negligent information serves the purpose of correcting the possible malfunctioning of contractual liability.

The party, X, contracting with the information provider (the Bank, let's assume), has an incentive to react against negligent appraisal and communication of the financial situation only in cases of underestimation, because only in these situations X will be harmed by the negligent action of the Bank. In cases of overestimation, the harm is external to the contracting partners, and X has no incentive (quite the contrary, actually), to pursue contractual remedies to correct this sort of behavior. The result of this biased incentive towards optimism would be a systematic and undesirable skew towards favorable financial reports[52]. In these circumstances, only relying third parties have the incentive to correct the biased results of contractual liability through tort suits.

Of course, the preceding paragraph does not imply that liability towards relying third parties should always be affirmed. The definition of efficient (that is, not excessive) levels of reliance is absolutely crucial[53]. The important thing is that the issue of tort liability in this context is precisely that of correcting the imperfect functioning of contractual liability.

d) Gatekeepers' liability

The majority of cases of economic loss arising out of negligent provision (or omission of provision) of information, concern the activities of auditors, lawyers, accountants, securities' underwriters, investment banks and the like. In all these cases, the real issue is the existence or absence of conditions for affirming a form of gatekeeper liability (negligently failing to detect and/or report misconduct by someone). There is a large literature on this subject[54], and to deal with it largely exceeds the scope of this paper.

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[52] There are, of course, countervailing factors, such as the reputation on the part of the Bank. This is something that approximates the surrogate rationale to the gatekeepers liability rationale.

[53] If tort liability were affirmed in these cases independently of the adoption by the plaintiff of the efficient level of reliance, a serious problem of moral hazard would arise, and recipients of financial information about other people would excessively rely on it.

[54] For a useful review, see Reinier KRAAKMAN, "Third-party liability", in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, Vol. III, MacMillan, London, (1998), p. 583. See also Frank PARTNOY, "Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime", University

My impression is that it also exceeds the scope of general tort liability rules, such as the ones I am trying to analyze here. It seems, at least to me, that the particular circumstances and conditions of each of those professional sectors, the role of reputation, the type and extent of regulation of the particular sector, and eventually, the use of criminal liability both for the underlying misconduct and for the gatekeeper failure, are necessary factors to consider in shaping an efficient legal regime.

## 5. Conclusion

In this paper I have tried to present a fresh Law and Economics perspective on the notion of economic loss in tort and the exclusionary rule that follows it. I have argued the misleading character of the notion, both as a normative category and as a useful term to group related cases and issues. In this respect, the increased reception of the category in Continental Europe cannot be welcomed.

I also claim that there is no single rationale able to explain coherently the range of issues raised by the major types of cases commonly analyzed under the economic loss rule, not even the most influential economic interpretation of the rule, namely the divergence between private loss and social loss. The proper approach to the broad set of issues present in those sets of cases is necessarily pluralistic. There are, though, several economic principles who can help us to organize and illuminate them: subrogation, social losses versus private losses in forgone sales, surrogate tort liability for failed contract liability, and liability of gatekeepers.

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