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The comparative law and economics of pure economic loss

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Abstract

Law and economics shows that a key factor in determining the optimal economic loss rule is found in the relationship between pure economic loss and social loss. Economic loss should be compensable in torts only to the extent that it corresponds to a socially relevant loss. In this paper we undertake a comparative evaluation of the economic loss rule to verify whether modern legal systems, although not formally adopting the economic criterion, define the exclusionary rule in light of efficiency considerations. The comparative analysis reveals that the substantive applications of the economic loss rule in European jurisdictions are consistent with the predicates of economic analysis.

Keywords: Economic loss; Comparative law; Private and social loss; Tort law; Negligence

1. Introduction

The recent comparative law studies of the pure economic loss rule reveal a great variance across legal systems in the recognition and scope of application of the pure economic loss rule.[1] In this regard European jurisdictions have been classified as being liberal, pragmatic and conservative, depending upon their stance toward the recovery of this loss under tort law rules. A rule of no-recovery in tort for pure economic loss is closely identified with

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[1] The comparative findings of this paper are largely drawn from our prior work on the subject. See, Bussani et al. (2003) and Bussani and Palmer (2003).

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conservative regimes such as Germany, Austria, Portugal and the Scandanavian systems, but in liberal regimes such as France and Belgium no such rule appears to exist. Comparative legal scholars have struggled to find a way to compare different legal solutions within a consistent construct. But their efforts have often led to the conclusion that most jurisdictions' current application of the pure economic loss rule is eventually the result of mere historical accidents.[2] Following the more extensive study by Bussani, Palmer, and Parisi (2003), this article revisits the apparent contradictions brought to light by comparative legal scholars through the lens of economic analysis.

Dari-Mattiacci (2004) suggests that the pure economic loss rule originates from the dual function of tort law in internalizing both negative and positive externalities. In an ideal world in which both positive liability (damages) and negative liability (subsidies) could be used, legal remedies would be able to generate optimal incentives for all parties involved. Dari Mattiacci suggests that the exclusionary rule cannot be explained by a divergence between privately and socially relevant losses. A liability system that links liability to the measure of the net social loss (negative externality at the net of positive externalities) would provides optimal incentives for the injurer but not for the victim. A rule limiting liability to the socially relevant loss would not create first-best incentives when bilateral or multi-lateral precautions are involved. In the present paper, we examine these two alternative economic explanations of the exclusionary rule in light of the comparative evidence. Although the rationales are not always transparent and are often obfuscated by judicial pragmatism, we suggest that the traditional economic explanation provides a valid key for the understanding of the exclusionary rule in a large variety of situations.

Section 2 discusses the most frequently identified rationales of the pure economic loss rule. We contrast the traditional explanations for the exclusionary rule – barring recovery of pure economic loss – with the economic formulation of the rule, highlighting how traditional explanations that are not based on notions of efficiency lead to practical inconsistencies. Section 3 applies this framework to consider the vast comparative data collected by Bussani and Palmer (2003) in the application of the exclusionary rule in European jurisdictions. We show that this evidence refutes the postulates of traditional theory, but supports an economic reformulation of the economic loss rule. Section 4 concludes suggesting that economic reformulation of the exclusionary rule may thus serve as a valuable benchmark in the ongoing attempts to harmonize and codify the rule in the European context. This harmonization effort is presently spearheaded by the European academic community with some institutional backing provided by the European Community.

2. Pure economic loss rule: in search of a rationale

In this section we consider the arguments usually presented in support of an exclusionary rule, offering some critical considerations of the traditional rationales and dogmatic explanations of this rule.[3] These rationales are then contrasted to the economic justifications of

[2] Rabin (1985), Schwartz (1995), Schwartz (2001), Bussani & Palmer (2003) and Gordley (2003).

[3] Naturally, these arguments were developed by jurists operating in legal systems which have recognized—or least considered and rejected—the exclusionary rule. The experience of countries that have ignored the exclusionary

the exclusionary rule. In Section 3 we shall use these competing rationales to identify the logic that appears to influence the decision-making process across European jurisdictions.

2.1. Foreseeability

A common explanation of the economic loss rule relates to the element of foreseeability of the harm. In case law, this rationale supports limitations on the extent of compensable harm, including cases of pure economic loss, emotional distress and loss of consortium. In this context, it has been suggested that tort rules based on foreseeability were developed for physical damage and are not workable outside such context. The evolution of the economic loss rule is explained as a pragmatic development of the law: applying the traditional foreseeability test to cases of pure financial loss would lead to ruinous levels of liability.[4]

Two objections to the foreseeability explanation should be considered at this point: one factual, the other theoretical.

First, the likelihood and extent of economic loss have a degree of foreseeability that does not differ qualitatively from the foresight of other non-economic consequences of a typical tort situation. The closure of a public service exemplified by the *Closed Motorway*[5] case is clearly on point. As a matter of foresight, congestion and traffic delays and consequential economic loss are unavoidable and foreseeable consequences of a closed motorway. Yet, almost all legal systems exclude the recoverability of economic losses of truckers and other professional travelers who suffered an economic prejudice from closure of the public motorway. The fact that pure economic loss is frequently foreseeable, however, should not mean that it is always recoverable due to foreseeability alone. Foreseeability may simply be a necessary condition of liability and not its sole determinant.

Second, from an efficiency standpoint, the optimal level of liability should include both foreseeable and unforeseeable consequences. To the extent causation is established, efficiency requires that the tortfeasor face all the consequences of his wrongful action, such that the *ex ante* level of expected liability coincides with the *ex ante* level of expected harm. Any departure from such a criterion of liability would not adequately provide the incentive to avoid the complete harm.[6]

Both factually and theoretically, therefore, the rule cannot be justified by an unforeseeability notion. Many accidents produce a chain of costly economic consequences which can be statistically estimated and causally linked to the wrongful action. As a policy matter, the presence or absence of foreseeability is a factual and legal question that enters the equation

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rule is indeed most valuable, since it often suggests to us counterarguments which would otherwise remain overlooked. For an overview of the policy arguments in tort law with respect to pure economic loss, see van Boom (2004). See also Benson (1995) (describing how claims falling under the exclusionary rule typically involve nonfeasance claims for which there is no liability at common law).

[4] Feldthusen (2000). The author asserts that the "remoteness" of the damage from the initial conduct of the defendant is the characteristic and endemic issue which distinguishes pure economic loss, as a practical matter, from cases involving physical damage.

[5] See case study no. 15 in Schwartz (2001).

[6] Richard Posner asserts that when a risk is unforeseeable, liability would not deter an actor from creating it (Economic Analysis of Law (2003) 188–189. In our view, however, if liability is excluded for unforeseeable risks, this may not provide an adequate incentive to avoid the complete harm.

of liability in the ways specified by the legal system, but no *a priori* distinction can (or should) be made between economic and non-economic consequences of a tort.

2.2. Absolute versus relative rights

The boundaries of compensable loss in torts have been expanding. Legal scholars have described the domain of protected interests as having gradually expanded along the following path: (a) protection of absolute rights; (b) protection of relative rights; and (c) protection of other (legitimate) expectations.[7] The recovery of economic loss confronts a dogmatic obstacle because the "unreified" economic interests often relate to the parties' unfulfilled contractual expectations or other expectations of economic significance. Several *Ricochet loss* cases are on point. The loss to the victim derives from the wrongful act of a party who is contractually unrelated to the victim and whose act prevents a third party from fulfilling the victim's contractual expectation. Other cases are similarly related to the infringement of a yet unmatured economic interest. Such cases of tortious interference with contractual expectations and pregnant economic interests have traditionally posed a problem in civil law systems. Economic loss derived from the breach of a contractual expectation, in fact, does not enjoy *erga omnes* protection, since the action could only be brought against the breaching party, not against a third party that interfered with the contractual interest.

This argument is grounded in well-established tradition, but in the context of pure economic loss this explanation proves too much and is ultimately bound to beg the question of why there should be no *erga omnes* protection of contractual expectations.[8]

The dogmatic distinction between absolute and relative rights is relevant to the issue of pure economic loss, particularly in the German and German-influenced countries of Europe. A striking characteristic of this group is that pure economic loss does not figure among the so-called 'absolute rights' which receive protection in tort law. Since it is unprotected in tort, refuge must be sought in the law of contract which is the classic domain of relative rights.[9] The basis of such classification is found in the different range of interests that are protected by the enforcement of those rights. In the cases of absolute rights (e.g. rights over real assets and bodily integrity), the right is over a "thing" and other individuals' behavior remains irrelevant insofar as their activities do not encroach upon the relationship between the owner of the right and the object being owned. Conversely, in the case of relative rights, the object of the right is an expectation over somebody else's behavior, a positive cooperation that is instrumental to the fulfillment and realization of the right. For relative rights, the person whose behavior is expected (i.e. the debtor) becomes particularly important. It is indeed a person or group that is distinct from the generality of other individuals. It is only from those individuals that the given behavior can be demanded. In the case of absolute rights, instead, the only relevant legal subject is the owner of the right. Others' behavior is only relevant when it encroaches or violates the relationship between the owner of the right and the "thing".

[7] See e.g. Rabin (1981), Viney (1995) and Bussani (1991).

[8] We shall return to this question in Section 4, after having examined the economic reformulation of the exclusionary rule.

[9] Bussani and Palmer (2003, p. 125).

The interests underlying these rights are substantially different from one another. Relative rights contain expectations from others, and are aimed at changing the *status quo*.[10] Through the behavior of other individuals, the owner of the right wants to acquire something that is not yet his own. The owner of a relative right has a mere *acquisitive* interest. Absolute rights, to the contrary, encompass a different group of situations, where the owner already enjoys a reified interest as part of his patrimony. Third parties are (in principle) extraneous to the legal relationship between the absolute owner of the right and his reified interest and have no affirmative duty of cooperation. The absolute right encompasses a legal interest which is already part of the patrimony of its owner, and it thus reflects a *conservative* interest. If any cooperation can be seen in this legal relationship, it is a cooperation that does not expand the preexisting scope of the right. The negative duty to abstain from interfering or encroaching on the protected right is only preventing a diminishment or violation of the right itself.

The civilian distinction between absolute or relative right – recognized by French legal systems and based upon the nature of the underlying interests protected by the legal system – has traditionally served as a theoretical framework providing a default template of remedies and rules concerning the standing and scope of protection of such rights. At the same time, the distinction has created some artificial inertia in the adaptation of the legal system to new changing realities.

We contend that this explanation proves too much and ultimately begs the question of what should be the desirable protection of pure economic interests. First, if the rationale for the exclusionary rule is that "relative" rights (such as economic interests and contractual expectations) should not be protected *erga omnes*, the explanation would suggest that all such relative rights would remain uncompensated if violated by a third party. This explanation contradicts the fact that the exclusionary rule is associated with the negligence standard, but not cases of intentional breach.[11] Furthermore, all "consequential" economic losses (i.e. losses that are related to a previous loss of the victim suffered because of the infringement of an absolute right of the victim) are fully recoverable in all European jurisdictions. These elements show that the exclusionary rule is not simply the consequence of dogmatic path dependence but a reflection of other policy concerns.

2.3. Policy pragmatism

A third explanation of the exclusionary rule maintains that intangible wealth is not and should not be treated on the same level as protecting bodily integrity or even physical property. People are more important than things, and things are more important than money. Our legal interest in liberty, bodily integrity, land, possessions, reputation, wealth, privacy and dignity are all good interests, "but they are not equally good". The law protects the better interests better. And so "a legal system which is concerned with human values

[10] Although the presence of a duty of cooperation is essential to the structure of this relative or personal right, the nature of the duty can be either positive or negative.

[11] All European legal systems considered in the Bussani and Palmer (2003) study permit recovery when pure financial loss is inflicted intentionally.

would be right to give greater protection to tangible property than to intangible wealth.[12]" The exclusionary rule is then a reflection of the lower value ascribed to our unreified wealth. This argument rests on a silent premise: these values must be ranked because the law *cannot* simultaneously protect all interests fully.[13] This pragmatic motivation should not be dismissed as mistaken in principle, but seems to find no clear empirical support. While the benefits of imposing liability for wrongful behavior should be balanced against the added administrative costs of adjudication, there is no obvious reason to believe that protecting pure economic loss, would decrease the effective protection of other worthier claims.[14]

This proposed doctrinal rationale also flies in the face of the full protection granted to intentionally inflicted "pure" economic loss and the fact that all "consequential" economic losses are recoverable under national law. These elements show the exclusionary rule is not simply the consequence of an ordering of interests but a reflection of other policy concerns that – for the reason that will become evident through the economic analysis – give relevance to the intentionality of the conduct and the existence of prior physical harm.

A plausible alternate explanation of the exclusionary rule is based on reasonable grounds. The actor's interest in freedom of action may outweigh the societal interest in protecting intangible wealth. Because pure economic loss may reflect the exercise of a reasonable act which is not wrongful, society denies liability in negligence for pure economic loss.

In Section 4, we will revisit these issues and offer an explanation of the apparent anomalies in the judicial application of the economic loss rule.

2.4. Administrative costs and derivative litigation

Common law countries, mixed jurisdictions and a number of civil law countries all share similar concerns about the danger of excessive liability entailed by pure economic loss claims. In this context, another frequently invoked explanation for the exclusionary rule concerns the problems of open-ended liability and derivative litigation, i.e. the extension of liability for the remote consequences of a wrongful act.[15]

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[12] Weir (2000).

[13] See also Spier (1996) and van Boom (2004).

[14] Bussani and Palmer (2003) have pointed out that even if we accept that wealth is less important than other values, there would still be no justification for a rule restricting its recovery unless we had to do so in order to protect other, more meritorious interests. Thus the philosophical point is persuasive to the extent that: (1) there is indeed a finite limit to the law's ability to protect interests and (2) giving full protection to pure patrimonial wealth would clearly exceed that capacity and therefore impinge on other protections.
Besides the added costs of adjudication, nothing seems to provide empirical support for the claim that the ultimate effect might be to crowd out "better" interests and leave them unsatisfied. Any such assumption would be at best conjectural, and raises the question how France and Belgium, which follow a rule of presumptive recovery of economic loss, have avoided such crowding out of more deserving legal claims.

[15] Recent literature has pointed out that the judicial applications of the economic loss rule have been one aspect of a general attempt to limit tort liability. (Schwartz, 1995; Schwartz, 2001; Bussani and Palmer, 2003); see also Markesinis, B. (1987). An expanding tort law—the price of a rigid contract law 354. *Law Quarterly Review, 103*; Stapleton, J. (1998). Duty of care factors: a selection from the judicial menus, In Cane, P., & Stapleton, J. (Eds.), *The law of obligations: Essays in celebration of John Fleming*: Oxford University Press). This goal is supported by the fact that the economic loss rule is fundamentally at odds with the overall tendency to expand the scope of

The common premise of these arguments is that in a complex economy, pure economic losses are likely to be serially linked to one another. The forgone production of a good, for example, often generates losses that affect several downstream individuals and firms who would have utilized the good as an input in their production process, and so on. In such world of economic networking, it becomes necessary to set reasonable limits to the extent to which remote economic effects of a tort should be made compensable. Open-ended liability arguments have a well-established doctrinal lineage.[16]

In spite of such a common pragmatic motivation, there are actually three distinct strands to the open-ended liability argument.

(a) The first strand is the belief that permitting recovery of pure economic loss in some cases (e.g. closure of trading markets or of a busy motorway) would unleash a large number of actions that would burden, if not overwhelm, the courts. The justice system could not cope with the sheer numbers of claims. This point closely relates to the concern for cost-effectiveness in the administration of tort law to minimize the total cost of accidents.
(b) The second strand is the fear that widespread liability would place an excessive burden upon the defendant who, for purposes of the argument, is treated as the living proxy of human initiative and enterprise. The fear is that crushing liability could produce overdeterrence, curb the spirit of enterprise and impose liability disproportionate to the negligence of the actor.
(c) The third strand of the argument is that pure economic loss is simply part of a broad modern trend toward greater and greater tort liability, a trend that threatens to get out of control. Allowing exceptions to the exclusionary rule is a slippery slope that may lead to reversal of the rule and may also encourage other types of tort liability.[17]

Economic analysis calls for a different response to each of the three open-ended liability concerns. From an economic point of view, the first strand of open-ended liability arguments is both factually and theoretically accurate. The justice system would unavoidably face an increase in administrative costs as a result of the proliferation of tort claims. Tort policy should account for such administrative costs, which ultimately affect the total social cost of accidents.

The second strand of arguments is theoretically flawed. According to this variation of the open-ended liability argument, the potentially staggering liability faced by tortfeasors

liability in other areas of tort law (e.g., personal injury and harm to property). Such opposite tendency is explained by the fact that expanded liability in those areas rarely yields problems of derivative and open-ended litigation.

[16] Von Ihering's statement "where would it all lead if everyone could be sued . . .!" is indeed a famous rendition of this general concern (1861, pp. 12–13).

[17] The Tilburg Group, for example, argues that the floodgates must be kept shut in order "to dam crushing liability" and to resist the general trend toward expansion of liability. See Spier (1996) and Spier (1998). Six of eight hypotheticals chosen for comparative study by the Tilburg Group deal with the subject of pure economic loss. The floodgates metaphor plays a central role in their orientation. It should be further pointed out that, even if allowing non-deduction of collateral benefits is preferable in terms of optimal tortfeasor's deterrence, the opportunity for the victim to accumulate collateral benefits may create moral hazard problems and a distortion of victim precaution incentives. As shown by Sykes (2001), subrogation may be necessary to correct the incentive problems occasioned by this rule.

would be disproportionate to the degree of the defendant's negligence. The danger of harsh consequences from minor blameworthiness is an issue of fairness no matter what kind of damages have been caused,[18] but some scholars believe that the danger is far greater in pure financial loss cases. These concerns are misplaced.[19] In order to maintain efficient precaution incentives, parties should under most circumstances face the full range of economic consequences of their activities, no matter how severe the harm. Furthermore, given the experience of the Liberal regimes, where the floodgates argument has not been a restraint and yet no dire consequences have resulted, it is not clear that the argument rests upon an empirical foundation.

The third strand of argument does not appear to apply particularly to situations of pure economic loss, since they could well relate to other kind of losses, pecuniary, non-pecuniary, or purely economic. This view argues that the exclusionary rule should be invoked even where there is no danger of a flood of claims or disproportionate recovery. No compensation should be made for fear of establishing an exception that erodes the rule or an exception that may receive analogical extension in the future.[20]

2.5. *Private versus social loss: the optimal scope of liability*

In order to understand the economic significance of the pure economic loss rule, it is necessary to proceed in two steps: first analyzing the notion of socially relevant economic loss, then applying that concept to the design of optimal liability rules.

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[18] See Waldron (1995).

[19] See, however, Stapleton, J., Extra-contractual recovery of pure economic loss in Europe, In Bussani, M. (Ed.), *European Tort Law: Eastern & Western Perspectives* (Sellier, 2006), where the author underscores how "the economic realities of litigation ensure that, in the modern era, the typical pure economic loss claim reaching common law appellate courts involves, not a consumer, but a business, often a repeat player such as a bank, whose aim may well be wider than victory in the isolated case such as the establishment of a favorable precedent." For example, in the pension mis-selling case of Gorham v. British Telecommunications Ltd. Plc ([2000] EWCA Civ 234), the defendants appealed against the success at trial of the plaintiff, a widow, but made it clear that the defendants "have no intention of taking the sum awarded by the [trial judge] back from Mrs. Gorham. They contest the appeal . . . with the object of establishing that they do not owe the claimants a legal duty" because so many other consumers were in her position." J. Stapleton, id. at fn 29.

[20] Financial harm is assumed to have a greater propensity to travel far and wide. It has often been pointed out that the laws of Newton do not apply on the road to financial ruin. Physical damage has at least a final resting point, but patrimonial harm is not slowed down by gravity and friction (see e.g. Weir, T. (1976). *Complex liabilities, IECL*, vol. XI, no. 14(d); James, F. (1972). Limitations on liability for economic loss caused by negligence: a pragmatic appraisal, 25 *Vanderbilt Law Review*, 43, 45). See, however, Stapleton, J. (2001). Legal cause: cause-in-fact and the scope of liability for consequences, 54 *Vanderbilt Law Review*, 941:

> The reference to the laws of physics reflects a long-standing fallacy in traditional running down cases that control of liability for consequences can be achieved by some 'billiard ball' notion of the laws of physics. That is, this reference rests upon the faulty notion that 'claims for physical damage', whether to person or property, are inherently limited by the laws of physics which teach that physical forces will ultimately come to rest. After I have run you over and broken your leg, we have 'come to rest' in a crude sense. Yet if you later suffer negligent treatment at a hospital that damages your other leg, the law may well say this injury is within the appropriate scope of my liability for consequences. What is doing the work in this judgment is not some inherent limit on my liability set by the law of physics but a judgment about the appropriate scope of liability for consequences in light of, among other things, the perceived purpose underlying the recognition of the obligation in the first place. Id. at 974.

From the perspective of law and economics, tort remedies are necessary to specify and quantify externalities. An externality is a cost imposed on a third party outside the voluntary mechanisms of the marketplace. In principle, tort liability should ensure that the entire social cost of an activity is addressed by the responsible party. In this context, the amount of "social" loss is given by the sum of all private losses imposed by a given action on the various parties less the sum of all external benefits generated by such conduct. According to this criterion, liability in torts should not be exclusively linked to the private losses of the parties, but should be further limited to the socially relevant harm.[21] The application of this version of the exclusionary rule would contribute to the minimization of the total cost of accidents.

Some activities, while imposing private losses on some third parties, may create benefits for others. A legal system aiming at creating optimal incentives for potential tortfeasors should impose a dual system of liability: imposing positive liability for the negative externalities and recognizing negative liability for the positive externalities.[22] From an efficiency point of view, the creation of a negative liability rule is as important a remedy as a positive liability rule in a standard tort situation.

As a policy matter, several legal limitations concerning compensable harm, including some variations of the economic loss rule, can be explained as ways to confine liability to only socially relevant externalities. The issue of pure economic loss is best understood contrasting a case of pure economic loss with a traditional situation of physical harm. Generally in cases of physical harm, the action correlates with the extent of the private and social cost of the harm. Any loss suffered by an individual occasions a private cost to the victim, which in turn counts as a social cost for the community. A different logic applies in the case of pure economic loss. In the case of foregone profits or earnings, for example, there is no one-to-one relationship between the private loss of the victim and the resulting social loss. To the contrary, the private loss generally exceeds the social loss, and the discrepancy between the two values may be substantial. This may lead to paradoxes where a private loss yields a social gain. In pure economic loss cases, we may have situations of wrongful behavior that occasion an economic loss for one victim but which may impose no cost, or may even generate a net benefit, to society at large. Whenever wrongful behavior creates a private loss, the magnitude of which differs from the resulting social loss, economic analysis indicates that the victim should only be compensated for the portion of the private loss (if any) which represents a social cost. Where a private loss to the victim yields a net gain to

[21] Applying this principle requires focusing on the tortfeasor's expected *ex ante* liability, rather than on the victim's actual compensation. This may occasionally require courts to set aside some other general principle of tort law. For example, the collateral-benefits rule, which allows the victim to recover the full value of a loss without deducting insurance payments for the same damage may be quite efficient. First, it creates efficient precaution incentives on the tortfeasor. Second, in most situations, the double payment from the insurance and the tortfeasor does not in fact amount to allowing the victim to recover twice. As pointed out by Posner (2003) and Landes and Posner (1987), the insured plaintiff already paid for the insurance benefit under the form of insurance premium, rendering full liability necessary to make him whole. (Landes & Posner, 1987; Posner, 2003). More generally, the risk of duplicate recovery should not necessarily generate over-deterrence, given the relevance of the *ex ante* expected liability, rather than actual *ex post* compensation, on individual incentives.

[22] See, however, Gilead (1997), suggesting various reasons why the exclusionary rule is unable to cope with the problem of positive externalities.

society at large, law and economics concludes that the wrongful behavior should actually be encouraged and economically subsidized by the legal system.[23] Put differently, an ideal set of liability rules should provide both positive liability for negative externalities (i.e. losses to third parties) and negative liability for positive externalities (i.e. benefits to third parties).

This dual function of liability rules would, in the abstract, consist of a combination of damage remedies paid to the victims and financial subsidies paid to the tortfeasor. If an individual occasions an unjustified transfer of wealth from one party to another and is made liable for the loss suffered by one victim, he should, by the same logic, be allowed to recover the value of the benefit from other third parties who received an unexpected benefit from his action. The important point here is that a zero net liability rule for the alleged tortfeasor does not necessarily require a rule denying compensation for those who suffered a private loss. Here lies an important element that drives the intellectual and dogmatic tension behind the economic loss rule. From an economic perspective, the legal notion of pure economic loss is thus an imperfect proxy for the economic category of socially relevant cost, which should guide the optimal design of liability rules.

3. Back to reality: revisiting the comparative findings

The findings of the comparative study of the rules governing the recovery of pure economic losses in European legal systems show relatively little coherence, let alone uniformity, in the treatment of pure economic loss cases.[24] Table 1 summarizes data collected by Bussani and Palmer (2001) and provides a summary of the solutions to typical pure economic loss situations in European national Courts. These categories of loss are explained and analyzed in the following subsections.

The applications of the economic loss rule summarized in Table 1 reveal that the issue of recoverability of pure financial loss cannot be approached in terms of some distinctive trait or characteristic of the "legal families" of Western Europe. The question is not simply an issue that pits civil law against common law. Contrary to the conclusions reached by several legal commentators on this issue,[25] the comparative findings however suggest that the emergence and diffusion of the economic loss rule in European legal systems is more than a mere historical accident. We evaluate these findings in the light of the alternative rationales presented in Section 2 and attempt to reconcile some of the apparent contradictions of the judicial applications of the economic loss rule.

The analysis provides a plausible explanation for the gradual departure of all European legal systems from their default attitude towards liability in torts: "liberal" systems, such as France, create exceptions to the domain of compensable economic loss, and "conservative" systems grant occasional compensation for losses that would otherwise fall outside the

[23] On this point, Arlen (2000) observes that, if an incumbent monopolistic firm loses part of its market share to a competitor selling the same product at a lower price as a result of the tortuous activity of the latter, the alleged tort, while occasioning the victim's lost profits, may actually be at the origin of a social welfare gain.

[24] For another comparative analysis of the pure economic loss, see van Boom (2004). Available at SSRN: http://ssrn.com/abstract=555809.

[25] Schwartz (1995), Schwartz (2001), Bussani and Palmer (2003) and Gordley (2003).

Table 1
Recovery of economic loss in European jurisdictions

	Recovery	Unsettled	No recovery
(a) Ricochet loss			
(i) Cable cases	France, Belgium, Greece, Italy, Spain, The Netherlands	–	Austria, England, Finland, Germany, Portugal, Scotland Sweden
(i) Loss of a "Star"	France, Italy	Spain	Austria, Belgium, England, Finland, Germany, Greece Portugal, Sweden, Scotland, The Netherlands
(b) Transferred loss	Austria, Belgium, France, Greece, Portugal, Spain, The Netherlands	Italy	England, Finland, Germany, Scotland Sweden
(c) Closure of public service	France	Italy, Greece, The Netherlands	Austria, Belgium, England, Finland Germany, Portugal, Scotland, Spain, Sweden
(d) Flawed professional advice			
(i) Lawyers/notaries	Austria, Belgium, England, France, Germany, Greece, Italy, Scotland, Spain, The Netherlands	Finland, Portugal, Sweden	–
(ii) Auditors	Belgium, Finland, Italy, Sweden, The Netherlands	France, Greece Portugal Spain	Austria, Germany, England, Scotland

listing of protected interests. In this context, economic analysis unveils the underlying logic of what would otherwise appear to be an *ad hoc* application of the exclusionary rule driven by a fuzzy judicial pragmatism.

3.1. The relevance of case law distinctions in Ricochet cases

In the first group of cases, the *Ricochet loss* cases, a physical damage is done to the property or person of one party, which impairs the contract rights of the plaintiff. Examples contemplate damage to things or persons that, in turn, occasion an economic prejudice to a third party. The direct victim of the accident sustains physical damage while plaintiff is a secondary victim who incurs only economic harm. The "Cable Cases"[26] and the "Loss of a Star" cases,[27] are real life examples on point.

In *Ricochet loss* cases the relationship between the private loss of the plaintiff and the resulting social loss deserves some consideration. The European cases reflect the mixed nature of the loss in *Ricochet loss* cases, as reflected by the split judicial decisions on the matter. The trends, however, strongly support our hypothesis that the contours of the economic loss rule are driven by implicit efficiency considerations. Indeed, European trends in the adjudication of *Ricochet* cases are consistent with our economic restatement of the rule, as shown by the fact that the very large majority of jurisdictions deny liability in "Loss

[26] See e.g. Spartan Steel and Alloys v. Martin & Co., QB 27 (1973).
[27] See, e.g. the Italian case Torino Calcio SPA v. Romero, Cass. Civ., SU 26.1.1971, no. 174, GI, 1971, I, 1, 681.

of a Star" cases, while nearly half grant compensation in the "Cable Cases". The empirical findings are even more striking in that "Cable Cases" present problems of open-ended litigation that the "Loss of a Star" situations do not.

The dichotomous treatment of these two categories of *Ricochet loss* is easily explained in economic terms. In many situations, an asset's market price already captures the discounted present value of the flow of income from the employment of the asset in valuable productive activities. The market for sport champions is highly competitive and players are able to exploit their bargaining power to their advantage. The value of a soccer player, thus, already captures most of the surplus that the team expects to earn from the player. In the market for "stars" individual champions capture most of the rent, given their position as monopolistic sellers of non-fungible services. If compensation received by the victim already includes the lost wages from his "star" employment, any additional liability of the tortfeasor toward the team would likely amount to duplicate compensation for the same loss, causing excessive liability and over-deterrence.

Not every *Ricochet* case, however, fits this mold. In the "Cable Cases," for instance, the asset's market price does not capture the full surplus that third parties derive from its use. The price of telephone services, for example, cannot be assumed to capture the full consumer benefit derived from the use of such services. If the exclusionary rule limits liability to the loss suffered by the telephone company, compensation would fall short of the true social loss occasioned by the accident. Exclusionary rules in these cases stem from concerns for open-ended liability and not from efficient incentive considerations. In most real life cases, the true social loss probably lies in between the above considered values, since neither upstream suppliers nor downstream consumers are likely to capture the full surplus. These intermediate cases would call for a partial application of the exclusionary rule, limiting liability to the "socially relevant" portion of the economic loss.

The observed pattern of adjudication in European jurisdictions contradicts scholars who maintain that the emergence and popularity of the exclusionary rule would be explained by concerns for open-ended litigation. If such claim were correct, we would observe the opposite pattern of adjudication in *Ricochet loss* cases. These findings clearly support our hypothesis that efficiency considerations could be strongly influencing results in this category of cases.

3.2. Normative agnosticism for transferred losses

In the second group of pure economic loss situations, which we call *Transferred loss* cases, a tortfeasor causes physical damage to a victim's property or person, but a contract, or the law itself, transfers the loss to a third party. As a result of an initial wrongdoing, a loss that would ordinarily be sustained by the primary victim alone (generally the direct victim of physical injury or the owner of a physical asset) is passed on to a secondary victim, who only has a contractual interest in the property or a contractual obligation to insure the victim's loss. A transfer of loss of this type usually occurs when the damaged property is subject to a lease, a pending sales contract, or an insurance agreement.[28] A similar transfer

[28] See e.g., Robins Dry Dock v. Flint, 13 F.2d 3 (2d Cir. 1926), *rev'd* 275 US 303 (1927); The Aliakmon, 2 AER 44 (1985).

of the loss can be effected by the law when, for example, a pay continuation statute requires an employee to pay the salary of an employee, even if the worker is unable to perform his obligations under the contract due to an injury occasioned by a third party tortfeasor. In these situations it is clear the tortfeasor is not exonerated from liability. It is merely the loss which is transferred, never the liability. The legal question is whether the transferor alone or the transferee as well has a cause of action against the tortfeasor. Since there is liability wherever the loss finally rests, there is no reason to be concerned that the loss will be externalized or that undedeterrence may result.

Legal systems address the question of whether the secondary victim should be able to obtain compensation for the pure financial loss from the tortfeasor with openly different solutions. From an economic point of view, the solution to these cases is quite straightforward. The relevant factor for determining the optimal level of liability is given by the extent of the socially relevant loss. The transfer of a loss from a primary victim to a secondary victim which results from a contract (e.g. a lease or an insurance contract), while changing the final allocation of the residual liability, does not modify the gravity of the actual loss occasioned by the accident. An accident produces an objective loss, regardless of who ultimately bears such loss. For example, an accident that destroys a commercial building creates a given amount of loss, whether the building is insured or whether a statute or a contract transfers some of the loss to a secondary victim. The optimal amount of liability imposed on the tortfeasor should, therefore, not depend on the existence of a loss transfer mechanism. The physical and economic losses that follow the destruction of a building should be compensated in full regardless of who ultimately bears the risk: an insurance company, a tenant, or the actual property owner.

The exclusionary rule should be utilized to prevent imposition of double liability – in favor of both primary and secondary victims – for the same loss, but should in no way reduce the amount of the tortfeasor's liability below the total social loss generated by the accident. Put differently, for the purpose of optimal deterrence, the expected liability should equal, but not exceed, the full social loss. The computation of the social loss in these cases should include the sum of the "net" loss received by the property owner and the additional loss received by those who have other interests over the property. Whether such total compensation is paid to the primary or the secondary victim, or split among the two, is immaterial from a deterrence standpoint. Other principles, however, come to the rescue in establishing who should receive compensation for the loss.

From an economic point of view, the main criterion for understanding the transferred loss problem flows from the following consideration. Rational parties account for the effect of their expected liability in setting the price for their contract. The clearest illustration can be found in the insurance case. If insurance companies are allowed to exercise a subrogation action to obtain compensation from the original tortfeasor in all cases of *Transferred loss*, the average net recovery from subrogation claims will be discounted from their expected liability cost. In turn, this will lower the insurance premium for all potential primary victims. The same holds in the converse case in which an exclusionary rule prevents the secondary victim from recovering the economic loss. If any other contractual relation or legal rule transfers the loss from a primary to a secondary victim, the underlying contract price would likewise reflect the expected cost of such transferred risk. For example, in the event of a pay continuation statute, the employer discounts the risk of an injury of his workers from

the expected value product of his work force. The equilibrium market wages would reflect the mandatory welfare coverage, shifting back on the workers most of the cost of such forced insurance. Identical conclusions would apply under a lease contract. Consider an exclusionary rule that states, if a third party occasions damage to the rented property, the lessee would be barred from recovering the economic loss from the lost use of the rented space. Under such rule, the lessee would discount from the rent the expected economic loss from potential accidents. In the aggregate, equilibrium market prices would reflect the lower protection and lower expected value of the lessee's interest, with lower rental prices.

The above considerations suggest that the application of the exclusionary rule in *Transferred loss* cases is likely to have no incentive or wealth effects. Criteria of efficiency and distributive justice are neutral to the question whether the exclusionary rule should apply to this class of cases.[29]

The economic criterion remains agnostic on which rule should be applied under the circumstances, but calls for clarity and coherence in the legal system. Assuming that the likelihood that a third party inflicts damage to the property is causally exogenous (i.e. it does not depend on the behavior of the victim), all possible allocations of the risk are efficient, as long as they are known by the parties and consistently applied. The legal system, in other words, by announcing the rule *ex ante* provides a valuable coordination device, which facilitates parties' bargaining. As long as the full social cost of the accident is borne by the tortfeasor, the exclusionary rule will have no impact on the efficient precautions of the parties or the final distribution of the cost of accidents. The price system will, in fact, offset any attempt by the legal system to transfer the exogenous risk of accidents between a primary and a secondary victim.

The conclusions generated by the efficiency criterion are thus easily reconcilable with the observed split among European legal systems in the treatment of *Transferred loss* cases. All the solutions we have examined are in fact acceptable, as long as: (1) the avoidance of the exclusionary rule does not lead to a duplication of the tortfeasor's liability for the same objective loss and (2) adoption of the exclusionary rule does not exclude the full compensation of the relevant social loss. The identification of the party who should ultimately be entitled to collect compensation is of no consequence for the purpose of determining efficient liability and fair risk allocation.

3.3. Private versus social loss for the closure of public service and infrastructures

In the third group of cases, an economic loss arises without a previous injury to anyone's property or person. Any physical damage is to "unowned resources" that lie in the

[29] See e.g. with respect to a leasing arrangement, if the exclusionary rule prevents the lessee from recovering from the injurer, the contract will allocate that risk of loss to the lessor, who could recover if the risk materializes, and if that reallocation of risk within the contract is not possible, the value of the lease would decrease for the lessee, and thus the rental price he would be willing to pay. However, if there is risk aversion, that the exclusionary rule prevents the efficient risk allocation (for example, to the lessee if he is less risk-averse) or forces additional transaction costs, decreases efficiency. In sum, the optimal tort rule is that which is neutral towards the allocation of risk determined by the contracting parties. This has already been applied to the pure economic loss problem (Gomez & Ruiz 2002).

public domain.[30] Examples of this category of cases include the scenario where a negligent act forces the closure of a public market or a highway, occasioning an economic loss to individuals whose production depends on such infrastructures.[31]

As we have pointed out above, this category raises the greatest concern about liability to an indeterminate class of individuals, with relevant concerns for open-ended liability and litigation. Not surprisingly, with the possible exception of France and a few unsettled jurisdictions, European courts have been reluctant to grant compensation for pure economic loss in these situations.

From an efficiency standpoint, the pragmatic tendency to deny compensation for pure economic losses does not raise serious concerns. The socially relevant extent of a pure economic loss suffered by an individual user of a public service or infrastructure is generally given by the difference between the first and second best opportunity available to such individual. The measure of lost profits from the sales in a closed market is not a good proxy for the computation of the relevant social loss in such cases. Compensation should not exceed the difference between the foregone profit and the profit such individual could have made by engaging in the second best productive activity. Furthermore, such measure only provides an upper limit in the amount of recoverable damages. Some of the lost profit for the plaintiff, in fact, could well result in a windfall gain for other suppliers, who might be able to draw a benefit from the larger share of demand that they can serve. In a perfectly elastic market response, the accident would occasion no socially relevant economic loss (i.e. the pure economic loss of one party would be offset by the pure economic gain of others, with no net social loss). With imperfect market elasticity, however, there could be positive social loss. A private economic loss of one party would not generate a social loss of equal magnitude, except in the purely abstract case of a perfectly inelastic market (i.e. situation where the market cannot compensate for the production shortage and thus satisfy the excess demand). In most cases, the pure economic loss of the victims thus constitutes a gross over-estimate of the true social loss, and the exclusionary rule correctly avoids excessive liability and over-deterrence.

The dominant trend in European jurisdictions, denying recovery for third parties' pure economic loss, is therefore fully consistent with our hypothesis that the practical contours of the economic loss rule are driven by implicit efficiency considerations. The overall social relevance of the economic losses for the various parties is likely to be at a minimum in this group of cases. Most likely, the quasi-unanimous application of the exclusionary rule in these situations reflects a combination of factors. First, the economic loss is likely to be a "purely private economic loss". Second, even in those few instances of inelastic market conditions in which the private loss of the parties might generate a social loss, the administrative costs of implementing a full liability system would be prohibitive. The occasional efficiency gains do not justify the creation of such large administrative costs.

The efficiency considerations driving the exclusionary rule for third party economic loss may, however, be obscured by countervailing pragmatic considerations. For example, the loss caused by closure or disruption of public utilities may be characterized as both a social

[30] Goldberg (1994).

[31] See, e.g. Weller v. Foot & Mouth Disease Research Inst., 1 QB 569 (1966); Louisiana ex rel. Guste, v. M/V Testbank, 752 F.2d 1019 (5th Cir. 1985).

and a private loss. Jurisdictions may be concerned with the resulting morass of indeterminate liability if pure economic loss claims were viable.

3.4. Economic loss and the market for professional services and information

The fourth and last group of cases considers the liability of those who furnish professional advice, prepare data or render services concerning financial matters. The information or services that they furnish to a client may be relied upon by third persons. If the advice, data or services are carelessly compiled or executed, the relying third party may sustain a pure economic loss. Textbook examples of this category of economic loss include the case of accountants who carelessly overstate the company's net financial worth causing investors, who rely on the accuracy of their audit, to buy shares in the company at more than its current value. Other examples contemplate the case of mistaken or false job reference and credit ratings, which may cause financial losses to a third party.[32] Professional services of lawyers may likewise occasion harm to a third party, such as in the case of a will carelessly prepared by a lawyer for his client, which is subsequently deemed invalid, with a pecuniary loss to a third party non-client.[33]

The empirical findings from European jurisdictions concerning this category of economic loss are quite peculiar. European courts are virtually unanimous in allowing recovery of pure economic loss when the flawed services are provided by lawyers and notaries,[34] but are more reluctant to allow such recovery in the case of auditors and accountants. The dichotomous approach followed by European courts is at first quite puzzling. There are no obvious features in the nature of the services provided by lawyers and notaries that can help us differentiate them from the case of auditors and accountants. A more careful consideration of the matter through economic lenses, however, unveils the latent qualitative difference between the two groups of cases.

Lawyers and notaries generally provide services that benefit exclusively the client or restricted group of third parties. Any third party that derives a benefit from the services of the notary or lawyer, such as to be able to claim an economic loss if the services were flawed, is likely to be an intended beneficiary of the client who is paying for the professional service. The price of services rendered by this group of professionals incorporates the expected cost of professional liability in the event of involuntary malpractice. As part of the professional fees charged by the lawyer or notary, the client is thus paying for the implicit warranty of quality.

The same logic applies in the case of accountants and auditors. In this case, however, there is a much larger range of individuals that may utilize and rely upon the information provided by these professionals. If liability were imposed for the pure economic loss suffered by all such third parties, the larger potential cost of liability for malpractice would be borne by

[32] See also, Hedley Byrne & Co. v. Heller & Partners Ltd., AC 465 (HL) (1964).

[33] See, e.g. White v. Jones, 2 AC 207 (HL) (1995); Lucas v. Hamm, 11 Cal. Rept. 727 (Cal. Ct. App. 1967); Ross v. Caunters [1980] Ch. 297.

[34] As discussed above, in the specific case of Notaries (e.g., the defective will drafted by a negligent Notary), there is virtual unanimity in favor of the intended beneficiary's recovery of his or her financial loss: 11 European countries sampled in the Bussani and Palmer (2003) study indicate the recoverability of the loss, with no system opposing such solution.

those who acquire the professional services, under the form of higher fees. This, in turn, would reduce the quantity of professional services demanded, with a potential deadweight loss for society.

What distinguishes the two groups of cases is, therefore, the ability of the "purchaser" of professional services (i.e. the client) to internalize the full benefit of the information or services acquired. If third parties (other than the intended beneficiaries of the professional service) can rely on the information produced by the professional (and claim compensation in case of flawed information), without directly or indirectly contributing to the cost of the service, creating externality problem, which would lead to a sub-optimal demand for professional services.

This analysis nicely squares with the dichotomous treatment of professional services cases in European jurisdictions. Due to the intrinsic nature of the services provided by accountants and auditors, it is more likely that third party investors and other financial institutions may rely upon the information they provide. Once the information is made available, the original purchaser of the professional service is generally unable to capture the full benefit generated by the information (e.g. collecting a payment from third parties who take advantage of the information). Here, the selective application of the exclusionary rule serves the very valuable purpose of correcting the externality problem that would otherwise affect the market for professional services.

In this last group of cases as well, therefore, the European trends are consistent with the economic model of optimal liability, yet the exclusionary rule reflects a slightly more complex set of considerations. The rule prevents the recovery from third parties (other than intended beneficiaries), since such parties would otherwise increase the cost of the service at the expense of the buyer of the service, with a resulting externality loss. This application of the exclusionary rule is consistent with the hypothesis that the practical contours of the economic loss rule are driven by efficiency considerations, but is not immediately derived from our economic restatement of the exclusionary rule. As is the case with the closure of public services, this efficiency rationale may coexist with such pragmatic considerations as a concern for indeterminate liability.

We may conclude that plaintiffs are barred from recovering damages, not because their losses are purely *private*, but because the compensation for such economic losses would impose an external cost on those who purchase professional services, with a resulting deadweight loss for society. The application of the exclusionary rule in these cases, is efficient, but represents a second-best outcome, compared to an ideal alternative in which all third parties could be induced to contribute to the cost of the information supplied by the professional, enjoying full compensation in the event of flawed professional services.

3.5. A postscript on intentional versus negligent torts

Intent is another feature of the economic loss rule with little explanation in the traditional rationales of the rule. All European legal systems agree intentionally inflicted pure economic loss is recoverable. The exclusionary rule only applies to economic loss caused by negligent behavior, not intentional wrongdoing.

The common treatment in European law of economic loss that arises from intentional wrongdoing poses an interesting puzzle. In determining the extent of liability, most European

systems give little significance to the subjective element of a tort, since negligent and intentional torts are governed by common principles as far as damages are concerned. The divergence in European systems, however, begins when negligence is found to be the cause of the pure economic loss.

The recoverability of the intentionally inflicted economic loss has two important economic explanations.

First, given the more difficult burden of proof, intentional torts represent only a small fraction of the total number of tort claims. Only a small fraction of tort cases are successfully decided as intentional torts. This renders the compensation of intentionally inflicted pure economic loss less problematic from the point of view of derivative and open-ended litigation.

Pure economic losses necessitate full compensation for a second, more compelling reason. As we noted in Section 3, several situations that fall within the scope of the exclusionary rule occasion zero-sum transfers from the victim to a third party. From a social welfare point of view, such cases may impose a loss on an individual, but they do not create a net social loss, because of the presence of offsetting benefits accruing to third parties.

In such cases, the optimal level of liability would require no liability for pure economic loss, since no corresponding social loss is created. The exclusionary rule, if applied, would create no inefficiency in terms of incentives. This logic does not apply to intentional torts, where the application of the exclusionary rule would create troubling results. It would, in fact, be possible for an intentional tortfeasor to impose a pure economic loss on a victim, creating a direct economic benefit for a third party, without having to face any tortious liability. This would create the opportunity for uncompensated "takings," intentionally carried out for the benefit of a third party to the detriment of another. From an economic point of view, these zero-sum transfers would generate the potential for a dangerous spiral of reciprocal takings with substantial rent dissipation for society as a whole.

This helps to explain the presence of a common rule among all European legal systems excluding the application of the economic loss rule for the case of intentional torts. This further explains the flexibility used by European courts in evaluating the "intention" element in this group of cases.[35] For the practical purposes discussed above, the risk for reciprocal takings to the benefit of third parties is not only the result of purposeful planning but also the possible consequence of indirect intent (*dolus eventualis*) which should be included within the notion of intentional wrongdoing in the application of the economic loss rule. Though harder to prove than negligence, the incidence of financial fraud is not a rare occurrence and the most liberal interpretation of the notion of intent is therefore explainable as a necessary effort to afford adequate protection.

4. Conclusions

We have examined the economic explanations of the exclusionary rule in light of the comparative evidence. The efficiency criterion appears to provide a fitting rationalization

[35] See, e.g. von Bar (1994); P. Cendon, "Il dolo nella responsabilità extracontrattuale" (Giappichelli, 1976).

of what would otherwise remain puzzling empirical findings. European legal systems that generally follow a different theoretical approach to tort issues seem to react quite similarly to the various categories of pure economic loss, with solutions that often depart from entrenched dogmatic principles. The European trends in pure economic loss cases are virtually inexplicable when combined with the traditional doctrines of pure economic loss. The economic restatement of the exclusionary rule allows us to return to the comparative findings confirming our hypothesis that the efficiency criterion strongly influences the observed judicial solutions.

Behind the veil of rhetorical dogmatism, European Courts attempt to implement an exclusionary rule that promotes efficient outcomes. European courts are attentive to the needs of striking a practical balance between the limiting litigation while maintaining effective deterrence, within the dogmatic constraints imposed by their legal tradition. The analysis has unveiled the sound economic logic of much European case law, dispelling the fist impression of *ad hoc* judicial pragmatism. Further empirical work should be carried out to validate the alternative economic explanations to verify whether courts apply the exclusionary rule as a pragmatic way to limit liability to the relevant net social loss in unilateral care cases, and/or whether the more complex formulation by Dari-Mattiacci (2004) is used in bilateral and multilateral care cases.

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