Pure Economic Loss: Comparing Posner's Idea of Economic Loss with the Treatment of Pure Economic Loss in English Common Law

Hannah Olusoga-Tinubi [1]

Abstract

This paper studies pure economic loss in torts with the aim of determining how well the law of torts, as developed in English Common Law, is well adjusted to the economics principle of efficiency. The study attempts to measure the efficiency or otherwise of economic loss doctrine in English Common Law by comparing the treatment of pure economic loss in the English legal system with economic criteria developed by Richard Posner– a United States of America's Court of Appeal Judge, jurist, economist, professor and major contributor in the field of Law and Economics. This comparative analysis reveals that the economic loss doctrine is in harmony with the principles of efficiency in Law and Economics. Using the French legal system as an example, this work finds out that a legal system's treatment of pure economic loss may still be in harmony with the principles of efficiency without necessarily relying on economic loss doctrine. This conclusion is however without prejudice to the fact that the English legal system, by alluding to the principles of efficiency, is able to determine not only the reason for the existence of certain legal rules but also the effect of such legal rules in the society thereby maintaining

1. Department of Social Justice, College of Social and Management Sciences, Afe Babalola University, Ado-Ekiti, Nigeria; hannaholusoga@gmail.com

an edge over some other legal systems which fail to take into account principle of efficiency.

Key Words: Economic loss doctrine; Law of torts; Law, Economics; Private and Social Cost.

Introduction

In English Common Law, a legal doctrine or rule dealing with economic loss has been fashioned out and continues to be upheld by Common Law courts. This doctrine is termed the economic loss doctrine. By this doctrine, which is a special feature of the law of torts, recovery or damages in torts are generally barred when the plaintiff suffers a loss that is exclusively pecuniary, unaccompanied by property damage or a personal injury (Miles, 2007). The foundation of the duty of care and the development of the rules of negligence in the law of torts in English Common Law are laid down in the landmark decision held in *Donoghue v. Stevenson* (1932). In this case, Donoghue and her friend went to a restaurant in Scotland. While at the restaurant, Donoghue's friend ordered an ice cream float for Donoghue. Donoghue was subsequently served a tumbler of ice cream alongside a bottle of ginger beer out of which the restaurant owner poured half of its content on the ice cream in order to create the float. The restaurant owner left the bottle of ginger beer with its remaining content on Donoghue's table. Donoghue ate some of the float and as she poured out the remaining contents of the bottle of ginger beer on her tumbler of ice cream in order to create more float, the remains of a decomposing snail slid out of the bottle of ginger beer. Consequently, Donoghue took ill and she sued the ginger beer manufacturer.

The English legal climate of that time however posed some challenges to Donoghue's case. On the authority of earlier decided cases applicable in that period of time, Donoghue was required to prove that she had a right against the manufacturer that he takes care to ensure the ginger beer was safe for consumption. However, under the legal climate of that time, such a right could only have been created if there was a contract between Donoghue and the manufacturer. Of course there was no contract between the manufacturer and Donoghue. A contract could not even be said to exist

between the owner of the restaurant and Donoghue because Donoghue's friend placed the order with the owner of the restaurant. In deciding the matter, the House of Lords held that the manufacturer holds a duty of care to the consumer of its product to ensure that it is safe for consumption and this right subsists even where there is no contractual agreement between the parties. This decision captures the very essence of the law of torts. The law of torts tells us "what rights we have against other people automatically– free of charge without having to make any special arrangements for them– and what remedies will be available when those rights are violated" (McBride & Bagshaw, 2012:1).

The law of torts seeks to remedy damages or losses which are occasioned by a breach of the duty of care especially in situations where there is no prior contractual arrangement between the tortfeasor and the injured. Tort law is very much unlike contract law in that whilst the former enforces obligations imposed by the law, the latter enforces obligations voluntarily agreed to by parties (Friedman, 2000). The word "tort" is an English word whose origin is derived from the French word *tort*. The word means wrong or injustice. In French language, the sentence ***"vous avez tort"*** translates into "***you are wrong***" in English language. In Common Law jurisdictions, tort is a legal wrong or a wrongful act which is remedied by way of private action. Crimes, on the other hand, are remedied by way of public action, i.e., actions by the state through its security agencies. As a matter of fact, the mere act of remedying torts by way of private action as opposed to public action is a distinguishing characteristic of torts from crimes. Apart from remedy by way of private or public action, another distinguishing factor is that the remedy for torts lays principally in damages while the remedies for crimes include fines, community service, caning, imprisonments or death penalty. The remedy of damages is, according to Friedman (2000), a way of "forcing potential tortfeasors to take account of the costs their acts impose on other people, a legal mechanism to internalise externalities and thus produce efficient choices" (p.190). By way of damages, costs are imposed on potential tortfeasors making it more expensive for them not to commit a tort than to commit it.

Economic Loss Doctrine

As stated above, by this doctrine, recovery or damages in torts are generally barred when the plaintiff suffers a loss that is exclusively pecuniary, unaccompanied by property damage or a personal injury (Miles, 2007). Losses occasioned or accompanied by property damages or personal injury are referred to as physical torts while losses which are unaccompanied by property damages or physical loss are referred to as economic torts. Economic torts "do not allege physical contact with the victim or his property or harm to such non-financial, or at least non-commercial, goods as business reputation and personal privacy" (Posner, 2006:735). To better understand how a loss can be exclusively pecuniary, let us consider the following illustration in the scenario below.

Assuming Mr. X owns a pharmaceutical store along Obafemi Close in Maitama, Abuja and a trailer load of goods owned by Company Y falls on the only road connecting Obafemi Close to the rest of the Maitama neighbourhood as a result of which, Mr. X's customers could have no access to his store and this caused him pecuniary loss because he made no sales for the period of two weeks in which the road was blocked. The implication of the economic loss doctrine, as it applies to the scenario above, is that Mr. X will be unable to claim damages from Company Y in torts because his financial loss is neither linked to any damage to his person nor any damage to his property.

In another scenario, assuming Company Y's trailer load of goods crashes into Mr. X's pharmaceutical store damaging his property and goods and causing injury to Mr. Z who is Mr. X's sales agent, then both Mr. X and Mr. Z would be able to claim damages from Company Y. While Mr. X can make a claim for the damage to the property, Mr. Z's claim would be with respect to the personal injury suffered.

Claims for economic loss could feature in cases of negligent misrepresentation, negligent harming of third parties beneficiaries, economic loss arising from product defects, negligent infliction of economic loss where the parties are related only by accident and so forth (Rhee, 2010). However, economic loss doctrine does not bar recovery for consequential economic harm i.e. recovery of economic losses arising from a plaintiff's physical injury or property loss (Rhee, 2010).

The Position in English Common Law

In Spartan Steel & Alloys Ltd v Martin & Co. (Contractors) Ltd., Lord Denning, in delivering the Lead Judgment, dealt with the issue of economic loss. In this case, Spartan Steel and Alloys Ltd. is a company engaged in the manufacturing of steel. To this end, it has a factory in Birmingham. In order to power its factory, it derives electric power from a direct cable linked to a power station of the Midlands Electricity Board. Martin and Co. (Contractors) Ltd., while going about their contracting business damaged the cable which supplied electricity to the Spartan factory because their men did not take reasonable care. As a result of this power disruption that lasted for 5 hours, Spartan Factory lost the metal that was processing (melting) when power was disrupted, valued at 368 pounds, as well as the profit that would have been made (had the metal been successfully processed), valued at 400 pounds. They also lost the profit that would have been made from four more set of metals that would have been processed had the power supply not been disrupted valued at 1,767 pounds. All these damages were claimed against Martin and Co. in negligence. Martin and Co. admitted that they were liable for the £368 physical damages. They did not greatly dispute that they were also liable for the £400 loss of profit on the first melt, because that was truly consequential on the physical damages but they denied liability for the £1,767 for the other four melts arguing that it was economic loss for which they were not liable.

It was held that Spartan Ltd. should recover for the physical damage to the one melt (£368), and the loss of profit on that melt consequent thereon (£400): but not for the loss of profit on the four melts (£1,767), because that was economic loss independent of the physical damage. In arriving at this conclusion, Lord Denning considered a few things. The first thing he considered relates to the position of statutory undertakers like electricity companies. In the words of his Learned Lordship, "if the electricity boards are not liable for economic loss due to negligence which results in the cutting off the supply, nor should a contractor be liable" (Spartan, 1973, para. 22). The second has to do with the nature of the hazard. Regarding this he posits that:

> This is a hazard which we all run. It may be due to a short circuit, to a flash of lightning, to a tree falling on the wires,

> to an accidental cutting of the cable, or even to the negligence of someone or other. And when it does happen, it affects a multitude of persons: not as a rule by way of physical damage to them or their property, but by putting them to inconvenience, and sometimes to economic loss. The supply is usually restored in a few hours, so the economic loss is not very large. Such a hazard is regarded by most people as a thing they must put up with- without seeking compensation from anyone. Some there are who install a standby system. Others seek refuge by taking out an insurance policy against breakdown in the supply. But most people are content to take the risk on themselves. When the supply is cut off, they do not go running round to their solicitor. They do not try to find out whether it was anyone's fault. They just put up with it. They try to make up the economic loss by doing more work next day. This is a healthy attitude which the law should encourage" (Spartan, 1973, para. 23).

The third is the flood gates of litigation that may be opened if claims for economic loss are allowed. The is followed by the need for the court to consider, drawing from the nature of the hazard, that "the risk of economic loss should be suffered by the whole community who suffer the losses usually many but comparatively small losses- rather than on the one pair of shoulders, that is, on the contractor on whom the total of them, all added together, might be very heavy" (Spartan, 1973, para. 25). Finally, it was also considered that the law provides for deserving cases. If the defendant is guilty of negligence which cuts off the electricity supply and causes actual physical damage to person or property, that physical damage can be recovered and also any economic loss truly consequential on the material damage and that such cases will be comparatively few and they will be readily capable of proof and will be easily checked (Spartan, 1973, para. 26).

The feeling amidst academic scholars concerning this doctrine can be rightly described as mixed. A school of thought sees it as advancing the Common Law systemic bias in favour of capitalists and the promotion of inegalitarian wealth redistribution (Perry, 2008) while other schools of thoughts in favour of the doctrine see it as a pragmatic objection to recovery

(Perry, 2008), a preclusion of arbitrary and disproportionate imposition of liability (Rabin, 1985), a denial of recovery because economic loss is not a social cost (Bishop 1982), and a means of channeling dispute into contract relationship and thereby minimising litigation cost (Rizzo, 1982). Yet for others, it is a puzzle for its seeming inconsistency with other tort principles that take a more expansive approach to liability, such as the eggshell skull rule or the adage that a defendant takes his victim as he finds him (Miles, 2007).

Judge Richard Posner's Analysis

Posner analysis stands in complete harmony with the economic loss doctrine of the English Common Law and he even gives more insight into how the Common Law position conforms to the principle of economics and efficiency. Posner distinguishes between torts in general and economic torts. Torts that are based solely on pure economic loss are economic torts. He argues that because they are economic torts, they should be strictly analysed economically and accordingly the best rule of law for economic torts is the most efficient rule of law. Posner then goes on to juxtapose the current legal doctrines (in English Common Law) as regards economic loss as against how an economist would analyse with the aim of bringing the legal doctrines in conformity with economics if there are any inconsistencies between the two. Posner's economic analysis in support of the Economic Loss Doctrine goes thus:

1. An economic tort only imposes private costs and not social costs. A social cost is a diminution in the total value of society's economic goods; a private cost is a loss to one person that produces an equal gain to another. Private costs result in a transfer of wealth but not a diminution of it.
2. He considers the difficulty of a potential tortfeasor to estimate his potential liability in advance of the accident that brings about the economic tort. Posner goes on to explain that the one against whom the tort is committed is in a better position to estimate his loss in advance and take care of it by either taking out an insurance policy or any other necessary measures that may help mitigate his economic loss. Posner remarked that, "efficiency may be promoted

by shifting the legal responsibility for an accident from an injurer to the victim" (Posner, 2006, p. 739).

3. The third economic reason for the Economic Loss Doctrine is that the determination of damages is more difficult when there is no physical connection to the injury because it is much harder to delimit the victims.
4. He considers also the flood gate of litigation that may be let loose and the complexity of such litigation. In his words: "there are likely to be many fewer victims in a physical tort case than in an economic tort case... accident that involves solely personal injury or property damage has only a few victims. In contrast, in a complex, integrated economy, an economic tort is apt to cause eddies of economic harm, encompassing a large number of victims incurring different levels of loss" (Posner, 2006, p. 739).
5. Liability for any personal injury or property damage caused by a negligent accident preserves at least some deterrence, making it less important to provide recovery to the additional victims, whose loss was purely financial (Posner 2006).

We see that both Posner and Lord Denning express concern on the floodgate of litigation that could be let loose if the economics loss doctrine was not in place and consequently the increased legal cost that that will bring in its wake and both agree that the doctrine helps to minimise cost. Also they both emphasise on the principle of demanding a party who can avoid a loss at the lowest cost to bear it thereby creating an incentive for the efficient precaution against loss.

I agree that if the purpose of the law of torts is to force potential tortfeasors to take account of the costs their acts impose on other people i.e. "to internalise externalities and thus produce efficient choices" (Friedman, 2000, p. 190), it is only logical that a tortfeasor who cannot accurately take into account the pure economic costs that his actions might impose on another be protected from bearing such costs.

It is worthy of note that the concept of private costs versus social costs is a special insight that Posner's analysis gives. The fault that I however find with this line of reasoning lies in the presumption that an economic loss

automatically leads to the transfer of wealth to competitors and not the diminution of such wealth. It assumes that lost profits are offset by gains of competitors to whom the customer must shift for the time being. On the contrary, situations however arise whereby competitors do not have the capacity to accommodate increased demands or where there are no suitable substitutes. In such situations what should be a private cost becomes a social cost and this argument no longer works in favour of the economic loss doctrine but rather works against the doctrine.

It is interesting to note that it is quite possible for a legal system to arrive at the efficient end which Posner and Lord Denning advocate without necessarily applying the economic loss doctrine. The French Civil Law system is an example of such a legal system. In this system, even though a claim for damages as a result of economic loss is not expressly ruled out, in reality, such a claim may not survive when measured by the general principles of civil liability as contained in article 1382 of the French *Code Civil* which provides that *any act whatever of man, which causes damage to another, obliges the one by whose fault it occurred, to compensate it*. The effect of this provision of the French *Code Civil* is that there must be a causal link between the fault and the damages. In general, economic loss is not treated in French Civil Law system as a specific problem. This does not mean that economic loss does not provide problems but rather that in the French view, certain characteristics which, as a matter of fact, economic loss possesses prevent the emergence of any specific problems which cannot be subsumed to the general principles of civil liability. These characteristics may, depending on the factual circumstances, include the absence of legal damages, the uncertainty of loss, the indirectness of loss, the lack of causal link between loss and fault, the fact that the defendant's conduct does not amount to fault (Marshall, 1975). In theory, a claim in respect of economic loss is just as good as any other but on the application of the principles of civil liability, the claim may well not succeed (Marshall, 1975).

Conclusion

Needless to repeat observations made from Lord Denning's judgment and Posner's analysis in the preceding page, the English Common Law position provides the most efficient rule from the perspective of law and economics. However, it has also been argued in this paper that the French legal system

produces efficient results as does the English legal system without having to rely on the doctrine of economic loss as does the English legal system. This fact notwithstanding, the fact that the English Common Law explains why legal rules exist and alludes to economics and efficiency gives the system an edge over other systems where even though, the same result is attained, there is no clear answer as to why that result is attained and more importantly what effects the legal rules would have in the society.

The questions of why particular legal rules are in existence and what effects these legal rules have are questions economics poses in order to arrive at a conclusion of what efficient legal rules should be in existence. It is respectfully submitted that without questions like these in the minds of jurists, judges and other key players in the legal system it becomes easy to lose focus and allow inefficient rules– a risk that a system like the French legal system may stand.

References

Bishop, W. (1982). Economic Loss in Tort. *Oxford Journal of Legal Studies*, 2(1), 1-29.

Donoghue v. Stevenson, A.C. 562 (1932).

Friedman, D. D. (2000). *What economics has to do with law and why it matters*. Princeton, NJ: Princeton University Press.

Marshall, D. (1975). *Liability for pure economic loss negligently caused: French and English law compared*. Cambridge: Cambridge University Press.

McBride, N. J. and Bagshaw, R. (2012). *Tort Law*. England: Longman.

Miles, T. J. (2007). Posner on economic loss in tort: EVRA Corp v Swiss Bank. *The University of Chicago Law Review*, 74, 1813-1830.

Perry, R. (2008). Economic bias in torts. *University of Illinois Law Review*, 2008(5), 1573-1622.

Posner, R. A. (2006). Common-law economic torts: An economic and legal analysis. *Arizona Law Review*, 48, 735-747.

Rabin, R. L. (1985). Tort recovery for negligently inflicted economic loss: A reassessment. *Stanford Law Review*, 37(6), 1513-1538.

Rhee, R. J. (2010). A production theory of pure economic loss. *Northwestern University Law Review*, 104(1), 49-104.

Rizzo, M. J. (1982). A theory of Economic Loss in the Law of Torts. *The Journal of Legal Studies*, 11(2), 281-310.

Spartan Steel & Alloys Ltd v. Martin & Co (Contractors) Ltd, 1 Q.B. 27 (1973).