Editorial

The law and economics of pure economic loss: Introduction to the special issue of the International Review of Law and Economics

1. The puzzle of pure economic losses

The notion of pure economic loss and its associated presumptive non-recovery rule in Tort Law continue to puzzle and fascinate lawyers, lawmakers, and Courts, and also a full array of academics in various fields: Tort Law, Comparative Law, Economics, and Law and Economics, to name a few. And the interest is not merely conceptual or theoretical: The American Law Institute is currently working on a Restatement of Economic Torts, of which pure economic losses constitute an (maybe “the”) essential part. Scholarly attention on this subject remains high, and highly contested. The marketplace for ideas now contains several —general or partial-theories about pure economic loss. In the existing literature we can encounter, at least, economic theories, comparative Law theories, legal policy theories, legal-philosophical theories, historical theories, political theories, and cognitive theories. Only the notion of pure economic loss itself remains relatively uncontroversial. Borrowing the words from a respected legal commentator, a pure economic loss could be defined as a pecuniary or commercial loss that does not arise from actionable physical, emotional, or reputational injury to person, or physical injury to property. The kinds of cases that

1 See, for a very recent sample of this attitude, the Symposium entitled “Dan B. Dobbs Conference on Economic Tort Law”, the contributions to which were later published in vol. 48 of the Arizona Law Review (2006).
3 See, van Boom (2004); van Dunné (1999).
4 See, Gergen (2006); James (1972); Rabin (1985); Stapleton (1991).
5 See, Benson (1997); Witting (2001).
7 See, Feinman (2006); Silverstein (1999).
8 See, Bernstein (2006).
readily come to mind when one evokes the notion of pure economic loss are heterogeneous in terms of factual circumstances, albeit surprisingly similar across legal systems. Destruction or impairment of transport, utilities or communications infrastructures (bridges, roads, power stations and networks, telephone lines) causing business closure or disruption to firms making use of the infrastructure; loss of profit suffered by individuals or firms who do not own the economic resource directly harmed (employers, employees, lessees, charterers, contractors); erroneous or misleading information provided to third parties (investors, lenders, buyers, contractors) not linked contractually with the information provider, and where reliance on the information leads to a regrettable business decision by the third party.

It is indeed legitimate to question10 in what respects the liability for negligently killing a valuable employee,11 or negligently injuring a worker who will collect wages from the employer even during the disability period,12 or negligently destroying or damaging a leased asset,13 negligently blockading access to selling space,14 negligently drafting a will,15 or negligently certifying the financial situation of a company or a prospective borrower,16 share essential common elements that will allow a legal system to take sensible decisions concerning the imposition or denial of liability. All of them are, at least potentially, candidates for the pure economic loss label, and as long as we do not infer from the label that the underlying efficiency issues in all of them are the same, the label is innocuous.

In fact, though, disagreement starts almost right after the very moment of formulating and agreeing on the notion: the contours and scope of the non-recovery rule (or its very nature: may be it can be conceived as merely a presumptive solution); the organizing and normative value – or lack thereof – in the notion; the rationale – singular or plural – behind the rule; the relationship of Contract and Tort concerning the rule; the proper solution to the major constellation of cases falling within the notion in the different legal systems, the existence and content of an overarching theory positively giving sense to that varied legal material.

Considering this level of disagreement it is fair to ask oneself if Law and Economics perspectives will be capable of bringing some marginal light upon such a scenario, when others, even from Law and Economics itself, have not fully succeeded?

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11 For instance, the Italian Superga and Meroni (Cass. Sez. un. 26 gennaio 1971, n. 174, in Giur. it. 1971, 1, 681) cases.
12 For instance, the Spanish cases 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, 2ª, 20.9.1982 (RJ 1982\4948); STS, 2ª, 13.12.1983 (RJ 1983\6522).
14 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.
15 For instance, White v Jones [1995] 2 AC 207.
16 For instance, Ultramares Corp. v Touche, 174 N. E. 441 (N. Y. 1931); Credit Alliance Corp. v Arthur Andersen & Co., 483 N. E. 2d 110 (N. Y. 1985).
2. The Conference

As is apparent from the references above, it was not the lack of economic analyses concerning the legal conundrum around pure economic losses, what lies behind the initiative of the European Association of Law and Economics, the International Review of Law and Economics, and Universitat Pompeu Fabra in Barcelona, to jointly co-organize an International Conference on the Law and Economics of Pure Economic Loss. We are indeed very grateful to the three institutions for making the Conference, and this Special Issue, possible.

Our goal was precisely to shed some light on the role of such theoretical, factual or institutional detail that had been, to some extent, overlooked, and how additional intellectual effort along those lines was worth exploring. The unifying theme and aim of the Conference was to present how the overarching theories and rationales were in need of refinement, and how the broad area captured by the notion of economic loss could be further illuminated by enhanced attention to the specific issues raised by more detailed analyses of the tools of Tort Law, and to the specific circumstances of the most important cases falling within the application of the non-recovery rule. It is not that we think that theory, most notably economic theory, cannot contribute to explaining the actual outcomes in legal systems in connection with losses occurring without – or relatively detached from – a primary personal or property loss, nor that theory cannot guide legal policy and legal practice in this area. Quite the contrary, we consider that both the explanatory and the normative appeal of legal-economic approaches, building on the existing contributions, would benefit much from more detailed or adaptive perspectives. We thought before the Conference, and we still think, that the analysis of the general consistency of the economic loss concept, and the associated exclusionary rule, and their descriptive, guiding, and normative values have already received a fair amount of attention, and the same happens with the major overarching theories, both economically oriented and not. If the reader will allow it, we thought that the time for a second generation literature building upon the first was already ripe.

The Conference took place at Universitat Pompeu Fabra, Barcelona, on 7–8 April 2005. The sample of contributions collected in this Special Issue, we believe, aptly reflects the above-mentioned goal, and also fairly represents the range of papers presented to it. The underlying thread giving a substantial degree of unity to this set of papers is the unveiling of the relevance of a given dimension, yet unexplored, or insufficiently explored in the existing literature. The papers are very diverse in terms of their approach, their tone, their emphasis on theory or on application, and the tools deployed to illuminate the central issue. But they share a common goal of de-emphasizing the interest in revising the overarching theories, and, at the same time, of making salient, and analyzing, the overlooked dimensions that pervade the area – or a fraction thereof – covered by the pure economic loss notion: market structure; the specifics of the negligence rule, or of liability of information provided to investors in capital markets; the role of knowledge by the injurer, and so forth.

3. The specific papers

The first paper, by Giuseppe Dari-Mattiacci, and Hans-Bernd Schäfer, “The Core of Pure Economic Loss”, points at several omitted components in the dominant Law and Eco-
nomics reconstruction of the pure economic loss notion and the accompanying exclusionary rule. They underline the fundamental commonality between destruction of a valuable and productive economic resource, and its impairment, thus essentially leading to a different understanding of the harm to infrastructure and similar kinds of cases. In such cases, moreover, the issue of added or spare capacity, already noted as relevant in previous economic analyses of the problem, had not been properly viewed as a form of costly precaution, which should be included in the social cost minimization program by the – ideal – social planner. In the area of negligent provision of information leading to adverse business decision, the role of what the parties would have contracted upon, had they had the chance to do so (a sort of majoritarian default, to use the Contract jargon) should be prominent, regardless of the legal characterization of the case as in Contract, in Tort, or in-between (as in some European legal systems). All in all, those overlooked dimensions downplay the appeal of the non-recovery rule for pure economic losses, according to the authors.

The second paper, by Urs Schweizer, “Tortious Acts Affecting Markets”, squarely addresses the salience of two elements: the liability rule in force (strict liability versus negligence, the latter in both the standard, and the Grady-Kahan, causation-including, versions), on the one side, and the structure of the market affected by the destruction or impairment produced by the injurer. The author shows how market structure is decisive for the relationship of private loss of the victim seeking compensation (by hypothesis, the firm loosing business from the initial harm) and social loss. Both under monopoly, and under perfect competition with rising marginal costs of production (if marginal cost were constant, all losses would be zero), the social loss exceeds the private loss, thus seriously questioning the social desirability of the non-recovery rule of pure economic losses. And under the more realistic setting of imperfect market competition, it is shown that social loss is positive, although under some conditions it can be proven to be lower than the private loss to the firm losing business. The absolute exclusionary rule would not be optimal in this plausible setting. In fact, under a negligence rule in which the optimal standard of care were chosen by Courts, a full recovery rule of private losses would induce optimal behavior by potential injurers, though it would lead to overprecaution if the liability rule in place were strict liability. The paper, finally goes on to analyze the effects of negligence rules on discrete decisions of entry into a market, and continuous decisions of capacity, and shows how the decisions would be suboptimal in both cases.

In the third paper, by Francesco Parisi, Vernon Palmer, and Mauro Bussani, “The Comparative Law and Economics of Pure Economic Loss”, the authors claim that if one looks in detail at the relevant decisions rendered by the Courts in the different European jurisdictions, the use of implicit economic reasoning, and the search for efficiency in the outcomes, concerning the – pragmatically feasible – incentives for precaution of the parties involved, is much more important than previously thought. They review the main legal rationales behind the notion of pure economic loss and the associated non-recovery rule (foreseeability, the pre-eminence of absolute rights over relative rights, administrative costs and open-ended litigation) and, independently of their intrinsic merit, they argue how the behavior of European Courts cannot be explained by reference to those “legal” theories. They then trace the pursuit of efficient incentives in several of the major typical cases of pure economic losses. Thus they contrast the restrictive attitude of European Courts in “Loss of a Star” –
performer, employee, player, – cases with the more liberal trend towards compensation of losses in “Cable Cases”. Or how in cases of “Transferred Losses” the use of the exclusionary rule is mainly to prevent imposing double liability on the injurer, thus generating over-precaution. Or in the “Misleading Information” cases, how the distinguishing feature between the cases in which liability is affirmed, and those in which it is denied, lies mainly in the ability of the client of professional services to internalize the full benefit of the information or services acquired. If non-paying (explicitly or implicitly) third parties can rely on the information produced by the professional and claim compensation in case of the information being negligently provided, there would be an externality giving rise to an efficiency loss associated with sub-optimal demand for professional services which imply advice or information available to third parties.

The fourth paper, by Susanne Kalss, “Recent Developments in the Liability for Prospects and Other Capital Market Information”, focuses on one of the most relevant, in theory and in practice, areas of pure economic losses, that of flawed financial information causing losses to investors who make erroneous investment decisions based on it. The author examines in depth the recent developments at the EU level, and at a sample of important European jurisdictions (Austria, Germany, Switzerland, the UK), showing how different legal doctrines in Tort, in Contract, or in the gray area in-between can serve functionally identical purposes to provide compensation and furnish incentives for the different players in capital markets. Moreover, it is emphasized how liability in this area cannot be analyzed in isolation as a matter of damages caused (pure economic versus other losses), or even of the number of harmed individuals, but one has to bring into the picture other elements that significantly affect the behavior of market participants. One is regulation by Public Bodies or Agencies, which directly influence the standards of behavior, and even (particularly in the UK) the right to sue for damages. In short, the issue of liability for misleading information in capital markets cannot be fully grasped without due attention to the global picture of enforcement, both from public and from private sources, of the informational duties in capital markets.

The last paper, by Juan-José Ganuza, and Fernando Gomez, “Should We Trust the Gatekeepers? Auditors’ and Lawyers’ Liability for Client’s Misconduct” also concentrates on the area of economic losses that take place – at least, most commonly – in capital markets. The authors address the liability of gatekeepers (such as auditors or corporate lawyers) as an instrument to reduce the losses to investors caused primarily by the illegal behavior of the firms who are the clients of the professional gatekeepers. Cases such as Enron or Worldcom would readily come to mind when thinking about the setting. In most legal systems, gate-keeping duties and liabilities are often imposed based on the condition of observation of misbehavior by the corporate clients.

But making liability conditional on scienter is subject to complex informational effects. The authors argue that the most plausible informational scenario in one in which gatekeepers’ information concerning the observation of the underlying behavior of the firm is verifiable by Courts, but is hideable by gatekeepers. Under this assumption, the policies adopted by Courts of trust or distrust towards gatekeepers’ statements on having observed, do not change the levels of control adopted by gatekeepers. Thus, building standards and imposing liabilities on gate-keeping based on observation do not improve efficient incentives for auditors and lawyers.
The policy recommendation would be that the attention of Courts and regulators should focus on the definition of relevant substantive standards of control, which could be implemented through negligence rules or regulatory sanctions.

References


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