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# LIABILITY FOR PURE FINANCIAL LOSS: REVISITING THE ECONOMIC FOUNDATIONS OF A LEGAL DOCTRINE

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# LIABILITY FOR PURE FINANCIAL LOSS: REVISITING THE ECONOMIC FOUNDATIONS OF A LEGAL DOCTRINE

ABSTRACT: The economic loss rule states that a plaintiff cannot recover damages for a pure financial loss. The comparative study of the pure economic loss rule reveals that in different jurisdictions, the legal definitions of the rule frequently lump together diverse situations. The actual significance of the notion of "economic loss" varies considerably across Western legal systems. Legal doctrines provide little insight as to why liability should, or should not, be denied. On the other hand, economic models of liability provide some valuable guidance for classifying different categories of economic loss, and identifying cases in which denial of recovery for economic loss would lead to inefficient outcomes. A law and economics analysis shows that a key factor in determining the optimal scope of the economic loss rule is 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 socially relevant loss. After identifying several factual categories, this paper characterizes the optimal level of liability with reference to the relevant economic and social loss components and the resulting optimal incentives to reduce risk. In a few situations, the application of the optimal liability rule finds obstacles in entrenched principles of civil liability. Generally, however, the legal applications of the economic loss rule are consistent with the ideal liability rule identified by the economic model.

As generally understood in the law and economics literature, the economic loss rule states that a plaintiff cannot recover damages for a pure financial loss. The comparative study of the pure economic loss rule reveals that the recognition and significance attributed to such rule and to the notion

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of “economic loss” varies considerably across Western legal systems. Bussani and Palmer (2001) analyze the results of an extensive case study on the issue of pure economic loss across all national legal systems of Europe and provide an interesting grouping of the approaches followed by national courts of Europe, describing them variously as “liberal,” “pragmatic” or “conservative”. The question has emerged in the European context in conjunction with the ongoing search for a common core of European private law and the consideration of a unified European civil code (Bussani and Palmer, 2001). Comparative legal analysis reveals that the policies and rules governing tortious liability for pure economic loss in Europe are not governed by common principles.

Legal systems simply do not share a common approach to this issue. Even those that seek to preclude recoverability of pure financial loss use different definitions and follow different formulations of the problem. An interesting point recently brought to light by comparative legal analysis is that, unlike most other issues in the field of torts, the different approaches on the issue of pure economic loss do not follow the familiar common law/civil law divide (Bussani and Palmer, 2001).

The comparative study unveils the existence of an area of law in which there is neither cross-national consensus, nor even always internal consistency in the recognition and application of the rule within individual jurisdictions, due to the intellectual significance of divergent theoretical approaches.

Among different dogmatic constructs used by Western legal systems to address the issue of pure economic loss, a common element seems to characterize the jurisprudence of all modern legal systems, specifically, a tension between theoretical statements and practical solutions sought by fact-specific case law. Comparative legal scholars have struggled to find a way to compare different legal solutions within a consistent construct, but their efforts have often given way to historical explanations based on path dependence. That is, the explanations generally conclude that any jurisdiction's current application of the pure economic loss rule is eventually the result of mere historical accidents (Rabin, 1985; Schwartz, 1995 and 2001; Gordley, 2001). Similarly, other scholars have lamented the failure of tort scholarship to produce persuasive positive theories of liability for pure

economic loss (Landes and Posner, 1987, p. 255) and have gone so far as to recommend the abandonment of any effort to formulate any single general theory. These individuals theorize that the economic loss problem is divisive, because it is simply non-unitary in character (Schwartz, 1986). This paper attempts to revisit the apparent contradictions brought to light by comparative legal scholars through the lens of economic analysis.

As is generally the case, comparative law is a valuable tool for revealing engaging issues for law and economics scholars (Mattei and Cafaggi, 1998). This paper reports on the recent findings of comparative law, revealing that legal notions of pure economic loss encompass several types of situations. In terms of economic analysis, these situations are easily distinguishable and have very different significance for social welfare analysis. What appear to be erratic judicial applications of a single economic loss rule are in fact justifiable and often valid applications of different underlying economic principles. From an economic perspective, it may in fact be necessary to have more than one dogmatic approach to the treatment of economic loss, given the substantial discrepancy between legal and economic categories. Consequentially, there is an inability of the legal notion of economic loss to easily capture and apply the many disparate economic situations that fall within any such iconoclastic rule.

Section 1 provides an economic redefinition of the concept of pure economic loss, distinguishing various situations. Section 2 briefly revisits the recent findings of comparative law scholars searching for comparable legal and economic categories. In conclusion, I suggest there is no single answer to the normative question of the liability for pure economic loss. In the final analysis, one must examine the general understanding of the economic function of civil liability and the economic implications of alternative liability rules on individual incentives.

## 1. The Economics of Pure Economic Loss

The law and economics literature suggests that, even where a rule of total liability is efficient, the victims should not necessarily be compensated to the full extent of their economic losses. In order to understand the logic

that drives this law and economics results, 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.

### *1.1 Socially Relevant Externalities and the Optimal Scope of Liability*

From the perspective of law and economics, remedies in torts are necessary to specify and quantify externalities. As a general definition, an externality is a cost imposed on a third party outside the voluntary mechanisms of the marketplace. In principle, liability in torts should ensure that the entire social cost of any particular activity is addressed by the responsible party, or economic agent. The application of this principle necessitates focusing on the tortfeasor's expected *ex ante* liability, rather than on the victim's actual compensation.[2]

As is well known in the economics literature, from the perspective of social welfare analysis, not every economic externality is socially relevant. The efficient design of liability rules should aim at addressing socially relevant externalities, thereby minimizing those external costs that reduce aggregate social welfare. Some external costs, however, have the peculiar effect of having only private effects: those private externalities do not induce direct or indirect social costs. I shall refer to this category of

[2] This may occasionally require courts to set aside some other general principle of tort law. For example, the collateral-benefits rule, which may allow the victim to recover the full value of the loss without deducting the payments received from an insurance company for the same damage is possibly quite efficient. First, because it creates efficient precaution incentives on the tortfeasor (liability should be linked to the true social loss occasioned by the accident, not the private uninsured loss of the victim). Second, because in most situations, the double payment from the insurance and the tortfeasor does not in fact amount to allowing the victim to recover double. As pointed out by Posner (1986) 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. More generally, the risk of duplicate recovery should not necessarily be linked to one of overdeterrence, given the different relevance of the *ex ante* liability and *ex post* compensation on individual incentives.

costs as socially irrelevant externalities. Given the administrative costs of the legal system, economic analysis suggests that socially irrelevant externalities can, and indeed, should, generally be left uncompensated. From a policy standpoint, in the case of socially irrelevant externalities, the choice of alternative liability rules has no effects on the efficiency of individual conduct. The exclusion of liability in such cases is generally justified by the desire to minimize the total cost of accidents: liability would impose administrative and judicial costs on the legal system, while creating no beneficial incentives for the parties involved.

To maximize the net social benefit of an activity, one must also consider the aggregate adjudication costs. This requires a balancing and subsequent evaluation of all ascertainable externalities of the activity, both positive and negative. 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, by the same token, recognizing (negative) liability for the positive externalities. 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.

### *1.2 Pure Economic Loss as a Social Cost*

As a policy matter, several legal limitations to the domain of compensable harm, including some variations of the economic loss rule, can be explained – or at least reinterpreted – as ways to confine liability to only socially relevant externalities.

The issue of pure economic loss poses a fascinating conundrum. This puzzle is best illustrated contrasting a case of pure economic loss with a traditional situation of physical harm.

Generally in cases of physical harm, there is a correlation between an action and the extent of the private and social cost of the harm. That is to say, any loss suffered by an individual occasions a private cost to the victim, which in turn counts as a social cost for the community. In such cases, tortious behavior should be met with full liability and compensation for the

victim's harm. Simply, efficient deterrence of activities that generate private harm is necessary to minimize the total social cost of accidents.

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, there is a strong tendency for the private and social costs to differ substantially from one another. Generally, the private loss exceeds the social loss, and the discrepancy between the two values may be substantial. This may lead to occasional paradoxes where the private and social cost have different results. For instance, a social benefit may result from an act that causes private loss. 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 a wrongful behavior creates a private loss, the magnitude of which differs from the resulting social loss, economic analysis indicates that the victim should not necessarily be compensated for the entire private economic loss (Shavell, 1987; Arlen, 2000).[3] Only the portion of the private loss (if any) which represents a social cost should be subject to liability.

Some of the policy dilemmas implicitly addressed by the economic loss rule concern wrongful behavior which imposes a private economic loss on the victim, with no corresponding social loss. In the case considered above, the private loss to the victim may be the source of a net gain for society at large.[4] In such cases, law and economics leads to the frequently

[3] As pointed out by Shavell (1987), when a tort interrupts the production process of a manufacturing firm, the firm's lost profits are not necessarily social costs, given the possible presence of other firms who could enter the market or expand its production making up the foregone output of the incumbent firm with the supply of perfect substitutes at comparable cost.

[4] 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.

paradoxical result that such wrongful behavior should be encouraged and economically subsidized by the legal system. Put differently, liability rules should be put into effect according to their fundamental economic functions, providing 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. For obvious pragmatic reasons, we rarely observe such combined operation of the liability system in the real world.

Beyond the irony of such theoretical considerations lies an important lesson. The core notion that seems to necessitate the theoretical contradictions of the economic loss rule is the idea that the optimal scope of liability is determined by the impact of alternative liability rules on the total social cost of accidents. Activities that occasion a mere reallocation of costs and benefits, with no incremental social cost, cannot as such be considered socially harmful. If no other considerations of the parties' reliance and distributive justice enter into the policy considerations, the imposition of full liability would be unwarranted. 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. In case of wrongful behavior which occasions a zero sum transfer of wealth, the amount of net liability imposed on the tortfeasor should also equal zero, given the offsetting effects of positive and negative liabilities when balancing harm to victims with potential benefits to unsuspecting third parties.

The important point here is to recognize that, according to several competing conceptions of justice, a zero net liability rule for the alleged tortfeasor does not necessarily justify a rule excluding liability altogether, denying compensation for those who suffered a private loss. Here lies one important element that drives the intellectual and dogmatic tension behind the economic loss rule. In the following section, I shall evaluate some elements of the traditional debate within the normative framework of law and economics.

## 2. Pure Economic Loss: Towards an Economic Restatement

From an economic perspective, the legal notion of pure economic loss is quite unfit to serve as a normative criterion of adjudication. As suggested above, the legal notion of economic loss is, in fact, a very imperfect proxy for the economic category of socially relevant cost, which ideally should guide the optimal design of liability rules.

The understanding of the relevant economic categories may in this context serve two valuable purposes: (a) as a positive criterion, to understand the many facets of the economic loss rule and to reconcile some of the apparent contradictions in the judicial implementation of such rule; and (b) as a normative criterion, to guide lawmakers and courts in the design and implementation of liability rules dealing with pure economic loss.

Contrary to the conclusions reached by several legal commentators on this issue (e.g., Schwartz, 1995 and 2001; Gordley, 2001), I suggests that the emergence and diffusion of the economic loss rule is more than a mere historical accident. I suggest that such exclusion of liability is in many instances appropriate and that several of the factual situations governed by the economic loss rule are correctly adjudicated. An economic analysis of the judicial applications of the economic loss rule in the various legal systems considered in this study, however, also unveils several mistaken applications of the rule.

### *2.1 In Search of Comparable Categories: A Hypothesis*

Legal systems utilize quite different constructs to define the boundaries of compensable harm.

I suggest that, to the extent that the economic loss rule may be understood as a way to restrict liability to only socially relevant externalities, it is appropriate to recast the rule in terms that are consistent

with its fundamental economic rationale.[5]

As a matter of ideal theory, lack of compensation for pure economic loss is inefficient to the extent that such uncompensated loss also involves social externalities. In such cases, full liability is both appropriate and necessary.

In a fault-based system, liability for the socially relevant externalities is desirable whenever the agent fails to adopt the optimal standard of behavior, which I shall call $x^*$.

(1) $D = Ls\,(x)$ " $x < x^*$

As discussed in the previous section, the application of this ideal liability rule is problematic for a variety of reasons.

First, the extent of liability does not depend on the actual loss suffered by the victim, *Lp*, but solely on the social loss, *Ls*. The decoupling of liability from the private loss is problematic since it may occasion undercompensation or overcompensation from the point of view of the victim.

(2) $D < Lp$ " $Lp < Ls$
$D > Lp$ " $Lp > Ls$

That is to say, the damage award will be fully compensatory only in the limited case of $Lp = Ls$.

Second, the stylized liability rule in equation (1) may lead to some paradoxical applications. For example:

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[5] For additional discussions of the issue of liability for economic losses from a law and economics perspective, see Goldberg, 1994; Landes and Posner, 1987, pp. 251-255; Rabin, 1985; Rizzo, 1982; G. Schwartz, 1986, 1996; and Arlen 2000.

(3) $D < 0$ " $Ls < 0$ (and for any value of $Lp$)

Negative liability (with the victim ironically made liable to compensate his tortfeasor) will result for all situations where the conduct generates a social benefit ($Ls < 0$), even when the victim suffered a private loss ($Lp > 0$).

These two practical difficulties may explain why the economic loss rule has evolved with such disparate contours in contemporary legal systems. In real life, we find the following additional constraints:

(4) $D = Ls$ s.t. $D > 0$ and $D £ Lp$

That is, the additional limits imposed by modern legal systems on the stylized liability rule formalized in equation (1) are consistent with established legal dogmas, according to which the amount of liability for a private loss is non-negative (i.e., victims are never asked to compensate their tortfeasor, even if the private wrong is source of a social gain)[6] and where the amount of liability should not exceed the extent of the victim's

[6] Note that different legal rules often deal with situations where $Lp > 0$. One can think of *negotiorum gestio* rules at civil law and unjust enrichment remedies in general as ways to compensate the agent for unjustified transfers of wealth. The mechanics of these remedies, however, do not easily fit within the structure of economic loss rule considered in this article, given the fact that liability for unjust enrichment is generally finds a dual limit in the actual cost borne by the unauthorized agent and the benefit received by the principal. Such dual limit would leave an empty core in the general application of the pure economic loss rule.

loss (i.e., damages should not be overcompensatory, unless they are punitive in nature).

The above formalization provides a viable hypothesis to explain the apparent exceptions and variations of the pure economic loss rule in modern and historical societies. Recasting the rule economic loss in such a fashion further assists the understanding of the appropriate scope of its application in real life cases. In turn, this allows us to sketch some presumptive normative guidelines for the adjudication of pure economic loss claims.

### *2.2 Recasting the Economic Loss Rule*

As discussed above, the desirability and the extent of liability for pure economic loss depends on thecritical relationship between private and social costs.

The above reconceptualization of the economic loss rule, suggests that liability for economic losses should be excluded whenever a private economic loss is offset by gains enjoyed by other third parties, such that the wrongful behavior does not generate any net social loss. In this context, the application of the economic loss rule should be quite attentive to its underlying economic rationale: the legal exclusion of liability should be based on the economic nature of the loss (i.e., private versus social externalities) rather than on the intrinsic nature of the loss (economic versus physical harm).

For example, several cases of economic loss often give origin to relevant social losses (e.g., imagine an accident that interferes with the manufacturing of goods with a resulting medium term shortage in the market). With a downward-sloping demand curve, negative production shocks cause social deadweight losses, as shown by the fact that any shortage causes the goods (or their close substitutes) to be sold at a higher prices with lower overall consumption. In such cases, the measure of the social loss is given by the difference between the variation in producer's surplus (if any) and the variation in consumer surplus. Such difference (i.e., the resulting deadweight loss triangle) constitutes an actual measure of social cost that should be included as a proper component of damages.

In adjudicating cases of economic loss the purely economic nature of

the harm suffered by the victim should not be dispositive and liability should be imposed on the tortfeasor, whenever the accident is the source of a socially relevant loss. In such cases, a pure economic loss – from a social welfare point of view – is indistinguishable from the social loss that follows from the destruction of a scarce physical resource.

It should be recognized clearly that on this subject there is a quite imperfect correlation between the legal and economic categories. As a consequence, it is not possible to formulate a general presumption as to whether economic loss should, or should not, be included in damage awards. Any general presumptive rule needs to be qualified with reference to the relevant economic categories: absent such reconceptualization, the application of the economic loss rule is likely to generate inaccurate levels of compensation with a resulting inefficient level of deterrence.

In applying the economic loss rule, courts and legislators should be aware that considerations of efficiency require an analysis of the level of social harm caused by the conduct. The optimal level of damages are those that create an *ex ante* level of expected liability equal to the expected social harm caused by the conduct. The quantification of the social harm should not necessarily include (but should not systematically exclude) the pure economic loss suffered by the victim, as currently intended in the legal discourse. In designing efficient liability rules, any reference to pure economic loss should be avoided, since such category quite rarely coincides with the appropriate notion of relevant social cost. Liability rules may exclude lost profits from the computation of damages only if they constitute a mere diminution of the victim's surplus to the benefit of other third parties, without any net impact on the aggregate well-being of society at large. Such an evaluation should include the potential benefits of other producers, sellers or consumers.

### *2.3 Practical Problems in the Application of the Economic Loss Rule*

Several judicial applications of the economic loss rule give little or no emphasis at all to the economic loss aspect of the case, often relying on distinguishing criteria, such as the directness of the loss. While such criteria of adjudication are often invoked as instrumental to specific functions of the

liability rule, such as risk-spreading, they often reveal the courts' uneasiness with the practical implementation of the economic loss rule.

Practical problems in the implementation of the economic loss rule emerge because, with rare exceptions, the measure of private economic loss does not coincide with the magnitude of the resulting social loss.[7]

In the more frequent case of competitive supply of substitutable goods, the amount of private economic loss generally constitutes an *overestimate* of the relevant social loss. Occasionally, however, the opposite may be true. For example, in the case of resources that are available with a perfectly inelastic supply (e.g., fixed-amount natural resources), the measure of private economic losses may represent an *underestimate* of the socially relevant losses. In the latter case, social losses exceed private economic losses, because true social losses result from the summation of the forgone producer surplus (i.e., the pure economic loss) and the lost consumer surplus. Note here a practical problem in the conceptualization of liability. There is a component of the social loss that is not borne by the victim: in our example, there is an additional loss represented by the forgone consumers' surplus which is not borne by the producer of our example. From an economic point of view, such loss should enter as a proper component of damages (although the payment of such damages may appropriately be decoupled from the compensation of the victim and paid instead to consumers or other third parties).[8]

In order to organize ideas on a manageable template, it is desirable

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[7] Given the difficult quantification of private and social losses, it is often thought best to let the free contracting of the parties reveal private information through the bargaining process. This in many ways relates to the intrinsic limits of tort law versus contract law in dealing with private externalities. On the proper domain of the economic loss rule outside of the proper tort law scenario, see Schwartz (1995 and 2001), who suggests that the in products liability cases contract law is the preferred legal framework within which to address claims concerning pure economic loss.

[8] On the relationship between private economic loss and social loss, see the important contributions of Bishop (1982); Shavell (1987, pp. 135-140) and Arlen (2000).

to map the relevant categories of economic loss and examine the appropriate legal solutions to the problem in each category.

Table 1 below shows the various combinations of private and social economic loss, defining the resulting levels of optimal liability of typical actions in torts.

| | PRIVATE VERSUS SOCIAL LOSS | RELEVANCE CONDITIONS | REMEDY | COMMENTS |
|---|---|---|---|---|
| 1 | $Lp = Ls$ | $Ls > 0$ | $D = Ls$ | |
| 2 | $Lp > Ls$ | $Ls > 0$ | $D = Ls$ | The Economic Loss Rule limits liability to "socially relevant" economic losses |
| 3 | $Lp > Ls$ | $Lp > 0$<br>$Ls \leq 0$ | $D = 0$ | Economic Loss Rule Applies (alternatives should be considered to subsidize positive social externalities) |
| 4 | $Lp < Ls$ | $Lp > 0$ | $D = Lp + T$<br>$T = Ls - Lp$ | Decoupling solution |
| 5 | $Lp < Ls$ | $Lp \leq 0$<br>$Ls > 0$ | $D = Ls$ or<br>$Ls < D \leq 0$ | $D = Ls$ is efficient<br>$Ls < D \leq 0$ can be adopted to reduce open-ended liability problems |

**Table 1:** *Applying the Economic Loss Rule*

Table 1 provides a graphic description of the ideas presented in the previous sections. The economic reformulation of the economic loss rule makes explicit reference to the critical relationship between the private and social components of the economic loss. Table 1 illustrates five situations, each characterized by a different qualitative balance between private and

social costs. Each of the five scenarios outlines a different group of factual circumstances, which require different remedial solutions to create efficient outcomes.

The first category considers the limit case in which the extent of the private and social loss coincide. In this situation, absent other normative goals, there should be no application of the economic loss rule. Moreover, in the first scenario, full compensation for the private economic loss should be granted. The remaining four categories of cases consider more general group of situations in which the private and social loss have different magnitudes. As a general criterion, in all such cases, the optimal level of liability should be linked to the extent of the social loss, Ls. But different practical and normative considerations are often in the way of a direct application of liability.

Proceeding in order, we can distinguish four general cases, based on the relative magnitude and sign of the private and social components of the loss.

In two situations, the economic loss rule serves a valuable purpose by excluding liability for a private economic loss for which there is no corresponding social loss, as in Case 3, or by limiting liability to only the portion of the private economic loss that also reflects a positive social loss, as in Case 2. These are the two situations most frequently discussed in the literature in conjunction with the economic loss rule. Case 3 is often illustrated by reference to economic loss due to forgone sales, when alternative sales at the same production cost can be made by the victim's competitors (e.g., Shavell, 1987, p. 136). Case 2 could be illustrated along the same lines with reference to the more realistic situation of sales that are delayed or made by competitors at higher cost.

The two remaining cases are more complex. Case 4 represents a situation where the total social loss exceeds the private economic loss suffered by the victim. Along the lines of the previous example, this case can be illustrated by economic losses due to forgone sales, in the event that no alternative sales can be made by competitors or by the victim at a later time. In this event, the total social loss is likely to be greater than the private economic loss, due to the presence of forgone consumers' surplus. As discussed above, in order to maintain the efficient level of *ex ante*

deterrence, the expected level of liability for the tortfeasor should equal the total social loss, *Ls*. However, if *ex post* liability is imposed in the measure of $D = Ls$, the victim would be overcompensated by the tort, since he would receive an amount of compensation higher than the loss actually suffered (i.e., $D > Lp$). In several legal systems, long-standing principles of civil liability would rule out the application of full liability for the total social loss, given the general legal principle that compensation in torts should not exceed actual loss. In order to maintain efficient *ex ante* incentives, while avoiding victims' overcompensation, some unconventional solutions should be considered. One such approach might involve decoupling liability from compensation, so that the total expected liability faced by the tortfeasor could be linked to the expected social loss, *Ls*, while keeping the level of victim's compensation capped at the value of the private loss actually suffered, *Lp*.[9] The difference between the amount collected from the tortfeasor and the amount paid to the victim could be collected as a penalty or tax payable to the administration or some other fund created for such purpose ($T = Ls - Lp$). Upon closer examination, it is possible to see that the combined effect of the liability for the private damages and the additional penalty or tax for the social externality would yield the optimal level of *ex ante* deterrence (i.e., $D = Lp + T = Ls$). Such a decoupling solution represents only one way in which the optimal level of *ex ante* deterrence can be pursued.

The last group of cases include situations in which the tort generates

[9] A few clarifications should be made at this point: (a) Not all economic looses should be compensable, only those economic losses that constitute a social loss, as extensively discussed above; (b) The payment of the additional damages for economic losses – if borne by a subject different from the immediate victim of the tort – should not necessarily be received by the immediate victim and could well be collected by an administrative fund or by the state. This will avoid the problem of overcompensation and moral hazard (i.e., adverse incentives for potential victims to suffer an economic loss, resulting in a potential gain). Obviously the complete decoupling of liability and compensation poses the practical problem of creating incentives for providing evidence of the extent of the actual harm, given the fact that the potential third party victims would not receive any benefit from the proof of their loss.

a social loss, *Ls*, but which, paradoxically, generates a benefit for the immediate victim of the wrongful action (i.e., Case 5). This is one of the hypothetical situations that, for the reasons explained below, falls outside the practical scope of application of the pure economic loss rule, but which I address briefly, for the sake of theoretical completeness. It is interesting to note that since *Lp £ 0*, the immediate victim of the tort does not have any incentive to bring action against the tortfeasor. In this case, the third parties who bear the residual social cost, *Ls*, would have an interest to file suit against the tortfeasor. Here lies one of the difficult cases of pure economic loss. Any exclusion of liability would violate the *ex ante* efficient rule *D = Ls*, but any recognition of liability would give rise to open-ended litigation and the creation of a "balance deficit" in the liability of the tortfeasor.

The open-ended litigation would follow from the fact that third parties other than the immediate victims are, by construction, those who suffer the loss and would require procedural standing for bringing suit. This would create the conditions for open-ended litigation, as it will be discussed more extensively in the following section.

The balance deficit problem follows from the fact that, in order to avoid overdeterrence, liability in torts should be limited to the amount of *Ls*.

In situations illustrated by Case 5, however, the wrongful action creates some positive benefit on the immediate victim of the tort. That is, there is a non-positive private loss *Lp £ 0*, while simultaneously an actual loss on other individuals (i.e., *Ls > 0*). The total value of the loss imposed on the various subjects equals *Ls + ½Lp½*, but as discussed above, only the net social loss, *Ls*, should be imposed under the form of liability on the tortfeasor. We would thus have legal claims for compensation in torts that exceed in value the amount of optimal liability. Granting systematic compensation to all such claims would create inefficient overdeterrence. To avoid such overdeterrence, two alternative solutions could be examined: (a) allow the tortfeasor to recover the value of the benefit, *Lp*, from the immediate beneficiary of his wrongful action, allowing him to give full compensation to all those who suffered a loss; (b) devise some arbitrary criterion to curtail the number (and amount) of legal claims to the efficient level, *Ls*, allowing the third parties who benefitted from the wrongful action

to keep such benefit.

Any further speculation on this matter, I fear, would fall outside the relevant scope of the present inquiry.

### *2.4 The Problem of Foreseeability of Pure Economic Losses*

One of the common explanations of the economic loss rule relates to the composite dynamics of the economic consequences of a tort and the resulting complexity of the element of foreseeability of the harm. In US law, this rationale tends to surface as a common denominator of several limitations imposed on the extent of compensable harm, including cases of pure economic loss, emotional distress, and loss of consortium.

Two objections to the foreseeability explanation should be considered at this point: one factual, the other theoretical. First, as a factual matter, it should be noted that 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. Second, as a theoretical matter, from an efficiency standpoint, the optimal level of liability should include both foreseeable and unforeseeable consequences. To the extent that causality is satisfactorily established, efficiency requires that the tortfeasor be faced with 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 criterion of liability would yield suboptimal precaution incentives.

Both factually and theoretically, therefore, the rule cannot be justified by the alleged unforeseeability of pure economic losses. Many accidents produce a chain of costly economic consequences which can be statistically estimated and which can be causally linked to the wrongful action on the basis of the *id quod plerumque accidit* principle, not unlike other effects of a tort. The presence or absence of foreseeability is a factual and legal matter that enters the equation of liability in the ways specified by the legal system, but no *a priori* distinction should be made between economic and non-economic consequences of a tort.

### *2.5 The Problems of Derivative and Open-Ended Litigation*

Another frequently invoked explanation for the pure economic loss rule concerns the issues of open-ended liability and derivative litigation, i.e., the extension of liability *ad infinitum* for the consequences of a wrongful act.[10] In this context, arguments in favor of the economic loss rule have often invoked a variety of practical considerations, pointing out that in a complex economy, pure economic losses are likely to be serially linked to one another. The forgone production of a good often generates losses that affect several downstream individuals and firms who would have utilized the good as an input of their production activities, 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. But the comparative study of tort law reveals that legal systems continue to struggle in their attempt to identify the boundaries of compensable injury, with the implicit realization that there is no easy way to truncate the chain of liability without arbitrary solutions.

For the sake of methodological simplicity, in the preceding sections the discussion was confined to the incentives effects of the economic loss rule. In such context, I attempted to identify the optimal liability remedy in terms of creation of efficient incentives. We are now left with the task of analyzing the issue of open-ended and derivative litigation, for the various categories of private and social economic loss discussed above.

Unlike the foreseeability argument, the concern for open-ended litigation is both factually and theoretically relevant. As discussed above, in many situations the economic loss rule is necessary in order to create

[10] In the recent literature, scholars have 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 and 2001). This goal is further evidenced by the fact that the economic loss rule is fundamentally at odds with the overall tendency to expand the scope of liability in other areas of tort law (e.g., personal injury and harm to property). Such opposite tendency is explained by the fact that the expansion of liability in those areas is rarely at the origin of problems of derivative and open-ended litigation.

efficient incentives for the parties. In such situations, the creation of efficient incentives justifies the application of the rule, even in the absence of any concern for open-ended litigation.

In other cases, we have seen that the economic loss rule cannot be justified in terms of optimal incentives. In these cases, considerations of open-ended liability may acquire relevance. Concerns for open-ended liability, however, cannot by themselves be regarded as dispositive of the normative solution and do not always justify the strict application of the economic loss rule.

When evaluating the alternative functions of the economic loss rule, it is important to note that it is not always possible to optimize the various policy objectives (i.e., the maintenance of optimal incentives and the avoidance of open-ended liability) with a single policy instrument (i.e., the economic loss rule). If the economic loss rule is used to prevent open-ended liability, it is important to realize that, absent decoupling of liability and compensation, the exclusion of liability for pure economic loss may have negative effects on the optimal *ex ante* incentives of the parties.

In a nutshell, the problem of open-ended litigation is an important one for the administration of justice. But, such an administrative problem cannot justify the choice of an inefficient substantive rule, which would create a sizeable bias in the quantification of damages and in the creation of incentives for efficient precaution. Other solutions, such as procedural standing rules, for example, can be utilized to pursue the same normative goal.[11] Put differently, if the true issue is one of open-ended liability, the appropriate solution should focus on correcting the derivative litigation problem, avoiding the creation of other problems on the front of individual incentives.

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[11] For example, legal systems could limit active legitimation for an action in torts to the direct victims of a tort, regardless of the economic or physical nature of the harm. This would avoid the denounced problem of open-ended liability, barring downstream creditors and other contracting parties of the victim from the exercise of remedies for the compensation of pure economic losses. The measure of damages, however, should be assessed taking into account the entire social loss, without any *a priori* exclusion of pure economic losses.

As a methodological matter, once the avoidance of open-ended liability is acknowledged as a driving rationale of the economic loss rule, such pragmatic concern should be addressed openly, avoiding the unnecessary and misleading use of other dogmatic constructs.

## 3. Conclusion

In spite of its historical resilience, the judicial propensity to limit liability for various categories of pure economic loss still lacks a coherent theoretical formulation. The economic analysis of the pure economic loss rule raises some questions on the cogency and significance of the theoretical and dogmatic arguments often invoked by judges and academic writers to justify the rule. The corrective justice and risk-spreading justifications of the rule, for example, have little to do with the legal distinction between direct and indirect economic losses. Likewise, goals of economic efficiency have little to do with the dogmatic distinction between absolute and relative subjective rights, used to draw the boundary between compensable and non compensable economic losses.

Behind the veil of rhetorical dogmatism, the analysis of actual cases of pure economic loss has revealed the judicial endorsement of sensible pragmatic goals. Due to the mixed use of dogmatic logic and judicial pragmatism, however, modern legal systems do not always draw the boundaries of the pure economic loss doctrines along coherent lines. As a result, some of the actual judicial applications are hardly defensible on economic grounds.

In this paper, I have discussed the theoretical independence – as well as the occasional interrelationship – between the private and social components of the economic loss occasioned by a tort. Liability rules should be attentive to the competing goals of (a) maintaining optimal levels of expected liability and efficient *ex ante* incentives; (b) avoiding open-ended and derivative litigation; and (c) to the extent possible, respecting entrenched legal dogmas and general principles of civil liability.

As a matter of policy design, the adoption of the legal doctrine of pure economic loss for the purpose of confining litigation in torts is

indefensible. The point for *ex ante* deterrence is not so much who obtains compensation, but how much should the tortfeasor pay, once a tort occurs. Some economic losses are as much a true social loss as other physical losses which are regularly treated as compensable harm. The doctrines of pure economic loss, while effective in avoiding open-ended litigation, occasionally create several problems on the front of *ex ante* efficiency. The question of whether the avoidance of open-ended liability is worth the distortion of *ex ante* incentives cannot be satisfactorily answered at this point. But, most importantly, the question may be properly avoided, once alternative solutions are taken into consideration.

This may require the theoretical reconceptualization of the rule. The economic loss rule is generally appreciated for its attempt to strike a practical balance between the opposing needs to confine litigation while maintaining effective deterrence, within the dogmatic constraints imposed by modern legal systems. It should be possible in this way to evaluate the true pragmatic rationales of the rule in light of alternative legal solutions to the problem of pure economic losses.

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