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## THE COMPARATIVE LAW AND ECONOMICS OF PURE ECONOMIC LOSS

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. We consider a restatement of the exclusionary rule consistent with the economic model of optimal liability, according to which “A plaintiff cannot recover damages for a purely *private* economic loss.” Our hypothesis is that, although not formally adopting this economic criterion, European courts are attentive to efficiency considerations. The comparative analysis reveals that, in a few situations, the application of the optimal liability rule finds obstacles in entrenched principles of civil liability. Generally, however, the practical contours of European economic loss rules—difficult to illuminate with traditional legal doctrines—are consistent with the predicates of economic analysis.

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

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that the recognition and significance attributed to such rule and to the notion of “economic loss” varies considerably across Western legal systems. 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.<sup>4</sup> Comparative legal analysis reveals that the policies and rules governing tortious liability for pure economic loss in Europe are not governed by common principles.

Traditionally, European legal systems have not undertaken 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 a comparative study of the economic loss rule is that, unlike most other issues in the field of torts, the different national approaches on the issue do not follow the familiar common law/civil law divide. The study unveils the existence of an area of law in which there has been neither cross-national consensus, nor even always internal consistency in the application of the rule within individual jurisdictions, due to the intellectual significance of divergent theoretical frameworks.

Among the 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 European 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.<sup>5</sup> Similarly, other scholars

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<sup>4</sup> Mauro Bussani & Vernon Palmer, *The Frontiers of Tort Liability: Pure Economic Loss in Europe*, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001)

<sup>5</sup> Robert L. Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 *Stan. L. Rev.* 1513 (1985); Gary T. Schwartz, *The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience*, in *Civil Liability for Pure Economic Loss* 103 (Efstathios K. Banakas ed. 1995); Gary T. Schwartz, *American*

have lamented the failure of tort scholarship to produce persuasive positive theories of liability for pure economic loss<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup> This paper revisits the recent findings of comparative law, revealing that legal notions of pure economic loss encompass several types of situations, with little or no correspondence with the relevant economic taxonomy. In terms of economic analysis, several situations of economic loss are distinguishable for their very different significance for social welfare analysis. What appears 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 category for the treatment of economic loss, given the inability for a single legal instrument to address the diverse economic situations that fall within such an iconoclastic rule.

Section 1 presents a comparative overview, providing a taxonomy of recovery for pure economic loss in European legal systems. Section 2 examines traditional explanations for the exclusionary rule, highlighting the many inconsistencies between the proclaimed rationales and the practical

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Tort Law and the (Supposed) Economic Loss Rule, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001); James R. Gordley, *the Rule Against Recovery in Negligence for Pure Economic Loss: An Historical Accident?*, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001)

<sup>6</sup> William M. Landes & Richard A. Posner, *The Economic Structure of Tort Law* 255 (1987)

<sup>7</sup> Gary T. Schwartz, *The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience*, in *Civil Liability for Pure Economic Loss* 103 (Efstathios K. Banakas ed. 1995)

<sup>8</sup> Ugo Mattei & Fabrizio Cafaggi, *Comparative Law and Economics*, 1 *New Palgrave Dictionary of Economics and the Law* (1998)

ways in which the rule is applied. Section 3 provides an alternative formulation of the exclusionary rule based on the economic criterion of efficiency. The redefinition of the concept of pure economic loss requires a distinction between several situations. We consider the hypothesis that several apparent anomalies in the judicial applications of the exclusionary rule are actually driven by substantial discrepancy between economic objectives and legal categories, and by the difficulty in balancing competing goals of judicial efficiency with the optimal level of deterrence for potential tortfeasors. Section 4 shows that, in spite of substantial variations in the specific applications of the rule, there is a substantial meeting of the minds in terms of the recognition of fundamental features of the exclusionary rule in European jurisdictions. Quite notably, these common features of the rule are those that remain hardly explained by traditional doctrines. Such points of convergence are fully consistent with the economic reformulation of the economic loss rule. The economic reformulation of the exclusionary rule may thus serve as a valuable benchmark in the ongoing attempts to harmonization and codification of European private law.

In conclusion, we revisit the original normative question of the liability for pure economic loss suggesting that one must recognize that in spite of the use of a single legal doctrine, there are in fact a multitude of different rules, each developed in response to different theoretical and pragmatic concerns. The search for a common core among the European legal rules is greatly enlightened by the understanding of the different dimensions of the economic loss problem and the impact of alternative hypothetical rules on individual incentives.

## **1. The Notion of Pure Economic Loss: A Comparative Overview**

The historical and comparative study of the civil law economic loss rules reveals that there has never been a universally accepted definition of what constitutes “pure economic loss.” Some European systems, such as France, still do not recognize the legal category and do not distinguish pure economic or financial loss as an autonomous form of damage. Other European systems, most notably Germany and England, recognize the category and utilize it in the context of a rule of no liability. The contrasting

approaches do not follow the traditional common law versus civil law grouping, for the civil law jurisdictions are themselves much divided over this question.<sup>9</sup>

### *1.1 Recovery for Economic Loss in the Civil Law Tradition*

In a recent historical study of the economic loss rule, James Gordley explores the evolution of the legal doctrines concerning the recovery for pure economic loss in some detail, noting that many early scholars versed in Roman and civil law said that plaintiff could recover if he suffered “damage” and damage meant simply a diminution of his *patrimonium*.<sup>10</sup> These conclusions are only superficially at odds with the conclusions reached with respect to the older actions in classical Roman law. Mario Talamanca shows that the problem of economic loss was not unknown to the classical Roman jurists, and the civilians who studied them.<sup>11</sup> Limits to the compensation of economic loss were indeed present in several contexts in Roman law. For example, under the *actio certi*, the creditor of a certain thing or amount could not recover the lost economic profit due to the breach of an obligation. Likewise, the forgone consumer surplus was generally not included in the computation of damages under the *litis aestimatio* (whenever the value of the obligation was of uncertain amount). Thus, creditors who suffered a pure economic loss may have been barred from recovery under both these actions, but the limit to recovery was not a direct consequence of the non-physical nature of the loss, but rather to the

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<sup>9</sup> Pure economic loss is one of the most discussed topics of European tort law scholarship. How should the tort law of the 21<sup>st</sup> century – or the provisions of a projected European code – approach this issue? In Bussani & Palmer (2001), twenty-one comparative legal scholars have examined to what extent, if any, there exists a common core of principles and rules concerning compensation for pure economic loss within European tort law. The study is part of the larger research of the “Common Core Project,” coordinated by Ugo Mattei and Mauro Bussani, and thus shares with the latter its basic aims and methodology, namely the factual approach with comparative work based on a common fact-based questionnaire.

<sup>10</sup> James R. Gordley, *The Rule Against Recovery in Negligence for Pure Economic Loss: An Historical Accident?*, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001)

<sup>11</sup> Mario Talamanca, *Istituzioni di Diritto Romano* 657 (Milan 1990)

uncertain and non-objectively ascertainable extent of the prejudice.

In these contexts, Roman and early civil law did not distinguish between loss of a physical asset and other kinds of loss. Nor was any distinction made between direct and consequential economic loss. Early civil law dealt with cases in which the plaintiff would recover what we would regard today as pure economic loss, but such cases never used the term, nor did they recognize an autonomous category of loss.<sup>12</sup> The factual issue of whether loss of expectation should be compensable in torts was debated in the 16th and early 17th century by the late scholastics or Spanish natural law school.<sup>13</sup> For example, there was the dependent's action for loss of support due to wrongful death, which clearly existed on the continent in the seventeenth century, as evidenced by Grotius' writings.<sup>14</sup> Evidence of this kind would suggest that there was no *per se* rule against compensation for pure economic harm in the civilian tradition.<sup>15</sup> Indeed, Gordley's account characterizes the rise of the exclusionary rule both in England and

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<sup>12</sup> James R. Gordley, the Rule Against Recovery in Negligence for Pure Economic Loss: An Historical Accident?, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001). See citations to the views of historical civilian jurists such as Durandis, Baldus, Brunnemann, Lauterbach and Grotius.

<sup>13</sup> James R. Gordley, the Rule Against Recovery in Negligence for Pure Economic Loss: An Historical Accident?, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001). See discussion of the positions of Tomasso de Vio, better known as Cajetan (1468-1534), Domingo de Soto (1494-1560), Luis de Molina (1535-1600), Leonard Lessius (1554-1623), and Juan de Lugo (1583-1660).

<sup>14</sup> H. Grotius, *De Iure Belli ac Pacis Libri Tres*, II, xvii, 1-2 (B.J.A. de Kanter- van Hettinga Tromp eds. 1939); James R. Gordley, the Rule Against Recovery in Negligence for Pure Economic Loss: An Historical Accident?, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001); S. Pufendorf, *De Iure Naturae et Gentium Libri Octo* III.i.2, III.i.3, III.i.6 (Amsterdam 1688); J. Barbeyrac, *Le Droit de la Nature et Des Gens ... Par le Baron de Pufendorf* n.1 to III.i.2, n.1 to III.i.3, n.4 to III.i.6 (5th ed. Amsterdam 1734). Gordley discusses the conclusions reached by other natural lawyers. A case discussed in Grotius was in effect an action for the recovery of pure economic loss sustained by wife and children, but it was not referred to in those terms.

<sup>15</sup> See Reinhard Zimmermann, *Law of Obligations* 1024-25 (Cape Town 1990); Vernon Palmer, *The Fate of the General Clause in a Cross-Cultural Setting: The Tort Experience of Louisiana*, 46 *Loy. L. Rev.* 535, 551 (2000)

Germany as a development of the late nineteenth century<sup>16</sup> and a peculiar outgrowth of analytical thinking. He concludes that the rule is an “accident” of legal history, not a pervasive feature of it.<sup>17</sup>

This view reflects the common wisdom among comparative law scholars and legal historians who have generally concluded that the economic loss rule is the product of history and has been shaped, in its current form, by modern legal dogmatism. As a result of such heterogeneous forces, traditional tort categories today are ill-adapted to the problem of pure economic loss.

In this essay we will consider an alternative hypothesis: that the apparent contradictions in the application of the economic loss rule in civil law systems are generally the result of judicial pragmatism, with piecemeal attempts by courts and legislators to balance needs of maintaining efficient behavioral incentives while minimizing the administrative costs of the liability system.

We shall proceed by providing a stylized taxonomy of pure economic loss situations, as they have been identified in modern European jurisdictions.

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<sup>16</sup> Insurance practices tend also to show the late development of the rule. Development of business interruption insurance, often called “consequential loss insurance,” belongs to the late nineteenth century, and even now the availability of such insurance is still rather limited. A prevalent restriction is that interruption insurance is essentially “follow-on” coverage to another insured peril, such as fire. Under the wording of standard fire policies, there is no compensation for interruption unless it results from a fire. This is not really compensation for pure economic loss, however, but rather compensation for parasitic loss. *See* G.J.R. Hickmott, *Principles and Practice of Interruption Insurance* 3-4 (London 1982); D.C. Jess, *The Insurance of Commercial Risks, Law and Practice* 244-251 (London 1986).

<sup>17</sup> Some scholars assert as an historical matter that pure economic loss has traditionally been left unprotected by the law. Professor Kötz deduces a teleological component in the evolution of tort law: The primary purpose of the law in England and Germany, he maintains, has “always been” to provide protection against personal injuries and harm to physical property. Pure economic loss seems left out of historical development, at least in those two countries. Hein Kötz, *Economic Loss in Tort and Contract*, in 58(3) *RabelsZ* 423 (1994).

## 1.2 *The Standard Cases: A Taxonomy*

Broadly speaking, pure economic loss arises out of the interdependence of relationships and interests in the modern world. These relationships may involve two or three parties. In this section we present a taxonomy of the principal ways in which pure economic loss arises within such relationships. Our list will not exhaust the conceivable ways in which such damage may arise. Instead, our interest lies in tracing the most recurrent and typical patterns, as recognized by modern European legal systems. We shall subsequently refer to these stylized fact patterns as the “standard cases.”<sup>18</sup> We set forth four categories that seem to be functionally and relationally distinct.

### a. “*Ricochet loss*”

Ricochet loss classically arises when physical damage is done to the property or person of one party, which in turn causes the impairment of the rights of the plaintiff. We refer to this as a three-dimensional situation. The direct victim sustains physical damage while plaintiff is a secondary victim who incurs only economic harm. As an illustration, A has a contract to tow B’s ship. C’s negligent act of sinking the ship makes it impossible for A to perform his contract and deprives him of expected profits. A’s financial loss is the Ricochet loss suffered as a result of C’s negligence toward B. The loss is purely economic since no property interest of A’s has been impaired.<sup>19</sup> A Ricochet loss can also arise from the impairment of an employment contract. For instance, B is a key employee on A’s sporting

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<sup>18</sup> This taxonomy reflects the listing used in the empirical study conducted by Bussani & Palmer (2001), with the aid of several jurists representing the various European jurisdictions. Although we have sometimes borrowed and other times given new names to these situations, we have not attempted to explain or employ all of the descriptive labels and tags that writers and judges have used. For a longer taxonomic list consisting of eight categories (in which there may be overlapping situations), see William Bishop and John Sutton, *Efficiency and Justice in Tort Damages: The Shortcomings of the Pecuniary Loss Rule*, 15 *J. of Legal Stud.* 347, 360-61 (1986).

<sup>19</sup> The example closely follows *La Société Anonyme de Remorquage à Helice v. Bennets*, 1 KB 243 (K.B. 1911).

team. C's negligent driving leads to B's death or incapacity, causing A's team to lose revenues. Here B's injury is physical, but A's loss is purely financial. The "Cable Cases,"<sup>20</sup> the Meroni Case,<sup>21</sup> and other hypotheticals studied in Bussani & Palmer (2001) are simply variations of Ricochet harm.

*b. "Transferred loss"*

Here C causes physical damage to B's property or person, but a contract between A and B (or the law itself) transfers a loss that would ordinarily be B's onto A. In this case, a loss *ordinarily falling on the primary victim* is passed on to a secondary victim. Again the situation is three dimensional, but it is the transfer of a risk from its natural bearer that distinguishes this from a case of Ricochet loss. Such a transfer frequently results from leases, sales, insurance agreements and other contracts, separating property rights from rights of use or risk bearing. To illustrate, A charters a ship owned by B. During dry dock repairs, C negligently damages the ship's propeller, necessitating further repairs and a two week delay, during which A loses all use of the ship. Here B suffers property damage and ordinarily he would recover for the loss of the ship's use, but the right of use had been transferred to A by the charter. So A's loss is purely pecuniary because he has suffered no property loss.<sup>22</sup> A similar effect can result under a sales contract which reserves title in B (seller) while the goods are in shipment but transfers the risk of any loss to the buyer A. If the goods (still technically owned by B) are damaged in transit by the shipper's negligence, then this loss has been transferred to A. A's loss is purely financial since he has no property interest in the goods.<sup>23</sup>

A similar result is reached when the transfer occurs by operation of law. For instance B, A's employee, may be injured by the negligent driving of C and thus find himself unable to work for three months. Nevertheless a statute requires A to continue to pay B's salary, even though no work is

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<sup>20</sup> Spartan Steel and Alloys v. Martin & Co., QB 27 (1973)

<sup>21</sup> Torino Calcio SPA v. Romero, Cass. Civ., SU 26.1.1971, n. 174, GI, 1971, I,1, 681

<sup>22</sup> See Robins Dry Dock v. Flint, 13 F.2d 3 (2d Cir. 1926), *rev'd* 275 U.S. 303 (1927)

<sup>23</sup> This illustration is based upon The Aliakmon, 2 AER 44 (1985)

done by B. Thus what ordinarily would have been B's loss is statutorily transferred to A as a combined result of C's negligence and the effects of a pay continuation statute.

*c. Closures of Public Service and Infrastructures*

Here economic loss arises without a previous injury to anyone's property or person. There may be physical damage, but it is to "unowned resources" that lie in the public domain.<sup>24</sup> A single negligent act may necessitate the closure of markets, highways and shipping lanes that no individual owns, yet the closure directly inflicts economic loss on individuals whose livelihoods depend on the use of these facilities. This category raises the greatest concern about liability to an indeterminate class in an indeterminate amount. In these situations, patrimonial ripple effect is at its maximum. For example, C negligently spills chemicals into the river, and all traffic on the waterway is suspended for two weeks during a cleanup effort. Shippers must then take more expensive overland routes, and marinas, boat suppliers, hotel operators, and commercial fishermen in the area suffer economic loss.<sup>25</sup> A similar chain of loss arises when C negligently allows infected cattle to escape from his premises, and the government must order all cattle and meat markets to close. As a result, broad classes of plaintiffs will suffer pure economic loss, including cattle farmers suddenly unable to sell their stock and butchers who are unable to obtain beef.<sup>26</sup> As we note below in Section 4, the concerns for open-ended liability acquires great relevance in such contexts.

*d. Reliance upon Flawed Information or Professional Services*

Those who furnish advice, prepare data or render services concerning financial matters generally understand that their information will

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<sup>24</sup> Victor Goldberg, Recovery For Economic Loss Following the Exxon Valdez Oil Spill, 23 J. Legal Stud. 1, 37 (1994)

<sup>25</sup> This illustration resembles the Testbank case. Louisiana ex rel. Guste v. M/V Testbank, 752 F.2d 1019 (5th Cir. 1985).

<sup>26</sup> See Weller v. Foot & Mouth Disease Research Inst., 1 QB 569 (1966)

be furnished to a client and may be relied upon by third persons with whom they have no contractual relation. If the advice, data or services are carelessly compiled or executed, this may or may not breach a contract with the client (even if there is breach, the damage will usually be strictly financial) but the relying third party will sustain pure pecuniary loss. For instance, C, an accountant, carelessly conducts an audit of B, a publicly traded company, and overstates the company's net financial worth. Relying upon the accuracy of the audit, investor A buys shares in B at twice their actual value. Here A's loss arises not in consequence of physical damage to B, but on the basis of misplaced reliance. Erroneous advice *with respect to* a client may cause financial losses to a third party. Thus A, concerned about doing business with and extending credit to B, takes the precaution of asking C (the merchant bank where B kept its account) for an assessment of B's creditworthiness. C carelessly replies that B is "good for its ordinary engagements" (when in fact B would soon go into liquidation) and thereby causes A to advance credit and to lose a large sum.<sup>27</sup> Here A's loss is purely financial, not because it Ricochets off or is transferred from someone else's physical damage, but because it arises directly from A's reliance.

Professional services for a client may cause pecuniary loss to a non-client. B, an elderly man, asks C, his lawyer, to prepare a will in which he will leave \$100,000 to A. C takes no action for six months, whereupon B dies intestate and A receives nothing.<sup>28</sup> A's loss is purely economic.

### *1.3 Rules for the Recovery for Pure Economic Loss in European Jurisdictions*

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 the four stylized categories considered above.

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<sup>27</sup> See *Hedley Byrne & Co. v. Heller & Partners Ltd.*, AC 465 (HL) (1964). For other instances of pecuniary harm from incorrect information, see the cases studied in Bussani & Palmer (2001) concerning mistaken or false job reference and credit ratings.

<sup>28</sup> See *White v. Jones*, 2 AC 207 (HL) (1995); *Lucas v. Hamm*, 11 Cal. Rept. 727 (Cal. Ct. App. 1967); *Ross v. Caunters*, Ch. 297 (1980)

Table 1 provides a summary of the solutions to each of the four factual scenarios in European national Courts.

	<b>Recovery</b>	<b>No Recovery</b>	<b>Unsettled or Problematic</b>
<b>(a) Ricochet Loss</b>	France, Belgium, Greece, Italy, Spain, The Netherlands	Austria, England, Finland, Germany, Portugal, Scotland Sweden	--
	<b>(i) Cable Cases</b> <b>(ii) Loss of a "Star"</b>	France, Italy	Austria, Belgium, England, Finland, Germany, Greece Portugal, Sweden, Scotland, The Netherlands Spain
<b>(b) Transferred loss</b>	Austria, Belgium, France, Greece, Spain, The Netherlands	England, Finland, Germany, Portugal, Scotland Sweden	Italy
<b>(c) Closure of Public Service</b>	France	Austria, Belgium, England, Finland Germany, Portugal, Scotland, Spain, Sweden	Italy, Greece, The Netherlands
<b>(d) Flawed Professional Advice</b>	<b>(i) Lawyers &amp; Notaries</b>		Finland, Portugal, Sweden
	<b>(ii) Auditors</b>	Austria, Belgium, England, France, Germany, Greece, Italy, Scotland, Spain, The Netherlands Belgium, Italy, Sweden, Finland, The Netherlands	-- Austria, Germany, Portugal, England, Scotland France, Spain, Greece

**Table 1:** *Recovery of Economic Loss in European Jurisdictions*

The comparative analysis of the economic loss rule summarized in Table 1 reveals 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. The matter is the subject of thriving debate, case law development and doctrinal writings within each family, though not necessarily within every system.<sup>29</sup> The approach of legal systems such as Germany, Austria, Portugal, Sweden and Finland are very close to the Common law perspective and clearly contrast the approach followed by other civil law jurisdictions, like France and Belgium, where the issue is hardly recognized, whereas in Italy, Spain and Greece, the exclusionary rule is only moderately applied within different constructs.<sup>30</sup>

These patterns and alignments are most clearly evidenced in some of the famous cases of pure economic loss. As Table 1 indicates, the recovery in cases of *Ricochet loss* are nearly evenly divided. Six European jurisdictions would allow recovery of the loss, but six judicial systems would deny it.<sup>31</sup> These results do not correspond to an alleged common

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<sup>29</sup> In this respect, the recent empirical findings of comparative legal scholars contradict the claim of previous scholars according to which the economic loss issue reflected a “civil law-common law split” or a “true Continental Divide.” *See, e.g.*, Jan van Dunné, Liability for Pure Economic Loss: Rule or Exception? A Comparatist’s View of the Civil Law-Common Law Split on Compensation of Non-physical Damage in Tort Law, 4 *Eur. Rev. Private L.* 397, 399 (1999).

<sup>30</sup> The recent empirical research carried out by Bussani & Palmer (2001) with the aid of several comparative legal scholars from different European jurisdictions clearly confirms these results. Out of the twenty factual patterns examined in such study, France permits delictual recoveries in seventeen cases, but in Portugal the number is only five. Belgium allows delictual recovery fourteen times, Austria only seven times. Italy grants recovery in thirteen cases, as compared to four in Sweden. If any split is to be recognized, it would appear, in our view, to lie between those countries which have an overt system of protected (vs. *unprotected*) interests (such as Germany and England) and those which do not. *See also* S. Banakas, Liability for Incorrect Financial Information: Theory and Practice in a General Clause System and in a Protected Interests System, 7 *Eur. Rev. Private L.* 261 (1999). *See also* K. Lipstein, Protected Interests in the Law of Torts, *Camb. J.* 85, (1962-63).

<sup>31</sup> In the *Meroni* type of case, the split widens: three liberal regimes allow recovery (with Belgium negative and Spain problematical) but all five conservative systems and three pragmatic systems are against a remedy.

law/civil law divide. Additionally, one should not overlook the widespread agreement that exists with respect to other paradigmatic cases. For example, in cases of flawed professional services, there is virtual unanimity in favor of the intended beneficiary's recovery of the suffered financial loss.<sup>32</sup>

In the other group of cases concerning the closure of a public service, European consensus exists in the opposite direction: ten systems oppose relief, while France alone permits it.<sup>33</sup>

These findings are puzzling for comparative legal scholars, since legal systems that follow a different theoretical approach seem to react quite similarly to such fact patterns, often contradicting the purported rationales of the rule. More interestingly for our analysis, we should note that almost all European legal systems depart from dogmatic principles when addressing cases of pure economic loss: "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 listing of protected interests.<sup>34</sup>

The convergence towards common solutions, which often necessitates a departure from the legal principles governing civil liability in the respective national legal systems, is virtually inexplicable when combined with the traditional doctrines of pure economic loss. In Section 2 we illustrated the limited explanatory power of the traditional doctrines in the face of the observed applications of the economic loss rule in European legal systems. After providing an economic restatement of the exclusionary

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<sup>32</sup> In the hypothetical case of the defective will drafted by a negligent Notary, there is virtual unanimity in favor of the intended beneficiary's recovery of his/her financial loss: eleven European countries sampled in the Bussani & Palmer (2001) study indicate the recoverability of the loss, with no system opposing such solution. Interestingly, eight countries reach this solution through the law of tort, while three others base it upon the contract with protective effects, or upon special legislation pertaining to notarial liability.

<sup>33</sup> These statistics were based on the fact pattern of the *Closed Motorway* case which caused traffic delays, with consequential financial loss of truckers.

<sup>34</sup> We are following the classification formulated by Bussani & Palmer (2001) who 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".

rule, we will return in Section 4 to the comparative findings and consider whether such economic reformulation can better explain the observed judicial solutions and unveil the logic of what would otherwise appear fuzzy judicial pragmatism in the adjudication of pure economic loss cases.

## **2. Economic Loss Doctrines at a Crossroad**

The iconoclastic data brought to light by the comparative study of the economic loss rule allows us to evaluate the competing doctrinal explanations of the rule. Several theories invoked in support of the economic loss rule are in fact inconsistent with empirical findings. Others are simply incapable of explaining different patterns of application of the rule across the various types of pure economic loss.

In the following sections, we consider the traditional arguments presented in support of an exclusionary rule, offering some critical considerations of the traditional rationales and dogmatic explanations of the exclusionary rule.<sup>35</sup> This helps us identify the common, yet unwritten, economic logic that appears to influence the decision-making process across jurisdictions.

### *2.1 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 case law, this rationale tends to surface in support of the several limitations imposed 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 the rules of tort based on foreseeability were developed for physical damage and are not workable outside of the context

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<sup>35</sup> 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 rule is indeed most valuable, since it often unveils certain difficulties or suggests to us counterarguments which would otherwise remain overlooked.

for which they were developed. The evolution of the economic loss rule is explained as a pragmatic development of the law: the straightforward application of the foreseeability test to cases of pure financial loss would lead to ruinous levels of liability.<sup>36</sup>

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. For example, the closure of a public service situation exemplified by the *Closed Motorway* case is clearly on point. As a matter of foresight, the congestion and traffic delays and consequential economic loss are part of the unavoidable and foreseeable consequences of a closed motorway. Yet, almost all legal systems considered in our study exclude the recoverability of economic losses of truckers and other professional travelers who suffered an economic prejudice from closure of the public motorway.

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 a criterion of liability would not adequately provide the incentive to avoid the complete harm.

Both factually and theoretically, therefore, the rule cannot be justified by some vague unforeseeability notion. Instead, the criterion of foreseeability, although invoked as a justification of the exclusionary rule,

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<sup>36</sup> Bruce Feldthusen, *Economic Negligence* 10-11 (2<sup>nd</sup> edition Carswell 1989). 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.

does not appear to be effectively driving the decision making process in European jurisdictions. 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. As a policy matter, the presence or absence of foreseeability is a factual and legal question that enters the equation 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 *The Different Domains of Legal Protection: 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 expectations.<sup>37</sup> Although with several theoretical variations, one dogmatic obstacle to the recovery of economic loss is attributable to the fact that several of the “unreified” economic interests are often related to unfulfilled contractual expectations of the parties or to other expectations having an economic significance. Several *Ricochet loss* cases are examples on point. The loss to the victim derives from the fact that the contractual expectation of a third party will not be fulfilled because of the wrongful behavior of a party contractually unrelated to the creditor. 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.

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<sup>37</sup> See, e.g., Francesco Galgano, *Le mobili frontiere del danno ingiusto*, in *1 Contratto e Impresa* 1-27 (1985).

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.<sup>38</sup>

The dogmatic distinction between absolute and relative rights has some direct relevance for the issue of pure economic loss. 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, body and personal integrity), the right is over a “thing” and other individuals’ behavior remains irrelevant as far as their activities do not encroach over relationship between the owner of the right and the object being owned. Conversely, in the case of relative rights, the object of the right has as its focal point 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 identification of the person whose behavior is expected (i.e., the debtor) becomes particularly important. It is indeed a person or a group of people that is distinct from the generality of the 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 becomes relevant only when it encroaches or violates the relationship between the owner of the right and the “thing.”

It is clear that 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* (i.e., aimed at obtaining something which is not yet part of the patrimony of the owner of the right).<sup>39</sup> Through the behavior of other individuals, the owner of the right wants to acquire something that is not yet his own. In a word, the owner of a relative right has a mere *acquisitive* interest.

Absolute rights, to the contrary, encompass a different group of situations. The owner of an absolute right already enjoys a reified interest

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<sup>38</sup> We shall return to this question in Section 4, after having examined the economic reformulation of the exclusionary rule.

<sup>39</sup> 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.

as part of his patrimony. Third parties are extraneous to the legal relationship between the owner of the right and his reified interest and have no affirmative duty of cooperation. The only duty is of negative content: abstaining from interfering with the owner's right over his property (i.e., a duty not to encroach on others' rights). In this case, 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 of abstention from interfering or encroaching on the protected right is not expanding the right itself. It is only preventing a diminishment or violation of the right itself.

The civilian distinction between absolute or relative right—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, as for every dogmatic construct, 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 true 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 prove too much, since it would suggest that all such relative rights would remain uncompensated if violated by a third party. This explanation clearly flies in the face of the fact that the exclusionary rule is associated with the negligence standard.<sup>40</sup> Full protection is given to cases of intentional breach. 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 are evidence that the exclusionary rule is not simply the consequence of a dogmatic path dependence but a

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<sup>40</sup> All European legal systems considered in the Bussani & Palmer (2001) study permit recovery when pure financial loss is inflicted intentionally.

reflection of other policy concerns which will be more extensively explored through the economic analysis in Section 3. Absent such an economic explanation, the dogmatic rationale would remain mostly tautological in nature, begging the very question of why pure economic interests, once classified as “relative” rights, should fall short of full protection in torts.

### 2.3 *The Scale of Human Values.*

A third explanation of the exclusionary rule is in some ways germane to the previous dogmatic explanation. This justification of the exclusionary rule, however, is supported by pragmatic considerations, often also recast in terms of philosophical values. This rationale 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 (and the law is supposed to reflect the proper values of society) would be right to give greater protection to tangible property than to intangible wealth.”<sup>41</sup> 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.<sup>42</sup> This pragmatic motivation should not be dismissed as mistaken in principle, but seems to find no clear empirical support. Judicial resources are not unlimited and the benefits of imposing liability for wrongful behavior

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<sup>41</sup> Tony Weir, *A Casebook on Tort 6* (9<sup>th</sup> ed. Sweet & Maxwell 2000)

<sup>42</sup> Bussani & Palmer (2001) have pointed out that even if we accept, for sake of argument, that wealth is less important than other values, still there would 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.

should be balanced against the added administrative costs of adjudication. But there is no obvious reason to believe that, if pure economic loss were freely protected, other worthier claims would lose effective protection.<sup>43</sup>

This proposed doctrinal rationale, while in tune with the previously examined dogmatic classification of rights, is also inconsistent with the practical applications of the exclusionary rule in European jurisdictions. Also in this case, the rationale flies in the face of the full protection granted to intentionally inflicted “pure” economic loss and of the fact that all “consequential” economic losses are recoverable under national law. These elements are evidence that 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. 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 *The Problems of Derivative and Open-Ended 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 *ad infinitum* for the consequences of a wrongful act.<sup>44</sup>

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<sup>43</sup> 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. It also raises the question how countries like France and Belgium, which follow a rule of presumptive recovery of economic loss, have managed to avoid the predicted crowding out of more deserving legal claims. *See also* J. Spier, *The Limits of Liability. Keeping the Floodgates Shut* (Kluwer Law International 1996).

<sup>44</sup> 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. Gary T. Schwartz, *The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience*, in *Civil Liability for Pure Economic Loss* 103 (Efstathios K. Banakas ed.

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. Von Ihering's statement "Where would it all lead if everyone could be sued...!"<sup>45</sup> is indeed a famous rendition of this general concern.

In spite of such a common pragmatic motivation, there are actually three distinct strands to the open-ended liability argument. Though not always distinguished in the literature, it is helpful to acknowledge them separately at this point.

(a) The first strand is the belief that to permit 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 is closely related to the concern for cost-effectiveness in the administration of tort law, as a necessary instrument for the minimization of 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 focus in this case is not on the courts' administrative costs but on the defendant's expected liability costs.

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1995); Gary T. Schwartz, American Tort Law and the (Supposed) Economic Loss Rule, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 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.

<sup>45</sup> Jherings *Jahrbücher* 4, 12-13 (1861)

(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.<sup>46</sup>

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 instead is theoretically flawed. According to this variation of the open-ended liability argument, the potentially staggering liability faced by potential tortfeasors would be out of all proportion to the degree to which defendant was negligent. The danger of disproportionate consequences resulting from minor blameworthiness is of course an issue of fairness no matter what kind of damages have been caused<sup>47</sup> but some scholars believe that the danger is far greater in pure financial loss cases. These concerns are misplaced from an economic point of view. Absent other constraints on human behavior, 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 big the gravity of the harm.

The third strand of arguments 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

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<sup>46</sup> 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 J. Spier (ed.) *The Limits of Liability* (Kluwer 1996); J. Spier, *The Limits of Expanding Liability* (Kluwer 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.

<sup>47</sup> See Jeremy Waldron, *Moments of Carelessness and Massive Loss*, in *Philosophical Foundations of Tort Law* 387 (David Owen ed. 1995)

seems to argue that the exclusionary rule should be invoked even in factual instances where there is no danger of a flood of claims or of 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.

In addition to the weak theoretical and factual soundness of the open-ended liability arguments, the comparative analysis of the economic loss rule in European jurisdictions seems to suggest that the so-called “floodgate” arguments have only limited explanatory power of the European approach to economic loss. The comparative evidence 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 recourse to an arbitrary solution.<sup>48</sup> None of the three variations of the economic loss fully explains the actual features of the exclusionary rule, as they have evolved in European jurisdictions.

We shall thus proceed to explore whether the points that were left unexplained by the traditional theories can be rationalized by an economic restatement of the exclusionary rule, one consistent with an efficiency criterion of adjudication.<sup>49</sup>

### **3. Pure Economic Loss Rule: Towards an Economic Restatement**

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

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<sup>48</sup> In assessing the cumulative weight of these arguments, it should be remembered that the floodgates argument has never purported to be a scientific claim, but rather a claim based on mere speculations lacking a verifiable empirical basis. It is not very easy to test whether the dire prophecy of the “nightmare scenario” is dream or reality. For instance, as observed by Bussani & Palmer (2001), for many scholars, the justification for a no-recovery rule based upon a supposed difference in ripple effect or in the sheer size of the plaintiff class is hard to reconcile with the recovery of extremely large economic losses resulting from negligently caused physical injury.

<sup>49</sup> The efficiency criterion would require the minimization of the total social cost of accidents, at the net of enforcement and adjudication costs.

that drives this puzzling 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.

### 3.1 *Pure Economic Loss 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. In this context, the amount of a “social” loss is given by the sum of all private losses imposed by a given action on the various parties minus the sum of all benefits generated by the same conduct. Liability in torts, whether for physical or economic losses, should not be exclusively linked to the private losses of the parties, but should be further limited to the socially relevant harm. The application of this principle necessitates focusing on the tortfeasor’s expected *ex ante* liability, rather than on the victim’s actual compensation.<sup>50</sup>

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

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<sup>50</sup> 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 & 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. Richard A. Posner, *Economic Analysis of Law* (3<sup>rd</sup> ed. 1986); William M. Landes & Richard A. Posner, *The Economic Structure of Tort Law* (1987). 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.

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. We shall refer to this category of 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.

### 3.2 *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.

Once again, we use the economic definition of social loss as the sum of all private losses and gains generated by a given action. In the context of pure financial loss, the private loss generally 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 costs 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.<sup>51</sup> 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

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<sup>51</sup> Steven Shavell, *Economic Analysis of Accident Law* (1987); Jennifer Arlen, Tort Damages, in 2 *Encyclopedia of Law and Economics* 682 (B. Bouckaert & G. De Geest eds. 2000). As pointed out by Shavell, 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.

above, the private loss to the victim may be the source of a net gain for society at large.<sup>52</sup> In such cases, law and economics leads to the frequently 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

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<sup>52</sup> 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 tortious 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.

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, we shall evaluate some elements of the traditional debate within the normative framework of law and economics.

### 3.3 *In Search of Comparable Categories*

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,<sup>53</sup> we suggest that the emergence and diffusion of the economic loss rule is more than a mere historical accident. We suggest that such exclusion of liability is in many instances appropriate and that several

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<sup>53</sup> Gary T. Schwartz, *The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience*, in *Civil Liability for Pure Economic Loss* 103 (Efstathios K. Banakas ed. 1995); Gary T. Schwartz, *American Tort Law and the (Supposed) Economic Loss Rule*, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001); James R. Gordley, *the Rule Against Recovery in Negligence for Pure Economic Loss: An Historical Accident?*, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001)

of the factual situations governed by the economic loss rule are correctly adjudicated. An economic analysis also reconciles some of the apparent contradictions of the judicial applications of the economic loss rule in the various legal systems considered in this study.

### 3.4 *An Economic Restatement*

Legal systems utilize quite different constructs to define the boundaries of compensable harm for economic loss. We 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 attempt a reformulation of the rule in terms that are consistent with its fundamental economic rationale.<sup>54</sup> A restatement of the exclusionary rule consistent with the economic model of optimal liability would require distinguishing between private losses that generate a corresponding social loss and losses that are merely private, in the sense that, while generating a prejudice for some individuals, generate an offsetting benefit for other subjects, so as to result in no net social loss. The exclusionary rule would thus include the above economic qualification and would state that: ‘a plaintiff cannot recover damages for a purely *private* economic loss.’

The above restatement allows us to revisit some of the peculiar features of the existing version of the exclusionary rule verifying their consistency with the proposed economic reformulation. Most interestingly, we will examine whether the economic restatement explains some of the general features of the rule that could not satisfactorily be explained by the traditional rationales.

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<sup>54</sup> For additional discussions of the issue of liability for economic losses from a law and economics perspective, see Victor P. Goldberg, Recovery for Economic Loss in Tort: Another Look at *Robins Dry Dock v. Flint*, 20 J. Legal Stud. 1 (1994); William M. Landes & Richard A. Posner, The Economic Structure of Tort Law 251-255 (1987); Robert L. Rabin, Tort Recovery for Negligently Inflicted Loss: A Reassessment, 37 Stan. L. Rev. 1513 (1985); Mario J. Rizzo, A Theory of Economic Loss in the Law of Torts, 11 J. Legal Stud. 281 (1982); Garty T. Schwartz, The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience, in Civil Liability for Pure Economic Loss 103 (Efsthathios K. Banakas ed. 1995); Jennifer Arlen, Tort Damages, in 2 Encyclopedia of Law and Economics 682 (B. Bouckaert & G. De Geest eds. 2000).

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 we shall call  $x^*$ . In such case, the level of due compensation,  $D$ , is determined by the following rule:

$$(1) \quad D = L_s(x) \quad " \quad x < x^*$$

The rule states that damages  $D$  should be paid in an amount equal to the social loss,  $L_s$ , every time the tortfeasor undertakes a level of precaution lower than the social optimum,  $x^*$ . As discussed in the previous section, the application of this liability rule in the context of pure economic loss is problematic for a variety of reasons.

First, the rule requires that the extent of liability be determined on the basis of the social loss,  $L_s$ , rather than the actual loss suffered by the victim,  $L_p$ . 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.

$$(2) \quad \begin{array}{l} D < L_p \quad " \quad L_p < L_s \\ D > L_p \quad " \quad L_p > L_s \end{array}$$

In the presence of a discrepancy between the extent of a private loss,  $L_p$ , and the actual social loss,  $L_s$ , the damage award,  $D$ , will be linked to the social loss and would thus result as either under-compensatory or over-compensatory from the point of view of the victim. The damage award will be fully compensatory only in the limited case in which private and social loss coincide,  $L_p = L_s$ .

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

$$(3) \quad D < 0 \quad " \quad L_s < 0 \quad (\text{and for any value of } L_p)$$

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 ( $Lp > 0$ ). According to this application of the criterion of optimal liability, we may subsidize wrongful behavior, whenever the private loss generates a social gain (e.g., a “wrongful” action that leads to the breakdown of a monopoly, with a resulting social welfare gain).

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:

$$(4) \quad D = Ls \quad \text{s.t.} \quad D > 0 \quad \text{and} \quad D \leq Lp$$

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)<sup>55</sup> and where the amount of liability should not exceed the extent of the victim’s loss (i.e., damages should not be overcompensatory, unless they are punitive

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<sup>55</sup> 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 exclusionary rule, with no room for application of this version of the rule within the context of liability for pure economic loss.

in nature).

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 rise 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 price 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.<sup>56</sup>

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

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<sup>56</sup> Other problems in calculating the efficient measure of damages for pure economic loss were pointed out by Bishop & Sutton (1986) who observe that, if an accident destroys a unit of some good or factor of production, the use of the market price of such good is only an imperfect measure of liability. William Bishop & John Sutton, *Efficiency and Justice in Tort Damages: The Shortcomings of the Pecuniary Loss Rule*, 15 *J. Legal Stud.* 347, 353 (1986).

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.

The above reconceptualization provides a viable hypothesis to explain the apparent exceptions and variations of the pure economic loss rule in modern and historical societies. Recasting the economic loss rule 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.

### 3.5 Applying the Economic Loss Rule: A Taxonomy of Cases

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

Several judicial applications of the economic loss rule, however, 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.<sup>57</sup>

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 sum of the foregone producer surplus (i.e., the pure economic loss) and the lost consumer surplus. Note here a practical problem in the conceptualization of liability.

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<sup>57</sup> 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 in products liability cases contract law is the preferred legal framework within which to address claims concerning pure economic loss. Gary T. Schwartz, The Economic Loss Doctrine in American Tort Law: Assessing the Recent Experience, in *Civil Liability for Pure Economic Loss* 103 (Efstathios K. Banakas ed. 1995); Gary T. Schwartz, American Tort Law and the (Supposed) Economic Loss Rule, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001).

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).<sup>58</sup>

In order to organize ideas on a manageable template, it is desirable to map the relevant categories of economic loss and examine the appropriate legal solutions to the problem in each category.

Table 2 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	$L_p = L_s$	$L_s > 0$	$D = L_s$	Full recovery
2	$L_p > L_s$	$L_s > 0$	$D = L_s$	Exclusionary Rule should apply limiting liability to "socially relevant" losses
3	$L_p > L_s$	$L_p > 0$ $L_s \leq 0$	$D = 0$	No recovery (alternatives should be considered to subsidize positive social externalities)
4	$L_p < L_s$	$L_p > 0$	$D = L_p + T$ $T = L_s - L_p$	Decoupling solution

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<sup>58</sup> On the relationship between private economic loss and social loss, see the important contributions of William Bishop, *Economic Loss in Tort*, 2 *Oxford J. Legal Stud.* 1 (1982); Steven Shavell, *Economic Analysis of Accident Law* 135-140 (1987); Jennifer Arlen, *Tort Damages*, in 2 *Encyclopedia of Law and Economics* 682 (B. Bouckaert & G. De Geest eds. 2000).

5	$L_p < L_s$	$L_p \leq 0$ $L_s > 0$	$D = L_s$ or $L_s < D \leq 0$	$D = L_s$ is efficient $L_s < D \leq 0$ can be adopted to reduce open- ended liability problems
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**Table 2:** *Applying the Economic Loss Rule*

Table 2 provides a summary 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 2 illustrates four situations, each characterized by a different qualitative balance between private and social costs. Each of the four 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,  $L_s$ . 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.<sup>59</sup> 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.

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<sup>59</sup> See, e.g., Steven Shavell, *Economic Analysis of Accident Law* 136 (1987)

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. Likewise, as pointed out by Bishop & Sutton (1986),<sup>60</sup> if the amount of goods destroyed is sufficiently large as to affect the market equilibrium, the old market price may be an inadequate measure, since it would not take into account the forgone consumer surplus for all inframarginal consumers. And again, if the accident has destroyed some inputs of production, the loss may have to be valued at the price of the final produced good (rather than at the market price of the inputs), at the net of production costs. Finally, Case 4 can be seen as symmetrical to Case 2, whenever the destruction of complementary goods, rather than substitute goods, is concerned. Imagine the destruction of a shopping mall in the proximity of a parking garage. The economic loss caused by the accident exceeds the loss suffered by the owner of the mall and should include the reduced value of a parking garage in the absence of the mall customers.

In all the above situations, 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,  $L_s$ . However, if *ex post* liability is imposed in the measure of  $D = L_s$ , the victim would be overcompensated by the tort, since he would receive an amount of compensation higher than the loss actually suffered (i.e.,  $D > L_p$ ). 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

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<sup>60</sup> William Bishop & John Sutton, Efficiency and Justice in Tort Damages: The Shortcomings of the Pecuniary Loss Rule, 15 J. Legal Stud. 347, 353 (1986)

liability faced by the tortfeasor could be linked to the expected social loss,  $L_s$ , while keeping the level of victim's compensation capped at the value of the private loss actually suffered,  $L_p$ .<sup>61</sup> 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 ( $T = L_s - L_p$ ). 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.,  $D = L_p + T = L_s$ ). 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 a social loss,  $L_s$ , 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 we address briefly, for the sake of theoretical completeness. It is interesting

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<sup>61</sup> A few clarifications should be made at this point: (a) Not all economic losses 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.

to note that since  $L_p \neq 0$ , 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,  $L_s$ , 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  $D = L_s$ , 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  $L_s$ .

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  $L_p \neq 0$ , while simultaneously an actual loss on other individuals (i.e.,  $L_s > 0$ ). The total value of the loss imposed on the various subjects equals  $L_s + |L_p|$ , but as discussed above, only the net social loss,  $L_s$ , 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,  $L_p$ , 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,  $L_s$ , allowing the third parties who benefited from the wrongful action to keep such benefit.

#### **4. Rethinking the Exclusionary Rule Through Economic Lenses**

The economic restatement of the exclusionary rule now allows us to

revisit some of the apparent anomalies observed in the application of the exclusionary rule in European jurisdictions: anomalies that were left partially or wholly unexplained by the traditional theories examined in Section 2. We shall proceed examining if the emergence of the current contours of the exclusionary rule can be explained by economic analysis and we will suggest that several such doctrines have evolved in response to efficiency considerations by courts and policymakers. Most importantly, 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 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.

#### *4.1 Exclusionary Rule for “Purely Private Economic Loss”: Revisiting the Legal Taxonomy*

In the above sections we presented a restatement of the exclusionary rule consistent with the economic model of optimal liability. Such reformulation distinguishes between “socially relevant economic losses” (which generate a private loss and a corresponding social loss) and “purely private economic losses” (which instead generate a prejudice for some individuals, with offsetting benefit for others, and no net loss for society). The economic restatement of the exclusionary rule would account for such distinction, stating that plaintiffs should be barred from recovering damages for purely *private* economic losses. We shall now revisit four “standard cases” of pure economic loss examined in Section 1.2, in the search for common elements between the legal and economic criteria of evaluation.

The analysis at first reveals a lack of correspondence between the traditional legal and economic categories. The empirical findings, however, strongly support our hypothesis that the practical contours of the economic loss rule in European jurisdictions have been strongly influenced by

efficiency considerations. What appears fuzzy judicial pragmatism in the European case law is instead a quite accurate implementation of the efficiency criterion. The economic restatement of the exclusionary rule indeed provides a good fit in explaining the apparently fragmented approach of European courts on the issue of pure economic loss.

*a. The Mixed Economic Nature of “Ricochet Loss”: The Relevance of Case Law Distinctions*

In the first group of cases, the *Ricochet loss* cases, a physical damage is done to the property or person of one party, which in turn causes the impairment of 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. Textbook illustrations include the case of wrongful behavior that damages a ship, with economic loss to a third party, who has relied on the shipping services of the sunk ship; or the case of impairment of an employment contract due to wrongful harm to the employee, with resulting economic losses for the employer. The “Cable Cases”<sup>62</sup> and the “Loss of a Star” cases,<sup>63</sup> 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 of a Star” cases, while granting compensation in “Cable Cases.” The empirical findings are even more

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<sup>62</sup> *E.g.*, *Spartan Steel and Alloys v. Martin & Co.*, QB 27 (1973)

<sup>63</sup> *E.g.*, *Torino Calcio SPA v. Romero*, Cass. Civ., SU 26.1.1971, n. 174, GI, 1971, I,1, 681

striking in that “Cable Cases” present problems of open-ended litigation that conversely do not affect “Loss of a Star” situations.

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 a good portion of the surplus that the team or club 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 primary 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, with resulting excessive liability and over-deterrence.

Not every *Ricochet* case, however, fits this mold. In other situations, such as in the “Cable Cases,” the asset’s market price does not capture the full surplus that third parties derive from its use. The price of telephone services or other utilities, for example, cannot be assumed to capture the full consumers’ benefit derived from the use of such services. In such cases, if the exclusionary rule limits liability to the loss suffered by the telephone or utility company, compensation would fall short of the true social loss occasioned by the accident. If liability is avoided in those cases, it is most likely because of concerns for open-ended liability and not for 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 throws into doubt of several 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 of *Ricochet loss* cases. These findings clearly support our hypothesis that efficiency considerations are strongly influencing the result in this category of cases.

*b. Normative Agnosticism in “Transferred Loss” Cases*

In the second group of pure economic loss situations, which we have called *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 fall on 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.<sup>64</sup> A similar transfer of the loss can be effected by the law. A loss transfer occurring by operation of law is, for example, found when a pay continuation statute requires an employer 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.

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

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<sup>64</sup> E.g., *Robins Dry Dock v. Flint*, 13 F.2d 3 (2d Cir. 1926), *rev’d* 275 U.S. 303 (1927); *The Aliakmon*, 2 AER 44 (1985)

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 properly 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 economic 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 (and the cost of remunerated sick leave) 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 to the case of a lease contract. Consider, for example, an exclusionary rule that states that, 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.

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 primary or secondary victim), from an efficiency point of view, 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 application (or lack thereof) of 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 solutions that we have examined are in fact acceptable, as long as the (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) the 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.

*c. Private versus Social Loss for the Closure of Public Service and Infrastructures*

In the third group of cases considered in Section 1.2, an economic loss arises without a previous injury to anyone's property or person. If there is a physical damage, it is to "unowned resources" that lie in the public domain.<sup>65</sup> Textbook examples of this category of cases include the scenario where a negligent act forces the closure of a public market or a highways, occasioning however an economic loss to individuals whose production depends on such infrastructures.<sup>66</sup>

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, in fact, should not exceed the difference between the foregone profit and the profit that such individual could have made by engaging in an alternative second best productive activity. Furthermore,

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<sup>65</sup> Victor Goldberg, *Recovery For Economic Loss Following the Exxon Valdez Oil Spill*, 23 J. Legal Stud. 1, 37 (1994)

<sup>66</sup> *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)

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 the limited case of 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 some positive social loss. A private economic loss of one party would not generate a social loss of equal magnitude, unless we consider the purely abstract case of a perfectly inelastic market (i.e., a situation where the market cannot compensate for the production shortage and thus satisfy the excess demand). In most real life cases, the pure economic loss of the victims therefore constitutes a gross over-estimate of the true social loss, and the exclusionary rule is correctly applied to avoid 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. We should additionally consider the fact that patrimonial ripple effect might also be at a maximum in these situations, giving relevance to the concerns for open-ended litigation. 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.

#### *d. 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 conduct an audit of a publicly traded company, overstating the company's net financial worth. Relying upon the accuracy of the audit, investors may buy shares in the company at more than their current value. The loss to the investor arises on the basis of misplaced reliance. Other examples contemplate the case of mistaken or false job reference and credit ratings, which may cause financial losses to a third party.<sup>67</sup> 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.<sup>68</sup>

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,<sup>69</sup> 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

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<sup>67</sup> See also, *Hedley Byrne & Co. v. Heller & Partners Ltd.*, AC 465 (HL) (1964)

<sup>68</sup> 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

<sup>69</sup> 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: eleven European countries sampled in the Bussani & Palmer (2001) study indicate the recoverability of the loss, with no system opposing such solution.

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 and the right to obtain compensation in case of defective services.

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 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, an externality problem would be created. This 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 provided by such professionals. 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). In these cases, 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 the intended beneficiaries of the service), 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 an economic restatement of the exclusionary rule.

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.

#### 4.2 *Pure vs. Consequential Economic Loss.*

The comparative study of the pure economic loss rule reveals that the rule is often cast in negative terms as a loss without antecedent harm to plaintiff's person or property. In this context, the word "pure" plays a central role, for if there is economic loss that is connected to the slightest damage to person or property of the plaintiff (provided that all other conditions of liability are met) then the latter is called *consequential* economic loss and the whole set of damages may be recuperated without question. According to the dogmatic statements often used to justify the rule, consequential economic loss (sometimes also termed *parasitic* loss) is recoverable because it presupposes the existence of physical injuries,

whereas pure economic loss strikes the victim's wallet and nothing else.<sup>70</sup> This explanation begs the question as to why pure economic interests should be granted lesser protection than interests in tangible property.

To facilitate our inquiry on the actual foundations of this peculiar feature of the exclusionary rule, it is noteworthy that “consequential” economic loss is in principle recoverable in every European system – whether the source of the loss is intentional or negligent conduct, or an activity subject to strict liability. This signals the clear tendency of European legal systems to conceptualize economic losses in general as compensable harm.<sup>71</sup>

What is actually surprising, then, is the different treatment several European legal systems reserve to the germane case of non-consequential (i.e., “pure”) economic loss. The exclusionary rule for “pure” economic losses indeed seems to be an exception, one not easily attributed to a dogmatic conceptualization of what constitutes unjust harm. We are left wondering what could explain the frequent adoption of this criterion in the European definitions of compensable loss.

From a theoretical point of view, the criterion is problematic. The affairs of economic actors are highly interdependent, connected to one another by a web of rights and duties that bind together legal, economic and proprietary interests. In these circumstances, it is reasonably foreseeable that damage to any one interest may affect other interests. Furthermore, much of

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<sup>70</sup> The distinction has been recognized as artificial by Bussani & Palmer, 2001, who suggest that those legal systems which employ these labels conceive of economic loss as an isolated phenomenon, as if plaintiff's patrimony were a separate world, cut off from all others. In the view of such authors, this logic defies economic and social reality. In the real world “a practically unlimited range of interests are intertwined in an almost unlimited variety of ways.” P. Benson, The Basis for excluding Liability for Economic Loss in Tort Law, in D.G. Owen, *The Philosophical Foundations of Tort Law* 427, 431 (Clarendon, Oxford, 1995).

<sup>71</sup> The ability of tort victims to recover consequential financial losses should not be surprising. In the civilian tradition, lost profit (i.e., *lucrum cessans*) has traditionally been recognized as compensable harm, not differently from the other direct harm suffered by the victim (i.e., *damnum emergens*). See Edoardo Volterra, *Istituzioni di Diritto Privato Romano* 128 (1980) on the Roman law origins of the liability for *lucrum cessans*; see also Mario Talamanca, *Istituzioni di Diritto Romano* 657 (1990), who shows that the exclusionary rule may have had some antecedents in classical Roman law.

the value of proprietary interests is often found in their potential as instruments of production, i.e., in the capacity of physical assets to generate a stream of economic income. But such potential is generally captured in the market value of the asset, so that the compensation for the physical loss would be duplicated by the eventual compensation for the consequential economic loss. On the contrary, in other cases, the economic interest is independent of any tangible asset. Absent any compensation for the “pure” economic loss, the victim would have no opportunity to recover his economic prejudice and the potential tortfeasor would face less than the ideal incentive to avoid creating a harm. In both cases, therefore, we have situations where the distinction between pure and consequential loss may fall short of inducing optimal outcomes.

Given the natural connection between harmful behavior and economic and financial losses, it is very hard to rationalize the exclusionary rule in terms of causation. Nothing seems to distinguish the “consequential” economic loss, which follows a small physical loss, from the case of a “pure” economic loss, when the victim escaped any physical harm to person or property and yet suffered an economic prejudice.

The comparative examination of cases from European jurisdictions that follow the exclusionary rule further shows that there is little agreement on when a loss should effectively be considered “consequential” and thus recoverable. Some national courts have developed rules that require a more stringent connection between antecedent physical loss and the resulting economic harm. Under such rules the court may conclude that plaintiff’s loss was “pure” (hence unrecoverable) because there was insufficient relation to prior physical harm sustained by plaintiff. Yet judges in other systems, employing less exigent notions, may deem the same loss “consequential” and thereby permit its recovery.

Without a clearly enunciated justification for requiring “consequentiality” as a standard for recoverability of economic loss, we then ask what makes the occurrence of a prior physical act so critical. Why would the absence of such an act justify the application of the exclusionary rule to the consequent economic loss, given that identical economic loss would enjoy full compensation in the presence of an antecedent physical prejudice?

We suggest that that consequential loss and “pure” economic loss are not treated as different in kind or in principle, but are only distinguishable by the circumstances in which they originate and the technical limits that have been imposed on their recoverability. In this context, comparative analysis reveals that the underlying rationale of this peculiar feature of the exclusionary rule is to be assessed beyond the dogmatic statements as a matter of judicial pragmatism. The comparative data indeed suggests that the notion of “consequential loss” is a legal construct that is simply invoked in response to different pragmatic policy concerns.

The criterion of “consequential” loss, however, remains mostly opaque to the true goals that drive the decision-making process. This rationale can be construed when one considers the intriguing contrast between the laws of physics and the dynamics of financial loss. Financial harm is assumed to have a greater likelihood to continue. It has interestingly been pointed out that the laws of Newton do not apply on the road to financial ruin. Physical damage may have a final resting point, but patrimonial harm is not slowed down by gravity and friction. The magnitude of economic losses may, to the contrary, be subject to the multiplier effect of modern economic systems.<sup>72</sup> The distinction between

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<sup>72</sup> The harm has often been compared to the recovery of damages for nervous shock, since there too the loss can be “pure” as opposed to parasitic, and there too the danger of reverberating impacts is commonly given as a reason for restrictive rules. The analogy, however, must not be pressed too far. Courts in emotional shock cases have been troubled by a number of rather different concerns, particularly the difficulty of defining the threshold harm (what degree of shock should be cognizable? what manifestation of the harm should be required?) and the difficulty of detecting false or fraudulent claims. In the case of pure economic loss, however, the problem of defining the threshold of the harm is minimal, (the threshold of financial damage always begins at zero); the factual existence of loss is objectively demonstrable and its measurement and proof are not easy but perhaps less problematic. The characteristic uncertainty of financial loss does not consist in defining or verifying the harm but in establishing the causal link between it and defendant’s conduct. The threat of fraud is also of less concern because such loss is free of the danger that claimants may simulate its symptoms. Accordingly economic loss is less easily feigned than the manifestations of nervous shock. We therefore suggest that the most important similarity between the two areas centers upon judicial concern about expanding liability in favor of an indeterminate number of plaintiffs, for indeterminate amounts of damages. For a

pure and consequential harm is therefore driven by the need to allow the physical laws of friction to restrict the domain of economic loss. There is nothing intrinsic in the nature of consequential economic losses that allow us to distinguish them from pure economic losses. Physical losses, however, can only affect so many individuals, while economic losses can travel far and wide.<sup>73</sup> The fact that an economic loss can be recovered only by an individual who suffered a prior physical loss seems to be focused on limiting the number of potential plaintiffs, while maintaining some positive level of deterrence for potential wrongdoers. It is noteworthy that in all such cases in which the economic loss is not likely to be related to an antecedent physical loss, a different criterion is established by European courts in order to balance the opposing needs of maintaining deterrence while minimizing adjudication costs.

#### *4.3 “Pure” Economic Loss for the Infringement of a Statutorily Protected Interest*

Another element is quite valuable for our understanding of the common -- and yet unspoken -- economic logic that drives the applications of the exclusionary rule in European jurisdictions. Quite interestingly, even when “pure” (i.e., not “consequential”) economic harm has been suffered, recovery can always be obtained if the loss stems from the infringement of statutorily protected interests, such as those protected by antitrust, copyright and patent laws. Although the European tendency to grant compensation in such cases is not openly explained in economic terms, the tendency is consistent with the hypothesis that the contours of the economic loss rule are driven by implicit efficiency considerations. The general tendency to

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discussion in American law, see Robert L. Rabin, Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment, 37 *Stan. L. Rev.* 1513, 1524-1525 (1985).

<sup>73</sup> Tony Weir, *A Casebook on Tort 6*, Vol. 14(d) (9<sup>th</sup> ed. Sweet & Maxwell 2000). This was also the view of Fleming James who stated that the “physical consequences of negligence usually have been limited, but the indirect economic repercussions of negligence may be far wider, indeed virtually open-ended.” Fleming James, *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 *Vand. L. Rev.* 43, 45 (1972).

grant compensation for this narrow category of protected economic interests is indeed consistent with microeconomic theory. Unlike other financial losses that derive from the loss of market share or production profit, pure economic loss that results from the infringement of copyright or patents relate to the loss of a monopoly profit that is socially desirable and thus legally protected.

Uncompensated economic loss that arises from the violation of a protected intellectual property occasions social losses that go beyond the specific transfer of profit from one a copyright or patent owner to a third party infringer. Copyright and patent laws grant a time-limited monopoly to reward the creative efforts of the inventor and to create incentives for individuals to engage in the production of valuable intellectual property. The lack of protection of such economic interest, far from being a zero-sum transfer from one party to another, corrodes the incentives that the intellectual property law attempted to create in the first place. Likewise pure economic losses that derive from the infringement of antitrust law are *prima facie* inefficient, since they create a social loss due to the distortion of competition that is goes beyond the specific transfer of profit from one party to another. Such economic transfers, if left uncompensated, would create incentives for inefficient negative-sum reallocations for society as a whole.

The same logic holds for economic losses that are the result of the so-called ‘business torts’, such as unfair advertising and detrimental competition.<sup>74</sup> Also in this case, European legal systems grant full compensation for the pure economic losses that are the consequence of such category of torts.

The rules in these areas largely depend on policy factors that are exceptional in nature and are mostly antithetical to those goals that apply to other fields of the law. For example, the law generally promotes competition and prevents the consolidation, let alone the legal protection, of monopoly positions in the marketplace. Yet in both copyright and patent law the law grants and protects a limited monopoly position to the intellectual property creator to reward his creative efforts. Likewise, in the

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<sup>74</sup> Although legal systems such as France, the Netherlands, the UK and Portugal handle these problems with the help of the general law of obligations (the 6th book of the Dutch civil code devotes an entire chapter to unfair advertising).

case of business torts, the law sanctions, rather than promote, competition, in order to avoid destructive forms of unfair advertising, which would likely create a net social loss. All such areas represent exceptions to the rule, and the lack of application of the economic loss rule should be correctly understood within such policy context, rather than treating it as an awkward dogmatic construct.

#### 4.4 *Actor's State of Mind: Intention vs. Negligence.*

One further feature of the economic loss rule finds little explanation in the traditional rationales of the rule. All European legal systems agree that intentionally inflicted pure economic loss is recoverable. The exclusionary rule, whenever it is applied, is only associated with 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 the assessment of damages is concerned. The divergence in European systems, however, begins when negligence is found to be the cause of the pure economic loss.

It has been suggested that the significance of this point is of more practical importance than it may initially appear. Its range of application may be somewhat greater than the narrow, infrequent form of liability that are suggested by the words, "intentionally inflicted." Furthermore, it is interesting to observe from the comparative point of view that the shift to higher degrees of culpability tends to broaden the scope of recovery in all systems. This suggests, at a minimum, that the exclusionary rule should not be conceived as a simple rule based solely on the nature of plaintiff's damage. The material nature of the loss, in the view of comparative legal scholars, is no more than one element in a complex balancing which decides where and when limits will be imposed in tort.<sup>75</sup> In tailoring the

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<sup>75</sup> See Mauro Bussani & Vernon Palmer, *The Frontiers of Tort Liability: Pure Economic Loss in Europe*, in *Liability for Pure Economic Loss: Frontiers of Tort Law* (Mauro Bussani & Vernon Palmer eds. 2001)

exclusionary rule, judges and legislators appear to consider other important factors as well, including the actor's state of mind.

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 it was 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 any net social loss, because of the presence of offsetting benefits accruing to third parties.

In such cases, we have seen an 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 the case of 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. The apparent zero-sum game could trigger a socially inefficient, negative-sum, epilogue.

This explains 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. In many ways, the economic analysis of the exclusionary rule offers an explanation for this peculiar feature of the economic loss doctrines in European law.

This further explains the flexibility used by European courts in evaluating the “intention” element in this group of cases.<sup>76</sup> 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.

#### 4.5 *Present vs. Future Loss*

Examples drawn from the European cases of pure economic loss indicate that patrimonial injury may take two distinguishable forms. It may relate to the existing as opposed to the anticipated wealth of the victim. In the first sense, plaintiff’s present wealth may be simply depleted by poor financial advice, or dissipated by wasting time and petrol circumnavigating a motorway that was closed due to an accident. In the second sense, plaintiff may instead lose whatever he or she expected to acquire, such as the profits from productive machinery suddenly shut down, or a testamentary legacy lost because of a defectively drawn instrument, or a sport team’s reduced gate receipts due to the accidental death of the team’s star player. Sometimes, when an expectation is destroyed *in utero* and proof that it would have materialized is difficult, it is called the loss of a chance.<sup>77</sup>

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<sup>76</sup> See, e.g., C. von Bar, Liability for Information and Opinions Causing Pure Economic Loss to Third Parties: A Comparison of English and German Case Law, in B. Markesinis, *The Gradual Convergence* 104 (OUP 1994)

<sup>77</sup> For instance, a commission unlawfully rejects a candidate’s application for a job or a fellowship. See e.g., Conseil d’Etat, 12.11.1965, in Rec. Lebon, 1965, 613 (: « le requérant, evincé d’un concours auquel il se serait présenté avec des chances sérieuses de succès en raison de ses titres et travaux, a subi un préjudice ».). As to the debate, see G. Viney & P. Jourdain, Introduction a la responsabilité, in *Traité dr. civ.*, sous la dir de J. Ghestin 21 (LGDJ 2<sup>nd</sup> ed. 1995). For a piece discussing the German and English experience, see N. Jansen, *The Idea of a Lost Chance*, 19 *Oxford J. Leg. St.* 271 (1999). See also P.G. Monateri, *La responsabilità civile*, in *Tratt. dir. civ. diretto da R. Sacco* 283 (1998) 583 ff.

As between these types of wealth, it is the loss of expected wealth—unrealized profits—that presents the sharpest question for tort systems to deal with. The difficulty is not simply that the demand for proof is more exigent—by definition expectancies explore a future that only might have occurred—but also the appropriateness of affording protection in tort.<sup>78</sup>

The difficulties faced by European courts in assessing liability in torts for the loss of expected wealth are fully justifiable. Assessing the best level of compensation for some future loss is not only difficult due to evidentiary issues, but is compounded by a methodological question. Should the compensation be linked to the discounted present value of the future economic interest, or to the risk-equivalent level of compensation, rendering the victim indifferent between the *ex ante* state of the world prior to the tort and the *ex post* situation, after damages have been paid? Clearly the former measure of compensation coincides with the latter in case of risk-neutrality, but exceeds the latter if the victim is risk-averse.<sup>79</sup> The methodological difficulties in computing the effects of risk aversion over the optimal measure of liability add to the general problems of determining whether liability for pure economic losses should be imposed in a specific case. The complexity of the overall problem explains the apparent ambiguities observed in the cases dealing with loss of expected wealth and unrealized profits.

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<sup>78</sup> In countries where an exclusionary rule of tort law exists, we may find a tendency to say that wealth expectancies should be protected in contract. Note for example the tense unease in the following statement from a British judge: “I do not consider that damages for loss of an expectation are excluded in cases of negligence arising under the principle in *Hedley Byrne*, simply because the cause of action is classified as tortious. Such damages may in principle be recoverable in cases of contractual negligence; and I cannot see that, for present purposes, any relevant distinction can be drawn between the two forms of action....” Per Lord Goff of Chieveley in *White v. Jones*, AC 207 (1995). See also H. Reece, *Loss of Chances in the Law*, 59 M.L.R. 188 (1996).

<sup>79</sup> In the presence of risk aversion, the discounted present value of the expected economic interest exceeds the risk-equivalent measure of damages because damages are paid in a certain amount, while future expected values are obtainable only with some level of uncertainty.

#### 4.6 *Reappraising the Economic Loss Rule in European Jurisdictions*

The efficiency criterion appears to provide a fitting rationalization 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 the solution of pure economic loss cases are virtually inexplicable when combined with the traditional doctrines of pure economic loss. In Section 2 we illustrated the limited explanatory power of the traditional doctrines in the face of the observed applications of the economic loss rule in European legal systems. The economic restatement of the exclusionary rule has allowed 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 first impression of *ad hoc* judicial pragmatism.

#### 4.7 *A Postscript on Derivative Litigation and Optimal Liability*

From a normative point of view, the concern for open-ended litigation is both factually and theoretically relevant. In many situations the economic loss rule is necessary in order to create 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. As often happens when trying to pursue two policy objectives with the aid of only one control variable,

one objective is often pursued at the expense of the other normative goal. Such a tradeoff is evident when applying the exclusionary rule to categories of cases that would require the imposition of full liability in order to maintain efficient precaution incentives. Because of this tradeoff, concerns for open-ended liability cannot be dispositive and may not always justify the strict application of the exclusionary rule.

When evaluating the alternative functions of the economic loss rule, it is important to note that it is not always possible to maintain optimal incentives while avoiding open-ended liability with a single policy instrument. 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 may have negative effects on the optimal *ex ante* incentives of the parties.

As a matter of policy design, the adoption of the exclusionary rule for the sole 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 loses significance once alternative solutions are taken into consideration.

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.<sup>80</sup> Put differently, if the true issue is one of open-ended liability, the

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<sup>80</sup> 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

appropriate solution should focus on correcting the derivative litigation problem, avoiding the creation of other problems on the front of individual incentives.

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.<sup>81</sup>

## 5. Conclusion

In spite of its historical resilience, the judicial propensity to limit liability for various categories of pure economic loss still lacks a theoretical formulation to explain the many facets and patterns of application of the exclusionary rule in European jurisdictions. The economic analysis of the pure economic loss rule raises questions of the cogency and significance of the theoretical and dogmatic arguments often invoked by judges and academic writers. Generally, traditional theories are unable to explain the current boundaries between compensable and non-compensable economic losses.

We have presented a restatement of the exclusionary rule consistent with the economic model of optimal liability. Such reformulation requires distinguishing between private losses that generate a corresponding social loss and losses that are merely private, in the sense that, while generating a prejudice for some individuals, generate an offsetting benefit for other subjects, with no resulting social loss. Our hypothesis is that, although not formally adopting this economic distinction, European courts are sensitive

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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.

<sup>81</sup> Bussani & Palmer (2001) observe another interesting facet of the floodgates argument, namely the geographical distribution of the legal systems that invoke such rationale. It does not seem accidental that in countries where English and German legal cultures have a decisive sphere of influence (*e.g.* English influence in Commonwealth countries and the United States; Germanic influence in Austria and Portugal) the floodgates argument has been received almost unquestioned. By contrast, in countries where French leadership is acknowledged, one vainly searches for any trace or mention of floodgates anxiety.

to these economic intuitions and attempt to implement an exclusionary rule that could be stated in the following terms: “A plaintiff cannot recover damages for a purely *private* economic loss.”

Behind the veil of rhetorical dogmatism, the analysis of actual cases of pure economic loss reveals the judicial endorsement of sensible pragmatic efficiency goals. Due to the mixed use of dogmatic rhetoric and judicial pragmatism, however, modern legal systems do not always coherently articulate the rationales for the exclusionary rule. As a result, some of the considered judicial decisions are largely indefensible on the basis of espoused traditional theories, but may be readily explained with the use of economic analysis.

This paper has 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 for pure economic loss cases need to balance 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.

The open recognition and practical balancing of these goals requires the theoretical reconceptualization of the exclusionary rule. In the process of attempting an economics-based restatement of the economic loss rule, we have come to the realization that several practical contours of the exclusionary rule – difficult to illuminate with traditional legal doctrines – are consistent with the predicates of economic analysis. European courts are not blind to the needs of striking a practical balance between limiting litigation while maintaining effective deterrence, within the dogmatic constraints imposed by their legal tradition. It has been possible through the comparative study of the rule to reassess and explain the economic and pragmatic rationales of the rule and the economic soundness of the emerging trends in the judicial solutions to the problem of pure economic loss.

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