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A Framework for Determining Liability for Negligently Caused Economic Losses

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NOTES

A Framework for Determining Liability for Negligently Caused Economic Losses

Tort law encompasses a heterogeneous mixture of civil wrongs including various acts resulting in physical injury, mental anguish, property damage, harm to interpersonal relationships, and lost economic opportunities. Aside from harm, few pervasive principles can be discerned.[1] Professor Prosser noted, "[I]t is not easy to discover any general principle upon which [all torts may] be based, unless it is the obvious one that injuries are to be compensated, and anti-social behavior is to be discouraged."[2] These broad goals provide little guidance in deciding particular cases. Instead, judicial reasoning often applies a number of specific legal rules to particular fact patterns. This approach leads to inconsistencies, because the rules applied are not always based on well-defined legal principles. In fact, one often suspects that courts decide tort cases first, and then look for a way to justify the result.[3]

The judicial reasoning employed in a particular group of tort cases is the subject of this note. Primary focus is on dicta surrounding the long-standing rule (herein referred to as the "economic loss rule") that purely economic losses, unaccompanied by injury to the plaintiff's person or property, cannot be

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1. Perhaps the best explanation for this lack of cohesiveness is that modern tort principles have developed from a myriad of unrelated common law causes of action that were not brought under a single rubric until the middle of the nineteenth century. *See* James, *Tort Law in Midstream: Its Challenge to the Judicial Process*, 8 BUFFALO L. REV. 315, 315 (1959); Seavey, *Principles of Torts*, 56 HARV. L. REV. 72 (1942); *see also infra* note 7.

2. W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 1, at 3 (5th ed. 1984) [hereinafter cited as PROSSER].

3. One analyst observed, "[If first year law students] are given a fair sampling of representative torts cases, they must become impressed by the unintellectual nature of legal thinking, by the repeated inconsistencies occurring at the principle and theory level, and by the shabbiness of explanations given for decisions in judicial opinions." Gregory, *Trespass to Negligence to Absolute Liability*, 37 VA. L. REV. 359, 359-60 (1951).

recovered in a negligence action. Recently, in *People Express Airlines, Inc. v. Consolidated Rail Corp.*,[4] the New Jersey Supreme Court considered whether courts should continue to follow that rule.

The main question examined in *People Express* is whether a principled distinction can be drawn between economic and noneconomic injuries such as would justify their different legal treatment. Although that question is significant, attempting a satisfactory answer here would be too ambitious. This note does not attack or defend the economic loss rule per se. Instead, it identifies factors that judges ought to consider in evaluating the rule, using the issues and arguments referred to by the New Jersey court as a starting point.[5]

I. The Economic Loss Rule

A. *Evolution of the Rule*

The economic loss rule may be viewed against the background of the relational torts[6] or in the negligence context. Since *People Express* takes the latter approach, this note treats the rule as an appendage or exception to negligence law. Interestingly, however, it has its roots in cases decided before the tort of negligence became a well-established cause of action.[7] For exam-

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4. 100 N.J. 246, 495 A.2d 107 (1985).

5. For general discussions of the economic loss rule, see James, *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 Vand. L. Rev. 43 (1972); Note, *Negligent Interference with Contracts: Knowledge as a Standard for Recovery*, 63 Va. L. Rev. 813 (1977); Note, *Negligent Interference with Economic Expectancy: The Case for Recovery*, 16 Stan. L. Rev. 664 (1964); Note, *Foreseeability of Third-Party Economic Injuries—A Problem in Analysis*, 20 U. Chi. L. Rev. 283 (1953).

6. Rather than focusing on the distinction between economic and physical harm, the relational torts approach would consider why mere negligence is insufficient to trigger liability when recovery for intentional injury is allowed. Prosser discusses compensation for injuries to business relationships in Prosser, *supra* note 2, §§ 128-130, at 962-1030.

7. It is suggested that negligence became an independent tort in the first part of the twentieth century:

> [Prior to the nineteenth century] the history of negligence is a skein of threads, most of which are fairly distinct, and no matter where we cut the skein we shall get little more than a bundle of frayed ends. In fact, the tale is from beginning to end almost exclusively a narrative of action upon the case. . . . The remedies afforded by action upon the case fell short of the present law of negligence, but by the earlier part of the nineteenth century their scope had gradually been extended until all that was needed to bring the law to its present shape was a change in form and a statement of a general rule instead of an enumeration of particular instances.

Winfield, *The History of Negligence in the Law of Torts*, 42 L.Q. Rev. 184, 185 (1926).

ple, in 1856, the Connecticut Mutual Life Insurance Company was not allowed to recover the amount of a life insurance policy that it became obligated to pay as the result of the defendant's conduct.[8] The company's insured had been the victim of a fatal accident while riding in defendant's train. Although defendant was thereby indirectly responsible for the insurance company's payment on the contract, the court refused to recognize a wrongful death cause of action.

In *Brink v. Wabash Railroad Co.*[9] a train had derailed, causing the death of the plaintiffs' son, a passenger on the train. The accident prevented the decedent from carrying out his contractual obligation to support plaintiffs. The court denied recovery, stating: "[W]hen one is injured by the wrongful act of another, and others are indirectly and consequentially injured, but not by reason of any natural or legal relation, the injuries of the latter are too remote to constitute a cause of action . . . ."[10]

The rule of nonrecovery for unintentional interference with contract became solidly established in the case of *Robins Dry Dock & Repair Co. v. Flint.*[11] The plaintiffs had chartered a ship from another party but were deprived of its use when it was negligently damaged. Relying in part on *Byrd v. English,*[12] a Georgia Supreme Court decision that denied recovery for what would now be referred to as negligent interference with prospective advantage,[13] *Robins Dry Dock* refused to grant compensation for unforeseeable interference with contract rights.[14]

Significantly, none of these cases distinguished economic and noneconomic injury. Instead, the reasoning employed in these early opinions centered on the existence of specific common law causes of action. Recovery was denied because the facts did not fit into any of the then-existing causes of action that would have entitled plaintiffs to compensation.

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8. Connecticut Mut. Life Ins. Co. v. New York & New Haven R.R. Co., 25 Conn. 265 (1856).

9. 160 Mo. 87, 60 S.W. 1058 (1901).

10. *Id.* at 94, 60 S.W. at 1060.

11. 275 U.S. 303 (1927).

12. 117 Ga. 191, 43 S.E. 419 (1903).

13. In *Byrd,* the defendants had negligently broken power lines which supplied electricity to the plaintiff's printing business. As a result, the plaintiff was unable to do business for a time and suffered economic losses.

14. "[A] tort to the person or property of one man does not make the tortfeasor liable to another merely because the injured person was under a contract with that other, unknown to the doer of the wrong." *Robins Dry Dock,* 275 U.S. at 309.

Most of these cases can also be explained using negligence terminology like proximate cause or remoteness,[15] foreseeability,[16] or lack of duty toward the defendant.[17] Yet they were not integrated into the negligence framework that later developed. Instead, they were interpreted as requiring denial of compensation for purely economic losses even when all the elements of negligence were present.[18]

That reading of the early cases is not only unnecessary, it is anomalous. When the result of the economic loss rule is consistent with the result under general negligence principles (e.g. economic losses are unforeseeable or too remote) there is no need for a special rule denying recovery. Ironically, the rule can only be meaningfully applied in the absence of the circumstances that originally brought it into existence.

Courts have avoided the necessity of justifying this irony in several ways. Resort to precedent has of course been significant. Some courts have identified the economic loss rule as the basis for a decision and then referred generally to negligence principles to establish the sensibility of the outcome. Others have declared adherence to the general rule, but carved out exceptions for particular situations so as to allow recovery.[19] However, some recent decisions such as *J'Aire Corp. v. Gregory*[20] and *In re*

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15. *Byrd*, 117 Ga. at 193, 43 S.E. at 420; *Brink*, 160 Mo. at 94, 60 S.W. at 1060.

16. *Robins Dry Dock*, 275 U.S. at 309.

17. The Federal No. 2, 21 F.2d 313, 313 (2d Cir. 1927); *Byrd*, 117 Ga. at 194, 43 S.E. at 420.

18. *See, e.g.*, Kingston Shipping Co. v. Roberts, 667 F.2d 34 (11th Cir. 1982); Louisville & Nashville R.R. Co. v. The Tug M/V Bayou Lacombe, 597 F.2d 469 (5th Cir. 1979); Stop & Shop Cos. v. Fisher, 387 Mass. 889, 444 N.E.2d 368 (1983); Chelsea Moving & Trucking Co. v. Ross Towboat Co., 280 Mass. 282, 182 N.E. 477 (1932); Local Joint Executive Bd. v. Stern, 98 Nev. 409, 651 P.2d 637 (1982); Stevenson v. East Ohio Gas Co., 73 N.E.2d 200 (Ohio App. 1946). Many American decisions have also relied on Cattle v. Stockton Waterworks Co., 10 L.R.-Q.B. 453 (1875), an early English case involving unintentional interference with contract. For a discussion of the economic loss rule as it has been applied in English cases, see Harvey, *Economic Losses and Negligence: The Search for a Just Solution*, 50 CAN. BAR REV. 580 (1972); James, *supra* note 5, at 45-46 (comparing the development of the rule in England and the United States).

19. Several of these exceptions are discussed in *People Express*, 100 N.J. at 256-261, 495 A.2d at 112-14 (1985) and in Union Oil Co. v. Oppen, 501 F.2d 558, 566 n.9 (9th Cir. 1974).

20. 24 Cal. 3d 799, 598 P.2d 60, 157 Cal. Rptr. 407 (1979). Negligence in the performance of a construction contract had ceused delays resulting in economic losses to building tenants. Since the harm was foreseeable, the court held that injury to the plaintiff's economic interests should not go uncompensated merely because it was unaccompanied by injury to person or property.

> To hold under these facts that a cause of action has been stated for negli-

Kinsman Transit Co.[21] acknowledge that the rule (and its many exceptions) makes little theoretical sense.[22]

In July, 1985, the rule was abandoned altogether by the New Jersey Supreme Court in *People Express Airlines, Inc. v. Consolidated Rail Corp.*[23] As the most recent and most comprehensive judicial discussion of the economic loss rule, *People Express* is an excellent springboard for identifying factors relevant to the recovery of economic losses.

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gent interference with prospective economic advantage is consistent with the recent trend in tort cases. This court has repeatedly eschewed overly rigid common law formulations of duty in favor of allowing compensation for foreseeable injuries caused by a defendant's want of ordinary care.

Id. at 805, 598 P.2d at 64, 157 Cal. Rptr. at 411.

21. 388 F.2d 821 (2d Cir. 1968). A vessel had broken loose from its moorings and struck a second vessel. These drifted downstream and crashed into a bridge which collapsed. The two vessels and the bridge created a dam which caused extensive flooding and economic losses. The court explicitly rejected the validity of the economic loss rule, *id.* at 823-24, but denied recovery since the losses were too remote.

22. One exception to this observation is found in a significant line of recent products liability cases. The economic loss rule has been invoked in these cases not to limit liability per se, but to justify resort to contract law rather than tort law in deciding the dispute. The following language from Seely v. White Motor Co., 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965), is typical:

> [The manufacturer] can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot therefore be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands. A consumer should not be charged at the will of the manufacturer with bearing the risk of physical injury when he buys a product on the market. He can, however, be fairly charged with the risk that the product will not meet his economic expectations unless the manufacturer agrees that it will.

63 Cal. 2d at 18, 403 P.2d at 151, 45 Cal. Rptr. at 23; *see also* East River S.S. Corp. v. Delaval Turbine, Inc., 752 F.2d 903 (3d Cir. 1985); Hart Eng. Co. v. FMC Corp., 593 F. Supp. 1471 (D.R.I. 1984); Eaton Corp. v. Magnavox Co., 581 F. Supp. 1514 (E.D. Mich. 1984); Sanco, Inc. v. Ford Motor Co., 579 F. Supp. 893 (S.D. Ind. 1984) *aff'd* 771 F.2d 1081 (7th Cir. 1985); Arrow Leasing Corp. v. Cummins Arizona Diesel, Inc., 136 Ariz. 444, 666 P.2d 544 (1983); Clark v. International Harvester Co. 99 Idaho 326, 581 P.2d 784 (1978). *See generally* Note, *Economic Loss in Products Liability Jurisprudence*, 66 COLUM. L. REV. 917 (1966).

This approach, however, is fundamentally different from that employed when warranty and benefit of the bargain are not at issue. The scope of this note is confined to application of the economic loss rule as a part of negligence analysis.

23. 100 N.J. 246, 495 A.2d 107 (1985). The specific fact situation before the court involved negligent interference with prospective advantage, but the holding of the court is directed at the economic loss rule and does not distinguish between interference with prospective advantage and interference with contract. Nor does it make reference to any special relationship between the parties that would make it possible to construe the holding narrowly. In these respects, *People Express* rejects the economic loss rule much more boldly than previous cases.

B. The People Express *Case*

The dispute in *People Express* arose when a dangerous chemical ignited in a Conrail freight yard. This created a risk of explosion, which necessitated evacuation of the surrounding area including the People Express airline terminal. Although the explosion did not occur, People Express suffered business interruption losses for which it sought compensation.

In such circumstances, the economic loss rule clearly precludes recovery, but the New Jersey court decided the case solely on foreseeability criteria, and unanimously decided to allow the claim.[24]

Central to the court's analysis is the observation that plaintiffs' interest in preserving economic benefits is as legally protectable as their interest in preserving property. In fact, courts have not historically denied compensation for economic losses in all circumstances:

> The single characteristic that distinguishes parties in negligence suits whose claims for economic losses have been regularly denied by American and English courts from those who have recovered economic losses is, with respect to the successful claimants, the fortuitous occurrence of physical harm or property damage, however slight. It is well-accepted that a defendant who negligently injures a plaintiff or his property may be liable for all proximately caused harm, including economic losses.[25]

Assuming therefore that economic interests are worthy of protection, the court turns to various arguments offered in support of the economic loss rule and evaluates them to determine whether they justify the distinction between economic and noneconomic losses.

Although this approach makes the economic loss rule look very unappealing, it does nothing to suggest a more acceptable alternative. Therefore, the court purports to undertake a more "searching analysis of underlying policies"[26] before announcing its own rule. Unfortunately, no such analysis is forthcoming. Instead, the court merely identifies "common threads" running through the established exceptions to the rule,[27] and uses them

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24. *See infra* note 28 and accompanying text.
25. *People Express*, 100 N.J. at 251, 495 A.2d at 109.
26. *Id.* at 255, 495 A.2d at 111.
27. In attempting to define a cause of action for negligently caused economic losses,

to weave the following foreseeability criteria for determining when recovery for economic losses will be allowed:

> [A] defendant owes a duty of care to take reasonable measures to avoid the risk of causing economic damages, aside from physical injury, to particular plaintiffs or plaintiffs comprising an identifiable class with respect to whom the defendant knows or has reason to know are likely to suffer such damages from its conduct. A defendant failing to adhere to this duty of care may be found liable for such economic damages proximately caused by its breach of duty.[28]

The court's use of prior authority indicates that it views these criteria basically as a restatement of prior case law. But citation of authority and bold, largely unsupported assertions concerning "the policies underlying tort law"[29] leave important issues unaddressed. For instance, the court does not describe the impact of its holding on future decision making, nor does it make clear how the named criteria will further public goals or the interests of the parties. And there is no discussion of criteria by which the legitimate interests of the plaintiff, the defendant, and the rest of society can be weighed.

Naturally, detailed analysis is not to be expected in every opinion. But *People Express* is inadequate because its analysis emphasizes two classes of potential plaintiffs—those that will suffer both physical and economic harm and those that will suffer only economic harm—while failing to adequately define other competing interests. Several important considerations are dealt with summarily and others are overlooked entirely.

In the following sections, a framework for determining liability for negligently caused economic losses is developed. Section II examines the interests of the actual parties to the litigation; section III considers broader societal interests. This framework does not encompass every legitimate goal a court

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the court noted:

> [T]wo common threads run throughout the exceptions. The first is that the element of foreseeability emerges as a more appropriate analytical standard to determine the question of liability than a *per se* prohibitory rule. The second is that the extent to which the defendant knew or should have known the particular consequences of his negligence, including the economic loss of a particularly foreseeable plaintiff, is dispositive of the issues of duty and fault.

Id. at 256, 495 A.2d at 112.

28. *Id.* at 263, 495 A.2d at 116.

29. *Id.* at 266, 495 A.2d at 117. The court's treatment of these policies is discussed in some detail below. *See infra* text accompanying notes 30-32, 43, 47, & 57.

may pursue. It is not intended to be an exhaustive checklist. Rather, it merely seeks to clarify some of the issues that judges should consider in deciding whether to allow recovery for economic losses.

II. The Interests of the Parties

The analysis should first focus on the interests of the plaintiff and the defendant. Somehow these interests must be balanced. It may seem pedantic to identify them, but to avoid the intermingling of interests in empty rhetoric, it is important to be clear as to the balancing that is taking place.

A. The Interest of the Plaintiff

Presumably, the plaintiff has been injured in some way.[30] His interest is to receive compensation for that injury—as much as the court will allow. *People Express* explicitly recognizes this interest as a guiding principle. "This [objective of protecting innocent victims] reflects the overarching purpose of tort law: that wronged persons should be compensated for their injuries and that those responsible for the wrong should bear the cost of their tortious conduct."[31] The plaintiff's argument is that he deserves to be compensated. Normally, a court would focus on that argument if it wanted to expand liability or remove some limitation on liability. The New Jersey Supreme Court accepts it as a reason to abandon the economic loss rule.[32] Of course, no court has used the argument to defend the rule, since denial of economic losses is not consistent with full compensation.

However, it is not enough to say plaintiffs should be compensated, and therefore economic losses should be allowed. The plaintiff's argument, when considered in isolation, simply proves too much. It justifies liability beyond the limits of negligence law and even beyond strict liability. As an illustration, suppose the plaintiff's house burns down. The defendant says, "I could not foresee it." But that is irrelevant, if the only purpose of tort law is to compensate plaintiffs. The defendant says, "I was reasona-

30. It is analytically important to restrict the discussion in this part to interests of the actual parties before the court. The interests of *potential* parties will be considered later. *See infra* text accompanying notes 40-44.

31. 100 N.J. at 255, 495 A.2d at 111.

32. Most courts fashioning exceptions to the rule have focused on the defendant's duty rather than the plaintiff's right to compensation. *See, e.g.*, Biakanja v. Irving, 49 Cal. 2d 647, 320 P.2d 16 (1958).

bly careful to avoid the fire." That is also irrelevant. The only thing that matters to the plaintiff is that his house burned down. The defendant says, "I didn't cause the fire." It still serves the plaintiff's interest to receive redress from someone.

Apparently, when courts identify only the plaintiff's interest to support a rule of law, they must implicitly be relying on other factors as well. If compensation were the sole objective of tort law, defendants would be subject to limitless liability, but courts will not compensate every loss.

B. The Interest of the Defendant

If the plaintiff wants compensation, the defendant wants to be left alone. To him, avoidance of liability is always beneficial. Although no one views this concept as an overarching purpose of tort law, limitations on liability are an important part of the negligence system. Each element defining negligent torts creates a boundary beyond which a defendant is not required to compensate.

Not surprisingly, the economic loss rule—one limitation on liability—has always been supported by reference to the defendant's interests. As *People Express* points out,

> [s]ome courts have viewed the general rule against recovery as necessary to limit damages to reasonably foreseeable consequences of negligent conduct. . . . The physical harm rule also reflects certain deep-seated concerns [including] . . . the fear of fraudulent claims, mass litigation, and limitless liability, or liability out of proportion to the defendant's fault.[33]

All of these concerns relate to limiting a defendant's liability, but they must not be allowed to stand alone in the analysis. Just as the argument for compensation is incomplete, the argument for limited liability—when considered in isolation—is also incomplete.

C. The Balancing Process

Some basis must be found for directly comparing the interests of the parties to the litigation. Compensation should be weighed against limited liability. Even though the court was not deciding the merits of the *People Express* case,[34] the interests of

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33. 100 N.J. at 252, 495 A.2d at 110.

34. *People Express* dealt only with the recoverability of economic losses. The case

the parties ought to have been more prominent in the court's analysis.

The principal problem with *People Express* in this respect is not that it ignores the interests of the parties, but that it improperly mixes the interests of potential and actual parties in the same analysis. The balancing process is thus distorted because of the way the court characterizes the issues. Its initial inquiry is whether the economic loss rule can be justified in light of the rule's discriminatory effect on two classes of potential plaintiffs, namely those that will suffer physical injury and those that will not. This approach is clearly wrong. Discrimination between plaintiffs is of itself irrelevant. It may, of course, be evidence that the parties' interests have been improperly balanced, but it should not be used as an independent standard for evaluating the rule.

The fact that the economic loss rule may appear arbitrary from the plaintiff's perspective is not a controlling consideration either. All limitations on liability divide potential plaintiffs into two groups, and the dividing line will always appear arbitrary to injured parties who may be denied compensation.

Note, for example, the court's own illustration of the necessity of limiting liability through the principle of proximate causation. "While a lone act can cause a finite amount of physical harm, that harm may be great and very remote in its final consequences. A single overturned lantern may burn Chicago. Some limitation is required . . . ."[35] Although the proximate causation doctrine makes sense from the viewpoint of the party it protects, it is as arbitrary as the economic loss rule from the potential plaintiff's point of view. After the lantern has tipped over and Chicago has burned, one searches for the place where the fire started to determine who will be compensated. Each potential plaintiff has just as surely lost his home, whether he lived next door, down the street, or on the other side of town. What difference does it make to any of them where the fire started?

The *People Express* analysis does not entirely overlook the interests of the parties; it alludes to them, but the balancing is not direct. Instead, the court weighs the plaintiff's interest in equal treatment with the class of potential plaintiffs against the defendant's interest in the per se nature of the economic loss

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was remanded for a hearing on the merits using the court's newly formulated criteria.

35. *Id.* at 252-53, 495 A.2d 110.

rule and its resulting limitation on liability. Neither of these interests is particularly meaningful.

On the other hand, direct balancing can also be problematic. A dollar for dollar approach is normally not dispositive because each step to one party's benefit is a step to the other's detriment.[36] Instead, analysis of the actual parties' interests must revolve around some independent balancing principle that permits an objective comparison of those interests and brings about a *fair* result.

D. Considering Fairness

The fairness inquiry is usually conducted implicitly. When, for example, a hotel burns down causing economic harm to employees through the loss of their jobs, the court says defendants must be shielded from limitless liability and denies recovery.[37] The implication is that imposing liability in such a case is unfair. When *A* negligently causes the death of an employee of *B*, thereby increasing *B*'s workers' compensation liability, the court says this purely economic injury is too remote.[38] What the court means, but does not explain, is that without a more direct causal nexus, imposing liability on the defendant is unfair. "Not the proximate cause," "utterly without fault," and "innocent victim" are also ways of implying unfairness. While such phrases are useful descriptions, they do not prove fairness, and conclusory statements of that kind should be avoided.

There are a number of possible standards for determining whether a rule is fair, and it is for each court to decide which are most appropriate. One possibility is fault. If a court thinks it fair to penalize improper conduct, liability could be tied to degree of culpability. Another possibility is spreading loss. Sometimes one party is able to insure against losses or otherwise spread the economic burden among members of society. Arguably, it is unfair to require one member of society to bear the full burden of an accident if losses can be shared. A third option is custom or prevailing practice. If one of the parties would customarily be ex-

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36. It should be kept in mind that this part of the analysis applies only to the actual parties to the litigation. The court's only concern respecting the parties is apportioning the losses of an accident that already occurred. Once the court turns its attention to the actions of potential future litigants and to other societal interests, it is not true that a step to one party's benefit is an equal step to another's detriment.

37. Local Joint Executive Bd. v. Stern, 98 Nev. 409, 651 P.2d 637 (1982).

38. Northern States Contracting Co. v. Oakes, 191 Minn. 88, 253 N.W. 371 (1934).

pected to bear the risk of some type of accident, perhaps it is fair to require that party to bear the loss when an accident occurs.

The fairness inquiry is difficult with respect to *People Express* and the economic loss rule because the *People Express* opinion contains insufficient facts to meaningfully compare the parties.[89] However, with the possible exception of prevailing commercial practices, it is difficult to see how any measure of fairness would dictate a denial of compensation for economic losses in every case. If a court were to explicitly balance the interests of Conrail and People Express, it would probably reach the same result as the New Jersey Supreme Court and abandon the economic loss rule.

III. The Interests of Society

Besides apportioning the adverse consequences of an accident among the actual parties, judicial opinions also define the legal duties of parties not before the court. The reasoning employed by courts often takes account of the interests of these parties, as well as broader social and economic issues. Since these interests are distinct and the outlook is prospective rather than retrospective, this part of the analysis should be kept separate from the balancing of plaintiffs' and defendants' interests.

A. The Interests of Potential Parties

One way to decide whether the economic loss rule is socially desirable is to determine its probable effect on potential plaintiffs and defendants, that is, those parties in a position to inflict or receive economic injuries. In one sense, of course, what is beneficial to the actual parties can also be said to benefit potential parties, since there is a possibility that any member of society may sometime find himself in court. On another level, however, the deterrent effect of laws assigning liability serves to protect persons who, without such laws, would suffer tortious injuries.

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39. An actual comparison is crucial. It is not enough to assert that requiring compensation in the absence of fault or foreseeability would be unfair to the defendant, for example. *Cf. People Express*, 100 N.J. at 266, 495 A.2d at 117 (compensation not required for unforeseeable risks). Such a statement overlooks the possibility that plaintiffs can also be innocent. The interests of both plaintiffs and defendants must be balanced. Denial of compansation whenever the defendant is innocent would often leave the burden of accidents on equally innocent plaintiffs. Since the fairness of that result is not immediately apparent, the above statement should not be allowed to stand on its own.

The interest, then, of potential plaintiffs is freedom from injury—related to the actual plaintiff's interest in compensation. In general, one expects the interests of actual and potential plaintiffs to coincide, because expanding the actual plaintiff's recovery will normally benefit potential plaintiffs by discouraging tortious conduct. However, the interests of these parties should not be merged. For example, unlimited compensation does not necessarily benefit the potential plaintiff. It makes no difference to the actual plaintiff who compensates his loss, but potential plaintiffs will not be helped unless liability is restricted to parties who cause (and therefore can prevent) injuries. Moreover, a decision may compensate the actual plaintiff without having a significant deterrent effect if the court's holding is stated too ambiguously to give guidance to potential parties.

Potential defendants have an interest in freedom to act, which is analogous to the actual defendant's interest in limited liability. One expects that limiting the liability of the actual defendant translates into a reduced duty of care, which gives potential defendants greater freedom. But again, the interests of those parties are not identical. The actual defendant—like the actual plaintiff—is most interested in apportionment of damages, while potential defendants are most interested in the way the rule is formulated.

Although the interests of potential and actual parties are significantly different, fairness must again be the touchstone of a desirable rule. And the burden of duty that a rule imposes on potential defendants must be weighed against the resulting freedom from injury that potential plaintiffs enjoy.

This balancing involves a prediction of how the rule will affect future behavior. Some cases making exceptions to the rule—and the one case abolishing the rule—have alluded to the future effects of their holdings in a general way. Usually this is done by identifying, as a basis for the decision, the objective of preventing future harm. Implicitly, if *this* notary public is liable, other notaries public will take greater care to avoid mistakes in attesting wills;[40] if *this* contractor has to pay, other contractors will be more diligent in completing construction projects on

40. Biakanja v. Irving, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958) ("The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors [including] . . . the policy of preventing future harm.").

time;[41] if *this* railroad must compensate for economic loss, other parties in analogous circumstances will take greater care to avoid economic losses.[42]

Theoretically, the economic loss rule restricts potential defendants' duty of care to the avoidance of physical harms. The *People Express* criteria expand this duty to include particularly foreseeable economic harms. If in fact *People Express* affects the way railroads conduct their operations,[43] one would expect them to take greater care to protect potential plaintiffs' economic interests in the future. However, courts must not assume that society should always seek to deter tortious conduct, because it is not desirable to avoid future injuries at all costs.[44] That is why a balancing is required; to determine whether the definition of the parties' respective duties is fair.

However, it is doubtful whether potential parties' interests are useful as a determinant of societal interests in the economic loss context. Although fairness to potential parties can presumably be determined by referring to the same standards applicable to actual parties, it is not clear that their interests are separable. Instead of asking whether it is fair to require railroads to compensate airlines when chemical leaks cause the interruption of normal business operations, one asks whether it is fair to place the risk of such losses (and other foreseeable economic losses) on potential defendants. But as a practical matter, the distinction may be very difficult to draw.[45]

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41. J'Aire Corp. v. Gregory, 24 Cal. 3d 799, 805, 598 P.2d 60, 64, 157 Cal. Rptr. 407, 411 (1979).

42. *People Express*, 100 N.J. 246, 495 A.2d 107. "Imposing liability on defendants for their negligent conduct discourages others from similar tortious behavior, fosters safer products to aid our daily tasks, [and] vindicates reasonable conduct that has regard for the safety of others . . . ." *Id.* at 255, 495 A.2d at 111.

43. It seems quite bold to suppose that a rule as broad as the one laid down in *People Express* will have a clearly predictable effect on future decision making. Arguably, the economic loss rule (with all of its exceptions) more clearly defines the duties of potential parties, and therefore provides a more solid basis for predicting future behavior.

44. *See infra* notes 50-51 and accompanying text.

45. In the economic loss context it is not clear that a distinction should even be attempted. If we assume that fair compensation is available, do potential plaintiffs have any legitimate interest in being protected from injury *beyond* the right to compensation? Whereas an argument can be made that potential plaintiffs have such an interest in being free from physical harm, because money damages are often inadequate to truly compensate physical injury, *cf.* Epstein, *A Theory of Strict Liability*, 2 J. LEG. STUD. 151 (1973), there is no reason to discourage negligent conduct that results only in economic harm if the tortfeasor must compensate.

Moreover, balancing the interests of potential litigants inadequately addresses societal concerns because a balancing presupposes the legitimacy of the interests at issue.

An economic interest is nothing more than an expectancy of deriving some economic benefit. Although the law gives force to many such expectancies, it does not and should not give force to all of them. Attempting to protect potential plaintiffs from every interference with their economic expectations would undermine the vitality of the free market, which society values. Therefore, society must establish the legitimacy of the interests at issue by identifying the benefits that will accrue from protecting some interests and not others. Rather than balancing the interests of particular parties, the vindication of societal interests is a matter of public policy.

One policy goal that could be instrumental in identifying the proper limits of protection to economic expectations is economic efficiency.

B. The Goal of Economic Efficiency

Characterizing social interests in terms of economic efficiency compares different legal rules in light of their total economic effects without making the interests of the actual parties dispositive. If changing a rule encourages people to produce more of a beneficial product or service, or stop producing something harmful, and if it does not simultaneously bring about a counterbalancing negative effect, that change is economically efficient.[46] Applied to *People Express,* one would seek to find the least expensive way to deal with the risk of chemical leaks. When there is a possibility that leaks may cause economic losses to nearby airlines, would it be less expensive for airlines or railroads to bear the risk?

People Express defends its foreseeability criteria by declar-

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46. This discussion is by no means intended as a comprehensive treatment of the economic issues surrounding the economic loss rule. The literature bearing on the subject is very large. For general discussions of economic efficiency and the law, see R. POSNER, ECONOMIC ANALYSIS OF THE LAW (2d ed. 1977); Coleman, *Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law,* 94 ETHICS 649 (1984). Some analysts have argued that economic efficiency is an improper (or at any rate, incomplete) objective. *See* J. MURPHY & J. COLEMAN, THE PHILOSOPHY OF LAW: AN INTRODUCTION TO JURISPRUDENCE 255-75 (1984); Baker, *The Ideology of the Economic Analysis of the Law,* 5 PHIL. & PUB. AFF. 3 (1975); Easterlin, *Does money buy happiness?,* 30 PUB. INTEREST 3 (1973). This note does not address what weight should be given economic considerations vis-à-vis other values, including fairness to the parties.

ing that "it would be unfair and socially inefficient to assign liability for harm that no reasonably-undertaken precaution could have avoided."[47] This assertion is based on the premise that "the imposition of liability should deter negligent conduct by creating incentives to minimize the risks and costs of accidents,"[48] and on the well-known Hand formula, laid out in *United States v. Carroll Towing Co.*[49] By negative implication, the court attempts to establish that the economic loss rule is inefficient. But it is not clear that deterring negligent conduct by expanding liability is the most efficient way to minimize the social cost of accidents. If courts justify their holdings based on claims of economic efficiency, a more thorough analysis is required. In particular, there are a number of assumptions that judges should avoid.

First, it should not be assumed that preventing all accidents is economically desirable.[50] Only those accidents that can be prevented in a cost-effective manner should be averted. If Conrail must spend two million dollars to prevent a chemical leak that would cause one million dollars of damages, perhaps society would be better off if the leak were allowed to occur.

Second, courts should not assume that parties will always act to avoid liability. Even if Conrail is held liable, it may choose not to increase its efforts to avoid chemical leaks, since liability rules do not function as prohibitions on antisocial conduct. Consider the reasoning found in *Clinton v. Commonwealth Edison Co.*,[51] which involved a fifteen-year-old boy who came into contact with an uninsulated electric line and was electrocuted. The court held that his parents could not recover:

> We feel that to require defendants under the facts of this case to have used an insulated line over the Clinton's property would in effect be tantamount to requiring defendants and all who are engaged in the business of supplying electrical service to insulate all of their lines. . . . The minimal risk of injury does not justify the imposition of such a heavy burden on the

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47. *People Express*, 100 N.J. at 267, 495 A.2d at 118.

48. *Id.* at 266, 495 A.2d at 117.

49. 159 F.2d 169, 173 (2d Cir. 1947) ("[I]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i. e., whether $B < PL$.").

50. The economic loss rule also cannot be declared "socially inefficient" merely because it fails to deter accidents that cause economic losses.

51. 36 Ill. App. 3d 1064, 344 N.E.2d 509 (1976).

> electrical business nor on the public who will undoubtedly bear the ultimate cost.[52]

This analysis is wrong because the "heavy burden" mentioned is the burden of insulating the wires. But the power company may choose instead to bear the "minimal risk" of compensating occasional injuries. The holding does not operate as an injunction, and if the risks truly are minimal, there is no reason to believe that the wires will be insulated even if liability is imposed on Commonwealth Edison. Therefore, since the holding will probably have no effect on the number of accidents, the court's statement that the risk does not justify the burden amounts to a value judgment that victims and their families should bear the impact of accidents rather than the power company and the public. Recourse to economic efficiency does not support that kind of value judgment.

Third, courts should not make their analysis depend on a characterization of potential parties as tortfeasors or victims.[53] At least one of the parties will suffer injury as a result of the leak in the Conrail freight yard. Often, it is not clear whose rights are most deserving of protection, and just because People Express did not realize its expected profits does not mean the law should vindicate its interests.[54] If the goal is to achieve economic efficiency, the court should attempt to place liability on

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52. *Id.* at 1070-71, 344 N.E.2d at 515.

53. *See* Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

54. A good illustration is the case of Bass v. Gregory, 25 Q.B.D. 481 (1890):

> The plaintiffs were the owners in fee, and her [sic] tenant, of a public-house called the Jolley Anglers, and the defendant was the owner of some cottages and a yard adjoining the plaintiffs' premises. The plaintiffs claimed to be entitled as of right to have the cellar of that public-house ventilated by means of a hole or shaft cut therefrom through the rock into an old well situated in the yard which was occupied by the defendant . . . . The plaintiffs further alleged that the defendant wrongfully removed a grating which was formerly placed across the mouth of the well, so as to stop or prevent the free passage of air from the cellar upwards through the well, and they asked for an injunction and damages . . . . It was obvious that, without some ventilation, the cellar could not be used; and it was equally clear that it had been used for a particular purpose in the process of brewing, which, without ventilation, could not be carried on.

Id. at 481-82.

Which of the parties is the tortfeasor and which the victim? Perhaps the defendant tortiously interfered with the plaintiffs' brewing operation, making them the victims. But if the court enjoins the defendant's conduct, he will be the victim of unpleasant odors. Both parties have legitimate interests which are not resolved simply by characterizing the party that suffers without judicial intervention as an "innocent victim."

the party best able to avoid the cost of an accident.[55] Even if accident losses are not preventable at all, one party may be able to avoid the impact more efficiently than another. If losses cannot be prevented, since parties can protect themselves from the impact of eventual accidents through some form of insurance, courts should impose liability on the parties that can insure at the smallest cost.

In many cases involving economic losses, the "victim" will be better able to avoid the loss than the "tortfeasor." If so, the economic loss rule can be efficiently applied. For example, Conrail may be able to predict eventual damage to People Express airplanes, but it may be unable to anticipate the cost of evacuating the terminal. If Conrail is unable to assess the probable losses, it cannot decide whether it is cost-effective to prevent chemical leaks even if the possibility of economic losses is generally foreseeable.

In fact, it is likely to be very difficult for potential "tortfeasors" to know how much care to take to avoid causing economic loss to potential "victims" in most circumstances. Since potential "victims" can also foresee accidents and in many circumstances can protect themselves against economic losses more easily than "tortfeasors," nonliability may often be the most efficient rule.

C. The Future Effect of Liability Rules

In dealing with the future economic effects of a given liability rule, two final considerations are appropriate. First, liability rules should be formulated so as to avoid uncertainty.[56] Courts often intend positive social effects, but those benefits will not accrue unless the standards are sufficiently definite and reliable that parties know what costs they must bear in the event of an accident. It is not enough, therefore, to discuss what the actual parties "should have done." The court must frame its holding in

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55. *See* G. CALABRESI, THE COST OF ACCIDENTS (1970). Union Oil Co. v. Oppen, 501 F.2d 558 (9th Cir. 1974), defends an exception to the economic loss rule by using Calabresi's lowest cost avoider approach. Although the court's analysis is not completely satisfactory, *see* Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 297-301 (1979), it is certainly better than the bald assertion that a holding is consistent with the interests of society.

56. "[I]n most matters it is more important that the applicable rule of law be settled than that it be settled right." Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 406 (1932)(Brandeis, J., dissenting).

terms helpful to potential parties. Otherwise, the risks will be miscalculated and perhaps both parties will spend resources to avoid or insure against accidents when only the resources of one party are required.

Secondly, liability rules should be framed with an eye to avoiding litigation. Not only does the judicial system itself have an interest in avoiding an unmanageable proliferation of litigation,[57] but litigation is also an inefficient use of resources.[58] However, judicial intervention cannot be avoided as long as liability rules are unclear, unreliable, and theoretically unsound. Instead, an injured party will almost always have an incentive to go to court, because even a fair chance of winning is likely to outweigh the certainty of bearing the costs of an accident that has already occurred.

IV. Conclusion

In determining liability for negligently caused economic losses, courts should keep in mind five basic points.

First, prior case law should not be used as a substitute for analysis. Most opinions discussing economic losses—including *People Express*—rely heavily on precedent to establish their positions. Naturally, if the law is settled and specific analysis is not required, citation of authority without more is appropriate. Prior authority is also helpful evidence that a legal objective has support or that a line of reasoning has been carefully explicated elsewhere.[59] But when new analysis is required, citation of authority alone is inadequate.

Second, courts should specifically identify the interests at stake, rather than merely assuming that principles applicable in one context should necessarily be extended to another.

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57. *People Express* briefly deals with this interest at 100 N.J. at 252, 495 A.2d at 110. However, the opinion improperly groups the threat of mass litigation with potentially infinite liability; this grouping leaves the courts' interest unaddressed.

58. "A liability system based on fault is the most expensive way to administer accident losses. It has been estimated that the benefits received under this system amount to about 44 percent of its total cost." James, *supra* note 5, at 52 (footnote omitted).

59. *People Express* develops its foreseeability criterion through a legitimate use of precedent. Its holding is essentially a synthesis of decisions granting exceptions to the economic loss rule. The authorities cited demonstrate what the law is and what other judges think. In other parts of the opinion, authority is cited to demonstrate that proximate cause is a sufficient limitation on liability, 100 N.J. at 253, 495 A.2d at 110; that the foreseeability requirement is socially efficient, *id.* at 267, 495 A.2d at 117-18; and that eliminating the economic loss rule will not lead to mass litigation, fraudulent claims, and excessive liability, *id.* at 252-54, 495 A.2d at 110-11.

Third, fairness to the parties should be examined explicitly. The plaintiff's interest should be weighed against the defendant's, and no other interests should be involved in that balancing. If other interests are relevant, they must be kept separate.

Fourth, treatment of social interests should not be restricted to statements of policy. It ought to include some justification for supposing the rule will bring about the desired results. If, for example, a court claims that a holding is economically efficient, careful economic analysis is required.

Fifth, a case-by-case balancing approach should be avoided to the extent that it will create uncertainty for parties not before the court. The balancing of interests should lead to a rule susceptible of consistent future application. Because of the nature of the interests involved, liability rules for economic injuries are much like commercial regulations, and they must be clear if they are to be effective in positively influencing future behavior.

Each of these points implies a need for careful reasoning. Decisions must not he founded on conclusory statements and precedent, but on cogent explications of the interests involved and the effects anticipated. Too often, the judicial discussions surrounding the economic loss rule have glossed over important issues with sweeping rhetoric and vague notions of public policy. As a result, issues are raised and policies stated, but the dicta are not convincing.

Whether judges choose to accept the particular framework presented in this note, it is hoped that they will avoid shallow reasoning and make a genuine attempt to evaluate the recoverability of economic losses through a clear-sighted treatment of the fundamental issues bearing on the outcome.

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