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Heuristics and the Problem of Pure Economics Loss

Heurystyki a problematyka szkody czysto majątkowej

Summary

The goal of this text is to pose hypotheses related to use of heuristics in the process of deciding cases related to pure economic loss and making laws governing liability for this phenomenon. Pure economic loss is a type of damage where the victim suffers only economically, i.e. there is no bodily harm or damage to property, and there is lack of contractual nexus between the victim and the tortfeasor. Pure economic loss is, in principle, not recoverable in the common law systems and, in principle, recoverable in civil law systems. Pure economic loss is a heterogenic category consisting of a variety of case types, here divided into (1) ricochet loss, (2) transferred loss, (3) loss induced by faulty information. Pure economic loss cases are usually more complex than physical injuries and consequential economic loss, as they may involve a loss of profits. This paper explores the use of heuristics in the process of deciding pure economic loss cases and in process of forming general norms related to them.

Keywords: availability heuristic, representativeness heuristic, attribute substitution, tort law, pure economic loss, causation

Streszczenie

Celem niniejszego tekstu jest przedstawienie hipotez na temat wykorzystania heurystyk w procesie rozstrzygania spraw związanych ze szkodą czysto majątkową i ustanawiania praw regulujących odpowiedzialność za nią. Szkoda czysto majątkowa jest rodzajem uszczerbku, przy którym poszkodowany ponosi szkodę wyłącznie na majątku, to jest nie zachodzi ani uszkodzenie ciała, ani rzeczy, przy czym brak jest umownego związku między poszkodowanym a sprawcą szkody. Szkoda czysto majątkowa zasadniczo nie podlega

naprawieniu w systemach *common law*, lecz co do zasady można żądać jej naprawienia w systemach *civil law*. Szkada czysto majątkowa jest heterogeniczną kategorią składającą się z różnych typów spraw, podzielonych na potrzeby niniejszego tekstu na: (1) stratę rykoszetową, (2) szkodę przeniesioną, (3) szkodę wywołaną przez wadliwe informacje. Przypadki szkód czysto majątkowych są zwykle bardziej złożone w porównaniu ze szkodami fizycznymi i wynikającymi z nich stratami majątkowymi, ponieważ mogą one polegać na utracie zysków. Niniejszy artykuł omawia występowanie heurystyk w procesie rozstrzygania o odpowiedzialności za szkody czysto majątkowe oraz w procesie tworzenia norm prawnych je regulujących.

Słowa kluczowe: heurystyka dostępności, heurystyka reprezentatywności, podstawienie atrybutów, prawo deliktowe, szkoda czysto majątkowa, związek przyczynowy

Pure economic loss is a negative change in the assets of a person or a legal entity (victim) caused by the behavior of a third party which does not inflict any physical damage to the property or injury to the body of the victim. The concept of pure economic loss does not cover moral harm or negative emotions, only economic assets.

Such loss is exemplified by *Spartan Steel v Martin*,¹ where an excavator operated by Martin negligently severed an electric cable by which Spartan Steel obtained the power necessary to do its business. As a consequence of the negligent behavior, Spartan Steel could not produce for 15 hours and some of its furnaces were damaged. The Court of Appeal, consisting of Lord Denning MR, Edmund-Davies LJ and Lawton LJ decided to allow only the recovery of damages to the furnaces and other physical damage, while denying the recovery of lost profits (pure economic loss) for the 15 non-operational hours.

¹ *Spartan Steel & Alloys Ltd v Martin & Co (Contractors) Ltd* [1973] QB 27.

The reasoning for not allowing recovery of pure economic loss was based on the fact that power cuts are a normal hazard of everyday life, and its risks should be shouldered by the whole community, not by a single person. Another argument, which forever lingered in the discussion on pure economic loss is the fear of excessive litigation if ever more remote economic losses are allowed recovery. *Spartan Steel v Martin* is representative of the cases which delineate the pure economic loss rule, present in the common law jurisdictions, which may be simply shortened to ‘pure economic loss is not recoverable’. The rule of pure economic loss, despite many efforts, was never abstracted into a single coherent theory, although many competing explanations exist (Sebok 2011). Lack of remedy in tort stimulates the growth of the insurance market for pure economic loss, although it is not necessarily effective (Pryor 2006, 907) and incentivizes political factors to compensate for losses with taxpayer money (see Palmer 2011, 106).

The pure economic loss rule is not present (in such a simple form) in civil law jurisdictions. A famous example of civil law considering pure economic loss is the Italian case of *Torino calcio c. Romero*.² On October 10th 1967, Luigi Meroni, a player for Torino calcio, the Torino football club, was killed in a car accident by Attilio Romero. Torino calcio demanded that Romero pay damages for its lost position in the Italian football league, as a result of being deprived of its star player, Luigi Meroni. The case was finally decided by the Court of Cassation. The underlying rule of liability was the so-called Aquilian liability, which related to the ancient Roman *lex Aquilia* of the 3rd or 2nd century BC (Zimmermann 1990, 953). *Lex Aquilia* provided a tort remedy for physical injury to a slave or an animal. The novum of *lex Aquilia* consisted in making the amount of compensation dependent on the value of the damage. The Court of Cassation decided this kind of liability is applicable not only to

² Corte di Cassazione, sezioni unite, sentenza 26 gennaio 1971 n. 174.

damage to things (protected by absolute rights against all persons) but also to relative rights, as was the relation between Luigi Meroni and Torino calcio.

Torino calcio vs. Meroni represents a way of thinking appropriate for the systems of continental Europe, but it would be a far too much of a simplification to say that pure economic losses are recoverable in Europe. A similar situation can be observed in other European jurisdictions, e.g. Spain (Martín-Casals and Ribot 2004, 62–76). Not all the legal systems of continental Europe are based on the general clause of liability in delict. Germanic systems developed a different approach, where the tort itself is not the main weight, but rather the interest which it infringes upon. In Germany, § 823 of the BGB protects tort interests such as life, body, health, freedom, property and other rights.

The above examples represent the category of ricochet loss, a kind of pure economic loss suffered by a non-owner or an employer due to damage to a thing owned by another person or injury to an employee (Boom, Koziol, and Witting 2004, 24). Another type of pure economic loss is transferred loss, where a contract or a special relationship makes another person (e.g. insurer) suffer loss in place of the primary victim (Boom, Koziol, and Witting 2004, 29). A third kind of pure economic loss is induced by faulty information (e.g. erroneous information about a firm's financial situation) or service (e.g. a badly drafted will causing the wrong person to inherit) when there is a lack of a contractual relationship between the person causing the loss and the victim (Burchell 1980, 2). All these categories are unusually complex when compared to direct economic losses incurred by damage to property. This regularity was noted by Bernstein (2006) in her explanation of the pure economic loss rule. Bernstein proposed that the five usual explanations for the pure economic rule (i.e. liability would be impossible to calculate, economic losses are not social losses, money is not as important as people, private

ordering should be encouraged, contract law should have priority) are missing the point, while the real explanation lies in the simplistic nature of tort law.

The literature on the optimal scope of liability for pure economic loss is quite abundant. Bishop (1982) discovered that pure economic losses are not social losses like physical injuries. If one breaks a window, society as a whole has one window less, pure economic loss is a mere transfer of wealth from one person to another. Bishop explains that while Spartan Steel could not conduct its business for a certain amount of time, some other company (e.g. Athenian Steel) would make more profit. The only time pure economic losses constitute social losses is when all the companies produce at maximum capacity. This observation distinguished private losses from social losses and served as one of the explanations for the pure economic loss rule. Later economic assessments of the problem of pure economic loss are increasingly complex (Bussani, Palmer, and Parisi 2003; Dari-Mattiacci 2003). All the analyses assume that the goal of tort law is to maximize social utility and the obligation to pay damages incentivizes utility-maximizing actors to incur precaution costs, a view which is not without its critics (see Sugarman 1985, 564 et seq.; also Weinrib 1988, 505 et seq.).

Rhee (2010) tried to simplify the problem, proposing that common law courts intuitively protect factors of production but not factors of outcome, however, the theory does not explain all case types. The so-called production theory of pure economic loss is based on the case of fishermen who suffered pure economic loss due to damage to the propeller of a rented boat.³ As there was no contractual relationship between the fishermen and the person that caused the damage, and since the fishermen did not have *in rem* interest in the ship, there

³ *Robins Dry Dock & Repair Co. v. Flint et al.* (1927) 275 U.S. 303, US Supreme Court.

should be no recovery of economic loss under the pure economic loss rule. However, the case was treated as an exception and the fishermen were able to recover. Rhee explains this doctrine by the implicit need to protect the factors of production.

Tort law deals with a large variety of situations: broken windows, personal injuries, car accidents, medical errors, dangerous consumer products, environmental damage, moral distress and so on. Always where the injurer and the victim have no opportunity to establish rules of liability due to prohibitive transaction costs. The majority of case types involve the need to establish causal links between the behavior of the defendant and the damage to the plaintiff. Causation is proven by the so-called “but for” test, also known as “sine qua non” in continental Europe. The test requires that the factfinder ask a question, whether the damage would still have occurred had it not been for the behavior of the defendant (Kouladis 2006, 69). This mental process is prone to errors and biases. Research has shown that it is very hard to imagine a counterfactual reality in which the counterfactuals are not the main fact (Kahneman and Miller 1986, 150; Roese 1997, 133), which may lead to faulty conclusions. Although the research is now quite well known in the legal profession, it seems that factfinders (judges) are still prone to bias (compare Golecki and Bełdowski 2018, 193). The causal link in pure economic loss cases is vastly more complex than in cases of physical harm and somewhat more complex than in cases of consequential economic loss. This complexity makes the human mind susceptible to the use of heuristics because memory and computational ability are finite. Economic losses are related to the concept of profit because they consist mostly of lost chances. Profits are always uncertain, hence the concept of business risk, and common sense tells us lost profits can result from various events. Some of these events are encouraged by society, for example pure economic loss can be caused by competition – which is not a subject of tort law as long as it is within the boundaries of

competition law. People instinctively know it is more certain to keep a thing in an undamaged state than to make a profit. Consequently, it is much harder to imagine losing profits than physical injury, which may lead to faulty conclusions in the “but for” test. It seems that the information on physical injuries is readily available, while the information on lost profits requires imagination. In passing it is worth mentioning some authors distinguish between lost chances and lost profits (see Bagińska 2013, 290). This distinction is dogmatically useful as we commonly distinguish between chance-based activities (e.g. lotteries) and business activities. From the point of view of economic analysis, the only difference between the two categories are the values of probability.

Even when analyzing the physical injury cases factfinders are systematically biased. In the famous “barrel experiment” (Guthrie, Rachlinski, and Wistrich 2000, 808) judges were asked to assess the probability of negligence on part of the defendant which might have caused injuries to the plaintiff who was hit by a barrel belonging to the defendant’s enterprise. The hypothetical case provided the following data: “(1) when barrels are negligently secured there is a 90% chance they will break loose, (2) when barrels are safely secured there is a 1% chance of them breaking loose, (3) workers negligently secure barrels only 1 in 1,000 times”. The probability of negligence was calculated by the researchers to be 8.3%. 156 judges answered the question. The most popular answers were 0-25% (40.9% of the judges) and 76-100% (40.3% of the judges) (Guthrie, Rachlinski, and Wistrich 2000, 809). This indicated that even in fairly simple cases some factfinders trust their gut rather than doing the calculation.

I propose a pure economic loss version of Guthrie, Rachlinski and Wistrich’s experiment.

A football player was killed in a car accident by a negligent car driver, subsequently the football team lost its position in the league. The football team was also less profitable in the

following period compared to last year. Sports experts assess there is a probability of 5 to 20% that the lack of the player will lead to the team's loss of position. Sport experts give various descriptive explanations. Economic experts argue there is a probability of 2 to 43% that profits will be lost due to a lower position in the league, they also give various explanations. One expert argues in the media that the death of the player might have been financially beneficial due to increased media coverage. What is the probability of the negligent car driver causing economic losses to the football team?

It is quite clear the pure economic loss version of the experiment requires more thinking on the part of the respondent. In this situation respondents are much more likely to ignore the expert opinions altogether and trust what they know from their individual experience. This could be the most rational reasoning. Experts may be doing the same thing – trusting their experience instead of assessing the situation based on the available evidence. Their experience is valuable; however, memories may be biased towards the most vivid events. In our case experts may remember much better the negative consequences of a valuable player leaving the club than the inconsequential examples leaving the club. A factfinder may be more rational to trust his own experience than to trust expert opinions multiplying layers of possibly faulty information. The problem of lost profits is also as complex. A company's profitability is dependent on many factors and rarely dependent on one event. It is therefore justified to suppose that factfinders are more likely to use heuristics of availability and representativeness to assess the cases of pure economic loss. This supposition requires empirical research.

The above supposition does not explain the difference in the treatment of pure economic loss in various legal cultures. This is dependent on the legal rules and customs that determine court decisions. Legal rules are general and encompass a wide variety of case types regardless of the legal system. The

general clause of tort liability, which simply forms the obligation to repair the damage culpably inflicted upon other, leaves it to the doctrine and jurisprudence to form specific rules in specific case types. The influential *lex Aquilia* remained in force for centuries, yet its application was often outside of its literal meaning (Giario 2009, 91). In principle, *lex Aquilia* protected interest in things, especially slaves and four-legged animals (Mousourakis 2012, 253). The meaning of the norms was broadened. At least in time of Justinian (see *Institutes of Justinian*, 4.3.16) *lex Aquilia* was believed to protect injuries to things even if not by physical action (e.g. one tells another person's slave to climb a tree and the slave falls) or even complete non-corporeal injuries (e.g. one frees another person's slave of pity and the slave runs away), which are precursors to the concept of pure economic loss (Szczerbowski 2013, 85). Thomas Aquinas broadened the rule even more, allowing the recovery of lost profits. He considered seeds being dug up as depriving the victim of future crops (Tomasz z Akwinu, 1970, 2–2, 62.4, p. 51). Durantis also gives an example of recoverable pure economic loss consisting of leaving trash in front of a victim's door which caused the imposition of an administrative fine on the victim (Durantis, 1574, Lib IV. Partic. IV, De iniuriis et damno dato §2 sequitur, p. 14). All the steps in the evolution of Aquilian liability led to the abstraction in form of the general principles of tort liability (Grotius 2001, 157) and a general clause of tort liability which first appeared in the famous Article 1382 of the French Civil Code (Zimmermann 1990, 1036).

The year 1804, when the Civil Code was established, was quite different than the 3rd or 2nd century BC – the time of *lex Aquilia*. Nevertheless, 1976, the year of *Spartan Steel v. Martin*, seems much further in economic terms from 1804 than 1804 is from the 3rd century BC. The difference lies in the greater interdependency of market actors. Progress in the field of communication facilitated circulation, but also increased systemic risks related to actors depending economically on one another.

These economic processes created new types of events which are still subject to somewhat aged rules. Each layer of abstraction extending the scope of application of *lex Aquilia* had to be based on the analysis of a finite number of case types which happened in the past. Extending the application of *lex Aquilia* meant opening the possibility that more unknown future case types would fall under the law of delict. Acceptance of this fact could mean that the scholars and philosophers creating new rules assessed they are good enough, or in the language of Simon (1956, 129) “satisficing” – satisfying and sufficing, not necessarily optimal.

The differences in the treatment of pure economic loss across legal systems are usually attributed to historical path dependence. This is, however, just a half of the explanation, as historical events are subject to inquiry as well. Heuristics may be proposed to explain the differences but because of the multiple layers of the problem empirical study is advised. Heuristics may cause differences in the treatment of pure economic loss at the levels of (1) law-making, (2) the application of law, and (3) general culture. As it is difficult to study law-making empirically (as it is a one-time phenomenon), it is reasonable to study the application of law and the general ethical attitude in a given society. The study should consist of a series of pure economic loss cases of increasing complexity given to professional judges and to the general population. The empirical study of professional judges would serve as a litmus test if the questions give the same results which are observed in the body of jurisprudence. If the results are positive, the general population should be asked the same questions. The similarity of answers in both groups would indicate that the attitude towards pure economic loss is rooted in the moral norms accepted in society. Differences in the answers given by the groups could indicate that the judges rely on legal training, but the path dependence of the legal norms (a source of their legal training) is a cause of divergence between the legal norms and the moral attitudes of

the general population. The dependence of the similarities on the complexity of each question could indicate that one group is less prone to the use of heuristics than the other.

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