Title
Liability of Experts for Pure Economic Losses, an Economic Analysis with Special Reference to German Cases

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This presentation is partly based on a paper coauthored with Roger Van den Berg and partly on another paper on expert liability which is so far only available in German language (to be published in Archiv fuer die civilistische Praxis (AcP)). Participants reading German can receive a copy of the second article.

Two propositions are made. The first proposition is that a rule of obvious or gross negligence is a good rule for pure tort law cases when it comes to pure financial loss. The second proposition is that this solution is not recommendable, if the borderline between tort and contract is not clear, as often in cases of expert liability. Special emphasis is therefore laid on the liability of experts who often act not only for their contractual partner but also for others. Under which conditions should they be protected by the law of contract or by the law of torts?
Pure Economic Loss in Tort and the Rationale for “Obvious” Negligence in tort law

1. Overcompensation as a Result of Liability for Pure Economic Losses

There is a fundamental difference between those effects of noxious behaviour which destroy or incapacitate an economic resource and those which lead to pure financial losses. If a house burns down, the value of the capital stock of the society is diminished by the value of the destroyed house. Therefore, the damage of the victim is equal to the damage of the society and, if negligence was shown and causation proven, compensation would be equal to the losses of the society. This equality of the victims’ damage, the loss of the society at large and the amount of damage compensation, however, is no longer existing in cases of pure financial losses.

Assume that a national regulator infringes the principle of free movement of goods by enacting a food quality standard, which allegedly serves a goal of consumer protection. Assume further that the effect of this standard is ambiguous for the consumers as a group. On the one hand, it prevents foreign suppliers from entering the relevant Member State’s market, thus increasing monopoly power and the product price. On the other hand, the national regulation might generate some benefits for the consumers as well. How must the damage to be compensated be assessed in such a case? How large are the social losses? It is evident that, unlike in the case of the burnt house, private losses and social losses are not equivalent.

The social losses or gains, resulting from the enactment of the national quality regulation, must be calculated taking into account the combined change of consumer and producer surplus. The social loss is almost necessarily different from the damage suffered by the foreign would-be exporters. Assume that as the result of the regulation consumers lose 10, domestic producers gain 100 and foreign producers loose 105. The social losses from infringing the economic freedom of free movement of goods then amount to 15. Losses of consumer surplus cannot be compensated in most

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European legal orders. If, however, the foreign producers are entitled to damage compensation they will claim 105, which is seven times the social losses. Overcompensation, in the sense that total damage compensation might (substantially) exceed the amount of the total social loss, is thus an unavoidable risk of liability rules which grant compensation for pure economic losses. This can lead to overdeterrence and to the choice of an excessively high level of care.

The need to restrict the award of damages for purely economic losses, shown by economic analysis, is partly reflected in the actual legal treatment of economic losses. As far as economic losses are caused by accidents (such as the interruption of the supply of electricity or collisions at sea cutting off from the mainland an island on which businesses are located\textsuperscript{2}), there are remarkable differences across legal systems. Whereas the English and the German legal system take a restrictive position, the French system adopts a much broader view. Pure economic losses, such as wages paid when no work could be done owing to the lack of current following a power interruption due to negligent earth-removal operations, are not recoverable under German law, since they do not relate to one of the legal interests protected under § 823 I BGB\textsuperscript{3}. The solution in English law is similar, albeit for different reasons\textsuperscript{4}. By contrast, there are no special doctrines restricting liability for economic losses in French law, but such liability may be limited by standards used for proof of causation and for the certainty of losses\textsuperscript{5}.

For the purposes of this paper it is not necessary to dwell at length on these differences, since the economic losses concerned are not the consequence of an accident, but flow from legislative acts or omissions violating superior rules of law for the protection of individuals. The facts of the cases discussed in this paper show similarities with economic losses suffered by businessmen, whose competitors engage in unfair competition by breaching economic laws (requirements as to production and regulations restricting or prohibiting certain selling arrangements). Indeed, many


\textsuperscript{3} BGH, 4 February 1964, \textit{BGHZ} 41, 123; \textit{NJW}, 1964, 720.

\textsuperscript{4} \textit{Spartan Steel & Alloys Ltd v. Martin & Co. (Contractors) Ltd} [1973] 1 Q.B. 27. See van Gerven, W., cited above note 8, p. 508-509 for a discussion British, German, French and Dutch cable cases.

\textsuperscript{5} See Zweigert, K. and Kötz, H., \textit{Einführung in die Rechtsvergleichung}, Tübingen, Mohr Siebeck, 1996, p. 621. The legal situation is the same in Belgium and the Netherlands.
Member States’ regulations violating the fundamental economic freedoms of the EC-Treaty have been enacted for protecting domestic trade from foreign competition. In cases involving economic losses due to the breach of legislative provisions, the differences between legal systems are less dramatic. According to German law, compensation for purely economic losses can be claimed if a protective norm („Schutznorm“) is breached by those whose interests are protected by the protective statute infringed; such breach gives rise to an action for damages to the extent that some fault can be imputed to the wrongdoer (§ 823 II BGB). In addition an intentional breach of *boni mores* leads to recovery of pure financial losses (§ 826 BGB). The latter rule has been interpreted by case law. Courts require in some cases, for example of consultancy, that the tortfeasor was fully aware of his negligent act. In the common law of England breach of a statutory duty may allow compensation for purely economic losses if the statute breached can be construed as giving an action for damages for the benefit of the injured plaintiff. The normal criteria for the action for breach of statutory duty include the need to prove that Parliament intended to create private rights and that the damage was of the kind that the statute was intended to guard against. In contrast with German law, there is no further requirement for a showing of fault. In sum, compensation for pure economic losses as a consequence of a violation of statutory duties is available in each of the major legal systems (France, Germany, United Kingdom), but the group of plaintiffs who may bring an action for damages may be limited (Germany, United Kingdom).

2. Some illustrative cases of pure financial loss related to wrong expertise

a. The Danish Consul Case

The plaintiff, relied upon a report issued by the defendant to another party (the Danish consul), and issued a loan to a planning developer. The report said that the planning developer rested on a property with a current market value of 20 million DM. The plaintiff that issued a loan acted on the beliefs of the expert that the planning developer would receive planning permission. Planning permission was not granted, the plaintiff had the property auctioned, thereby receiving 1.9 million DM. The plaintiff incurred losses of 7.5 million DM and sued for recovery of this sum.

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6 For example, § 1 UWG which prohibits unfair trade practices (*inter alia* violations of economic statutes, giving an unfair advantage to competitors) is considered a Schutznorm in the relation between competitors, but not between businessmen and consumers. See: Emmerich, V., *Das Recht des unlauteren Wettbewerbs*, München, Beck, 1995, p. 384 and 412-415.

7 „bewußt leichtfertig“
2. The collective group case

An interested party commissioned a report by an expert on the valuation of a property, making it explicitly clear that either he or a collective group of purchasers would purchase the property. The property was purchased by the group of buyers at an inflated price as a result of a valuators report. The report grossly overvalued the property leading to a loss of the purchasers.

3. Takeover Bid

A group of individuals launched a takeover bid on the basis of an auditor’s report that overvalued a firm, failing to take into account various deficiencies in the companies accounts. The report was both publicly available and statutorily required.

4. Overvaluation

A man commissioned a valuator to write a report on the condition and value of his house. The son of the aforementioned man concealed information regarding the condition of the roof in order to use get a better price for the house with help of the report. The house was purchased at an inflated price. The buyer sued the expert for compensation.

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8 see Craig, P.P., cited above note 8, p. 88-89 and van Gerven, cited above note 8, p. 510-511.
3. Overdeterrence, the Case of the Cost Minimizing Firm

Hereinafter we will first analyse how overcompensation (in case of pure financial losses) affects the behaviour of a cost minimising firm.

3.1. Overcompensation under a Precise Standard of Care

In this situation it is quite obvious that overcompensation cannot lead to overdeterrence. If the tortfeasor has to pay damage compensation which is m times higher than the actual damage (m>1) he will nevertheless choose the efficient level of care, if courts use this level of care in setting the legal standard to define negligence. In this case compensation falls to zero as soon as the tortfeasor complies with the legal standard and the costs of reaching the efficient level of care will be the only costs of the tortfeasor. Therefore, if the standard of care is precisely defined and efficient, there is no economic reason to refuse full compensation, including even damages for pure financial losses. Especially there is no reason to restrict compensation to cases of intent or willful behaviour.

3.2. Overcompensation under an Imprecise Standard of Care

The above result is no longer valid, if the standard of care is imprecise. In the following section it is assumed that courts try to find an efficient standard but that due to lack of information they erroneously deviate to either side of the efficient level of care. Therefore the tortfeasor does not know ex ante the due level of care. He knows only a probability distribution. Crasswell and Calfee\(^9\) have shown that it is profitable for a risk neutral tortfeasor to either undercomply or overcomply, if he is informed only about the probability distribution of possible standards of care, from which the courts will choose to determine the legal standard, but does not know \textit{ex ante} the level of care which will actually be required. We will show below that overcompliance is the

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necessary outcome of an imprecise standard, if the overcompensation reaches a certain threshold level.

Let damages (D) be a function of the level of care (x). \( D = D(x) \), with \( D'(x) < 0, \ D''(x) > 0 \). Let prevention costs \( (\alpha x) \) be a linear function of the care level, with the parameter \( \alpha > 0 \). Total costs (C) are then

\[
(1) \quad C = \alpha x + D(x) .
\]

The first order condition for minimizing total costs (Learned Hand formula) is then

\[
(2) \quad D'(x^*) = -\alpha
\]

with \( x^* \) as the socially optimal level of care. Assume now that the due level of care is uncertain and that the tortfeasor knows only the probability with which a court will fix the legal standard. Let \( F(x) \) be the distribution function, \( F \) indicating the probability that the tortfeasor, when choosing a certain level of care (x) is not held liable because the courts will regard this level as sufficient (or more than sufficient). Consequently \( (1-F) \) denotes the probability that at any care level the tortfeasor is held liable. It is further assumed that there are two threshold levels of care \( (x_l, x_h) \). If the tortfeasor chooses a care level lower or equal to \( x_l \) he knows for sure that he will be liable in damages, because the court will regard his behaviour as being below the level of due care. The equivalent holds for \( x_h \), which is so high, that everybody knows that he will not be held liable when reaching this level of care. The optimal level of care is assumed to lie between these threshold values \( (x_l > x^* > x_h) \) and with \( F'(x) \) single peaked, representing one of the usual (bell shaped) density functions.

Consequently we get \( F(x) = 0, \text{ if } x \leq x_l \) and \( F(x) = 1, \text{ if } x \geq x_h \). If \( x_l > x^* > x_h \) we get \( 1 > F > 0 \) with \( F'(x) > 0 \).

Private costs of the tortfeasor (\( C_p \)) are then
\[ C_p = \alpha x + D(x), \text{ if } x \leq x_l \text{ and } \]
\[ C_p = \alpha x, \quad \text{if } x \geq x_h \]
\[ C_p = \alpha x + (1-F(x))D(x), \text{ otherwise, and for the first order condition for the private cost minimum } \]

(3) \[ 0 = C_p'(x) = \alpha + D'(x) - (F'(x)D(x) + D'(x)F(x)) \text{ if } x_h \geq x \geq x_l. \]

This leads to the cost minimising level of care \((x^+)\), provided an interior solution exists. Without an interior solution the cost minimizing level of care would be \(x_h\). The question - already addressed by Crasswell and Calfee (1986) - now arises under which condition this situation of uncertainty leads to a level of care which is higher or lower than the efficient level \((x^*)\). The answer to this question depends on whether at the optimal care level \((x^*)\) the first derivative of the private cost function \(C_p(x^*)\) is lower or higher than zero. The tortfeasor will reach a higher than optimal care level \((x^* < x^+)\), if

\[ 0 > \alpha + D'(x^*) - (F'(x^*)D(x^*) + D'(x^*)F(x^*)). \]

Taking into account that \(F(x^*)\) and \(D(x^*)\) are fixed values and that \(D'(x^*) = -\alpha\), this results in

(4) \[ x^* < x^+ \text{ if } F'(x^*) > F(x^*) \alpha / D(x^*) \]

**Proposition 1:** If at the efficient level of care more care increases the probability that courts accept the acquired standard of care as the level of due care by more (less) than a constant value \((\alpha F(x^*) / D(x^*))\), the tortfeasor has incentives to reach a care level which is higher (lower) than the efficient care level.

We can now extend the analysis to the case of pure financial losses assuming that the social losses are lower than the private costs of possible claimants. It is therefore assumed that their losses are higher than the social losses. Let \(m\) be a multiplier \((m \geq 1)\) whereas \(D\) denotes the total social loss. Then instead of (3) we get

(5) \[ C_p'(x) = 0 = \alpha + mD'(x) - (F'(x)mD(x) + mD'(x)F(x)) \]
Again taking into account that \( D'(x^*) = -\alpha \), the condition for reaching a cost minimizing level of care \((x^+)^*\) which is higher than the efficient level of care is

\[
x^* < x^+ \text{ if } F'(x^*) > \frac{\alpha(F(x^*) - \frac{(m-1)}{m})}{D(x^*)}
\]

Note that (6) reduces to (4), if \( m=1 \). If the bracket term and with it the total value of the right hand side of the inequation becomes zero or negative and as \( F'(x^*) > 0 \) the tortfeasor will always achieve a higher than optimal level of care, if

\[
\frac{(m-1)}{m} \geq F(x^*) \text{ however small the value of } F'(x^*) \text{ is. This expression reduces to}
\]

\[
(1 - F(x^*)) > \frac{1}{m}
\]

i.e. higher than the reciprocal value of the probability of being held liable at the efficiency level of care.

**Proposition 2:** If the due level of care is imprecise ex ante and if courts are expected to deviate at random from the efficient standard of care when fixing the due level of care, and if damage compensation is higher than damages by a multiplier \( m > \frac{1}{1 - F(x^*)} \), a cost minimizing tortfeasor will choose a level of care which is higher than the efficient level of care. The same holds even for a multiplier, which is lower than this threshold value as long as equation (6) holds.

### 3.3. The Economic Rationale for ‘Obvious Negligence’

It is clear from what has been said that an imprecise negligence standard combined with liability for pure financial losses, which are often much higher than total social losses, leads to an inefficiently high care level, if overcompensation is high enough. It therefore serves the efficiency goal, if the legal order restricts compensation to cases, in which the level of due care has been obviously violated. An evident or obvious violation means in terms of the above model that the courts restrict themselves to a lower than usual upper threshold level \( x_{\text{max}} \leq x_h \), and that this restriction becomes known ex-ante to tortfeasors. Obvious liability as defined here thus means, that
at every level of care the tortfeasor knows with higher probability than under normal negligence whether he will be held liable in case of a damage or not. This reduces the adverse effect of overcompensation. Theoretically the courts can restrict themselves to such an extent that the tortfeasor reaches his cost minimum at the optimal level of care.

Assume that in a system of ‘obvious negligence’ the courts keep the lower threshold level \((x_l)\) constant, whereas they reduce the upper threshold level from \(x_h\) to \(x_{\text{max}}\). Assume further that under a system of ‘normal’ negligence the tortfeasor reaches the cost minimum at \(x^+ > x^*\). Then \(x^+\) becomes a function of \(x_{\text{max}}\) if one assumes that the new distribution function takes a higher value than the old one for every \(x\)\(^10\)

\[
(8) \quad x^+ = x^*(x_{\text{max}}) \quad \text{with} \quad dx^+/dx_{\text{max}}>0
\]

Thus if the courts do not include those damage prevention projects into consideration which are costly and not obviously efficient they might be able to find an \(x_{\text{max}}\) with \(x_{\text{max}} < x_l\), which gives incentives to the tortfeasor to choose the efficient level of care, even though he might have to pay an amount of compensation which is substantially higher than the damage caused in case he does not reach the standard. Little can be said from a theoretical point of view as to how much the upper level of due care should be reduced, as this is a matter of experience and practical knowledge. The important point, however, is that in cases of pure financial losses the tortfeasor should know as precisely as possible ex ante whether he violates a standard or not. Such a standard could be termed obvious negligence, evident negligence („Evidenzhaftung“) or gross negligence.

This consideration holds for many torts in the market place, which often result in high individual but small social losses. For those torts a rule of obvious negligence is more efficient than an ordinary rule. An alternative to avoid overdeterrence would be a very precise definition of the standard of due care for torts in the marketplace.

\(^{10}\) We get now 2 distribution functions, \(F_1\), which runs from \(x_l\) to \(x_h\) and \(F_2\) which runs from \(x_l\) to \(x_{\text{max}}\). The sufficient condition for \(dx^+/dx_{\text{max}}>0\) is that \(F_2 > F_1\) for every \(x\) and that \(F_2(x-x_l)=F_1(x_h-x_l)^*(x-x_l)/(x_{\text{max}}-x_l)\).
Note that this is not the end of the story. The situation again changes, if one asks under which conditions contract law should be applied to solve the cases. It is shown that in the illustrative cases there is a rationale to use contract law and consequently negligence (not gross negligence) as a legal rule.