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# Navigating through the Murky Waters of the Economic Loss Rule in Law of Torts

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*The Economic Loss Rule, which precludes recovery of 'purely economic losses' has been a contentious doctrine within Tort Law. This paper examines the concept using examples and case laws. It also delves into the challenges and nuances in determining its applicability. It analyses landmark English and American judgements, discussing how they shaped this doctrine. Through analysis and critique, it aims to offer a comprehensive understanding of the Economic Loss Rule in the Law of Torts. Many case laws have cited reasons such as the damage being too remote or a lack of proximity as the basis of rejecting claims seeking recovery of such losses. However, the judgment in Spartan Steel & Alloys Ltd v Martin and Co. by Lord Denning provided a paradigm shift, by emphasizing that economic losses should be non-recoverable, not due to issues of proximity or remoteness, but as a matter of policy. Furthermore, universal adoption of the principle in the judgment, which provides that only economic losses directly linked to tangible harm are compensable, while purely economic losses remain non-recoverable, would enhance consistency and equity in the application of this rule. Additionally, the paper explores various theories that attempt to explain the purpose and significance of this rule.*

**Keywords:** *economic loss rule, recovery of pure economic loss, compensation in negligence claims.*

## INTRODUCTION

At its core, the economic loss rule entails that when the Plaintiff brings an action under tort law, especially an action for negligence, seeking compensation for 'purely economic loss' and is not able to connect such loss to any tangible bodily injury or property damage caused as a result of the acts of the Defendant, her action would not be maintainable.

'Connect' is the operative word here. If the Plaintiff is not able to demonstrate a direct nexus between the physical injury or property damage and the economic loss suffered by her, the Plaintiff's claim typically would not be successful. Some types of cases where the loss sustained by the Plaintiff is considered to be of a 'pure economic nature' are:

**Defective Products:** Cases such as *Donoghue v Stevenson*[1] where the Plaintiff suffered personal harm due to the negligent conduct of the manufacturer are textbook examples of negligence. However, defective products may be the cause of purely economic losses without any tangible harm to a person or property. For instance, in *East River Steam Ship Corp. v Transamerica Delaval*[2], the Plaintiff, a shipping company, incurred a loss of around eight million dollars due to the income lost when the ship manufactured by the Defendants had to go out of service for repairs due to some defects in the ship. The Court unanimously ruled that an action in tort was not maintainable and that the remedy for such losses largely lies in contract.

**Transferred Losses:** These are cases where a tangible injury may have been caused, but the Plaintiff is not suing for that tangible injury. One of the earliest case laws dealing with the economic loss rule was under this category. In *Connecticut Mutual Life Insurance Co. v New York & New Haven Railway*[3] where the insurance company brought a claim against the railways for recovery of the sum it had to pay to the deceased's family whose death was allegedly caused due to the negligence of the railways. However, it was held that the railway owed no duty to the Insurance Company and the Court observed that if such claims were allowed, it would invite voluminous litigation. Similarly, in *Allegheny General Hospital v Philip Morris,*[4] the hospital

[1] *Donoghue v Stevenson* [1932] SC (HL) 31
[2] *East River Steam Ship Corp. v Transamerica Delaval* [1986] 476 US 858
[3] *Connecticut Mutual Life Insurance Co. v New York & New Haven Railway* [1856] 25 Conn 265
[4] *Allegheny General Hospital v Philip Morris* [2000] 228 F.3d 429

brought an action against the Tobacco Company Philip Morris for recovering expenditure incurred in treating patients of cigarette-linked illnesses. Although tangible bodily harm had been caused to the patients due to the use of cigarettes manufactured by the Defendants, the economic loss caused to the Plaintiff was not a direct consequence of the act of the Defendant. The action was not brought due to the harm caused to the patients, rather it sought compensation for economic loss suffered by the Plaintiff in treating the illness of the patients. The Court applied the economic loss rule and held that the Plaintiff lacked standing.

**Spoliation of Evidence:** Sometimes spoilation of evidence by Defendant, who was supposed to preserve such evidence, can cause economic loss to Plaintiff, who could have used that evidence to get damages or other form of pecuniary benefit in some action. However, in *Coprich v Superior Court,*[5] it was held that such claims were not maintainable under tort law; the only remedy available is such cases would have been under contract law if there was an agreement between the Plaintiff and the Defendant to the effect that the Defendant would preserve such evidence.

**The Curious Case of Defamation:** Since, to prima facie prove defamation, the Plaintiff must show fault on the part of the Tortfeasor, amounting to at least negligence, situations somewhat similar to the above cases where the Plaintiff suffered 'mere economic loss' may arise in actions for defamation.

For example, B, the Tortfeasor, spreads the word that A, a shopkeeper shortchanges his customers. Due to B's statement, many customers stopped making purchases from A's store, which caused A to suffer economic loss. In such a case the loss suffered by A is practically of pure economic nature. However, interestingly, if A is able to establish all the other three elements of negligence, i.e. false statement, communication to third party, and harm to Plaintiff's reputation, then A's action against B for defamation would be successful. The reason why the Economic Loss Rule would not preclude the Courts from holding B liable in the present example is that, unlike most other torts, in defamation claims, the Plaintiff must not necessarily establish that the Defendant's slanderous remarks had any physical impact, resulted in any damage to

[5] *Coprich v Superior Court* [2000] 95 Cal. Rptr. 2d 884

tangible property, or were made intentionally. In *Time Inc. v Firestone*[6], it was held that sheer emotional or dignitary injury could be a cause of action for defamation claims.

## ORIGIN AND EVOLUTION OF THE ECONOMIC LOSS RULE

Some scholars have suggested that the roots of this doctrine go back to the late nineteenth and early twentieth century when injured Plaintiffs who were denied relief under contract law turned to the law of torts seeking alternate avenues of compensation.[7] This created a judicial chasm regarding the recoverability of purely economic losses under tort law, as economic interests are not something tort law has conventionally protected.

There appears to be a consensus amongst most case laws that such claims should not be maintainable under the law of tort; though the reasons attributed for substantiating the verdict differed. Early English case laws rejected such claims on the ground that Defendant did not owe a duty of care to Plaintiff (the test of proximity)[8], or that the causation was too remote[9]. Most American Case Laws also reasoned along similar lines, but also recognised that allowing such claims under Tort Low would result in 'mass litigation' or 'limitless liability'.

For instance, in the case of *Ultramares Corp. v Touche, Niven & Co.*[10] before the New York Court of Appeals, an accountant had negligently prepared a financial statement for one of his clients. This caused financial loss to a third party who relied on the accuracy of the financial statement prepared by the account. The accountant was sued by a third party for negligence. The Court held that an accountant did not have any 'duty of care' to third parties, and thus cannot be held liable for negligently causing economic injury. It was further observed that the recognition of duty of care towards third parties would open the floodgates to mass litigation, and would inevitably expose the accountant to indeterminate liability.

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[6] *Time Inc. v Firestone* (1976) 424 US 448
[7] Sidney R. Barrett Jr, 'Recovery of Economic Loss in Tort for Construction Defects' (1989) 40(4) South Carolina Law Review <https://scholarcommons.sc.edu/sclr/vol40/iss4/5/> accessed 07 May 2024
[8] *Elliot Steam Tug Co. Ltd v Shipping Controller* [1922] 1 KB 127
[9] *King v Phillips* [1953] 1 QB 429
[10] *Ultramares Corp. v Touche, Niven & Co* [1931] 255 NY 170

In the case of *Stevenson v East Ohio Gas Co.*[11] before the Ohio Court of Appeals, the Defendant's negligence resulted in an explosion, which in turn destroyed the factory where the Plaintiff used to work. Due to the destruction of the factory, the Plaintiff lost his job and sued the Defendant for damages. The Court, however, held that the Plaintiff did not have a sufficient cause of action, not because the causation was 'too remote'; but rather because the Court was apprehensive that if a worker could sue for lost wages, so could the power company, sellers of the factory's products, the neighbourhood restaurant that relied on the trade of the factory employees, and so on.

On the other hand, many case laws have misinterpreted the doctrine of no recovery of purely economic losses. In *Morrison Steamship Co. Ltd. v Greystoke (Cargo Owners)*[12], an English case where one ship negligently collided with another ship, resultantly, the cargo had to be unloaded and reloaded, the cost of which was borne by the cargo owners. The cargo owners sued the company that owned the negligent ship for damages. Their initial suit was unsuccessful; however, the appeal was allowed and the Court held that the damage caused was reasonably foreseeable and thus the Defendants could be held liable.

In another English case, *Hedley Byrne & Co. Ltd v Heller & Partners Ltd.*[13], where the question for consideration before the Court was whether claims for recovery of pure economic loss caused due to negligent advice of experts were maintainable. It was held that economic loss could be recovered if the expert owed a duty of care to the Plaintiff.

In *Coburn v Lenox Homes, Inc.*[14], an American case, the Court held that, *inter alia*, a builder-vendor should be held liable in negligence for foreseeable damage arising out of a defectively constructed house.

These decisions roiled the already murky waters of the doctrine, spawning a host of veritable questions. On what grounds are purely economic losses not recoverable under tort law? Are the grounds of lack of proximity, remoteness of causation, etc. justifiable grounds for denying

[11] *Stevenson v East Ohio Gas Co.* [1946] 73 NE 2d 200
[12] *Morrison Steamship Co. Ltd. v Greystoke (Cargo Owners)* [1946] 80 Ll.L.Rep. 55
[13] *Hedley Byrne & Co. Ltd v Heller & Partners Ltd.* [1963] 2 All ER 575
[14] *Coburn v Lenox Homes, Inc.* [1977] 173 Conn 567

recovery of economic losses under tort law, or are economic losses inherently not recoverable under tort law? To what extent can economic losses be recovered under tort law when accompanied by tangible harm to a person or property?

Many of these questions have been answered by Lord Denning, in the case of *Spartan Steel & Alloys Ltd v Martin & Co.*[15] In this case, the Plaintiff company ran a steel factory. The Defendant contractor while doing some construction work, damaged the cable through which the power was supplied to the Plaintiff. This resulted in a blackout and caused tangible physical damage to the factory's machinery and metal, loss of profit on the discarded metal, and loss of profits on the metal that could not be machined and sold. The Plaintiff initiated an action for negligence seeking recovery of damages under all the above three heads. The Court held that Plaintiff was only entitled to the tangible damage to the machinery and the profit lost on discarded metal, as the profits lost on the metal that could not be machined and sold were not recoverable. The Court distinguished between damage and lost profit 'directly consequential' upon damage and 'pure economic loss'.

The rationale given in the judgment authored by Lord Denning is that pure economic loss should not be recoverable 'as a matter of policy' and the 'elusive' tests of duty of care and remoteness of damage for such cases should be discarded. The Spartan Judgement[16] admirably brings clarity to the murky waters of the economic loss rule, in two aspects.

Firstly, it clarified that economic losses were not recoverable under tort law, not because they failed the test of proximity or because the damage caused in such cases was too remote, etc., but rather because such cases should not be entertained under tort law 'as a matter of policy' without going into the question of proximity and remoteness.

Lord Denning's reasoning highlighted that the traditional tort concepts of remoteness or duty of care, which served as the basis for denying or allowing recovery of economic losses in earlier judgements, may be effective in addressing other tort actions for physical harm or property damage, but these concepts fail to mark definitive boundaries for economic loss claims.

[15] *Spartan Steel & Alloys Ltd v Martin & Co.* [1973] QB 27
[16] *Ibid*

Secondly, and more importantly, the judgement gave much-needed clarity regarding the extent of economic losses recoverable when accompanied by tangible damage to person or property, by distinguishing between 'economic losses directly consequential upon damage' and 'purely economic losses'. The former is recoverable, while the latter is not.

Even after the Spartan Judgement, the American Case Laws have misinterpreted this aspect of the economic loss rule, or have given it an overly lenient interpretation, to say the least. In *Neumann v Bishop*[17], purely economic losses such as lost profits were held to be recoverable under general damages for negligence. Although the Spartan Judgement[18] being an English case law holds no authoritative value in the United States, it nonetheless holds tremendous persuasive value, and ought to have been considered by the American Courts.

The ramifications of this misinterpretation become glaringly evident when examining a scenario presented in a scholarly paper.[19] The author uses a hypothetical example of a case where a negligently maintained telephone pole fell on the little finger of the Plaintiff, thereby physically disabling him from sending a fax transmission authorising a transaction that would have made him earn $2 million. She then compares this situation to another example where the negligently maintained pole did not result in any physical damage to the Plaintiff, but caused an interruption of communication, thereby causing a loss of $2 million to the Plaintiff. As per the principle in *Neumann v Bishop*[20], in the former example, the loss of $2 million to the Plaintiff was compensable under an action for negligence as it was accompanied by tangible physical injury, whereas, in the second example, although the Plaintiff suffered a loss of similar nature, he would not be awarded any compensation as he suffered purely economic loss.

This intriguing example makes one question the very basic premise of the economic loss rule. However, had the American Courts adopted the principle by Lord Denning in the Spartan Judgement[21], the outcome in the first example, would have seemed much more equitable as the

[17] *Neumann v Bishop* (1976) 59 Cal App 3d 451
[18] *Spartan Steel & Alloys Ltd v Martin & Co.* [1973] QB 27
[19] Eileen Silverstein, 'On Recovery in Tort for Pure Economic Loss' (1999) 32 <https://core.ac.uk/download/pdf/232707699.pdf> accessed 15 June 2024
[20] *Neumann v Bishop* (1976) 59 Cal App 3d 451
[21] *Spartan Steel & Alloys Ltd v Martin & Co.* [1973] QB 27

Plaintiff would not have been compensated for the $2 million because it would still have been considered as 'pure economic loss', and she would only be awarded damages for medical treatment of her injured finger, deemed 'consequential'.

Thus, the proposition that the economic loss rule mandates that large sums of compensation can be awarded for the remotest causation even if there was the slightest tangible harm to a person or property, is flawed. What the doctrine truly envisages is that the Plaintiff is only entitled to be compensated for those economic losses which are directly connected to the tangible harm to the person or property. This is because the Law of Torts imposes duties *in rem*, towards persons generally; and imposing a general duty not to cause financial harm to anyone is vague and impractical, given the impossibility of foreseeing all economic consequences of one's actions.

## PURPOSE AND SIGNIFICANCE OF THE ECONOMIC LOSS RULE

**Flood Gates Thesis:** At this point, one might wonder why are the Courts reluctant to entertain claims for recovery of purely economic losses under Tort Law. In the case laws discussed so far, we have seen that this reluctance stems from the fear of 'mass litigation' and 'limitless liability'. Some authors have termed it the 'floodgates thesis'[22] as it was believed that such limitless liability would open the floodgates to mass litigation.[23] Allowing claims for recovery of purely economic losses would expose the Defendants to limitless liability as it is virtually impossible to verify whether the Plaintiff suffered any economic loss, or whether or not she took measures to mitigate the losses. This unlimited liability and mass litigation would both burden the judicial system and make liability for commercial activities unpredictable.

**Boundary Line Thesis:** This theory argues that the Economic Loss Rule serves as the boundary line between Tort Law and Contract Law, thereby, preventing Plaintiffs from seeking larger sums of compensation than what would otherwise have been available under agreed-upon terms of contract or other remedies. This theory is based on the concept of private ordering, which strives to preserve the priority of other areas of the law like contract law over tort law

[22] Anita Bernstein, 'Keep it Simple: An Explanation to the Rule of no Recovery of Pure Economic Loss' (2006) 48(773) Arizona Law Review <https://arizonalawreview.org/pdf/48-4/48arizlrev773.pdf> accessed 05 May 2024
[23] Robert L. Rabin, 'Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment' (1985) 37(6) Stanford Law Review <https://doi.org/10.2307/1228639> accessed 05 May 2024

which are deemed to be superior to torts. In other words, it entails that responsibility emanating from a contract is a more concrete one than the concept of negligence and thus, Defendant must face no liability when Plaintiff could have allocated the loss in advance by contract.[24]

**Simplicity Thesis:** This theory posits that connecting liability to simplicity is integral to any law. Thus, since tort law applies universally over parties not bound by voluntary agreements, doctrines in tort law must rest on principles that are intelligible to the layperson. However, the peculiar cases where the Plaintiff brings an action for negligence, admitting that the Defendants intended them no harm nor have they violated any express promise, but nonetheless the Plaintiff wants them to compensate for the economic loss she suffered, are more nuanced. A higher level of understanding and cognition is a prerequisite for fully understanding the complexities of these abstract injuries.[25] In the United States, the role of the Civil Jury has been crucial when it comes to Tort Litigation.[2627] Trial by jury is a central feature of the Constitution of the United States.[2829] However, American Civil Juries are notorious for their incompetence.[30] Thus, the proponents of the simplicity thesis argue that another reason why claims for compensation for purely economic loss, are not maintainable under tort law might be the inability of a layperson (who may also be the one serving as the juror) to grasp the invisible damage caused in such cases.[31]

## CONCLUSION

While navigating through the murky waters of the economic loss rule, this paper has discussed how the doctrine provides definitive boundaries to liability under tort law and serves the

[24] Vincent R. Johnson, 'The Boundary-Line Function of the Economic Loss Rule' (2009) 66(2) Washington and Lee Law Review <https://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=1054&context=wlulr> accessed 05 May 2024
[25] Bernstein (n 22)
[26] Michael D. Green 'The Impact of the Civil Jury on American Tort Law' (2011) 38(2) Pepperdine Law Review <https://digitalcommons.pepperdine.edu/cgi/viewcontent.cgi?article=1011&context=plr> accessed 05 May 2024
[27] Shari Seidman Diamond and Jessica M Salerno 'Empirical Analysis of Juries in Tort Cases' (2012) Research Handbook on the Economics of Torts <http://surl.li/uncom> accessed accessed 05 May 2024
[28] Constitution of the United States 1789, art III(2)
[29] *Duncan v Louisiana* (1968) 391 US 145
[30] Valerie P Hans, 'Empowering the Active Jury: A Genuine Tort Reform' (2008) 13(1) Roger Williams University Law Review <https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1379&context=facpub> accessed 05 May 2024
[31] Bernstein (n 22)

important function of keeping the floodgates closed. It also promotes a system of private ordering, which encourages parties having commercial relations to form a mutual agreement and avail remedy under contract law, or remedies available under other areas of law, rather than bringing an action under tort. However, in recent years, the traditional boundaries of the Economic Loss Rule have become increasingly blurred as the Courts have been reluctant to apply this rule to product liability claims.[32] [33] The adoption of the framework established by Lord Denning in the Spartan Judgement[34] by other jurisdictions would be a more pragmatic approach as it obliterates the concerns of arbitrariness and impracticality, yet provides a clear framework that will be effective in keeping the floodgates closed. Rather than exempting the application of this rule to an entire class of cases, it is desirable that as a general rule losses of a purely economic nature should not be made recoverable, while consequential economic losses should be compensable.

[32] *Murphy v Brentwood District Council* [1991] 1 AC 398
[33] *Seely v White Motor Co.* [1965] 63 Cal 2d 9
[34] *Spartan Steel & Alloys Ltd v Martin & Co.* [1973] QB 27