LIABILITY FOR NEGLIGENTLY PERFORMED FINANCIAL SERVICES: AN ECONOMIC THEORY

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I Introduction

The law governing the recovery of negligently inflicted pure economic losses is complex and confusing.[1] The judicial inclination is typically to restrict liability, but the traditional legal analysis is neither consistent nor convincing. In this article I focus on pure economic losses caused by negligently performed financial services,[2] and consider whether a "law

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1 A *pure economic loss* is a financial loss suffered by a person in the absence of any injury to her person or to her property. There are many articles which canvas this area of the law. See for example, Karen M Hogg "Negligence and Economic Loss in England, Australia, Canada and New Zealand" (1994) 23 International and Comparative LQ 116; B S Markesinis and Simon Deakin "The Random Element of their Lordships' Infallible Judgment: An Economic and Comparative Analysis of the Tort of Negligence from *Anns* to *Murphy*" (1992) 55 MLR 619; Jane Stapleton "Duty of Care and Economic Loss: A Wider Agenda" (1991) 107 LQR 249; Ann O'Brien "Limited Recovery Rule as a Dam: Preventing a Flood of Litigation for Negligent Infliction of Pure Economic Loss" (1989) 31 Ariz L Rev 959; William Tetley "Damages and Economic Loss in Marine Collision: Controlling the Floodgates" (1991) 22 J Mar L and Com 539; Daniel Jutras "Civil Law and Pure Economic Loss: What are We Missing?" (1986-87) 12 CBLJ 295; and P S Atiyah "Negligence and Economic Loss" (1967) 83 LQR 248. See also Bruce Feldthusen *Economic Negligence* (3 ed, Carswell, Scarborough, 1994).

2 Different economic considerations apply to different types of economic loss cases. Other typical settings for pure economic losses are certain public authority cases (eg a public authority may carelessly certify a bank that later collapses), relational economic losses caused by damage to the property of a third party (eg a ditch digger may sever a power cable belonging to an electricity supply authority and cause a factory to shut down for a number of hours) and quality defect cases where a chattel or building is less valuable than anticipated. In all these areas, the fact that the loss suffered was purely economic is typically treated by courts as a factor counting against the imposition of liability.

and economics" approach provides a superior framework for analysing the desirability of imposing negligence liability than that provided by traditional legal analysis.[3]

Part II of this article briefly discusses the law regarding negligently performed financial services and critiques the legal reasoning used to justify restricted liability. Part III introduces the law and economics approach to negligence liability. The special considerations which apply when a loss is purely economic and caused by a carelessly performed financial service are analysed in Part IV. In Part V a rule of recovery based on the economic analysis is presented and its application is discussed with respect to some of the leading cases. My overall conclusions are that the economic approach provides a powerful set of tools capable of explaining the major decisions in this area in terms of economic efficiency and wealth maximisation, and that this explanation is more convincing than the traditional legal analysis used in the cases themselves.

II The Legal Approach to Negligently Performed Fianncial Services

Financial services are intended to facilitate the organisation of the financial affairs of a person or company, and are typically performed for the purpose of acquiring, transferring or protecting income flows.[4] If a financial service is performed negligently an income flow may be misdirected causing a financial loss to the immediate requestor of the service (eg if the requestor invests in an ailing company on the basis of an erroneously positive credit report) and/or third parties (eg an intended beneficiary will suffer a financial loss if she is excluded from a will due to a solicitor's negligence). The law distinguishes between these two groups of claimants.

With respect to the requestor of the service, it is well established that by undertaking to perform a financial service the provider assumes responsibility for its diligent performance

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3 This article therefore attempts to address the need, remarked upon by a number of judges, for an economic analysis of the merits of competing rules of recovery. For example, in *Williams v Attorney-General* [1990] 1 NZLR 646, 681 Richardson J noted that the court was "not referred to any economics and law analyses of the potential effects on behaviour in cost benefit terms of imposing a duty of care" and suggested that "the Court should be furnished with arguments and available analytical materials so that proposed policy alternatives are considered in an informed way rather than resting on instinctive responses supported by generalized reasons." See also *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd* [1992] 2 NZLR 282, 305 (per Richardson J); *Day v Mead* [1987] 2 NZLR 431, 458 (per Somers J); *Canadian National Railway Co v Norsk Pacific Steamship Co ("Jervis Crown")* (1992) 91 DLR (4th) 289, 360 (per McLachlin J); and *Morgan Crucible Co Plc v Hill Samuel Bank Ltd* [1990] 3 All ER 330, 335 (per Hoffman J); over-ruled [1991] 1 All ER 148 (CA).

4 The following are all examples of financial services: the supply of a credit worthiness report by an auditor or a bank, a will prepared by a solicitor, the valuation of a property by a surveyor and the provision of insurance.

and therefore owes a duty to take reasonable care to avoid causing economic (as well as physical) losses.[5]

A different approach is apparent where the injured party is someone other than the immediate requestor of the service. With respect to these "third party claims", the fact that the loss is purely economic becomes a reason for restricting liability. For example, in the context of an auditor's liability to third parties relying on audited financial statements, Lord Bridge in *Caparo Industries plc v Dickman* stated that:[6]

> One of the most important distinctions always to be observed lies in the law's essentially different approach to the different kinds of damage which one party may have suffered in consequence of the acts or omissions of another. It is one thing to owe a duty of care to avoid causing injury to the person or property of others. It is quite another to avoid causing others to suffer purely economic loss.

The usual reason given for limiting liability to third parties is the fear that the extent of liability may be disproportionate to the defendant's degree of fault and would dissuade her from engaging in useful economic activity.[7] However, this reasoning does not seem to bear up to even a cursory analysis. First, it seems counter-intuitive that immunity should be available *because* the loss may be very large — normally our response would be that this is a reason pointing to the importance of imposing liability.[8] If liability discourages economic activity, it maybe because that activity is not desirable, at least unless a high level of care is taken. Secondly, although the scope of liability for economic loss can be huge, in many cases the potential liability is obvious and easily quantified yet liability is still denied. And thirdly, why does this rationale result in such a stark distinction being drawn between claims by the requestor of the service and claims by third parties?

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5 See *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, 502-503, 526, 528-529 and 531-532; *Allied Finance and Investments Ltd v Haddow & Co* [1983] NZLR 22; *Day v Mead*, above n 3; and *Henderson v Merrett Syndicates Ltd* [1994] 3 WLR 761, 773-777.

6 *Caparo Industries plc v Dickman* [1990] 2 AC 605, 618.

7 This was most famously articulated by Cardozo CJ in *Ultramares Corp v Touche* (1931) 255 NY 170, 179; 174 NE 441, 444 as the risk of exposing defendants to "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." Similarly Lord Oliver in *Caparo*, above n 6, 632-633 noted that:

"The opportunities for the infliction of pecuniary loss from the imperfect performance of everyday tasks on the proper performance of which people rely for regulating their affairs are illimitable and the effects are far reaching. A defective bottle of ginger beer may injure a single consumer but the damage stops there. A single statement may be repeated endlessly with or without the permission of its author and may be relied on in a different way by many different people."

8 See W Bishop "Economic Loss in Tort" (1982) 2 Oxford J of Legal Stud 1, 1-3; and *Scott Group Ltd v McFarlane* [1978] 1 NZLR 553, 572 (per Woodhouse J).

Given the inconsistencies in the underlying rationale for limiting liability to third parties, it is perhaps not surprising that there is no generally accepted liability test.[9] In some cases, the pure economic loss distinction has been all but eliminated and liability predicated on the loss being reasonably foreseeable.[10] Looking at the cases where the distinction has been invoked, a variety of approaches are apparent. Sometimes the question asked is whether the plaintiff assumed responsibility for the loss suffered.[11] In other cases, the court has stated that liability will only be imposed where "the third party's reliance was the very purpose of the transaction."[12] In recent pure economic loss cases the nature of the loss has tended not to be central to the inquiry, but merely a factor telling against the imposition of the duty,[13] and not a sufficient reason to prevent the imposition of a duty where "practical justice" requires a remedy.[14]

In these cases traditional legal reasoning is unable to offer a coherent explanation of whether, and how, liability should be limited. In the remainder of this article I present an economic analysis of financial service cases and consider whether this approach provides a better explanatory theory.

III The Economic Approach to Negligence Liability

The law and economics approach analyses legal doctrine from an efficiency perspective. In the context of negligence liability the goal is to create incentives that will minimise the total cost of accidents to society. This cost includes both the cost of any precautions taken and the cost of any accidents that still occur. Cost minimisation will occur if potential

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9 The sentiments that "the courts rely on an array of distinctions whose plausibility and cogency are profoundly suspect" (see A C Hutchinson and R Maisey "Blurred Visions: The Politics of Civil Obligation" in Ken Cooper-Stephenson and Elaine Gibson (eds) *Tort Theory* (Captus University Press, 1993) 276, 290) and that within this body of cases "support can be found for almost any position whatsoever" (R Soloman and B Feldthusen "Recovery for Pure Economic Loss: The Exclusionary Rule" in Klar (ed) *Studies in Canadian Tort Law* (Butterworths, Toronto, 1977) 167, 173) are entirely appropriate to this subset of pure economic loss cases. See also W Bishop "Negligent Misrepresentation through Economists' Eyes" (1980) 96 LQR 360, 360-362; and Bishop (1982), above n 8, 1.

10 See for example *Scott Group*, above n 8, 574-576 (per Woodhouse J) and 583 (per Cooke J); *H. Rosenblum Inc v Adler* 461 A2d 138 (NJ 1983); *Citizens State Bank v Timm, Schmidt & Co* (1983) 355 NW2d 361 (Wiss); and *Touche Ross & Co v Commercial Union Ins Co* (1987) 514 So2d 315 (Miss).

11 See *Hedley Byrne*, above n 5.

12 See for example *Caparo*, above n 6; *Credit Alliance Corp v Arthur Anderson & Co* 483 NE2d 110 (NY 1985); and *Raritan River Steel Co v Cherry, Bekaert & Holland* (1988) 367 SE2d 609 (NC).

13 *South Pacific*, above n 3, 294 (per Cooke P). Also, in both *Deloitte Haskins and Sells v National Mutual Life Nominees Ltd* [1993] 3 WLR 347 and *Downsview Nominees Ltd v First City Corporation Ltd* [1993] 1 NZLR 513 the Privy Council paid little attention to the fact that the loss was purely economic.

14 *White v Jones* [1995] 2 WLR 187, 204 (per Lord Goff).

accident creators take those precautions that reduce expected accident losses by more than the cost of the precautions.[15]

Example A

This theory can be demonstrated by a simple example. Suppose that Piper is laying a water main on her land and that there is a risk that it will leak and flood her neighbour, Drenched. If the water main leaks then losses of $1,000 are caused. There are three levels of care which Piper can take to reduce the chance of the water main leaking. The following table shows the costs of each level of care, the corresponding probabilities of the water main leaking, the expected accident costs and the expected total costs.

Table 1

Level of care	Cost of care	Accident probability	Expected accident losses	Expected total cost
none	$0	20%	(20% x $1,000)=$200	$200
moderate	$50	10%	(10% x $1,000)=$100	$150
high	$300	0%	(0% x $1,000)=$0	$300

The optimal level of care is that which minimises the expected total cost of laying the water main. It can be seen from Table 1 that in this case the moderate care level is socially optimal. If costless bargaining occurred between the parties they would agree to this level of care.[16] However, the existence of transaction costs (such as the remoteness of the parties, the number of parties involved, the willingness of the parties to bargain and imperfect knowledge) often prevents optimal contracting and creates a role for negligence liability as a surrogate for voluntary exchanges. If courts set due care (ie the level of care that must be

15 See generally Steven Shavell *Economic Analysis of Accident Law* (Harvard University Press, Cambridge, 1987), 6-9; William M Landes and Richard A Posner *The Economic Structure of Tort Law* (Harvard University Press, Cambridge, 1987), 85-88; and Richard A Posner *Economic Analysis of Law* (4 ed, Little Brown, Boston, 1992), 163-168. The analysis in this article is restricted to the negligence standard of liability. In particular, the possibility of strict liability is not considered. Under the economic theory, both these regimes ensure that optimal care is taken by potential injurers, but they differ with respect to (1) the activity levels of the potential injurers, (2) the care and activity levels of potential victims, and (3) administrative costs. Accounts of these differences can be found in Shavell (1987), 5-46; and Landes and Posner (1987), 54-84.

16 In the absence of liability Drenched would be willing to pay Piper up to $100 for her to take moderate care rather than no care. The cost of moderate care is only $50, so the parties will contract for Piper to take moderate care for a price between $50 and $100 (the exact price will be determined by bargaining between the Piper and Drenched). The parties will not contract for high care because Drenched will not pay more than the reduction in accident costs ($200), which is less that the cost of high care ($300).

taken for accident causers to avoid liability) at the theoretically optimal level and correctly determine the level of care actually taken, then negligence liability will induce potential accident causers to take the optimal level of care.[17] In Example A, if a court sets the level of due care at moderate care, then Piper will be induced to behave optimally. She will evaluate the costs that she will face for each prospective level of care. If she takes no care she will be liable for any losses she causes with an expected cost to her of $200. If she takes moderate care she will spend $50 on precautions and escape liability for any losses because she has taken due care. The water main may still leak, but if it does then the cost will be borne by Drenched. Therefore Piper's total cost will be $50. If she takes high care she will be spending $300 on precautions. The extra $250 spent on precautions above the moderate care level does not benefit Piper as she is not liable for any losses either way. Given these choices Piper will chose moderate care, which is optimal.

IV The Economic Approach to Negligently Performed Financial Services

A The desirability of liability for negligently performed financial services

Determining the desirability of liability for professional financial services is more complicated than determining the desirability of liability in the simple example just discussed. There are three main arguments against imposing liability. First, since many financial services merely channel income flows, it may be argued that net wealth in society is not affected by the level of care taken. That is, even if the service provider is negligent, nothing is damaged or destroyed; money is merely channeled. Judicial resources should therefore not be wasted in ensuring that reasonable care is taken. Secondly, many financial services result in a significant benefit for which the producer is unable to charge. In these circumstances, if liability is imposed, the producer will face the full social cost of her services but will be unable to appropriate the full social benefit. The provision of the service will therefore be sub-optimal. Finally, the administrative costs of negligence liability may outweigh the benefits of liability. I will examine these arguments in turn.

B The social cost of negligently performed financial services

Often the aim of a financial service is to create or prevent an income transfer in order to acquire a financial advantage that would otherwise accrue to another party. Resources are therefore spent on an activity that *does not increase the net level of wealth in society*. If a lack of care simply means that wealth is not distributed in the intended manner, then it may be argued that, unlike damage to physical property (such as the flooded land in Example A),

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17 For discussions of this proposition and mathematical proofs see Landes and Posner (1987), above n 15, 29-83; and Shavell (1987), above n 15, 5-72.

there is no social cost associated with negligent performance and therefore it is inefficient to impose liability.[18] Consider the following example:

Example B

Suppose that an investor is considering loaning $100,000 to the Acme Company. The investor requests the Acme Company to arrange for a credit reference to be supplied by its bank. The cost of the bank performing a thorough credit check is $1,000 and the cost of a less thorough check is $500. The expensive check is always accurate. The cheaper check, however, will fail to detect the existence of severe financial problems in 20% of the cases where those problems exist. There is a 10% chance that the Acme Company is in fact in severe financial trouble. The investor will only lend the money if a credit check is performed and is favourable. The probability of a loan being made is therefore 90% in the case of high care, and 92% in the case of low care since 2% of the time the credit check will be favorable even though the Company is in financial trouble (ie 10% x 20%). If the loan is made and the Acme Company is viable then there is a benefit to society of $20,000 from the investment (for simplicity we will assume that the whole benefit is taken by the investor). If the loan is made and the Acme Company is in financial trouble none of the money will be repaid, instead it will go to pay some of Acme's current debts.

Table 2

Level of care	Cost of care	Probability of the loan being made	Expected gain to investor	Expected gain to other creditors	Expected social welfare
low	$500	90% + 20%x10% =92%	(90%x$20,000) - (2%x$100,000) = $16,000	2%x$100,000 = $2,000	$18,000 - $500 = $17,500

18 The idea that there is no immediate social cost associated with many financial losses will be foreign to many lawyers. It is important to remember that law and economics is concerned with the *net cost to society* of a particular transaction or accident. That is, a distinction is drawn between the loss of real societal resources and mere transfers from one economic actor to another. The economic analysis of laws against theft is illustrative. Theft, of a car for example, is not a cost to society per se — it is a mere transfer of wealth from the owner to the thief. The economic explanation for the illegality of such forced transfers is that if they were legal, societal resources would be wasted on owners' efforts to protect their resources and thieves' efforts to thwart that protection. See Posner (1992), above n 15, 208. This argument is not applicable to all categories of pure economic loss cases and therefore illustrates the importance of a disaggregated analysis (see above n 2).

high	$1000	90%	90%x$20,000 = $18,000	0	$18,000 - $1,000 = $17,000

It is clear from Table 2 that it is mutually beneficial for the investor and the bank if the bank takes the high level of care. This results in an increase in the expected gain to the investor of $2,000 ($18,000 - $16,000) at a cost to the bank of an extra $500. But it appears that the taking of care is not optimal from society's point of view. The extra care is a cost to society with no corresponding gain because the collapse of the company does not make the money disappear — it is simply transferred to the lucky creditors. Therefore, at least at first glance, there is no net social cost associated with the pure economic loss and imposing liability upon the careless auditor would be a waste of society's resources.

However, even if a service merely influences income flows, imposing liability may still produce indirect social benefits. First, a by-product of some financial services may be an improved allocation of scarce resources. Like many financial services, the bank's credit reference in Example B benefits society by promoting the efficient allocation of society's resources. The private incentives to move the economy closer to equilibrium are part of the "invisible hand" of resource allocation.[19] Ensuring that the auditor takes reasonable care will improve the resource allocation decisions of investors which is an indirect (and hard to measure) benefit to society.

Secondly, even if we think it is socially optimal for less care to be taken than the parties would choose, not imposing liability may be futile, or even more costly, because the parties will seek the same result through other means.[20] This is because the actions of an individual are governed by the *individual* costs and benefits she faces and not the *social* costs and benefits of her actions. So, in Example B, if there is no liability on the bank, then the investor will face the 2% risk of losing $100,000. Although society may be indifferent whether the investor or the other creditors have this money, the investor certainly is not. Therefore if the bank is not under a duty of care, the investor (and all other potential

19 For example, this is the justification for encouraging capital market traders to acquire information even though their trading gains are another trader's losses. See Ronald J Gilson & Reinier H Kraakman "The mechanisms of Market Efficiency" (1984) 70 Va L Rev 549, 623. It is, of course, very difficult to know if the ability to capture these private benefits creates an incentive to spend resources on financial services that is socially correct or too large or too small because it is impossible to put an accurate value on improved resource allocations. See James Boyle "A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading" (1992) 80 Calif L Rev 1413, 1449 (note 83).

20 See Posner (1992), above n 15, 191-192; and Harris and Veljanovski "Liability for Economic Loss in Tort" in Furmston (ed) *The Law of Tort: Policies and Trends in Liability for Damage to Property and Economic Loss* (Duckworth, London, 1986) 48, 50-51.

investors) will take other, typically less efficient, precautions or investigations or incur the extra transaction costs of requiring the Acme Company to request a credit reference from the bank and to secure a contractual warranty to the effect that the bank took reasonable care.[21]

Finally, the imposition of liability on the professional is desirable from a social point of view if the beneficiary of the service is risk averse and the professional is less risk averse or has cheaper access to insurance.[22] As Richardson J remarked in *Allied Finance and Investments Ltd v Haddow & Co*:[23]

> [T]o the extent that the action in negligence is a loss allocation mechanism there is much to be said for the view that where in relationships of proximity laymen rely on the advice of professionals the costs of that careless advice should be borne by the professional advisers who are in a position to protect themselves by professional negligence insurance and in that way spread the risk.

In summary, even where a financial service is aimed at directing income flows there are still benefits associated with improving the quality of the service through the imposition of liability. Even if those benefits are smaller than the costs of liability, a failure to impose liability may be counter-productive because the parties will follow their private costs and benefits and seek to produce the same result through more expensive channels.

C *The problem of appropriability*

The second argument for restricting liability is the so-called "problem of appropriability". The performer of a financial service will frequently be unable to appropriate the full benefit which results from the service she performs.[24] For example, an

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21 Courts have recognised that the imposition of a duty of care may avoid the performance of socially inefficient duplicate services. For example, the Court in *H. Rosenblum, Inc v Adler*, above n 10, 150 felt that by imposing liability on the auditor the accuracy of audits would improve and there would be a reduction in the need for "costly separate investigations by each party at interest ... which are so much sand in the economic machine."

22 If a party is risk averse and insurance is unavailable then the bearing of risk by that person is a real cost to society (see Shavell (1987) above n 15, 206-208; and Harris and Veljanovski, above n 20, 56). Therefore where insurance is unavailable and one or more of the parties is risk averse, the costs of risk bearing should be taken into account in determining whether or not a duty of care should be imposed.

23 Above n 5, 31. Similarly Hoffman J in *Morgan Crucible*, above n 3, 335, referring to the relationship between a residential house buyer and a property valuer, noted that the typical house buyer "is a person of modest means and making the most expensive purchase of his or her life. He is very unlikely to be insured against the manifestation of inherent defects. The surveyor can protect himself relatively easily by insurance."

24 Bishop (1980), above n 9, 364 makes this point in the context of the production of information.

audited financial statement may be utilised by various third parties who the auditor is not able to charge. Similarly a solicitor who creates a will confers a benefit on the beneficiaries, but can only charge the testator. Additionally, whenever a service improves the allocation of resources in society, everyone in society benefits indirectly, but only the person who requests the service pays. What is the effect if a financial service provider is unable to capture the full benefit of a service?

If the performer of a service cannot charge all the people who benefit from that service then the level of service provision will be less than optimal. One response would be for the legal system to attempt to require all the people who benefit from the service to pay a fee to the performer.[25] But this would be extremely costly when the benefits are widely dispersed. An alternative approach, evident in the law of negligence, is to compensate financial services for being unable to appropriate all the benefits they create by reducing the costs they face through restricted liability.[26] The difficult question is to determine exactly how much immunity should be granted. In determining the appropriate extent of negligence liability a court must balance expanding liability (which improves the *quality* of the services that are provided) and contracting liability (which increases the *quantity* of services that will be provided). Determining the optimal scope of liability is intractable in the abstract and very complicated for any given case.

D *The administrative costs of negligence liability*

If the administrative costs of tort liability outweigh the benefits from creating incentives to take reasonable care then imposing liability is undesirable.[27] The administrative costs of tort liability (that is, the time and effort spent by injurers, victims, legal counsel and the judiciary) create a wedge between private incentives to sue and the social desirability of an action.[28] If these costs exceed the social benefit from liability then imposing liability is

25 The law of restitution, which sometimes requires payment for a benefit provided in the absence of a contract, can be understood in this way.

26 Lord Bridge in *Caparo*, above n 6, at 621 correctly felt that a failure to restrict third party liability would "confer on the world at large a quite unwarranted entitlement to appropriate for their own purposes the benefit of expert knowledge or professional expertise attributed to the maker of the statement."

27 See Harris and Veljanovski, above n 20, 51-53; and Shavell (1987), above n 15, 265-267.

28 In theory, negligence liability should be costless — the injurer should be induced to take the optimal level of care and hence would not be found liable if an action was taken, so no actions should be taken. There are, however, a number of reason why negligence actions are taken. An injurer may fail to take due care if she suffers a momentary lapse of care, she does not take reasonable care because she believes that her negligence will not be punished (for example if she is judgment proof), or she incorrectly calculates the level at which the court will set due care. Alternatively, because of errors and misperceptions, victims may take actions even if due care was taken. See Shavell (1987), above n 15, 83-84, and 268.

undesirable. The strength of this argument against liability will increase where: (1) the administrative costs are high (for example, if the losses are widespread, if the value of the loss is uncertain and will be disputed at trial, or if the level of care that the injurer took is hard to measure and will be disputed at trial); or (2) the benefits from liability are low (for example, if there are already other procedures in place to ensure that reasonable care is taken, or if reasonable care can be achieved by imposing liability for a subset of the losses).

A financial service case may give rise to a number of the factors which tell against the imposition of liability — there may be a large number of potential claimants, the costs of proving the economic losses and the level of care taken may be high, and professional organizations often regulate the quality of services provided by their members. Courts should therefore be sensitive to the administrative costs that their decisions will give rise to, and refuse liability where the resulting administrative costs outweigh the benefits of improved care.

E Summary

A number of points emerge from the above economic analysis. There are two kinds of social benefits from imposing liability: (1) for those services that directly improve social welfare (eg the provision of insurance) the liability-induced quality improvement directly benefits society; and (2) properly performed financial services typically produce an indirect but important benefit by improving resource allocations and, in some cases, by efficiently allocating risk. Even in cases where these benefits seem small and hard to measure, liability still seems desirable because the parties involved will follow their private costs and benefits rather than the social costs and benefits of their actions and try to impose liability through other more costly channels. This conclusion must, however, be qualified and liability limited for two reasons: (1) it may be desirable to limit liability when the provider of the service is unable to charge all the people who benefit from the service; and (2) liability should not be imposed when the administrative costs seem likely to outweigh the benefits.

V A Rule of Liability Consistent with the Economic Approach

A An appropriability-based rule of liability

The foregoing analysis makes it clear that there is no simple liability rule that will ensure optimal levels of care and provision for all financial services. Evaluating cases on an individual basis is not an attractive option either; the complexity of calculating the exact social costs and benefits of a service and the benefits that the provider is able to capture is daunting to say the least. The best that can realistically be hoped for is a general rule of liability that provides an approximate solution and suggestions as to when departures from the rule should be made.

A prima facie rule of liability that is consistent with both the economic analysis and most of the leading cases is this. The provider of a financial service should owe a prima facie duty of care to the claimant if:

1 the claimant was, or could have been, charged directly or indirectly for the financial benefit that would have been provided (or the financial loss that would have been prevented) had the service been properly performed; and

2 the provider could have reasonably foreseen the way in which the performance of the service was going to affect the claimant.

From an economic perspective, this rule has a number of desirable features: the rule is clear and reasonably certain in application and will therefore limit administrative costs; liability is restricted to those third party claimants from whom the provider can appropriate the benefit she creates so that the provider's expected liability is reduced as a trade-off for revenue she cannot collect; desirable disclosure incentives are established which "creates value because if the [performer of the service] foresees the loss, he will be able to prevent it more efficiently"[29] and this knowledge allows the performer to set an appropriate price for the service; and transaction costs should be saved since proximate parties in relationships such as those envisaged by the rule would seek to impose liability through more expensive channels were it not imposed through the law of negligence.

The next section of this paper demonstrates that this prima facie liability rule is capable of rationalising most of the leading cases in this area. The following section discusses when the economic reasoning suggests that the rule should be departed from and shows that these suggested departures also track the case law.

B Liability under the general rule of appropriability

1 Liability to the requestor of the service

If a person directly requests a financial service then the two requirements of the prima facie rule will usually be met. That is, the provider will be able to charge the requestor and reasonably foresee her reliance. This result accords with the current legal position. For example the Court of Appeal in *Haddow*[30] imposed a duty of care on the defendant solicitors who had agreed to certify that the security their client was offering to the plaintiff was fully effective. In these circumstances it was reasonably foreseeable that the plaintiff

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29 Ian Ayres & Robert Gertner "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 Yale LJ 87, 101 (footnote omitted). See also William Bishop "The Contract-Tort Boundary and the Economics of Insurance" 12 J Legal Stud 241, 254.

30 Above n 5; and the other cases referred to at n 5 above.

would not be repaid if the security was ineffective and the defendant would have been able to indirectly charge for the service through its client.[31]

An interesting question, upon which the economic approach can shed some light, arises where the requestor and provider are in a contractual relationship. Where this is the case, courts sometimes become reluctant either to imply a contractual term requiring reasonable care to be taken, or to allow concurrent liability in tort. This is based on the "classical" view of contract which sees the explicitly agreed to contractual terms as being definitive of the parties' obligations to each other.[32] The difficulty with this analysis is that it does not account for the possibility that transaction costs may prevent the complete specification of a contract.[33] Restricting contractual obligations to the explicit voluntarily assumed obligations and refusing to impose additional obligations in tort (or to imply equivalent contractual terms) will therefore result in non-optimal relationships.[34] The better view, which seems to have gained ascendancy in the courts, is therefore that, subject always to the

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31 The concept of being able to charge for the service is a broad one; no charge has to be made in fact and it includes the possibility of passing the charge through another party. In many of these cases the payment will not be in a form that would be recognised by a court as legal consideration. Instead the performer may be acting in the expectation of some form of reciprocation at a later date or an indirect benefit from another party. For example the provision of information by a professional may confer a benefit on one of the professional's clients from whom she can expect indirect compensation. In *Hedley Byrne*, above n 5, 529 Lord Devlin suggested that "[t]he service that a bank performs in giving a reference is not done simply out of a desire to assist commerce. It would discourage the customers of the bank if their deals fell through because the bank had refused to testify to their credit when it was good."

32 See for example *Rowlands v Collow* [1992] 1 NZLR 178, 190; *Sinclair Horder O'Malley v National Insurance Company of New Zealand Ltd* [1992] 2 NZLR 706, 719; and *Greater Nottingham Co-op v Cementation* [1989] 1 QB 71.

33 For a number of reasons it is often efficient for the parties not to specify every detail of an agreement. For example if the negotiation costs are high, contingencies are remote or if the parties know that the court will imply certain terms, then an under-specified agreement is likely to be optimal. See Steven Shavell "Damage Measures for the Breach of Contract" (1980) 11 Bell J Econ 466; Ayres and Gertner, above n 29, 92-93; Harris and Veljanovski, above n 20, 46; and William Bishop "Economic Loss: Economic Theory and Emerging Doctrine" in Furmston (1986), above n 20, 73, 78.

34 Frank Easterbrook and Daniel Fischel "The Economic Structure of Corporate Law" (1989) 89 Colum L Rev 1416. Similarly, Bishop (1986), above n 33, 78 argues that since it may be efficient to have under-specified contracts "there is no sharp break between contract and tort." He goes on to say that "[i]n this model of the law tort is a kind of giant standard form contract which regulates investment in accident precautions by allowing a lawsuit if the contract is 'breached', i.e. if a tort is committed. The duty of care required is 'all care whose cost is justified by the benefit of the procedures, but no more'. Thus the terms of this 'contract' are just those that the parties as economic men would themselves negotiate in a perfect market."

express terms of the contract, a promise to exercise reasonable care and skill should be implied,[35] or concurrent liability allowed in tort.[36]

2 *Liability to third parties affected by the service*

Where the provider of the service charged, or could have charged, the third party claimant for the provision of the service (typically by channeling the charge through the person who actually requests the service) and the provider could have reasonably foreseen the manner in which the third party was going to be affected if the service was negligently performed then, according to the prima facie rule, a duty of care should be imposed. After answering an initial objection to the imposition of third party liability I will show that this liability rule is consistent with a large body of case law.

The preliminary issue is this. Since a harmed third party typically could have sought contractual protection from the performer of the service but did not, why should the court interfere?[37] This argument incorrectly assumes that an optimal contractual solution is likely. This assumption is unwarranted for two reasons. First, third party losses are generally remote contingencies. Once a loss has occurred it may seem reasonable to say that the disappointed third party should have sought contractual protection. However, from an ex ante perspective, third party losses occur in a very small fraction of all those transactions that may affect third parties. Secondly, the large transaction costs involved will typically prevent third parties from seeking contractual protection for these remote

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35 In *Haddow*, above n 5, 24 for example, Cooke J considered that if a contract had existed between Allied Finance and the solicitors "it would have imported a duty of reasonable care." See also *South Pacific*, above n 3, 308 (per Richardson J); *Midland Bank Trust Co Ltd v Hett, Stubbs & Kemp* [1979] Ch 384; and *Merrett Syndicates*, above n 5, 788.

36 The issue of concurrent liability has generated a great deal of conflicting judicial opinion and academic commentary. The House of Lords has recently ruled in favour of allowing concurrent liability, see *Merrett Syndicates*, above n 5. This accords with *Rowlands v Collow*, above n 32; *Central Trust Company v Rafuse* [1986] 31 DLR (4th) 481; *Midland Bank Trust Co Ltd v Hett, Stubbs & Kemp*, above n 35 and *Lancashire and Cheshire Association of Baptist Churches Inc v Howard & Seddon Partnership (a firm)* [1993] 3 All ER 467; but compare *Simms Jones Ltd v Protochem Trading NZ Ltd* [1993] 3 NZLR 369; *Tai Hing v Liu Bank* [1986] AC 80; *Simaan General Contracting Co v Pilkington Glass Ltd (No 2)* [1988] QB 758; *South Pacific*, above n 3; and *Downsview Nominees*, above n 13. See also Christine French "The Contract/Tort Dilemma" (1983) 5 Otago LR 236; and Schlosser "Some Recent Developments in the Law of Limitation of Actions, Concurrent Liability and Pure Economic Loss" (1987) 25 Alberta Law Review 388. *Merrett Syndicates* was followed by Thomas J in *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30, 74 and his Honour regarded this decision as ending the controversy over concurrent liability.

37 For example, Goldberg "Accountable Accountants: Is Third-Party Liability Really Necessary?" (1988) 17 J Leg Stud 295, 300 (footnote omitted) argues that there is no need for tortious liability in cases like these because "it would not be very difficult to have [service providers] assume the liability by contract rather than by having it imposed by tort."

contingencies.[38] It is therefore advantageous to allow a direct action in tort,[39] and this is the approach that most courts take.[40]

The decision of Cardozo J in *Glanzer v Shepard*[41] is a good starting point for analysing the case law. Here the plaintiff was purchasing beans at a price that was to be based on their weight as determined by a public weigher hired by the seller. The weigher negligently certified the weight higher than it actually was and the plaintiff purchaser sued the weigher to recover the resulting overpayment. The Court allowed the claim on the grounds that the weigher knew that he had been hired by the seller for the very purpose of effecting this transaction. Liability is also supported by the prima facie rule of appropriability-based liability — the weigher was in a position to indirectly charge the plaintiff purchaser for the service and he knew the scope of the losses that would be caused by his negligence.

The English decision in *Smith v Bush*[42] is similar. The plaintiff was a house purchaser who relied upon a negligent valuation made by a surveyor acting for a building society that was considering granting the plaintiff a mortgage. The fee for the survey was paid for by the plaintiff and the surveyor knew that the plaintiff would rely on the information in deciding whether or not to purchase the property. Lord Templeman concluded, consistently with the rule of appropriability-based liability, that:[43]

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38 To list a few examples: the third party may not have any contact with either the requestor or the provider; even if the third party has a relationship with the requestor, the issue of third party liability may be quite peripheral to that relationship and to the relationship between the requestor and the provider; the third party may not have any information about the agreement between the requestor and the provider; and timing problems may obstruct a simultaneous agreement between the three parties.

39 A possible exception is where the parties are well informed and the contracts between the requestor and the provider and the requestor and the third party are in reality two sides of an overall agreement between all three. An example of a quality defect case involving this issue is *Simaan General Contracting Co v Pilkington Glass Ltd (No 2)*, above n 36. Here the plaintiffs employed a subcontractor to erect a glass curtain. The subcontractors arranged for the supply of the glass by the defendant. The plaintiff attempted to sue the defendant in negligence. The English Court of Appeal rejected the plaintiff's claim as there was no reason to depart from the "normal chain of liability" where the plaintiffs would sue the contractors who would sue the defendant. The court was clearly worried that the individual bargains between the parties would be subverted and a mockery would be made of the contractual negotiations (at 772, 775, 782-783, and 785-786).

40 See *Hedley Byrne*, above n 5; *Scott Group*, above n 8 and *Smith v Bush* [1990] 1 AC 831; but compare *South Pacific*, above n 3, at 308, 319 and 326.

41 *Glanzer v Shepard* (1922) 233 NY 236. See also *Arenson v Arenson* [1977] AC 405.

42 Above n 39.

43 Above n 39, 847.

> [T]he valuer assumes responsibility to both mortgagee and purchaser by agreeing to carry out a valuation for mortgage purposes knowing that the valuation fee has been paid by the purchaser and knowing that the valuation will probably be relied on by the purchaser in order to decide whether or not to enter into a contract to purchase the house.

These two cases may be contrasted with the famous case of *Ultramares Corp v Touche*.[44] The defendants were auditors who negligently prepared a certified balance sheet of the Stern Company. The certificate was shown to the plaintiffs who lent money to Stern on the strength of it and sued the defendants when Stern went bankrupt. The reasons given by Cardozo CJ for not imposing liability are the same reasons that liability would not be imposed under the appropriability-based rule of liability. Cardozo CJ explained that:[45]

> Nothing was said [to the accountants] as to the persons to whom [the accounts] would be shown or the extent or number of transactions in which they would be used. In particular there was no mention of the plaintiff .... The range of the transactions in which a certificate of the audit might be expected to play a part was as indefinite and wide as the possibilities of the business that was mirrored in the summary.

Applying these principles to the more recent cases in this area, the more restrictive stance taken in cases such as *Caparo* is preferable. This approach was summarised by Lord Bridge who stated that an accountant should only be liable to third parties if:[46]

> [He] knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind ... and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter on that transaction or on a transaction of that kind."

The "reasonable foreseeability" approach taken in New Zealand and a number of American States should therefore be rejected as it casts the net too widely for this class of case.[47]

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44 Above n 7. On the liability of auditors to third parties see generally John W Bagby and John C Ruhnka "The Controversy Over Third Party Rights: Toward More Predictable Parameters Of Auditor Liability" (1987) 22 Ga L Rev 149; Goldberg (1988), above n 37; and Bruce Chapman "Limited Auditors' Liability: Economic Analysis and the Theory of Tort Law" (1992) 20 Can Bus LJ 180.

45 Above n 7, 255 NY 170, 174; 174 NE 441, 442.

46 Above n 6, 621. See also *Bily v Arthur Young & Co* (1992) 834 P2d 745, 733 (Cal); *Candler v Crane, Christmas & Co* [1951] 2 KB 164, 184-185 (per Lord Denning); *Scott Group*, above n 8, 266 (per Richmond P); and *B.D.C. Ltd v Hofstrand Farms Ltd* (1986) 26 DLR (4th) 1.

47 See cases cited above n 10.

C *Fine Tuning Liability*

1 *Restricting liability*

In some circumstances, it is desirable to depart from the prima facie rule of appropriability-based liability either to restrict or to enlarge liability.

Liability should be more restrictive than the prima facie rule suggests when: (1) it is possible to identify a significant external benefit from the service that is not matched by a corresponding reduction in liability for the provider; (2) liability to a particular class of people would give rise to very high administrative costs without a correspondingly large benefit to society; or (3) conflicting duties would be created.

An example of a case in the first category is *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd.*[48] The New Zealand Court of Appeal had to decide whether an insurance investigator employed by an insurance company owes a duty of care to an insured person when they investigate that person's claim. The plaintiff claimed that the investigator's report was negligently prepared and had resulted in losses due to a police prosecution and the insurance company's refusal to honour the claim. Here there is a clear uncompensated external benefit of the investigator's service that deserves protection. The actions of the insurance investigator create a benefit to society by discovering evidence of arson. Often, as in this case, the law has already created a special set of rules to provide appropriate incentives for activities that create extraordinary externalities such as this. The elements of the tort of malicious prosecution,[49] which are stricter than those needed to establish negligence, embody the public interest in private detection of crime and produce an efficient outcome.[50] The court rejected the duty of care argument and prevented the plaintiff from circumventing the stricter rules as to liability for malicious prosecution.[51]

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48 Above n 3.

49 The plaintiff must prove that the defendant set in motion a criminal prosecution acting maliciously and without reasonable and probable cause.

50 The law relating to malicious prosecution has a sound economic basis. The initiation of criminal proceedings by members of the public creates a large uncompensated benefit to society. To encourage reporting of crimes, the law does not judge reports to the police by the normal standards of negligence or defamation, but has narrower rules of liability for malicious prosecution. See Posner (1992), above n 15, 213 making a similar point in the context of the qualified privilege defence to defamation.

51 As a general rule a cause of action in negligence should not be allowed when the facts are covered by a more restrictive rule of recovery that reflects an efficient result for society. See *South Pacific*, above n 3, 301-304, 309, 314, 319, and 326; *Bell-Booth Group Ltd v Attorney General* [1989] 3 NZLR 148; *Balfour v Attorney-General* [1991] 1 NZLR 519; and *Downsview Nominees*, above n 13, 525; but compare *Spring v Guardian Assurance* [1994] 3 All ER 129.

Another factor which may make the imposition of a duty of care owed to a third party inappropriate is where this would prevent the provider performing her obligations to the requestor. If this is the case then a duty should not be imposed as this would subvert the agreement between the requestor and the provider. A more efficient solution is to require the third party to protect her own interests without relying on the service provider. For example, a lawyer does not normally owe a duty to the party her client is contracting with or litigating against as this would impede the lawyer's ability to fulfil her obligations to her client.[52]

2 *Expanding liability*

Liability should be wider that the prima facie rule suggests when the provider can capture most of the benefits from the service and would not otherwise face liability for the full costs of the service. An example of this is where the rule does not give any party the ability to sanction the careless performance of the service. For example, under the prima facie rule a solicitor who has accepted instructions to make a will would not normally owe a duty of care to the intended beneficiaries. So if the testator dies and the solicitor has negligently failed to implement the will an unusual result occurs: "The only person who has a valid claim against the solicitor [the executor of the estate] has suffered no loss, and the only person who has suffered a loss has no valid claim."[53] The sanction of a negligence action by a disappointed beneficiary provides the only generally effective "incentive for lawyers to conform their conduct to a standard of reasonable care."[54] If such an action was not allowed then there would be a real social cost as the testator would have to seek a more expensive method of ensuring that her intentions are carried out.[55]

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52 See *Haddow*, above n 5, 24; *Mid-Northern Fertilisers Ltd v Connell Lamb Gerard & Co* (1991) 3 NZBLC 102,032; *Farrington v Rose McBride & Ptners* [1985] 1 NZLR 81; and *Mouat v Clark Boyce* (1991) 1 NZConvC 190-917. Similarly, in *Downsview Nominees*, above n 13, 523-525 the problem of inconsistent duties influenced the Privy Council's refusal to impose a duty of care on a receiver and manager appointed by a first debenture holder with respect to interests of subsequent debenture holders.

53 *Ross v Caunters* [1980] 1 Ch 297, 330. In the Commonwealth see also *Gartside v Sheffield Young and Ellis* [1983] NZLR 37; and *White v Jones*, above n 14; but compare *Seale v Perry* [1982] VR 193; and *Weir v J. M. Hodge & Son* 1990 SLT 266. In America recovery is permitted on a mix of third-party beneficiary and negligence theories (see for example Melvin Aron Eisenberg "Third-Party Beneficiaries" (1992) 92 Colum LR 1358 1395).

54 *Gartside v Sheffield Young and Ellis*, above n 52, 51 (per Richardson J).

55 See Bishop (1982), above n 8, 28-29; and Harris and Veljanovski, above n 20, 62.

D Disclaimers

1 The relevance of a disclaimer to a claim by the requestor

In normal circumstances, a contract struck by two parties following their own self interest is more likely to be optimal than a judicially imposed agreement. Therefore, unless the market in question is strongly characterized by features likely to lead to inefficient contractual terms (such as inequality of bargaining power, price discrimination and high transaction costs) a contractual disclaimer of liability between the requestor and the provider should be enforced.[56] Subject to any statutes limiting the scope of liability disclaimers, courts typically enforce liability disclaimers.

2 The relevance of a disclaimer to a claim by a third party

Should a disclaimer in the agreement between the requestor and the provider of the service also affect a claim by a third party against the provider? The case-law on this issue is unsettled, but appears to favour allowing a disclaimer to block a third party's claim.[57] This approach is economically sound if the interests of the requestor and the third party are aligned in the sense that they will be similarly affected if the provider is negligent. If this is the case, it is reasonable to rely on the requestor to strike a bargain which is likely to be optimal with respect to the third party as well. Lord Goff took this approach in *White v Jones*[58] by suggesting that a liability disclaimer in a contract between a solicitor and a testator should be effective against an intended beneficiary who takes a negligence action against the solicitor. However, if the interests of the requestor and the third party are not aligned then opportunities arise for socially inefficient strategic contracting between the requestor and the provider.[59] That is, the contracting parties may agree to terms that decrease the total gains to all the three parties in order to increase the benefit from the transaction captured by the contracting parties. For example, the bean seller and the

56 See generally Landes and Posner (1987), above n 15, 280-284; Shavell (1987), above n 15, 53-64; William K Jones "Product Defects Causing Commercial Loss: The Ascendancy of Contract over Tort" (1990) 44 University of Miami L Rev 731; and Steven R Swanson "The Citadel Survives A Naval Bombardment: A Policy Analysis Of The Economic Loss Doctrine" (1987) 12 Tul Mar LJ 135.

57 See *White v Jones*, above n 14, 207 (per Lord Goff); *Junior Books Ltd v Veitchi Co Ltd* [1983] 1 AC 520, 534; *Leigh & Sillivan Ltd v Aliakmon Shipping Co Ltd ("The Aliakmon")* [1985] 2 All ER 44, 77 (CA); and *Muirhead v Industrial Tank Specialities Ltd* [1986] QB 507, 530. A strong opinion in the other direction was put forward by Lord Brandon in the House of Lords in *Leigh & Sillivan Ltd v Aliakmon Shipping Co Ltd ("The Aliakmon")* [1986] 1 AC 785 (HL), 817 and 819-820.

58 Above n 14, 207.

59 For the discussion of this concept in the context of incentives for a contracting party to remain silent even though their disclosure would provide a joint benefit to the parties see Ayres and Gertner, above n 29, 94.

weigher in *Glanzer v Shepard*[60] may agree that the weigher will not be liable for over-weighings. Although this would decrease the total gains to all three parties, it increases the share that is captured by the seller and the weigher. This suggests a distinction not currently present in the case law: in cases where the interests of the requestor and third party are not aligned, a disclaimer should not generally be effective against a third party claimant.[61]

E Summary

The prima facie liability rule coupled with the suggested departures provides a more consistent and convincing positive theory for the imposition of liability in financial service cases than is provided either by judges or academics using traditional legal analysis and concepts such as "foreseeability", "proximity", "just and reasonable" and "assumption of responsibility". The economic approach is also useful for analysing difficult legal issues such as the desirability of concurrent liability and what effect disclaimers should have on third parties.

VI Conclusions

The economic approach provides a powerful lens through which financial service cases may be examined. It confirms the judicial intuition that pure economic losses are different from physical losses and that liability should, in some cases, be restricted. More importantly, it also provides a clearer understanding of the factors that determine what the appropriate restrictions are. It is submitted that this framework, and the liability guidelines derived from it, are more convincing and provide a more certain basis for determining liability than the traditional legal analysis. Although this area of law remains difficult to understand, the economic approach at least makes sure the cause of the confusion is better understood.

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60 Above n 40.

61 An exception should, however, be admitted, and the disclaimer applied, if the disclaimer represents a term genuinely consented to by all three parties. An example would be where the third party was notified of the term before the service was provided and had a chance to renegotiate. This would allow the parties to set their own terms while minimising the possibility of non-optimal strategic behaviour.