COMMENTS

ECONOMIC LOSS AND THE TORT OF NEGLIGENCE

[*Recently Robert Hayes argued ((1979) 12* M.U.L.R. *79) that in the context of recovery for purely economic loss in a tort action there was a valid distinction between expenses incurred and benefits not received. In this comment Mr Cane argues that this distinction is a doubtful one and, furthermore, that it cannot be justified on policy grounds.*]

In a recent issue of this Review[1] Robert Hayes, in a most interesting and illuminating article, argued, *inter alia*, that *Caltex Oil (Australia) Pty Ltd v. The Dredge 'Willemstad'*[2] went no further than allowing recovery for purely economic loss consisting of expenses actually incurred and that it must not be taken as allowing recovery for profits lost on collateral contractual arrangements or, in other words, for the benefit of contracts with third parties lost due to the defendant's negligence, except in certain cases where the plaintiff and defendant were engaged in a joint venture. There is no doubt that *dicta* in the judgments of Stephen J.[3] and Jacobs J.[4] appear to support such a formulation. However, I wish to argue that the distinction between expenses incurred and benefits not received is not as strong analytically as Professor Hayes maintains, and also that it imposes an unnecessary limitation on recovery for purely economic loss if one accepts, as Professor Hayes seems to do,[5] the 'specific' or 'individual' foreseeability test proposed by Gibbs and Mason JJ.

The distinction operates fortuitously

In many cases it will be entirely fortuitous whether the plaintiff's loss consists of actual expenditure or of loss of profits.[6] Suppose, on the facts of *Caltex* itself, that Caltex had been unable to arrange alternative transport for its products and so had been unable to supply its customers. In that case, on Professor Hayes' view, Caltex would not have been entitled to recover its economic loss. And yet the effect on it of incurring additional transportation expenses was exactly the same as would have been the effect of being unable to arrange alternative transport — namely, that its earnings from sale of petroleum products were cut. That it could characterize this

[1] Hayes R., 'The Duty of Care and Liability for Purely Economic Loss' (1979) 12 *M.U.L.R.* 79.
[2] (1976) 136 C.L.R. 529.
[3] *Ibid.* 577.
[4] *Ibid.* 598 f.
[5] Hayes, *op. cit.* 96 f.
[6] *Pace* Davies J. W., 1977 *Annual Survey of Commonwealth Law* 549.

shortfall as expenditure actually incurred was, as it turned out, a good fortune which should have no legal significance.

Professor Hayes has no doubt that lost profits are recoverable if they are consequential upon damage to the person or property of the plaintiff.[7] Accompanying physical damage was laid down as a necessary condition of recovery in *Spartan Steel & Alloys Ltd v. Martin & Co. (Contractors) Ltd.*[8] In that case, however, no distinction was drawn between different types of economic loss and so the decision cannot be applied to profits lost to the exclusion of expenses incurred. In *Rivtow Marine Ltd v. Washington Iron Works*[9] the Supreme Court of Canada allowed recovery for loss of profits resulting from the need to take the crane out of service in the high season rather than the low season. The loss was consequential upon physical damage to the crane but this fact was not the basis of recovery, and could not have been, because the Court refused to allow recovery in tort for the cost of repair of the crane. Rather the defendants were held liable for failure to give a timely warning of the defect. Thus the case provides an example of recovery for lost profits regardless of the fact that it was consequential upon physical damage. The reasoning of the majority would allow recovery for the loss of profits even if the crane was taken out of service to repair the defect before it had caused any physical damage to the crane. In *Bowen v. Paramount Builders (Hamilton) Ltd*[10] the New Zealand Court of Appeal held that the plaintiff could recover in tort residual diminution in the value of his house after defects and physical damage caused to it by the defendant's negligence had been repaired. Residual diminution is, in effect, loss of profits on resale since it is the difference between the market values of a perfect and an imperfect house. Richmond P. stressed the fact that the loss was 'directly and immediately connected to the structural damage to the building';[11] but there are indications in the judgments of Woodhouse and Cooke JJ.[12] that their Honours would have allowed recovery for the depreciation even if there had been no physical damage to the house.

Leaving authority aside, Professor Hayes' willingness to allow recovery for loss of profits if it is consequential upon physical damage but not otherwise seems arbitrary. The force of the reasoning in *Caltex* is that the *Spartan Steel* rule operates fortuitously and unjustly to deny recovery for economic loss. If it is arbitrary to deny recovery for economic loss generally on the basis of the *Spartan Steel* rule, it is even more arbitrary to deny recovery for one type of economic loss on the basis of that rule. Some

[7] Hayes, *op. cit.* 104. The requirement laid down in n. 47 that loss of profit must measure physical damage follows, it is suggested, from the requirement of direct causal connection between the physical and the economic loss.
[8] [1973] Q.B. 27.
[9] (1973) 40 D.L.R. (3d) 530.
[10] [1977] 1 N.Z.L.R. 394.
[11] *Ibid.* 411.
[12] *Ibid.* 417, 423.

better ground than this must be found for denying recovery for lost profits standing alone but not for expenses incurred in the absence of physical damage.

It is submitted that while the *dictum* of Stephen J. relied upon by Professor Hayes[13] does clearly support his position, the *dicta* of Jacobs J. are not so conclusive. Jacobs J. was prepared to allow recovery for economic loss arising from a physical effect on property of the plaintiff of the defendant's act. Immobilization is such an effect,[14] and his Honour seems to have been prepared to allow recovery not only for the cost of mobilizing the property but also for loss of the use of the property during immobilization.[15] It would be strangely arbitrary to interpret this to mean that damages for loss of use due to a physical effect were only recoverable if that loss was accompanied by loss consisting of the cost of mobilization. His Honour's claim was that loss which could *only* be described as loss of the benefit of a contract with a third party was irrecoverable, and that losses which could also be described as the result of a physical effect such as immobilization would not fall within the prohibition on recovery. Loss of profits on lost contracts for the supply of petroleum products could, on the facts of *Caltex*, be described as loss of the use of immobilized products and hence, as a result of a physical effect, of the plaintiff's oil.

Loss of earnings and loss of earnings capacity

In support of his view Professor Hayes relies on the distinction between loss of earnings or profits on the one hand and loss of earning or profit earning capacity on the other.[16] The former is no more than the measure of the latter so that recovery for loss of earnings or profits is not recovery for the loss of the benefit of a contract with a third party but for the loss of a valuable asset or ability. Therefore such loss does not fall within Jacobs J.'s prohibition on recovery for loss which can only be characterized as loss of the benefit of a contract with a third party.[17] Professor Hayes' two illustrations are a claim for loss of earnings in an ordinary action for personal injuries and the claim for loss of profits in *The Liesbosch*.[18] There are three difficulties with these examples. First, neither is entirely apposite in the context of recovery for purely economic loss. Although Professor Hayes' discussion of this matter is contained in his section entitled 'Economic Loss Flowing from Physical Harm to Property', it seems that he is at this point discussing liability for purely economic loss: he prefaces the discussion by quoting the *dictum* of Jacobs J. discussed above; and he accepts the *Spartan Steel* rule that economic losses consequential upon

[13] *Ibid.* 577.
[14] *Ibid.* 605.
[15] *Ibid.* 597.
[16] Hayes, *op. cit.* 103.
[17] (1976) 136 C.L.R. 529, 598.
[18] [1933] A.C. 449.

physical damage are recoverable regardless of type.[19] I argue that the distinction between cases in which economic loss is consequential upon physical damage and cases in which it is not is of no importance as such, but this course is not open to Professor Hayes who retains the distinction in relation to loss of profits.[20]

Secondly, the claim for the cost of hiring, as opposed to buying a new dredge made in *The Liesbosch* was, as Professor Hayes notes, essentially a claim for expenses incurred. The failure of this claim can be explained, without reference to the type of economic loss, on the ground that the loss was not a causal consequence of the defendant's act or on the ground that it was too remote, the thin skull rule not applying to economic loss generally. Both of these grounds were canvassed by Lord Wright although his Lordship preferred the former ground.[21]

The third difficulty is that the method of calculation of loss of profit earning capacity adopted in *The Liesbosch* is different from the method used in personal injury cases for calculating loss of earnings or earning capacity. In the case of a profit-earning chattel the accepted method[22] of making allowance for loss of earnings is to award the plaintiff the 'capitalized value of the chattel as a profit-earning machine'.[23] This supports Professor Hayes' contention. But the multiplier method used in calculating compensation for loss of earnings rests on a different theoretical basis. The aim is not to award the plaintiff the capitalized value of his income-earning capacity but an amount, suitably discounted to take account of the vicissitudes of life and, by and large, ignoring the effects of inflation, which will yield to the plaintiff, by exhaustion of both income and capital, his estimated earnings for the period of his expected life. The rationale of this method is that whereas in the case of a profit-earning chattel the capitalized profit-earning value of the asset can often be used to buy a replacement, in the case of personal injuries no question of replacement of the income-earning ability usually arises; the plaintiff needs income-replacement since income-earning capacity cannot be replaced. This analysis throws doubt on the view that compensation for loss of earnings is really compensation for loss of earning capacity.

If, then, damages can be awarded in personal injury actions for loss of the benefit of contracts with third parties, why not also in cases of property damage if replacement of the property is not possible? It does not, of course, follow that such loss should be recoverable where it is not the plaintiff's property which has been damaged but it seems arbitrary to deny

[19] Hayes, *op. cit.* 104.
[20] The *Spartan Steel* rule is, of course, important as a sub-rule of a more general rule that there must be a close degree of proximity between the defendant and the plaintiff who claims recovery for economic loss.
[21] [1933] A.C. 449, 460-1.
[22] Ogus, *Law of Damages* (1973) 126-31.
[23] [1933] A.C. 449, 464.

recovery in such cases if it was not possible for the plaintiff to mitigate his loss by reasonable expenditure to preserve the benefit of contracts with third parties.

But even if my analysis is not acceptable, it is suggested that the distinction between loss of the benefit of a contract with a third party and loss of a profitable asset is terminological only. It is only by stipulation that simple immobilization of oil *cannot* be called loss of the profitability of an asset of which actual loss of profits would be the measure.

Finally, in the context of *The Liesbosch*, Professor Hayes argues for an analytical distinction between loss of profit-earning capacity of a sunken dredge and the cost of hiring a replacement dredge. The latter is, but the former is not, loss of the benefit of a contract with a third party. The difficulty with this distinction is that it would make the loss actually held recoverable in *Caltex* irrecoverable, since analytically the cost to Caltex of arranging alternative transport is exactly analogous to the cost of hiring a dredge: both are the added cost of performing contracts with third parties. The only difference between the two cases is the relative remoteness of the consequent economic loss from the act of the defendant; in *The Liesbosch* impecuniosity intervened, in *Caltex* it did not. Alternatively, it could be said that the owners of the Liesbosch did not take reasonable steps in mitigation of their loss[24] whereas Caltex did. If, as Professor Hayes proposes,[25] economic losses 'taking the form of *additional burdens from contracts with others forced upon the plaintiff*'[26] are irrecoverable in negligence, how is *Caltex* to be explained?

Joint ventures

Professor Hayes is prepared to allow recovery for loss of profits on contracts, or penalties incurred under contracts, with third parties where the plaintiff and the third party are engaged in a joint venture and where the contract in question is 'central to the joint venture' and when the profits provide the *raison d'être* of the venture.[27] *Main v. Leask*[28] is an example of such a case. The joint venture idea discussed in *Caltex* was inspired by Lord Roche's hypothetical in *Morrison Steamship Co. Ltd v. Owners of Cargo lately laden on S.S. Greystoke Castle.*[29] That case is an example of Professor Hayes' principle because the plaintiff's loss consisted of a sum payable by way of general average contribution under the plaintiff's contract

[24] The former explanation was preferred to the latter by Donaldson L.J. in *Dodd Properties (Kent) Ltd v. Canterbury City Council* 1980 1 All E.R. 928, 940 f.; *cf.* Megaw L.J. at 935. The Court of Appeal would have preferred to overrule *The Liesbosch* if it had been free to do so. In the event, the decision was restricted to cases of impecuniosity in the sense of inability to pay as opposed to unwillingness to pay on grounds of commercial prudence.

[25] Hayes, *op. cit.* 103.

[26] Emphasis in original.

[27] Hayes, *op. cit.* 112.

[28] [1910] S.C. 772.

[29] [1947] A.C. 265, 280.

with his joint venturer. This amount was, in a sense, a cost of the joint venture. But there is no suggestion in Lord Roche's hypothetical that the cost of alternative transport had to be in this sense a cost of the joint venture to be recoverable since the doctrine of general average contribution is peculiar to maritime law; and anyway, the sum payable by the cargo owner in *Morrison* was a contribution towards the cost of repairing the ship, that is a contribution towards the third party's costs, whereas in the hypothetical case the cost is of alternative transport and it is not a cost to be borne in the first instance by the third party since the force of the example depends on the cost of alternative transport being a cost of the goods' owner alone, as was the case in *Caltex*.

It is suggested, therefore, that Lord Roche's example was not concerned primarily with the sort of situation which was before the court in *Main v. Leask* or in *Morrison* but with the sort of case where, because property of the plaintiff is engaged, along with property of the third party, in a joint venture, each is specifically foreseeable as likely to suffer economic loss if the property of the other is damaged. This seems the best interpretation of Stephen J.'s discussion[30] of Lord Roche's hypothetical; the relevance of the joint venture is that it makes the plaintiff individually and specifically foreseeable.

Given this interpretation of the joint venture notion, it seems to offer no basis on which to distinguish between expenses incurred and profits lost. The fact that there is a different joint venture notion exemplified by *Main v. Leask* and by virtue of which lost profits can be recovered in tort does not show that lost profits cannot be recovered by virtue of the Caltex joint venture notion.

Finally, Professor Hayes' criteria for recovery for lost profits are inadequate to distinguish between *Caltex* and *Main v. Leask*. The contract between Caltex and A.O.R. was central to their joint venture and the making of profits on the sale of petroleum products was, for Caltex, the *raison d'être* of the joint venture. The only difference between *Caltex* and *Main v. Leask* is that in the latter there was a profit-sharing arrangement absent in *Caltex*. But this element of profit-sharing was not present in *Morrison*, and Professor Hayes does not write it into his conditions. *Main v. Leask* was in one sense a stronger case than *Caltex* or *Morrison*, but Professor Hayes gives no reason for restricting recovery for profits lost to the stronger case.

The relationship between negligence and the economic torts

A third argument of Professor Hayes in support of his position is that if recovery for loss of anticipated profits were allowed in negligence this would indirectly undermine the economic torts which require intention and

[30] (1976) 136 C.L.R. 529, 579.

often also unlawful means.[31] There are two possible answers to this worry. The first is to point to the fact that this undermining of the intentional torts has already begun without much protest; *Derry v. Peek*[32] was virtually annihilated in *Hedley Byrne & Co. Ltd v. Heller & Partners Ltd.*[33] The second answer is to point out that the dividing lines between torts are not analytic but based on policy considerations. Is there any policy argument against extending liability for loss of profits from cases where the loss is intentionally inflicted to cases in which it is negligently inflicted? The policy arguments behind the law's reluctance to compensate for economic loss seem to be:

(1) That economic loss is relatively unimportant as compared with personal injury or property loss, to the extent that property has more than purely monetary value. This argument could justify allowing recovery for fewer rather than more categories of economic loss and so could justify allowing recovery for expenses actually incurred but not for profits not received — although it could, of course, also justify a refusal of recovery for the former type of loss as well as the latter. I have argued that there is no better reason to refuse recovery for lost benefits and at the same time allow recovery for expenses incurred than there is for refusing recovery of both types of economic loss. Another important recent development in this respect is *Ross v. Caunters*[34] in which a disappointed beneficiary recovered in negligence from the solicitor who drew up the will the value of the intended benefit. It might have been thought that an argument could be made for allowing recovery for benefits not received only in cases in which there was a relationship equivalent to contract between the plaintiff and the defendant, but this case specifically rejects any such limitation. The case is, however, distinguishable from the *Caltex* type of case because the duty owed to the disappointed beneficiary was held to be derived from the duty owed to the testator, which latter duty included a duty to take care in securing the intended benefit for the plaintiff; securing this benefit was the very aim of employing the solicitor. There was no such nexus between the activities of the dredging company and the profits expected by Caltex. On the other hand, the main relevance of the fact that the very aim of consulting the solicitor was, *inter alia*, to benefit the plaintiff was that it forged a relationship of close proximity between the plaintiff and the defendant. In *Caltex* it was held that there was close proximity between the plaintiff and the defendant because, *inter alia*, Caltex was a specifically foreseeable user of the pipeline. The factor common to the two cases — close proximity between the parties — is more important and basic than the fact that different facts give rise to the close degree of proximity in the two different cases.[35] Since Caltex was a specifically foreseeable user of the

[31] Hayes, *op. cit.* 84, 94.
[32] (1889) 14 App. Cas. 337.
[33] [1964] A.C. 465.
[34] [1979] 3 W.L.R. 605.
[35] *Cf. ibid.* 618.

pipeline, it was also specifically foreseeable as likely to suffer economic loss consisting either of additional expenditure or loss of profits if the pipeline was rendered inoperative.

While allowing recovery for less rather than more economic loss is clearly justifiable, it seems wrong to suggest that doing so by distinguishing between types of economic loss is analytically sound or, indeed, any more principled[36] than doing so by requiring that the plaintiff be individually or specifically foreseeable. If it is thought that, in addition to the latter test, a criterion is also needed to limit the amount of his economic loss that each individually foreseeable plaintiff may recover, then this could be provided by requiring that not only the type but also the amount of the plaintiff's economic loss must be foreseeable.[37]

(2) That economic loss has a propensity to spread widely. This in itself provides no reason to limit the *kinds* of economic loss recoverable provided the number of plaintiffs is limited.

(3) That economic loss has a propensity to inflict particular individuals heavily. This argument, too, provides a justification for limiting recoverable economic loss to expenses actually incurred. But, as with (1), the argument can be met in other ways.

Professor Hayes argues, in addition,[38] that to allow recovery for profits lost would be to encourage corporate plaintiffs who could well afford to make alternative arrangements to sit by in the confident expectation of being able to recover their lost profits from the negligent defendant. This is implausible: most companies have much more to lose than the profits on unfulfilled contracts by having their business shut down for any significant length of time. The prospect of protracted litigation at some uncertain future date is unlikely to appear worth the disruption of a shut-down. But also, under ordinary principles of mitigation a plaintiff will not be allowed to sit by idly when the reasonable thing for him to do would be to make alternative arrangements. Claims for loss of profits in situations of this type will only be sympathetically heard when it would be unreasonable to expect the plaintiff to have taken active steps or when the taking of such steps was impossible.

But even if recovery for benefits not received is allowed in tort, it does not follow that the economic torts will be swallowed up. A good argument could still be made for requiring intention and unlawful means in cases in which the loss was inflicted by engaging in trade and competition. In a free enterprise economy competition is a value worth preserving at the price of

[36] [1977] A.S.C.L. 549.

[37] *The Liesbosch* [1933] A.C. 449, 460-1; but see n. 24 and *Taupo B.C. v. Birnie* [1978] 2 N.Z.L.R. 397. In some cases it is an argument against shifting economic loss from the plaintiff to the defendant that such loss has been suffered by very many people but only in small amounts, *e.g.* the case of a bridge collapse which cuts thousands off from the city centre.

[38] Hayes, *op. cit.* 114.

not giving protection against the activities of those who engage in trade with less than full regard for the interests of their competitors. The point could be put more strongly by saying that freedom to compete and a duty to take reasonable care not to injure the interests of one's competitors are mutually incompatible. But negligence which furthers no end other than the freedom to be careless hardly deserves immunity.

Tort and contract

There is one argument not adverted to by Professor Hayes which could be put forward in support of his position, namely that expectation losses are recoverable only in contract and not in tort. This argument is usually based on the contentions that legitimate expectations only arise from and can only be measured by reference to bargains. This argument is fairly easily countered in cases in which there is a relationship of reliance or one equivalent to contract between the parties;[39] or when the loss consists of having paid for a product more than it is worth.[40] It is also fairly easily countered in a *Ross v. Caunters* situation: the expectation in such a case seems clearly legitimate, being founded on the voluntary exercise of professional skill; the expected benefit can be measured by reference to the terms of the will; and the very aim of consulting the solicitor was to secure the benefit for the plaintiff.

How is the argument to be countered in a *Caltex* type of case? It is suggested that, given the contentions underlying the argument, it has no relevance to this type of case. It is clear that an expectation of profit from a contract with a third party is legitimate and that it is measurable by reference to that contract. It is not that the expectation has been disappointed in that the person looked to for that benefit has failed to fulfil his part of the bargain — he is quite willing and able to perform. It is one thing not to deliver a benefit which another expects one to provide; it is quite another to disable a party from performing the acts on which entitlement to the benefit depends.

It is concluded, therefore, that there are good reasons against and no compelling reasons in favour of restricting recovery for economic loss in negligence to expenses actually incurred as opposed to benefits not received.

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[39] Cane P., 'Physical Loss, Economic Loss and Products Liability' (1979) 95 *Law Quarterly Review* 117, 138-9.
[40] *Ibid.* 140.
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