

COMMON-LAW ECONOMIC TORTS: AN ECONOMIC AND LEGAL ANALYSIS

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I. INTRODUCTION

When the kind of behavior on which tort liability can be predicated, such as carelessness, causes a physical or emotional injury, or even a loss of reputation, it is natural to suppose that more than “economics” is involved and that economic analysis is merely one candidate for guiding the formulation of doctrine. But when the behavior causes only an “economic” harm in the narrowest sense, that is, a financial loss unrelated to any physical contact with the victim or even with his property, there is no ground that I can understand for framing the inquiry in other than economic terms. This is provided, however, that the inquiry is understood to comprehend all relevant costs and benefits, including costs of using the legal system to redress harms, costs of insuring, and the possible disutility from having to bear a risk that cannot be shifted through insurance or otherwise. But given these qualifications, which amount merely to an insistence that economic analysis be done correctly, it should be uncontroversial to claim that the best rule of law for the “economic torts” will be the most efficient rule of law. I define economic torts to mean tort claims that do not allege physical contact with the victim or his property or harm to such nonfinancial, or at least noncommercial, goods as business reputation and personal privacy.

It is surprising that the economic literature on the economic torts is so sparse relative to the economic literature on the physical torts—torts involving personal injury or property damage—including the wrongful taking of property (conversion).¹ One might have thought the economic torts a more natural target of

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1. For other discussions of the economic-loss doctrine, see WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 251–55 (1987); W. Bishop, *Economic Loss in Tort*, 2 OXFORD J. LEGAL STUD. 1 (1982); Mauro Bussani,

economic analysis. The principal exception to the neglect of those torts concerns the competitive torts, which are based on notions similar to those that inform the antitrust laws—a field deeply plowed by economists. I exclude them from the category of “economic torts” discussed in this paper. I discuss just four areas, all controversial, within the nebulously bounded domain of economic torts: the economic-loss doctrine, liability of negligent providers of services to third parties, intentional interference with contract, and the award of punitive damages for breaking a contract (usually an insurance contract) in bad faith.

If the only normative issue regarding the law of economic torts should be the law’s efficiency, then we have only to determine the congruence between the particular doctrines of that law and how an economist would analyze the disputes governed by those doctrines. If there are discrepancies, the law should be changed to bring it into line with the economics.

II. THE ECONOMIC-LOSS DOCTRINE

I begin with a concrete illustration that clearly exhibits the difference between economic and physical torts. The example will be my vehicle for discussing the “economic-loss” doctrine,² the most discussed doctrine of the law relating to economic torts.

Suppose *A* owns a store and *B* is a builder who is using a crane to construct a building next to *A*’s store. Through *B*’s negligence, his crane falls on *A*’s store, damaging the store and injuring *C*, one of the store’s customers. *A* can sue for the property damage plus loss of profits while the store is closed for repairs, and *C* can sue for her pain and suffering and lost earnings even if she is an “eggshell skull” plaintiff who would not have been injured at all had her skull been of average thickness. The fact that *C*’s damages are unforeseeable is no bar to her recovering her full damages from *B*; likewise, the fact that the amount of *A*’s lost profits would have been completely unforeseeable.

But now suppose that the crane, instead of falling on *A*’s store, falls on the public sidewalk directly in front of the store, blocking the entrance and thereby forcing the store to close until the crane is removed and the sidewalk repaired, which might take several days. Assuming as before that the accident was caused by *B*’s negligence, should *A* be allowed to sue *B* for the profits lost while the store is closed?

The answer given by the economic-loss doctrine is “no.”³ The economic reasons—the only reasons I am interested in—are several.⁴ First, *A*’s lost profits

Vernon Valentine Palmer & Francesco Parisi, *Liability for Pure Financial Loss in Europe: An Economic Restatement*, 51 AM. J. COMP. L. 113 (2003); Victor P. Goldberg, *Recovery for Economic Loss Following the Exxon Valdez Oil Spill*, 23 J. LEGAL STUD. 1 (1994). Bishop’s 1982 paper makes most of the economic points relevant to assessing the doctrine.

2. See generally *E. River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858 (1986); *Miller v. U.S. Steel Corp.*, 902 F.2d 573 (7th Cir. 1990).

3. See, e.g., *532 Madison Ave. Gourmet Foods, Inc. v. Finlandia Ctr., Inc.*, 750 N.E.2d 1097, 1103 (N.Y. 2001).

4. For other discussions of the economics of the economic-loss doctrine, similar though not identical to the present one, see the references in note 1 above (especially

are, in the language of economics, a “private” rather than a “social” cost. A social cost is a diminution in the total value of society’s economic goods; a private cost is a loss to one person that produces an equal gain to another. In other words, private costs result in a transfer of wealth but not a diminution of it. The property damage to *A*’s store and the physical injury to *C* are social costs because they are not offset by gains elsewhere. But *A*’s lost profits *are* offset elsewhere and are therefore merely a private cost. If *A*’s store is closed, his customers will shop elsewhere: *A*’s lost profits will be his competitors’ gain.

But we must consider whether his *entire* lost profit will be their gain or whether there will be some slippage, and therefore a diminution of aggregate wealth as well as a wealth transfer. There will be no significant slippage if but only if the average costs to the other stores of selling to additional customers do not increase. They will not increase if, for example, the stores do not have to add staff, or pay a premium to obtain the additional goods they need to cope with the surge in demand.

The “only if” (their costs do not rise) qualification is important. If a firm is at full capacity and therefore selling in a region of increasing marginal cost, the adjustments necessary to increase its output, especially in the short run, are apt to increase its marginal cost significantly. But not if it has some excess capacity. Although “excess capacity” sounds like waste, it need not be. Most retail establishments operate most of the time with a bit of excess capacity in order to handle peak demands. “Extra” would be a better term for it, because this “excess” capacity is really peak-load capacity, and so provided that the collapse of the crane does not occur at Christmas or some other peak selling period, the stores to which *A*’s customers switch when *A*’s store is closed will be able to handle the additional demand at no or very slight extra cost, especially if *A*’s customers spread out among a number of other stores rather than piling into just one. Assuming, therefore, that all of *A*’s lost profits are shifted to other store owners rather than being eaten up in higher costs incurred by those store owners, *B* has not caused a net social loss beyond the cost of repairing the sidewalk, for which it should be liable—but of course not to *A*, who does not own the sidewalk or have an obligation to pay for its repair.

A second reason not to impose liability for *A*’s lost profits is that it is very difficult for *B*, the crane company, to estimate its potential liability in advance of the accident. It would have a general idea of how many people it might hurt, or how much property damage it might do, if its crane collapsed; but it could not estimate the costs arising from the interruption that the collapse might cause in business activities and the inconvenience that the collapse might cause customers of those businesses. This uncertainty would prevent *B* from determining how much it should invest in precautions to prevent the collapse of its crane (that is, the investment that would equate the cost of precaution to the expected benefit in reduced legal liability). It would also make it difficult, and indeed probably impossible, for *B* to buy insurance against liability for such consequences. In

Bishop’s 1982 article) and my opinion in *Rardin v. T & D Machine Handling, Inc.*, 890 F.2d 24 (7th Cir. 1989).

general, insurance can be purchased only if the insurance company can calculate the risk of loss, since without such a calculation there is no way to fix a premium.⁵

In contrast to the debilitating uncertainty faced by the crane company, each business that might be affected by such an accident knows the value of its inventory and of its fixed assets, knows its customers' behaviors, the pattern of demands, staff expense, and so forth, and can use that information either to take precautions (the commercial equivalent of fastening one's seatbelt) that will minimize any business losses from an accident, or to buy insurance. For an insurance company should be able to calculate the risk of business loss from *all* accidents, as distinct from an accident caused by the fall of a crane. Business-loss insurance, it is true, is bound to be incomplete because of the moral-hazard problem of insuring a business against a loss of profits, that is, the tendency of insurance to cause the insured to relax his efforts to prevent the event insured against from coming to pass. But the limited liability of businesses that operate in the corporate form, and their ability to discharge their liabilities in bankruptcy, are, from a functional standpoint, forms of business-loss insurance.

In addition, however, if the victims of an economic tort are numerous (unlike my hypothetical case, where there was only one principal victim), and each incurs only a small loss, then letting the loss rest with them, rather than shifting it to the injurer, is an automatic if highly imperfect form of insurance. It is in fact self-insurance, with the victims constituting the insurance pool. Most people prefer to self-insure against risks of small losses—hence the deductibles found in most insurance policies—although, deductibles have the additional function of inducing the insured to exercise care, which reduces the moral-hazard problem inherent in insurance.

I have described two distinct methods by which potential victims can, in advance, minimize their losses from the collapse of the crane: preventing a loss from occurring in the first place (as by minimizing the amount of inventory kept in the store) and insuring against the loss. The second method may seem merely a way of shifting a loss, from the insured to the insurance pool, much like the shifting of profits from *A* to his competitors, rather than a way of reducing the loss. But that is incorrect. Risk is a real cost, in the sense of disutility, to anyone who is risk averse.⁶ Insurance reduces the risk by translating it into a certain cost (the insurance premium) borne by all the members of the insurance pool. One might doubt that business firms would be risk averse, since corporate shareholders can eliminate the risk of a plunge in the value of the individual stocks in their portfolio by diversifying their portfolio. But not all firms are corporations, let alone

5. It is true that members of the Lloyd's syndicate in London will "insure" against risks that cannot be quantified, but this is not insurance in the conventional sense; it is gambling.

6. Risk aversion is an implication of diminishing marginal utility of income. Most people would prefer to pay \$20 to avoid a .001 probability of a \$10,000 loss than to take their chances on the loss, even though the expected cost of the loss is only \$10 ($\$10,000 \times .001$). The reason is that the expected disutility of such a loss is much greater than the expected cost because inframarginal dollars are worth more than marginal ones. It is the same reason that most people would not put up \$1 million for a 50 percent chance of winning \$2 million.

corporations whose stock is publicly traded, and not all risk-averse investors hold diversified portfolios; they might like to, but it might be too costly for them. Moreover, corporate officers and employees may have firm-specific human capital, which is not diversifiable, and if so they will incur disutility from the risk that their corporation faces.

It is true that by reducing the disutility of a damages judgment, liability insurance may increase the number of accidents. But provided that compensation is full, an increase in the number of accidents need not reduce economic welfare.

The upshot of this analysis is that efficiency may be promoted by shifting the legal responsibility for an accident from the injurer to the victim. This is simply generalizing to tort law the contract-law rule of *Hadley v. Baxendale*,⁷ and indeed I did this many years ago in a case called *Evra*,⁸ which was much like *Hadley* except that there was no contractual relation between injurer and victim. The point in *Hadley*, as in my hypothetical case of the crane, was that the carrier could not estimate the loss that the customer would incur from a delay in the delivery of the repaired mill shaft to the customer, but the customer could estimate this cost and, therefore, was in a better position to avoid the loss by taking appropriate precautions or by buying insurance.

The third economic reason for the economic-loss doctrine is that the determination of damages is more difficult when there is no physical connection to the injury because it is much harder to delimit the victims. The collapse of the crane would undoubtedly interrupt more routines than merely that of the store it fell in front of. Owners of other stores on the block might complain that they had lost sales because of the obstructed sidewalk, though in fact their loss might have been due to other factors. *A*'s suppliers and employees would claim they had lost profits and wages respectively when the closing of the store eliminated its purchase of goods and caused it to lay off most of its workers. And many of these losses would generate offsetting gains to others—other buyers of the goods, other stores—exacerbating the first problem that I discussed that motivates the economic-loss doctrine. No doubt the losses incurred by customers inconvenienced by having to find another store to shop at could be disregarded as *de minimis*, but this approach could be carried only so far without liability unraveling altogether. Although litigation over such matters could be simplified by means of the class-action device, class actions present their own problems and have at best only limited value when members of the class incur different damages, which must be separately assessed.

Closely related is the fact that there are likely to be many fewer victims in a physical tort case than in an economic tort case. There have of course been a number of “mass tort” cases, but generally an accident that involves solely personal injury or property damage has only a few victims. In contrast, in a complex, integrated economy, an economic tort is apt to cause eddies of economic harm, encompassing a large number of victims incurring different levels of loss.

7. (1854) 156 Eng. Rep. 145 (Exch.).

8. *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951 (7th Cir. 1982).

There would also be a risk of double-counting. Suppose *A*'s store sold goods at wholesale rather than retail. Its closure might force its wholesale customers to buy elsewhere at a higher price. They would try to pass on a portion of their costs to their customers in the form of a higher price. To the extent they succeeded, their loss from the closure would be shifted to the customers. Deciding in what proportions the loss had been split between the two tiers would present baffling problems of incidence analysis that caused the Supreme Court, in a related context, to forbid indirect purchasers (purchasers from purchasers) from a price-fixing seller to sue the seller for his antitrust violation.⁹

A final point is that liability for any personal injury or property damage caused by a negligent accident preserves at least some deterrence, making it less important to provide recovery to the additional victims, whose loss was purely financial. But this will not work in all cases: The crane might have fallen and blocked the entrance to *A*'s store without damaging the sidewalk, though even then the accident will not be completely costless to *B*, because it will interrupt his business as well as *A*'s.

Thus economic analysis supports the economic-loss doctrine, which denies tort liability for a purely economic tort. But remember the other victim in our first hypothetical case, *C*, who was physically injured yet is allowed to recover her purely "economic" losses, namely her lost earnings, and also the "unforeseeable" damages resulting from the fact that she is an abnormally vulnerable victim. Is not that result inconsistent with the economics of the economic-loss doctrine? It is in tension with it, certainly, but it is not completely inconsistent with it. The uncertainty is much greater in *A*'s case than in *C*'s case. In *C*'s case, the owner of the crane, or his insurer, will be able to estimate the damages, both economic (lost earnings) and noneconomic, of the average victim. This estimate will be correct on average and will enable the owner of the crane to determine the optimal precautions to take against the risk of its collapsing. It will also enable the insurance company to compute a premium. The variance in potential losses to a business is much greater and the mean much more difficult to estimate. Other differences between the cases are the greater ease of delimiting the victims when the basis of liability is a physical injury and the fact that there are likely to be many fewer victims.

To complete the economic analysis of the economic-loss doctrine, it is necessary to consider why in most jurisdictions the doctrine is no longer applied to cases of misrepresentation: Why, in short, Cardozo's famous opinion in the *Ultramares* case¹⁰—which establishes the principle that an auditor who misrepresents the financial condition of the firm that he audited is not liable to the

9. Ill. Brick Co. v. Illinois, 431 U.S. 720, 730 (1977); see also William M. Landes & Richard A. Posner, *Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws? An Economic Analysis of the Rule of Illinois Brick*, 46 U. CHI. L. REV. 602 (1979).

10. *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931).

firm's lenders for the consequences of the misrepresentation even though they reasonably relied on it in deciding to lend to the firm—is now a minority view.¹¹

In fact, the considerations that support the economic-loss doctrine support the denial of liability in the auditor case and suggest that *Ultramares* was correctly decided. True, the victims are much better delineated: They are the firm's lenders (or in some cases their other creditors, or their shareholders), whose identity is a matter of public record. And the auditor will have a better idea of the potential magnitude of a misrepresentation, since he will know a lot about the company he is auditing. But the gap between private and social cost, the first strut of the economic-loss doctrine, is at its widest. The auditor's misrepresentation will ordinarily consist of concealing bad news about the company being audited. That bad news will eventually leak or otherwise become public, which means that the effect of the misrepresentation will have been to transfer wealth from one group of lenders or shareholders to another, rather than to bring about a net diminution of the lenders' or shareholders' wealth. Shareholders who sold their shares before the bad news emerged will benefit at the expense of those who bought the shares and were left holding the bag when the price of the stock crashed. The only net economic loss will be the injection of additional uncertainty into credit or securities markets, rendering these markets slightly less efficient. That is a loss different from and much smaller than the private losses of the lenders who decided to lend or not to lend to the firm, or the shareholders induced to buy its shares. In such a case, tort liability is an inferior remedy to a fine calibrated to the actual social loss caused by the misrepresentation.

If the misrepresentation is deliberate, it might seem that we should not worry about excessive damages; the threat of liability will deter. In contrast, when liability is strict or even when it is based on negligence, excess liability may deter excessively because it cannot be avoided simply by good behavior. The reason this is true in negligence cases as well as in strict liability cases is that negligence has, by virtue of the "reasonable person" rule, a strict-liability component: Failure to employ average care is negligence even if the injurer is incapable of taking that much care.¹²

III. LIABILITY TO THIRD PARTIES OF NEGLIGENT PROVIDERS OF SERVICES

Ultramares belongs to a class of cases some of which, unlike the auditor cases, do not involve a large gap between private and social cost, or some other impediment to liability. These are cases in which a breach of contract injures a third party. Precisely because the victim is a third party (and, let me assume for the moment, not a third-party beneficiary of the contract, who would have the rights of an original party), his remedy if at all is in tort, and the question is whether such a person should ever have a tort remedy. The simplest such case is where the breach results in a mistaken wealth transfer. For example, a testator instructs his lawyer to include in the testator's will a bequest to *A*, and by mistake the lawyer makes the

11. See, e.g., *Vigil v. State Auditor's Office*, 116 P.3d 854, 860 (N.M. Ct. App. 2005).

12. LANDES & POSNER, *supra* note 1, at 124–28.

bequest to *B* and the testator signs the will without noticing the mistake.¹³ If *B* has the money when the mistake is discovered, *A* should be able to obtain restitution of it; mistake is a common ground for restitution. If *B* no longer has the money, or, having reasonably relied on the legitimacy of the bequest, would incur costs (beyond merely the loss of the use of the money) in returning it, the lawyer should be liable for the consequences of his negligent mistake.

But I want to revisit the assumption that the plaintiff, *A*, is not a third-party beneficiary of the contract between the testator and the lawyer. A person is a third-party beneficiary if the parties to the contract intended him to have the rights of a party; specifically the right to sue in the event of a breach and recover damages. The doctrine of third-party beneficiaries provides a superior approach to tort liability in the case of the erroneous bequest and probably in the auditor cases as well. If the intended legatees are third-party beneficiaries, the lawyer will be exposed to greater liability and as a result will presumably charge a higher price for preparing the will. The testator will then decide whether the increase in the price is worth incurring in order to reduce the risk that the wrong legatee will inherit. (The risk will be reduced because as a third-party beneficiary the intended legatee will be able to enforce the bequest.) It is better that the tradeoff be made by the parties themselves, namely the testator and his lawyer, than by a court in a tort suit. So here is another area where application of the economic-loss doctrine is efficient.

This recasting of tort as contract will not work in an important class of cases involving the negligent provision of services that harms a third party. These are cases in which the negligent performance of a contract between an employer and a third party causes the employee to be fired or incur other harm. Illustrative are cases in which an employer requires an employee to take a test for the presence of illegal drugs in his body and the lab to which the employer sends the employee's urine specimen negligently conducts the test and reports a false-positive. It is unlikely that the contract parties—the employer and the lab—intended that the employee be empowered to enforce their contract, which expressly or by implication required the lab to use due care in evaluating the test results. So the employee is not a third-party beneficiary; but should he be allowed to bring a tort suit, even though it is an “economic-loss” case because there has been no physical injury to person or property? The courts are divided.¹⁴ The argument against tort liability is that the employer has an adequate incentive to enforce the contract, and if it learns of the erroneous result it will terminate the contract or insist on better care or a lower price and it will rehire the erroneously fired employee (presumably an employee at will, who therefore had no right to be rehired even though he had been fired without good cause). But this seems implausible. Generally it is only lower-level employees who are required by their employers to submit to drug tests, and an occasional false positive will do little

13. See, e.g., *Conn. Junior Republic v. Sharon Hosp.*, 448 A.2d 190 (Conn. 1982); *In re King's Will*, 128 S.E. 850 (S.C. 1925).

14. Compare *Willis v. Roche Biomedical Labs., Inc.*, 61 F.3d 313 (5th Cir. 1995) (no liability under Texas law), with *Stinson v. Physicians Immediate Care, Ltd.*, 646 N.E.2d 930 (Ill. App. Ct. 1995) (liability), and *Elliott v. Lab. Specialists, Inc.*, 588 So. 2d 175 (La. Ct. App. 1991) (liability).

harm to the employer; he will easily find substitute workers. The principal victim and therefore logical enforcer of the lab's duty of due care is the employee, and so he should have a right to bring a tort suit.

IV. INTENTIONAL INTERFERENCE WITH CONTRACT

The type of economic tort (or rather, what would be a tort were it not for the economic-loss doctrine) that falls within the scope of the economic-loss doctrine might be called the "pure" economic tort because it does not arise from a contractual relation between injurer and victim, although there may be, as in the cases I discussed in Part III, a contract lurking in the background. The other major type of economic tort is supervenient on a contract in a more direct sense. One example, which is the subject of this part of the paper, is intentional interference with a contract (or with advantageous business relations that have not yet crystallized in a contract); another is bad-faith breach of an insurance contract; another is defrauding a customer.

If *A* and *B* have a valid contract, and *C* induces *B* to break it and recontract with him (*C*) instead, *C* has committed the tort of intentional interference with contract.¹⁵ At first glance this result seems contrary to the dictates of efficiency, and in particular to the important economic doctrine of "efficient breach." Suppose that in the contract between *A* and *B*, *A* had agreed to pay *B* \$100,000 for *B*'s performance, and that *B*'s breach of that contract (committed in order to recontract with *C*) would impose damages of \$10,000 on *A*. Then *B* will not agree to break his contract with *A* and recontract with *C* unless *C* agrees to pay *B* at least \$110,000 (\$100,000 for the performance itself, \$10,000 to compensate *A* for *B*'s breach of contract, for which *B* is liable), which *C* will not do unless *B*'s performance is worth at least \$110,000 to him. That will therefore be the minimum price in the new contract, the contract between *B* and *C*. So at the end of the sequence of breach and recontracting, *A* will be no worse off and no better off than before, *B* will also be no worse off—he will have \$110,000, or more if *C* agrees to pay him more, in which case *B* will be better off—and *C* will be better off by whatever the difference between what he agrees to pay *B* and what *B*'s performance is worth to him.

One party is better off and the other two are no worse off (and one of them, *B*, may be better off too), so the sequence is efficient and why should *C* be guilty of a tort? Of course, if barred from dealing directly with *B*—if forced instead to orchestrate a three-cornered deal in which *A* would voluntarily terminate his contract with *B*—*C* might achieve the same result. But the cost would be higher because of the complexity of the transaction. So *C* should not be liable.

But if the facts are changed, an economic rationale for liability for procuring a breach of contract heaves into view. Suppose that *B* is judgment-proof; then there is no longer a basis for confidence that the breach and recontracting will produce a net gain in economic welfare; *A*'s uncompensated loss might exceed the benefit to *B* and *C*. Or suppose there is no recontracting but merely a breach induced by mistaken information conveyed by *C* to *B*; maybe *C*, having agreed to

15. See, e.g., *Lumley v. Gye*, (1853) 118 Eng. Rep. 749 (Q.B.).

guarantee *B* against certain business losses, mistakenly informs *B* that *A* is about to declare bankruptcy, and this causes *B* to terminate the contract, as *C* intended. Such a breach may well be inefficient, in which event *C* should be liable. None of the considerations, discussed earlier, that support the economic-loss doctrine argues against liability in such a case.

The law is not as clear as it could be in differentiating between “interferences” with contract that result in an efficient breach and should therefore not be deemed a tort and subjected to sanctions that would either prevent the efficient breach or require a roundabout recontracting, and interferences that induce breaches that reduce efficiency. In generally distinguishing between proper and “improper” inducements to breach, however, the law is not necessarily inconsistent with the economic approach. The Prosser treatise notes that “it is usually said that tort liability may be imposed upon a defendant who intentionally and improperly interferes with” the contract of another, but that “a defendant might intentionally interfere with the plaintiff’s interests without liability if there were good grounds for the interference.”¹⁶ This leaves it nicely vague.

But the Restatement’s treatment of the issue is hopelessly vague. On the one hand, “Even though *A* knows of *B*’s contract with *C*, he may nevertheless send his regular advertising to *B* and may solicit business in normal course. This conduct does not constitute inducement of breach of the contract.” On the other hand,

A writes to *B*: “I know you are under contract to buy these goods from *C*. Therefore I offer you a special price way below my cost. If you accept this offer, you can break your contract with *C*, pay him something in settlement and still make money. I am confident that you will find it more satisfactory to deal with me than with *C*.” As a result of this letter, *B* breaks his contract with *C*. *A* has induced the breach.¹⁷

The first hypothetical case may be hinting at a mass mailing; *A* shouldn’t be put to the bother of filtering out addressees who he knows already have a contract, but the example does not say this. The second hypothetical case may be hinting at the presence of predatory pricing (“a special price way below my cost”), though in fact sales below cost need not be predatory; they may be ways of marketing a new product or disposing of obsolete inventory. Again the example does not say. Stripped of equivocal overtones, the second case merely makes explicit what is implicit in the first. If *B* accepts the solicitation in the first case, he will break his contract, and the second case is just the same: He will break his contract if he thinks he will do better dealing with *A* even though he will have to compensate *C* for the damages to *C* from the breach. Of course if *A*’s solicitation in the second case is inaccurate in promising *B* a better deal, there may be liability; but that is not part of the Restatement’s example.

16. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 129, at 978, 983 (5th ed. 1984). *See also id.* at 979.

17. RESTATEMENT (SECOND) OF TORTS § 766 cmt. m, illus. 3 (1979). To avoid being confused, note that in the Restatement example, *A* is the “interferer” and *C* the victim of the breach; in my example, *C* was the interferer and *A* the victim.

The sensible rule would be to refuse to impose tort liability unless the contract remedy is inadequate. The principal case in which this condition will be fulfilled is where the victim of the breach has no incentive to sue, for example because the contract breaker is insolvent (but the procurer of the breach—the interferer—is not), or because, as in my drug-testing example, the principal harm from the breach falls on a third party rather than on the contract victim of the breach (that is, the promisee).

V. BAD-FAITH BREACH OF CONTRACT

Consider finally the case of a breach of contract in bad faith, which is sometimes treated as a tort. The main significance of such treatment is that it might entitle the victim of the breach to punitive damages, which are not awarded in a contract suit for breach. It gratuitously complicates the law to create a tort in order to be able to award punitive damages in certain breach of contract cases. If it is a good idea to award such damages when a contract is broken in bad faith, then the rule denying punitive damages for breach of contract should be modified to allow them to be awarded in such cases. In other words, the question should not be posed as contract versus tort, but as compensatory versus punitive damages in contract cases. It is not a good idea to allow contract cases to be recast as tort cases in order to escape the limitations that the law has placed on suits for breach of contract. Indeed, the original office of the economic-loss doctrine was to prevent the kind of end run around those limitations that is attempted when, for example, the buyer under a contract that disclaims oral warranties sues the seller on the ground that he made an oral misrepresentation.¹⁸

But what about the end run that is attempted—and that the law allows to succeed—when one sues one’s doctor for the tort of professional malpractice rather than just suing for breach of one’s contract with the doctor? Perhaps the answer is simply that tort law is oriented toward cases involving a physical injury and contract law is not, but that answer will not do when the suit for professional malpractice is not against one’s doctor but against one’s lawyer. Here the unsatisfactory answer is that the lawyer is a fiduciary of his client rather than merely a seller of services, and breach of a fiduciary obligation is a tort. But wouldn’t it make more sense to say that a fiduciary duty (basically the duty to treat the obligee as well as you would treat yourself, rather than at arm’s length) is an implicit term of some contracts, rather than use the presence of such a duty to change a dispute arising out of a contractual relation from a breach of contract case to a tort case?

This discussion, however, leaves unanswered the basic question, which is whether punitive damages should ever be awarded for a breach of contract. The general rule denying such damages for breach makes good economic sense. Quite apart from the fact that many breaches are either efficient or involuntary, many contracts contain an insurance component even when they are not insurance contracts. An example is when by promising performance that may prove beyond the promisor’s ability to deliver, the promisor assumes the risk of failure and thus

18. See, e.g., *All-Tech Telecom, Inc. v. Amway Corp.*, 174 F.3d 862, 866 (7th Cir. 1999).

insures the promisee against the consequences of failure. There is no “wrongdoing” when the risk materializes; the “breach” is the equivalent to an insured event coming to pass, obligating the insurance company to pay insurance proceeds to the insured.

Punitive damages are an efficient remedy when wrongful acts are likely to go undetected. When such an act *is* detected, the damages must be jacked up to generate the proper level of deterrence.¹⁹ In addition, when the wrongful act is so patently wrongful that there is no risk of overdeterrence, we might as well throw the book at the wrongdoer in order to make doubly sure that such wrongful acts are deterred. A related reason for awarding punitive damages is found in cases in which there is significant injury but compensatory damages cannot be computed accurately, so that adding a dollop of punitive damages has the effect of resolving the uncertainty about the magnitude of the injury in favor of the victim. And still another case is when, though aggregate damages may be significant, no single victim of the wrongful act has sufficient damages to make suing worthwhile.

None of these is a general feature of breaches of contract. The breach itself is rarely concealable; liability for breach of contract is strict, so that as noted many breaches are involuntary rather than willful; even deliberate breaches may be efficient and therefore socially desirable rather than wrongful; compensatory damages can usually be calculated with a fair degree of confidence in their accuracy; and potential victims of breaches of small contracts are compensated in the contract price for not having a good legal remedy in the event of a breach.

The last point may require a bit of elaboration. Since liability for breach of contract is strict, contracts are, as we know, often broken for reasons beyond the control of the party who broke the contract. Knowing this, the party to a small contract should realize that he cannot rely on legal remedies for breach and must seek protection elsewhere, for example in the seller’s interest in maintaining a good reputation; or else he must demand compensation for bearing the risk that the other party will not honor the contract.

So it will be rare for punitive damages to be appropriate for breach of contract; but rare is not never. If a party to a contract deliberately takes advantage of a gap in the remedial structure that makes compensatory damages an inadequate remedy, then an award of additional damages makes sense to deter opportunistic conduct not otherwise deterred. These cases will be extremely rare, and perhaps limited to very small contracts, where it just doesn’t pay to sue without a boost in expected damages. In the ordinary case, the victim’s legitimate interests are fully protected by an award of compensatory damages, whether or not the breach was willful. For example, if a party to a contract uses the threat of a breach to extract a

19. Suppose that a tortfeasor’s torts impose an average cost on his victim of \$1,000, but the tort is detected and the tortfeasor forced to pay damages in only one out of every four cases. If damages are limited to \$1,000 per case, the expected cost to the tortfeasor will be only \$250. The correct measure of damages is calculated by dividing the cost imposed on each victim by the probability that the victim will sue and win, so in the example the proper damages award is \$4,000 ($\$1,000 \div .25$), of which \$3,000 represents the punitive component, since the victim’s damages are only \$1,000.

favorable modification of the contract—a form of duress—the modification will not be enforced.²⁰

The principal case in which punitive damages are awarded for breach of contract is an insurance company's bad-faith refusal to honor the insurance contract.²¹ "Bad faith" means simply groundless (what else could it mean in this context?). Of course if it is groundless, this means that the insured has a solid claim for the insurance proceeds and can sue for them with excellent prospects for winning. It is not clear why he needs to be allowed to obtain punitive damages to boot. It is unsatisfactory to say that "there are no efficient breaches in the insurance context; breaches of insurance contracts can *only* be opportunistic."²² Breaches can be involuntary or accidental without being either efficient or opportunistic. There may be genuine factual or legal uncertainty about the insurer's duty to indemnify the insured. In some jurisdictions, the result of the bad-faith rule is that insurers who do not consider themselves liable on the policy bring declaratory judgment suits to establish their nonliability. There would be fewer such suits without the rule.

A better reason for the bad-faith principle, though it is applicable only to some cases, is that the insured may be highly dependent on prompt receipt of the insurance proceeds (for example if his house has burned down), and this might enable the insurance company to drive a hard bargain in settlement negotiations. However, this problem could be handled, as other opportunistic breaches of contract are, by the doctrine of duress, without need to award punitive damages.

VI. CONCLUSION

To summarize briefly, viewed through the lens of economics, the area of tort law that I am calling "economic torts" is reasonably coherent and efficient, as we would expect of common law doctrine dealing with commercial transactions. Here as in many other areas of the common law, economics cuts beneath the semantic complexity of legal doctrine and renders law intelligible in practical, intuitive terms. The fit between economic theory and economic-tort doctrine is imperfect, however, and so my economic analysis has normative as well as positive implications. Because one is dealing here with commercial relations rather than personal injury or profound moral issues, the normative guidance that economics provides should be relatively uncontroversial. The economist's hand on the tiller should enable the necessary mid-course corrections to be made.

20. See, e.g., *Alaska Packers' Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902).

21. See, e.g., *Willow Inn, Inc. v. Pub. Serv. Mut. Ins. Co.*, 399 F.3d 224, 229 (3d Cir. 2005); *Farmers Group, Inc. v. Trimble*, 768 P.2d 1243, 1247 (Colo. Ct. App. 1988). And in Pennsylvania, for example, it is the only type of contract for which punitive damages can be awarded in the case of a bad-faith breach. *DiGregorio v. Keystone Health Plan E.*, 840 A.2d 361, 370 (Pa. Super. Ct. 2003).

22. Dominick C. Capozzola, Note, *First-Party Bad Faith: The Search for a Uniform Standard of Culpability*, 52 HASTINGS L.J. 181, 196 (2000).