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RDL609S **Comparative Private Law 1998**
Dale Hutchison, UCT

Minor LLM Dissertation

Liability in the building industry for negligent acts causing pure economic loss to third parties: A comparative analysis of English, South African, and German law with special reference to *Junior Books v. Veitchi* and the concept of *Vertrag mit Schutzwirkung zugunsten Dritter.*

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Contents

Bibliography

This bibliography contains not only the literature quoted in and used for this dissertation, but contains a detailed list of far-reaching literature for everybody who intends to carry on with the investigation of this interesting comparative topic. This theme has enough substance to be elaborated in a major dissertation.

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Introduction

Third parties in the building industry, contractual *versus* delictual liability

In any major building project many parties are involved, and the various contractual and other legal relationships become complex and require careful analysis.[1] The legal rights and obligations of the building parties like the employer[2]; the main contractor[3]; the sub-contractors; the architect; the quantity surveyor; the clerk of works; and all the specialists depend on each other or at least can influence and effect each other. Often engineering and building works will overlap, intermingle, or are based on each other. The breach of contractual or delictual duties by one building party can have an essential impact on the economical legal interests of other parties connected with the construction project. Not only the contractual parties themselves but everyone who is involved in the building process is in danger to suffer damage. Hence, especially and typically in the building industry third parties may suffer pure economic loss as a result of negligent acts of one party which is not bound by a building contract in relation to the person suffering damage. Because of the multi-party involvement in design and construction few of the involved parties are in contractual relationship with each other, and owners are tempted to recover repair costs and associated consequential losses by seeking to shift the responsibility on those who are insured or financially secure. Liability for negligent acts causing pure financial loss is generally a legal problem that plagues many legal systems[4]. In England especially in the early 1960s until the mid 1980s the construction industry was faced with a remarkable

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1 The scope of building projects is vast, and includes the whole of man's endeavour to create and improve his physical environment. For the construction of roads, railways, large buildings, dams, docks, bridges, power stations, pipe lines, tunnels, sea defences and so on a huge variety of parties come into contact with the construction enterprise. The danger to harms each other by breaches of contractual or other duties is obvious. See **Marks, Marks, Grant,** *Aspects of Civil Engineering Contract Procedure,* p. 1.

2 This party is also named the owner, building owner, or construction user.

3 The contractor is sometimes referred to as the builder or constructual engineer.

4 Economic loss claims in negligence continue to confound the courts, see **Stapleton,** *'Duty of care and Economic loss: A Wider Agenda'*, 1991 (107) LQR p. 249.

growth of extension of negligent-based liabilities to third parties. In the mid 1980s the English Courts began a new trend of caution, tending to restrict liability for negligence and overrule some previous decisions. In South Africa the trend is vice versa. After a reluctance to recover economic loss of third parties, in these days the courts tend to further extend negligent liability infavour third parties. However, the history, present stage and development of economic loss claims may further elucidated in this study. There are not many areas in private law which öffer a better topic for a comparison of law than the present one, *pure economic loss suffered by third parties*.[5] In England, South Africa and Germany[6] the issue of negligence causing economic loss employs the juridical branches and the legal writers since years[7], but the main problems remain still unsolved. This comparative study may reveal the different approaches in English, South African and German law to determine the responsibility especially of sub-contractors and other professionals involved in building projects to third parties. A brief historical background will set the scene, showing that at the beginning of the century there have been gaps in contractual as well as in delictual liability on this field. As we will see, the starting point of the approaches to close these gaps in the common law systems[8] is completely different from the dogmatic origin of the civil law approach in Germany. Today in German law professional liability for negligence towards third parties is in first instance grounded in the law of contract[9]. Only under exceptional circumstances the

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5 See **Van Dunné**, *General Report on Civil Liability for Pure Economic loss,* XVth International Congress of Comparative Law, Bristol, 27 July 1998, p. 1.

6 Other than in the common law and Germanic legal worlds in the Romanistic group of the law systems (like as France, Italy, Belgium, Spain, etc.) the subject is of less interest, see **Markesinis/Deakin**, *An Economic and Comparative Analysis of the Tort of Negligence from Anns to Murphy,* 1992 (55) Modern LR 620.

7 **Markesinis/Deakin** complain the sea of ink which was written about negligence cases, see 1992 Modern LR at p. 619-620, and list the most relevant cases in fn 2.

8 Because of the similarities and the extraordinary strong influence of English law on South African law on the field of liability for negligence in this study both systems are sometimes regarded as 'one common law system'. South African law (Roman Dutch law) is named South African common law. This is not exactly correct but helpful for a comparison.

9 Introductive: **Soergel-Hadding**, *Bürgerliches Gesetzbuch* Band 2 (1990), p. 1582 ff.; Palandt-**Heinrichs**, *Bürgerliches Gesetzbuch* (1996), p. 421, note 13 ff.; *Münchener Kommentar zum Bürgerlichen* Gesetzbuch-**Gottwald**, Band 2 (1985), p. 1024, note 60 ff.

law of delict is applicable. Because of particular shortcomings of delictual remedies[10] the courts mainly invented the concept of 'contract with protective effect to third parties' *(Vertag mit Schutzwirkung zugunsten Dritter)*. In English and South African law liability to third parties is exclusively ruled by the law of tort and Aquilian.[11] The privity of contract doctrine prohibited the extension of contractual liability. Hence, the courts in creating a remedy for recovery of pure economic loss were restricted to the law of delict. The rules governing liability for delict traditionally differ in important aspects from the rules governing liability for breach of contract and constitute a special category of law. *First* for example, a delict consists in the breach of a general *duty imposed by law* independently from the will of the party bound, which will ground an action for damages at the suit of any person to whom the duty was owed has suffered harm in consequence of the breach.[12] The breach of contract, on the other side, consists in the breach of a *duty voluntary assumed*, for example implied obligations of the contractor.[13] In the latter case the duty is not imposed independently of the parties' will, but owes its existence to his voluntary act in entering into the contract.[14] *Secondly*, the delictual duty is a *general* duty, that means it is a duty to persons in general, and not in regard to the existence of a contractual or similar relationship. Obviously the duty in contract is always a *duty to a special and very close circle* of persons - in first instance of course to the contractual parties themselves.[15] In this context, a pre-existing relationship is essential for contractual liability. *Thirdly,* another fundamental difference between contractual and delictual liability is that contractual duties are principally duties to achieve results or a certain level of performance, in contrast to that the functional purpose of delictual duties is to avoid particular harm. *Finally,* the legal interests protected by the law of delict are traditionally restricted to person and property; pure economic interests belong typically to the law of contract. Other than in the law of delict in the neighbouring

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10 Under the general tort provision, par. 823 section 1 *Bürgerliches Gesetzbuch*, only legal interests like *life, body, health, freedom to move, property* and *other absolute legal rights* (economic loss excluded) are protected.

11 See **Salmond/Heuston**, *Law of Torts* (1992), p. 199, 214 ff.; **Boberg**, *The Law of Delict* (1984), p. 91 ff.; **Fleming**, *The Law of Torts* (1987), p. 158 ff.

12 **Mc Kerron**, *The Law of Delict* (7th ed.), p. 5.

13 **Loots**, *Engineering and Construction Law*, p. 27.

14 Ibid., p. 27.

15 As we will see later in German and South African law there are exemptions like *third party beneficiaries* and exclusively in German law *contracts with a protective effect to third parties.*

field of contract the issue of pure economic loss is generally not controversial.[16] However, at the end of this study we will see that today it is true to say, that both the delictual and the contractual approach in issue refer to the overlapping hybridzone between contract and delict. The comparison of German civil law and the corresponding common law solutions will reveal that in both systems the traditional divide between contract and delict has been abolished, or at least has become blurred.[17] Contractual elements like voluntary assumption of liability as well as delictual elements like fault (negligence) are relevant in both approaches. The traditionally strict distinction between contract and delict has developed further to a merger of both categories of liability, the merger between contract and delict. In the light of this merger it is not astonishing that the main requirements of the German contractual approach to extend liability are very similar to the ones of the delictual approach in England and South Africa. In the comparative part of this study a detailed analysis will show that elements like 'foreseeability', 'special degree of proximity', 'the floodgate argument', and the other public policy concern of 'no other means of protection' play their role in all the systems. Finally, at the end of this paper, the advantages and disadvantages of the contractual and delictual approach will be elucidated in particular in the context with surrounding legal issues like limitation of liability and exemption clauses.

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16 **Van Dunné**, *General Report on Civil Liability for Pure Economic Loss*, p. 1.

17 See **Hutchison/van Heerden**, *The Tort/Contract Divide from the South African Perspective*, p. 97.

Part 1

Setting the scene: factual situation, building contracts, liability for negligent acts, third parties and economic loss

I Scope of the paper

This study is restricted to legal relationships of building parties involved in a construction project. The reason for this limitation is threefold: *First*, on the field of building enterprises all relevant legal issues can become relevant. Normally various parties are involved in the building process which has the effect that typically also non-contractual parties are in danger to suffer economic damage by breach of legal duties by another building party. The relationships in the multi-party projects are complex and not limited to mere contractual contacts. The construction site is the ideal stage where construction claims of third parties to recover economic loss arise. *Secondly*, The investigation of all important negligence-economic-loss-cases would be impossible because of the huge number of relevant cases which the courts have decided in the last 30 years. The restriction to building cases might help to find a path through the dgungle of case authorities. *Thirdly*, the building industry is a major part of the states economies. There might be a practical interest of all who are involved in this part of the productive industry to get a concrete view of the topic at issue.

This study is limited to *building contracts* which are underlying the building parties' relationships, it is further limited to liability for *negligent acts*, and to *economic loss* suffered by *third parties*.

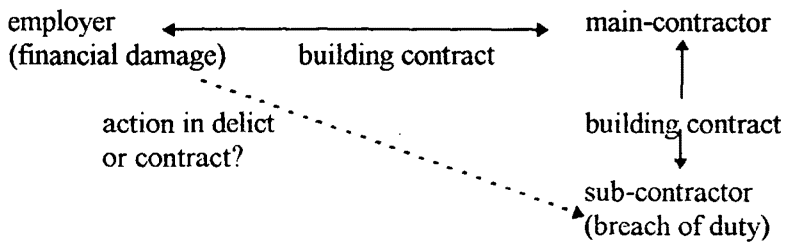
(1) Factual situations

The typical factual situation which are investigated in this paper and where all these elements become relevant can be described in the light of the *Junior Books*[18] case as follows: A sub-contractor, for example a building company or a planning engineer, has a contractual relationship with the main-contractor. There is no privity of contract between the building owner and the sub-contractor or planing engineer. In breach of his contractual duties towards the main-contractor the sub-contractor/planing engineer damages the economical interests of the building owner without causing physical

18 *Junior Books v. Veitchi Co. Ltd.* 1983 (1) AC 520 (HL).

damage to person or property. The building owner suffers pure economic loss caused by the sub-contractor.

Fig. 1: Factual situation



In this cases the interesting question rises if the building owner should have some contractual or delictual remedies against the sub-contractors; in other words if the wrongdoer can held legally responsible for the damage.

(2) Focusing on underlying building and engineering contracts

As we will see later in most cases a particular building contract is underlying the relationship of the wrongdoer and the third party who suffered economic loss although the latter, as the plaintiff, and the wrongdoer as the defendant are not bound by this contract. The plaintiff is not direct party to the contract, but third party. However, in German law the existence of an underlying contract is essential because the third party is protected by being put under the 'protective umbrella' of the underlying building contract. The third party can derive own rights from the building contract although he is a stranger to the contract. Also in English and South African law the effect of the underlying building contract can be essential; but contrary to German law only and exclusively in a delictual context. The contract could, for example, function as a tool to determine the scope of the delictual 'duty of care'. Hence, in this study it is important to focus on underlying building and engineering contracts. A construction or building contract may generally be defined as a contract in terms of which one party, called the builder or contractor, agrees to perform building or engineering work for another.[19] The essence of building and civil engineering contracts is that the contractor agrees to supply works and materials for the erection of a building or other works for the benefit of the employer.[20] In Germany according to par. 1 *VOB Teil A*[21] construction works are defined as works by which a building object is created, maintained, changed or destroyed. For the

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19 **McKenzie/McKenzie**, *Building and Engineering Contracts* (5th ed.), p. 1.

20 **Uff**, *Construction Law*, p. 87.

21 Verdingungsordnung für Bauleistungen.

comparative purpose of this paper these definitions are too restrictive. A building contract in the sense it is used in this study is a contract which is directly connected to the realisation of a building project. Keeping in mind that a construction process can mainly be divided into the planing stage and the construction stage - also the works of the architects, planning and consulting engineers and all the others involved in the building enterprise is considered as to be governed by the 'building contract'. Hence, in this paper the scope of the term 'building, construction or engineer contract' ought to be considered as a wider one.

(3) Liability in general

The rights and duties of construction parties and building professions encompass virtually all forms of liability. Nearly every category of liability comes into play in one form or another. Many building owners, contractors, architects and engineers believe that liabilities, obligations and responsibilities are limited to what is written in the contract. This believe is a misconception. Of course, first and foremost you must read the contract. But the scope of liability is wider. There are many cases when courts will not enforce written agreements, or on the other hand, will enforce inferred or implied obligations. There are also various cases when courts may impose liability by law, like for example delictual liability. A second misconception in the construction industry is that liability is limited to only those who are party to the contract. Delictual liability for instance is completely dissolved from the existence of an agreement. So, the scope of liability is much more complex. In German law and English/South African law liability generally can be divided and sub-divided into the following categories:

(a) contractual liability
(b) delictual liability
(i) intentional tort
(ii) negligence
(c) strict liability
(d) statutionary liability
(e) criminal liability
(f) state responsibility*

Of course there are typical and significant differences between the common law and the civil law system. However, at the end of the day contractual, delictual, strict and criminal liability is similar or at least comparable. But there is one great difference according to state responsibility. In English and South African law public authorities enjoy no dispensation from the ordinary law of tort and contract, except in so far a

special statute gives it to them.[22] That means unless acting within their powers, public authorities are liable like any other person for delicts like for example negligence. This is an important difference to German law. In Germany liability of authorities is governed by an own and separated category of law. The wrongdoing of public authorities is governed by special rules of public law in particular administrative law.[23] Generally there is no connective link between public and private law. Hence, if for example a local authority negligently causes damage, liability is not a question of private law but of public law. This is an important aspect for the further comparative analysis.

(4) Negligent acts

The concept of negligence today governs, for most significant purposes, losses that are caused by accidents.[24] Other than the early common law which was almost exclusively preoccupied with the intentional wrongdoer and gave little attention to the inadvertent harm, the law of negligence focuses on damages the defendant caused without intent. From the moral point of view it makes good sense to penalise careless behaviour that causes damage. For most of the people in the different legal systems it seems to be just and reasonable that also the careless wrongdoer should compensate his luckless victim although he did not harm latter intentionally.[25] Of course this approach is too broad. The task of the 'law of negligence' is to determine situations, categories and requirements under which it is adequate to impose liability for careless behaviour. Usually the plaintiff in an action in negligence must show three respectively four things:

(a) First, that the defendant owed him a *duty of care,*
(b) secondly, that there was a *breach of this duty*
(c) thirdly, that *damage was thereby caused.*
(d) and fourth, that the defendant acted *wrongful* or with *fault**[26]

How each single element is determined we will see later. At this point noteworthy is that careless or negligent behaviour is usually divided into different categories, namely negligent *acts*, negligent *omissions*, and negligent *misstatements*. This paper

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22 **Wade/Forsyth**, *Administrative Law*, p. 763.

23 For example: art. 34 *Grundgesetz*, par. 839 *BGB*; par. 39 *Ordnungsbehördengesetz.*

24 **Fleming**, *The Law of Torts*, p. 93.

25 **Holyoak**, *Negligence in Building Law*, p. 1.

26 * These elements are required in German and South African law.

deals mainly with liability for negligent acts. In England liability for negligence in word (misstatements, wrong information, wrong advice, etc.) has developed differently from responsibility for negligence in act. In the leading case for negligent misstatements *Hedley Byrne v. Heller*[27] the court argued that people take less trouble over what they say than what they do. Furthermore, 'words are more volatile than deeds, they travel fast and far afield, they are used without being expended'. Hence, the courts felt obliged to distinguish strictly between words and acts. In the end it is doubtful if such a distinction is useful and necessary. However, for our comparative purpose we will - as far as possible - draw our attention mainly on the category 'negligent acts' and less on the 'misstatement' cases. This limitation is less a logical than a practical one. For a proper analysis we have to find a save and marked way through the forest of precedent cases. Otherwise we will get lost.

(5) Third Parties

The major aspect of this investigation is liability to third parties. We are dealing with triangular relationships between the contracting parties and third parties. As we have already pointed out a huge variety of parties is involved in major building projects. The first and most essential person is the client, who initiates the building project and who has to pay for the new building or works. The client may be referred to as the building owner or promoter, but commonly the term employer was established.[28] The party who carries out the works is usually named the contractor (builder, civil engineering contractor, etc.). The employer and the contractor are usually the essential parties to the main building contract. However, there are several other contractual links and relations on the construction site. Whether these parties involved are directly connected with the main contract or with separate sub-contracts either with the employer or with the contractor is less important for the determination of 'who is third party'. All in all the following parties are generally involved in major building projects:

(i) the employer
(ii) the contractor
(iii) the architect
(iv) the consulting engineer
(v) the quantity surveyor
(vi) the clerk of works
(vii) the resident engineer
(viii) various sub-contractors

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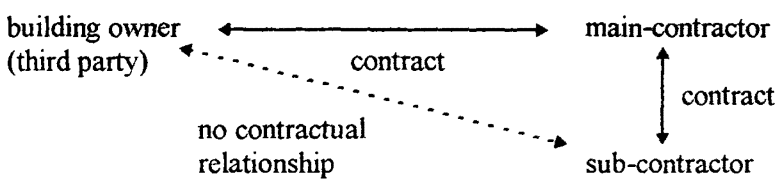
27 1964 AC 465 at 482.

28 Not at least because this term is used in both the JCT and ICE standard forms of contract. See **Uff**, *Construction Law*, p. 29.

(iv) the specialists
(v) the local authorities[29]*

What precisely makes one of these parties a '**third party**'? In English law this question is uncontroversial, because the *privity of contract doctrine* clearly states that third parties are those persons not bound by, or enjoying any rights under a valid contract.[30] In light of the privity concept only the parties to a contract but never third persons are entitled to the rights it creates, and only the parties to it can be burdened with obligations it imposes.[31] Third parties who are not privy to the contract, as contracting parties, cannot take advantage of the contractual obligations.[32] Hence, every of the above listed persons is a third party in relation to another party when there is no direct contractual link between both. The building owner, for example, can be third party in relation to a sub-contractor if the latter is employed by the main-contractor. In this case there is no contractual link between the owner and the sub-contractor. The building owner would be third party.

Fig. 2: Third party under the privity doctrine



In German and South African law the privity of contract concept is completely unknown or in the latter case at least less strict. Several exemptions are codified or generally accepted. In Germany for example in paras. 328 ff. *Bürgerliches Gesetzbuch* (BGB) third party beneficiaries[33] are governed. Under the concept of party autonomy the contractual parties are free to grand a third party an own right to claim the fulfilment of *primary* contractual obligations. Well-known examples are life insurance contracts. South African law too - like English law - attach considerable importance to the concept of privity of contract, but they do recognise and enforce *contracts for the benefit of a third party*. Consequently, in Germany and South Africa

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29 *Although not 'parties' to a building contract, local authorities are typically involved in approving plans and inspecting the building works.

30 **Uff**, *Construction Law*, p. 101.

31 **Capper**, *'A guide to construction liability'*, in **Andrea Bruns** (ed.), *Construction Disputes, Liability and Expert Witness*, p. 17.

32 Ibid., p. 17.

33 Echte Verträge zugunsten Dritter.

the courts could theoretically be able to base the liability of the building professions towards third parties in contract. The demarcation of contractual parties and 'third parties' is less clear because third parties can be involved in a contract. To distinguish contractual parties from "third parties" we must have a brief look to the contractual rights and duties. In Germany there is a distinction between *primary* or main contractual obligations (*Primaerleistungspflichten*) and *secondary* or in other words certain *collateral* obligations like duties of care, protection and giving sufficient information (*Nebenleistungspflichten*).[34] One of the major primary contractual obligations is the duty to pay the price for a service. In this context it has to be mentioned that both legal systems do not recognise contracts imposing a burden on a third party. The contractual parties have not the power to agree on that a third party is obliged to fulfil special duties. So, as a common definition of who constitutes a 'third party' one could state that a 'third party' is that person who is not obliged in law to fulfil the contractual *primary* obligations, that means in first instance to pay or to accept the payment. A further helpful aspect is the right to contest the contract. The right of contestation of an agreement is normally restricted to the contractual main party and not to the third party. At the end the determination whether a party is "third party" is a question of the circumstances of the isolated case.

(6) Economic loss

The law of negligence does not proceed from the assumption that just because a service or product is negligent or defective someone must be legally liable. For negligent behaviour to be actionable, damage is needed. So the claimant relying on an allegation of negligence in tort has to complain not only a defect, whether in a service, some professional advice or a product, but also a *loss*.[35] The second main aspect of this study is the liability for **'pure economic loss[36]'**. What precisely is meant by purely economic, commercial or financial loss? Not only for this study it is vital to distinguish between the different types of losses which normally the law classifies:

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34 See **Lorenz**, *'Contracts and Third-Party Rights in German and English Law'*, in **Markesinis** (ed.) *The Gradual Convergence* (1994), p. 68, 96.

35 **Capper**, *'A guide to construction liability'*, in **Andrea Burns**, *Construction Disputes - Liability and Expert Witness*, p. 36.

36 Sometimes referred to as mere pecuniary, financial, or non-physical loss.

The negligent act causes:	(a) death or personal injury
	(b) physical damage to property.
	(c) consequential loss connected to damage to person or property
	(d) pure economical loss,
	(e) expectations

This pyramid or hierarchy of losses is very significant in the law of delict.[37] Responsibility for negligence is progressively more difficult to establish as one moves down from category (a) to category (b). The case is obvious when a workman looses his life, his leg is broken on the construction site or when property is damaged by a passing truck. These are typical and recoverable cases of physical damage to person or property; and not economic loss cases. An economic interest or loss - on the other side - is an interest for the invasion of which a finite sum of money can provide complete compensation of the damage, that is *not* connected with damage to person or property.[38] Economic loss is, in the first instance, to distinguish from physical damage to person and from damage to or destruction of the plaintiff's property *and all consequences* in relation to the damage to property or person. In the cases of category (c) the plaintiff probably can claim 'consequential damages' caused by the harmful event, such as decline of value, loss of profits, earnings and so on.[39] Of course economic loss is involved here, but, these matters are related to the requirements of causation and damage assessment. This is not *pure* economic loss in the meaning of this study. The notion of *pure* economic loss in category (d) and (e) can be defined as pecuniary loss *not* flowing from physical damage to the person or property of the plaintiff.[40] In other words, the circumstances which make economic loss *pure*, is the lack of physical damage to the plaintiff's property or person that caused consequential damage of intangible nature.[41] However, in some understanding, pure economic loss is not exactly a loss at all, but a failure to make a gain.[42] Normally, if a person wishes to make profit, he will have to enter into a

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37 Compare with **Capper**, *'A guide to construction liability'*, in **Andrea Burns**, *Construction Disputes - Liability and Expert Witness*, p. 36.

38 See **Cane**, *Tort Law and Economic Interests* (1991) p. 5.

39 **Van Dunné**, *General Report on Civil Liability for Pure Economic Loss*, p. 1.

40 **Feldhusen**, *Economic Negligence*, p. 1; Boberg, *The Law of Delict* Volume I, p. 103.

41 **Van Dunné**, *General Report on Civil Liability for Pure Economic Loss*, p. 1.

42 **Holyoak**, *Negligence in Building Law*, p. 18.

contract with someone in order to reach this aim. Traditionally it is the contract allowing the party to claim for future failure to earn a profit.[43] This would of course be a very intangible claim. But economic loss occurs on both fields, the law of contract and the law of delict. Although the law of delict - as will be shown later - had been notably reluctant to recover economic loss. Removing even some of the constraints on delictual claims for pure economic loss effects to bring the law of delict into potential conflict with the law of contract.[44] However, it is undoubtedly right to say that pure economic loss in a delictual sense has many times a strong contractual nature. Finally economic loss must be distinguished from *idealistic loss.* A party whose economic interests have been injured should feel no further sense of loss when he has received a sum of money that accurately reflects the value of what he has lost besides or of what he has failed to gain.[45] If the party feels - after the compensation - a sense of unsatisfied loss then his interest in the thing is not purely economic. This would be a case of idealistic loss that is not recoverable. Economic interests are in any case capable of objective valuation.

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43 **Holyoak**, *Negligence in Building Law*, p. 26.

44 Ibid., p. 26.

45 Ibid., p. 5.

Part 2

Traditional Approaches: Concept of consideration, privity of contract, exclusionary rule, contractual relativity

A brief look at the history of economic loss claims will reveal the main concerns of the courts in both systems, the English and South African common law and the German civil law, to recover pure economic loss suffered by third parties in the previous mentioned situation.

I Traditional English and South African law[46]

Prior to the landmark decision of the House of Lords in *Hedley Byrne v. Heller*[47] in the year 1963 it was generally assumed that pure economic loss suffered by a third party was irrecoverable neither in the law of tort nor in the law of contract.[48] This general rule was also valid for building contracts. On the one hand, in English law an action in contract was unthinkable because of the **concept of consideration** and the **privity of contract**[49] doctrine.[50] These are two fundamental principles of English (and only in parts South African) law that materially affect the relationship of the parties involved in the building process.[51] The doctrine of consideration states that

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46 The English and South African system is put in the same category because of the extraordinary strong influence exerted by English law on this field.

47 1964 AC 465; 1963 (2) All ER 575 (HL).

48 **Hutchison**, *'Murphy's Law: The recovery of Pure Economic Loss in the Tort of Negligence'* in [1995] 1 STELL LR p. 3.

49 English law has not jet been able to bring itself to adopt the contract for benefit of third parties as a legal institution of general application. As **Viscount Haldane** has stated: "My Lords, in the law of England certain principles are fundamental. One is that only a person who is party to a contract can sue on it. Our law knows nothing of a *ius quaesitum tertio* arising by way of contract. Such a right may be conferred by way of property, as, for example, under a trust, but it cannot be conferred on a stranger to a contract as a right to enforce the contract *in personam*." *Dunlop v. Sefridge* 1915 AC 847, 853.

50 **Von Bar**, *Contracts and Third-Party Rights*, p. 110.

51 **Parris**, *Default by Sub-contractors and Suppliers*, p. 9.

promises are only legally enforceable if they are given in return for some counterprestation from the promise, that is a 'consideration'.[52] Contractual promises will only be enforced at the instance of those who have given what is termed 'consideration' for them.[53] The classic case authority is *Tweddle v. Atkinson* (1861)[54]. Today there are numerous exceptions to this principle either created by statutes or by equity.[55] But in essence the concept is still valid and applicable. The **privity of contract doctrine**[56] states that only the parties to a contract and under no circumstances third persons could have rights and duties under a contract; only the parties themselves can claim contractual rights. In other words, a third party can not enforce the benefits of a contract, even if the contract expressly grants such benefits to him.[57] So, if for example a building owner agreed with the contractor that he shall fulfil his obligation to pay to a sub-contractor - who is not party to their contract - the sub-contractor cannot sue under that contract for the money due to him. Consequently the concept of consideration and the privity of contract rule have blocked the extension of contract law. Exceptions like third party beneficiaries in German law or US-common law were and are unknown. The South African law of contract, despite its civilian foundations, is in the main aspects very similar to the English law of contract. Ever since the English law has a strong influence on South African law. However, there are *two important differences*. *First*, South African law has *no* doctrine of consideration. Every serious and deliberate agreement that is intended to create legal obligations is a contract, provided that the other requirements for validity, like legality and possibility, are satisfied. *And secondly*, though South African laws too attach considerable importance to the concept of privity of contract, they do recognise and enforce *contracts for the benefit of a third party*. However, we will see later that these differences to English law have no impact on the extension of liability for negligent acts causing pure financial loss. On the other hand, on the fields of tort (Aquilian) the **exclusionary rule** was established and in principle generally recognised. In order to succeed in his claim, the plaintiff had to prove that as a result of the negligence of the defendant, he had suffered injury to his person or loss of or damage to his property.[58] Exclusively interests in close relation to person and property were protected by the law of tort. If there was no infringement of any of the

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52 **Zweigert/Koetz**, *An Introduction to Comparative Law*, Volume II (1977), p. 134.

53 **Parris**, *Default by Sub-Contractors and Suppliers*, p. 9.

54 1861-73 All ER 369.

55 Ibid., p. 9.

56 See also *Midland Silicones Ltd. v. Scrutton Ltd.* 1962 (1) All ER 1.

57 **Parris**, *Default by Sub-Contractors and Suppliers*, p. 9.

plaintiff's right to unharmed person or property there could not be a successful claim in delict. Hence, the general rule is that the common law duty to take care to avoid causing injury to others is restricted to physical injury either to person or to property, and to financial losses consequent upon such injury.[59] The courts have never enunciated this rule expressly, but it was assumed that the existence of such an exclusionary rule could be discerned from several lines of authority.[60] One based this rule on the two foundation cases *Cattle v. The Stockton Waterworks Company*[61] and *Simpson and Company v. Thomson, Burell et al*[62]. In both cases the plaintiff's claim for the recovery of economic loss was dismissed by the court, largely on the ground of the today familiar *floodgates* argument. In the *Simpson* case for example the House of Lords refused to allow recovery where a person suffered loss as a result of damage to property but where the pursuer did not own that property.[63]

II Traditional German approach

At the beginning of the century also in Germany **contractual liability was limited** to the relation of the contractual parties themselves.[64] That means *like* under the concept of privity of contract in England only the parties to a contract could bear contractual rights and duties.[65] Damages of third parties caused negligently by mistaken acts were not actionable in contract. The doctrine of **contractual relativity** was and is firmly established in German law as it is in the common law systems.[66] But there is one big exemption. The provisions relating to the *third party beneficiaries*[67] (paras. 328 - 335 BGB) are dealing with fact situations in which the third party has a direct claim to demand from the debtor/promisor the performance of the contractual *primary* obligation (*primärer Leistungsanspruch*), like for example payment.[68] This is not,

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58 **Hutchison**, *Murphy's Law*, p. 10.

59 **Salmond/Heuston**, *Law of Torts* (1992), p. 210.

60 **Hutchison**, *Murphy's Law*, p. 10.

61 1875 LR 10 QB 453.

62 1877 (3) App Cas 279 (HL).

63 **Stewart**, *Delict and related obligations* (1993), p. 95.

64 Palandt-**Heinrichs**, p. 418, note 1; Münchener Kommentar-**Gottwald**, p. 1024, note 60.

65 Soergel-**Hadding**, *Bürgerliches Gesetzbuch* Band 2, p. 1582, note. 2; RGZ 81, 214 ff.; RG JW 1910, 1003.

66 **Markesinis**, *An Expanding tort Law*, p. 359.

67 Or contract in favour of third parties.

68 **Lorenz**, *'Contracts and Third-Party Rights in German and English Law'* in **Markesinis** (ed.) *The Gradual Convergence* (1994), p. 68;

however, the case we are looking at. The question of damages for negligent acts causing economic loss is not governed by the concept of third party beneficiaries.

Also the German **law of delict** did **not** and does not **protect pure economic interests** in the mentioned case situation. Under the basic tort rule para. 823, I BGB compensation for economic loss may only be claimed if it is the consequence of an unlawfully inflicted personal injury or if it follows from material damage to property.[69] This provision is comparable with the exclusionary rule in English law. Para. 823, I BGB includes only legally protected interests as *life*, *body*, *health*, *freedom to move*, *property* and *other absolute legal rights* which must be respected by everybody. These legally protected interests are listed in an exhaustive manner. Pure financial interests do not fit into this frame. Pure economic loss is excluded from compensation, as legislative history clearly shows. Pure economic or commercial loss, which is not connected with the invasion of any of these listed interests, is recoverable only under exceptional circumstances. For example paras. 823, II and 826 BGB could be applicable but have very strict requirements, which makes them applicable in very few cases.[70] Besides delictual intention the violation of a legal provision designed to protect individuals and their legal interests (Schutzgesetze) or a wilfully breach of the *bonas mores* is required. Only in very rare cases the plaintiff will be able to prove delictual intent and the breach of the *bonas mores*. These restricted possibilities to recover pure economic loss, gave rise to several theories and techniques to extend delictual liability. The major part of this struggle took place in relation with the legal interests as 'property' (including its possession and use) and 'other rights'. Most successful in the latter category is the notion of a 'right to an established and operating business'. But, also this concept does not apply in the cases we are looking at.

III Conclusion: gap of liability

As well in English and South African common law as in German civil law traditionally there were certain shortcomings of the law of contract and the law of delict which did not permit the recovery of pure financial loss caused by negligent acts. All these legal systems did not provide a third party with a protective

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Markesinis, '*An Expanding Tort Law*', p. 358.

69 **Lorenz**, *'Contracts and Third-Party Rights in German and English Law'*, in **Markesinis** (ed.) *The Gradual Convergence* (1994), p. 68.

70 In this study we are not dealing with cases that require intention or thoughtless behaviour amounting to gross negligence. We are only dealing with ordinary negligence.

mechanism[71] for their pure economical assets. In principal only contractual parties could claim in contract and only persons who suffered physical damage of person or property could claim in delict. That means conversely that a wrongdoer was free to damage the economic interests of third parties. By denying third parties' claims, in effect, the courts grant a construction professional the right or freedom to do his job negligently but with impunity as far as innocent, close and directly involved third parties who suffer economic loss are concerned. It seems to be obvious that this should not be the law.[72]

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71 As with claims for other forms of damage, negligence claims for economic loss highlight the question of the common and civil law's protectionism, **Stapleton**, '*Duty of Care and Economic loss: A Wider Agenda*', 1991 (107) LQR p. 249.

72 See **Simons**, *Construction Claims and Liability*, p. 41.

Part 3

Expanding the Law: analogies, general principles and incrementalism, delictual and contractual approach

I. Two general ways to extend liability

Because of these shortcomings and deficits of contractual and delictual liability for economic loss to third parties, since beginning of the century, both systems started to develop different ways to protect also pure commercial interests and assets of parties involved in construction projects. Common and civil law courts tried to extend the traditional categories of liability to a modern liability to third parties for financial loss. Therefore, theoretically *two* starting points were thinkable: The first one is the **contract** itself as the foundation of an extension. The second starting point is the set of recognised traditional **causes of action in delict.** On the one hand, it is possible to extend traditional existing contractual remedies to achieve the protection of third parties and their commercial interests. Here, the major way is to build up an analogy to recognised contractual remedies. In this context the court could try to reveal the parties' intent by the interpretation of the parties' declarations of will. At least the courts can rely on the *boni mores* to justify an extension. On the other hand - especially as far as the delictual liability in the common law systems is concerned - there are **two subdivided main approaches** to extend responsibility for economic loss and third parties. *First*, as the more traditional approach which is paraphrased as **'incrementalism'**, the plaintiff can try to persuade the court to extend an existing traditional and recognised category of tortious negligence to cover the case in hand.[73] The development of existing lines of authorities is the typical common law way to extend liability. This approach thus clings to precedent, but leaves some room for an expansion of liability through the process of gradual 'incrementalism'.[74] This approach states that the law should develop novel categories of negligence incrementally and by analogy with established categories, rather than by a massive

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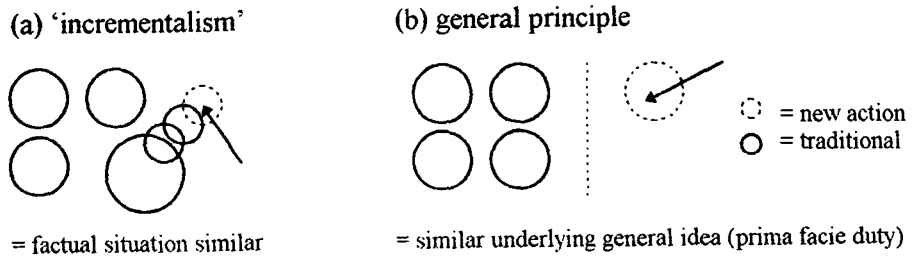
73 **Hutchison**, *Murphy's Law*, p. 4.

74 **Braizer**, *Streets on* Torts, p. 171; **Hutchison**, *Murphy's Law*, p. 4.

extension of a *prima facie* duty of care that is based on general principles.[75] So, in first instance the courts have to ask whether the particular factual situation which has arisen does or does not resemble some earlier and different situations where liability has been confirmed.[76] The *second* approach is more typical for the civil law systems, and therefore it is suspect in the view of conservative common lawyers. This approach to extend liability tries to isolate a common denominator underlying all the existing duty situations on the basis of which a **general principle** can be formulated.[77] So, when an extension is developed the main issue is not whether the facts of the present case are covered by the line of case authorities or precedents, but whether the requirements and circumstances of the general idea or principle of the former decisions are satisfied.

Fig. 3: Extension by 'incrementalism' or by application of general principles?



Hence, the limits of liability can be pushed by a broad-minded comparison with precedents or by analysing and applying an isolated general principle. In the end the general principles and ideas are the more essential part of extensions of law because in all the numerous cases it is the principle of a former decision that is applied to different but analogous factual situations. It is nearly impossible to compare cases without isolating the underlying sense of the decisions. If the factual situations are not identical a comparison is not possible without a step of generalisation or abstraction. Furthermore, if the method of 'incrementalism' is the dominating way to extend liability, how could we proceed if we are faced in the future with a case were no relevant precedents exist? Of course, the way in which the common law has always proceeded, and should always proceed, is by way of identifying, isolating and

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75 See **Brennan** J in the High Court of Australia in *Sutherland Shire Council v. Heyman* 1985 (60) ALR 1, 43-44 cited by Lord **Bridge** in *Caparo Industries plc v. Dickman* 1990 (2) AC at 617.

76 See Lord **Roskill** in *Junior Books Ltd. v. Veitchi Co. Ltd.* 1983 (1) AC 520, 542.

77 **Hutchison**, *Murphy's Law*, p. 4.

applying the general principles that underlie the decisions.[78] The denial of the role of general principles like for example 'proximity' and 'voluntary assumption of responsibility' is not merely regressive, but rather simply misleading.[79] The way from liability for selling a bottle of ginger beer with a snail inside (*Donoghue v. Stevenson*) to responsibility of the local authority in respect of not recognising defective foundations (*Murphy v. Brentwood District Council*) by the way of 'incrementalism' is impossible without applying isolated general principles. The factual situations are far too different to be compared without an act of generalisation.

How the courts in England, South Africa and Germany in fact have extended the law of negligence in respect to negligent acts causing pure economic loss we will see now.

II The quasi-delictual approach in English and South African law

In England the concept of consideration and the privity of contract doctrine is still valid and applicable. Third parties who are not privy to a contract, as contracting parties, cannot take advantage of the contractual rights and duties. Because of the privity rule the courts have been impeded to choose the law of contract as the base for the expansion of liability towards third parties. The courts still cling to the privity requirement and in most cases statutionary legislation do not exist, hence, English courts exclusively had to rely on delictual remedies only to extend liability and protect third parties. The English battlefield is the law of tort, in particular the tort of negligence.

(1) The cornerstone cases

Liability in the building industry for negligent acts causing pure economic loss can *not* be discussed without a brief introduction in the development of the law of negligence. A short elucidation of the two foundation cases in the modern law regarding the tort of negligence *Donoghue v. Stevenson*[80] and *Hedley Byrne v. Heller*[81] may build the base for a further investigation. Every common law student has heard of the 'snail-in-the-ginger-beer-bottle' case:

> In the case *Donoghue v. Stevenson*, in origin a Scottish case, a married lady, the plaintiff Mrs Donoghue, went out with a boy friend. The friend purchased for her a

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78 **Holyoak**, *Negligence in Building Law*, p. 30.

79 Ibid., p. 30.

80 *M'Alister (or Donoghue) v. Stevenson* 1932 AC 562 (HL).

81 1964 AC 465; 1963 (2) All ER 575 (HL).

> bottle of ginger beer. Mrs Donoghue drank part of the beer and then poured out another glass. Allegedly, there then appeared parts of a decomposing snail, which so upset Mrs Donoghue that she suffered from shock and nervous injury.[82]

If Mrs Donoghue as the plaintiff had brought the bottle of ginger beer herself, the case would have been an easy one. She could have sued the seller for damages suffered by his breach of contract and implied warranties of the Sale of Goods Act from 1893. But, unhappily Mrs Donoghue was a 'stranger and foreigner' to the contract of sale. Under the concept of consideration and the privity of contract doctrine only the friend as the party to the contract of sale could sue on the contract but he had suffered no damage. The only possibility for Mrs Donoghue, having no contractual relationship with the seller or the ginger beer manufacturer, was to sue the manufacturer in tort for negligence. And so, the case found its way to the House of Lords, but then was eventually settled for its nuisance value of Pounds 100,-.
However, the speeches of the Law Lords and the *obiter dicta* shaped the whole future of the law of negligence in the English-speaking world. Lord Atkin's words have become immortal in the legal world of the common law systems:

> The rule that you are to love your neighbour becomes in law, you must not injure your neighbour; and the Lawyer's question, "who is my neighbour?" receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably foresee could be likely to injure your neighbour. Who then in law is my neighbour? The answer seems to be - persons who are so close and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.

Lord Atkin used the first unsuccessful attempt to **generalise the duty of care concept**, by Brett MR in *Heaven v. Pender*[83], together with the notion of 'proximity', which derived from the *Le Lievre*[84] case, to help formulate his now famous **'neighbour principle'**.[85] Under this concept delictual liability for negligence was extended in favour of third parties. If a third party falls under the general requirements of the principle, if the third party is a 'neighbour' in the legal sense he is

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82 See for the brief summary of the facts **Parris**, *Default by Sub-contractors and Suppliers*, p. 55.

83 1883 (11) QBD 503, 509.

84 *Le Lievre & Dennes v. Gould* 1893 1 QB 491 (CA) 497, 504.

85 **Hutchison**, *Murphy's Law*, p. 5.

to be protected. In short, the elements of 'reasonableness', 'proximity' and 'foreseeability' are essential for the neighbour principle. We will discuss these notions in detail later when we are dealing with the building cases.

Donoghue v. Stevenson was not an economic loss case but it was the first step to apply the law of delict to protect third parties in a contractual context, and was therefore quickly and widely accepted as good authority. The main practical significance was that it allowed a short cut for the end user to claim directly against an original manufacturer, if the latter was negligent. It took long time until the law of negligence and the 'neighbour principle' entered the field of construction law. However, it was the connection between tort and contract and the involvement of a third party to the contract that explains the relevance of this decision to construction law. Just as in a pub not everyone purchases his drink directly from the manufacturer, so likewise client's houses and factories have not purchased directly from the builder or the subcontractor does not owe this contractual duties directly to the building owner. Often contractual relationships of building parties are not existing although the parties come intentionally in a close and direct contact; a contact close to a contract.[86]

Before we draw our attention to the construction and building cases we have to introduce the second cornerstone case of modern liability for negligence. In the year 1964 the decision of the House of Lords in *Hedley Byrne v. Heller*[87] effected the second minor legal revolution[88] by **abolishing the exclusionary rule** which requires that negligent misstatements are only recoverable if they have caused physical harm to person or property. It is true to say that at 'one stroke the tort of negligence had broken through two very significant barriers: the one limiting it to negligent acts, as opposed to words, and the other confining it within the bounds of physical harm to person or property'.[89] The court's decision is based on the following factual situation:

> Hedley Byrne, the plaintiff, was doing business with a company called Easipower. Hedley wasn't secure about Easipower's financial situation so they wanted a banker's report concerning a statement assuring Easipower's creditworthiness. In a letter Hedley Byrne asked the Heller bank (defendant) for their „opinion in

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86 See **Holyoak**, *Negligence in Building Law*, p. 6.

87 1964 AC 465; 1963 (2) All ER 575 (HL).

88 'Before *Hedley Byrne* there had been no case allowing recovery in negligence for economic loss caused by negligent words', Lord **Delvin** 1964 AC at p. 515.

89 **Hutchison**, *Murphy's Law*, p. 14.

> confidence as to the respectability and standing of Easipower", „whether they considered Easipower trustworthy in the way of business to extent of 100.000 Pounds per annum, advertising contract". The Heller bank gave positive and satisfactory references. They considered Easipower good for its normal business engagements. Relying on these replies Hedley placed orders for advertising time and space for Easipower, on which orders they assumed personal responsibility for payment to television and newspaper companies concerned. Easipower went into liquidation and Hedley lost over 17.000 Pounds on the advertising contracts. Hedley sued the Heller alleging that the bank made a negligent misstatement causing economic loss.

In the end the claim was *not* successful. The court denied that Heller owed a duty of care towards Hedley, because Heller answered the inquiry „without responsibility on the part of the bank or its officials". By this words Heller effectively disclaimed any assumption of a duty of care.[90] This result might have been important and essential for the parties, but for the development of the law of negligence not the considerations about the exclusion of liability but about the **existence of a duty to take care** was the landmarking aspect of the judgement in *Hedley Byrne*. The court clearly has stated that in case the liability for giving the information would not have been disclaimed the action would have been successful. The House of Lords has been fully aware of the importance of the *obiter dictum* and the relevant issues concerning misstatements and economic loss. They decided to extent the traditional approach of liability for economic loss. In this context all of their Lordships' reasoning required a '*special relationship*' between the parties.[91] The explanation of the circumstances and situations in which such a 'relationship' will be recognised varied, but common to all was the *element of reasonable reliance* by the plaintiff upon the statement made by the defendant.[92] Moreover, the defendant must have been prepared for such a reliance in the sense that he must have '*assumed responsibility*' for what he said.[93] The duty of care arises only upon a 'voluntary assumption of responsibility' by the maker of the statement.[94] All in all the most relevant aspects of the judgement may be summarised

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90 Lord **Morris of Borth-Y-Gest**, 1963 (2) All ER p. 595 (A).

91 **Boberg**, *The Law of Delict* Volume I, p. 91; Lord **Delvin** 1963 (2) All ER at 611.

92 Ibid., p. 91.

93 Ibid., p. 92.

94 See, e.g. Lord **Delvin** 1963 (2) All ER at 611, and 1964 AC at pp. 483, 486, 494; This element indeed has more recently become a significant element in the elusive quest for a formula to determine liability in cases of negligent acts leading to economic loss (see *Simaan Gerneral Contracting Co. v. Pilkington Glass Ltd.* 1988 (2) QB 758), **Allen**, '*Hedley Byrne Revalued*', 1989 (105) LQR 511.

as follows: A **duty of care arises** when there is a *special relationship* between the parties; a *voluntary assumption of liability*; when the plaintiff could *reasonable rely* upon the statement; and when the statement has been given from a defendant *with special skills* and in a *professional context*. Also the following statement of Lord Morris of Borth-Y-Gest may be a useful summary of the courts judgement:

> My Lords, I consider that it follows and that it should now be regarded as settled that if someone possessed of a *special skill* undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who *relies* upon such skill, a *duty of care* will arise. The fact that the service is to be given by means of or by the instrumentality of words can make no difference. Furthermore, if in a sphere in which a person is so placed that others could *reasonably rely* upon his judgement or his *skills* or upon his ability to make careful inquiry, a person takes it upon himself to give information or advice to, or allows his information or advice to be passed on to, another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise.[95]

The first important aspects of the House of Lords' unanimous judgement was that in principle there was **no difference between physical and financial loss**;[96] and furthermore, as Lord Pearce pointed out, that there was **no reasonable distinction** drawn in the line of authority **between negligence in act and in word.**[97] In the judgement remarkably little was said about both problems, liability for pure economic loss and for negligent words. Only two of the five Law Lords specifically referred to the nature of the loss in question. Lord Hodson stated that it was difficult to see why liability should depend on the nature of the damage.[98] Also Lord Devlin rejected the argument that liability for negligent misstatements requires physical injury, that pure economic loss were not sufficient. He could not find neither logic nor common sense in this distinction.[99]

> If irrespective of contract, a doctor negligently advises a patient that he can safely pursue his occupation and he cannot and the patient's health suffers and he looses his livelihood, the patient has a remedy. But if the doctor negligently advises him that he cannot safely pursue his occupation when in fact he can and he loses his livelihood,

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95 1963 (2) All ER p. 594 (B, C).

96 **Salmond/Heuston**, *Law of Torts*, p. 214.

97 1963 (2) All ER at p. 616 (H).

98 1963 (2) All ER at p. 598 (C).

99 1963 (2) All ER at p. 602 (I).

> there is said to be no remedy. Unless, of course, the patient was a private patient and the doctor accepted half a guinea for his trouble: the patient can recover all.[100]

Lord Devlin though this to be nonsense. The borderline was not drawn on any intelligible principle. He stated that it just happened to be the line which those who have been driven from the extreme assertion that negligent statements in the absence of contractual or fiduciary duty give no cause of action have in course of their retreat so far reached. The impact of these strong words was that the rigid distinction between physical and financial loss had suffered a major breach.[101]

The second major aspect of the judgement was pointed out by Lord Devlin[102] who stressed that the most essential requirement for liability for negligence is a **special relationship** between the parties:

> The duty is limited to those who can establish some *relationship of proximity* such as was found to exist in *Donoghue v. Stevenson*[103]. A plaintiff cannot therefore recover for financial loss caused by a careless statement unless he can show that the maker of the statement was under a special duty to him to be careful. This special duty must be brought under one of three categories. It must be contractual; or it must be fiduciary; or it must arise from relationship of proximity.[104] [...] There is ample authority to justify your lordships in saying now that the categories of *special relationship*, which may give rise to a duty to take care in words as well in deeds, are not limited to contractual relations or to relationships of fiduciary duty, but include also relationships which in the words of Lord Shaw in *Nocton v. Lord Ashburton*[105] are "*equivalent to contract*" that is, where there is an assumption of responsibility in circumstances in which, but for the absence of consideration, there would be a contract.[106] [...] It is a responsibility that is *voluntary accepted or undertaken* either generally [...] or specifically in relation to a particular transaction.[107]

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100 1963 (2) All ER at p. 602, 603.

101 **Hutchison**, *Murphy's Law*, p. 15.

102 1963 (2) All ER at p. 601 (F), 606 (G), 608 (A), 611 (F).

103 1932 (1) All ER 426.

104 1963 (2) All ER at p. 601 (F).

105 1914-1915 All ER at p. 62.

106 1963 (2) All ER at p. 610 (F, G).

107 1963 (2) All ER at p. 611 (A).

The court established the wholly new general principle of liability in negligence[108] that wherever there is a relationship equivalent to a contract there is a duty of care. This proposition was regarded as an application of the general conception of proximity. The Lords were of the opinion that the English law was wide enough to embrace any new category or proposition that exemplifies the principle of proximity.

Finally, such a special relationship would be held to exist whenever one person possessed of a **special skill** voluntary undertook to supply information or advice to another, whom he knew or could **reasonable foresee** would **place reliance** on his skill[109] and judgement in giving the information or advice.[110] Specially the requirement of reliance should play an important role for the further development of the principle of liability enunciated in *Hedley Byrne*.

In the light of these two cornerstone cases *Donoghue v. Stevenson* and *Hedley Byrne* we can isolate two major developments in the law of negligence: *First*, a third party has an own remedy if there is a **special relationship of proximity** between the plaintiff and the wrongdoer (neighbour principle). *Secondly*, there is **no reasonable distinction between physical and economic loss**. These conclusions must be considered as good law - at least as far as the category of negligent misstatement cases is concerned.

(2) The building cases

Keeping the two foundation cases in mind, we can now draw our attention to the building cases. In England the line of construction law authorities was initiated with the Court of Appeal's decision in *Dutton v. Bognor Regis UDC*[111] in the year 1972, and was mainly confirmed and approved by the House of Lords in *Anns v. Merton London Borough Council*[112] in 1977. In both cases the local authorities were held liable for the negligence of its building inspectors to subsequent purchasers of houses containing defects and requiring repair. Though the *Dutton* and *Anns* case are specifically concerned with local authority inspectors on the side of the defendants, they were supposed to apply to all other persons concerned with the production of

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108 See **Hutchison**, *Murphy's Law*, p. 14.

109 Lord **Pearce**, 1963 (2) All ER at p. 616 (I).

110 **Hutchison**, *Murphy's Law*, p. 14

111 1972 (1) QB 373 (CA).

112 1978 AC 728 (HL).

buildings or structures.[113] As we already pointed out in Part 1 in English law public authorities are liable like any other person for trespass, nuisance, negligence and so forth.[114] There is no real distinction between 'public and private negligence'. As far as *pure* economic loss is concerned it must be stressed that in both cases, *Dutton* and *Anns*, the court still found a link between the loss claimed and at least an existing danger to life, limb or property on the plaintiffs' side.[115] The peak of the development of allowing claims in delict for negligently inflicted economic loss in a contractual context was reached in *Junior Books v. Veitchi Co. Ltd.*[116] in the year 1982. Here, in fact, it was impossible to find a connective link between the negligent act and a danger to person or property. Strictly speaking *Junior Books* is the 'only and real' *pure* economic loss case. However, in the whole line of cases the courts continued to extend liability for negligence causing - at least consequential - economic loss step by step and more by application of general principles than by the traditional way of incrementalism. The old divide between physical and economic loss and the strict separation of contract and delict became more and more blurred. Though, in 1990 in the decision in *Murphy v. Brentwood District Council*[117] the House of Lords made a radical step back to the traditional, cautious, incremental approach to govern delictual liability for negligent acts causing economic loss. In fact the court once more restricted responsibility and fall back to the situation prevailing in the time of *Donughe v. Stevenson* and *Hedley Byrne*. In the *Murphy* case the court overruled *Anns* and entirely undermined the authority of *Junior Books.*[118] In the legal world, on the one hand, there are many authors - in particular overseas - who regret this restrictive development, on the other hand, the supporter of the floodgates argument have welcomed the radical U-turn in the law of negligence. We will see how the development will go on.

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113 **Loots**, *Engineering and Construction Law*, p. 30;
Duncan Wallace, *Building and Engineering Contracts*, note 63-75.

114 **Wade/Forsyth**, *Administrative Law*, p 763.

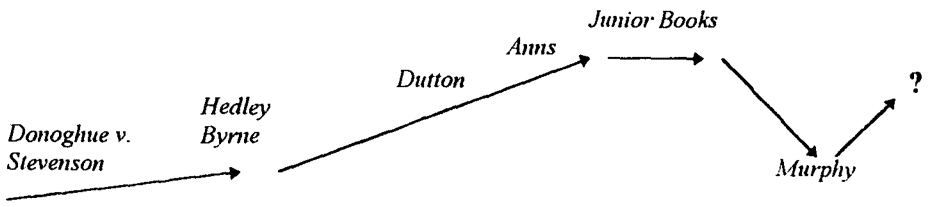
115 Even tough Lord Denning had extra-judicially made it clear that this was a mis-description. See **Markesinis/Deakin**, *'The Random Element of their Lordship's Infallible Judgement: An Economic and Comparative Analysis of the Tort of Negligence from Anns to Murphy'*, 1992 (55) Modern LR at p. 621.

116 1983 (1) AC 520 (HL).

117 1991 (1) AC 398 (HL).

118 See **Fleming**, *'Requiem for Anns'*, 1990 (106) LQR 525; **Duncan Wallace**, *'Anns beyond repair'*, 1991 (107) LQR 228.

Fig. 4: The line of authority



(a) From *Dutton* to *Junior Books*: Opening the floodgates?

After having built the foundation the time is due now to have a detailed analysis of the major building cases in which the courts granted recovery for economic loss of third parties caused by negligent acts of a building party which is not directly bound by a contract.

(aa) *Dutton v. Bognor Regis UDC*

As we have already pointed out the line of building case authorities started with the *Dutton*[119] case in the year 1972:

> Mrs *Dutton* has bought a house that was built on an unstable ground. Soon subsidence occurred and walls and ceilings began to develop serious cracks. Mrs Dutton sued the local authority for damages in respect of the costs of repairs and the diminution of the house's value. The claim was based on the fact that on recommendation of the competent building inspector the defendant local authority had negligently approved the inadequate foundations of the house.

Mrs *Dutton's* claim was successful, although the court was faced with two difficulties: *First*, the *Hedley Byrne* principle could be applicable, but here the **requirement of reliance** wasn't satisfied. Mrs *Dutton* couldn't reasonable prove that she had relied on the report of the local authority. Lord Denning overcame this concern by drawing a distinction between the situation where negligent advice was given on financial or property matters - as in *Hedley Byrne* - and the situation where the advice was given on the safety of buildings, machines or material. In the first case reliance was required, but in the second situation the duty of care was owed to all who might suffer damage if the advice was wrong and therefore a misstatement.[120] *Secondly*, if the claim was based on the principle evoked in *Donoghue v. Stevenson* the concern could rise that the **loss was pure economic** in nature. Here, the defect

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119 *Dutton v. Bognor Regis* UDC 1972 (1) QB 373 (CA); 1972 (1) All ER 462.

120 1972 (1) QB at 395; **Hutchison**, *'Murphy's Law'*, 1995 (1) STELL LR 20.

merely reduced the market value of the house without causing any damage to person or property. The court overcame this objection by classifying the damage as physical in nature. But, the court stated that they would have allowed the claim even if the loss was purely economic.[121] In case there was responsibility for a dangerous defect that in fact caused physical harm to person or property, there should also be liability for the cost of repairing the defect before it could cause such damage.[122] It was a fallacious approach to distinguish between physical or financial harm; the nature of harm should no longer matter. After having overcame with the mentioned concerns the court applied Lord Atkin's **neighbour principle** and found that the local authorities owed Mrs Dutton a duty of care because the damage was foreseeable and *no* policy considerations spoke against the protection of the plaintiff.

(bb) Lord Wilberforce's two stage test enunciated in the *Anns* case

Lord Wilberforce in *Anns v. Merton London Borough*[123] approved and confirmed the decision in *Dutton*. But, he restricted the scope of the duty to take care by stating that the cause of action can only arise when the state of the building is such that there is **present or imminent danger** to the health or safety of persons occupying it.[124] So, he was also concerned about the nature of the loss. This major principle was developed from the following material facts of the case:

> The builders of a block of eight maisonettes deposited the construction plans at the local authorities for approval under the building bylaws. The council passed such plans. The approved plans showed the base walls and concrete strip foundations of the blocks and stated in relation to the depth from ground level to the underside of the concrete foundations: 3' 0'' or deeper to the approval of local authority. But the foundation of the blocks was constructed thereof throughout to a depth of only 2' 6'' below ground level. The council failed to ensure that the foundations were constructed to a depth of 3' 0'' as shown on the approved plans. The authorities omitted to make any inspection to reveal that the foundations had not been constructed to a depth of 3' 0''. Because of the defective foundations structural movements in the block began to occur. The results were cracking of main walls, sloping of some floors, sticking doors and other defects. Mr *Anns* claimed damages against the council. Such damage would mainly include the costs of work to remedy

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121 **Hutchison**, *'Murphy's Law'*, 1995 (1) STELL LR 20.

122 Ibid., 21; **Craig**, *'Negligent Misstatements, Negligent Acts and Economic Loss'*, 1976 (92) LQR 222.

123 1977 (2) All ER at 498.

124 Lord **Wilberforce**, 1978 AC at 760.

> structural damage, to underpin the foundations to prevent further structural movement and other expenses.

The House of Lords decided infavour Mr *Anns* and held the council liable for the loss the plaintiff suffered. Lord Wilberforce tried to redefine and update Lord Atkin's **neighbour principle**. He enunciated the famous **two-stage test** to determine the existence of a duty of care:

> [...] the position has now been reached that in order to establish that a *duty of care* arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather the question has to be approached in two stages. *First* one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a *sufficient relationship of proximity or neighbourhood* such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a *prima facie duty of care arises.* Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are *any considerations which ought to negative, or to reduce or limit the scope of the duty* or the class of person to whom it is owed or the damage to which a breach of it may give rise [...][125]

As far as the nature of the damage is concerned Lord Wilberforce found that all damage is recoverable which foreseeably arise from the breach of the duty of care. Subject always to adequate proof of causation, the damage may include damages for personal injury or damage to property.[126] The damage recoverable was the damage to the building itself. Furthermore the **present or imminent danger to health or safety of persons** occupying a build would be sufficient.[127] In the present case Lord Wilberforce stated that the recovery of the damage follows from the normal principle. He classifies the damage as material, physical damage which would be recoverable in the amount of expediture necessary to restore the house to a condition which is no longer dangerous for the persons occupying it.[128] He stressed that he have had much assistance from the dissenting opinion of Laskin J in the Canadian case *Rivtow*

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125 1978 AC at 751, 752.

126 1978 AC at 758.

127 1978 AC at 760.

128 1978 AC at 759.

Marine Ltd. v. Washington Iron Works[129] and from the New Zealand decision in *Bowen v. Paramount Builders (Hamilton) Ltd. and McKay*[130].

It is difficult to follow Lord Wilberforce's classification of the loss as physical.

(cc) The 'real' economic loss case *Junior Books v. Veitchi*

However, the development of the tendency to recover also pure economic loss reached its peak with *Junior Books v. Veitchi Co. Ltd.*[131] This case deals with the liability of a nominated sub-contractors for negligent flooring works towards the building owner who were not in a contractual relationship. In detail the court has been faced with the following factual situation:

> In 1969 the plaintiff, *Junior Books Ltd.*, engaged a building company called Ogilvie (Builders) Ltd. as the main contractors to build a factory for them in Grangemouth. The building owner's architect nominated the defendant, *Veitchi Co. Ltd.*, as a specialist sub-contractors to lay a special concrete floor in the main production area of the factory. For this purpose the sub-contractors (defendant) entered into a contract with the main-contractors. There was no contractual relationship between the plaintiff as the owners and the sub-contractors. Two years after the defendant has laid the concrete floor it developed serious cracks over the whole of its surface. The owners brought a legal suit against the sub-contractor alleging that the defendant had carried out the flooring work negligently. They claimed against the sub-contractors the costs for the replacement of the factory floor and certain consequential loss, namely the consequential economic loss arising out of the moving of production mashinery, the closing of the factory during the repairment time, the payment of wages and overheads, and the loss of profits during the time of replacement. The sub-contractor in response claimed that because there was neither a contractual relationship between the parties *nor at least a risk of damage to the plaintiffs property or a danger to the health or safety of any person* the plaintiff had not a good cause of action.

Junior Book's claim was successful; the House of Lords dismissed *Veitchi's* appeal. The law lords were fully aware that the appeal raised questions of fundamental importance in the development of the law of delict.[132] For the first time in the history of the economic loss claims in *Junior Books* it was absolutely evident that the result of the building works was *not* in a dangerous state or that its condition was *not* such

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129 1973 (6) WWR 692, 715.

130 1975 (2) NZLR 546.

131 1983 (1) AC 520 (HL).

132 Lord **Roskill** 1982 (3) All ER 207.

as to cause danger to life or limb or property of other persons, or that any economic or financial loss had been, or would be, suffered as a consequence of such a danger to person or property.[133] The floor developed cracks in its surface without causing any physical danger. The court was dealing with a non-dangerous defect. The plaintiff applied for recovery of his *pure* economic loss. Lord Roskill knew that there was no decided case which clearly points the way.[134] He tried to extend liability more by isolating and applying general principles of former decisions rather than to ask whether the particular situation in *Junior Books* does or does not resemble some earlier and different situations where a duty of care has been or has not been affirmed.[135] Lord Roskill started the reasoning by elucidating the development of the law of negligence under *Donogue v. Stevenson* and *Hedley Byrne*. As we already know, in the first case it was Lord Atkin who enunciated the **notion of proximity** as the foundation and probably most important element of the **duty of care** concept. As we have also already pointed out, elements like 'reasonableness', 'proximity' and 'foreseeability' are essential for Lord Atkin's neighbour principle. To recall to mind, in *Hedley Byrne* the court developed this principle and held that wherever there is *a relationship equivalent to a contract*, or in other words, wherever there is a *responsibility that is voluntary accepted or undertaken*, and wherever elements of reasonable reliance on special skills in a professional context exist, there is a duty of care.[136] Lord Roskill came to the conclusion that this rule has become a general principle in the modern law of negligence. Finally, at the end of his speech he did nothing else than **applying Lord Wilberforce's two stage test**. Lord Roskill showed (1) that on the first stage there has been a sufficient relationship of proximity between the wrongdoer and the plaintiff, and (2) on the second stage he could *not* find any considerations negating, reducing or limiting the scope of the duty of care.

As far as the requisite **degree of proximity** is concerned he regarded the following elements as of essential importance for the decision: (i) the appellants were nominated sub-contractors; (ii) the appellants were specialists in flooring; (iii) the appellants knew what products were required by the respondents and their main-contractors and were specialised in the production of those products; (iv) the appellants alone were responsible for the composition and construction of the flooring; (v) the respondents relied on the appellants' skill and experience; (vi) the appellants as nominated sub-contractors must have known that the respondents relied

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133 Lord **Roskill** 1982 (3) All ER 208.

134 1982 (3) All ER at 211.

135 1982 (3) All ER at 211.

136 Lord **Delvin** 1963 (2) All ER at 611. Compare in detail above.

on their skill and experience; (vii) the relationship between the parties was as close as it could be short of actual privity of contract; (viii) the appellants must be taken to have known that if they did the work negligently the resulting defects would at some time require remedying by the respondents expending money on the remedial measures as a consequence of which the respondents would suffer financial loss.

Reverting to Lord Delvin's speech in *Hedley Byrne* it seemed to Lord Roskill that all these conditions existed. For him *Veitchi* owed a relevant duty of care to *Junior Books*. Also Lord Brandon of Oakbrook agreed that it was difficult to imagine a greater degree of proximity, where there is no contractual relationship, than that which, under the modern type of building contract, exists between a building owner and a sub-contractor nominated by him.[137] This relationship was close to a contractual one.

In respect to the second proposition, the **policy concerns**, Lord Roskill could *not* see any reason to negative, limit or reduce the duty of care arising from the relationship of proximity. For example, there was *not* a relevant exclusion clause in the main contract as in *Hedley Byrne*. The only suggested reason to limit the recovery because the loss was *pure economic* and the law has not allowed such recovery and therefore ought not in the future to do so couldn't persuade Lord Roskill. He thought that the recovery also of pure economic loss was the logical step forward in the development of the law of negligence. There was not any reason why a claim for pure economic loss should be disallowed when one for economic loss coupled with physical loss had always been allowed.[138] The majority of the Law Lords agreed with this opinion.

Lord Fraser of Tullybelton added two important matters. (1) The first one is the concern that the effect of relaxing strict limitations on the field of delictual liability - like in the present case the rejection to recover economic loss - would be to introduce 'liability in an indeterminate amount for an indeterminate time to an indeterminate class'.[139] This concern is the **floodgates argument**. In his opinion this argument leads to drawing an arbitrary and illogical line just because a line has to be drawn somewhere. And, if knowledge of the plaintiff's identity was a relevant test in light of the floodgates argument, it would be one the plaintiff could satisfy. The defendant, *Veitchi*, knew that a particular person, not merely as a member of an uncertained class

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137 1982 (3) All ER at 217.

138 Lord **Rosskill** 1983 (1) AC at 546.

139 1982 (3) All ER at 203, 204. These words originally come from **Cardozo** CJ in *Ultramares Corp. v. Touche* 1931 (255) NY at 179.

would be likely to suffer economic loss as a consequence of his negligence.[140] As we have seen above the plaintiff could also satisfy most of the other tests - like proximity, foreseeability and directness of the harm, and reliance - that should work as safeguards against opening the floodgates. In the end here liability would be limited both in regard to person and amount. There was no room for the floodgate argument. In Lord Frasers view it would be wrong to deny a claim which is so strongly based, only because of the fear about the possible effects the decision could have on other cases where proximity is less evident.[141] (2) His second concern relates to the **difficulty of ascertaining the standard of the duty of care**. In his opinion the standard of the duty was imposed by the general law and in addition to that by the contractual duties to other parties to the contract. The determination can be difficult where the wrongdoer as a third party to the contract do not know anything about the duties of the contractual parties. For example, a builder and a purchaser are free to make arrangements about the quality of the building the purchaser wishes. They can also make agreements about an inferior or lower standard of quality. Now, it would not be reasonable if a subsequent owner would be in a better position than the original purchaser. In this case the contractual agreements about the quality would also bind the new building owner. In fact there is a merger of delictual and contractual duties, and in many cases the delictual duty can not be determined without having a look at the details of the contractual arrangements. However, finally Lord Fraser did not consider this issue as relevant in the present case because the defendant, although not party to the building contract, had full knowledge of the contractual duties of the main-contractors towards the building owner.

In his dissenting opinion Lord Brandon stated that the recovery of economic loss unconnected to a danger to person or property was a radical departure from long-established authority and therefore a wholly undesirable extension of the law of delict.[142] He stressed the inherent difficulty and inappropriateness of trying to extend the law of tort into the traditional domain of contract.[143]

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140 Lord **Fraser of Tullybelton** 1982 (3) All ER at 204 quoting the High Court of Australia in *Caltex Oil (Australia) Pty. Ltd. v. Dredge Willemstad* 1976 (136) CLR 529.

141 Lord **Fraser of Tullybelton** 1982 (3) All ER at 204.

142 1982 (3) All ER at 218.

143 1983 (1) AC at 552; see also **Hutchison**, *Murphy's Law*, 1995 (1) Stell LR 25.

However, at the end the court held that, if there is such *immediate proximity* as present and there are *not any considerations negating, reducing or limiting the scope of the duty of care* or the persons to whom it is owed or the damage to which a breach of the duty may give rise, a duty of care arises and **also pure economic loss is recoverable.**[144]

(b) The U-turn in *Murphy v. Brentwood District Council*

This rule did not last long as good law. Soon, in the year 1990, finally Lord Brandon's dissenting opinion has triumphed over the arguments of the majority in *Junior Books*. The decision of the House of Lords in *Murphy v. Brentwood District Council*[145] at once interrupted the liberal development to extent liability for negligence. The six law lords invoked the *Practice Statement* (*Judicial Precedent*) of 1966[146] for only the eighth time in its near-quarter century of history. They completely overruled the decision in the *Anns* case and entirely undermined the authority of *Junior Books*. Once again the court had to decide a case in which a local authority was involved. The facts are very similar to those in *Anns*:

> The plaintiff purchased a house which has been built on the site on a concrete raft foundation to prevent damage from differential settlement. When the raft was designed an error was made in the calculations. The local authority employed a firm of construction engineers to check all designs and calculations. The consulting engineers failed to notice the error in the calculations, and on their recommendation the council approved the design under s 64 a of the Public Health Act 1936. The Act required to pass plans for building works unless they were defective or did not contravene the building bylaws. Later the house developed serious cracks, because the raft foundation was defective and the differential settlement beneath it had caused it to distort. The owner was unable to carry out the necessary repairs and sold the house with notice that the defects caused a reduction of the market value of 35.000,- Pounds. The plaintiff brought an action against the council claiming that it was liable for the loss.

Again a building owner sued a local authority for the costs of remedying defects of a house which was built on unstable foundations. The lower court and the court of appeal granted recovery of the loss to the plaintiff under the principles enunciated in

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144 See Lord **Russell of Killowen** 1982 (3) All Er at 205.

145 1991 (1) AC 398 (HL).

146 1966 (1) WLR 1234.

Anns and *Junior Books*, but finally the House of Lords has allowed the appeal of the local authorities and **refused the recovery of the loss**. Members of the public were no longer entitled to compensation if local authorities negligently fail to protect them against construction industry negligence.[147] The reason for this was mainly and simply that the loss was **purely economic in its nature**.[148] But, the speeches in *Murphy* fail to consider precisely why the recovery of economic loss is so problematic.[149] Their Lordships spend much time to show that in *Anns* in fact the court imposed on local authorities liability for pure economic loss; and not liability for causing danger to person or property. In case of pure financial loss the House of Lords saw good reasons for doubting that any duty of care was owed. The courts arguments were not persuading. Lord Bridge, for example, held that economic loss claims are only legitimate if the plaintiff can show **reliance** on the defendant within the principle enunciated in *Hedley Byrne*.[150] Probably Lord Bridge misunderstand the function of a control factor like the requirement of reasonable reliance. The *purpose of control factors* such as reliance is to prevent indeterminate liability for an indeterminate amount to an indeterminate class for an indeterminate period.[151] In *Murphy* there is no danger of indeterminate liability. The defendant could only be liable to the owners of the house and limited to the value of the house. Besides that, everybody who is involved in a building process or who owns a building places reliance in the proper approval of plans by local authorities or planing engineers. To fulfil this reliance is the main task of the approvals. In this context an important and interesting question would have been: What is the purpose and function of the building bylaws? Are the provisions of the Public Health Act 1936 created to protect only persons and physical property from damage, or does the Public Health Act also intend to protect a building owners pure economical interest? The wording of the bylaw - „Health Act" - seems to give a clear answer. However, the question of the purpose of the building bylaws was irrelevant for the House of Lords.

The court mainly based the judgement on the floodgates argument. The House of Lords held that in either event the loss was economic and to allow its recovery this

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147 **O'Dair**, *'Murphy v. Brentwood District Council: A House with Firm Foundations?'*, 1991 (54) Modern LR 561.

148 **Hutchison**, *Murphy's Law*, 1995 (1) STELL LR 28.

149 **O'Dair**, *'Murphy v. Brentwood District Council: A House with Firm Foundations?'*, 1991 (54) Modern LR 563.

150 Ibid., p. 563.

151 Ibid., p. 563.

would have grave implications for builders and manufactures and would amount the judicial legislation.[152]

The decision in *Murphy* can be summarised as follows: A **duty of care** in the tort of negligence is directly connected with safety from physical injury to person or property. Therefore, in that context the protection of property as such and of pure economic interests is not intended.[153] Consequently, the costs for repair of originally defective property and the diminution of its value are not recoverable in negligence. The decision in *Murphy* stresses that the existence of **damage or danger of damage to person or property** is the main prerequisite for compensation of pure economic loss.

(c) Comment and conclusion

For an European continental lawyer - probably for a common lawyer as well - it is difficult to understand how the courts tried to extend liability for economic loss. It seems to be that phrases like "foreseeability', 'proximity', 'neighbourhood', 'just an reasonable', 'fairness', 'voluntary acceptance of risk', 'voluntary assumption of responsibility' how they are used from time to time in different cases are not precise definitions.[154] These phrases seem to be not more than labels or circumscriptions descriptive of the very different factual situations which can exist in particular cases.[155] These concepts are regarded to be mere labels or *ex post facto* rationalisations for the courts decisions taken on policy grounds.[156] The concepts seem not to be useful tests to predict the outcomes of the cases.[157] Notions like proximity and incrementalism in the end are more semantic than practical useful labels.[158]

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152 See **Hutchison**, *'Murphy's Law'*, 1995)1) STELL LR 28.

153 **van Dunné**, *General Report on Civil Liability for Pure Economic Loss, XVth International Congress of Comparative Law*, p. 21.

154 See also Lord **Roskill** in *Caparo Industries plc v. Dickman* 1990 (2) AC at p. 628.

155 Ibid., p. 628.

156 **Hutchison/van Heerden**, *The tort/contract divide seen from the South African perspective*, p. 99.

157 Ibid., p. 99.

158 **Cooke**, *'An Impossible Distinction'* 1991 (107) LQR at 52.

However, the recent decisions in the law of professional negligence in the building industry seem to lead to a threefold test.[159] The search for general principles since *Hedley Byrne* has continued and probably has lead to three separate but parallel paths'. According to the modern three paths approach[160] recognition of a **duty of care requires** positive answers to the following questions:

> (i) Could the wrongdoer **reasonably foresee** that the plaintiff would suffer the kind of damage which occurred?
> (ii) Was there a **special relationship of sufficient proximity** between the parties? Was this relationship close or similar to a contractual one?
> (iii) Was it **fair, just and reasonable** to impose a duty of care in the special circumstances?

The first path is the least controversial prerequisite of a duty of care concept. The second paths derives from the requirement of 'voluntary assumption of responsibility'. While the first two paths prefer to apply general principles, the third path is more the use of the incremental approach, that means the development of the law of negligence step by step, guided by the factual situation in each single case.

As conclusion we can state that in England since the decision in *Murphy* the basic principle is that **economic loss is generally *not* recoverable**. But, this no-liability rule is not without important exemptions. One important **exemption** is liability for *negligent misstatements or professional advice* causing pure economic loss. The principle enunciated in *Hedley Byrne* remains good law[161], if in particular the major requirements namely proximity and reasonable reliance on professional skills are satisfied. Furthermore, economic loss can be recoverable in very rare *Junior Books* type situations, where the proximity between the wrongdoer and the third party is very close to a contractual relationship.

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159 **van Dunné**, *General Report on Civil Liability for Pure Economic Loss, XVth International Congress of Comparative Law*, p. 23.

160 See e.g. in *Caparo Industries Plc v. Dickman* 1990 (2) AC 605, 617, 632.

161 Confirmed in *Caparo Industries Plc v. Dickman* 1990 (2) AC 605 and *Smith v. Eric S Bush* 1990 (1) AC 831.

The courts in the other Commonwealth systems traditionally have tended to follow the decisions of the House of Lords and the Privy Council. But, mainly because of the conservative tenor in the *Murphy* case the English law of tort in the field of negligence causing pure economic loss is getting isolated in the Commonwealth jurisdictions.[162] The courts in Canada, Australia, New Zealand, Singapore and Hong Kong do not accept Murphy's law as good law.[163] The Canadian Supreme Court for example refused to follow *Murphy's* law in *Canadian National Railway Co v. Norsk Pacific Steamship Co Ltd*[164]. Here the court granted recovery of economic loss outside negligent misstatements and reliance. Mainly the proof of sufficient proximity and no limitation by policy concerns was sufficient to establish the claim in negligence.

(3) An Excursion to South African law

The number of South African cases in the field of negligence causing economic loss is still relatively small.[165] However, the development of liability in the building industry for negligent acts causing pure economic loss in **South Africa** is generally comparable with the English history of this remedy. For the major part of the century it was highly controversial whether Aquilian liability encompassed claims for pure economic loss. In the decision in *Union Government v. Ocean Accident and Guarantee Co., Ltd.*[166] Judge Schreiner pointed out that if liability in negligence were allowed to extend beyond the person physically injured in an accident to all those who, owing to a contractual or other relationship with the injured person, suffered indirect but material harm through his incapacitation, the situation would become unmanageable.[167] So, he mainly argued by mentioning the floodgates concern. Furthermore, the extension of liability in such cases would constitute an unjustifiable invasion in the field of contract. Hence, at this time the general rule was valid that

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162 See also **Hutchison**, *'Murphy's Law'*, 1995 (1) STELL LR 30.

163 **van Dunné**, *General Report on Civil Liability for Pure Economic Loss, XVth International Congress of Comparative Law*, p. 25; with reference to **Duncan Wallace**, *'No Somersault after Murphy: New Zealand follows Canada'*, 1995 (111) LQR 285.

164 1992 (91) DLR 289 quoted in **Hutchison**, *'Murphy's Law'*, 1995 (1) STELL LR 30.

165 **Hutchison/van Heerden**, *The tort/contract divide seen from the South African perspective*, 99.

166 1956 (1) SA 577, at 585.

167 **Hutchison**, *Aquilian Liability II*, 619.

negligent acts causing pure economic loss - unaccompanied by physical injury or damage and outside a contractual context - were generally not actionable.[168] But then compared to English law, in the early 70th and 80th the development of South African law compared to English law went completely in the opposite direction. While the English courts relaxed the requirements to recover economic loss in delict, the South African courts made clear that their law adopts a more cautious, incremental approach to the expansion of Aquilian liability into new areas.[169] Specially when economic loss was involved the courts applied a conservative rejecting approach. To afford an insight into the South African law of Aquilian for the purpose of this paper it should be sufficient to have an analysis of only two significant and representative cases, namely *Lillicrap*[170] and *Tsimatakopoulos*[171] In the first case the court rejected to grant recovery for economic loss, but at least after the decision in *Tsimatakopoulos* today in South Africa it is nearly uncontroversial that pure economic loss is actionable in the law of delict (Aquilian).

(a) Keeping the floodgates close in *Lillicrap, Wassenaar & Partners*[172]

The peak of the conservative, restrictive South African trend to reject the recovery of economic loss was reached in the year 1985 in the case *Lillicrap Wassennaar & Partners v. Pilkington Brothers (SA) (Pty) Ltd.*:

> The plaintiffs, *Pilkington*, is a glass manufacturer. The defendant, a professional and skilled firm of consulting and structural engineers, performed professional services in relation with the planning and building of a glass factory for the plaintiffs. The plaintiff appointed the engineers to make a soil investigation and analysis of its results at the building site in order to determine the suitability of the site for the erection of the glass plant. In case the site was suitable the defendants were further appointed to design and supervise the engineering and building works. The defendant

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168 **Lewis**, *'Damages for Negligent Misrepresentation - The Appellate Division Leaps Forward'*, 1992 (109) SALJ 382.

169 **Hutchison/van Heerden**, *The tort/contract divide seen from the South African perspective*, 100.

170 *Lillicrap Wassennaar & Partners v. Pilkington Brothers (SA) (Pty) Ltd.* 1985 (1) SA 475;

171 *Tsimatakopoulos v. Hemingway, Isaacs & Coetzee cc And another* 1993 (4) SA 428.

172 *Lillicrap Wassennaar & Partners v. Pilkington Brothers (SA) (Pty) Ltd.* 1985 (1) SA 475; See in particular: **Hutchison/Visser**, *'Lillicrap revisited: further thoughts on pure economic loss and concurrence of actions'*, 1985 (102) SALJ 587; **Beck**, *'Delictual liability for breach of contract'*, 1985 (102) SALJ 222; **van Warmelo**, *'Liability in contract and delict'*, 1985 (102) SALJ 227.

> found the site suitable and therefore they were responsible for design and supervision. The contractual relationship changed when the parties agreed to change the defendants status to that of a sub-contractor of Salnac Contractors (Pty) Ltd., who have been assigned by the plaintiff as the main-contractors. From this point there was privity of contract between Salnac and *Pilkington* but none between *Pilkington* and *Lillicrap* anymore. When the plant was put into operation, movements of the foundations became apparent. This movements were caused by the instability of the soil upon the plant had been build and the inadequacy of the design for the plaintiff's purposes. The costs for remedying these defaults reached a sum of R 3,5 million. *Pilkington* based its claim in delict, alleging *Lillicrap* had negligently committed a breach of a duty of care by failing to carry out its contractual obligations properly and with the necessary professional skill and care.

The court was fully aware about the fact that the case raises fundamental questions relating to delictual liability, in particular its relationship to liability for breach of contract.[173] After illustrating the distinction between the law of contract and delict and the possibility of concurrence Grosskopf AJA himself realises that in the present case this considerations are in fact nearly irrelevant, because all the plaintiff need is to show that the facts pleaded establish a cause of action in delict.[174] A breach of contractual duties might constitute a delict, provided all the requirements for a delict were met.[175] Therefore, to succeed in an extended Aquilian claim for pecuniary loss, the plaintiff must only allege and prove that the defendant has been guilty of conduct which is both **wrongful and culpable** and which adequately **caused damage**.[176] In the end the court answered both questions in the negative.

As far as the **element of wrongfulness** is concerned, on the one hand, delictual actions arise from acts which are *prima facie* clearly wrongful like the causing of damage to person or property. But, in the present case the situation is more complicated. From Grosskopf's point of view he could *not* find anything in *Lillicrap* - either in *Anns* and *Dutton* - which alleged or implied that the defects in the construction of the plant created a danger of damage to person or the plaintiff's property. The building owner's sole concern seemed to be that the defects made the construction unsuitable for its purpose.[177] The only infringement which the building

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173 1985 (1) SA 495.

174 1985 (1) SA 496.

175 See **Hutchison/van Heerden**, *The tort/contract divide from the South African perspective*, p 102.

176 1985 (1) SA 496-497.

177 1985 (1) SA 498.

owner complained was the infringement of the defendant's contractual duty to perform specific professional work with due diligence.[178] The owner did not suffer a danger of relevant damage, solely pure economic loss. So, the question arose, what then is the nature of the wrongfulness upon which the plaintiff based its claim? It was the general criterion of **reasonableness** and involved **policy considerations**.[179] The main question was whether there were 'positive' policy considerations which justified an expansion of delictual liability to cover the facts of the present case. Grosskopf AJA held there were *not*. In his view there wasn't a need to extend liability, because there was a contractual *nexus* between the parties and each party had adequate and satisfactory remedies if the other were to have committed a breach of contractual duties.[180] The plaintiff would have other means of protection; namely an action based on breach of contract. Moreover, the delictual action would not fit comfortably in a contractual setting like the present.[181] Besides that the judge asks, if the contractual parties normally define, expressly or tacitly, the nature and quality of the performance required from each party, how can a negligent performance be tested by delictual standards? How is a delictual standard for a breach of contract to be determined.[182] In his opinion the law of delict can not be invoked to reinforce the law of contract. It seemed anomalous that the delictual standard of *culpa* or fault should be governed by what was contractually agreed upon by the parties.[183] Furthermore, the parties may limit or extend responsibility, impose penalties or grant indemnities etc. Therefore if the independent law of delict would be applicable the danger would rise that the delictual standards would eliminate provisions the parties considered necessary for their own protection. The circumvention of the parties' intend by the application of the law of delict would not be adequate in the present case.

Turning to the nature of damage the judge did not think that the pure economic loss should be recoverable in delict.[184] The plaintiff had computed his loss as being the amount which would have to spend to bring the plant up to the standard laid down by the contract. This loss in Grosskopf's opinion did not represent a loss in the ordinary sense of the word. This was a contractual measure of damage.

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178 1985 (1) SA 499.

179 1985 (1) SA 498.

180 1985 (1) SA 500.

181 1985 (1) SA 500.

182 1985 (1) SA 500.

183 1985 (1) SA 501.

184 1985 (1) SA 505.

Finally Grosskopf AJA draws the conclusion that policy considerations did *not* require that delictual liability should be imposed for the negligent breach of a contractual duties in a professional context and the **economic loss was *not* actionable in delict.**[185]

(b) The recovery of economic loss in *Tsimatakopoulos*[186]

In South Africa this conservative attitude towards economic loss claims changed continuously. In *Tsimatakopoulos v. Hemingway, Isaacs & Coetzee cc and another* the court reached a very broad-minded and liberal attitude towards the recovery of economic loss caused by negligence. The court had to decide the following factual situation:

> The plaintiff had purchased certain immovable property from Crawford, the second defendant. Crawford had engaged the first defendant ('the defendant'), an engineering firm, to design a retaining wall which was to be built on the property. The defendant duely prepared such design and submitted the drawing to Crawford. After the wall was built in accordance with the drawing the estate was sold to the plaintiff. Soon, the wall began to fall over. The plaintiff was obliged to replace it for costs about R 39.000,-. The parties considered these costs as economic loss. It was furthermore uncontroversial that a reasonable engineer in the position of the defendant would have foreseen that the wall would not bear up to the pressure exerted upon it. The defendant calculated the wall negligently. The second defendant has been sequestrated and the action is therefore an action for damages against the first defendant only.

The court had to decide the question whether the first defendant owed a duty of care to the plaintiff, the successor in title to the second defendant. The main argument of the defendants was that the same policy considerations speaking against an imposition of delictual liability mentioned in *Lillicrap* were analogous applicable in the present case. The parties' relationship had its origin in contract, hence delictual liability was inadequate here. Foxcroft J rejected this argument. Unlike the situation in *Lillicrap* in the present case the relationship of the parties originated at no stage from a contract between the plaintiff and the defendant. Here, were being no contractual *nexus* between the plaintiff, Crawford's successor in title, and the engineering firm (the defendant) the claim was naturally restricted to delictual remedies. For Foxcroft J it seemed to be irrelevant that the plaintiff might have been

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185 1985 (1) SA 501.

186 *Tsimatakopoulos v. Hemingway, Isaacs & Coetzee cc And another* 1993 (4) SA 428.

able to take cession from Crawford to then claim in contract, if the plaintiff has an independent cause of action in delict which flows from a wrongful act in the Aquilian sense.[187] The defendant's concern that to allow the claim in the present situation would render every building contractor and sub-contractor, architect, engineer, plumber, electrician, etc. liable not only *ex contractu* to his direct contracting partner but also *ex delicto* to all their successors in title *ad infinitum*. Moreover, contractual limitations and exclusions may circumvented. Foxcroft J counter-argued this concern by stressing that in the present case the wall could only fall over once and the event will not happen again. Therefore the spectre of an unlimited class of possible plaintiffs cannot haunt on the present facts.[188]

Having in mind the decision in *Murphy* Foxcroft J stressed that in South African law the artificial distinction between economic loss and damage to person or property does not exist any more.[189] Hence, no similar difficulties as in *Anns, Junior Books* and *Murphy* arise in the law of Aquilian. The foreseeability of harm and not its nature was the essential aspect. In fact Foxcroft J spent little attendance to the nature of the harm as recoverable or not recoverable. Also pure economic loss is actionable in delict.

Today, in South Africa it is uncontroversial that delictual liability can arise for negligent misstatements causing pure economic loss and for negligent conduct causing pure economic loss. The distinction between words and other conduct and between loss flowing from physical damage to person or property and economic loss does not play an important role for the principle of delictual liability anymore.[190] The function of this distinctions is only to co-determine the fixing of areas of liability. Normally, the test for delictual liability in a contractual context is not whether there is an independent liability for breach of contract but whether all the prerequisites of delictual liability are satisfied.[191] In other words, the duty of care on which the action is based must arise independently of any contract.[192]

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187 1993 (4) SA 433.

188 1993 (4) SA 434.

189 1993 (4) SA 435.

190 **Loots**, *Engineering and Construction Law*, 34.

191 Ibid., 35.

192 **McKenzie/McKenzie**, *The Law of Building and Engineering Contracts and Arbitration*, p 59.

South African law has extended liability for negligent conduct causing pure economic loss more by applying general principles and requirements of the law of Aquilian than by the way of incrementalism.

III The quasi-contractual approach in German law

Because of the deficits and shortcomings of the traditional contractual and delictual remedies in Germany the courts have developed the legal concepts of '**contract with protective effect to third parties**' (*Vertrag mit Schutzwirkung zugunsten Dritter*) and the **theory of 'transferred loss'** (*Drittschadensliquidation*). Contrary to the common law in Germany the courts have chosen the contractual and not the delictual way for the extension of liability. It seems to be easy to explain why English law - and influenced by this also South African law - took one direction and German law another. English Courts strictly have to follow the doctrines of consideration and privity of contract. In German law the BGB codifies according to paras. 328 ff. the *third party beneficiaries*; in other words contracts in favour of third parties. So, for German law it is not unusual to extent contractual rights to third parties - at least as far as *primary* contractual obligations are concerned.

(1) Introduction to *Vertrag mit Schutzwirkung zugunsten Dritter* and the theory of 'transferred loss'

At the beginning of the century the *Reichsgericht* (RG) started to respect and protect further interests of third parties by including them into the protective sphere of the contract.[193] Under the concept of *Vertrag mit Schutzwirkung zugunsten Dritter* they opened the 'protective umbrella' for a restricted circle of persons besides the contractual parties. The court decided that also in case of breach of *secondary* contractual obligations, namely the duty of care[194] and protection, not only the parties to the contract but also third parties could have the contractual right to claim damage. For justification of this notion the court mainly based its argumentation on interpretation of the contract and the resulting rights and duties according to paras.

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193 RGZ 81, 214 ff.; RGZ 85, 183; RGZ 87, 64 ff.; Palandt-**Heinrichs**, p. 421, note 13; BGH NJW 49, 353; BGH NJW 59, 1676; Soergel-**Hadding**, p. 1582, note 1, 2.

194 We cannot compare this notion of duty of care in Germany with the concept in English law. In Germany the duty of care is the extension of contractual duties. The duty of care is a ancillary contractual duty.

133, 157 BGB.[195] This way was later expressly continued by the *Bundesgerichtshof* (BGH). Under the concept of third party beneficiaries (paras. 328 ff. BGB) and the principle of party autonomy parties have the possibility to grand a third party the own contractual right to claim the *primary* contractual obligation like payment or other *Primaerleistungspflichten*. In analogy to this provisions the courts extended this right to *secondary* contractual obligations like the duty of protection and care. By way of interpretation of the parties' intention and declaration of wills this should be fair, just and reasonable. What happened in Germany is that the third party can - through judicial creativity - be brought under the 'protective umbrella' of the contract so that he can entertain an action if injured as a result of a breach of one of the *secondary* obligation in the contract.[196] By and large the legal writers supported the courts' creation of a new contractual remedy.

Also today courts and legal writers agree that the extension of liability to third parties and pure economic loss is necessary. But the question of the persuasive dogmatic explanation is still unsolved. Noteworthy is first of all the fact that we are here faced with a judicial creation - a judge-made doctrine. True, courts and legal writers have tried - as is customary in a civil law system like Germany - to pin their views on some article of the code.[197] Thus, sometimes the expansion of the contract has been based on paras. 133, 157 BGB (broad interpretation of the contract; implied intentions of the parties; end-aim of the transaction)[198] As another way to justify the expansion of contractual liability the even more amorphous para. 242 BGB (good faith) has been invoked to render respectability to what is a clear example of judicial activism.[199] In the years the theoretical basis of the concept was deliberately left undecided[200] and later was regarded as irrelevant.[201] The courts refused to solve this pure theoretically issue in a very pragmatic manner. They preferred to focus on the narrow and more important aspects of each action before them.

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195 RG 127, 222; BGH 56, 273; BGH NJW 84,356; cited in Palandt-**Heinrichs**, p. 421, note 14; Soergel-**Hadding**, p. 1583, note 2;

196 **Markesinis**, *'An Expanding Tort Law'*, p. 359.

197 Ibid., p. 360.

198 RGZ 87, 292; 98, 213; 106, 126; 127, 218; 152, 177. For a time this practice was continued by the BGH. Thus see: BGHZ 1, 383, 386; 5, 378, 384; BGH NJW 1956, 1193 all cited in **Markesinis**, *'An Expanding Tort Law'*, p. 360.

199 Ibid., p. 360.

200 BGHZ 56, 269, 273 cited in **Markesinis**, *'An Expanding Tort Law'*, p. 360, fn. 30.

201 BGH NJW 1977, 2073, 2074 in **Markesinis**, *'An Expanding Tort Law'*, p. 360, fn. 30

The **'theory of transferred loss'** (*Drittschadensliquidation*) is older, similar, but not identical to the institution of a contract with protective effects to third parties. This concept is applicable in circumstances where the party with the title to sue has suffered no loss and the party suffering the loss has no title. In this case German law allows that the title is transferred to the one suffered the loss. A typical situations where this concept is applicable is the separation of risk and property.

(2) Requirements to include third parties

The base for the extension of the law of negligence are the legal institutions *„Positive Vertragsverletzung"* (pVV) and *„culpa in contrahendo"* (cic). Because we are dealing with civil law concepts the focal point is laid on the elaboration of general principles and the requirements of the institutions. Precedents and case authorities are only mentioned to underpin the general principles.

(a) Remedies of the contractual creditor: pVV and cic

The *Bürgerliches Gesetzbuch (BGB)* and the German case law provide the direct party to a contract (creditor) with special contractual rights and remedies. For example according to paras. 459 ff. BGB under a contract of sale the buyer has the right to claim new delivery, to reduce the price of goods, to withdrawal from the contract or he can claim damages if the goods of sale are faulty or defective and special requirements are satisfied. The BGB grants similar rights to govern contracts of services and contracts of manufacture (paras. 631 ff. BGB). These explicitly granted rights and remedies are strictly limited to the contractual parties. Only under paras. 328 ff. BGB extensions are made in favour of third parties. Mainly in case of breaches of *secondary* contractual obligations like the duty of protection, care and the duty to give sufficient information the courts developed the legal institution of **"Positive Vertragsverletzung** (pVV)". This concept can be translated with "*positive breach of contract*". As we will see soon, it is in first case this contractual or strictly speaking this "quasi"-contractual remedy which - under certain circumstance - can be extended in favour of third parties. The general requirements for liability under *Positive Vertragsverletzung* are a mixture of contractual and delictual aspects:

> (1) *First*, there must be a valid **contractual relation** between the contracting parties. If the contract is invalid or not concluded jet liability under **culpa in contrahendo** (cic) is be possible. The notion of *culpa in contrahendo* has the same requirements as the notion of *Positive Vertragsverletzungs.* In principle, the only difference is that there is a lack of a contractual relation between the parties. Instead of a contract there must be a relationship of trust and regard or consideration. Where no contractual

relation exists between the parties, the courts are willing to assume the formation of a contract, to apply the construction of ancillary duties (pVV). (2) *Secondly*, a certain **conduct of the defendant** - act or omission - is required which leads to a (3) **breach** of a contractual, in particular ***secondary*** **(ancillary) contractual obligation**, like a duty of protection, care and information. (4) This breach of the contractual obligation must cause physical **damage** to the plaintiffs person or property or must cause economic and financial loss. The latter aspect is not controversial because we are dealing with a contractual remedy. (5) Furthermore, in this context the requirement of **adequate causation** must be satisfied. (6) *Finally,* there must be the aspect of **fault or wrongfulness** on the side of the defendant. The definition of fault can be found in para. 276 BGB that determines that fault is acting with intent or in negligence of the necessary caution.

If all these requirements are satisfies cumulatively the contractual party can successfully claim damages in contract. Not only damage to person or property is covered but **also pure economic loss**. Of course this is only a brief outline of the concept of *Positive Vertragsverletzung*. Later in the comparative part we will come back to several requirements.

(b) Extension to protect third parties

Under the legal creation of **Vertrag mit Schutzwirkung zugunsten Dritter** the above mentioned concepts of liability (pVV and cic) can be extended to protect also third parties. Most questions referring to the *contract with protective effect to third parties* are unsolved as far as the dogmatically justification, the requirements and in particular the circle of protected persons are concerned. The following remarks may not only be sufficient to show how contracts with protective effects to third parties work, but, also to demonstrate that within their framework German lawyers, like English lawyers, face exactly the same problems of determining the range of protected persons. Both legal systems are preoccupied with the same questions, namely with the question who belongs to the group of persons owed a duty of care by the defendant?[202] The courts[203] and legal writers[204] are in agreement with the position to restrict the circle of persons who should be protected. This group must be exclusively small because "quasi"-contractual and not delictual claims are covered. If the sphere of a contract is to be enlarged - as it is by concepts like *the contract with*

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202 **Von Bar**, '*Contracts and Third-Party Rights*', p. 121.

203 BGHZ 51, 96; BGH NJW 76, 1844 cited in Palandt-**Heinrichs**, p. 421, note 16.

204 **Strauch** JuS 82, 826 in Ibid.; **Lorenz** JZ 1966, 143, 145; **Boehmer** JR 1966, 173 cited in Münchener Kommentar-**Gottwald**, p. 1026, note 67.

protective effect to third parties - special care must be taken so that the expansion is kept under control and the boarder line between contractual and delictual liability is not blurred or, even, abolished.[205] In other words a merger of contract and delict must be avoided. The way German lawyers have grappled with these, at times, incompatible aims is instructive and at the end in some way comparable to the common law solutions. As we will see, also in Germany the courts elaborated **considerations of public policy** to avoid a undetermined liability. In this context the *floodgates argument* is well known in German law. Therefore, the requirements of liability are strict and nearly every single requirement is influenced by concerns of public policy. The investigation of the requirements of the contract with protective effect to third parties may show if German courts are successful in handling liability to third parties for economic loss in a restrictive and reasonable manner. Turning to the **conditions** required for the opening of the contractual umbrella in favour of third parties we note that there are four:

(i) Proximity to the performance

First, the decisive criterion for a claim is some special relationship between the defendant (contractual debtor/promisor) and the plaintiff (third party) usually described as '**proximity to the performance**' (Leistungsnähe).[206] Condition is that the third party must come as directed into direct contact with the contract - especially in contact with the contractual *primary* obligations.[207] The third party must come into direct contact with the performance of the contractual debtor and be endangered (or otherwise effected) by any misperformance in roughly the same way as the contractual creditor.[208] Also in Germany a special relationship of proximity is required. This requirement places bounds to the number of potential claimants. Coincidental proximity to the contract is not sufficient.[209]

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205 **Markesinis**, '*An Expanding Tort Law*', p. 359.

206 **Lorenz**, '*Contracts and Third-Party Rights*' p. 70.

207 Münchener Kommentar-**Gottwald**, p. 1026, note 68; BGH NJW 56, 1193 cited in Erman-**Westermann**, p. 800, note 13; BGHZ 49, 350, 354 = BGH NJW 1968, 885, 887 cited in Soergel-**Hadding**, p. 1588, note 14;

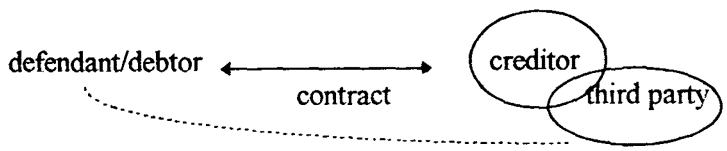
208 **Markesinis** '*An Expanding Tort Law*', p. 360.

209 BGHZ 2, 94, 97 = BGH NJW 1951, 596; BGH NJW 1956, 1193 cited in Soergel-**Hadding**, p. 1588, note 14.

(ii) Creditor's own personal interest in protecting the third party

Secondly, the contractual creditor must have some **personal interest in protecting** the third party.[210] A particular internal relationship between the contractual creditor and the third party is required. This second prerequisite of liability infavour a third party is different from the English and South African approach. However, the existence of any type of relationship between the creditor and the third party will not automatically bring the latter under the protective umbrella of the creditor's contract with the debtor/defendant.[211] In principle, the relationship between the creditor and the plaintiff/third party must be 'sufficiently close so as to create an interest in the former to safeguard the rights of the latter'.

Fig. 6: Relationship between contractual creditor and third party



This proximity is particularly obvious whenever the creditor is himself under a duty of care towards the third party.[212] The courts requisited that it was necessary for the creditor to be responsible for the third party 'for better or for worse" (Wohl und Wehe). Hence, in earlier days the courts required that between the contractual creditor and the third party there must be a certain close personal relationship based on family or employment matters.[213] Exclusively legal relationships with a personal aspect on the field of family-, labour- and social law were protected. For example, parents are responsible for the well being of their children and close family members, and employers for the safety of their employees.[214] This limitation of 'personal relationship' was qualified as being too restrictive. There was a strong tendency to reduce the requirement of 'personal', 'intimate' link and to extend the group of protected persons. Consequently, today not only a personal but also a *pure contractual interest* of the contractual creditor is sufficient to satisfy the extension of

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210 Palandt-**Heinrichs**, p. 422, note 17;

211 See **Markesinis** '*An Expanding Tort Law*', p. 361.

212 Ibid., p. 361.

213 BGHZ 51, 96; BGHZ 56, 273; BGH NJW 1970, 40; BGH NJW 1968, 1931 cited in Palandt-**Heinrichs**, p. 422, Note 17; Münchener Kommentar-**Gottwald**, p. 1027, note 69.

liability to third parties.[215] In principle it is not only the third parties' interests but also the creditors own interests that justify an extension of liability in favour of the third party. The third party belongs as kind of an annex to the circle of interests of the creditor.

(iii) Requirement of foreseeability

Thirdly, the defendant/debtor must have been able to foresee that the third party (plaintiff) is likely to suffer damage in case of bad performance.[216] The above two elements must be known to the defendant at the time of conclusion of the contract (or in case of *culpa in contrahendo* the commencement of the contractual negotiations).[217] The circle of the protected persons must be foreseeable for the defendant.[218] This prerequisite of **foreseeability** is necessary because only in this case the risk of contractual liability is justified and bearable for the defendant. The defendant must have the possibility to calculate his risk and to cover the risk for example by an insurance. If the condition of foreseeability is not fulfilled the defendant can not be held liable.

(iv) No other means of adequate protection

Finally, the last requirement is that the **third party is unprotected** in light of other contractual remedies.[219] If he has in the same case in fact another own claim against the contractual party he can not rely on the institute of contract with protective effect to third parties.[220] This aspect is comparable with the consideration of public policy "no other means of adequate protection" in the common law systems.

All in all the requirements to include a third party into the protective sphere of a building contract are functionally equivalent to the question to whom a duty of care is owed in a tort action for negligence in English law.[221] The difficulties of delimiting the scope of persons who may be protected and the relevant protective effect of the

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214 Par. 1626 and par. 618 BGB.

215 BGH NJW 1984, 355 in Münchener Kommentar-**Gottwald**, p. 1027, note 69; Soergel-**Hadding**, p. 1588, note 15.

216 **Lorenz**, '*Contracts and Third-Party Rights*', p. 70.

217 **Markesinis** '*An Expanding Tort Law*', p. 360.

218 BGHZ 49, 350, 354 = BGH NJW 1968, 885; BGH NJW 1985, 2411 in Soergel-**Hadding**, p. 1589, note 17.

219 BGHZ 70, 330; BGH NJW 1995, 1747 cited in Palandt-**Heinrichs**, p. 422, note 18.

220 Münchener Kommentar-**Gottwald**, p. 1028, note 71a.

221 **Lorenz**, '*Contracts and Third-Party Rights*', 96.

collateral duties are comparable with the task of determining the scope of the duty of care.[222]

(3) Examples for successful claims

In Germany the number of claims in which the courts have recovered financial loss for negligent conduct (or misstatements) is enormous. The following enumeration[223] of successful claims based on the *'Vertrag mit Schutzwirkung zugunsten Dritter'* should give a general overview of the importance of the remedy in German law:

* Damage to family members of the building owner, BGH MDR 1956, 534.
* Protection of the building owner's lessees and their dependants, BGH VersR 1979, 1009.
* Protection of domestic servants of the employer, RGZ, 127, 224.
* Recovery of damage to the landlord's interests, BGH NJW 1954, 874.
* The property owner is protected from damage caused by demolition works, NJW 1958, 185.
* Protection of the building owners employees, BGHZ 55, 11, 18.
* Successful action of a neighbour for a defective boundary-wall, OLG Düsseldorf NJW 1965, 539.
* Credit bank for negligent report on credit-worthiness of client, BGH BauR 1984, 189 = NJW 1984, 355;

There are of course many other cases. However, in German law *not* the line of authorities is the most important factor but the satisfaction of the general requirements of the remedy. If the plaintiff as a third party to a building contract can prove that the prerequisites of *pVV* (or cic) and the concept of *Vertrag mit Schutzwirkung zugunsten Dritter* are satisfied he has a good change to succeed with his claim. In this case the plaintiff has an own quasi-contractual action against the wrongdoer who has to recover all the loss he caused by his negligent conduct. Besides damage to person and property **also the pure economic loss**[224] is recoverable.

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222 Ibid., p. 96.

223 See **Werner/Pastor**, *Der Bauprozeß*, 7th ed., p. 548; Soergel-**Hadding**, *Bürgerliches Gesetzbuch* Band 2 (1990), p. 1593-1600.

224 See for example BGH NJW 1970, 38, 40.

Part 4

Comparison

In common law and the German civil law the different approaches to extend liability to third persons for pure economic loss have completely different starting points. At the end of the day in some cases the outcomes may be the same, but the legal systems deliver the outcomes through different avenues. English and South African courts prefer the avenue of tort/Aquilian; German lawyers feel more comfortable in the avenue of contract. The question is whether, in fact, we are driving on two different avenues or whether we are close to the point of intersection. On the first view the requirements of liability to third parties for negligence causing economic loss, in all systems, seem to be influenced by both delictual and contractual elements. For example, the requirement of *special relationship of proximity* in the light of the duty of care concept in English law is in many cases a more contractual than a delictual approach. The requirement of *voluntary assumption of liability* has a more contractual than delictual appearance. In German law elements of *Positive Vertragsverletzung* like *breach of ancillary duties* which prescribe to behave in a special manner and not to cause damage; *causation*, and *fault* are requirements that are also typical for delictual liability under para. 823, I BGB. Traditionally contractual duties are designed to achieve results. But, in the light of the notion of 'contract with protective effects to third parties' as far as the breach of ancillary contractual duties is concerned their main purpose is to avoid particular harm. Hence, it is difficult to distinguish between pure contractual and pure delictual elements and their function. The **merger between delict and contract** will become more obvious after having compared typical and significant aspects of delict with those of contract. The following comparison will reveal that typical contractual and their delictual counter-parts are relevant for both categories of liability:

Typical contractual elements:	**Typical delictual elements**
* pre-existing relation	* no pre-existing relationship
* agreement, free will	* behaviour required by law
* voluntary act (willtheory)	* mostly pure accident
* transacting between parties	* unilateral action
* duties to achieve results	* duties to avoid harm

* duty voluntary assumed	* duties imposed by law
* privity or relativity of contract	* general protection
* contract is productive	* tort law is protective
* subj. rights (only between parties)	* obj. right (everybody is bound)
* behaviour contrary contract	* conduct in violation of law
* no fault, mere question of taking over the risk	* no liability without fault (exempt. strict liability)
* economic loss and expectations	* physical damage to person or property

Bearing in mind these typical elements of delictual and contractual liability, we will now draw our attention on a detailed comparison of the South African, English and German approach to protect pure economic interests of third parties. We will see that it is nearly impossible to clearly distinguish between pure delictual and pure contractual liability for negligent acts causing economic loss.

(1) General considerations

First, in all systems, most courts and legal authors agree that in many cases the extension of liability to third parties and their economic assets and interests is necessary. The protection of third parties' interests is under special circumstances *fair, just and reasonable.* The need and motivation to extend liability for negligence causing financial damage to "non"-parties in the contractual sense has laid in clinch with the traditional approaches of liability. *Secondly,* the extensions of traditional liability are pure judicial creations. We are talking about judge-made concepts. Because of the strict application of the concepts of consideration and privity of contract the English courts' creativity was restricted to take the delictual way, hence, they created a kind of 'quasi"-delictual liability for negligence. In South African and German law third party beneficiaries are recognised. Nevertheless, South African courts followed the English example. That is not surprising because traditionally English influence on South African law is immense. German courts tried to circumvent the deficits and restrictions of the German law of delict and created a "quasi"-contractual remedy. *Thirdly,* most questions concerning the dogmatic justification are controversial and unsolved as far as the requirements, in particular the circle of protected persons are concerned. This is also not surprising and typical for judge-made concepts. The courts tried to derive the requirements of liability from the traditional approaches, but, were forced to bring new elements into play. These requirements in German and the common law are basically very similar. *Finally,* the

courts endeavour to prevent an undetermined liability. They try to keep the floodgates closed, or at least to strictly regulate the floodgates.

(2) The requirements and their background

The comparison of the prerequisites of liability for economic loss to third parties will show, that the lock-keepers in all systems feel the need to avoid a flood. At the first glance, the major elements of the different approaches to include third parties seem to have obvious similarities. For instance in all of the mentioned legal systems, considerations about *proximity* and *foreseeability* have their principle task to determine who belongs to the circle of third parties that is to be, or not to be, protected. Does classifying the cases as contractual or as tortious make any difference at the end of the day? Or can one detect, behind the technical labels, precisely the same factors at work?[225]

(a) Physical damage and pure economic loss

The phrase 'pure economic loss' has probably the same meaning both in German civil law and South African/English common law. Pure economic or financial loss is namely loss unconnected to physical injury or property or, in Germany other rights having effect on all the world.[226] The recovery of pure economic loss is common in the German civil law and more uncommon in common law.

Especially **in England** the courts have a great tendency to reject the recovery of economic loss. It is difficult to accept the House of Lords' decision in *Murphy* where the court clearly states that economic loss without flowing from physical damage or the danger of physical damage to person or property is generally *not* recoverable. The majority of the other common law countries were right not to follow this rule. In modern life there is a great need to protect also pure commercial interests. The wealth of modern man consists more and more of 'pure economic interests', and a legal system has the function and duty to take the developments of modern life into account. Today, nearly every value is abstract and divided from physical things. For example, large sums of money are transferred from one bank account to another. Yet, these funds, rather than being physically tangible, are bits of data. Non-cash payment transactions are more the rule than the exemption. Pure physical acts like handing over a value and physical property are becoming less important than abstract - non-tangible transactions. In our modern economies there always exists the possibility of re-acquisition. Consequently, the distinction between *ownership* (meaning the interest

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225 Asked by **von Bar**, *Contracts and Third-Party Rights*, p. 111.

226 **von Bar**, p. 106.

in preserving individual tangible objects) and *money* (representing the possibility of acquiring ownership and representing the value of the asset) has lost some of its importance.[227] Life depends more and more on pure economic values than on corporal ones, and legal systems have to recognise this development. If modern legal systems are not able to govern the modern economy, then the legislative powers are required to find solutions. Furthermore, it is difficult to comprehend why economic loss is *not recoverable* in the law of delict when it is caused by negligent conduct while it *is* - under the rule enunciated in *Hedley Byrne* - actionable when it is caused by negligent misstatements. This distinction makes no sense. The inadequacy of different treatment of physical loss or danger of physical loss and pure economic loss becomes more evident in the light of the following example. According to Lord Wilberforce's opinion in *Anns* a cause of action arises when the state of the building is such that there is present an imminent danger to the health or safety of persons occupying it. So, if the owner realises that such a danger might occur and chooses to remedy the defects before they switch to a dangerous state for his person or property, he has *no* cause of action. Hence, the building owner is forced to wait till the danger of or the damage to person or property itself occurs to have legal protection. This can't be the law.

Moreover, the distinction between liability for negligent misstatements under *Hedley Byrne* and liability for negligent conduct causing economic loss under *Murphy's* law leads to the unacceptable result that, for example, architects and consulting engineers who give bad advice leading to the construction of defective buildings may held liable to the building owner, but the builders themselves, who negligently produce the same result, will *not* be liable.[228] After the decisions in *Hedley Byrne* and *Murphy* the distinction between negligently making or building something (no liability), and negligently misinforming someone (liability) is difficult to justify in any rational way.[229]

In Germany the dispute about the recovery of economic and pure physical loss is incomprehensible. Also in German law the first cases decided in light of 'contracts with protective effect to third parties' dealt with physical loss, but, later the courts stated that this was a mere question of coincidence. The line of authorities also could

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227 **von Bar**, p. 108.

228 **Markesinis/Deakin**, *'The Random Element of their Lordship's Infallible Judgement: An Economic and Comparative Analysis of the Tort of Negligence from Anns to Murphy'*, 1992 (55) Modern LR at p. 621.

229 Ibid., p. 632.

have started with a cases involving pure economic loss. Of course the German courts attitude is not surprising because the German approach is based on the law of contract, where pure economic interests are normally recoverable.

The English - and in earlier days the South African - struggle to recover pure financial loss is a consequence of the privity of contract maxim and the traditional exclusionary rule in the tort of negligence. The question remains if the time is due now to completely abandon either the notion of privity or the exclusionary rule to open possibilities to effectively protect pure economic interests. If English courts would have the chance to apply the law of contract or an quasi-contractual approach like in German law the economic-loss-problem wouldn't be at issue any more.

(b) Duty of care also towards third parties?

The next issue causes the 'real' problems: Who besides the contractual building party should be protected from damage caused by negligent acts? How far the circle of protected persons involved in a building project shall be drawn? It seems to be obvious that within their framework German lawyers, like English and South African lawyers, face exactly the same problems of determining the range of protected persons. All the major issues, all uncertainties as far as the requirements and the considerations of public policy are concerned are connected with the extension of liability to third parties; with the extension to 'non'-contractual parties. Here, elements like *proximity, foreseeability, reliance* and *policy concerns* like *indeterminate liability* and *no other means of protection* become relevant. General speaking there are three main elements to determine whether to include or exclude third parties: First, an element of 'foreseeability', secondly the requirement of 'sufficient proximity'; and thirdly 'considerations of public policy'.

(i) Foreseeability

The prerequisite of **foreseeability** is required in all systems. Foreseeability is the most uncontroversial requirement of the extension of liability. This requirement is necessary because only in case the defendant can foresee the damage to a third person the risk of contractual or delictual liability is justified and bearable for the defendant. The defendant must have the possibility to calculate his risk and to cover the risk for example by an insurance. In English law the element of foreseeability is generally speaking one of the conditions of the duty of care, in South African law foreseeability belongs more to the aspect of negligence/fault. In the German system it is one major requirement that the defendant can foresee who will stand under the protective umbrella of the contract. Foreseeability of harm and the involvement of a third party

is a necessary ingredient of liability (or the duty of care), but of course it is not the only one. Otherwise a defendant could held liable when he saw another about to walk over a cliff with his head in the air, and forreaded to shout a warning. [230]

(ii) Relationship of proximity

In all systems the courts require a certain relationship between the plaintiff and the defendant. In Germany there must also be proximity between the contractual creditor and the plaintiff. In English law the **relationship of proximity** was enunciated in *Donoghue v. Stevenson* as the 'neighbour principle'. Next to the determination of foreseeability it is necessary to go on to see whether the parties are in a 'close and direct' relationship of proximity.[231] In the *Hedley Byrne* case Lord Reid and Lord Devlin elaborated this principle to the requirement of '*responsibility that is voluntary accepted or undertaken*'. The court established the general principle of liability for negligence that wherever there is a relationship equivalent to a contract there is a duty of care. This proposition was regarded as an application of the general conception of proximity. Also in South Africa the courts - in the light of the requirement of wrongfulness - drew their major attention to the *nature* and *proximity of the relationship* between the parties. The influence of the English line of authority is immense. We are dealing with the same issue. In Germany the first decisive criterion for a claim under *Vertrag mit Schutzwirkung zugunsten Dritter* is some special relationship between the defendant and the plaintiff described as '*proximity to the performance*' (Leistungsnähe). The requirement is that the third party must come as directed into some contact with the contract - especially in contact with the contractual *primary* and *secondary* obligations. As we see all systems protect a third party if he is in contact with the contract 'like a contractual party'. The conditions for the extension of liability to third parties have the same content. In English and South African law the merger between contract and delict is more obvious than in Germany because, as we have pointed out, elements like *pre-existing relation between the parties*, *transacting between the parties* and *voluntary assumption of duties* constitute typical contractual aspects. The delictual counterparts are: *no pre-existing relation but accident; unilateral action;* and *general protection.* Hence, the assumption of liability is anything but uncontroversial. Many legal writers are of the opinion that 'correcting the law of delict by means of principles borrowed from the law of contract is not acceptable'. This argument is a strong one. The element of 'voluntariness' should

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230 Lord **Keith** in *Yuen Kun-Yeu v. Attorney-General of Hong Kong* 1988 AC 175 at p. 191.

231 **Holyoak**, *Negligence in Building Law*, p. 17.

have nothing to do with delictual liability. The law and not the free will of the parties will impose delictual liability.

(iii) Consideration of public policy

In all systems consideration of public policy play an important role to keep the extension of liability within reasonable limits. The most important policy concern might be the familiar **floodgates** argument. Every system is concerned about the danger to hold defendants liable to an indeterminate number of claimants for claims of indeterminate size.[232] The problem centres on the question of insurability and reasonableness. The other important policy consideration is whether **other adequate protection** from the risk of the loss was reasonably available to the plaintiff elsewhere. In this regard the first question is whether the plaintiff has in fact got other legal remedies available to him. This concern has its impact as well in the English/South African system as in the German concept of *Vertrag mit Schutzwirkung zugunsten Dritter.* Other policy concerns like for example *circumvention of the parties' intent* have their justification in England and South Africa but in Germany they are less important. Here, the remedy is a quasi-contractual one and the intent of the main parties is to be recognised. However, generally speaking the main ideas of the policy concerns are similar and in their concepts comparable.

In the cases where complaint was made by the plaintiff as an ultimate consumer that a building, product or service made by the defendant with whom he himself had *no* contract was defective, **by what standards of quality** would the question of defectives fall to be decide?[233] For example in case of a sale of goods, it could hardly be the standard prescribed by the contract between the manufacturer and the distributor or between the distributor and the seller. The terms of these contracts would not even be known to the ultimate consumer. The same problem arises also in the building industry where it could hardly be that the standard prescribed by the building contract between the sub-contractor and the main contractor determines the legal relationship between the building owner and the sub-contractor if the latter breaches a contractual duty owed to the main-contractor but damages interests of the building owner. Because of the strict distinction between contract and delict in English and South African law great uncertainties arise about the question whether the standard of the delictual duty of care can be determined by investigate the

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232 See **Stapleton**, *'Duty of Care and Economic Loss'*, 1991 (107) LQR at 254.

233 **Holyoak**, *Negligence in Building Law*, p. 26.

contractual duties of the wrongdoer to an uninvolved party. In this relation the English and South African approach must be criticised for leading to the misleading categorisation of tort cases as contractual. All these difficulties do not become relevant in German law. Here the quasi-contractual solution avoids at one stroke these real or imaginary difficulties.[234] In German law under the concept of *contract with protective effect to third parties* of course the contractual duties are relevant to determine the duty of care of the wrongdoer, because we are dealing with a contractual concept.

A similar problem arises in relation with exemption and limitation clauses by which the parties to a contract can protect themselves from liability. Do courts have to recognise these contractual agreements when they determine the delictual duty of care. Is it fair, just and reasonable when the contractual parties' intend is circumvented by the law of delict? In German law since ever it is uncontroversial that the contractual debtor can oppose against the third party/plaintiff all defences like exemption from or limitation of contractual liability he may have against the contractual creditor.[235]

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234 **Markesinis**, *'An Expanding Tort Law'*, 1987 (103) LQR at 392.

235 Ibid., 392.

Concluding Comment

The comparison of the different approaches in English, South African and German law has shown that in some cases it is of relatively little consequences whether one decide the cases of professional liability in the building industry towards third parties for negligent acts causing economic loss by using the law of delict or the law of contract. Though the quasi-contractual approach seems to cause less problems with regard to issues like *recovery of economic loss, the determination of the standard of care* and the danger of *circumvention of the contractual parties' intend.* The German approach has found a better way round the basic problems that face the common law courts in all the above mentioned cases.[236] Before relying on the law of tort, in order to correct inadequacies of contract law, one should ask whether the *privity requirement* itself should be modified; whether it is useful to let the law of delict intrude into the field of the complex contractual relationships between the building parties.[237]

Where there is no direct contract between the parties, then such a contract or a similar close relationship must be assumed by law. The criteria to extend liability to "non"-contractual parties are incapable of being expressed in one neat, unified formula. Mere *foreseeability* is insufficient. The decisive requirements to include or exclude third parties into or out of a protective sphere are mainly resulting out of elements like a *'special relationship of proximity'*, *'foreseeability'*, and *'considerations of public policy'*. German courts are also interested in proximity between the contractual creditor as the first beneficiary of the contractual obligations and the third party. The contractual creditor must have some personal interests in the protection of the third party. This requirement is unknown in the other systems. English and South African judges draw their main attention to the connection between wrongdoer and the third party, the relation to the other contractual party is irrelevant. In fact both factors seem to be relevant. Probably both systems can learn from each other. All in all the main tools to fill the gaps of traditional contractual and delictual liability towards third parties for negligent conduct causing pure economic loss are mainly similar or at least comparable.

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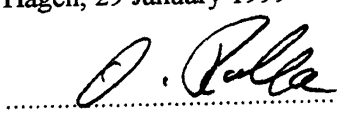
236 **Markesinis**, *'An Expanding Tort Law'*, 1987 (103) LQR 359.

237 **Fleming**, *'Comparative Law of Torts'*, 1986 (4) OJLS at 241 quoted in **Markesinis**, *'An Expanding Tort Law'*, 1987 (103) LQR 397.

As the direct comparison has shown, the obvious similarities of the mentioned civil and common law approaches and their resembling requirements are a strong argument for the allegation that in both systems the traditional distinction between contract and delict has broken down or at least has become blurred. The statement that contractual duties are productive and delictual duties are designed to avoid harm is not valid anymore. In the light of the German contractual concept of 'contract with protective effect to third parties' the ancillary contractual duties have sometimes the main function to avoid damage. On the other side in English and South African law the delictual duty of care sometimes has the function to serve as a tool to achieve contractual standards of quality. It is difficult to determine a clear borderline between contract and delict.

Hagen, 29 January 1999



(Olaf Rolla)