Chapter 1

Introduction

§ 1.1 Third Party Economic Loss

Professionals such as lawyers, accountants, architects, engineers, and appraisers owe a primary duty of care to their clients and are liable for breach of that duty. Professionals also are frequently sued for breach of duties owed to third parties—persons other than their clients. Consider some examples:

- A will beneficiary who fails to take because the will is invalid sues the lawyer who negligently supervised the execution of the will.
- Following the failure of a business, disappointed investors and lenders pursue the lawyers who issued the opinions, the accountants who performed the audits, and others who were involved in the deal gone sour.
- A subcontractor who is delayed in its performance on a construction project sues the owner’s architect for negligently drawing the plans and supervising the construction.
- The successor in title to a landowner sues a surveyor or title abstracter whose errors in performing its contract with the original landowner caused the successor’s interest to be less valuable than it expected when it purchased the land.
- The purchaser of a jet airplane sues the company that had serviced the plane for a previous owner for failing to keep proper maintenance logs.

These claims follow a common pattern. Two parties have a contract. The breach or negligent performance of one of the contracting parties injures the economic interests of a third party. The third party sues the negligently performing party, either in tort or as a third party beneficiary of the contract.
Once, nearly all of these claims would have been barred for lack of priv-ity. Today, however, professional liability to third parties is recognized in practically every jurisdiction. Because third party liability issues arise from a wide range of fact situations, until recently they have seldom been seen as part of a distinct field of law. Today, that field, sometimes known as “economic negligence,” brings together all of the instances of third party economic loss.

§ 1.2 The Characteristics of Third Party Economic Loss Cases

Cases involving professional liability to third parties have four distinctive features:

(1) Every case arises out of a contractual setting. At a minimum, the defendant enters into a contract with a second party, the performance of which affects a third person (the plaintiff), as when a lawyer drafts a will that would convey property to a beneficiary. Many cases involve more elaborate contractual relationships, such as those arising out of complex financial transactions or commercial construction projects.

(2) A third party case differs from an ordinary contract case, though, because it implicates the policies of tort law. The harm to the plaintiff arises because the defendant failed to exercise reasonable care in performing its contract, thereby causing injury to the plaintiff’s economic interests (negligently supervising the execution of a will, for example). Therefore, principles of negligence apply to these cases. Frequently the defendant’s performance culminates in a communication upon which the plaintiff relies, such as an audit report or a legal opinion, so principles of negligent misrepresentation apply when the communication is erroneous due to the defendant’s failure to exercise reasonable care in making the investigation upon which the communication depends.

(3) A third party case is different from the classic tort case, however, in that it involves purely economic loss, not physical injury. The

traditional view is that physical injury is qualitatively different from economic loss, because the former often has catastrophic consequences for the victim and because monetary compensation is unable wholly to remedy physical injury, so that tort principles do not have the same force in economic loss cases. This view has been challenged, and one of the issues in third party cases is determining how much of the traditional law of negligence applies to these cases.

(4) A final distinctive feature is the fear of indeterminate liability. Because the plaintiff’s loss is not bounded by either a direct relationship with the defendant (as in a contract case) or physical causation (as in a personal injury case), liability for economic loss to a third party has the potential of creating indeterminate liability on the defendant. For example, an accountant’s audit report may be relied on by many investors, lenders, and creditors who are unknown to the accountant but who receive a copy of the report and rely on it. Two features of these situations make the threat of indeterminate liability particularly acute. First, the economic consequences of a negligent act can extend very far, unlike the consequences of a negligent act causing physical injury. The consequences of a physical act can be catastrophic, but they tend to be limited in time and space to the immediate victims. The economic consequences of a negligent act, on the other hand, can extend along chains of causation to many persons far removed in time and contact from the defendant. Second, many cases arise from the making of a statement or the communication of information. The rippling of consequences is particularly likely to occur with information, which can be passed quickly and costlessly from person to person, and often to many persons at once, in ways over which the defendant who produced the information has no control. In short, a key problem in these cases is not simply the scope of liability but the uncertainty of liability.

§ 1.3 Analyzing and Arguing Third Party Professional Liability Cases

Lawyers and judges often find third party liability cases to be particularly troublesome. The case law in any given jurisdiction may not cover the
range of issues that can arise. In many jurisdictions, there is some author-
ity, but the particular case falls outside the direct scope of the authorities. In other jurisdic-
tions, the authorities are vague or not fully developed.

Moreover, different doctrines are available to address economic loss issues. Every case arises out of a fact situation in which two parties have a contract, the breach of which injures a third party. Typically, the breach takes the form of a negligent performance. Every case, therefore, could be addressed as a third party beneficiary case or a negligence case. In many of the cases, the defendant’s performance has a communicative element, so the case could be treated as a misrepresentation case as well. At least two, and sometimes three, of these doctrines potentially apply to every case, in addition to other doctrines relevant to particular cases, such as fiduciary duty.

That different doctrines apply to a single case is not problematic in itself. The difficulty comes about when the different doctrines lead in dif-
ferent directions. In many cases the doctrines lead to different results in a particular case; liability in negligence may be imposed even though the third party is not an intended beneficiary, for example.

Even when a judge or lawyer settles on a particular doctrine as appro-
priate in a case, how the doctrine should be applied is often controversial. There is, for example, a considerable range between the most restrictive and the most expansive applications of third party beneficiary rules; some courts focus narrowly on the intent of the contracting parties expressed in the written contract itself, while others expand the analysis to consider the relationships of the parties in the context in which the contract is made. Similar problems arise in the application of negligence and negligent misrepresentation doctrines. For all of the available doctrines, the correct answer from the court’s point of view, or the means to achieve the desir-
able answer from the advocate’s point of view, often is not clear.

Courts that deal most effectively with the limits of doctrine in this area use a multifaceted analysis that combines an understanding of the context from which a case arises with general analysis of third party economic loss cases. Lawyers need to understand this approach to successfully analyze and argue difficult cases.

The analysis begins by identifying the key elements of the setting from which the case arises. The key elements often include the roles played by the parties in the setting, the extent to which they have mutually planned their relationship, the benefits and burdens imposed on each, the
dependence of one party on the other, and the risk of indeterminate liability. In these respects, for example, cases involving an accountant’s audit are distinctive because of the accountant’s role as independent watchdog, the great reliance placed on the audit by third parties, and the ease of providing the results of the audit to third parties. Cases involving lawyers are unique because of the need to maintain the lawyer’s primary obligation to the client.

The key elements are often summarized in a paradigm case. The paradigm case is a representation of the most common and most important features of the context. Summarizing complex facts in a simple if idealized picture makes them more accessible and makes comparison among cases easier. For example, the paradigm case of accountant liability is an accountant who performs an audit to be used by a known third party in an identified transaction. This is the easiest case to analyze and argue and, once it is understood, it becomes a jumping-off point for analyzing and arguing other cases, as when the third party is foreseeable but not identified or when the transaction is a review rather than an audit.

The key elements of the context and the paradigm case are important because they suggest the application of more general policies relevant across all types of economic negligence cases. In looking at third party cases as a whole, it is possible to identify recurrent arguments that transcend particular cases or even particular lines of cases. These arguments take the form of two general approaches to economic loss cases that often appear in judicial opinions. These approaches color the perception of the facts underlying the case and provide arguments for and against the expansion of liability.

The first approach, typically offered to limit liability, is a contractual argument. It emphasizes the contractual origins of the relationships that give rise to the cases and asserts that liability should be imposed only when the narrow standards of third party beneficiary law are met. Every case arises from a contractual setting. The parties allocate the costs, benefits, and risks of their interaction through this contracting process, sometimes explicitly and sometimes implicitly. The law’s role in this process is to support the parties’ private ordering by using contract law, including third party beneficiary law, to fulfill the parties’ expectations by enforcing the contracts as the parties have made them. Tort law is better suited to the redress of accidental physical harm than to the regulation of consensual economic relationships. When the courts impose liability beyond the
contract, it upsets the parties’ own allocation of rights and duties, diminishes their ability to regulate their own affairs, introduces inefficiencies into the process, and raises the threat of indeterminate liability.

The second approach, typically offered to expand liability, is a relational argument. It builds on extracontractual elements of the parties’ relationships and stresses the responsibility that arises from causing harm to another. From this expanded perspective, the law’s role is not limited to enforcement of the express terms of the parties’ contracts. The express terms must be supplemented by factors from the context and by concern for policies not adequately captured in the concept of enforcing the parties’ contracts. In the relational argument, the law has values to serve in addition to effectuating the parties’ explicit planning—not particularly the values expressed in tort policies. Accordingly, tort liability is an appropriate supplement to liability on the contract.

This is the structure of the law of professional liability to third parties. It includes doctrine, but doctrine alone cannot satisfactorily resolve all of the cases. Doctrine is supplemented by an analysis that identifies key elements of the factual contexts from which the cases arise and uses the contractual and relational arguments to analyze those elements.

§ 1.4 Structure of the Book

The structure of the law dictates the structure of this book. The objectives of the book are to provide a general introduction to the law and a comprehensive survey of its application in substantive areas. Doctrine is the starting point. After a survey of the historical development of liability (Chapter 2), Part II presents the doctrines through which the cases are analyzed. Part III takes each of the topical areas in which cases arise and analyzes the doctrines used, the factual context, and the general arguments applied.

Chapter 2 discusses the historical development of the law. Two periods characterize this development. In one period, beginning in the 19th century and extending through the 1950s, liability was severely limited. In the second period, beginning in the 1950s and continuing to the present, liability has been more seriously considered, with some courts expanding liability significantly and others reacting by developing new limitations on liability.

Part II focuses on the doctrines through which the law is usually expressed: privity and near privity (Chapter 3), third party beneficiary
Each of these chapters presents relevant general discussion of the doctrine and a description of the ways in which the doctrine is applied in professional liability cases. Other less frequently used doctrines are discussed in relation to the situations in which they are applied in subsequent chapters of the book.

The remaining chapters discuss applications of the law in particular subject areas. Each chapter describes which doctrines are used in the area and how they are applied. Each chapter also presents an analysis of the factual context and the contractual and relational arguments as applicable to the context.

Chapters 7 and 8 deal with the liability of lawyers and accountants, respectively, the two groups of professionals who are involved in the largest number of cases.

Chapter 9 combines a number of different contexts into the category of evaluative business services, in which the defendant is engaged to provide an expert opinion of condition, quality, or value, upon which the plaintiff relies. The chapter discusses the liability of title abstracters, appraisers, surveyors, pest inspectors, persons engaged in testing and inspection in real estate and construction, and others performing evaluative services.

Chapter 10 concerns the liability of design professionals—architects and engineers. The third parties in these cases include both other participants in the construction process, such as contractors, and users of the constructed property, such as purchasers and tenants.

Chapter 11 concludes by discussing a variety of other situations in which professionals and businesses performing services are potentially liable to third parties for economic loss.

The end matter of the book contains a Table of Cases, Table of Authorities by Jurisdiction, and Index. While the book attempts to be comprehensive, it cannot include every case decided in every jurisdiction, nor can it summarize the current state of the law in every jurisdiction. The Table of Authorities by Jurisdiction is useful in researching the law in a particular jurisdiction; it identifies the cited cases and statutes in each jurisdiction and points out where the cases are referred to in the book.

Given the structure of the book, it is evident that an attorney or a judge with a particular problem—the liability of a lawyer for a trustee to the beneficiary of the trust, for example—could turn to the section of the book that specifically deals with that problem (§ 7.5.3). The book is designed to
make that sort of reference as convenient as possible. To obtain maximum benefit from the survey of the law and the alternative approaches, however, a user of this work should refer to the doctrinal surveys in Part II and the presentation of the contractual and relational arguments in each chapter, as well as to the more specifically fact-oriented sections.