LIMITED AUDITORS' LIABILITY: ECONOMIC ANALYSIS AND THE THEORY OF TORT LAW

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I. LIMITED AUDITORS' LIABILITY IN THE HOUSE OF LORDS

In Caparo Industries Plc. v. Dickman,1 the House of Lords turned its attention again to the age-old problem of determining the liability that is appropriate for a defendant that has caused pure economic loss to a plaintiff by way of a negligent misrepresentation. In that case, the plaintiff, contemplating a takeover of a target company, had bought shares in the company in apparent reliance upon the defendants' audit of the company's annual financial statements. Subsequent to the success of the takeover attempt, the plaintiff discovered that the target company was in worse financial condition than expected, and that the takeover bid had been made at too high a price. The plaintiff attributed its mistaken bid to the negligent failure of the defendants to detect the misrepresentation when they audited the company's financial statements. The plaintiff, therefore, sued the defendants for its economic loss.

While the Court of Appeal agreed that the defendant auditing company was liable because it had breached a duty of care that it owed to the plaintiff as a shareholder,2 the House of Lords reversed this decision, arguing that information and advice in general, and auditing services in particular, are provided with a specific purpose in mind, and that liability for negligence must be restricted to losses following upon uses of the information for that particular purpose.3 The House of Lords was of the view that the Companies Act4 indicated that the financial statements in this case had been prepared for the use of the target company's shareholders at their annual meeting and not for the purpose of an investor launching a takeover, no matter how foreseeable that takeover might be. Thus, since the plaintiff had not used the negligently audited financial statements for their intended purpose, there was no liability.

It goes without saying that Caparo will be enthusiastically received by the accounting profession. Accountants have been lobbying for some time for limitations to be placed on their liability for negligence. However, what is more interesting is that many policy analysts, and lawyer economists in particular,5 will also accord the decision a warm welcome, for they too have been arguing for more limited liability for accountants and auditors.6

2 See, e.g., Caparo, supra, footnote 1, at p. 397, per Lord Oliver of Aylmerton:
A company's annual accounts are capable of being utilized for a number of purposes and if one thinks about it it is entirely foreseeable that they may be so employed. But many of such purposes have absolutely no connection with the recipient's status or capacity, whether as a shareholder, voting or non-voting, or as a debenture holder. Before it can be concluded that the duty is imposed to protect the recipient against harm which he suffers by reason of the particular use that he chooses to make of the information which he receives, one must, I think, first ascertain the purpose for which the information is required to be given.
3 The Companies Act 1985, 1985 (U.K.), c. 6, was in force when the facts in Caparo arose. The relevant provisions in that Act were ss. 236, 237, 241 and 384. These provisions have been amended by the Companies Act, 1989, 1989 (U.K.), c. 40, ss. 9, 10, and 119.
4 The term "lawyer economist" should be construed as referring to anyone who brings economic analysis to bear on legal issues. Thus, it refers as much to lawyers and legal academics as to economists. When a legal issue is at stake, the term will be used interchangeably here with another term: "economic policy analyst".
5 See, e.g., Fischel, "The Regulation of Accounting: Some Economic Issues" (1987), 52
Worried that increased accountant liability will only increase the costs of auditing services for both corporations and their investors and, therefore, will lead to the possible withdrawal of quality auditing services from those corporations most in need of them, the economic policy analysts have effectively argued that the social costs of increasing the scope of auditors' liability beyond that envisaged by the House of Lords in Caparo will probably exceed the social benefits. Indeed, some lawyer economists would probably suggest that the extent to which auditors can be held liable even within the limitations of Caparo is inefficient.7

There is, nevertheless, something ironic in the economic policy analyst's predictable enthusiasm for the Caparo decision. It is clear that the law lords did not envisage themselves as providing a good policy decision on what auditors should do and how they should be regulated. Indeed, the law lords' speeches in Caparo are replete with judicial deference to the idea that legislatures rather than the courts are the appropriate source of policy initiative in this area.8 Moreover, the law lords spent little or no time on, for example, any forward-looking analysis of the implications of increased auditors' liability for insurance costs and the general availability of auditors' services.9 In fact, at one point in his speech, Lord Bridge suggested that his argument for more limited auditors' liability should prevail not because it might accord with what a legislature would choose as appropriate policy but rather in spite of the fact that it might not.10

7 See, e.g., Goldberg, supra, footnote 6.
8 See, e.g., the extended discussion of the statutory purpose lying behind the legislative requirement for the carrying out of an annual audit in Lord Oliver's reasons, supra, footnote 1, at pp. 376-8, 394 and 398, and in Lord Jauncey of Tullichettle's reasons, at p. 406.
9 The only exception to this pattern is the brief reference Lord Oliver makes to "a limitless vista of uninsurable risk for the professional man" which will be the consequence of allowing mere foreseeability of damage to be a test for auditors' liability. However, Lord Oliver neither defends nor develops the point, and it seems not to play an essential role in his reasoning towards the limited-liability result.
10 See, supra, footnote 1, at p. 376.

In the final analysis, each of the law lords in Caparo chose to favour the more traditional approach to legal reasoning, citing with approval the judgment of Brennan J. of the High Court of Australia in which he explicitly rejected the Anns approach:16

Instead of doing policy analysis in Caparo, the law lords appealed to the nature of adjudication and legal reasoning, tracing what Lord Bridge called "a long tension between two different approaches" for determining "the existence and scope of the duty of care which one person may owe to another in the infinitely varied circumstances of human relationships".11 The first approach and the more traditional one, according to Lord Bridge, is to find the existence of a duty of care "in different specific situations each exhibiting its own particular characteristics" and "sufficiently distinct to require separate definition of the essential ingredients by which the existence of the duty is to be recognized".12 The second and more modern approach is to seek a single common element in all those cases where a duty is said to exist and liability is established.13 This is the approach adopted by Lord Atkin in the classic case of M'Alister (or Donoghue) v. Stevenson,14 with its emphasis on "foreseeability" as the general touchstone for liability, and it is the one which culminated, according to Lord Bridge, in its most comprehensive form in Lord Wilberforce's attempt, in Anns v. Merton London Borough Council,15 to articulate a perfectly general two-stage test for tort liability. The first stage of this test incorporated Lord Atkin's foreseeability test, a test which, apparently, was only to be qualified at the second stage, if necessary, by considerations of public policy.

In the end, each of the law lords in Caparo chose to favour the more traditional approach to legal reasoning, citing with approval the judgment of Brennan J. of the High Court of Australia in which he explicitly rejected the Anns approach:16

such an unlimited duty would be a legislative step which it would be for Parliament, not the courts, to take.

11 Supra, footnote 1, at p. 363. The same dichotomy of approach was represented in the two very different judgments of Lord Reid and Lord Diplock in Home Office v. Dorset Yacht Co. Ltd., [1970] A.C. 1004 (H.L.).
12 Supra, footnote 1, at p. 363.
15 Sutherland Shire Council v. Heyman (1985), 60 A.L.R. 1 at pp. 43-4. Lord Bridge makes the same point in his judgment:

"Whilst recognizing, of course, the importance of the underlying general principles common to the whole field of negligence, I think the law has now moved in the direction of attaching greater significance to the more traditional categorization of distinct and recognizable situations as guides to the existence, the scope and the limits of the varied duties of care which the law imposes."
It is preferable, in my view, that the law should develop novel categories of negligence incrementally and by analogy with established categories, rather than by a massive extension of a prima facie duty of care restrained only by indefinable "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".

In Caparo, this more traditional incremental approach led the House of Lords to incorporate the situation of auditors' liability into a category of analogous cases like Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd., cases which had involved economic loss and negligent misrepresentation, and cases for which it had already been decided, contra Anns, that mere foreseeability of harm was not sufficient for establishing a prima facie duty of care. In Hedley Byrne, the additional element necessary for liability was deemed to be a "special relationship" between the defendant and the plaintiff, but, in other cases, ideas relating to some corresponding "proximity" or "neighbourhood" between the parties have also been invoked. In Caparo, as already indicated, the analogous liability-limiting idea went to whether or not the plaintiff's loss followed directly from the "special use" for which the negligently prepared audit was intended.

It is tempting to believe that, whatever the House of Lords might have said in Caparo about public policy or legal reasoning, the true rationale for its adoption of a rule which severely limited auditors' liability was the policy-oriented one that all along has been the lawyer economist's real concern. After all, what difference can there truly be between, on the one hand, beginning with a prima facie foreseeability test for general liability and then paring that down according to the demands of public policy (the Anns two-stage approach) and, on the other hand, building up incrementally through a set of analogous case categories to a determination of liability which is limited by (depending on the case category) notions of proximity, neighbourhood, special relationship or, as in Caparo, a special purpose test? In the latter process the different cases must, it will be argued, be analogous in some relevant respect, or analogous under some general principle, and it will be tempting to think that the criterion for relevance and categorization, if it is not to be completely ad hoc, will bring us back to the same sort of policy concerns that would be invoked in the second stage of the Anns process. The only alternative, or so this argument might go, is to accept the full liability-enhancing implications of an unconstrained foreseeability principle, unconstrained as it then would be by either the express policy limitations of the second stage of analysis in Anns, or by the implicit policy limitations that go under the guise of the additional elements of proximity, neighbourhood, special relationship, or special purpose. But this would allow so much scope for liability that the House of Lords would likely find it unacceptable on policy grounds.

This article attempts to argue that a truly coherent or principled understanding of the workings of foreseeability in tort law, even in the context of negligent misrepresentation causing economic loss, does not have the liability-enhancing implications that are of so much concern to the economic policy analysts. Indeed, the opposite may well be closer to the truth; it is economic policy analysis that recommends that accountants be held liable to
investors that foreseeably rely on negligently prepared or audited financial statements. Thus, there is still a tension between, on the one hand, the general principle of foreseeability that animates tort law and, on the other, what economic policy requires in cases of auditors' liability, but it is a tension that is the reverse of what is generally thought to be the case. Thus, in Caparo, the House of Lords was correct on traditional tort grounds to limit the auditor's liability in the way that it did, although on policy grounds a more enhanced form of auditors' liability might well have been appropriate. However, the law lords were also right to confine themselves to the principles of tort law and to leave public policy to the legislatures. This more limited role is the one required of the judiciary on grounds of both institutional competence and political legitimacy.19

Section II of the article surveys and critiques three different arguments that might be invoked by lawyer economists to explain why, contrary to one's initial intuitions, it might be reasonable not to hold a negligent auditor liable for losses suffered by a foreseeable subsequent user of a negligently audited financial statement. The section shows that none of the arguments can successfully explain the intermediate form that limited auditors' liability takes in Caparo but, depending on what factual assumptions are plausibly made, tend rather to support an all-or-nothing form of auditors' liability. Section III shows that the intermediate form of limited liability exemplified by Caparo follows instead from a coherent and integrated understanding of all the necessary elements of a successful negligence action, and in particular from a recognition that tort law provides both a particular plaintiff and a particular defendant with equal and essential roles in a process of private law adjudication. By contrast, it will be shown that public policy analyses, of which economic analysis of auditors' liability is just one example, treat either one or the other of the two parties to the adjudication as non-essential or, as one such analyst has put it, as a matter of mere "detail"; it is this aspect of these sorts of analyses that tends to drive them toward the extreme all-or-nothing forms of liability which are rejected in Caparo. The article concludes with section IV.

II. ECONOMIC ANALYSIS OF AUDITORS' LIABILITY

If it is reasonably foreseeable that a misrepresentation in a financial statement will likely cause loss to a plaintiff investor relying on the accuracy of the statement, and if the costs to a defendant auditor of taking additional care to avoid this loss are less than the expected costs of the damage to the plaintiff, then it seems plausible that the defendant auditor should be encouraged by the law to take this additional care. This could easily be done by holding the defendant liable to the plaintiff in negligence for failing to take such care.

Moreover, this would also appear to be the prescription that follows from a straightforward application of economic analysis. Economics, after all, is concerned with the efficient avoidance of accidents,20 and efficient or non-negligent behaviour is defined for the economist as the taking of precautions up to the point at which the (marginal) costs of taking such care cease to be less than the (marginal) costs of the expected damage involved in not taking it.21 The real puzzle, therefore, is to understand why the economic

19 Cf., Lord Scarman's judgment in McLoughlin v. O'Brien, [1982] 2 All E.R. 298 at p. 310: The distinguishing feature of the common law is this judicial development and formulation of principle. Policy considerations have to be weighed; but the objective of the judges is the formulation of principle. And, if principle inexorably requires a decision which entails a degree of policy risk, the court's function is to adjudicate according to principle, leaving policy curtailment to the judgment of Parliament. Here lies the true role of the two law-making institutions in our constitution. By concentrating on principle the judges can keep the common law alive, flexible and consistent and can keep the legal system clear of policy problems which neither they, nor the forensic process which is their duty to operate, are equipped to resolve. If principle leads to results which are thought to be socially unacceptable, Parliament can legislate to draw a line or map out a new path.

20 Posner, Economic Analysis of Law, 2nd ed. (Boston, Little, Brown & Co. 1977), p. 143: The association of negligence with purely compensatory damages has prompted the erroneous impression that liability for negligence is intended solely as a device for compensation. Its economic function is different: it is to deter uneconomical accidents.

It is now standard form within economic analysis of tort law to add the efficient allocation of risk, or the provision of insurance, as one of the economic functions of liability rules; see, e.g., Polinsky, An Introduction to Law and Economics (Boston, Little, Brown & Co., 1983); Shavell, Economic Analysis of Accident Law (Cambridge, Harvard University Press, 1987); and Landes and Posner, The Economic Structure of Tort Law (Cambridge, Harvard University Press, 1987).

21 The parenthetical reference to marginal costs is important for attaining a strict maximum of benefits over costs. Marginal cost is the effect on total costs of a very small change in the relevant quantity of goods being produced, here the quantity of care. Without attending to costs and benefits at the margin, or for small changes, it is possible that, even though we might choose a quantity increase for which benefits exceed costs, we will overshoot the maximum net benefit.
analysts of law seem poised enthusiastically to embrace the House of Lords' decision in Caparo despite the fact that this decision seems to deny holding a defendant liable in just such a situation.22

The answer to this puzzle lies in appreciating that the usual case of auditors' liability has several features which serve to distinguish it, in the economist's view, from a classic accident case such as Donoghue v. Stevenson. First, an auditor's liability claim typically involves the defendant in an allegation of negligent misstatement rather than negligent misdeed. While the common law has long distinguished its treatment of negligent words from its treatment of negligent acts (at least since Derry v. Peek23), the economist has a very special appreciation of that distinction which calls, arguably, for a smaller burden of liability in the case of negligent misstatements.

Second, where a classic accident or products liability situation like Donoghue v. Stevenson typically involves physical injury or loss, a case of auditors' liability most commonly will concern lost financial investments; that is, pure economic loss only. The latter sort of loss may call for a smaller degree of protection in tort law, at least according to some economic arguments.

Finally, there is some reason to believe that, in the context of auditors' liability, a whole range of alternative market controls on an auditor's possible negligence can be at play in a way that they cannot credibly be in the typical products liability case. These include such devices as explicit contractual warranties and the effective workings of market reputation on sophisticated parties to financial transactions. The presence of these alternative market controls suggests to some economists that there is little to be gained, and quite possibly much to be lost, by also imposing the burden of tort liability for negligent misstatement on most auditing transactions.

In this section, each of these three different sorts of economic argument for the more limited liability of auditors is examined in greater detail. We shall see that, while the arguments have a surface plausibility, on closer scrutiny they must yield to the view that treats auditors' liability on a par with the more usual accident case. As a matter of economic policy, therefore, the relatively limited liability that auditors enjoy under Caparo cannot be justified. This, of course, was the original intuition with which we began this section. Eventually, section III of this article will show that the real justification of Caparo is not to be found within economic policy at all, but rather within the general principles of tort law properly understood.

1. The Special Case of Negligent Misstatements

Until fewer than 30 years ago, there was essentially no tort liability for negligent misstatements unless actual fraud was involved. Then, in 1964, in Hedley Byrne v. Heller,24 the House of Lords determined that there could be liability for negligent misstatements causing economic loss in the absence of fraud. However, even as it took its bold new step against the "timorous souls" who would rather not have recognized such a cause of action,25 the House of Lords still continued to restrict liability to those situations where there was a "special relationship" or even a "relationship equivalent to contract" between the parties.26 Of course, by insisting on such a close prior connection between the parties, the law lords were dangerously close to invoking something very much like the "privity" requirement that had been exploded in Donoghue v. Stevenson for cases of negligent misconduct some 30 years earlier.

Such glaring preferential treatment for the perpetrators of negligent misstatements over those guilty of negligent misdeeds clearly called for some kind of explanation, and while the law lords made their own attempt in Hedley Byrne, there is now general agreement that the explanations they provided are not particularly convincing. Lord Reid, for example, observed that even quite careful people often express definite opinions without taking the care that they would take if they were asked for their opinion professionally,27 a fact that, even if true, hardly goes very far towards excusing them; in its analogous form, it would surely do little to absolve the perpetrator of negligent misdeeds, for example. Nor does Lord Reid's observation that "words can be

22 See the references, supra, footnote 6.


24 Supra, footnote 17.

25 Lord Denning referred to those who were reluctant to recognize this new cause of action as "timorous souls" in his powerful dissent in Candler v. Crane Christmas & Co., [1931] 1 All E. R. 426 (C.A.), a dissent which ultimately set the agenda for the majority judgment in Hedley Byrne.

26 Supra, footnote 17, at p. 530.

27 Ibid., at pp. 482-3.
broadcast with or without the consent or the foresight of the speaker or writer\textsuperscript{28} have much persuasive force in an argument attempting to limit liability for negligent misstatements as compared to negligent misdeeds. On the facts of \textit{Donoghue v. Stevenson}, for example, it was surely beside the point that the bottle of ginger beer was transferred to the plaintiff without the defendant's consent so long as the plaintiff was foreseeable as the ultimate consumer. Thus, for both negligent misstatements and negligent misdeeds, the defendant's consent to a subsequent transfer of the dangerous thing will generally be irrelevant to liability although his or her foresight of this transfer will always be necessary for it. There is nothing, therefore, in Lord Reid's invocation of either consent or foresight to distinguish negligent misstatements from negligent misdeeds.

In the face of the apparent inadequacy of these judicial attempts to rationalize why negligent misstatements should be more indulged legally than negligent misdeeds, at least one lawyer economist has attempted to provide his own explanation. In an innovative and illuminating article,\textsuperscript{29} William Bishop has effectively argued that the key to understanding the distinctive aspects of negligent misrepresentation is that statements and representations involve the provision of information, where information is a peculiar sort of economic good. In the case of most economic goods, one person's consumption of the good precludes another person from consuming it as well. Consider, for example, Mrs. Donoghue's consumption of the ginger beer. However, in the case of information, there is no such "rivalry" in consumption; the initial purchaser of the information can pass the information on to another consumer while still making use of the information herself.\textsuperscript{30} Indeed, if the costs of transferring the information to a subsequent user are small, as they typically are, and yet there are benefits or gains for the first user in making the transfer — for example, from selling it — then the first user of the information may well be tempted to make the transfer, appropriate some of the value of the subsequent use herself, and thus "free ride" on the efforts of the original producer of the information. Since the original producer is not able, therefore, to capture privately a share of the economic value of subsequent uses of the information by selling it herself, the information tends to be underproduced from a social point of view.\textsuperscript{31}

Bishop argues that extensive tort liability for misinformation negligently provided to reasonably foreseeable subsequent users may tend to exacerbate this problem of underproduction of information.\textsuperscript{32} Underproduction is problem enough if the original producers of the information are not rewarded privately for providing all the social benefits that accrue to subsequent users of the information. Consider how much worse that problem of underproduction might be, Bishop argues, if the subsequent users, in addition to not paying the producer for these benefits, can nevertheless sue the producer for the costs of any negligent misrepresentation. It is Bishop's view that the courts' tendency to impose a smaller burden of liability on negligent misrepresentations than on negligent misdeeds reflects their appreciation of the special problems of producing adequate amounts of publicly useful information.

Bishop is not unaware, of course, that an additional effect of limiting liability for negligent misstatement is that the information that is produced will be of a lesser quality than it would be if it were produced by a defendant who faced full liability for the costs of subsequent foreseeable uses of negligently provided information.\textsuperscript{33} Thus, the overall effect on the supply of information without being expended and take effect in combination with innumerable facts and other words. [Emphasis added.]

However, it is clear from the context that Lord Pearce does not mean to put the emphasized idea to the same use as Bishop does.

\textsuperscript{28}Ibid.

\textsuperscript{29}Bishop, "Negligent Misrepresentation Through Economists' Eyes" (1980), 96 L.Q. Rev. 360.

\textsuperscript{30}The "non-rivalry" characteristic of information consumption is also described in the public goods literature as a "jointness of supply" characteristic: once a unit of the good is supplied to one consumer, that same unit is equally available to other consumers without detracting from the first consumer's consumption: see, e.g., Mueller, \textit{Public Choice II} (Cambridge, Cambridge University Press, 1989), p. 11. Compare the following remarks of Lord Reid in \textit{Hedley Byrne, supra}, footnote 17, at p. 534, which come much closer than Lord Reid's remarks to capturing the same idea:

\textit{The reason for some divergence between the law of negligence in word and that of negligence in act is clear. Negligence in word creates problems different from those of negligence in act. Words are more volatile than deeds. They are used
mation of a rule of attenuated liability for negligent misstatement, as compared to the rule of full liability for all subsequent foreseeable uses, is the provision of a greater quantity of information which is of inferior quality. 34

However, given this effect on quality, there is also an effect on the demand side of the market for information, something to which Bishop refers as well. The demand for information of inferior quality should be less than the demand for information of superior quality. Thus, while the supply of information under the limited liability rule will increase, the demand for the information will decrease, and the final overall effect of the limited liability rule on the quantity of information actually produced in the market is indeterminate, at least a priori. What is clear, after this demand-side effect is accounted for, is that the amount of information (whatever that is) that is provided by the market will be of a lesser quality than it would be under the full liability rule.

It is an important part of Bishop's claim, therefore, that the judiciary's general support for such a rule of liability, which is more limiting of a plaintiff's recovery in the case of negligent misrepresentation than would be a rule of full liability for all subsequent foreseeable uses of the information, reflects a judgment by the courts, first, that limited liability actually increases the amount of information that is supplied and, second, that there is more to be gained socially by increasing the quantity of information supplied than there is to be lost socially in reducing its overall quality. 35 The key question for the purposes of this article is whether this is a plausible claim to make in the context of auditors' liability. Bishop seems to think that it is; the following argument suggests that it is not.

The difficulty with Bishop's argument for a more limited auditors' liability is in envisaging why the supplier of the information, or the auditor in this case, should face any real problem in privately appropriating its share of the social benefits of reasonably foreseeable subsequent uses of the information that it provides. Typically, the corporation whose financial statements are being audited will benefit if subsequent users of the information — for example, new investors or creditors — are induced to rely on the information in the hope that they are making a good investment. The corporation, for example, will be able to issue equity or debt at more favourable prices. Thus, even if the auditor cannot appropriate its share of the benefits of subsequent uses of its information by selling the information to those users directly, it can appropriate its share indirectly by charging the audited corporation a higher price for the sort of careful audit that attracts these subsequent users to the corporation. 36 This higher price should be one that the corporation would be willing to pay if it wants to signal quality to its new investors and, furthermore, it should be a price that the auditor would demand if it were fully liable to these subsequent users of information for any negligent misrepresentations.

Under such a contract, therefore, careful auditing should be provided up to the point where the costs of taking additional care cease to be less (at the margin) than the benefits, exactly what is optimal from the economic point of view. Thus, because there is no real problem in the auditor fully appropriating its share of the benefits of foreseeable subsequent uses of its information, there is no need under Bishop's own argument to provide the auditor with the attendant protection of a rule limiting its liability under negligent misrepresentation.

This is not to say that it is impossible to conjure up a situation where the corporation is not benefited by some subsequent foreseeable use of the audited information. (For example, suppose a plaintiff reasonably relied on a negligently audited statement which showed the corporation had assets sufficient for it to be profitably sued by the plaintiff.) The point is only that use of the information by subsequent investors in the corporation is unlikely to be such a case. And that, of course, was the situation in Caparo. Bishop's argument, therefore, cannot credibly be invoked to support the decision of the House of Lords in that case.

2. The Special Case of Economic Loss

However, in another article, 37 Bishop has attempted to argue

34 Ibid. In the limit, of course, quantity and quality of information are inextricably linked. Just as a great deal of very poor-quality information is no information at all, so it is the case that there is little of informative value in providing only very small quantities of very high-quality information. One is reminded of the increasingly specialized approach to teaching in which one informs one's students more and more about less and less until they reach the point that they know absolutely everything about nothing at all.

35 Ibid., at p. 369.

36 Goldberg makes a similar argument against Bishop; see, supra, footnote 6, at p. 302a.

that there may also be a good economic reason for providing pure economic loss with less protection in tort law than is traditionally provided in cases of physical loss to persons or property. The reason is that pure economic losses are less likely than physical losses to involve real social costs. Thus, it would be wasteful from a social point of view to have a potential defendant invest a great deal in taking care to avoid such losses, something the defendant would have an incentive to do if there was full liability for economic loss.

An example will help to illustrate the point. Suppose there is a bridge connecting the mainland to an island on which a seafood restaurant is profitably located. As a result of the defendant's negligence, the bridge is damaged and rendered unusable for a week, and the seafood restaurant loses business from its usual mainland customers. Should the restaurant be able to recover for this loss of profits from the defendant? More specifically, at least from the economic point of view, is this the sort of loss that society necessarily wishes to avoid by having the defendant invest in the reasonable costs of taking care? The answer may be no. Suppose that the loss in business at the seafood restaurant is largely made up for by increased business at a steak restaurant on the mainland to which restaurant goers still have access. Then, at the end of the week when the bridge is finally repaired, even though the private economic losses to the seafood restaurant are large, the net social economic losses may still be quite small since losses to the seafood restaurant must be balanced by the private gains which are enjoyed by the steak restaurant. (It is possible that even the private economic losses are small. Suppose, for example, that the two restaurants have the same owner; then the private losses are either small or zero. Bishop's argument simply generalizes this example.)

It should be observed in reply, however, that if the plaintiff is not compensated for her private economic loss then she will have incentives of her own to incur socially wasteful precautionary expenditures. In our example she might, for instance, construct her own private bridge to the mainland so as to ensure her customers continued access to the restaurant. The payment of compensation to her in the event of lost business makes her worry less about that loss and, therefore, discourages these socially wasteful expenditures. However, while this is a forceful reply to Bishop's argument, it is not a good argument for allowing the plaintiff to recover fully for her economic losses. To discourage the plaintiff from incurring her own precautionary expenditures, one has only to allow her to recover enough in the event of an economic loss so that she would rather suffer the loss and take this recovery than incur the precautionary expenditure. In general this will be less than a full recovery for the economic loss. On this, see Weinrib, "Understanding Tort Law" (1989), 23 Valparaiso U. L. Rev. 485, at pp. 308-9.

This is not to say that the same argument cannot be applied to cases of physical loss. For example, if a worker were negligently injured and could not work, Bishop's argument might suggest that in times of high unemployment, where there were many substitute workers available, there is no real social loss matching the plaintiff's private loss of employment and earnings. Bishop recognizes this point, but suggests only as a general matter that physical losses are likely, particularly in the long run, to mean real social losses in the way that pure economic losses do not.
the “investor” in the secondary market, whose investment losses and gains are private rather than social, since they tend to be balanced by the equal and corresponding gains and losses of other secondary market investors, and the investor in the primary market who has chosen to finance some real alternative allocation of scarce social resources. More specifically, it may be that, consistent with Bishop’s argument, we ought to provide less legal protection in tort law for, and thus less incentive to avoid, the purely private economic losses suffered by investors in the secondary market for shares as a result of some negligent audit than we do for the social losses that might be incurred by investors in the primary market.

However, this argument makes too much of the distinction in real allocative effect between the primary and secondary market for shares. The operations of the secondary market for shares may also have very serious implications for the real investment of scarce social resources. Indeed, Caparo provides us with a ready example; while that case involved a plaintiff buying shares in the secondary market at prices that were artificially higher because of a negligent audit, it would be a mistake to think that these higher prices only represented a social transfer between different shareholders in the secondary market and had no implications for real investments. After all, the plaintiff in Caparo was buying shares to effect a takeover of the corporation in question, a takeover that was ultimately successful. Now takeovers are typically accompanied by a change in the real investment pattern of the acquired corporation; indeed, they may even be associated with a full or partial replacement of the corporation’s management team. That, at least, is the favourite theory of corporate acquisitions among economists and certainly the empirical evidence on takeovers is more consistent with these transactions involving real social gains than mere social transfers. In such circumstances, therefore, we may want, more than Bishop’s argument suggests, to protect plaintiff investors in the secondary market against their pure economic losses.


The irony in Caparo is that the distinction that was so important to the law lords between, on the one hand, a financial statement prepared and audited only for the limited purpose of informing investor shareholders of the state of their corporation so that they could vote on its management team in an informed way at its annual meeting and, on the other hand, a statement prepared for the larger purpose of informing subsequent shareholders choosing to buy into the corporation, is precisely the distinction that might be involved in any attempt, on Bishop’s sort of argument, to distinguish a context where real social costs might be at stake from one where only social transfers are. A proxy contest is, for example, another method of changing the corporation’s management team and, therefore, its real investment profile. The mistake, if this is a reasonable rationalization of the distinction which the House of Lords was attempting to draw in Caparo, is in thinking that there is not a comparable potential for a real investment change in the secondary market for shares by way of the corporate takeover. Once that potential is appreciated, there is little point in making the distinction that the law lords made in Caparo, at least on Bishop’s argument.

Moreover, even when takeovers and proxy contests are not involved, the fact remains that the pricing of a corporation’s shares in the secondary market will have a profound effect on the real investment decisions it faces in the primary market. It will be very difficult if not impossible, for example, to float a new public offering of shares at a price which is different from the price of substantially similar shares that are already available on the secondary market. Thus, even if it were true that the direct effect of a negligent audit inducing trades at artificially inflated prices between investors in the secondary market was only a social transfer between those investors, it would nevertheless remain true that the negligent audit would also have the effect of inflating the prices that could be commanded on all subsequent real investments in the primary market. This latter effect involves a real social cost that is worthy of reasonable (i.e., cost effective) avoidance measures on the part of auditors, and the failure to take such measures should attract tort liability under the usual economic deterrence rationale. Thus, Bishop’s general argument for the special characteristics of pure economic loss as tending to involve merely private rather than social costs seems in the end to provide only a very shaky foundation for the limited tort liability of auditors that was exemplified by Caparo.
3. Alternative Market Controls on Auditors' Negligence

In section II(1), it was argued that, in the context of the typical auditor's liability claim, there would be little reason to think that the auditor, as a provider of publicly useful information, would be unable to capture its share of the benefits of foreseeable uses of its information by subsequent investors. The reason is that, while the auditor may not be able to charge these investors directly for the use of its information, she can nevertheless capture benefits from these investors indirectly by charging the corporation a higher price for her audit; the corporation can then pass on this higher auditing cost to the subsequent users of the information who have been induced to invest at prices more beneficial to the corporation because of the favourable audit. Thus, since there is no appropriation problem on the benefits side of the equation to be anticipated in this case, there is no reason on the costs side to provide auditors with the advantages of the more limited liability rule for negligent misstatement which Bishop had so effectively argued for and which might otherwise have been appropriate on economic grounds for the suppliers of information.

However, it might now be objected that this reply to Bishop's argument can serve to undercut the need for any tort liability for negligent misstatement in the typical case involving auditors. 43 If subsequent users of the audited statement can be induced to invest in the audited corporation at more favourable prices because of the audit, and if the auditor can then charge the corporation higher prices reflecting this subsequent use which is, after all, beneficial to the corporation, then it seems that the auditor has a strong market or contractual incentive to do the audit as carefully as these ultimate consumers of the information would desire. A less careful audit or, more accurately perhaps, a reputation for lack of care in its auditing, would mean that the auditing company could not charge the audited corporation as high a price for its services because subsequent investors in the corporation would pay less to invest in such a corporation.

Thus, to preserve its reputation and its market price, the auditing company will have a strong economic incentive to take adequate care in its auditing even if it faced no possibility of liability in tort law towards subsequent investors for negligent misstatement. This would be particularly so for the larger accounting firms since the costs of any reputational loss on an extensive portfolio of clients would be large as compared to the gains of taking less care in a particular client's situation. 44 Moreover, even in the absence of such reputational effects from a poor performance, those auditors which are capable of taking more care and are willing to do so should be able to signal this fact to their clients, and charge for it accordingly, by offering explicit contractual warranties. 45 Thus, through either the effects on reputation ex post or the effects of explicit contractual guarantees offered ex ante, the auditing company has a strong market incentive to perform its audit with reasonable care even in the absence of any possible liability in tort law for failing to do so.

The difficulty with this third type of economic rationale for limited auditors' liability is that it both assumes and proves too much. It assumes too much in thinking that an auditor's reputation and, therefore, the prices the auditor can charge, will be determined by the quality of its own auditing performances without the aid of actual tort litigation. Those who invest in a corporation subsequent to, and in reliance upon, its being audited by an apparently reputable auditor cannot observe directly the auditor's actual efforts at verification and evaluation. All they can observe is the market performance of their investment in the corporation, something that can be determined as much by luck or the general vagaries of the stock-market as by any special features of the corporation which a more attentive (or less negligent) audit might have highlighted. As a result, market reputation will only operate as a crude proxy for careful auditing unless there is the further possibility, for example, through actual tort litigation, of refining the explanation for a specific investment's poor market performance. 46

Of course, it is true that, given a sufficiently large number of good market performances by corporations audited by some particular auditing company, there is better reason to believe that all the other possible explanations for the good performances have been averaged away and that only careful auditing, operating as an

43 This, essentially, is Goldberg's argument; see, supra, footnote 6.
44 Ibid., at p. 303.
effective kind of screening device, remains as the key explanation. However, as Reinier Kraakman has recently suggested, there is something in the very logic of the reputational model that prevents an investor from waiting too long (and thus waiting for too large a sample of good market performances) to refine and determine a given auditor's reputation. In the early stages of production the development of a reputation for quality requires the delivery of high-quality services at only average-quality prices; this initial "shortfall" is later made up for by the premium that is charged for delivering good quality once the reputation is established. But there is always the danger that a given producer will seek to make up for the shortfall by later "milling" the reputation it has established, i.e., by delivering average or even low-quality services at premium or high-quality prices. This is the possibility of moral hazard that forces the investor constantly to update its evaluation of a given auditor's reputation and, therefore, to limit that evaluation only to the short-run sample of the market performances of those corporations which have been most recently audited by the auditing company.

However, this short-run evaluative horizon exacerbates the problem, alluded to earlier, of using only the market performance of an investment in a given corporation as a proxy for judging the auditing company's care or quality of service; that market performance might have any number of other possible explanations. This, in turn, leads to further problems of moral hazard as reputable auditors become inclined to reduce the quality they want to deliver at auditing prices which, increasingly, fail accurately to distinguish auditors according to the actual care or quality of services they provide. In the extreme, the reciprocal expectations that support the incentives for taking care in a world based only on market reputation completely collapse. Less drastically, one must at least admit that where an auditor's actual care or quality of service cannot be directly observed by an investor ex post, there may only be a highly attenuated incentive for the auditing company to take care on the basis of the higher prices that it can charge its corporate clients.

In such a situation, there is a good economic argument for supplementing these inadequate market incentives with auditors' tort liability towards foreseeable subsequent investors. Such tort liability not only provides auditors with the usual direct incentive to take care. It also helps indirectly to provide the auditors with the market or reputational incentive to take care because the tort litigation will focus on the care or quality of service actually delivered by the auditor and, therefore, helps to refine further the possible explanations for the poor market performance of any given investment. The result will be an auditor's reputation which more closely tracks the quality of service actually provided than would be the case if, unaided by any tort law litigation, market reputation were only based on the crude proxy which is provided by an investment's market performance.

However, the economic argument that there is a sufficient incentive in the market for the auditor to take care not only assumes too much of the market to explain limited auditors' liability; it also proves too much even if its assumptions are taken for granted. For the point is to understand why the House of Lords might provide for a very limited form of auditors' liability in tort in Caparo, and in particular for liability only extending as far as the audited financial statement's intended use, not all foreseeable subsequent uses. But the economic argument, based as it is on the efficacy of market forces, is really an argument for no tort liability at all, leaving the appropriate levels of care to be worked out contractually by all the parties concerned. The possibility of tort liability only represents the danger of an ill-advised judicial intervention into a situation where there is every reason to expect the parties, if left to their own devices, to work things out for themselves, a cost without any obvious benefit.48

Thus, the third economic argument for the particular version of limited auditors' liability that we observe in Caparo fails just as the first two arguments did. If we accept the argument's assumptions, then we are left with the complete displacement of auditors' tort liability by contract, i.e., we should not even observe the limited form of auditors' tort liability which is still present in Caparo. On the other hand, if we question the assumptions but continue to accept the economic logic, we end up with a traditional version of market failure where tort law can be useful in providing incentives to defendants to avoid negligently causing injury to foreseeable plaintiffs, in this case, foreseeable subsequent users of the negligently audited information. But this too is inconsistent with the

47 Ibid., at pp. 96-7.

48 See, e.g., Goldberg and Cheffins, supra, footnote 6.
House of Lords' decision in *Caparo*, which denied recovery in tort to just such a group of foreseeable subsequent users. This seems to be the appropriate point, therefore, to look for a better positive understanding of *Caparo* which takes us beyond the confines of economic analysis.

III. LIMITED AUDITORS' LIABILITY AND THE MORALITY OF TORT LAW

1. The Inherent Limits of an Economic Analysis of Tort Liability

In the last section, three different kinds of arguments were canvassed that might reasonably be derived from an economic analysis of law to explain why, as in the *Caparo* decision, auditors should not be held liable for all of the foreseeable injury they cause to subsequent users of a negligently audited financial statement. Each of the different arguments was found to be deficient, either because it was too weak, and could not explain why the liability of auditors should be limited, or because it was too strong, and suggested that there should be no auditors' liability in tort law at all. The intermediate liability position exemplified by *Caparo*, where negligence liability is imposed upon auditors for all losses incurred by the intended user of the audited statement but where there is to be no liability for losses incurred by foreseeable subsequent users, seems not to be one that economic analysis can easily hold. In this section, it will be argued that the morality of tort law, a morality that treats the private law nature of tort as fundamental to its understanding, can make sense of this intermediate liability position in a way that economics, as a very special and sophisticated kind of public policy analysis, cannot.

The pure public policy aspects of the economic arguments that were analyzed in section II can be starkly appreciated once one recognizes that, in all of these arguments, whatever else their differences, the individual rights of the tort victim are to be determined by the dictates of economic efficiency. That is, the plaintiff does not have rights as such, or rights that have any independent standing, but only such rights as are conducive to, or follow from, the maximization of some social calculus or measure of the overall good of society.

For example, in the first argument which concerned the problems of fully appropriating the benefits of producing information, any right that the plaintiff might otherwise have had to recover from the defendant for negligent misstatement is simply outweighed by society's need to provide some kind of subsidy to the information industry lest too little in the way of socially beneficial information be produced. The fact that it is the plaintiff who is singled out to provide the necessary subsidy for this greater social good seems not to be worthy of any special comment.

In the second argument, the secondary status of the plaintiff's individual rights within the overall calculus of greatest net social benefit is even more apparent. There, it will be recalled, the plaintiff was to be given less protection in tort law for economic losses than for more traditional physical losses because the former, while admittedly very real as losses for the individual plaintiff, were nevertheless much more likely to involve only transfers between individuals and thus not be genuine losses from a social point of view.

Finally, in the third economic argument for limited auditors' liability, which emphasized that even in the absence of any sanction in tort law there would be sufficient negative market impact to deter an auditor from doing a poor job of reviewing a corporation's financial statement, the individual victim of a negligent audit again only has a secondary role. While a reputational sanction working through the market for an auditor's services might, as planned, have the effect of encouraging the auditor to take reasonable care, the fact remains that the argument provides for no tort remedy to be made available to the victim of an auditor's negligence should such negligence actually occur. Rather, the important feature of the argument is that the negligent auditing company will end up paying for its negligence, because of the lower prices it will subsequently be able to charge for its services to other clients, not that the victim of the negligence will actually receive any compensation for its injury.

This emphasis on the defendant, and in particular on what the negligent defendant must pay rather than on what the victim should receive, is symptomatic of the economist's primary concern with providing incentives for the efficient deterrence of negligent conduct. Indeed, in the early editions of his highly influential book *Economic Analysis of Law*, Richard Posner made the point that it was "essential that the defendant be made to pay damages and
that they be equal to the plaintiff’s loss. But that the damages are paid to the plaintiff is, from an economic standpoint, a detail.\footnote{Ibid., at p. 143. Posner does admit, in a footnote to this page, that the “detail” is an important one for the following reasons. First, payment of damages to the plaintiff is important to encourage the private enforcement of law. Second, if the payment is not made to the plaintiff in the event of an injury, then the plaintiff may have his or her own incentives to take precautions against the injury, something that might be socially inefficient if the defendant, who would otherwise take the precautions, is “the least cost avoider” of the injury. The latter argument fails as an explanation for the plaintiff recovering damages for the reason provided supra, footnote 40. And the former argument also fails for analogous reasons; all one need pay the plaintiff to induce private enforcement of the law is some amount sufficient to compensate for his or her opportunity costs. The amount of this “bounty” payment need bear no relationship to damages, or to the amount required to compensate for the injury. On this, see Weinrib, supra, footnote 40, at p. 296.}

This general sort of thinking has recently been carried forward by the economist Victor Goldberg into his analysis of auditors’ liability. This is particularly true when he suggests that “it is of no consequence whether the defendant’s liability arises as a matter of tort or of securities law”.\footnote{Supra, footnote 6, at p. 296.} When one recognizes that the role of the plaintiff might be what distinguishes the private law of tort from the public regulation that is characteristic of securities law, it is clear that the conventions of economics still view the presence or absence of the plaintiff in tort litigation as a matter of mere detail.

Now one might think that the relatively cavalier treatment of the plaintiff that seems to follow from the economic theory of deterrence is unattractive just as a matter of substantive ethics. Certainly someone who thought it was more important ethically to compensate victims than it was to deter defendants would deem it more a matter of detail whether the plaintiff actually received the damage payment from the defendant. Indeed, such a person would naturally focus more on what is received than on what is paid, and might even suggest the mirror image idea that whether or not the damages paid to the plaintiff are paid by the defendant is really only a question of detail. That is why such thinking often leads quite naturally away from tort law to the endorsement of some alternative, no-fault accident compensation scheme where the behaviour or status of the defendant is typically less decisive for what the accident victim receives.

However, what one thinks as a matter of substantive ethics about the role of either the plaintiff or the defendant, or what one thinks about tort law as compared to some alternative scheme for the regulation of the defendant’s behaviour or for the compensation of the plaintiff’s injury, is not the essential point here. Rather, the point is that, as a matter of tort law, both the plaintiff and the defendant play essential roles in the litigation. Without their equal standing in the action, it is clear that we are talking about something other than private law in general, and about something other than tort law in particular.\footnote{Cf. Weinrib, supra, footnote 40, at pp. 493-4: ... other aspects of tort law are so general and pervasive that they are indispensable to our conception of what tort law is. They characterize tort law in the literal sense of providing the indicia of its distinctive character. If they were removed, we would no longer be able to recognize what remained as tort law at all. These features together constitute what can be termed the basic structure of tort law. Because it is impossible for us to conceive of tort law without them, a theory of tort is necessarily a theory of these features. ... the defendant’s payment of damages to the victorious plaintiff is a feature of the basic structure of tort law. Changing the form of damages would move us from tort law to a different mode of ordering. For example, requiring the injurer to pay the state rather than the victim would be the sign of a system of penal fines. Similarly, a system under which the plaintiff received money, but not from the defendant, would strike us as a compensation scheme that has replaced tort law. The direct remedial connection of defendant and plaintiff seems to be essential to our conception of tort law.}

However, the law lords in Caparo clearly did not envisage themselves as being provided with an opportunity for stepping outside tort law and into a consideration of its regulatory and compensatory alternatives; that would be to engage in the sort of legislative task which they sought to avoid.\footnote{See, supra, text at footnotes 8 and 9.} Thus, to understand what the House of Lords did in Caparo, and to understand in particular why the law lords limited auditors’ liability to something less than full liability for the losses experienced by all foreseeable subsequent users of a negligently audited financial statement, it is essential to see the decision as an attempt to make sense of the equal standing of the plaintiff and the defendant in the litigation; that is, it is essential to see the decision as reflecting the private law demands of tort. Because the economic theories canvassed above do not do that, something that is reflected in their general indifference to the presence of the plaintiff in the litigation, they are inherently unable to provide us with a genuine rationale for the Caparo decision.
2. Towards A More Coherent Conception of Limited Auditors' Liability

The weakness of public policy analyses in general, and of economic analysis in particular, is not limited to their inability to explain the necessary presence of both the plaintiff and the defendant in tort law adjudication. Such analyses also tend to render other key elements of tort law inconsequential. This is particularly true of the "cause-in-fact" element of any successful negligence action. Nor is this just another contingent result of economic analysis. The argument which follows will show that this particular failure to explain factual causation is related in an illuminating way both to the general failure of economic policy analysis to explain the plaintiff's role in tort law adjudication and, more specifically, to the limited auditors' liability result in Caparo. All of these inadequacies, the argument will suggest, follow from the same failure to appreciate that the different elements of a successful negligence action are related as parts to a whole. Thus, an inadequate account of any one part is an inadequate account of them all; as parts they stand or fall together.

It is well-known that a plaintiff must show that the defendant's negligence was, on a balance of probabilities, an actual cause, or cause-in-fact, of the plaintiff's injury. However, the meaning of factual causation has always been a source of great confusion for the courts and the various fact situations in the cases have shown the futility of attempting to reduce the concept of causation to a set of necessary or sufficient — or necessary and sufficient — conditions for the occurrence of the plaintiff's injury. Impatient with this judicial inability to come up with a specific and usable formula for finding factual causation in the cases, the lawyer economists have been moved to adopt what Richard Posner has called a "probability enhancement" account of causation in tort law.55


56 See the discussion of the relevant cases in Weinrib, "A Step Forward in Factual Causation" (1975), 38 Mod. L. Rev. 518. Also see Posner, Tort Law: Cases and Economic Analysis (Boston, Little, Brown & Co., 1982), Chapter 8, and Landes and Posner, supra, footnote 20, at p. 228, for accounts of causation which are very sceptical of the possibility of coming up with a defining set of "necessary and sufficient conditions". This article is an attempt to show that it is a mistake even to think that the point of the judicial exercise is to come up with a set of necessary and sufficient conditions which define factual causation in isolation from the other elements of the negligence action. On this, see infra, text at footnote 65.

57 The "Learned Hand formula" is the linchpin for economic analyses of liability rules. It originates with Judge Learned Hand's opinion in United States v. Carroll Towing Co., 159 F.2d 169 (2nd Cir., 1947). Speaking of a defendant barge-owner's duty in negligence to prevent his barge from breaking away from its moorings and damaging other ships, Judge Learned Hand said (at p. 173):

... the owner's duty, as in other situations, to provide against resulting injuries is a function of three variables: (1) the probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, I; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B < L P. Posner's "probability enhancement" account of causation works through the Hand formula by interpreting P more generally as the difference between Pn, or the probability the accident will occur if the defendant is negligent, and Pn, the probability that the accident will occur if due care is taken, i.e., Pn = P - Pn. This is the case that Posner uses to illustrate the force of his "probability enhancement" approach to factual causation: see Posner, supra, footnote 54, at p. 558.
defendant municipality, whose responsibility it was to remove the
dangerous tree, can use to ground a defence of contributory
negligence? Certainly his speeding seems to be a necessary condition
for the accident to occur in that it is the particular speed at which
he is travelling which brings him to that fateful spot under the tree
just at the time when the tree falls down. Yet it seems wrong to
think of his negligent speeding as a cause-in-fact of the accident
and, therefore, a reason for any reduced recovery under contrib­
utory negligence.

Moreover, the analysis provided by the lawyer economist can be
used to show why this might be so. Although it is true that ex post
the plaintiff’s speeding was, in some literal sense, a cause of the
accident, ex ante the accident was no more likely to occur if he
were going quickly than if he were going slowly; he could just as
easily have been at the wrong place at the wrong time under either
scenario. Thus, his speeding did not really enhance the probability
of the accident’s occurrence, and since he would not, therefore, be
negligent in the lawyer economist’s sense of that term, he should
not be held legally responsible for any of the costs of the accident.

However, while the lawyer economist can make some progress
towards a sensible result in such a case of problematic factual
causation, the same sort of analysis creates difficulties when it
comes up against another classic American case, Palsgraf v. Long
Island R. Co.59 In Palsgraf, the defendant’s conductor was
negligent in trying to help a passenger aboard a train after the train
had started moving. The passenger stumbled and dropped an
unmarked package on the platform. The package contained
fireworks which exploded on impact. As a result of the explosion,
and in all likelihood because of some panic in the crowd standing
on the platform,60 a heavy weigh scale at the other end of the
platform was tipped over and injured the plaintiff, Mrs. Palsgraf.
The court held that, while the railroad may have been negligent
with respect to the passenger who was attempting to board the
train, it was not liable for Mrs. Palsgraf’s injury.

Now there can be little doubt that, in the court’s view, the
defendant’s negligence was a cause-in-fact of the plaintiff’s injury.

Moreover, it seems plausible to say that ex ante the negligence
enhanced the probability of the accident’s occurrence. To be sure,
the enhanced probability that Mrs. Palsgraf would be injured as a
result of the defendant’s negligence was very small, but if the
defendant had already been construed as negligent with respect to
the passenger boarding the train, indicating on an economic
analysis that the costs of taking additional precautions to avoid
that sort of injury are less than the benefits of doing so, then surely
the failure to take those same precautions ought a fortiori to have
been viewed as negligent with respect to Mrs. Palsgraf even in the
face of such a small enhanced probability of injury. Moreover, the
railroad must be held liable in this sort of situation to preserve the
railroad’s incentive to undertake any additional precautions that
might avoid the sort of injury that Mrs. Palsgraf suffered. It seems,
therefore, that the economic analysis of negligence and causation
argues for a result contrary to the one reached by the court in
Palsgraf 61

One might well wonder at this point what all this has to do with
developing a principled understanding of the limited auditors’
liability decision in Caparo. In particular, it is tempting to point to
the fact that, while both the Palsgraf and the Caparo decisions
turned on the all-important element of duty in a successful negli­
gence action, that similarity is overwhelmed by the obvious
difference that, whereas in Palsgraf the plaintiff’s injury was
deemed not to be reasonably foreseeable and therefore not
something for which the defendant could be held liable, in Caparo
the negligent defendant was held not liable despite the reasonable
foreseeability of the plaintiff’s injury as a subsequent user of the
negligently audited information. Indeed, for many, including the

59 162 N.E. 99 (1928).
60 There is much speculation surrounding the exact sequence of events leading up to the
plaintiff’s injury in the Palsgraf case; see Noonan, Persons and Masks of the Law (New

61 This was Posner’s view in his casebook, supra, footnote 54, at p. 586. To explain the
result in Palsgraf, Posner was there inclined to invoke some scepticism about whether the
facts were really as described in the case; see ibid., at p. 587. In Landes and Posner,
supra, footnote 20, at p. 246, the economic analysis of Palsgraf is slightly different. There
it is argued that, because the injury to Mrs. Palsgraf is so improbable, there is no
beneficial allocative effect in holding the railway liable, and, moreover, there is some
cost in requiring a costly transfer of damages between the parties. In the limit this may be
so, but the more general argument is the one that recognizes, first, that even low proba­
bility injuries are worth avoiding up to some point and, second, that the costs of litigating
a transfer of damages are also to be discounted ex ante by the same low probability of the
litigated event occurring. On this point, see Shavell, “An Analysis of Causation and
also (at p. 491) makes it clear that he thinks Cardozo’s opinion in Palsgraf is mistaken for
the same sort of reasons that are provided in the text of this article.
lawyer economists surveyed above who have laboured so hard to provide the explanation, it is the decision in Caparo not to hold the negligent defendant liable in the face of this foreseeability that needs to be explained.

However, this is a shallow understanding of the relationship between the Palsgraf and Caparo decisions. In his majority judgment for the defendant, Judge Cardozo emphasized that, while the defendant may have been negligent, and while this negligence may have been a cause-in-fact of the plaintiff's injury, the injury was not the result of any wrongdoing done to her. Rather, the wrongdoing was committed against the passenger who held the package and, according to Cardozo, Mrs. Palsgraf must sue "in her own right for a wrong personal to her, and not as the vicarious beneficiary of a breach of duty to another". Now one way in which one might fall outside the ambit of the defendant's wrongdoing, of course, is to be unforeseeable as a plaintiff or, at least, unforeseeable as a plaintiff suffering the kind of injury that is the subject of the litigation. But this need not be the only way. One could be foreseeable as someone who might suffer an injury as a result of the defendant's negligence and yet still not lie within the ambit of the wrongdoing contemplated by that negligence. In such a situation, therefore, one would still not be able to recover on Cardozo's view despite the facts that, first (contra Palsgraf), one is foreseeable as a victim; second, the defendant has been negligent (to someone else); and third, this negligence has been a cause-in-fact of one's injury.

In other words, what matters for a successful negligence action on Cardozo's analysis is not just the satisfaction of a loose aggregation, or list, of three unrelated but somehow necessary considerations, viz., "foreseeability" (or the existence of a duty) plus negligence (or breach of a duty) plus causation (or a cause-in-fact connection between the breach of the duty and the plaintiff's injury). That understanding of Cardozo's opinion suggests that the plaintiff lost in Palsgraf only because she was not reasonably foreseeable, something which would obviously distinguish her from the plaintiff in Caparo. Rather, what is essential to understanding Cardozo's view is the more fundamental idea that these three elements of a successful negligence action are necessary because they form the essential, integrated parts of a wholly unified conception of wrongdoing for which it makes sense as a remedy that this plaintiff sue this defendant for this injury. Once the Cardozo opinion is appreciated at this level, it becomes apparent that the unforeseeability of the plaintiff in Palsgraf is only one way in which the integrity of a successful negligence action can be compromised. It can also be compromised if all the necessary elements of the action are present but they are not coherently related to one another.

The importance of this point for an understanding of Caparo can be made clearer if we consider a slight variant on the facts of Berry. Suppose that a negligently speeding defendant has had a car accident with a plaintiff who pulled out in front of her, but can show that, even had she been driving at a non-negligent speed, she would not have been able to stop in time and that the same accident would have occurred anyway. In such a case, just as in Berry, the defendant's negligence, although a necessary condition for the occurrence of the accident in the strict sense that it was the speeding that brought her to the wrong place at the wrong time, will not be deemed a cause-in-fact of the accident. This is because the meaning of the cause-in-fact element of a negligence action is something that is in part conditioned by the other essential elements of the action, including the defendant's negligent speeding, and it is no part of that negligence, or not within the ambit of its wrongdoing, that one might be in the wrong place at the wrong time. Alternatively, but equivalently, we might say that

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62 Supra, footnote 59, at p. 100.

63 Cf. Caparo, supra, footnote 1, at p. 396, per Lord Oliver:
   It has to be borne in mind that the duty of care is inseparable from the damage which the plaintiff claims to have suffered from its breach. It is not a duty to take care in the abstract but a duty to avoid causing to the particular plaintiff damage of the particular kind which he has in fact sustained.

This search for a unified understanding of tort law, which takes as central the fact that a very particular plaintiff is suing a very particular defendant, forms the basis for the impressive series of articles by Ernest Weinrib which are the source of inspiration for this article. See, e.g., Weinrib, supra, footnote 40, as well as his "Caution and Wrongdoing" (1987), 148 C.L.R. 218 at pp. 241-2 (quoted in Caparo, supra, footnote 1, at p. 396, per Lord Oliver, with approval):

"His duty of care is a thing written on the wind unless damage is caused by the breach of that duty; there is no actionable negligence unless duty, breach, and consequential damage coincide ... for the purposes of determining liability in a given case, each element can be defined only in terms of the others." [Emphasis added.]
it is no part of the purpose of having laws against speeding that drivers not end up in locations in which accidents (which are otherwise unavoidable) might occur.

This attention to the limited purpose of rules controlling negligent behaviour is what suggests the connection between Caparo and those classic tort cases involving unforeseeable plaintiffs (Palsgraf) and problematic causation (Berry). Contrary to what has been suggested by the lawyer economists and others, there is nothing special about auditors' liability, as a situation involving negligent misrepresentation causing economic loss, that calls for an additional "limited purpose" test to limit an auditor's liability on grounds of public policy. Rather, the limited liability that was achieved in Caparo under this test, despite the reasonable foreseeability of the plaintiff's injury, follows from the same set of principles that denied the plaintiff her recovery in Palsgraf and the defendant municipality its defence of contributory negligence in Berry. In a tort law adjudication of the matter, the court has to attend to some understanding of the purpose of a given audit in order to form an appreciation of the sorts of consequences that properly fall within the ambit of risk or wrongdoing that such an audit, negligently performed, entails. Anything less cannot explain, as Cardozo so clearly felt in Palsgraf he had to, why a particular plaintiff is suing a particular defendant or, more generally, why we even need a plaintiff to bring the action at all. But then, that is to say that nothing less can make sense of the decision as one of tort law.

Now, it will be objected that there is little in the general analysis presented here which allows us to assess whether the House of Lords correctly determined the particular purpose of the auditing transaction which occurred in Caparo. It might be, for example, that a proper understanding of the limited purpose of the auditing in Caparo would show that in fact the negligent performance of such an audit entails the sort of risk which covers the kind of injury the plaintiff suffered. However, while this might be true, it does not go to the purpose of the analysis presented here. Rather than provide a final assessment of the specific result that was arrived at in Caparo, the purpose of the argument has only been to provide some understanding, better than public policy analysis can provide, of the general structure of the reasoning used in the case.

In particular, a proper understanding of the case must explain the attention which the law lords gave to the special purpose of the auditing transaction which was involved when to do this has the effect of limiting the auditor's liability despite the presence of a reasonably foreseeable injury that was suffered as a result of the auditor's negligence.

Furthermore, it is not at all obvious that this lack of a final determinative assessment of the specific Caparo result should be viewed as a deficiency of the analysis presented here of its legal reasoning. Legal reasoning and adjudication are rule-governed processes, or at least they purport to be. This means that particular legal results are to be justified according to how they conform to the rules or general categories of reasoning that have been identified, articulated, and refined in the different cases. But the application of a given rule to a particular case cannot itself be a rule-governed process. There cannot, in other words, be a rule for when we should follow the rule; that would lead to a hopelessly infinite regress. So there must be a point where the rules, and, therefore, our analysis of and arguments about the rules which are appropriate to a given area of adjudication, run out. This means that when a rule governs a case, there will inevitably be a "gap", or indeterminacy, between the particular result and the rule which acts as its general justification. This gap, which is after all only a gap in the rules, will be closed by the exercise of judgment, something which, in its better forms at least, will reflect the insight that comes from actual (often extensive) legal experience. However, the exercise of this judgment will not be something which can itself be rationalized by rules even as it is constrained by them.

Further, in Caparo, while reasonable people might disagree about whether the law lords were correct in their final judgment

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66 E.g., Klar, supra, footnote 18.
that the particular purpose of the auditing transaction in question was only to inform shareholders at their annual meeting, and was not prepared for investors contemplating a takeover bid, it would be a mistake to think that this indeterminacy of purpose, which called for their best judgment, means that they could have attended to just any possible public policy purpose of their own choosing that auditing and, therefore, auditors’ liability might serve. Rather, they attended to the purpose of auditing in that case because they needed to determine whether the plaintiff’s injury fell within the scope of wrongdoing which was presented by doing such an audit negligently. And while one could argue more about whether they judged the purpose of that audit correctly, it has been the purpose of this article only to argue that they were right to consider and ultimately judge, as best they could, the limited purposes of that auditing transaction as a matter of tort law. What they were not free to do as tort law adjudicators was to determine the purpose of auditing and limited auditors’ liability as a general matter of public policy. Nor were they free to find liability just because the plaintiff’s injury was foreseeably caused by the defendant’s negligence.

IV. CONCLUSION

Put succinctly, what cases like Palsgraf and Caparo show is that it is not enough for a finding of liability that the plaintiff was injured, even if foreseeably so, by the defendant’s wrongful conduct. Instead what matters is that the plaintiff be wrongfully injured by the defendant, that is, that the plaintiff’s injury fall within the ambit of the defendant’s wrongdoing rather than just be a cause-in-fact result of it. This is a subtle distinction to be sure. But it is an important distinction which preserves the intellectual integrity of tort law as something that can properly be the subject of adjudication — that is, legal argument and reasoned judgment — in a way that a pure public policy, or economic, analysis of tort law cannot.

68 For the same reason, it is inaccurate and misleading to say, as does Klar, supra, footnote 18, p. 113, that “the action for negligence compensates those who have suffered injuries as a result of the unreasonable conduct of others.” The phrase “as a result of” has the effect of listing factual causation as an element of a successful negligence action but it does not adequately integrate it into the action as one part of a coherent whole. For this reason, moreover, Klar’s characterization of the negligence action would, infelicitously, imply defendant liability in both Palsgraf and Caparo.