1-1-1995

The Economics of Canadian National Railway v. Norsk Pacific Steamship (The Jervis Crown)

David S. Cohen
Pace Law School

David Cohen*

THE ECONOMICS OF *CANADIAN NATIONAL RAILWAY* v. *NORSK PACIFIC STEAMSHIP* (THE JERVIS CROWN)†

Introduction

Economic analysis of legal doctrine assumes, indeed its relevance largely depends upon the assumption, that judicial decisions will have an instrumental impact on the future behaviour of firms and individuals who are not themselves parties to the litigation which resulted in the specific doctrinal development being analysed. In other words, economic analysis assumes that the decisions of courts – and particularly, for what should be obvious reasons, the decisions of the Supreme Court of Canada – have a direct influence upon the manner in which non-litigants will choose to order their affairs following that decision. Thus, the focus of a 'law and economics' analysis – as it is often colloquially termed – is not on the legal entitlements or welfare of a particular plaintiff or the obligations or responsibilities of a particular defendant. Rather, it is on the economic implications for other analogous actors of allowing or denying a claim brought by a particular individual or firm. The decision of the Supreme Court of Canada, in *Canadian National Railway Co.* v. *Norsk Pacific Steamship Co. Ltd. et al.*,[1] is particularly amenable to such an analysis.

The *Norsk* litigation arose out of a collision between a barge and a bridge on the Fraser River. Near the city of New Westminster in British Columbia, spanning the Fraser River, stands a railway bridge commonly referred to locally as the CNR bridge. The bridge is owned by the federal government and managed by Public Works Canada (PWC). Although PWC had contracted with four railway companies to use the bridge, the principal user of the bridge around the time of the accident which led to the *Norsk* litigation was the Canadian National Railway (CN). The bridge was an integral link in CN's system – joining the Vancouver terminus to the main line – and the railway sent, on average, 32 trains with 1,530 cars a day across the bridge in 1987. This represented

* Faculty of Law, University of Victoria.

† The author would like to acknowledge the invaluable assistance of Paul Fairweather.

1 91 DLR (4th) 289, [1992] 1 SCR 1021. All subsequent references are to the DLR citation.

(1995), 45 UNIVERSITY OF TORONTO LAW JOURNAL 143

approximately 85 per cent of the daily traffic on the bridge. Under the terms of the contract which the railway had with PWC, CN was responsible for repair and maintenance of the bridge when necessary, at the request of the owner. There was, in other words, a sufficiently close functional relationship between the bridge and the railway to cause most persons to believe that the bridge belonged to CN.[2]

On 28 November 1987, through a heavy fog, a barge, the Crown Forest No. 4, was being towed west down the Fraser River by a tugboat, the Jervis Crown, which was owned and operated by the Norsk Pacific Steamship Company (Norsk). The barge, through the negligent operation of the tugboat, collided with the bridge, which caused extensive damage and closed the bridge to all traffic for several weeks while repairs were made. PWC, representing the Queen in right of Canada, claimed damages as owner of the bridge against Norsk as well as against the owners of the barge and the owners of another tugboat which was assisting the Jervis Crown at the time of the accident. Only the action for damages against Norsk was successful, and that decision – of Addy J in the Federal Trial Court[3] – was not appealed.

Consolidated with the action brought by PWC, was an action brought by three of the four railway companies which used the bridge.[4] This claim, against Norsk and the other defendants, was for pure economic loss represented by the expenses CN necessarily incurred by the rerouting of passenger and freight trains which would normally have used the bridge; by losses incurred by CN due to delays in shipments of freight and, in some cases, failure to ship at all; and by additional shipping

2 The data on which this 'impression of ownership' conclusion was reached is not apparent from the written reasons in the case. Nonetheless, this relationship was of some consequence to the decision of the Court. As noted by La Forest J (at 339), 'C.N. heavily stressed the defendants' undoubtedly high level of subjective and objective knowledge that C.N. as a particular company would suffer loss. My colleague Stevenson J relies on this factor as his principal ground for finding liability in this case. There is no question that Norsk knew and ought to have known that C.N. would suffer loss. Indeed, the facts reveal that the tug captain thought C.N. would suffer even more than it did, since he erroneously thought the bridge belonged to it.'

3 26 FTR 81, 49 CCLT 1, 15 ACWS (3d) 357.

4 In a pre-trial agreement between Norsk, the Burlington Northern Railway, and the B.C. Hydro and Power Authority Railway – Canadian Pacific, the other railway involved, chose not to participate in the litigation – the respective claims of the two railway companies were to be determined by the result of the action brought by CN. On the strength of that agreement, the two railways took no part in the litigation. Consequently, it was only CN's claim which was at issue during the trial, appeal, and subsequent appeal to the Supreme Court of Canada. See 26 FTR at 100.

expenses incurred by CN – as there was also interference with the watercourse, cargo which would have normally gone by ship or barge had to be delayed or transported by land. Addy J allowed CN's claim against Norsk, dismissing the action against the others, and that decision was upheld by the Federal Court of Appeal.[5] Norsk appealed the Federal Court of Appeal decision to the Supreme Court of Canada.

The Supreme Court dismissed the appeal and allowed recovery for the pure economic losses suffered by CN. The decision, consisting of three extremely complicated judgments,[6] has generated interest both in academic literature[7] and in lower court judgments.[8] On a doctrinal level, recovery for pure economic loss – that is, loss which is not associated with any physical harm to the plaintiff or the plaintiff's property – is a hotly disputed issue in Canada,[9] and the judgments in *Norsk* have done little to provide any definitive answers to that dispute. In fact, the only propositions which are firmly established are negative ones.[10] First, the case clearly stands for the proposition that there is no

5 65 DLR (4th) 321, [1990] 3 FC 114, 3 CCLT (2d) 229.

6 In the result, the Court was divided 4 to 3. McLachlin J – L'Heureux-Dubé and Cory JJ concurring – and Stevenson J wrote judgments dismissing the appeal and allowing CN's claim for pure economic loss against Norsk. La Forest J – Sopinka and Iacobucci JJ concurring – wrote in dissent.

7 See Anne Mactavish 'Tort Recovery for Economic Loss: Recent Developments' (1993) 21 *CBLJ* 395. See also B.S. Markesinis 'Compensation for Negligently Inflicted Pure Economic Loss' (1993) 109 *Law QR* 5.

8 See *Comeau's Sea Foods Ltd.* v. *Canada (Minister of Fisheries and Oceans* (1992), 33 ACWS (3d) 889 (Fed. Ct TD); *British Columbia Hydro and Power Authority* v. *N.D. Lea & Associates Ltd. et al.* (1992), 92 DLR (4th) 403, 33 ACWS (3d) 1304 (BCSC); *MacIntosh & Norman (1981) Ltd.* v. *Ceco Properties Ltd.* (1992), 36 ACWS (3d) 733 (BCCA); *Can-Dive Services Ltd.* v. *Pacific Coast Energy Corp.* (1993), 39 ACWS (3d) 385 (BCCA); *London Drugs Ltd.* v. *Kuehne & Nagel International Ltd. et al.* (1992), 97 DLR (4th) 261, 36 ACWS (3d) 669 (SCC); *Kripps et al.* v. *Touche Ross & Co. et al.* (1992), 94 DLR (4th) 284, 34 ACWS (3d) 758 (BCCA).

9 For a particularly thorough discussion of the entire area see Bruce Feldthusen 'Economic Loss in the Supreme Court of Canada: Yesterday and Tomorrow' (1991) 17 *CBLJ* 356. See also Joost Blom 'Economic Loss: Curbs on the Way Ahead?' (1987) 12 *CBLJ* 275; B. Feldthusen 'Economic Loss: Where Are We Going After *Junior Books*?' (1986–87) 12 *CBLJ* 241; David Cohen 'Bleeding Hearts and Pealing Floors: Compensation for Economic Loss at the House of Lords [*Junior Books Ltd.* v. *Veitchi & Co.*, [1982] 3 All ER 201]' (1984) 18 *UBCLR* 289. See also, generally, B. Feldthusen *Economic Negligence* 2d ed. (Toronto: Carswell 1989).

10 I am indebted to Professor Joost Blom, who has written about this judgment in some detail in 'Torts' in *Annual Review of Law and Practice* (Vancouver: Continuing Legal Education Society of British Columbia 1993) 480–3, for his excellent analysis of the case.

blanket exclusionary rule to recovery for pure economic loss in Canada.[11] Furthermore, the Supreme Court held that there is no single rule which will adequately address all the different activities that can result in pure economic loss – typically, the social contexts in which economic loss claims are generated involve the manufacture and design of malfunctioning products; the destruction of property which adversely affects the economic interests of third parties; the failure of governments to fulfil regulatory mandates; and inaccurate information leading to disappointed investor expectations. Finally, recovery for such loss, notwithstanding the category, will *not* be based solely upon the reasonable foreseeability of the risk of damage. According to the Court, there must be additional criteria or control devices to ensure that the 'floodgates' of potentially indeterminate liability are not flung wide.[12] What is immediately apparent is that there are few, if any, positive propositions which one might state with certainty as comprising the law in Canada with regard to recovery for pure economic loss.[13]

I began this comment by noting that the focus of a law and economics analysis is not on the legal entitlements, welfare, obligations, or

11 All three judgments reject (at 303, 367, and 380) the decision of the House of Lords in *Murphy* v. *Brentwood District Council* [1991] 1 AC 398, which is seen as denying recovery for pure economic loss in all cases other than those which fall under the *Hedley Byrne* doctrine (*Hedley, Byrne & Co. Ltd.* v. *Heller & Partners Ltd* [1964] AC 465, [1963] 2 All ER 575). The 'incremental approach' which the Court adopted in *Kamloops (City)* v. *Nielsen* [1984] 2 SCR 2, (1984) 10 DLR (4th) 641 is seen as the appropriate Canadian position.

12 Thus, the liability for negligent misstatement in *Hedley Byrne* is based upon concepts of 'reliance'; the liability for lost use of a chattel in *Rivtow* is based upon a duty to warn of physical danger (*Rivtow Marine Ltd.* v. *Washington Iron Works* (1984), 40 DLR (3d) 530 (SCC)) and the liability found in *Kamloops* v. *Nielsen* is based on the duty of public officials to pursue their statutory obligations. The liability in *Norsk* was based upon 'contractual relational economic loss,' a phrase which La Forest J termed (at 291) 'convenient if somewhat barbarous.'

13 La Forest J notes (at 291–2), 'The courts below and my colleagues, Justices McLachlin and Stevenson, are all of the view that CN's claim should be upheld. But this unanimity is more apparent than real, for they do so for different reasons and, indeed, there is significant disagreement on the determining issues.'

As Professor Blom points out, there is technically no ratio to the case, although if McLachlin J's judgment is taken as the majority position, recovery for pure economic loss will be available in situations where the plaintiff's connection with the damaged property makes it virtually a joint venturer with the owner. Blom goes on to say, 'Beyond that extremely narrow category, *Norsk* settles nothing, except that the courts will be open-minded about pure economic loss and will consider a wide range of policy arguments in deciding whether a particular category of such loss should be recoverable.' See supra note 10, 483.

responsibilities of the particular parties to an individual action. For that reason, I will not focus further upon the decision in terms of its specific economic effect upon Norsk Pacific or its shareholders, nor upon the position of the federal government, nor on the rights or well-being of Canadian National Railway. Rather my focus is on the impact of recognizing tort liability or denying claims in cases like *Norsk*, first, on the activities of what might be referred to as *transportation firms* where those activities may result in property damage; second, on the activities of *property owners* who face the risk of damage to their property as a result of the activities of transportation firms; and third, on the activities of *relational contractors* who contract with property owners to use the property which might be damaged, and which therefore face the risk of economic losses (or the lost opportunity of economic gain) associated with the interruption of their business activities.[14] The important point is that this categorization requires that my analysis look to the future and the expected behaviour of firms other than the particular litigants who came before the Court. It is, on that level, quite different from doctrinal or principled legal analysis, which looks to rules or principles developed in earlier decisions and the actual behaviour of the individuals engaged in the particular dispute.

The decision in *Norsk* is very likely to have significant effects upon the manner in which analogous actors structure their future economic activities and, for this reason, it is particularly well suited as the starting point for economic analysis. The second element which makes this case suitable for economic analysis is that it involves firms and property owners and the effect of accidents on the wealth of those firms and property owners. While property damage did occur, it was damage to investment property. It was not damage to property to which individuals might have personal or psychological attachments. The case apparently did not adversely affect the welfare or well-being of individuals, except insofar as the shareholders of the firms involved in the litigation might have experienced an increase or reduction in the expected income stream represented by their shares, due to the combined effect of the accident and the decision. It is fair, as well, to assume that firms like Norsk and CN, and the federal government represented by Public Works Canada, are all interested in structuring their interactions in a way which generates wealth for their shareholders or members. The link with economics is obvious. Finally, the judg-

14 The relationship between these groups is schematically diagrammed in Appendix A.

ments themselves are amenable to economic analysis. The nature of the issues before the Court dictated that there be discussion of a number of points which can be said to have the flavour of law and economics.

I *Law and economics*

Law and economics is concerned with efficiency – that is, with the development or evaluation of legal decisions which result in the production of goods and services in society at a lower marginal cost than that associated with alternative decisions. Consequently, in this analysis, I will not be concerned with the 'correctness' or 'rightness' of the decision in terms of its consistency with precedent, notions of desert, corrective justice, equal treatment, or any other normative basis for decision-making. In evaluating the decision, I take the position that one should examine the efficiency implications of the rule it contains. Costs do count in developing solutions to human problems.

Furthermore, law and economics recognizes that law is a social institution and that, in using the law, the legal system is attempting to respond in a rational manner to real, practical social problems. In that light, legal decision-makers should think carefully before using abstract legal concepts developed in one context to resolve issues in another. A law and economics analysis rejects the assimilation of 'economic loss' claims – which may arise in contexts as varied as product liability, negligent information or advice, delayed delivery of documents by couriers, and so on – and subsequent attempts to apply a single set of principles to the varied claims.[15] For example, there is, under current doctrine, a considerable immunity for negligent misrepresentation.[16]

15 La Forest J made this point when he stated (at 299): 'It does not follow ... that all economic loss cases are susceptible to the same analysis, or that cases of one type are necessarily relevant to cases of another. Nor does it follow that the constellation of policy concerns that have grown up around the issue of economic loss can be ignored. The fact is that different types of factual situations may invite different approaches to economic loss, and it seem to me to be at best unwise to lump them all together for purposes of analysis.'

16 Until quite recently, in the absence of a contractual or a fiduciary relationship, there was no liability in tort for negligent misrepresentation. Although this situation was changed by the decision of the House of Lords in *Hedley Byrne* – and expanded in subsequent decisions in England and in Canada – the circumstances under which one might bring a successful action for damages for pure economic loss due to negligent statements remain quite circumscribed. As Earl Cherniak and Kirk Stevens suggest in 'Two Steps Forward or One Step Back? Anns at the

This immunity may be justified by the fact that, in the absence of such immunity, there would be an underproduction of information which has some characteristics of a public good. The increased production of information – predicated upon an immunity from tort liability – may offset the lower than optimal production of information associated with the inability of firms to capture all of the profits from the use of information by others whom they cannot charge for the right to the information. It should be obvious that that idea has little or no relevance to an analysis of the Norsk situation – in which we are attempting to determine whether firms engaged in transporting goods and services who damage property of other firms, should be liable for the economic losses of still another set of firms who contracted with the property owner for the use of the property.

Finally, I must apply one codicil to the analysis presented here. A law and economics analysis of legal rules requires considerable information about the activities of third parties, the availability and cost of insurance schemes, the costs to firms of managing and reducing liability risks, the ability of firms to shift costs to others, and so on. This is quite unlike the information required either for a doctrinal analysis of a legal decision based on precedent at the appellate level, or for a judicial determination of liability in negligence in a particular case at trial. In the former case, judges need information about prior decisions of Canadian courts on the point of law under consideration; in the latter case, judges need information about the standard of care reasonably expected of defendants, about the contributory negligence on the part of the plaintiff, and so forth. The information necessary to an analysis of the expected behaviour of transportation firms, it appears to me, was not available to the Court in *Norsk*.[17] Neither is it available to me.

Crossroads in Canada' (1992) 20 *CBLJ* 164 at 169, a major policy reason for such restrictions is the 'potentially chilling effect on flows of commercial information upon which a modern competitive economy depends.' For a thorough discussion see B. Feldthusen *Economic Negligence* supra note 9. See also Allen M. Linden *Canadian Tort Law* 4th ed. (Toronto: Butterworths 1988).

17 This information gap is a product of judicial choice about institutional design, reflecting the self-defined needs of many judges, and indeed of all trial judges, to justify decisions based on independent legal rules, and on the behaviour of the particular individuals before the court. My concern is that the Supreme Court of Canada is much more than a trial court. It is, of course, making decisions which affect the legal rights of the parties to the litigation. However, it is, as well, making decisions on which literally millions of others will base their behaviour in the future. It is difficult to defend the operation of legal institutions which reject information about, and analysis of, that expected future behaviour.

II *The reduction of accident costs*

One approach employed in law and economics in the context of accident compensation policy is to ask, simply, what system of legal rules, administered by what institution, will reduce the (net) costs of accidents in society?[18] That question can itself be broken down still further into three components. First, what set of legal rules will reduce the number of accidents which will occur in a particular social context? That is, which of the two legal rules debated in the *Norsk* case – imposing liability on Norsk for CN's economic losses or immunizing Norsk from that liability – will be more likely to reduce 'primary accident costs'? Second, what system of legal rules will reduce the consequences of those accidents which do occur in that context? That is, which of the majority or minority decisions will reduce 'secondary accident costs'? Finally, what system of legal rules, and what institutional framework within which those rules operate, will reduce the public and private costs of administering the accident compensation process? That is, which of the two legal outcomes will most effectively reduce 'tertiary accident costs'? Both La Forest and McLachlin JJ touch upon aspects of these questions in their judgments, although neither is as well organized or structured as one might hope.[19]

REDUCING PRIMARY ACCIDENT COSTS

Transportation firms – airlines, shipping companies, trucking firms, and so on – are engaged in activities which, for a variety of reasons, may result in damage or losses to property owners and others. These accidents may occur for a number of reasons. Perhaps employees have not been properly trained. Perhaps senior management has accepted too many orders, forcing the firm to overuse equipment. Perhaps the inspection and maintenance operations of the firm have been systematically underfinanced due to demands by the marketing department for more advertising resources. Perhaps the firm has neglected to invest in weather-monitoring activities and thus ships goods in high risk situations. Perhaps the radar system purchased by the firm for its carriers is inadequate. Perhaps the firm did not purchase radar for its carriers at all. Whatever the reason, society is faced with a situation in which the

18 See Guido Calabresi *The Costs of Accidents* (New Haven: Yale University Press 1970).

19 See, for example, the judgment of La Forest J at 345–53 entitled, 'Part IV: A refined proximity analysis in contractual relational economic loss cases,' and see also the judgment of McLachlin J at 372–4 entitled '(2) Economic Theory.'

activities of the transportation firm expose others (including property owners and relational contractors) to risks which they would not otherwise have faced. Moreover, absent a social institution which shifts those risks to the transportation firm, the costs generated by the accidents which do occur are not included in the price of the service which the transportation firm is selling.

This externalization of costs results in two undesirable consequences. In the first place, it reduces the incentive of the firm to engage in accident-prevention measures as compared with the incentives which the firm would have if it faced those risks and bore those costs. In the second place, it results in lower prices for the transportation service, a concomitantly higher demand for the service and, thus, more transportation activity – and, ultimately, more damage and loss to third parties – than would be the case if the costs were borne by the transportation firm. Most law and economics theorists would argue, therefore, that transportation firms should bear *all* of the costs of their transportation activities. There should be no distinctions among the various ways in which these losses manifest themselves – whether through personal injury, property damage, or economic losses associated with property damage. A social interest in reducing the number of accidents will be furthered by legal rules which allocate these costs to the transportation firm. Analysed in this way, all of the losses associated with the collision between the Jervis Crown and the railway bridge (and thus all of the costs generated by transportation firms in general) should be allocated to the defendant in this case. Viewed in this light, the Supreme Court did not go far enough: there should be *no* restriction on recovery of economic losses associated with transportation accidents.[20]

20 This analysis should, however, require us to go further and determine whether liability should be generated by the application of a simple causality test, or whether liability should be predicated on a determination of negligence. If the cost internalization rationale is correct, there seems to be no reason to limit the liability of transportation firms to losses caused by their negligence. This appears to be a powerful argument in favour of making transportation firms strictly liable for *all* of the damage they 'cause.' While this may be true, it is not because it will result in a greater reduction of primary costs. Rather, we should prefer strict liability because it may result in lower secondary and tertiary costs. The standard of care which we expect of firms can be analysed using precisely the same tripartite analysis employed in this comment. For example, concerns with minimizing tertiary accident costs will lead to preferences for a strict liability rule. This will avoid public and private litigation costs associated with determining negligence as compared with the costs of determining causation. In a strict liability regime, firms still engage in cost-effective accident reduction measures, but managers will determine when it is cost

However, this primary accident-cost-avoidance rationale for cost internalization to transportation firms, which would support the *Norsk* outcome, and perhaps more, must be qualified by a number of important points which support the dissenting position expressed by La Forest J, or at least significantly weaken the cost internalization argument that might otherwise justify and support McLachlin J's majority position. First, one could argue that the property owner 'caused the accident,' and that it is property owners who should internalize the costs of damage and losses to transportation firms when their bridges get in the way of tugboats.[21] That is, the cost-internalization argument can be reversed, and one can argue for the allocation of accident costs to bridge-owning firms, to ensure that *they* engage in accident-prevention measures. Although this is an attractive argument, the question is better phrased in the following manner – in general, as between transportation firms and property owners, which of these can most effectively prevent collisions from occurring at the lower marginal cost?[22] It may be that the installation of protective barriers in front of

effective to reduce accidents and when the costs of accident-reduction measures exceed the reduction in liability for accidents which are avoided. Managers are simply better at doing that than are judges. More important, if judges are systematically wrong there is no way to correct them. If managers are systematically wrong, the firm will generate less profit than competitive firms and the managers will either modify their decisions or, one hopes, be replaced. Where the market will discipline managers, it will not – cannot – discipline judges.

21 This is one of the more important insights Ronald Coase developed in 'The Problem of Social Cost' (1960) 3 *J. of Law & Econ.* 1. The welfare losses represented by tugboat accidents are produced as a result of the interaction of two or more activities – in this case, bridge owning and tugboat operating. It is only because both activities occur in temporal and geographical proximity that accidents occur.

22 It should be noted that asking which of transportation firms or bridge owners can either 'prevent or reduce the probability and/or consequences of the risk occurring at the lower marginal cost' may be an oversimplification of the analysis and may result in inaccurate risk allocation and contractual design. The preferred approach should be to ask 'who can maximize the expected return on their investment in accident reduction measures.' Simply to ask who can reduce the probability and/or consequences of the risk occurring at the lower marginal cost may, notwithstanding its apparent simplicity, produce an inefficient presumptive rule. The following examples illustrate the point.

Assume that the expected cost of a particular risk (that is, the expected accident costs, *eac*) is $100. A can, by investing $40, reduce the *eac* to $70. B, by expending $15, can reduce the *eac* to $80. Clearly it is in the interests of both parties to allocate responsibility for this risk to B.

Assume again that the *eac* is $100 but in this case A, by expending $6, can reduce the *eac* to $30 while B, by expending $3, can reduce the *eac* to $40. Clearly, while

bridges could cost-effectively minimize collisions between tugboats, barges, and bridges. Perhaps bridge owners could install beacons which would be transmitted on a medium which tugboat operators use in any event, thus warning operators when they approach bridges. If bridge owners can prevent accidents from occurring, or otherwise reduce the number of accidents which do occur, at a lower marginal cost than the transportation firm, then it is clear that we should be internalizing costs to the bridge owner and not to the transportation firm. As I noted earlier, information as to the identity of the party who can manage collision risks most effectively is not generated in most legal proceedings. However, it would seem, intuitively, that tugboat operators are, in general, better equipped to manage those risks. More important, it would seem incontrovertible that, as between tugboat operators and firms contracting to use bridges – such as CN – the former group is *much* more likely to be able to reduce the risks of accidents occurring, at a lower marginal cost than the latter. Thus while the necessary information to access this issue is not available, the cost internalization argument, even with this more complicated analysis, would appear to support the majority decision in *Norsk*.

Second, it may be that the legal system, insofar as it is driven by allocative efficiency norms, should not develop legal rules which treat all losses as equivalent. Legal rules which are sensitive to efficiency norms should, perhaps, distinguish between adverse effects on third parties (that is, negative externalities) which are 'technological' from those which are 'pecuniary.' Technological externalities consist of costs or losses – personal injuries or property damage – in which the productive capacity of society's human capital or industrial base is reduced temporarily or permanently. In such cases, legal rules should impose those costs on the firm which is the most efficient accident avoider. Pecuniary externalities, by contrast, consist of costs or losses – usually contract entitlements or lost opportunities – in which there is no reduction in our social capital, but merely a transfer of wealth from one firm to another. For example, the business losses of both PWC and CN

the *eac* is lower if we allocate the risk to A, it is better to allocate the risk to B. An investment of $3 to obtain a return of $60 is better than an investment of $6 to obtain a return of $70.

This is all to say that a prescription stating that we should develop common law rules which allocate risks so as to 'minimize expected accident costs' is somewhat of an oversimplification. Rather, the objective of the legal system in shaping common law rules should be to maximize the expected rate of return on investments in accident prevention measures.

due to CN's temporary inability to use the bridge were very likely someone else's gain. While pecuniary externalities are a subset of social costs, they are distributive rather than allocative, and thus categorically different from property damage or personal injury. The distinction between pecuniary and technological externalities supports La Forest J's dissenting judgment which would insulate tugboat and other transportation firms from the former subset of externalities.

The third qualification on a simple cost-internalization argument which otherwise might support the majority judgment is produced through an analysis of the most efficient way to force internalization by transportation firms. For example, the legal rules may, as was done in the *Norsk* decision, give to numerous relational contractors the right to sue in tort against transportation firms to recover lost profits and other economic losses. Cost internalization in that situation will be produced through a combination of cost-efficient accident reduction measures by transportation firms, and tort litigation by relational contractors. Conversely, the legal rules might, as La Forest J argued, deny relational contractors the right to recover economic losses from transportation firms. This legal rule would create incentives for relational contractors to include a term in their contracts with property owners which stipulate that property owners will bear the losses suffered by relational contractors in the event of damage to the property.[23] Some property owners will then, perhaps, be able to recover that loss as a consequential loss in a tort action against the transportation company. The losses of what might be substantial numbers of relational contractors will, where it is cost effective to do so, be 'channeled' through the property owner to the transportation firm.[24] While each of these methods is equally viable in theory as an instrument which will reduce primary costs and internalize externalities, the latter channeling structure will be preferable if it will increase the extent of cost internalization which takes place. This structure will reduce secondary and tertiary costs and, thus, will more likely result in cost internalization and accident-avoidance measures where justified. Once one investigates the cost-internalization issue more closely, La Forest J's judgment would appear to be favoured on efficiency grounds.

23 This term will be included only where, as between a contracting party and the property owner, the property owner is in a better position to manage collision risks and the ensuing consequences to contracting parties. As I point out later, in many cases that will not be so.

24 See William Bishop 'Economic Loss in Tort' (1982) 2 *Oxford J. of Legal Studies*, 1, 2.

As well, La Forest J's analysis is supported when one takes into account the increased costs of insurance which will be generated by allocating risk of property damage and economic losses to transportation firms. It is generally assumed that first-party insurance – insurance purchased by firms to cover their direct losses if an accident occurs – is generally less expensive than third-party liability insurance – insurance purchased by firms which might be sued by other firms who experience losses. That is, insurance firms would charge transportation firms more for protection against lawsuits brought by property owners than the same insurance firms would charge property owners for protection against damage to their property caused by the same accident. This is so simply because the insurance firms are likely to know more about the risks they are assuming when they insure a particular piece of property than they know about risks when they insure the transportation company against damage to as yet undetermined property owned by as yet unidentified property owners. Assuming that it is less costly for property owners to obtain insurance protecting them from the losses associated with damage from accidents caused by transportation firms, we ought to prefer a world where the transportation firm is not liable for damage to property owners.[25]

A final qualification on the cost-internalization rationale for the majority position is presented through an assessment of the implications of accident and business loss insurance on primary cost-avoidance measures. There is some intimation in the decision that the majority dismisses the cost-internalization argument by assuming that the existence of insurance will attenuate primary accident avoidance measures.[26] That is true, but only to a very limited degree. Insurance companies can be expected to include terms in their insurance contracts with transportation firms as well as with property owners and relational contractors, which consensually regulate the behaviour of insured firms so as to control and reduce the exposure of the insurance firm to claims. For example, insurers of transportation firms may require certification of vessels, compliance with regulations, proper training of personnel, exclusions of some kinds of claims, deductibles, and so

25 The same argument is developed below in connection with insurance and the allocation of risks of economic losses to transportation firms.

26 Specifically, McLachlin J (at 372–3) implies that, first, to eliminate recovery for economic loss would significantly reduce the incentives of transportation firms to take care; and, second, that insurance, and in particular insurance for loss profits, would be unavailable at a reasonable cost. La Forest J, by contrast, (at 349–50), rejects both of these premises.

forth. Furthermore, insurance firms will 'risk-rate' insureds into categories, thus penalizing individual firms which have the characteristics of firms which present higher or more numerous claims, or which have a personal history of higher or more numerous claims. If insurance firms do this well,[27] the incidence of accidents will not increase substantially as a result of insurance coverage. The 'contractual regulation' by insurance firms, in effect, replaces the deterrent effects of tort liability with the deterrent effects of well-designed insurance policies. What this might mean is that the legal system should develop rules which allocate accident risks to the party whose insurance company is best able to monitor and control primary costs – that is, to the transportation firm. However, as I point out below,[28] the issue is complicated when one considers a more nuanced assessment of the insurance question, which takes into account insurance for secondary costs. However, this analysis does suggest that a societal interest in reducing primary accident costs would appear to support the majority judgment in *Norsk.*

In the end, an analysis of the impact of legal rules on primary accident costs suggests that while the majority judgment in *Norsk* is defensible, there are a number of important qualifications on a simplistic cost-internalization argument which might otherwise justify imposing liability on transportation firms. These qualifications operate more strongly in the context of an analysis of the allocation of risks of economic losses experienced by relational contractors, and, taken together, offer considerable support for the minority position articulated by La Forest J. This support is strengthened when one extends the analysis of legal rules to take into account their impact on secondary and tertiary costs.

REDUCING SECONDARY COSTS

Once we have designed a liability rule which will optimally reduce the number of accidents which occur, we must then reconsider the design of that rule in the light of a societal interest in reducing the *consequences* of those accidents which cannot be eliminated in a cost-effective manner. One significant way to reduce the consequences of accidents is through 'loss-spreading.' The consequences of accidents are reduced – that is, welfare losses experienced by firms and individuals are lessened – when many individuals and firms bear a relatively small loss, as

27 And there is, it might be argued, a sufficient degree of competition within the insurance industry to expect this to be the case.

28 See under the heading Reducing Tertiary Costs, infra.

compared with the situation where one or two individuals or firms face highly focused, catastrophic losses. The question then becomes, what set of legal rules will result in the greatest amount of loss-spreading? First, we might look at the structure of transportation firms, property owning firms and relational contracting firms, and their associated relationships among one another, to determine the implications of shifting losses from one to the other through tort law, as compared with the implications of leaving losses where they fall. At this point the question becomes, as between transportation firms, property owners, and relational contractors, who is the most efficient insurer against the consequences of accidents? Prior to examining some answers to that question, we should note that loss-spreading can take place through the purchase of insurance from independent or captive insurance companies or through self-insurance as firms factor expected losses into production decisions and reallocate them through price, dividend, and wage adjustments.

In my analysis of primary accident costs, I suggested that it is generally assumed that first-party insurance – insurance purchased by firms to cover their direct losses if an accident occurs – is generally less expensive than third-party liability insurance – insurance purchased by firms which might be sued by other firms who experience losses. This led to a conclusion that the cost-internalization benefits of making transportation firms liable for property damage and economic losses would be offset, to some degree, by the increased insurance costs and the reduction in insurance coverage associated with that rule. Assuming that it is less costly for property owners to obtain insurance protecting them from the losses associated with damage from accidents caused by transportation firms, we ought to prefer a world where the transportation firm is not liable for damage to property owners.

Similarly, one predicts that insurance firms will generally charge both transportation firms and property owners more for third-party liability insurance protection against lawsuits brought by relational contractors for recovery of economic losses than the same insurance firms would charge those contractors directly for first-party insurance against business losses which the contractors experience. This is so simply because the insurance firms know more about the risks faced by the firms for which they provide first-party insurance than they do about the unknowable claims which third-party liability insurance must apply to. Insurance firms know more about the business risks faced by relational contractors – the first-party insurance case – than about the risks they would be assuming on behalf of transportation companies faced with economic loss claims. This suggests that the dissenting

position of La Forest J is preferable, and that transportation firms should not be held liable when others can purchase insurance at a much lower cost for the same anticipated incident. La Forest J's decision would place responsibility for obtaining first-party liability insurance against business losses on relational contractors. This would appear to be an efficient outcome, at least as compared with the outcome produced by McLachlin J's judgment, which places responsibility on transportation firms to obtain third-party liability insurance against at least some business losses experienced by relational contractors. If La Forest J's judgment were to prevail, not only would relational contractors obtain insurance for their business losses at a lower marginal cost than could transportation firms and insurance companies for the same coverage, but insurance firms could ensure that relational contractors reduce their loss exposure through the development of alternative transportation measures, or through risk allocation arrangements in their subcontracts, which would be available in emergency situations. Whatever the option chosen, economic incentives to allocate the risk of transportation accidents through contractual negotiation are substantially reduced if, as McLachlin J would have it, at least some relational contractors are given a claim in tort against transportation firms.

Finally, an analysis of the way in which legal rules affect secondary costs suggests that transportation firms should *not* be liable for business losses experienced by relational contractors, because this immunity will increase the incentive for relational contractors to negotiate with property owners for protection against those losses. This, in turn, ensures that, as between property owners and relational contractors, the cost of the accident will be allocated to the party who can manage the risk of accidents in the most cost-effective manner. Where that contractual risk-shifting does not occur, relational contractors, knowing they cannot recover in tort against transportation firms and knowing that they cannot recover against the property owners in contract, can mitigate the consequences of accidents in other ways. Perhaps relational contractors can purchase options to use alternative modes of transportation at a cost which is less than property owners' costs of ensuring access to the bridge. Perhaps relational contractors can negotiate subcontracts with consignors so as to relieve relational contractors of liability for delays in delivery due to bridge closures. All of this suggests, confirming the efficiency rationale for La Forest J's judgment, that the consequences of transportation accidents could be significantly reduced if the risk of those consequences were placed on relational contractors, such as CN, and not on transportation firms.

This efficient allocation of the risk of bridge closures will occur so

long as contractual freedom exists – that is, in the absence of governmental regulation of the terms of the relevant contracts – and so long as there are no systematic informational errors which lead parties to make inefficient decisions. McLachlin J is simply wrong when she says[29] that inequality of bargaining power results in attenuation of efficient contractual risk allocation. First, there is no reason to assume, in general, and as between property owners and relational contractors, that one party could systematically exploit informational errors and thus negotiate inefficient risk allocation arrangements. Mere inequality of market power may affect the distribution of the gains associated with efficient risk allocation, but will not affect the allocative arrangements themselves.

REDUCING TERTIARY COSTS

The final stage in an analysis of the efficiency implications of legal doctrine is to attempt to reduce the administrative costs of the accident compensation system through which the legal rule will be implemented. For example, a legal rule such as that articulated in the dissent in *Norsk*, which establishes clear legal entitlements – so-called 'bright lines' between liability and no-liability states – are generally preferable to more nuanced standards. First, they provide clear signals to parties as to who must take steps to prevent accidents and obtain insurance and, thus, reduce duplication and waste. Second, bright lines reduce uncertainty, which, to most firms and individuals, represents an additional cost of engaging in business or other activities. Finally, bright lines reduce the public and private administrative costs of determining whether a particular plaintiff falls within the class of persons who have legal entitlements. With that in mind, it is eminently sensible to limit actions against transportation companies exclusively to property owners – and to exclude relational contractors – and thus provide a clear line demarcating who can sue and who cannot. There are significant costs associated with the majority decision in *Norsk* which would permit non-property owners to argue that they are effectively 'owners of property' due to some informal, implicit joint venture or partnership relationship, or because they are the primary users of the property, or because they own property around the property in question or are, in some sense, believed to be the owners of the property.[30] Clearly, none of

29 At 374.

30 McLachlin J, accepting the reasoning of the trial judge, held that CN could be characterized as a 'joint' or 'common venturer' with PWC and thereby be entitled to

these situations, or any others like them, serve to make them property owners identifiable through a clearly delineated legal rule, and concerns with tertiary costs suggests that they should not be treated as such.

The reduction of administrative costs also implies that legal rules should be developed which tend to *deny* liability since, by doing so, society avoids both private litigation costs as well as the public subsidization of private legal action. Rules which allow recovery of economic losses by relational contractors substantially increase litigation costs beyond what they would have been if only property owners were permitted to litigate rights arising from transportation incidents. Furthermore, this rule again provides incentives to relational contractors to assess the risk of business interruption and negotiate the allocation of that risk during negotiation of the contract to use the property. These negotiation costs are private, not public and, more importantly, are likely to be substantially less than the costs of litigation even when taken in the aggregate. That is, secondary as well as tertiary cost avoidance considerations suggest the advantage of channeling structures.

Finally, a societal interest in reducing tertiary costs implies the development of legal rules which lead to single insurers over multiple insurers. Where a no-liability rule forces relational contractors to insure against business losses, one might expect substantial administrative costs associated with the negotiation of large numbers of these first-party insurance policies. One alternative is to impose liability on transportation firms, who then take out one policy (a third-party liability policy) which provides coverage against claims from large numbers of relational contractors. Where the cost of the insurance exceeds the benefits to the particular transportation firm, a liability rule imposing risks of relational contractor business losses on transportation firms may result in avoidance of the transaction costs of insurance entirely. Avoiding these transaction costs would be associated with their replacement by litigation and settlement costs where transportation accidents occur. This advantage, though, might be more

recover for its economic loss. She stated (at 376), 'The reasoning, as I apprehend it, is that where the plaintiff's operations are so closely allied to the operations of the party suffering physical damage and to its property (which – as damaged – causes the plaintiff's loss) that it can be considered a joint venturer with the owner of the property, the plaintiff can recover its economic loss even though the plaintiff has suffered no physical damage to its own property. To deny recovery in such circumstances would be to deny it to a person who for practical purposes is in the same position as if he or she owned the property physically damaged.' See also supra, note 2.

apparent than real. Relational contractors, even under a rule which does not preclude their suing transportation firms, may insure in any event in order to avoid litigation costs and, by so doing, buy into a strict liability regime which will avoid or reduce delays in obtaining compensation.

Conclusion

This comment has been predicated upon one definition of efficiency and one model of law and economics analysis in arriving at the outcomes presented. Other definitions and models – Coasian, cost-benefit analysis – may well produce other answers, other ways of viewing the problem, or other sets of criteria upon which to make future decisions as to the best distribution of costs and liability risks. Ultimately, knowing whether a particular legal rule is efficient relative to the alternatives must depend on the acquisition of substantial amounts of information about the behaviour of large numbers of firms and individuals in the future and not on the facts which arise from litigation and the courts. The inadequacy of the current legal institutions to generate the information necessary to arrive at defensible prescriptions on the efficacy of particular legal rules provides another basis for supporting the dissent of La Forest J over the outcome under the majority judgment.

The major insight generated by the Coase theorem[31] is that if parties are free to bargain costlessly, the ultimate allocation of legal liability (or, put another way, the ultimate allocation of a legal entitlement) is independent of the initial determination of liability (or the initial allocation of the legal entitlement) by the legal system. It may be that transportation firms are *not*, in general, the superior risk-bearers in relation to economic loss suffered by relational contractors. In that case, and in the light of the transaction costs involved, the majority decision of the Supreme Court holding transportation firms responsible for the losses of relational contractors cannot be corrected through bilateral or multilateral contractual negotiation through which the risks could be reallocated to the superior insurer or risk-bearer.[32] Conversely, the legal rule produced by La Forest J's dissenting judgment, which allocates the risk of loss to relational contractors, can, at a relatively low cost, be trumped by contractual risk allocations between

31 R. Coase 'The Problem of Social Cost' (1960) 3 *J. of Law & Econ.* 1.

32 A specious caveat to that assertion would be the possibility of transportation firms identifying major relational contractors ex ante, and negotiating with them to shift the risk of economic losses to the relational contractor where it is efficient to do so.

the relational contractors and the property owner in circumstances where the property owner is the superior risk-bearer. In this situation, the relational loss can be reallocated to the transportation firm through the recovery of consequential damages by the property owner against the transportation firm.[33] Again, if one considers the consequences of a misallocation of risk by the legal system, the dissenting judgment of La Forest J would appear to be preferable insofar as it permits the legal system and contractual negotiation between the parties to remedy the legal error.[34]

Economic analysis of law suggests that, if efficiency is a dominant norm which should shape social ordering in this context, La Forest J's dissent should be adopted as the governing legal rule. Furthermore, economic analysis of law suggests that even if La Forest J's dissent is not efficient, it is more likely than what seems to be the inefficient decision of the majority to be corrected over time through contractual negotiation and tort law.

33 This contemplates a situation where the contract between the property owner and the relational contractor imposes liability upon the property owner for any unplanned closures of the bridge. The economic losses suffered by the property owner might then be characterized as positive outlays (due and owing under contract) and not simply as lost profits (where remoteness rules may preclude recovery). Support for the recovery of economic losses in the form of positive outlays can be found in the case of *Dominion Tape of Canada Ltd.* v. *L.R. McDonald & Sons Ltd.*, [1971] 3 OR 627. The plaintiff, the owner of a manufacturing plant, sued for the recovery of lost profits and wages when the negligently loaded trailer of the defendant knocked over a power pole, causing a power failure. The Court ruled that while the loss of profit was foreseeable, it was too remote. However, the wages were recoverable in that they were a 'proximate and direct consequence of the wrongful act of the defendants and not too remote to be recovered.' Such losses can be contrasted with 'negative' losses consisting of a 'mere deprivation of an opportunity to earn an income.' As Linden notes (supra note 15, 385): 'On the basis of this approach, which is not too dissimilar to the property damage cases, economic losses that take the form of actual expenses incurred, as contrasted to potential profits that are not earned, may yield liability.'

It should be obvious that if the Court is willing to allow recovery by CN for relational losses of the kind under discussion – that is, pure economic loss – there is little, if any, difference in allowing recovery of such provable consequential economic losses suffered by the property owner. The foreseeability and remoteness considerations are clearly identical, if not stronger in the latter case.

34 This reallocation will not occur, however, where the relational contractor is, as between it and the property owner, the superior risk bearer; and where, simultaneously, the transportation firm is the superior risk bearer as between it and the property owner; and where the transportation firm is, as between it and the relational contractor, the superior risk bearer.