

RECOVERY OF PURE ECONOMIC LOSS
IN CONSTRUCTION INDUSTRY

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DEDICATION

To my beloved
Father and Mother
Brother, William,
Ee Len, Sylvia and Friends

.....**Thank you for everything**

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ABSTRACT

Pure economic loss is financial loss unaccompanied by damage or injury other than the defective building itself. It was formerly thought to be trite law that liability in tort did not extend to pure economic loss, without the attendant of physical damage. Hence the non-recovery would leave the entire group of first and subsequent purchasers (especially the dwelling houses owners) with no legal remedy against the errant builders, architects, engineers and the local authorities, in tort. It is arguable that the disallowance has resulted in unfair justice. However the disallowance does not find favour in other common law jurisdictions, in particular Canada, Australia and New Zealand, that have departed from the United Kingdom position in this area of law. Malaysia seems to have adopted the English policy in this issue. However, recent court decisions in other common law jurisdictions seemed to indicate that there was a concerted effort to rethink the legal reasons behind allowing the recovery of pure economic loss. Therefore this study intends to identify the legal reasons for allowing recovery of pure economic loss, in relation to the positions adopted by the courts in Canada, Australia and New Zealand. This project was carried out mainly by analysing leading cases reported in law journals in those countries. The findings showed that there were 2 legal reasons adopted by Canada and New Zealand and 3 legal reasons adopted by the Australian courts in allowing the recovery. However the courts have also set out limitation to the application of these reasons.

ABSTRAK

Kerugian ekonomi tulen adalah kerugian kewangan tanpa kerosakan atau kecederaan selain daripada kecacatan bangunan itu sendiri. Secara amnya, undang-undang tort tidak melanjutkan liabiliti dalam menuntut kerugian ekonomi tulen, tanpa kehadiran kerosakan fizikal. Akibatnya pembeli-pembeli pertama dan berikutnya (terutama pemilik-pemilik rumah) tidak mempunyai remedi terhadap kontraktor, arkitek, jurutera dan pihak berkuasa tempatan yang tidak bertanggungjawab, dalam tort. Ia adalah dibahaskan bahawa nafian terhadap tuntutan kerugian ekonomi tulen oleh mahkamah boleh mengakibatkan ketidakeadilan. Walaubagaimanapun nafian terhadap tuntutan ini tidak disokong oleh bidang kuasa *common law* yang lain, khususnya Canada, Australia dan New Zealand, yang menyimpangi *common law* Inggeris. Kedudukan Malaysia dalam isu ini adalah dikatakan mengikuti *common law* Inggeris. Akan tetapi tuntutan kerugian ekonomik tulen yang dibenarkan oleh bidang kuasa *common law* yang lain baru-baru ini menunjukkan bahawa terdapat sebab-sebab yang sah di sebalik tuntutan yang berjaya ini. Oleh itu kajian ini bertujuan untuk mengenalpasti sebab-sebab sah dalam membenarkan kerugian ekonomi tulen dituntut yang dipertimbangkan dalam bidang kuasa Canada, Australia dan New Zealand. Kajian ini adalah dijalankan dengan menganalisis kes-kes utama daripada jurnal undang. Hasil penemuan menunjukkan bahawa terdapat 2 sebab sah yang diaplikasikan oleh bidang kuasa Canada dan New Zealand masing-masing dan 3 sebab sah yang diaplikasikan oleh bidang kuasa Australia. Akan tetapi, mahkamah telah juga menetapkan had terhadap aplikasi sebab-sebab sah ini.

TABLE OF CONTENTS

CHAPTER	TITLE	PAGE
	DECLARATION	ii
	DEDICATION	iii
	ACKNOWLEDGEMENTS	iv
	ABSTRACT	v
	ABSTRAK	vi
	TABLE OF CONTENTS	vii
	LIST OF TABLES	xi
	LIST OF FIGURES	xii
	LIST OF ABBREVIATIONS	xiii
	LIST OF CASES	xiv
1	INTRODUCTION	1
	1.1 Background	1
	1.2 Problem Statement	5
	1.3 Objective of Research	11
	1.4 Scope of Research	11
	1.5 Importance of Research	11
	1.6 Research Process and Methods of Approach	12
	1.6.1 First Stage: Initial Study	12
	1.6.2 Second Stage: Data Collection and Data Recording	12
	1.6.3 Third Stage: Data Analysis	13
	1.6.4 Fourth Stage: Writing-Up	14
	1.6.5 Fifth Stage: Checking and Correction	14

CHAPTER	TITLE	PAGE
2	NEGLIGENCE AND PURE ECONOMIC LOSS	16
2.1	Negligence	16
2.1.1	Element of Liability	17
2.1.2	Contractual Influences	21
2.1.3	Negligence Contrasted with Breach of Contract	24
2.1.4	Conclusion	25
2.2	Pure Economic Loss	27
2.2.1	Definition of Pure Economic Loss	27
2.2.2	The Traditional Approach	29
2.2.3	Reasons for the Disallowance of Pure Economic Loss	34
2.2.4	The Debate For Recoverability	37
2.2.5	Conclusion	40
3	POSITION IN UNITED KINGDOM	41
3.1	Introduction	41
3.2	Recognised Exception to the Rule of Pure Economic Loss	42
3.2.1	Negligent Misstatement	42
3.2.2	The Tort of Deceit	48
3.3	Historical Development	48
3.4	Recoverability of Pure Economic Loss	55
3.4.1	D & F Estates & Ors v Church Commissioners for England & Ors	56
3.4.2	Murphy v Brentwood District Council	59
3.4.3	Department of Environment v Thomas Bates and Son Ltd	62
3.4.4	Leigh & Silavan Ltd v Aliakmon Shipping Co Ltd	64
3.5	Conclusion	65

CHAPTER	TITLE	PAGE
4	POSITION IN OTHER COMMON LAW COUNTRIES	66
	4.1 Introduction	66
	4.2 Canada Jurisdiction	67
	4.3 Australia Jurisdiction	73
	4.4 New Zealand Jurisdiction	82
	4.5 Conclusion	86
5	POSITION IN MALAYSIA	88
	5.1 Introduction	88
	5.2 Recoverability of Pure Economic Loss	88
	5.2.1 Kerajaan Malaysia v Cheah Foong Chiew & Ors	89
	5.2.2 Teh Khem On & Anor v Yeoh & Wu Development Sdn Bhd & Ors	90
	5.2.3 Lim Teck Kong v Dr Abdul Hamid Abdul Rashid & Anor	92
	5.2.4 Majlis Perbandaran Ampang Jaya v Steven Phoa Cheng Loon & Ors	96
	5.3 Conclusion	99
6	LEGAL REASONS FOR ALLOWING THE RECOVERY OF PURE ECONOMIC LOSS	102
	6.1 Introduction	102
	6.2 Canada Jurisdiction	104
	6.2.1 Safety – The Prevention of Threatened Harm	104
	6.2.1.1 Allowance of the Recovery of Pure Economic Loss based on Safety Reason	105
	6.2.1.2 The Limitation based on the Safety Reason for the Recovery of Pure Economic Loss	108

CHAPTER	TITLE	PAGE
	6.2.2 The Policy Considerations in Canada	110
	6.2.2.1 The Two-Stage Analysis in <i>Anns</i>	111
	6.2.2.2 The Category-by-Category Approach Outlined by Professor Feldthusen	115
6.3	Australia Jurisdiction	123
6.3.1	Factual Components of the Relevant Category of Relationship which Signified Proximity of Relationship	124
6.3.2	The Policy Considerations in Australia	131
6.3.3	Vulnerability to Risk	134
6.3.4	The Combination of the Three Legal Reasons for Allowing the Recovery of Pure Economic Loss	142
6.4	New Zealand Jurisdiction	147
6.4.1	The Policy Considerations / Perception in New Zealand	149
6.4.2	The New Zealand Court of Appeal Is Entitled to Develop the Common Law of Its Country	158
6.5	The Applicability on the Legal Reasons which Allowed the Recovery of Pure Economic Loss in the Malaysian Cases	160
6.6	Conclusion	170
7	CONCLUSION AND RECOMMENDATIONS	174
7.1	Introduction	174
7.2	Summary of Research Findings	174
7.3	Problem Encountered During Research	189
7.4	Future Researches	189
7.5	Conclusion	190
	REFERENCES	191
	BIBLIOGRAPHY	194

LIST OF TABLES

TABLE NO	TITLE	PAGE
7.1	Legal Reasons for Allowing the Recovery of Pure Economic Loss	176
7.2	The Applicability of the Legal Reasons Adopted for Allowing the Recovery of Pure Economic Loss in Malaysian Cases	186

LIST OF FIGURES

FIGURE NO	TITLE	PAGE
1	Research Process and Methods of Approach	15
2	Analysis of Liability based on the <i>Hedley Byrne</i> Principle	44

LIST OF ABBREVIATIONS

AC	Law Reports: Appeal Cases
All ER	All England Law Reports
ALR	Australian Law Report
AMR	All Malaysia Reports
App Cas	Appeal Cases
BLR	Building Law Reports
CA	Court of Appeal
Cal LR	California Law Review
Ch	Cases in Chancery
Ch D	The Law Reports, Chancery Division
CIDB	Construction Industry Development Board
CLJ	Current Law Journal (Malaysia)
CLR	Commonwealth Law Reports
Const LR	Construction Law Reports
HL	House of Lords
Lloyd's Rep	Lloyd's List Reports
LR	Law Reports
MLJ	Malayan Law Journal
MLJA	Malayan Law Journal Article
NZLR	New Zealand Law Report
PC	Privy Council
QB	Queen Bench

LIST OF CASES

CASES	PAGE
<i>Anns v London Borough of Merton</i> [1978] AC 728	5, 6, 7, 50, 52, 53, 55, 60, 61, 68, 71, 84, 111, 112, 114, 115, 117, 120, 122, 123
<i>Australian Consolidated Press Ltd v Uren</i> [1967] 3 All ER 523, [1969] 1 AC 590.	85
<i>Bank of Credit and Commerce International (Overseas) Ltd v Price Waterhouse</i> [1998] PNLR 564	47
<i>Batty v Metropolitan Property Realisations Limited</i> [1978] QB 554 (CA).	49
<i>B.D.C. Ltd. v. Hofstrand Farms Ltd.</i> [1986] 1 S.C.R. 228	116
<i>Bolam v Friern Hospital Management Committee</i> [1957] 2 All ER 118, [1957] 1 WLR 582, 1 BMLR 1	94
<i>Bottemley v Bannister</i> [1932] 1 KB 458	39
<i>Bowen v Paramount Builders (Hamilton) Ltd</i> [1977] 1 NZLR 394	83, 85, 147, 158, 159
<i>Bow Valley Husky (Bermuda) Ltd. v. Saint John Shipbuilding Ltd.</i> , [1997] 3 S.C.R. 1210	116, 118
<i>Brown v Heathcote County Council</i> [1986] 1 NZLR 76	85, 147, 158, 159
<i>Bryan v Maloney</i> [1995] 128 ALR 163	7, 67, 73, 74, 84, 86, 95, 107, 123-136, 142, 147, 160, 171
<i>Caltex Oil (Australia) Pty Ltd v The Dredge 'Willemstad'</i> [1973] 40 DLR (3d) 530.	74, 76, 132

CASES	PAGE
<i>Canadian National Rly Co v Norsk Pacific Steamship Co</i> [1992] 91 DLR (4th) 289	68, 113, 115
<i>Caparo Industries v Dickman</i> [1990] 2 AC 605.	45, 130
<i>Carriere v. Bell Canada</i> [2006] O.J. No. 2360; 2006 ON.C. LEXIS 2305	104
<i>Catalyst Management Ltd. v. Walter & SCI Construction (Canada) Ltd.</i> [2005] B.C.J. No. 45; 2005 BCSC 36; 2005 BC.C. LEXIS 45	116
<i>Cattle v Stockton Waterworks</i> [1875] LR 10 QB 453; [1874-80] All ER Rep 220	37, 74
<i>Central Trust Co v Rafuse</i> [1986] 2 SCR 147	113
<i>City of Kamloops v Nielsen</i> [1984] 10 DLR (4Th) 641.	67, 71, 104, 111, 114, 123
<i>Chase v de Groot</i> [1994] 1 NZLR 613	147
<i>Clay v AJ Crump and Sons Ltd</i> [1964] 1 QB 533	23, 31
<i>Clayton v Woodman & Son</i> [1962] 2 QB 533	23
<i>Craig v East Coast Bays City Council</i> [1986] 1 NZLR 99	85, 158, 159
<i>D'Amato v. Badger</i> , [1996] 2 S.C.R. 107	118
<i>Day v Ost</i> [1973] 2 NZLR 385	24
<i>D & F Estates Ltd & Ors v Church Commissioners for England & Ors</i> [1989] AC 177.	25, 32, 56, 60, 68, 71, 74, 82, 84 ,91, 95, 100 ,101,158, 159
<i>Department of Environment v Thomas Bates</i> [1990] 3 W. L. R. 457	31, 62, 64
<i>Donoghue v Stevenson</i> [1932] AC 562	18, 19, 22 ,25-28, 31, 38, 48, 52
<i>Doyle v Olby</i> [1969] 2 QB 158	48
<i>Dr Abdul Hamid Abdul Rashid & Anor v Jurusan Malaysia Consultants (sued as firm) & Ors</i> [1997] 3 MLJ 546	92, 94
<i>Dutton v Bognor Regis Urban District Council</i> [1972] 1 QB 373	48, 50, 78
<i>F.W. Hearn/Actes - A Joint Venture v. University of British Columbia</i> 2000 BCSC 1827, [2000] B.C.J. No. 2569	121

CASES	PAGE
<i>Governors of the Pabody Donation Fund v Sir Lindsay Parkinson</i> [1985] AC 210	3
<i>Greater Nottinghamshire Co-operative Society Ltd v Cementation Piling and Foundations Ltd and Ors</i> [1988] 3 WLR 396.	55
<i>Heaven v Pender</i> [1883] 11 QBD 503	19
<i>Hedley Byrne & Co. Ltd v. Heller & Partners Ltd</i> [1946] AC 465	6, 21,26,29,42,44, 46-48,52,61,65,84
<i>Heinicke v. Cooper Rankin Ltd</i> [2006] M.J. No. 446; 2006 MBQB 273; 2006 MB.C. LEXIS 442	108
<i>Henderson v Merrett Syndicates Ltd</i> [1995] 2 AC 145, 179-180 HL; [1994] 3 All ER 506	46
<i>Hercules Managements Ltd. v. Ernst & Young</i> [1997] 2 S.C.R. 165	116, 118
<i>Invercargill City Council v Hamlin</i> [1996] 1 All ER 756	7,67,73,82-84,86- 87,107,147,153, 158,171
<i>Junior Books Ltd v Veitchi Co Ltd</i> [1983] 1 AC 520	5,6,25,53,54, 55,61
<i>Le Livre v Gould</i> [1893] 1 QB 491	19
<i>Leigh and Sullivan Ltd v Aliakmon Shipping Co Ltd, The Aliakmon</i> [1985] 2 All ER 44	54,64
<i>Lester v White</i> [1992] 2 NZLR 483.	82
<i>Lim Teck Kong v Dr Abdul Hamid Abdul Rashid & Anor</i> [2006] 3 MLJ 213	8,92,99,100, 165-167
<i>Lubenham Fidelities and Investment Company Limited v South Pembrokeshire District Council</i> [1986] 33 BLR 39	24
<i>Kerajaan Malaysia v Cheah Foong Chiew & Lain-lain</i> [1993] 2 MLJ 439	7,89,99,161-163
<i>Majlis Perbandaran Ampang Jaya v Steven Phoa Cheng Loon & Ors.</i> [2006] 2 MLJ 389.	9,10,32,96,99, 100,167-170
<i>Martel Building Ltd v Canada</i> [2000] 2 S.C.R. 860; 2000 SCC 60; 2000 S.C.R. LEXIS 503;	113,118

CASES	PAGE
<i>Michael Sallis and Company Limited v ECA and Calil and Others</i> [1988] 4 Const LJ 125	24
<i>Morgan Crucible Co Plc v Hill Samuel & Co Ltd & Ors</i> [1991] Ch 295	129
<i>Moorabool Shire Council and Anor v Taitapanui and Ors.</i> [2006] VSCA 30	124,142-146
<i>Mount Albert Borough Council v Johnson</i> [1979] 2 NZLR 234	83,85,147,158, 159
<i>Muirhead v Industrial Tank Specialities Ltd</i> [1985] 3 All ER 705; [1986] QB 507, CA	30,55
<i>Murphy v. Brentwood District Council</i> [1991] AC 398	6,7,8,32,59,61,62, 64,66,67,68,71,72 74,83-86,89,91, 95,100,101,103, 104,106,148,153, 160
<i>Pacific Associates Inc & Anor v Baxter & Ors</i> [1990] 1 QB 993	33
<i>Perre v Apand Pty Ltd</i> [1999] 164 ALR 606	81,87,137,140, 141
<i>Rivtow Marine Ltd v Washington Iron Works</i> [1973] 40 DLR (3d) 530.	72,106
<i>SCM (United Kingdom) Ltd v WJ Whittal & Son Ltd</i> [1970] 1 QB 337.	29,39
<i>Simman General Contracting Co v Pilkington Glass</i> [1988]	55
<i>Simpson & Co v Thomson</i> [1877] 3 App Cas 27	4
<i>Smith v Eric Bush</i> [1990] 1 AC 831.	36,45,129
<i>Sparham-Souter v Town and Country Developments (Essex) Ltd</i> [1976] QB 858.	53
<i>Spartan Steel & Alloy Ltd. v Martin & Co. (Contractors) Ltd.</i>	29
<i>Stevenson v East Ohio Gas Co.</i> [1946] 73 N.E.2d 200	37
<i>Stieller v Porirua City Council</i> [1983] NZLR 628; [1986] 1 NZLR 84	85,147,158,159
<i>Sutherland-Shire Council v Hayman and Anor</i> [1985] 60 ALA1	73
<i>Tai Hing Cotton Mill Ltd v Chong Hing Bank Ltd</i> [1986] AC 80; [1985] 2 All ER 987 PC	55

CASES	PAGE
<i>Teh Khem On & Anor v Yeoh & Wu Development Sdn Bhd & Ors</i> [1995] 2 MLJ 663	8,37,90,99, 163-165
<i>Three Meade Street Ltd v Rotorua District Council</i> [2005] 1 NZLR 504; 2004 NZLR LEXIS 34	148,153-157
<i>Townsend (Builders) Ltd v Cinema News & Property Management Ltd</i> [1959] 1 All ER 7	24
<i>Utamares v Touche</i> [1931] 174 NE 441, 444; 255 NY 170, 174;	4,34,38,91,122, 160
<i>Voli v Inglewood Shire Council</i> [1963] 56 Qd. R 256	23,31,132
<i>Williams v Mount Eden BC</i> [1986] 1 NZBLC 102	85,158,159
<i>Winnipeg Condominium Corp No 36 v Bird Construction Co Ltd & Ors</i> (1995) 121 DLR 193;	7,67-69,71-73, 86,104-107,109, 113,116,117,171
<i>Woolcock Street Investments Pty Ltd v CDG Pty Ltd</i> [2004] 205 ALR 522	78,82,87,123, 134-142,145,147

CHAPTER 1

INTRODUCTION

1.1 Background

Most occupier (whether purchaser of a house or already owning or renting a house) are likely to find defects appearing in the house, or damage being caused to the house by construction activities around the surrounding area of the house. Quite often, when defects appear or damage is done, some might not know what to do. For instance, when there is an on-going development next to A's house, and as a result of the construction works from the development, cracks appear in A's house. What are A's rights in such a situation? Who should A look for the cracks in the house? Another example which commonly happens is, when an occupier just moved into a new house, which he or she just bought or constructed or renovated, and discovered defects in the house. What should he or she do in such a situation?

As a starting point, the basis of the right to claim will usually arise either in contract or in tort. Generally, a contractual claim will arise if there is a contract in existence, and a tortious claim will only arise if a duty of care is found to exist in law. It is briefly mentioned, at this point that, liabilities in tort and in contract can co-exist.¹ However, it is settled law that one could not by founding a cause of action in tort avoid the exemptions and limitations imposed by contract between the parties.²

Thus when the defective building collapses and causes personal injury or physical damage to other property, the injured person may bring a tort action in negligence against the builder, surveyor, architect, or engineer at fault. The developer, if he is also the builder, may be liable to the immediate buyer of the defective building for breach of contract and for negligence.³

The problem arises when a negligence action is brought by a non-contracting third party such as an occupier, remote buyer or lessee who has suffered pure economic loss. This occurs when the builder, though defective in itself, caused no actual damage to person or other property, yet has caused economic loss in the form of either diminution in value of the building, loss profits, cost of repair or remedial action undertaken to avert possible damage. Such loss is by definition of pure economic loss.⁴

¹ Neo, Monica, *Construction Defects: Your Rights and Remedies*, Singapore: Thomas Sweet & Maxwell Asia, 2005, p. 4.

² *Ibid.*

³ The developer is also liable under r 18(1) of the Housing Developers Rules 1985 to make good any defect, shrinkage or other fault in the building appearing within 12 months after the date of delivery of vacant possession or issue of the certificate of fitness for occupation (whichever is earlier) and which is caused by defective workmanship or material or to the building not having been constructed in accordance with specification and plans.

⁴ Ter, Kah Leng, "Builder's Tort Liability for Pure Economic Loss Arising from Defective Buildings," *Malayan Law Journal Article*, [1989] 2 MLJ, p. 1.

Generally, a pure economic loss may be defined as “*a financial loss not causally consequent upon physical injury to the plaintiff or his property or other infringement of his absolute (that is, protected erga omnes) rights.*”⁵ In other words, ‘pure’ economic loss is economic loss unaccompanied by damage or injury.⁶ The gist of the problem is a defect for which there is no contractual remedy available to the plaintiff, a breach of tortious duty by the defendant, now need for remedial work, yet no physical damage.⁷

One example that is applicable in the construction industry is a careless architect: An owner hires a contractor to build a house. The owner also hires an architect to supervise the construction. As a result of poor supervision of the architect, the contractor has to do the same work twice. Can the contractor sue the architect if the owner does not have to pay for the additional work? In this case, the contractor does not have an explicit contract with the tortfeasor (architect), which would entitle him beyond doubt to compensation for financial losses resulting from a breach of contract.⁸

It was formerly thought to be trite law that liability in tort did not extend to pure economic loss, without attendant of physical damage.⁹ The courts in the United Kingdom reject claims for the recovery of loss suffered by a person due to the negligent act of another, if it is a claim for pure economic loss. No action may lie in contract either because of the absence of privity between the wrongdoer and the aggrieved person.¹⁰

⁵ Feldthusen, Bruce, *Economic Negligence: The Recovery of Pure Economic Loss*, 4th Edition, Canada, 2000, p. 4.

⁶ Boone, K, The K-Zone, 2006, Access date: 10 Jan 2007 from <http://kevinboone.com/lawglos>

⁷ Per Smout J in *Development of Environment v Thomas Bates & Son Ltd* (1987) Constr LJ 130 at 144.

⁸ Dari-Mattiacci et al, “The Core of Pure Economic Loss,” *Bepress*, University of Hamburg, Germany, Volume 2005, Paper 10, 2005 from <http://www.bepress.com/gwp/default/vol2005/iss1/art10>. This case is very similar to *Pacific Associates Inc & Anor v Baxter & Ors* [1990] 1 QB 993 whereby the court of appeal held that no direct contractual relationship between the contractor and the engineer and therefore the engineer owed no duty of care to the contractor. The appeal was dismissed.

⁹ Uff, J, *Construction Law – An Outline of Law and Practice Relating to the Construction Industry*, 3rd Edition, London: Sweet & Maxwell, 1981, p. 227.

¹⁰ Matta, A. M. and Kulliyyah, A. I, “Claimability of Economic Loss: Malaysia Takes A Stand Amid Inconsistencies,” *The Malayan Law Journal Articles*, Volume 4, [2003] 4 MLJ 178, p. 2.

The situation is not easy to comprehend. Broadly stated, the legal position is that one who suffers a loss caused by another and wants to claim compensation for the loss has to prove either that the person who caused the loss did so by breaching the contract or in the absence of contract, by being negligent. In other words, the liability could arise either for breach of contract or for negligence under tort.¹¹ In a situation where the plaintiff has suffered loss as a result of the negligence of the defendant, in the absence of privity of contract between the two, an action under contract would generally fail.

Hence, the plaintiff's other option is to claim on the ground of negligence in tort. The plaintiff's claim against the defendant in tort would not succeed if there were lack of proximity between the two or if the damage were not reasonably foreseeable or unless the claim is prevented by the "remoteness of damage" rule.¹² Nonetheless, the plaintiff's woes do not end here. It is further required that the loss suffered by the plaintiff, in order to be recoverable, should not be pure economic loss.¹³

The principle rationale behind this restriction of pure economic loss is to prevent opening of floodgates to litigation and to avoid the creation of liability "*for an indeterminate amount for an indeterminate time to an indeterminate class.*"¹⁴ It is also argued that it is often difficult to assess how much economic loss has really been suffered.¹⁵

¹¹ *Ibid.*

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ Cordozo CJ in the American case of *Utamares v Touche* [1931] 174 NE 441, 444; 255 NY 170, 174; Lord Penzance, in *Simpson & Co v Thomson* [1877] 3 App Cas 27 referred to various hypothetical situations of pure economic loss.

¹⁵ *Supra* 6.

1.2 Problem Statement

The historical development of the recoverability of pure economic loss started with the significant point for the recovery of pure economic loss was probably the decision in *Anns v London Borough of Merton*.¹⁶ This case probably marks the high-point of the English courts' willingness to entertain claims in negligence for pure economic loss.

The fact of the case was that a local authority approved building plans for a block of flats, which turned out to be defective. When the flats started to subside, the lessees sought to recover the cost of repairs from the authority, among others. In determining whether the authority had a duty of care to the lessees, whom they had no prior dealings or direct contact with, Lord Wilberforce proposed a two-stage test. This two-stage test generally favors the claimant, because it suggests that once “neighbourhood”¹⁷ is established, there is a *prima facie* duty of care, which can only be rebutted on policy grounds.¹⁸ It was the decision in *Anns* that the courts have gradually allowed the recovery of pure economic loss in negligence.

The principle of recovery of economic loss was then extended to cover any situation in which a defendant might foresee that another might suffer economic loss. This step was taken in the difficult case of *Junior Books Ltd v Veitchi Co Ltd*.¹⁹ The plaintiffs who were owners of a building arranged with a contractor for renovation of the building. The plaintiffs needed specially smooth flooring for their operations and so recommended to the main contractors that the preparation of the flooring be subcontracted to the defendant flooring specialists. The defendant's work on the floors was inadequate and the plaintiffs sued in negligence for the defective floors.

¹⁶ [1978] AC 728.

¹⁷ *Donoghue v Stevenson* [1932] AC 562.

¹⁸ *Supra* 6.

¹⁹ [1982] 3 All ER 201.

This case marked that where there is a sufficiently close degree of proximity between the parties, damages for economic loss can be recovered. Lord Roskill held that: “*The appellants must be have known that if they did the work negligently (as it must be assumed that they did) the resulting defects would at some time require remedying by the respondents expending money upon the remedial measures, as a consequence of which, the respondents would suffer financial or economic loss.*”²⁰ Lord Roskill thus has encouraged the next logical step of the development on this branch of the law.²¹

However, the liberal views adopted in *Anns*’ and *Junior Books*’ case were not followed subsequently. In *Murphy v Brentwood District Council*,²² the House of Lords expressly departed from *Anns*. According to *Murphy*, pure economic loss is *prima facie* unrecoverable, unless the relationship between the claimant and the defendant can be brought within the principle of *Hedley Byrne v Heller*.²³ In the *Murphy* case, the defendant local authority failed to inspect the foundations of a building adequately, with the result that building became dangerously unstable. The claimant, being unable to raise the money for repairs, had to sell that house at a considerable lower value than the market price, which he sought to recover from the local authority. His action failed, thus bringing to an end the explosion in liability for pure economic loss experienced over the proceeding 20 years. The House of Lords in *Murphy* placed strict limits on the recovery of pure economic loss.²⁴

²⁰ *Ibid*, at 254-255

²¹ Owen, Stephanie, *Law for the Builder*, England: Longman Scientific & Technical, 1987, p. 261.

²² [1991] AC 398

²³ [1946] AC 465 In this case, negligent misstatement causing pure economic loss was held actionable even though the plaintiff had no contractual rights.

²⁴ Lam Wai Loon. “Recovering the Pure Economic Loss in Negligence”. *Legal Insights A Skrine Newsletter*, June 2006.

The courts elsewhere have decided to disagree with the English jurisdiction of pure economic loss. This has further complicated the position. It was seen that all these commonwealth nations, in particular Canada, Australia and New Zealand, have declined to follow the decision in *Murphy*, and had either adopted the *Anns* two-staged test, or formulated their own test to suit their perceived needs of their individual societies.²⁵

Somehow, the principles expounded in *Murphy*, despite the reliance principle, did not find favour with the judges who decided the trilogy of Commonwealth cases.²⁶ The Commonwealth landmark cases that allowed pure economic loss are Canada: *Winnipeg Condominium Corp No 36 v Bird Construction Co Ltd & Ors*,²⁷ Australia: *Bryan v Maloney*,²⁸ and New Zealand: *Invercargill City Council v Hamlin*.²⁹

The position of pure economic loss in Malaysia can be seen in 1993 when the recoverability of pure economic loss issue started to arise in Malaysia. In the first case of *Kerajaan Malaysia v Cheah Foong Chiew & Ors*,³⁰ the plaintiff claimed damages resulting from the negligence of the defendants in superintending and supervising buildings constructed for the plaintiff by a construction company, SK Sdn Bhd. All the defendants were employees or agents of the consultant firms, SD Sdn Bhd, which was responsible for superintending and supervising the construction. The High Court was keen to follow *Murphy* and held that pure economic loss is not recoverable in tort.

²⁵ *Ibid.*

²⁶ Xavier, Grace, "Dr Abdul Hamid Abdul Rashid & Anor v Jurusan Malaysia Consultants (Sued as a Firm) & Ors: Breakthrough For Recovery in Pure Economic Loss," *The Malayan Law Journal Articles*, Volume 3, [1998] 3 MLJA 26, p. 11.

²⁷ [1995] 121 DLR 193

²⁸ [1995] 128 ALR 163

²⁹ [1996] 1 All ER 756

³⁰ [1993] 2 MLJ 439.

The second High Court decision came in a more recent case of *Teh Khem On & Anor v Yeoh & Wu Development Sdn Bhd & Ors*.³¹ In this case, the plaintiff purchasers moved into a house which they had purchased from the defendants. Soon after they moved in, there were cracks on the walls, a leak in the bathroom and the ground was uneven. On being informed, the defendants carried out the necessary repairs. Two weeks later the back door could not be closed, the house was tilting to one side and was sinking with a long crack line between the kitchen and the lounge. A year later, the plaintiffs moved out and commence an action against the builder, the builder's architects and engineers. The defendants admitted their liability to affect the repairs.

The High Court held that the builder was in breach of the express provision that the house must be constructed in a good workmanlike manner but dismissed the claims on the architects and engineers were for pure economic loss and adopted the decisions in *Murphy* and *D & F Estates*. Therefore the claims were not recoverable. Architect or engineer, in the absence of any direct contractual relationship with the owner of a building or a house, cannot be liable in negligence in a claim for pure economic loss.

In the case of *Lim Teck Kong v Dr Abdul Hamid Abdul Rashid & Anor*,³² the subject of this case concerned the plaintiffs intended to build a bungalow on their land and engaged the services of the first defendant who was a civil and structural engineering firm. The first defendant was owned by the fourth defendant who was a registered engineer at the material time. After the bungalow was completed, the plaintiffs moved in. Two years later, the third defendant began construction works on a plot of land adjoining the plaintiffs' land. Some time after the construction works, the rear portion of the plaintiffs' bungalow collapsed. The plaintiffs suffered losses and damages. The plaintiffs sued, *inter alia*, the first, third and fourth defendants.

³¹ [1995] 2 MLJ 663; [1995] 2 AMR 1558.

³² [2006] 3 MLJ 213

James Foong J held that a claim for pure economic loss can be entertained in an action of contractual negligence. Liability was apportioned 40% against the third defendant and 60% against the fourth defendant and the fourth defendant appealed to the Court of Appeal. However, the Court of Appeal dismissed the judgment of High Court with costs. The Court of Appeal upheld the decision of the trial judge and said that the High Court was correct in concluding that the fourth defendant was also negligent and liable in contract.

The high point of pure economic loss was overruled in the landmark case of *Majlis Perbandaran Ampang Jaya v Steven Phoa Cheng Loon & Ors.*³³ The subject of the case was the Highland Towers consisted of three blocks of apartment known as Blocks 1, 2 and 3. A landslide occurred resulting in the collapse of Block 1 and the subsequent evacuation of the respondents from Blocks 2 and 3. The respondents then filed a suit in the High Court against various parties including the appellant MPAJ, for negligence and nuisance. The learned trial judge found the appellant who was the fourth defendant in the case to be 15% liable for negligence in respect of the appellant's acts and omissions prior to the collapse of Block 1 of the Highland Towers.

The local authority appealed to Court of Appeal and subsequently to Federal Court. The Federal Court reversed the judgment of Court of Appeal and held that the local authority (MPAJ) was fully protected from liability under the specific provision under s 95(2) of the Street, Drainage and Building Act 1974. Therefore the pure economic loss against the local authority was not recoverable.

Therefore, it is clear that the position of United Kingdom and Malaysia in pure economic loss is not recoverable. However, who should be liable to the non-contracting third party (A) whereby he/she suffers economic losses due to the negligence caused by another party (B) when B will most probably be held not liable

³³ [2006] 2 MLJ 389.

to his negligence under pure economic loss? In Malaysia, it will be interesting to look at pure economic loss claims against other parties involved as the highest trial in the Federal Court decision was found in the case of *Majlis Perbandaran Ampang Jaya v Steven Phoa Cheng Loon & Ors*,³⁴ which concerned on the liability from the local authorities to the owners,

Recent court decisions in other commonwealth nations, in particular Canada, Australia and New Zealand, seem to indicate that there is a concerted effort to rethink the economic loss doctrine. The question is, should the recovery of pure economic loss be made allowable since there are controversies in the common law practicing countries? What are the grounds of proximity that allowed the recovery of pure economic loss, which evolved the principle of pure economic loss in Canada, Australia and New Zealand?

To these and others, I add my modest question: what are the legal reasons for the recovery of pure economic loss in Canada, Australia and New Zealand? Therefore, this research is an attempt to identify the position of the tort law relating to this highly complicated and controversial concept of pure economic loss.

³⁴ [2006] 2 MLJ 389.

1.3 Objective of Research

From the problem statement, the following is the objective of the study:

- i. To identify the legal reasons in allowing the recovery of pure economic loss under the law of tort in common law jurisdictions, in particular Canada, Australia and New Zealand.

1.4 Scope of Research

The following are the scopes for this study: -

- i. Only cases related to construction industry will be discussed in the study.
- ii. Only court cases related to the jurisdiction in Canada, Australia and New Zealand that allowed the recovery of pure economic loss will be used to identify the legal reasons.

1.5 Importance of Research

The importance of this research is to clarify the Malaysian position on pure economic loss. After this study, the parties will know the extent and limitations of recovery of pure economic loss when they seek for remedies in defective premises in Malaysia in relation to Canada, Australia and New Zealand jurisdictions. Besides, this allows the Malaysian Courts to rethink the principles on pure economic loss and adopt the recognised legal reasons if they are reasonable and applicable to the Malaysia position.

1.6 Research Process and Method of Approach

Research process and method of approach will be used as guidelines so that the research could be done in a systematic way to achieve the research objective. The research process generally consists of 5 stages, i.e. first stage: initial study, second stage: data collection, third stage: data analysis, fourth stage: writing-up and fifth stage: checking and correction. The following will be the research process and the methods of approach used for this research (refer to figure 1).

1.6.1 First Stage: Initial Study

First stage of research involves initial study before the identification of research topic. Two approaches will be used here, i.e. discussion with friends and lecturers regarding what research topic can be done, and initial literature review on the issue of this research. After the research issue is obtained, the objective and scope of the research are determined as well as the research outline is formulated to guide the process of the whole research.

1.6.2 Second Stage: Data Collection and Data Recording

After identifying all the background and relevant issues through literature review, legal cases based on previous court cases which are related to the research issue will be collected. The previous court cases which are related to the recovery of pure economic loss in Canada, Australia, New Zealand and Malaysia will be sorted out from the collected cases.

The cases are obtained from the primary source. Primary data is collected mainly from Malayan Law Journal, Canadian Law Report, Australian Law Report, New Zealand Law Report, Building Law Report, Construction Law Report and other law journals. It is collected through the Lexis-Nexis Legal Database.

Data is also collected from the secondary source which is obtained from the latest reading materials in printing from research done by third parties other than the writer. Sources of secondary data consist of books, act, articles, research paper and seminar papers. These sources are important to complete the literature review chapter.

1.6.3 Third Stage: Data Analysis

Once the previous related court cases under Malayan Law Journal are collected, case study on the related legal cases is conducted. The case study is started by carefully analyzing and interpreting all the facts of the cases, legal principles and statutory provisions. This process involves the identification of the legal reasons allowed and its limitation for the recovery of pure economic loss. Arrangement of data is carried out to streamline the process of writing of the paper.

1.6.4 Fourth Stage: Writing-Up

Fourth stage of the research is mainly involves writing-up after the data is being collected, interpreted, analyzed and arranged. This writing-up part is the written presentation of the research findings. The conclusion is made based on the findings during the analysis stage. After presenting the research conclusion, further research will be suggested.

1.6.5 Fifth Stage: Checking and Correction

In the last stage, error checking is be done by the writer with the guidance of supervisor. The error identified will need to be attended and corrected immediately. Essentially, the whole process of the study is reviewed to identify whether the research objective has been achieved. The last stage will end with the necessary correction.

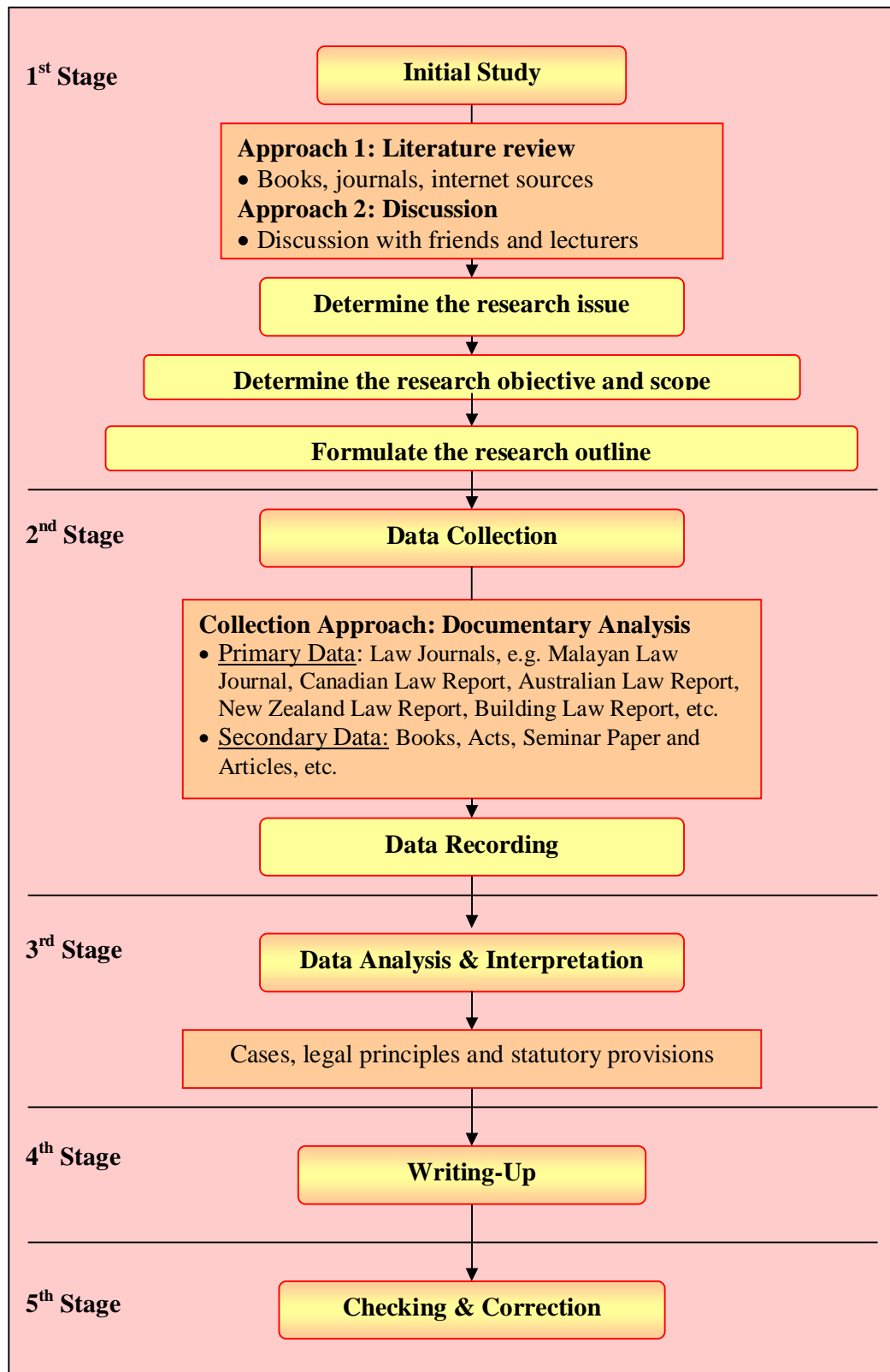


Figure 1: Research Process and Method of Approach