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Francovich and its Aftermath: Member State Liability for Breaches of European Law from an Economic Perspective

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Introduction

According to settled case law of the European Court of Justice (ECJ), Member States can be held liable for damage caused to individuals as a result of breaches of European law. In the landmark *Francovich* case,[63], the ECJ stated that individuals must be able to obtain compensation to guarantee the full effectiveness of Community law and the protection of the rights which it grants. This judgment established the basic conditions for deciding a liability claim in the case of non-implementation of a directive, but no guidance was given in relation to other breaches of European law. The conditions for state liability were further clarified in the joined cases *Brasserie du Pêcheur* and *Factortame III*.[64] The ECJ ruled that the state will be liable whichever organ of the state is responsible for the breach (the legislature, the executive or the judiciary) and regardless of the internal division of powers between constitutional authorities. Moreover, the conditions for state liability were spelled out with respect to other breaches of Community law, in particular an infringement by a Member State of the Treaty rules relating to free movement of goods. More recently, in the *Köbler* case[65] the ECJ explicitly confirmed that Member Sates must compensate the damage caused to individuals by infringements of Community law stemming from a decision of a court adjudicating at last instance. The ECJ clarified that the duty to compensate is subject to the same conditions as in the case of an infringement by a Member State of the fundamental economic freedoms protected by the Treaty.

It follows from the ECJ's case law that Member States are bound to compensate harm to individuals if they infringe a rule of European law which confers rights on individuals and there is a causal link between the breach and the damage suffered by the injured parties. In the case of non-implementation of a directive it must be possible to identify the content of those rights on the basis of its provisions. In the case of an infringement of the fundamental economic freedoms or a misinterpretation of a rule of European law by a

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[63] Cases C-6 and 9/90 *Francovich and Bonifaci v Italy* [1991] ECR I-5357.

[64] Cases C-46/93 and C-48/93 *Brasserie du Pêcheur SA v Germany and R v Secretary of State for Transport, ex parte Factortame Ltd and others* [1996] ECR I-1029.

[65] Case C-224/01 *Gerhard Köbler v Republik Österreich* [2003] I-10239.

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national court adjudicating at last instance, the infringement must be 'sufficiently serious'. This last condition has received the greatest attention in the literature. Some authors have argued that the requirement of a 'sufficiently serious' breach may be too restrictive and does not guarantee full compensation of the loss suffered by individuals.[66] However, from an economic perspective there are strong arguments to support the requirement set by the ECJ. After this introduction, the second section of this commentary will confront the concept of 'sufficiently serious breach' with the main insights from the literature on economic analysis of liability law. It will be shown that there are strong economic arguments to limit the scope of liability (in particular by not adopting a rule of strict liability and requiring a form of gross negligence) to avoid an inefficient outcome. In the third section, three leading cases of the ECJ will be analysed from an economic perspective. Finally, the most important conclusions will be summarised.

Economic Analysis of the Concept of a 'Sufficiently Serious Breach'

Pure Financial Losses and Imprecise Standards of Care

The facts of the cases decided by the ECJ make clear that individuals mainly seek compensation for financial losses: workers or employees complain not to be entitled to financial benefits because of the non-implementation of a directive or due to indirectly discriminatory rules of national law, or companies argue to have suffered financial losses because of a legal rule impeding their access to a national market for goods or services. From an economic perspective, there is an important difference between the violation of a property right which leads to the damage or destruction of an economic resource and a pure financial loss. If a house burns down, the value of the capital stock of society is diminished by the value of the destroyed house. The damage of the victim is equal to the damage of society. Conversely, in the case of a pure financial loss the social loss may be less than the personal loss. For example: if a company cannot import products into a national territory, it may claim compensation equal to the entire value of the lost sales. However, those sales will be diverted to domestic producers who will gain from the enforcement of the national rule which indirectly discriminates against foreign would-be exporters. The social loss consists of the difference between the gains of the domestic firms and the losses of the foreign firms (and potentially the losses of consumers in the import country). If foreign firms are entitled to full compensation, they will claim an amount of compensation which is several times higher than the social loss.

If the private loss is less than the social loss full compensation will be in excess of the social damage. It is a crucial insight of the economic analysis of law that a liability rule may provide incentives to individuals to change their behaviour in order to escape from

[66] See, eg, J Steiner, 'From Direct Effect to *Francovich*: Shifting Means of Enforcement of Community Law' (1993) 22 *EL Rev* 3; W van Gerven, 'Bridging the Unbridgeable: Community and National Tort Laws after *Francovich* and *Brasserie*' (1996) *ICLQ* 507; P Craig, 'Once More unto the Breach: the Community, the State and Damages Liability' (1997) 113 *LQR* 67.

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the payment of damages.[67] In economic terms, individuals should be given incentives to adopt efficient preventative measures or, in other words, to choose an economically optimal level of care. Thereto the amount of the damage compensation must equal the social loss; in this way the negative externalities caused by the tort will be fully internalised in the decision-making process of the potential tortfeasor. A rational individual will choose the level of care which minimizes the sum of the costs of care and the harm caused (efficient care). However, if the amount of the compensation exceeds the social loss this may lead to over-deterrence and the choice of an excessively high level of care.

Whether or not over-deterrence will occur is dependent upon the degree of precision and clarity of the standard of care.[68] If the legal system (legislature or courts) fixes an efficient and precise standard of care, overcompensation cannot lead to over-deterrence. If the standard of care is observed, there will be no liability irrespective of whether the compensation payment is equal to or higher than the real social damage. This result is no longer valid if the legal standard of care is not exactly defined ex ante. If there is a wide gamut of possible precautions to avoid harm, it is unlikely that the law can exactly define ex ante which level of care is sufficiently high to avoid liability. Consequently, the negligence standard becomes somewhat fuzzy in the eyes of the tortfeasor. If the latter faces the risk of having to pay damage compensation which is several times higher than the social damage he or she may choose an inefficiently high level of care. The important insight is that overcompensation coupled with an imprecise standard of due care leads to over-deterrence. How can this be avoided?

To enhance optimal deterrence, the legal system may restrict compensation to cases in which the level of due care has been obviously violated. Whether this is termed obvious negligence, evident liability (*Evidenzhaftung*), gross negligence, or otherwise, the message will be the same. If the standard of care is imprecisely defined ex ante, the limitation of liability to cases of obvious negligence will act as a signal that very costly damage prevention projects are excluded from being candidates for the legally required level of care. The requirement of obvious negligence mitigates the imprecision of the required standard of care and thus reduces the risk of over-deterrence. For torts in the market place, which often result in high individual but small social losses,[69] a rule of obvious negligence is preferable to reach optimal deterrence.

Lessons for European Law

The above insights will now be applied to the requirement formulated by the ECJ that there must be a 'sufficiently serious breach' of Community law to trigger off liability of a Member State for harm caused to individuals. The cases in which this requirement has been formulated (in particular *Brasserie du Pêcheur* and *Köbler*) concerned liability claims where the individual loss exceeded the social loss and the standard of care was unclear, so that there were powerful economic reasons in favour of a rule of obvious negligence. The ECJ's requirement of a 'sufficiently serious breach' can be seen as a way to prevent

[67] See generally S Shavell, *Economic Analysis of Accident Law* (Cambridge, Harvard University Press, 1987).

[68] See generally H-B Schäfer and C Ott, *The Economic Analysis of Civil Law* (Cheltenham, Edward Elgar, 2004) 253–9.

[69] One may think of incorrect information about the financial situation of a firm, which benefits some shareholders but harms others. For a discussion of this example, see Schaefer and Ott, *ibid.*

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over-investment in preventative measures and to avoid over-deterrence. In this respect it is efficient to increase the burden of proof. Conversely, expanding the domain of state liability by softening the proof of a fault committed by the state or accepting a rule of strict liability (implying that no breach of a duty of care is required to establish state liability) will lead to over-deterrence. Obviously, it must be added that the goal of optimal deterrence will be reached only if the concept of 'sufficiently serious breach' is interpreted in conformity with the economic concept of efficient care. In this respect, a critical look must be given at the factors which, according to the ECJ, are relevant for deciding whether a breach of European law is sufficiently serious.

In *Brasserie du Pêcheur*, the ECJ mentioned a number of criteria to be taken into consideration in assessing the seriousness of the breach: the clarity and precision of the rule breached, the measure of discretion left by that rule to the national authorities, whether the infringement was intentional or involuntary, whether any error of law was excusable or inexcusable, the fact that the position taken by a Community institution may have contributed towards the omission, and the adoption or retention of national measures or practices contrary to Community law. The ECJ concluded that a breach of Community law will clearly be sufficiently serious if it has persisted despite a judgment establishing the infringement, or a preliminary ruling or settled case law from which it is clear that the conduct constituted an infringement.[70] In *Köbler*, the ECJ repeated the same factors and added the non-compliance by the court in question with its obligation to make a reference for a preliminary ruling under Article 234(3) EC Treaty. The ECJ concluded that courts adjudicating at last instance commit a serious beach of Community law when the decision is made in manifest breach of settled case law.[71]

Many of the factors mentioned by the ECJ fit in an economic analysis of whether a rule of obvious negligence is efficient. If the rule breached is unclear or imprecise, a normal negligence rule causes a risk of over-deterrence if the claimed compensation for individual losses exceeds the social damage. If national authorities enjoy a great degree of discretion they should not too easily be held liable for exercising those discretionary powers in cases of damage claims for pure financial losses. An excusable error of law again may indicate that the rule of Community law breached was not sufficiently precise. Conversely, if the decision taken by a national legislative authority or a national court adjudicating at last instance violates a clear rule of Community law or is a manifest breach of the case law of the ECJ in the matter, liability of the state can be supported also on economic grounds. However, there is no full harmony between economic analysis and the case law of the ECJ on state liability for infringements of Community law. The term 'sufficiently serious breach' incorporates not only the clarity and precision of the rule breached but also other factors, such as the intention of the Member State to infringe Community law. The latter criterion may be relevant from a legal perspective but does not fit in an economic approach. To achieve optimal deterrence, the liability rule should provide incentives to take optimal care. Efficient care is reached where the marginal cost of additional care equals the marginal benefit in terms of reduction of the expected damage. Intention is irrelevant in an efficiency-based assessment. Also the criterion that the state was acting in an area where it had little discretionary power should not be used in a too formalistic way.

[70] Cases C-46/93 and C-48/93 *Brasserie du Pêcheur SA v Germany and R v Secretary of State for Transport, ex parte Factortame Ltd and others* [1996] ECR I-1029, at paras 56–57.

[71] Case C-224/01 *Gerhard Köbler v Republik Österreich* [2003] I-10239, at paras 55–56.

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The crucial requirement is that the state must have acted in breach of a sufficiently precise rule; liability should be made dependent upon the showing of an obvious breach of a rule of Community law.[72]

Economic Analysis of Three Leading Cases

The *Francovich* Case: Non-implementation of a Directive

The landmark *Francovich* case established the principle of an action for compensation against a Member State for breach of Community law. The Italian government had failed to implement Directive 80/987 on the protection of employees in the event of their employer's insolvency. To guarantee payment of wages Italian employees could not invoke the direct effectiveness of the Directive, since its provisions lacked sufficient precision. However, the ECJ created an additional instrument to enhance the effectiveness of unimplemented directives by establishing the principle of state liability in damages as a general requirement of Community law.[73] The ECJ formulated three basic conditions for state liability in the case of non-implementation of a directive: i) the result prescribed by the directive must entail the grant of rights to individuals; ii) it must be possible to identify the content of those rights on the basis of the provisions of the directive, and iii) there must be a causal link between the breach of the state's obligation and the harm suffered by the injured parties.[74]

Most legal commentators have welcomed the *Francovich* decision, since the duty to compensate losses suffered by individuals may constitute an effective remedy for the enforcement of Community obligations imposed upon Member States. The economic analysis of law supports the basic tenet of this assessment. The economic function of liability is forcing actors to internalise the negative consequences of their actions imposed on third parties (in the economic jargon: negative externalities). The prospect of liability gives incentives to change the behaviour and take efficient measures to reduce the damage. In spite of this general positive assessment, an economic analysis also warns against potential negative consequences. There is a risk of over-deterrence, implying that actors take too much (inefficient) care if the compensation due is higher than the social damage and the duty of care is not sufficiently precise. However, in the case of non-implementation of a directive the latter concern is not directly relevant. The duty of care is very precisely formulated: Member States have to implement a Community directive within the time limits set by the directive. If they fail to do so, they commit an obvious

[72] R Van den Bergh and H-B Schäfer, 'State Liability for Infringement of the EC Treaty: Economic Arguments in Support of a Rule of "Obvious Negligence"' (1998) 23 *EL Rev* 552; for a technical elaboration, see R Van den Bergh and H-B Schäfer, 'Member States Liability for Infringement of the Free Movement of Goods in the EC: An Economic Analysis' (2000) 156 *Journal of Institutional and Theoretical Economics* 382–403.

[73] P Craig and G de Burca, *EU Law. Text, Cases and Materials* 3rd edn (Oxford, Oxford University Press, 2003) 259.

[74] Cases C-6 and 9/90 *Francovich and Bonifaci v Italy* [1991] ECR I-5357, at para 41.

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infringement of Community law. In the case of non-implementation of a directive, there is no need for an explicit requirement of a 'sufficiently serious breach' of Community law. This is different in the following cases.

The *Brasserie du Pêcheur* Case: Potential Infringement of the Principle of Free Movement of Goods

In its *Brasserie du Pêcheur* judgment, the ECJ explicitly formulated the requirement of a 'sufficiently serious breach' of a provision of Community law protecting individuals' rights. The ECJ did not exclude the possibility of claiming compensation of financial losses but added that the decisive test for finding liability is 'whether the Member State manifestly and gravely disregarded the limits on its discretion'.[75] Important factors for deciding whether the latter behaviour occurred are the clarity and precision of the rule breached, the margin of discretion left to national authorities and the question whether an excusable error of law was made. Consequently, the German provisions concerning the purity of beer which prohibited the marketing under the German designation 'Bier' of beers imported from other Member States was seen as a sufficiently serious breach, whereas an excusable error of law was found to condone the prohibitions on the import of beers containing additives, in which field Community law was held to be significantly less conclusive.[76]

This judgment shows that the ECJ is able to reach conclusions, which are also defensible from an efficiency viewpoint. The outcome of this case is indeed not different from what the economic analysis of liability for pure financial losses would suggest. Economic analysis makes it clear that, if an efficient allocation of resources is to be achieved, automatic compensation of pure financial losses may lead to over-deterrence. In the *Brasserie du Pêcheur* case, the size of the social losses depends both on the extent to which alternative sales are made and the utility derived by German consumers from these alternative sales, as well as on the extent to which French firms may use resources devoted to the production of beer for the production of other goods. Consumer surplus may be reduced as a consequence of higher beer prices on the German market and less product diversity. In the absence of any relevant gains from the German purity law for the health or safety of consumers, the net result on consumer welfare may be negative. Additionally, there may be some losses of producer surplus if French firms shift their resources to second best alternatives. These effects are, however, counterbalanced by the increasing producer surplus of the German breweries. The important point is that the economic losses of the French beer producers are higher than the total social losses.

If private losses exceed social losses and standards of care are uncertain, economic analysis teaches that liability should be limited to obvious infringements of the duty of care. The ECJ reaches this result by requiring a 'sufficiently serious breach' which is to be assessed taking into account the clarity and precision of the relevant provision of

[75] Cases C-46/93 and C-48/93 *Brasserie du Pêcheur SA v Germany and R v Secretary of State for Transport, ex parte Factortame Ltd and others* [1996] ECR I-1029, at paras 86–87.

[76] It may be added that the German Bundesgerichtshof, which had to decide the compensation claim brought by French breweries, found that the prohibition on the use of additives was the predominant cause of the damage and, therefore, denied a right to compensation (BGH, 24 October 1996 (1997) *Neue Juristische Wochenschrift* 123).

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Community law. Most other factors mentioned by the ECJ, such as the degree of discretion and the existence of an excusable error of law, may be subsumed under the crucial criterion of the clarity and precision of the rule breached. It seems that the ECJ has implicitly accepted the economic arguments against a too broad scope of state liability. In the absence of a the requirement of a 'sufficiently serious breach', the legislators of the Member States may be unduly deterred from taking legislative action to protect the interests of their citizens in fields such as consumer protection and environmental legislation. The explicit requirement of a sufficiently serious breach of Community law prevents this type of over-deterrence and contributes to an efficient outcome.

The *Köbler* Case: Alleged Infringement of European Law by a National Court

The *Köbler* case concerns the conformity with Community law on freedom of movement for workers of an Austrian provision excluding periods spent abroad for assessing the eligibility for receiving a special length-of-service increment on top of the regular salary. The answer to the question whether this Austrian rule infringes Community law is not obvious, since the issue is not expressly covered in secondary legislation and no clear answer can be found in the ECJ's case law. Consequently, the ECJ decided that the Austrian court adjudicating at last instance did not commit a manifest breach of Community law in reaching its decision on the matter. In the absence of a 'sufficiently serious breach' of Community law a Member State is not liable in damages.

The judgment in *Köbler* largely reconfirms earlier case law on state liability for breaches of Community law. It explicitly states that the principle of liability also applies to court decisions. Also this case concerned purely financial losses, so that the above economic arguments in favour of a rule of obvious negligence fully apply. Hence, the ECJ's decision can again be economically rationalised. The interesting point in *Köbler* is that the ECJ confirms the principle of state liability for judicial decisions, whereas the law in this respect varies quite considerably across Member States. Not surprisingly, national governments intervened in the case and formulated several objections to state liability for breach of Community law owing to a fault made by a court. These objections included: the principle of *res judicata* (that is, that the legal decision is held to be true between the parties), the principle of legal certainty, the independence of the judiciary and its authority and reputation. The ECJ rejected these arguments, arguing that an action in damages does not necessarily invalidate the judicial decision which was responsible for the damage, and stressing that the principle of liability does not concern the personal liability of the judge but that of the state.

Liability rules provide incentives for careful behaviour, and this is not different if judicial decisions are at stake. However, as it is the case with legislative action, over-deterrence must be avoided. In addition, the risk of frivolous suits must be reduced.[77] For these reasons, a standard of obvious negligence ('sufficiently serious breach' of Community law) again seems appropriate. Under the threat of a simple negligence rule, judges might spend too much time on their decisions or not feel free to make use of their

[77] See especially H Kerkmeester, 'State Liability for Judicial Decisions: An Economic Analysis' in H-B Schäfer and H-J Lwowski (eds), *Konsequenzen wirtschaftsrechtlicher Normen* (Wiesbaden, Gabler, 2002) 391.

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experience and intuition. To remain on the safe side, a judge may be hesitant to deviate from precedents and look for new and potentially better rules. Next to the risk of an inefficiently high level of care, an unqualified negligence rule may also lead to frivolous suits. Parties who have lost a case and cannot appeal the decision because the court has judged at last instance may decide to claim damages to vent their anger. The vast majority of such suits would be frivolous. It must be acknowledged that the risks of both over-deterrence and frivolous suits are higher when individual judges are sued, rather than the state. However, also under a principle of state liability for judicial errors it may not be excluded that judges become too cautious to avoid that their decisions are labelled erroneous and damaging and that losing parties initiate frivolous suits. It should be recalled that the main argument of this Chapter is that a rule of obvious negligence is required to avoid over-deterrence in cases where private losses are higher than social losses and standards of care are uncertain. On top of this argument, the risk of frivolous suits supports a standard of gross negligence. In sum, there are powerful economic reasons to support the ECJ's ruling in *Köbler*, according to which state liability should be limited to 'sufficiently serious' infringements of Community law.

Conclusions

According to settled case law of the ECJ, Member States can be held liable for breaches of European law. Injured parties may claim damage compensation in the case of non-implementation of a directive, an infringement by a Member State of the principle of free movement of goods or a misinterpretation of a rule of European law by a national court adjudicating at last instance. Legal commentators have generally acclaimed this case law since the duty to compensate contributes to the full effectiveness of Community law and may constitute an effective sanction for the enforcement of obligations imposed upon Member States. However, they have also criticised the requirement that the infringement of European law must be 'sufficiently serious', since it puts a clear limitation on the compensation of losses.

This commentary has shown that there are powerful economic reasons to justify the requirement of a 'sufficiently serious breach'. It is crucial to avoid over-deterrence if purely financial losses must be compensated and the standards of care are imprecise. This is the case when it must be assessed whether a Member State has violated the rules on free movement of goods or a national court of last instance has misinterpreted a rule of European law. The losses suffered by harmed parties will often be purely financial and the damage to society will be smaller than the harm suffered by individuals. The law and economics literature has emphasised that the duty to compensate pure economic losses may cause over-deterrence in cases where the standard of care is imprecise. By requiring a 'sufficiently serious breach' the ECJ has reduced the risk of over-deterrence. In this way it is avoided that the legislature or the judiciary of Member States will be excessively hindered in performing their functions by the prospect of actions for damages.

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