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Produced by URS' Claims and Dispute Resolution Group Spring 2007

The Economic Loss Rule: Some Practical Consequences of the Distinction Between Contractual Duties and Other Legal Duties

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The "economic loss rule" provides that a party who suffers only economic harm may recover damages for that harm based only upon a contractual claim and not on a tort theory, such as negligence or strict liability. The law of torts provides a basis for recovering for personal injury or property damage. By contrast, economic loss includes damages for disappointed expectations, whether relating to a product or structure that does not perform as promised or to other types of financial harm, such as lost profits, delay damages, loss of benefit of the bargain, and the reduced value of property. The economic loss doctrine has been recognized or applied in some fashion in courts throughout the United States. However, the "rule" is not uniform, and its application does not bring about consistent results in courts in different states. In fact, the economic loss rule is characterized and applied differently in different jurisdictions, and different exceptions to the rule are applied. The economic loss rule, as applied under the law of a particular state, may bring about an outcome entirely different from its application in another state.

The following discussion is not a comprehensive survey of the law of the fifty states. Rather, this article highlights some of the differences in and practical effects of the rule as it is applied in several different states.

Origins of the Economic Loss Rule

The economic loss rule originated in California in *Seely v. White Motor Co.*, 403 P.2d 145 (Cal. 1965). *Seely* was a products liability lawsuit involving a defective truck. The accident resulting from the defect caused only property damage to the truck itself; there was no personal injury or damage to other property. The California Supreme Court drew a distinction between recovery based upon tort law for physical injuries to person or to property other than the defective product and recovery for economic loss because a product did not perform as it was warranted to perform. The Court held that the manufacturer should be liable for commercial or economic loss based only upon its agreement or warranty with the purchaser, not based upon tort theory. The Court stated, however, that it was reasonable also for a manufacturer to be liable in tort for personal injury or damage to other property caused by a defective product. The Court believed that to permit a plaintiff to recover for purely economic loss outside the context of a contract or warranty would mean that a manufacturer could be held liable for unknown and potentially unlimited economic damages. *Seely*, 403 P.2d at 150-51.

Scope of Rule

Since the decision in *Seely*, courts across the country have applied the doctrine in a wide variety of cases going far beyond the realm of products liability. Courts have applied the rule and have dismissed negligence and other tort law claims where the dispute among the parties is the subject of an existing contract. For example, if a claim is made for defects in a construction project built under a contract that limits warranties or remedies, a party may not generally avoid those contractual limitations by suing for negligence in the performance of services under the contract. *Town of Alma v. AZCO Constr., Inc.*, 10 P.3d 1256, 1262 (Colo. 2000) ("Limiting the availability of tort remedies in these situations holds parties to the terms of their bargain."). However, courts also have applied the rule and denied recovery in circumstances where the parties did not have a contract. For example, in *532 Madison Ave. Gourmet Foods v. Finlandia Ctr.*, 750 N.E.2d 1097 (N.Y. 2001), the New York Court of Appeals applied the rule in cases involving construction disasters that resulted in streets being closed in the heart of Manhattan. Though nearby businesses were not physically damaged by construction-related collapses, they either were evacuated and closed or were inaccessible to customers for long periods of time. The damages

resulting were real and very substantial. However, the court held that a landowner did not have a common law “duty to protect an entire urban neighborhood against purely economic losses.” *Id.* at 1102. The court dismissed negligence claims against the landowners whose work had caused the losses, noting that, in these circumstances, it was appropriate to impose limits upon the liability of the landowners to losses arising from injury to person or property. *Id.* at 1103.

Application of the Rule and Exceptions

Many courts have applied the economic loss rule in ways that exclude certain claims or recognize certain exceptions to the rule. Again, however, application of the doctrine varies from state to state. In Maryland the doctrine has been construed to bar recovery in tort for economic loss unless the condition giving rise to the claim involves a risk of death or severe personal injury – even though such damages did not occur. *Morris v. Osmose Wood Preserving*, 667 A.2d 624 (Md. 1995). In the *Morris* case, the Court of Appeals of Maryland did not permit the plaintiff to recover on products liability tort claims for deterioration of plywood in town home roofs because there was not in the court’s view a high probability of death or severe injury occurring as a result of the conditions.

The Supreme Court of the United States in an admiralty case, *East River S.S. Corp. v. TransAmerica Delaval, Inc.*, 476 U.S. 858 (1986) rejected an approach that would permit plaintiffs to recover on tort claims because there was a risk of death or personal injury. In *East River*, the Supreme Court considered tort claims against the designer and manufacturer of turbines for ocean-going supertankers. When the turbines malfunctioned because of design and manufacturing defects, the ship owners incurred purely economic losses for the cost of repair and lost revenues. Arguably, there was also a risk of death, personal injury, and other property damage if the engines failed under dangerous conditions at sea. The Court, nevertheless, rejected an application of the rule based upon risk and instead focused on the type of duty that was violated. The Court held that “a manufacturer in a commercial relationship has no duty under either a negligence or strict products-liability theory to prevent a product from injuring itself.” *Id.* at 871. Rather, the recoverability of damages for this type of purely economic harm was to be determined by the bargain struck between the parties, i.e., the terms of contracts or warranties. *Id.* at 872-73. Many courts, regardless of whether they apply the rule based upon an analysis of the risks or duties of the parties, also carve out exceptions to the rule based upon policies considered important in the particular jurisdiction. Courts have held that certain claims, such as claims for physician and attorney malpractice, as a matter of public policy exist independent of contractual claims, even though the parties also have a contract. *Town of Alma*, 10 P.3d at 1263. They also recognize that certain tort claims exist to provide remedies for harm that almost necessarily is economic in nature, such as claims for common law fraud, and, therefore, they hold that such claims are not subject to the rule. *Id.*

Because public policies recognized by the courts vary from state to state, so do the exceptions to the rule. The variations in the exceptions are of great importance to parties in the construction industry. For example, some states have applied an exception to the economic loss rule for home builders, developers, and others involved in residential construction. See, e.g., *A.C. Excavating v. Yacht Club II Homeowners Ass’n.*, 114 P.3d 862, 864 (Colo. 2005) (home builders, including subcontractors, have a duty of care independent of contractual obligations to build homes without negligence); *Kennedy v. Columbia Lumber and Mfg. Co.*, 384 S.E.2d 730, 738 (S.C. 1989) (“A builder may be liable to a home buyer in tort despite the fact that the buyer suffered only ‘economic losses’ where: (1) the builder has violated an applicable building code; (2) the builder has deviated from industry standards; or (3) the builder has constructed housing that he knows or should know will pose serious risks of physical harm.”). But see *Snow Flower Homeowners Ass’n v. Snow Flower, Ltd.*, 31 P.3d 576, 581 (Utah Ct. App. 2001) (homeowner’s association could pursue economic loss damages against developer only based upon contract).

The courts seem particularly divided as to whether, like some other professionals, design professionals are excluded from the protection of the economic loss rule. Some states exclude design professionals from the rule. See, e.g., *Eastern Steel Constructors, Inc. v. City of Salem*, 549 S.E.2d 266, 275 (W. Va. 2001) (“a design professional . . . owes a duty of care to a contractor, who has been employed by the same project owner . . . and who has relied upon the design professional’s work product in carrying out his or her obligations to the owner . . .”); *Moransais v. Heathman*, 744 So. 2d 973, 983 84 (Fla. 1999)

(economic loss rule does not bar a claim for professional negligence against a professional engineer); *Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc.*, 463 S.E.2d 85, 88-89 (S.C. 1995) (like lawyers and accountants, design professionals not protected from tort claims by economic loss rule where there is "special relationship" with injured party). In other states, however, the rule protects the design professional. See, e.g., *Blaht v. Richard B. Smith, Inc.*, 108 P.3d 996, 1001-02 (Idaho 2005) (court recognized existence of a "special relationship" exception and a "unique circumstances" exception but did not apply them to geotechnical engineer); *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 72-73 (Colo. 2004) (no exception to rule for claim against an engineer by subcontractor who relied upon allegedly defective specifications where a "network of interrelated contracts" was involved); *SME Indus., Inc. v. Thompson, Ventulett, Stainback and Associates, Inc.*, 28 P.3d 669, 680-82 (Utah 2001) (negligence claim of contractor or subcontractor against design professional rejected); *City Express, Inc. v. Express Partners*, 959 P.2d 836, 840 (Haw. 1998) (owner who contracted with architect could not assert claim against the architect in negligence); *Fireman's Fund Ins. Co. v. SEC Donohue, Inc.*, 679 N.E.2d 1197, 1200-02 (Ill. 1997) (negligent misrepresentation claim not permitted against engineer because engineer's plans and drawings were "incidental to a tangible product").

Implications for Drafting Contracts

There are many practical implications of the economic loss rule. The most important consequence of the rule is to increase the likelihood (i) that allocations of risks under contracts will be enforced and (ii) that tort claims which seek to avoid those risk allocations will be rejected. Thus, although there are significant differences from jurisdiction to jurisdiction in what the courts will do, there almost always will be some benefit in preparing contracts with provisions that clearly define the scope of warranties and remedies. The great differences in state law also underline the importance of choice of law clauses. Though most courts are not likely to enforce a contract clause that opts for the law of a state having no connection to the transaction, they are likely to enforce a contract term that mandates application of the law of a contracting party's state or the state in which the contract is to be performed. Thus, at the time the contract documents are prepared, it is important to know which law is most favorable.

Insurance Implications

Though generally the elimination of potential tort claims against a party is a good thing for that party, the absence of such claims may reduce the likelihood that the party's insurance coverage will provide a defense or indemnity for a dispute. A claimed breach of contract for construction defects may not be considered a covered "occurrence" under commercial general liability ("CGL") policies. See, generally, Aylward, "Construction Defect Litigation and Economic Loss Doctrine," *In House Defense Quarterly*, Fall 2006. Many courts hold that breaches of contract are not "accidents" within the meaning of CGL policies. See, e.g., *Oak Crest Constr. Co. v. Austin Mut. Ins. Co.*, 998 P.2d 1254, 1257 (Or. 2000). Although the majority of cases appear to interpret CGL policies as covering tort rather than contract liabilities, some courts have interpreted coverage provisions more broadly. For example, in *Vandenberg v. Superior Court*, 982 P.2d 229 (Cal. 1999), the California Supreme Court rejected the concept that coverage under a CGL policy should be determined entirely based upon whether the plaintiff sues in contract or tort. "Coverage under a CGL insurance policy is not based upon the fortuity of the form of action chosen by the injured party. Thus, . . . determination of coverage must be made individually by considering "the nature of [the] property, the injury, and the risk that caused the injury, in light of the particular provisions of each applicable insurance policy.'" *Id.* at 243-44. In *1325 North Van Buren, LLC v. T 3 Group, Ltd.*, 716 N.W.2d 822, 839-40 (Wis. 2006), which was the subject of the Aylward article, the Wisconsin Supreme Court also rejected the concept that insurance coverage is dependent upon the theory of liability and found that there was coverage under professional liability insurance for an alleged breach of a contract.

Conclusion

The economic loss rule is frequently invoked by the courts but varies significantly from state to state. The rule may have a great impact upon the ultimate success of parties to litigation, the scope of any recovery, and determinations of insurance coverage. Thus, a careful review and analysis of the rule of law

likely to be applied to a transaction should be undertaken at the time of entering into a contract.■

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This commentary is produced by the URS Claims and Dispute Resolution Group and is written by a guest author as a forum to address key issues related to the construction industry.