The Economic Loss Doctrine: The Monster in the Property Subrogation Closet



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Introduction



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Economic Loss Doctrine Basics



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What Is The ELD?

- Judicially created doctrine that bars *purchasers* of *goods* from recovering solely *economic losses* from manufacturers under a *tort theory*.
- ELD prohibits recovery in tort for a product defect that causes damage only to the product itself.
- "Disappointed Expectations Test"

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What is an Economic Loss

- Basically, "economic loss" is a loss of benefits expected under a contract.
- Damages resulting from inadequate value because the product is inferior and does not work for the purposes for it was sold.
- For example, if a building is constructed in a shoddy manner, the owner has experienced an economic loss in the sense that it has not gotten the benefit of what it bargained for.
  - Repair or replacement costs.
  - Rental costs of temporary substitute.
  - Loss of use.
  - Lost profits.

NOT an Economic Loss

- Personal Injuries & "Other Property" Damage

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Tort Law v. Contract Law

- Torts - The law of torts deals with legally imposed duties. We all have a duty imposed by law to act reasonably. Where we fail to exercise reasonable and ordinary care and it leads to an accident, we may be liable for negligence. The claim for personal injuries arising out of the accident would sound in tort rather than contract.
- Contracts - Contracts deal with bargained expectations of the parties. Where one party fails to perform its obligations under the contract, the other party suffers disappointed economic expectations under the contract. Many states find that these types of damages are "economic losses" whose remedy is in contract, not tort.



Contract v. Tort Recovery

Contract Damages – Foreseeable damages as a result of the breach. Can also be limited in the contract through liquidated damages provisions and limited warranties.

Tort Damages – Plaintiff can recover all compensatory and consequential damages as a result of the wrong.

- Punitive Damages are eliminated once tort claims are dismissed.
- "Deep Pocket" Defendants – Eliminating defendants in the chain of distribution due to lack of privity.
- Limits on Insurance Coverage – Business Risk Exclusions for "Contractual Liability"

Early Decisions



- *Santor v. A & M Karaghensian*, 207 A.2d 305 (N.J. 1965)
  - Multiple remedies: strict product, contract or U.C.C. warranties.
- *Seeley v. White Motor Co.*, 403 P.2d 145 (Cal. 1965)
  - Links to the U.C.C.
- *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858 (1986)
  - Tort v. Contract Law

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Policy Justifications

1. Maintain the distinct functions of tort law and contract law.
2. Protect commercial parties' freedom to allocate economic risk by contract.
3. Encourage the commercial purchaser to assume, allocate or insure risk.

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Requirement of Privity

- Contract between Buyer & Seller
- A remote commercial purchaser has no privity with product manufacturer.
  - No Contract or Warranty Claims.
- Economic loss rule will bar remote purchasers from recovering purely economic losses under tort theories.
  - No Tort Claim
- Some courts apply a lack of privity exception to provide remedy to remote purchasers. Lord v. Customized Consulting Specialty, Inc., 643 S.E.2d 28 (N.C. App. 2007) (allowed homeowner suit against subcontractor).

  Note: Subrogated Insurer has privity if its insured had privity.

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Exceptions To The Economic Loss Doctrine

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"Other Property" Exception

- Damage to "Other Property" takes a claim outside the ELD.
- *Ice Fern Shipping Co. v. Golten Serv. Co.*, 04-C-20741, (S.D. Fla. Mar. 22, 2005).
- Shipowner sued company that removed and serviced the engine's governor.
- Governor failed in trans-Atlantic trip damaging entire engine.
- Court: "because only the governor was covered under the terms of the contract, the failure of the governor caused damage to the Vessel's engine, Plaintiffs may recover for such damages under a negligence theory."

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Component Parts & Integrated Systems

- Once a part becomes integrated into a completed product or system, the entire product or system ceases to be 'other property' for purposes of the economic loss doctrine.
- *St. Paul Mercury Ins. Co. v. Viking Corp.*, 04-C-1124, 2007 WL 129063 (E.D. Wis. Jan. 12, 2007).
- Viking sprinkler system errantly activated at bank building causing property damage.
- Bank contracted with GC for construction of bank building, including sprinkler system.
- Court held that the product was the building itself and "the failure of the sprinkler system resulting in damage to the building constituted a failed economic expectation."



"Sudden Calamitous Event" Exception (Allowed)

Some states allow tort claims where the harm occurs from a sudden or dangerous occurrence.

- *Morris v. Osmose Wood Preserving*, 667 A.2d 624 (Md. 1995) (fire retardant wood).
- *Vulcan Materials Co. v. Drilltech*, 306 S.E.2d 253 (Ga. 1983) (defective drilling machine that ignited).
- Is the product so defective as to present a clear and imminent danger of death or personal injury.



"Sudden Calamitous Event" Exception (Rejected)

- Some courts differentiate between the disappointed users and endangered ones and permit endangered users to sue in tort even when only the product itself is injured.
- Naporano Iron & Metal Co. v. Am. Crane Corp., 79 F.Supp.2d 494 (D.N.J. 1999) (crane collapse).

Asbestos Exception



- Asbestos Contamination
- Courts are sufficiently troubled by the public dangers of asbestos warranting exception.
- *Northridge Co. v. W.R. Grace & Co.*, 471 N.W.2d 179 (Wis. 1991)
- *Detroit Bd. of Educ. v. Celotex Corp.*, 493 N.W.2d 513 (Mich. App. 1992)

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Fraud or Misrepresentation Exceptions

- Fraud in the Inducement
  - Where one party's fraudulent behavior undermines a freely negotiated contract, the ELD will not apply
- Negligent Misrepresentation
  - Some courts even extend an exception to plaintiff lacking privity with defendant where plaintiff relied on representations made by defendant to his detriment.
    - *Bilt-Rite Contractors, Inc. v. The Architectural Studio*, 866 A.2d 270 (Pa. 2005).

Consumer Transactions

- Courts have extended the ELD into consumer purchases, *e.g.*, automobiles, computers, etc.
- "relative bargaining power is not the touchstone of the economic loss rule" State Farm Mut. Ins. Co. v. Ford Motor Co., 592 N.W.2d 201 (Wis. 1999).
- Consumer is the best party to allocate risk (*e.g.*, purchasing a State Farm insurance policy).

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Consumer Statutory Causes of Action

- State Consumer Protection Acts
  - unfair and deceptive trade practices
- *Olson v. Richard*, 89 P.3d 31 (Nev. 2004)
- NRS Chapter 40 - Makes contractor liable for any construction defects.
- Homeowners' brought contract, negligence and Chapter 40 claims against general contractor for poor stucco work.
- Chapter 40 overrides the economic loss doctrine and allows homeowner to bring a negligence claim.

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Service Contracts



Professional Negligence Exception

- Attorneys and Doctors
- Engineers and Architects
- Environmental Consultants

Split of Authority

- Majority Rule – ELD Applies to Service Contracts. *Fireman's Funds Ins. Co v. SEC Donohue*, 679 N.E.2d 1197 (Ill. 1997).
- Minority Rule – Service Contracts Excepted *Insurance Co. of North Am. v. Cease Elec. Inc,* 688 N.W.2d 462 (Wis. 2004)

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Mixed Service & Product Cases

- *Totality of Circumstances* - Depends upon the contract's predominant purpose.

Examples:

- New construction cases – Contract for a Product and ELD will apply.
- Renovation projects – Contract for a Service and ELD will not apply.

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Practice Tips and Predictions



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A Checklist for Avoiding the Economic Loss Doctrine

- Was there damage to "other property"?
- Was there a sudden and calamitous event or inherently hazardous product?
- Was this a commercial or consumer purchase?
- Did the contract involves services?
- Is there a professional liability claim?
- Was there fraud or misrepresentation?

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Protections From The ELD

- Contractual claims against general contractors.
  - Consider drafting appropriate remedies in your contract.
- Negligent misrepresentation and third party beneficiary claims against subcontractors.
  - Try obtaining warranties from the subcontractors.

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Practice and Procedure



- Subrogation counsel should determine if consumer protection-type statute applies.
- ELD is not an affirmative defense that must be pled.
- ELD issues are resolved on motions to dismiss and motions for summary judgment.
- Discovery – parsing factual issues like is the product inherently dangerous, is a misrepresentation extraneous to the contract, is product independent or a part of an integrated system, and is the contract predominantly for goods or services?

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The Future of the ELD



Electronic Data

- Comprehensive cyberinsurance policies covering loss of information assets and business interruption.
- Negligent Cybersecurity Claims

- Identity Theft
  - ID Theft Insurance
  - Negligent Security
- Climate Change Litigation



Questions



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