The Economic Loss Doctrine

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THE ECONOMIC LOSS DOCTRINE

A new dumptruck's brakes fail when it is parked and the truck rolls into a guard-rail. The truck is "in the shop" for repairs for three weeks. Can the truck's owner recover for his lost profit while the truck is being repaired? As a general rule, no. Recovery of such lost profits is barred by the "economic loss doctrine". This judicially crafted doctrine prohibits tort recovery for economic loss, generally defined as a loss resulting from product failure when there is no personal injury or damage to "other property".

Typically, the economic loss doctrine arises from product liability cases where the "injury" is limited to the product itself. East River Steamship Corporation v. Transamerica Delaval, Inc., 476 U.S. 858 (1986). In such cases, to recover for "economic losses," including damages for diminution or inadequate value, cost to repair or replacement of the defective product or consequent loss of use or profits, plaintiffs are limited to contract remedies. The policy behind the rule is that the loss of the value of a product that suffers physical harm is very much like the loss of the value of a product that does not work properly or at all. The complaining party has simply lost the benefit of its contractual bargain, and thus, "contract law, and the law of warranty in particular," is the appropriate remedy. Id. at 872-873.

According to the United States Supreme Court in East River, a plaintiff cannot recover for either the physical damage a defective product causes to the product itself, or those incidental or consequential damages flowing from damage to the product itself, i.e., lost profits, and cost of repair/replacement. A plaintiff can recover in tort for damage other than the product which the manufacturer placed in the stream of commerce and which was purchased by the initial user. For example, a large oven used in the manufacture of clay pots malfunctions, destroying itself and the plant it occupies. Under this scenario, damages caused by the malfunctioning oven (loss of

plant, loss of profits, etc.) would not be subject to the economic loss doctrine. A majority of jurisdictions have adopted East River and prohibit tort recovery for economic damages where there is no personal injury or damage to property "other than the component that was the subject of the sale." See, *W. Dudley McCarter, The Economic Loss Doctrine in Construction Litigation.*

RECENT TRENDS

A. RESTATEMENT OF TORTS

The American Law Institute adopted a new element of the Restatement 3d of Torts in 1997, entitled *Products Liability.* In restating the law of products liability after more than a quarter of a century, the Institute had to respond to many questions left unanswered, including those related to the economic loss doctrine. Under Restatement 3d of Torts: Products Liability, Section 21, the Institute provided that harm to persons or property subject to tort recovery may include economic loss, but only when one of the following is present:

(1) Harm to the plaintiff's person;

(2) Harm to the person of another when harm to the other interferes with an interest of the plaintiff protected by tort law;

(3) Harm to the plaintiff's property other than the defective product itself.

Comment A to Section 21, provides the following rationale for the exception:

> "First, products liability law lies at the boundary between tort and contract. Some categories of loss, including those often referred to as 'pure economic loss' are more appropriately assigned to contract law and the remedies set forth in Articles 2, and 2A of the Uniform Commercial Code. When a code governs a claim, its

provisions regarding such issues as statute of limitation, privity, notice of claim, and disclaimer ordinarily govern the litigation. Second, some forms of economic loss have traditionally been excluded from the realm of tort law even when the plaintiff has no contractual remedy for a claim."

B. MIDWEST

Beginning with the 1992 Michigan Supreme Court decision of Neibarger v. Universal Cooperatives, Inc. 439 Mich. 512, 486 N.W. 2d 612 (1992), a growing number of courts have used the economic loss doctrine to prohibit tort recovery for both losses to the product itself and "other property," where the damage to the "other property" was foreseeable at the time of contracting.

In most instances where the courts have significantly narrowed the "other property" exception to the economic loss doctrine, there is an understandable connection between the defective product and the "other property" which permits an inference that the damage to the "other property" was within the "contemplation" of the parties at the time of contracting. For example, at the time of contracting for the construction of a plant, it is within the contemplation of the parties that if the plant collapses, the equipment and goods stored in the plant will be damaged. See, e.g., Crosica Co-Op Ass'n v. Behlen Manufacturing Co., 967 F. Supp. 382(D.S.D. 1997)

Despite Michigan's harsh application of the economic loss doctrine, and the growing number of courts in the Midwest adopting Michigan's position, there are ways to avoid application of the doctrine. For example, under Michigan law, the economic loss doctrine does

not apply if: (1) the contract is for services as opposed to a sale of goods; (2) there exists the potential for serious injury or death; and (3) plaintiff is a consumer as opposed to a commercial entity.

C. MID-ATLANTIC STATES

The Pennsylvania Supreme Court has yet to address the economic loss doctrine, and as such, the status of the economic loss doctrine is still in question. However, the federal courts applying Pennsylvania law, and lower Pennsylvania state courts, have adopted a form of the economic loss doctrine in line with East River, where a plaintiff is prohibited from recovery in tort for economic losses which do not result in physical injury or damage to other property.

The New Jersey Supreme Court has recently held that the doctrine precludes both individual consumers and commercial entities from recovering in tort for economic losses which do not result in personal injury or damage to other property.

In 1995, the New York Court of Appeals, upon review of a question certified by the United States Court of Appeals for the Second Circuit, adopted the East River approach to the economic loss doctrine. Thus, under New York law, the tort recovery for economic loss is prohibited where there is no physical injury or damage to other property.

D. THE WEST

The economic loss doctrine, adopted by the California Supreme Court in Seely v. White Motor Company (1965) 63 Cal.2d 9, held a manufacturer may be liable in tort (strict liability and negligence) for physical injuries to persons or property, but not for purely economic loss arising from a defective product. In California, economic loss includes lost profits, loss of prospective clients, repair expenses and lost earnings. Pisano v. American Leasing 146 Cal.App.3d 194 (1983). However, California courts have struggled to apply the economic loss doctrine in a consistent manner. Until the California Supreme Court addresses the issue, the lower courts will continue to debate the doctrine's limitations and application. For example, see Stearman v. Syntex Homes 78 Cal.App.4th 611 (2000), discussed on page 8, which holds that the economic loss doctrine does not apply to a component part which damages the product in which it is incorporated.

Arizona courts follow the rules set forth in Salt River Project v. Westinghouse, 694 P.2d 198 (Ariz. 1984) and weigh three factors to determine whether a plaintiff can recover in tort for economic loss. If these elements are present:

(1) Product posed an unreasonable danger to those who used it;

(2) Loss must be from a sudden accident, such as violence, fire or collision;

(3) Plaintiff can recover economic losses via tort law channels.

A plaintiff in Nevada may not recover in negligence or strict products liability for economic loss absent privity of contract or an injury to person or other property. Central Bit Supply v. Waldrop Drilling & Pump, 717 P.2d 35 (Nev. 1986).

E. PACIFIC NORTHWEST

The Washington Supreme Court in Washington Water & Power Company v. Graybar Electric Co. 774 P.2d 1199 (1989), held that the Washington Product Liability Act did not provide a cause of action for a claim of purely economic loss except where the product defect creates a "risk of harm." A claim falling within this exception may be brought under the Product Liability Act. The court analyzed two tests to determine if the product created a "risk of harm" (1) the sudden and dangerous test, and (2) the evaluative approach, but declined to adopt either because the issue was moot.

In a subsequent case, Touchet Valley v. Opp & Seibold Construction (1992) 831 P.2d 724 (1992), the Washington Supreme Court discussed the exception and the two tests suggesting that under the "sudden and dangerous test," if the failure is the result of a sudden and dangerous event, it is actionable under tort law principles. The evaluative approach proceeds on the theory that a product user should not have to suffer a calamitous event before earning his remedy in tort. This approach examines interrelated factors such as the nature of the defect, the type of risk and the manner in which the injury arose. Id. at 733.

The Oregon Supreme Court in Russell v. Ford Motor Co.575 P.2d at 1383 (1978), held that "the loss must be a consequence of the kind of danger and occurred under the kind of circumstances, 'accidental' or not, that made the condition of the product a basis for strict liability" in order for a loss to fall outside the economic loss doctrine. Id. at 595. Such losses are to be distinguished from losses "due only to the poor performance or the reduced resale value of a defective, even dangerously defective product." Applying this new rule to plaintiff's strict product liability claim for damages to his truck incurred when a defective weld in an axle housing caused him to lose control of the vehicle and hit a rock pile, the court found that

plaintiff's claim sounded in products liability because the defect was "man-endangering" and the damages occurred in precisely the situation that made the product dangerous.

F. SOUTHEAST

Generally, the economic loss rule bars a tort claim for purely economic losses from an alleged product defect that does not damage other property in Alabama, Florida, Georgia, Mississippi and South Carolina. North Carolina does not have a well-defined rule but it appears that a party cannot bring a products liability claim under a negligence or intentional tort theory where it would be governed by the UCC or contract law for damages where the product damages itself or produces other intangible economic losses. In Virginia, however, case law holds that the economic loss rule does not bar a negligence claim so long as there is privity of contract between the parties.

G. COMPONENT PART EXCEPTION TO ECONOMIC LOSS DOCTRINE

Can a subrogating carrier recover under a strict products liability theory against a component part manufacturer whose component part caused damage/destroyed the manufacturing system to which it was incorporated?

Answer:

Generally, Yes.

A component part manufacturer will be held strictly liable for a defective part if the defect is not the result of a substantial change in later processing of the product. The economic loss doctrine would not apply in those states recognizing damage to "other property" because the manufacturing system to which the component part was incorporated would be considered "other property." The California Court of Appeals Fourth Appellate District, most

recently attempted to elucidate this issue in Stearman v. Syntex Homes 78 Cal.App.4th 611 (2000).

Stearman arose in a construction defect context. The gravamen of the underlying case was that defective construction of a tract home caused severe slab movement and deformation. Extensive cracks ultimately manifested themselves throughout the home's interior and exterior as a result of those defects.

The primary issue on appeal was whether a strict liability cause of action was appropriate when a defect in one component part of the home caused damage to other component parts of the residence without damaging persons or property separate from the structure. Relying heavily on the landmark decision in Stealy v. White Motor Co. (1965) 63 Cal.2d 9, Syntex Homes contended that a strict liability cause of action was barred by the "economic loss rule" since the subject damage involved nothing more than "injury to the product (home) itself." The Stearman Court rejected that argument, holding that strict liability was applicable since defects in the home had caused physical damage to the property (i.e., other component parts of the house).

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