THE IMPACT OF THE ECONOMIC LOSS DOCTRINE ON OCEAN AND INLAND MARINE SUBROGATION CLAIMS

I. INTRODUCTION

The economic loss doctrine significantly impacts the availability of tort remedies in the context of marine subrogation claims. The ability to recover in tort is important because of restrictions on rights of recovery under contract or warranty. If warranty/contract law is determined to be the exclusive remedy, then recovery may be limited to claimants who satisfy the stringent requirements of the Uniform Commercial Code ("UCC"). These requirements include the need to file suit within the UCC four year statute of limitations, running from the date of tender of the goods or products. Other issues may arise with respect to warranty disclaimers and remedy limitations. Accordingly, determining the parameters of the economic loss doctrine is a critical task when dealing with marine subrogation claims.

II. THE DEVELOPMENT OF THE ECONOMIC LOSS DOCTRINE

Under the economic loss doctrine, there generally is no tort recovery when a product causes only economic loss and does not cause personal injury or damage to other property. East River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 106 S.Ct. 2295, 90 L.Ed.2d 865 (1986). Economic loss has been defined as the decreased value of a product because of its inferior quality or its failure to work for the general purpose for which it was manufactured and sold. Alloway v. General Marine Industries, L.P., 695 A.2d 264 (N.J. 1997). Economic loss also has been defined as including damages for inadequate value, costs to repair or replace the product, and loss of profits. Alloway, *supra*.

The genesis of the economic loss doctrine can be found in two opinions issued by the high courts of New Jersey and California. In Santor v. A&M Karagheusin, Inc., 207 A.2d 305 (N.J. 1965), the Supreme Court of New Jersey held that a cause of action in strict liability exists in cases where the product injures itself. The Supreme Court of California reached a contrary conclusion a few months later in Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965). In Seely, the court denied tort recovery to the owner of a defective truck that had overturned because the only damage was to the truck itself. The court reasoned that tort recovery was not appropriate because the buyer had suffered only economic loss (in the form of the damage to the product itself).

In 1986, the United States Supreme Court in East River, supra, adopted the economic loss doctrine in admiralty product liability cases. In East River, the plaintiff contracted with a ship builder for the ship builder to design and manufacture turbines to be used as the main propulsion units for four oil super tankers. The turbines on all four tankers malfunctioned due to design and manufacturing defects. Significantly, only the turbines were damaged. The plaintiff filed a complaint against the manufacturer of the turbines alleging tortious conduct based on strict products liability, seeking damages for the cost of repairing the ships and for income lost while the ships were out of service.

The East River court examined the difference between tort and warranty law. The Court explained that tort law was designed to protect people and property from dangerous and defective products that cause unexpected personal injury or property

damage. On the contrary, the Court explained that contract law is better suited for economic loss. The Court summarized:

> The distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the luck of one plaintiff having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products. When a product injures only itself, the reasons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong.

East River, *supra*, at 872-73.

The United States Supreme Court went on to hold that the plaintiff had no tort cause of action because the turbines had not caused physical damage to anything other than the turbines themselves. The Court also ruled that in traditional property damage cases the defective product damages “other property.” The Court indicated that damage to “other property” caused by a product defect is recoverable in tort. East River, supra, at 874.

Since the United States Supreme Court’s decision in East River, a majority of jurisdictions have adopted the economic loss doctrine. Christopher S. D’Angelo, The Economic Loss Doctrine: Saving Contract Warranty Law From Drowning In A Sea of Tort, 26 Tol. L. Rev., 591 (1995) (collecting cases). Most of the courts which have adopted the economic loss doctrine have relied upon the contract versus tort rationale set forth in East River.

III. DEFINING OTHER PROPERTY

"East River provides little guidance on how a court should distinguish between damage to 'the product', for which tort recovery is barred by the economic loss doctrine, and damage to 'other property', for which tort recovery remains available." 2-J Corporation v. Tice, 126 F.3d 539, 542 (3d Cir. 1997). Since the landmark decision of East River, relatively few federal courts sitting in admiralty have attempted to differentiate between economic loss and damage to other property. However, in 1997, the United States Supreme Court once again addressed the economic loss doctrine in Saratoga Fishing Company v. J.M. Martinac & Company, 117 S. Ct. 1783 (1997). In Saratoga, an owner of a fishing vessel, which had caught fire and sank, filed a products liability action against the builder of the vessel and the designer of the vessel's hydraulic system alleging that the hydraulic system was defective.

The United States Supreme Court reiterated its rule that a plaintiff cannot recover for physical damage that a product causes to the product itself, but can recover for physical damage that the product causes to other property. The Court held that equipment added to the product after the manufacturer or distributor sold the product constituted other property. In so ruling, the Supreme Court indicated that the product "is no more or no less than whatever the manufacturer placed in the stream of commerce by selling it to the initial user." 2-J Corporation, 126 F.3d at 542 (explaining Saratoga Fishing); Nicor Supply Ships Associates v. General Motors Corp., 876 F.2d 501 (5th Cir. 1989) (seismic equipment added to ship after sale of other property is other property). When defining other property the Supreme Court stated:

When a manufacturer places an item in the stream of commerce by selling it to an initial user, that item is the product itself under East River. Items added to the product by the initial user are therefore other property, and the initial user's sale of the product to a subsequent user does not change these characterizations.
Saratoga, *supra*, at 1786.

Since the Supreme Court's decision in Saratoga, the United States Court of Appeals for the Third Circuit has addressed the economic loss doctrine in the context of an

admiralty products liability claim in Sea-Land Service, Inc. v. General Electric Corp., 1988 W.L. 12562 (3d Cir. January 15, 1998). In Sea-Land, the plaintiff filed suit against General Electric alleging that a connection rod manufactured by GE for a GE diesel engine failed. The failed rod damaged the entire engine and caused a loss of profits while the cruise ship was being repaired. The failed rod was a replacement part, which was not sold with the original purchase of the engine.

Because the part was a replacement part, the plaintiff argued that the damaged engine was "other property." From this premise, the plaintiff argued that it was entitled to its loss of profits while repairs to the engine were being completed. In defining a rule of law to apply to the case the court stated:

> We conclude that every component that was the benefit of the bargain should be integrated into the product; consequently, there is no other property. However, we distinguish from the product additional parts that are not encompassed in the original bargain but are subsequently acquired. These should not be integrated.

Sea-Land, supra, at p. 4

Because the component part had been purchased after the initial sale of the engine, the Court attempted to determine whether the replacement part was part of the original bargain between the parties. The Court stated:

> It is common commercial practice for the parties to a transaction to contemplate the integration of replacement parts subsequent to a purchase. In the instant case, it was expected that all the replacement parts would [be] eventually have to be integrated into the engine. The GE connecting rod was purchased to be installed and to become integrated with the GE engine. It is a component part of that engine; it has no use to the plaintiff otherwise.

Sea-Land, *supra*, at p. 5.

Important to the decision in Sea-Land was the fact that the connecting rod at issue was a renewable part, which must be replaced periodically, and was not a life cycle part, which a vessel operator would not expect to replace. In Lease Navajo, Inc. v. Cap Aviation, Inc., 760 F.Supp 445 (E.D.Pa. 1991), the court held that a replacement part purchased during an overhaul of the plaintiff's engine was seperarte property from the engine and the rest of the helicopter, which crashed as a result of the failure of the replacement part. Significantly, the Sea-Land court cited to, but did not reject the opinion in Lease Navajo.

. Saratoga adopted a bright-line test for determining what is the product as opposed to what is other property. Items added to a vessel after the sale to the initial user are other property. Saratoga. Likewise, cargo and personal property on a vessel are considered other property. 2-J Corporation, 126 F.3d at 539 (goods located in a warehouse are other property under Saratoga's definition of other property). In the context of replacement parts which damage a vessel, the application of the economic loss doctrine hinges on whether the purchaser expected to replace certain parts. If the original part is designed to last the life of the product and the replacement part fails, a convincing argument exists that the replacement part is separate and distinct from the product.

A. EXPANSION OF THE ECONOMIC LOSS DOCTRINE INTO CONSUMER TRANSACTIONS

Left unanswered by the United States Supreme Court in East River was whether the economic loss doctrine applied to consumer transactions (i.e., the sale of recreational vessels) as well as commercial transactions. Specifically, the United States Supreme Court held that "a manufacturer *in a commercial relationship* had no duty under negligence or strict products liability theory to prevent a product from injuring itself." East River, supra, at p. 869. (*emphasis added*).

Because the Supreme Court arguably had limited its holding in East River to commercial transactions, it is questionable whether the economic loss doctrine bars tort causes of action for property damage to pleasure craft and other noncommercial vessels. One of the first cases to address this issue was Sherman v. Johnson & Towers Baltimore, Inc., 760 F.Supp. 449 (D.Md. 1990). In Sherman, a buyer of a pleasure yacht filed a products liability action against the manufacturer of the yacht after the yacht had been destroyed by a fire. The Sherman court ruled that the economic loss doctrine did not bar the plaintiff's tort claims because the economic loss doctrine was limited to commercial transactions.

Likewise, in Farley v. Magnum Marine Corp, N.V., 1995 AMC 2800 (S.D. Florida 1995), the court held that the economic loss doctrine did not apply in a consumer transaction. In Farley, the plaintiff's sixty foot yacht caught fire and sank during a cruise of the coast of Maine. The plaintiffs filed suit against the yacht manufacturer alleging that the yacht's fire suppression system was defective. The plaintiffs were seeking recovery of the cost of the yacht and the cost to replace personal property on the yacht at the time of the fire. The Farley court declined to apply the economic loss doctrine to a case which was outside of the commercial arena. The Farley court reasoned that:

> In consumer transactions . . . the consumer is not in a position to negotiate for warranties or other contractual protection, especially if he or she is a downstream buyer.

Farley, at p. 2801 .

Although Sherman and Farley stand for the proposition that the economic loss doctrine does not apply to consumer transactions, several courts have held to the contrary and have applied the economic loss doctrine in the context of the sale of recreational vessels. Alloway v. General Marine Industries, L.P., 695 A.2d 264 (N.J. 1997); Stanton v. Bayliner Marine Corporation, 866 P.2d 15 (Wash. 1993) Sbarbaro v. Yacht Sales International, Inc., 1996 AMC 133 (S.D.Fla. 1995); Karshan v. Mattiuck Inlet, 785 F.Supp. 363 (E.D.N.Y. 1992). Most recently, the Supreme Court of New Jersey addressed whether the economic loss doctrine should apply to consumer as well as commercial transactions. Alloway, *supra*. In Alloway, the buyer of a luxury boat, which sank while docked, filed tort actions against the boat manufacturer. The Supreme Court of New Jersey held that the economic loss doctrine applied to both commercial and consumer transactions. Accordingly, the plaintiff in Alloway could not maintain a strict liability or negligence action.

The emerging trend is to expand the economic loss doctrine to bar tort claims in the context of consumer transactions. However, the Supreme Court has not addressed the issue. Accordingly, the consumer transaction exception should be argued as an exception to the economic loss doctrine.

IV. EROSION OF THE POST-SALE DUTY TO WARN EXCEPTION

There is a split in the cases which have addressed whether a tort theory based on the post-sale duty to warn is barred by the economic loss doctrine. Two divergent views exist concerning whether a post-sale duty to warn claim survives application of the economic loss doctrine. One approach emphasizes the nature of the harm at issue over the conduct and culpability of the defendant, and concludes that post-sale duty to warn claims, asserting only economic harm, are barred. Airport Rent-A-Car v. Prevost Car, Inc., 660 So.2d 628 (Fla. 1995) (finding that the economic loss doctrine focuses on the nature of the injury, and therefore, that the doctrine precludes recovery in tort for economic loss due to a post-sale failure to warn); Continental Ins. Co. v. Page Engineering Co., 783 P.2d 641 (Wyo. 1989) (denying recovery in tort for a post-sale duty to warn because "the rejection of recovery for pure economic loss under theories of negligence and strict liability . . . has not been because of the absence of culpability,

but because of the policy that economic loss is better adjusted by contract rules rather than tort principles.").

The other approach reasons that information which comes to the knowledge of one of the parties after a transaction is not part of the bargain at issue. This approach evaluates the culpable conduct, sometimes grossly negligent or intentional, involved in many post-sale duty to warn claims, as distinct from claims for negligent manufacturing that are usually at issue in economic loss cases. McConnell v. Caterpillar Tractor Co., 646 F.Supp. 1520 (D.N.J. 1986) ("a duty to warn of a product's defects of which the seller becomes aware goes not to the quality of the product that the buyer expects from the bargain, but to the type of conduct which tort law governs as a matter of social and public policy.") (quoting Miller Indus. v. Caterpillar Tractor Co., 733 F.2d 813 (11th Cir. 1984). This approach would not bar a claim for economic loss due to a post-sale failure to warn.

Recently, in Sea-Land Service, Inc. v. General Electric Corp., 1988 W.L. 12562 (3d Cir. January 15, 1998), the United States Court of Appeals rejected the holding in McConnell. Specifically, the Sea-Land court held that there is no tort recovery for damage to the product itself under a post-sale duty to warn theory. In so holding, the Sea-Land court focused on the nature of the injury.

The more recent decisions addressing a post-sale duty to warn have rejected it as an exception to the economic loss doctrine. However, there is a split among the United States courts of appeals over the application of the economic loss doctrine to post-sale duty to warn theories. Therefore, until the Supreme Court of the United States addresses the application of the economic loss doctrine to a post-sale duty to warn, a post-sale duty to warn remains a viable argument against application of the economic loss doctrine.

V. EXPANSION OF THE ECONOMIC LOSS DOCTRINE TO SERVICE TRANSACTIONS

The issue of whether the economic loss doctrine applies to service transactions under admiralty law is a question that been addressed by only a few courts. Unfortunately, from a subrogation standpoint, the courts which have addressed the issue have denied tort recovery. Sea-Land Service, Inc. v. General Electric Corp., 1988 W.L. 12562 (3d Cir. January 15, 1998); Nathaniel Shipping v. General Electric Company, 932 F.2d (5th Cir. 1992); Employers Ins. of Wausau v. Suwanee River Spa Lines, Inc., 866 F.2d 752 (5th Cir. 1989) *cert. denied*, Employers Ins. of Wausau v. Avondale Shipyards, Inc., 493 U.S. 820, 110 S.Ct. 77, 107 L.Ed 43 (1989); Princess Cruise Lines, Inc. v. General Electric Company, 950 F.Supp. 151 (E.D.Va. 1996).

For example, in Princess a shipowner filed suit against a ship repairer alleging that the ship repairer improperly effectuated repairs on a rotor. The improper repairs caused damage to the rotor shaft, the bearings and other parts of the ship. Because of the damage, the shipowner had to cancel several cruises. Neither party contended that the ship repairer had sold or supplied products as part of the repair services. Despite the absence of a sale of goods, the court applied the economic loss doctrine and barred the plaintiff's tort claims.

However, some jurisdictions have rejected the expansion of the economic loss doctrine beyond U.C.C. transactions in land-based cases. Frommert v. Bobson Construction Company, 558 N.W.2d 239 (Mich. App. 1997) (U.C.C. and economic loss doctrine do not apply to claims for a negligently constructed roof against a roofing contractor because the provision of roofing services was primarily a transaction in services and not goods); Cargill, Inc. v. Boag Cold Storage Warehouse, Inc., 71 F.3d 545, 550 (6th Cir. 1995) (applying Michigan law and stating that economic loss doctrine applies "only in situations involving the sale of goods"); Gateway Condominium Trust v. Clinton, 1996 W.L. 655 784, (Mass. Super. 1996). As the Gateway court stated:

> There is no appellate authority for extending the economic loss rule's application in defective product cases under the Uniform Commercial Code to actions involving the provision of professional services rendered in connection with improvements to real property. Therefore, the economic loss rule is inapplicable to the present action.

Gateway Condominium, 1996 W.L. 655784, page 2.

The courts which have expanded the economic loss doctrine in service cases have done so with little, if any, reasoning. These cases simply indicate that the economic loss applies to commercial transactions regardless of whether the transaction involves a sale of goods under the UCC or sale of services. Despite the absence of any stated justification for expansion of the economic loss doctrine into service cases, the trend in admiralty law is to endorse such an expansion. However, several state courts in land-based cases have rejected such an expansion. Therefore, until the United States

Supreme Court addresses the issue, arguments against application of the economic loss doctrine in service cases should be made.

VI. RECOVERY OF ECONOMIC LOSSES WHICH RESULT FROM DAMAGE TO OTHER PROPERTY

Research has located only one admiralty case which has addressed whether a victim may recover loss of profits once the victim has shown that it has suffered damage to other property. Nicor Supply Ships Associates v. General Motors Corp., 876 F.2d 501 (5th Cir. 1989). In Nicor, the plaintiff filed suit against a shipbuilder and manufacturer of a marine engine which caught fire and sank the plaintiff's vessel. After holding that the plaintiff had suffered damage to other property, in the form of damage to $8,000,000.00 worth of seismic equipment placed on the vessel after its delivery to the plaintiff, the court addressed whether the plaintiff could recover lost profits. In holding that the plaintiff might be able to prove lost profits recoverable in tort, the court stated:

> Having sustained physical injury to a proprietary interest [the plaintiff] may recover for economic loss as well, but its recovery for loss of profits is limited to the losses resulting from its inability to use the 'other property' it placed on the vessel . . . The [plaintiff] is not entitled to recover for its loss of profits resulting from its inability to use the vessel itself of from its inability to use the 'other property' that resulted solely from the disability of the vessel itself.

Nicor, 876 F.2d at 504.

Land-based decisions similarly hold that economic losses are recoverable when a sufficient nexus is established between the damage to other property and the resulting economic damages. General Public Utilities v. Glass Kitchens, 374 Pa.Super. 203, 542 A.2d 567 (1988); S.J. Groves and Son Company v. Aerospatiale Helicopter Corporation, 374 N.W.2d 431 (Minn. 1985). As was stated by the Minnesota Supreme Court in S.J. Groves:

> As long as an individual seeks economic losses arising out of personal injury or damage to other property, recovery lies outside of the realm of warranty and accordingly the losses are compensable in tort.

S.J. Groves, 374 N.W.2d at 434.

Many losses may result in damage to the product (i.e., the vessel) and at the same time damage or destroy other property (i.e., cargo and equipment added to the vessel after sale). Traditional economic damages in the form of loss of profits and extra-ordinary expenses which are caused by the loss of the other property are recoverable in tort but are not recoverable when caused by damage to the product itself. Therefore, particular attention should be paid during the adjustment and investigative stages to determine if the insured's business interruption and other economic damages have been caused by damage to other property.

VII. CONCLUSION

An often quoted phrase of supporters of the expansion of the economic loss doctrine is that the economic loss doctrine saves "contract law from drowning in a sea of tort." In their haste to save contract law from drowning, courts have smothered tort law and denied recovery to legitimate victims of defective products. For the foreseeable future, the expansion of the economic loss doctrine most likely will continue to erode tort-based recovery in marine matters.

Because the statute of limitations for UCC claims runs from the date of sale, it is imperative that identification of subrogation potential in the early part of the adjustment process takes place, in order to preserve viable contract and warranty claims. An immediate determination of the date of sale of the product is critical. In cases where the product is less than four years old at the time of the loss, subrogation counsel should be contacted in order to assist in the development of viable contract-based theories of recovery. Indeed, because of the erosion of tort-based theories of recovery, it often may be necessary to initiate suit soon after the loss,

before the loss has been fully adjusted. In addition, subrogation counsel should be consulted to assist in developing tort-based theories of recovery that are outside the application of the economic loss doctrine.

COZEN AND O'CONNOR
RICHARD C. GLAZER, ESQUIRE
WILLIAM N. CLARK, JR., ESQUIRE

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