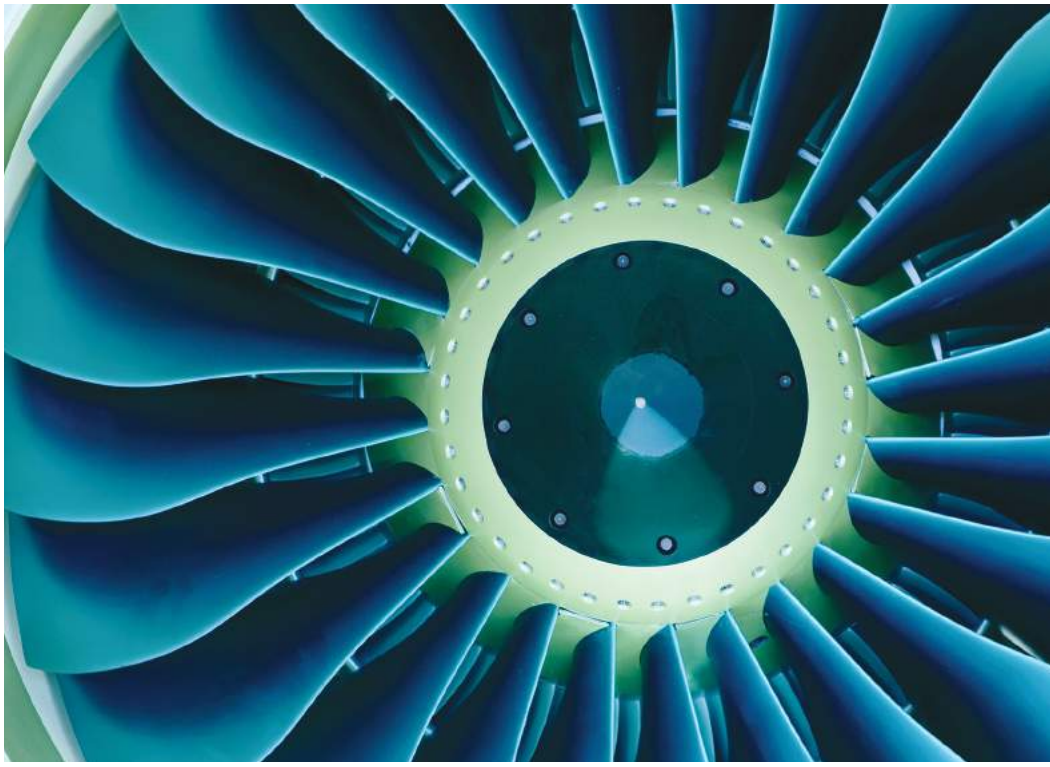
Building Upon Successes

The Economic-Loss Steam Reversing Lawnmowers

By Jeff Goodman and Kevin Rutan

In recent years, product manufacturers have successfully used the economic-loss doctrine to dismiss tort claims and enforce the terms of written warranties.



The economic-loss doctrine was judicially created to preserve the important distinction between contract and tort law. It originated to prohibit tort claims when the only damages suffered are economic damages and the only obligations between the parties exist because of contract law. Since its inception, the economic-loss doctrine has been a complex and sometimes confusing legal theory, but it is nonetheless one of the most potent weapons in a defense attorney's arsenal.

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Doctrine and What Turbines, Rings, Windows, Walls, and Have in Common

Tort and contract law are the two separate and distinct theories of recovery in civil cases. Duties under tort law are created by law. In construction-defect cases, many of the duties owed by the various parties—a property owner, a contractor, product manufacturers, and suppliers, among others—are often created by contracts with mutually agreed-to terms.

Sometimes labor is performed negligently, products fail, or other problems arise years after construction is completed. When a construction project goes awry, a property owner generally sues the other parties involved in the project, alleging tort claims in addition to contract claims for the purpose of expanding liability beyond those damages contemplated under the contract.

The distinction between the remedies for tort and contract claims is significant. Contract claims generally limit a defendant's liability to damages that are foreseeable as a result of a breach of a contract. A cause of action based on tortious conduct expands a defendant's liability to include "all harm proximately caused by the defendant's conduct." It can include consequential damages, meaning those naturally flowing from the tortious conduct. Because of this difference in the available damages, plaintiffs often plead both contract and tort claims with the goal of expanding the damages available through torts. This article will explain how attorneys can use the economic-loss doctrine to dismiss tort claims tacked onto contract claims by building upon the successes in recent cases against product manufacturers.

Economic-Loss Doctrice Basics

Under the economic-loss doctrine, tort claims are prohibited when a plaintiff is merely disappointed with the performance of a product because courts have found that plaintiffs should not be allowed to use strict product liability law to expand the scope of a defendant's liability.

Tort claims are based on obligations created by statutory or common law. In construction, the obligations taken on by the parties involved in a project are the result of contracts in which each party has expectations and is only entitled to the benefit of that individual party's bargain. Tort law compensates people for foreseeable losses

caused by personal injury. In construction cases, the economic-loss doctrine prevents shifting those damages after a contract is consummated.

Damages under a contract are limited to "expectation damages," which means that an aggrieved party is entitled to receive what was bargained for—no more and no less. By pleading contract and tort claims together, a plaintiff attempts to make an end run around the terms and limitations of a contract, seeking more than what was bargained for. In addition, if for some reason the elements of breach of contract cannot be proved, then a plaintiff may hope that a tort theory of recovery will allow the plaintiff to recover something, even if the plaintiff loses whatever they bargained for in a contract. *See, e.g., David v. Hett*, 293 Kan. 679, 683, 270 P.3d 1102, 1105 (Kan. 2011).

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The economic-loss doctrine was judicially created by California State Supreme Court Justice Roger Traynor in 1965, in *Seeley v. White Motor Company,* 403 P.2d 145, 155 (Cal. 1965). In October 1959, Seeley purchased a truck for his hauling business. White Motor Company manufactured the truck and offered an express warranty with it. The truck "galloped" (a technical term to describe violent bouncing), and the brakes later failed, causing the truck to overturn. Seeley was not injured. The costs of repairs to his vehicle were $5,466.09. Seeley sued the dealer and the manufacturer for the repair costs, for the purchase price, and for his business' lost profits. Seeley's claims for damages beyond those allowed under the express warranty were denied. In his frequently quoted opinion, Justice Traynor reasoned:

> 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 in 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. He can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands.

The economic-loss doctrine prevents parties from receiving more than what they bargained for by prohibiting tort claims solely for the recovery of economic damages. Economic damages include direct and consequential economic damages, and the term is often used interchangeably with the terms "economic loss," "pure economic loss," and "commercial loss."

Direct economic damages include damage to a product itself, the product's diminished value from being defective, and the costs associated with repair or replacement of the defective product. *See generally* 1 James J. White & Robert S. Summers, Uniform Commercial Code §11-6, at 539 (3d ed.1988). Direct economic damages have been described as "the difference between the actual value of the goods accepted and the value they would have had if they had been as warranted." *See Tomka v. Hoechst Celanese Corp.*, 528 N.W.2d 103, 107 (Iowa 1995). Further, direct economic damages can include a product's diminished value caused by its inferiority in quality and caused by its failure to work for the general purposes for which it was manufactured.

Consequential damages are those damages that proximately flow from an incident that caused initial, direct damage to a destroyed product. Simply put, consequential damages are all other economic losses "attributable to the product defect" such as lost profits, loss of operating revenue, loss of a product, loss of goodwill, and loss of business reputation.

The Exceptions Permitting Recovery Under the Doctrine

The economic-loss doctrine does not bar recovery of economic damages if there is damage to property other than the product itself or if a plaintiff has suffered a personal injury. *Robinson Helicopter Co. v. Dana Corp.*, 34 Cal. 4th 979, 989, 102 P.3d 268, 273 (Cal. 2004). If there is damage to other property, a plaintiff may plead tort claims to recover economic damages, which will include costs related to damage to the product itself and those related to the damage caused to the other property.

The definition of the term "other property" varies by jurisdiction, but the basic concept is simple. If, for example, a window manufacturer is sued, the plaintiff may claim that some other part of a home has been damaged, such as the wall system (*i.e.*, the window and materials beyond the window), and the plaintiff would seek to circumvent the economic-loss doctrine by recovering damages to other property by alleging a tort claim.

In states that allow the other property exception, most use a foreseeability test, which focuses on the foreseeability of the harm caused to other property. The foreseeability test renders the other property exception unavailable if a plaintiff knew (or should have known) of the risk of damage to other property at the time of contracting. This means that even if it is undisputed that damage occurred to other property, a plaintiff may be prohibited from suing in tort if the harm was a foreseeable risk. The logic behind this is that parties agreed to certain terms when they consummated their sales contract, and neither party should be allowed to alter the contract after the sale. *Arena Holdings Charitable, LLC v. Harman Prof'l, Inc.*, 785 F.3d 292, 296 (8th Cir. 2015) (citing *Dakota Gasification Co. v. Pascoe Building Systems* 91 F.3d 1094, 1101 (8th Cir.1996).

The "Integrated System" Approach

There is also the "integrated system" approach, which is useful to defend component part manufacturers. Integrated systems are products that are composed of

many smaller products but are sold as a single product. For example, a lawnmower is a machine made up of about 270 parts, which, in turn, form many subassemblies, such as power and propulsion, cutting, steering, guarding, and safety mechanisms. However, few people think of a lawnmower in terms of separate components and systems. When a lawnmower breaks down, the owner generally returns it to the hardware store that sold it and complains, "My lawn mower doesn't work." believing that he or she bought an integrated system known as a lawnmower with a warranty, rather than 270 component parts covered by 270 separate warranties.

The Supreme Court adopted the concept of an integrated system in 1986 in a landmark case, *East River S.S. Corp. v. Transamerica Delavel, Inc.,* 476 U.S. 858, 867, 106 S. Ct. 2295, 2300 (1986). In *East River*, the defendant manufactured and installed turbines that each cost $1.4 million. Steam reversing rings inside of the turbine engines malfunctioned and caused the turbine engines to fail. The plaintiffs sought $8 million in damages. The claims of tortious conduct included strict liability for design defects and negligently supervising the installation of one of the turbines during the manufacturing process.

The Supreme Court held that as a matter of law, no damage to other property had occurred because the turbines had only damaged themselves, and they were manufactured by the defendant as a single package. The Supreme Court relied on *Northern Power & Engineering Corp. v. Caterpillar Tractor Co.*, 623 P.2d 324, 330 (Alaska 1981), which stated, "Since all but the very simplest of machines have component parts, [a contrary] holding would require a finding of 'property damage' in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability."

The Supreme Court in *East River* adopted the majority rule of the economic-loss doctrine for federal admiralty cases, and about thirty states now follow the majority rule. The majority rule prohibits a party from making a tort claim for economic damages in cases involving contracts or warranties unless damage to other property or personal injury occurred.

The Supreme Court refined the *East River* analysis of the economic-loss doctrine in *Saratoga Fishing Co. v. J.M. Martinac & Co.*, 520 U.S. 875, 117 S. Ct. 1783, 138 L. Ed. 2d 76 (1997), in which it ruled that miscellaneous equipment added to a ship by its first owner after his purchase of the ship constituted "other property." The second owner of the ship, which caught fire and sank due to a defectively designed hydraulic system installed by the first owner, was allowed to recover for extra skiff, nets, spare parts, and other added equipment from the shipbuilder because it constituted other property.

Unlike *East River,* which has influenced countless economic-loss doctrine decisions, *Saratoga's* holding has been viewed as placing a "limited restriction" on the economic-loss doctrine. *See* J. Brandon Sieg, *Tort, Not Contract: An Argument for Reevaluating the Economic Loss Rule and Classifying Building Damage as "Other Property" When It Is Caused by Defective Construction Materials*, 53 Wm. & Mary L. Rev. 275 (2011), http://scholarship.law.wm.edu/wmlr/vol53/iss1/7 (discussing this view). Notably, both *East River* and *Saratoga* are admiralty law decisions, which means they are only binding in cases applying admiralty law.

Coupling the Integrated System Approach with the Doctrine

In recent years, product manufacturers have successfully used the economic-loss doctrine to dismiss tort claims in favor of enforcing the terms of written warranties with the "integrated systems" approach. For example, with this approach, once a window is installed into a wall system, the window and the wall become an integrated system. A wall is usually composed of 2 x 4 studs, drywall, insulation, gypsum board, screws, nails, tape, joint compound, and paint. Just as the separate components comprising the wall have been found to be an integrated system, some jurisdictions have held that once built, an entire house is an integrated system. Thus, the economic-loss doctrine applies to the entire dwelling structure, barring causes of action for economic damages caused by the component parts. *See, e.g., Fishman v. Boldt*, 666 So.2d 273 (Fla. Dist. Ct. App. 1996) (holding that the "product" is the home with all of its parts, which includes a seawall, which is an integrated component of a house, pool, and patio).

When, for example, a window manufacturer is sued because its product allegedly caused water damage, plaintiffs routinely allege that the window allowed water to damage portions of the structure beyond the window. The window manufacturer will often argue that once the window is installed and the wall is fully constructed, the window and the wall are an "integrated system."

The economic-loss doctrine does not bar recovery of economic damages if there is damage to property other than the product itself or if a plaintiff has suffered a personal injury.

An integrated system exists when "component materials become indistinguishable parts of a final product." *Nw. Arkansas Masonry, Inc. v. Summit Specialty Products, Inc.*, 29 Kan. App. 2d 735, 744, 31 P.3d 982, 988 (Kan. Ct. App. 2001). When a wall—or an entire house—is considered an integrated system, the economic-loss doctrine will prohibit tort causes of action alleging that a window damaged the wall because the whole wall or house will be an integrated piece of property. *Bay Breeze Condo. Ass'n, Inc. v. Norco Windows, Inc.*, 2002 WI App 205, ¶ 4, 257 Wis. 2d 511, 516, 651 N.W.2d 738, 740 (Wis. Ct. App. 2002)

Damage to a window, drywall, or any other part of this "integrated system" is considered damage to the product itself (rather than damage to other property), and any claim for economic damages against the window manufacturer would be barred by the economic-loss doctrine. The window manufacturer's warranty should be the sole remedy limiting the

manufacturer's exposure to what it promised in the warranty. In Wisconsin, Kansas, and approximately five other jurisdictions, damage to different parts of an integrated system such as a wall will not constitute damage to other property.

Consider the following example from Wisconsin. Windows with a two-year replacement warranty were installed in four condominiums. The condo association sued the window manufacturer after water infiltrated the windows and caused this to happen:

> leakage of water into the units and into the walls of the buildings at or around the windows; excessive peeling of paint on the exterior wooden window casements and frames and on the exterior of the buildings around or near the windows; rotting and deterioration of wood window casements and frames and of certain portions of the building; and water damage to the interior of the condominium units and structural components of the walls of certain buildings as a result of water leakage at or near the windows.

The association alleged strict product liability (*i.e.*, tort), negligence, and breach of warranty. The window manufacturer prevailed on summary judgment motion on all claims with the integrated system theory. The district court held that the materials comprising the wall and the window were an integrated system, which was formed from the construction of component parts and materials, including the windows. Because the wall was an integrated system, there was no damage done to other property. The other property exception did not apply, so the court reasoned that the tort claims were barred by the economic-loss doctrine. The window manufacturer prevailed on the warranty claim on summary judgment as well because the limited warranty provided with the windows did not provide any recovery for incidental or consequential damages when a wall was damaged; the warranty only covered damage done to the window itself. The Wisconsin Court of Appeals affirmed, upholding application of the integrated system theory.

The economic-loss doctrine, coupled with the integrated system theory, expands the scope of what the ultimate product is, which means that fewer plaintiffs will prevail by suing in tort under the other property exception.

The integrated system approach has been adopted by the *Restatement (Third) of Torts*, and it has been adopted in a handful of jurisdictions. *Restatement (Third) of Torts* §21. Iowa has adopted a slight variation of the integrated system approach by excluding recovery under the other property exception when a plaintiff claims damages for any product that is "an integral part of the finished product." *Richards v. Midland Brick Sales Co.*, 551 N.W.2d 649, 651 (Iowa App. 1996) (citing *Pulte Home Corp. v. Osmose Wood Preserving*, 60 F.3d 734, 741 (11th Cir. 1995) (citing *Casa Clara Condominium Ass'n, v. Charley Toppino & Sons, Inc.*, 620 So. 2d 1244, 1247 (Fla. 1993)).

Wausau Tile, Inc. v. Cnty. Concrete Corp., 226 Wis. 2d 235, 251, 593 N.W.2d 445, 453 (Wis.1999), is Wisconsin's first case on this theory, and the *Bay Breeze* court relied on *Wausau Tile* to render that conclusion. In *Wausau Tile*, a manufacturer of concrete blocks sued the manufacturer of the cement used to create these blocks. The manufacturer of the concrete blocks alleged the cement had too much alkalinity, which caused many of the blocks to split and crack, subjecting Wausau Tile to liability. The plaintiff pleaded multiple theories of recovery, including breach of warranty, negligence, contribution, and strict liability. The court applied the economic-loss doctrine and refused to find damage to other property, reasoning that the cement was merely part of an integrated system—the block—and that this finding precluded recovery for a claim for damage to other property. The Wisconsin Supreme Court relied on the following rule from Comment e of the Restatement (Third) of Torts §21: "When a product or a system is deemed to be an integrated whole, a court treats such damage as harm to the product itself. When so characterized, the damage is excluded from the coverage of this Restatement." *Wasau Tile* also held that

> [i]f a product has no function apart from its value as part of a larger system, the larger system and its component parts are not 'Other Property.' The defective product must be an "integral" part of the larger system that includes the damaged property for the two to be considered parts of an integrated system.

The economic-loss doctrine, coupled with the integrated system theory, expands the scope of what the ultimate product is, which means that fewer plaintiffs will prevail by suing in tort under the other property exception. This result encourages the party best situated to assess the risk of loss and to assume, allocate, or insure against that risk. *Daanen & Janssen, Inc. v. Cedarapids, Inc.*, 216 Wis. 2d 395, 407, 573 N.W.2d 842, 847 (Wis. 1998). A product manufacturer does not know how well a product will be installed, or if the product will be misused, and a buyer is in the best position to assess the risk of loss, allocate, and to insure against that risk. *Daanen & Janssen, Inc.*, 216 Wis. 2d at 407. During this process, a product buyer can purchase insurance, or he or she can bargain for a better price or a better warranty from the product seller, whether through a third party, such as a distributor, or directly from the product manufacturer. *Beyond the Garden Gate, Inc. v. Northstar Freeze-Dry Mfg., Inc.*, 526 N.W.2d 305, 310 (Iowa 1995). As a result, the outcome is more efficient because a product manufacturer can price each of its products at the lowest price possible instead of trying to speculate about how the product may be misused or improperly installed or what damage may occur in the future.

The Majority, the Minority, and the Intermediate Rules

The economic-loss doctrine prohibits tort claims when a product is defective and the only damages suffered are economic damages. *David v. Hett*, 293 Kan.

679, 683, 270 P.3d 1102, 1105 (Kan. 2011). Courts will limit a plaintiff's remedy to a contract claim such as breach of warranty. The two main exceptions to the economic-loss doctrine in states that have adopted the majority rule are (1) personal injury or (2) damage to other property. The majority rule is followed in Alabama, Delaware, Florida, Hawaii, Idaho, Indiana, Kentucky, Maine, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Tennessee, Vermont, and Wisconsin.

A handful of states such as Arkansas and Colorado follow the minority rule, which declines to recognize the integrated system theory or the economic-loss doctrine in any form. This sometimes results in manufacturers incurring substantial and unnecessary legal fees and exposes a manufacturer to inestimable consequential damages. Approximately fifteen states follow the intermediate rule.

The intermediate rule allows recovery of economic damages under a tort theory when there is an element of danger. The intermediate rule is nearly identical to the majority rule, except that the intermediate rule makes an exception for products that present "sudden or immediate danger." *See, e.g.*, *Pennsylvania Glass Sand Corp. v. Caterpillar Tractor Co.,* 652 F.2d 1165, 1173 (3rd Cir. 1981). If a product presents such a danger, a party is allowed to use tort claims to recover economic damages, even if there is no damage to other property. In most cases, products lack the ability to cause sudden or immediate danger, meaning the results under either the intermediate rule or the majority rule will typically be the same.

Conclusion

Scholars have challenged the economic-loss doctrine by proposing dramatic changes. *See, e.g.*, Sieg, *supra*. The effect of some legal challenges has caused the doctrine to evolve. For example, in *Insurance Co. of N. Am. V. Cease Electric, Inc.*, 688 N.W.2d 462 (Wis. 2004), the Wisconsin Supreme Court held that the economic-loss doctrine does not apply to service contracts. The court reasoned that the Uniform Commercial Code does not apply to services, and so logically, the economic-loss doctrine should not either.

The premise of the economic-loss doctrine is simple: the relationship between a manufacturer and a consumer is typically created by contract law. A party that agrees to a contract limiting recovery in the event of a breach should not be allowed to circumvent those provisions by pleading a tort claim. A warranty or a contract describes which defects and damages a manufacturer will and will not cover, and contains terms and conditions that govern the contractual relationship. Tort claims expand a manufacturer's liability beyond the liability to which a manufacturer and a consumer mutually agreed in their contract or warranty. If those terms and conditions are not satisfactory, a consumer can purchase a different product or they can purchase insurance to provide coverage for any losses that a warranty does not. Some manufacturers will even negotiate different terms, and a product's price can be set accordingly. FD