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In The Voice

The Economic-Loss Doctrine: A Common Sense Approach

by Andrew L. Smith

The economic-loss doctrine is a misunderstood creature, an enigma of the law, which first was adopted by the U.S. Supreme Court in 1986 in the context of admiralty law. *East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 866, 106 S. Ct. 2295, 90 L. Ed. 2d 865 (1986). If properly utilized, the economic-loss doctrine is one of the most powerful defenses of any tort case, and especially appropriate in the realm of construction law.

Under the economic-loss doctrine, privity of contract, or alternatively, a nexus sufficient to establish a substitute for parties entering into an actual contract, is required when a plaintiff sues a defendant for purely economic loss. Courts hold that recovery for economic loss is solely the subject for contract negotiation and breach of contract suits. Three policies support applying the economic-loss doctrine to commercial transactions:

1. It maintains the historical distinction between tort and contract law;
2. It protects parties' freedom to allocate economic risk by contract; and
3. It encourages the party best situated to assess the risk of economic loss, usually the purchaser, to assume, allocate, or insure against that risk.

Giddings & Lewis, Inc. v. Indus. Risk Insurers, 348 S.W.3d 729, 739 (Ky. 2011).

Courts frequently disagree regarding the scope of the doctrine. This has led to a constant source of confusion and head-scratching among anyone attempting to decipher the application of the doctrine.

What Is the Meaning of "Economic Loss"?

In the context of construction, "economic loss" includes the cost to repair or to replace defective materials, damage to a structure, diminution in value of a damaged structure not repaired, loss of use or delay in using property for its intended purposes, and related lost profits, lost revenue, and costs. *See, e.g.,* R.C. 2315.18 (3)(a)–(c). In sum, economic losses are intangible losses that do not arise from tangible physical harm to persons or property.

The Majority View

Under the majority view of the economic-loss doctrine, a party suffering only economic harm may recover damages for harm based only upon a contractual claim and not upon a tort theory, such as negligence or strict liability. States following this viewpoint include Alabama, Colorado, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, West Virginia, Wisconsin, and Wyoming.

For example, in *Santucci Constr. Co. v. Baxter & Woodman Inc.*, 502 N.E.2d 1134, 1137 (Ill. App. Ct. 1986), a construction company contracted with a town to construct sewer and water facilities. Before entering into that contract, the town contracted with an engineering service to provide professional services for the project. The construction company then filed a lawsuit against the engineering service for negligence, intentional interference with contractual relationships, and interference with prospective advantage. The appellate court held that the construction contractor could not recover purely economic losses from an architect or engineer when it had no written contract. *Id.*

Even those states following the traditional economic-loss doctrine, requiring privity of contract between the parties to recover purely economic damages, allow

several limited exceptions for the recovery of purely economic damages in the absence of privity of contract. Depending upon the jurisdiction, these exceptions include (1) the "sufficient nexus" exception, (2) the "third-party beneficiary" exception, and (3) the "other property" exception.

The Minority View

A minority of states takes the opposite view and does not require privity of contract for a party to pursue economic-loss damages. This viewpoint essentially eviscerates the economic-loss doctrine as any form of defense in construction cases. These states reason that the absence of privity is not a bar to the recovery of economic losses arising from a construction project. This view is based upon the proposition that the distinction between property damage and personal injury is arbitrary because in either case the defendant's conduct caused the harm, and therefore the defendant should be liable for all resulting harm. *Lincoln General Ins. Co. v. Detroit Diesel Corp.*, 293 S.W.3d 487 (Tenn. 2009).

States following this viewpoint include Alaska, Arkansas, Colorado, Connecticut, Louisiana, Oklahoma, South Carolina, and Washington.

For example, in *Seattle W. Indus. Inc. v. David A. Mowat Co.*, 750 P.2d 245 (Wash. 1988), the Supreme Court of Washington held that a subcontractor could in fact pursue economic loss in the form of delay damages against an architect under a negligence claim.

Points to Remember

The economic-loss doctrine is a powerful tool to limit and eliminate damages in any tort lawsuit in which privity of contract between the parties is lacking, and it is especially commonplace in the world of construction law. When evaluating the application of the doctrine, it is important to consider the following:

- Does the subject claim stem from a unique claim such as an intentional tort or negligent misrepresentation and not simple negligence? If so, the doctrine is inapplicable, and recovery of purely economic loss is available.
- Is there a written contract between the parties? If so, the doctrine is inapplicable, and recovery of purely economic loss is available.
- If not, does a limited exception apply, depending upon the particular jurisdiction?
- If there is neither a written contract nor a privity substitute, the economic-loss doctrine would likely apply and may bar any claims for purely economic loss.

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