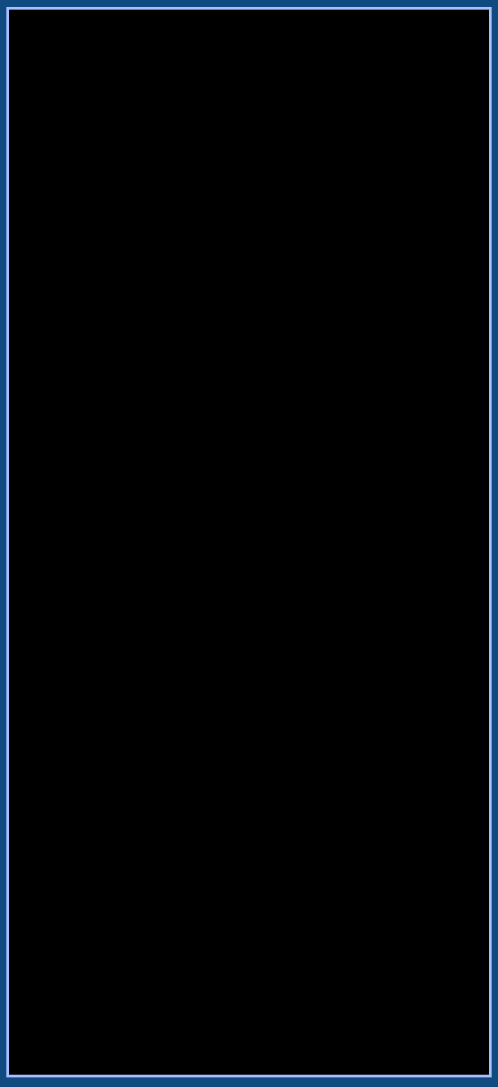
Construct a Defense Using the Economic Loss Doctrine

By Michael J. Sepanik



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Under the economic loss doctrine, contract is the sole remedy for the failure of a product to perform as expected. The economic loss doctrine bars a plaintiff from suing in tort where the plaintiff suffers a solely economic loss that is not accompanied by personal injury or damage to other property. The economic loss doctrine marks the fundamental boundary between contract law, which is designed to enforce the expectancy interest of the parties, and tort law, which imposes a duty of reasonable care and thereby encourages citizens to avoid causing physical harm to others. *See* Sidney Barrett, *Recovery of Economic Loss in Tort for Construction Defect: A Critical Analysis*, 40 S.C.L. Rev. 891, 894 (1989). This article focuses on how manufacturers of component parts and raw materials can benefit from the protection afforded by the economic loss doctrine. The state of the economic loss doctrine in many jurisdictions is far from bedrock, and the decisions are often highly fact-specific, leaving products manufacturers room to argue for extensions or refinement of the doctrine in their jurisdiction.

What Is an Economic Loss?

The law of most jurisdictions, as well as admiralty law, defines economic losses as those where there is no personal injury and no physical harm to other property. Losses meeting this definition are viewed as disappointed contractual or commercial expectations. *See Am. United Logistics, Inc. v. Catellus Dev. Corp.*, 319 F.3d 921, 926 (7th Cir. 2003). Generally, disappointed commercial expectations occur in situations where a product is inferior in quality and does not work for the general purposes for which it was manufactured and sold. Economic loss, as dictated by the terms of a contract or warranty, can include repair and replacement costs, rental expense, lost time, or lost profit. Plaintiffs generally have greater potential for recovery, more favorable limitations period calculations, and less warranty-related obstacles if they are permitted to sue in tort.

Distinguishing between the Product and Other Property

Since the economic loss doctrine permits tort recovery only for personal injury or damage to other property, the method used to identify the product at issue is critical, as that will define the boundaries of "other property." The manner in which the term "other property" is defined can have significant implications on the amount of recovery a plaintiff might receive, and has been

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the subject of disparate decisions in various jurisdictions. The case law interpreting the concept of "other property" generally centers the analysis on the issue of whether the other property is a distinct item or merely a component of the overall defective product at issue. *Gunkel v. Renovations, Inc.*, 822 N.E.2d 150, 154 (Ind. 2005).

East River Steamship Corp. v. Transamerica Delaval, Inc.

The United States Supreme Court's seminal admiralty ruling on the subject of economic loss is *East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 106 S. Ct. 2295 (1986). *East River* held that an admiralty tort plaintiff cannot recover for the physical damage a defective product causes to the "product itself." *See id.* Under *East River*, a key component of the analysis of property damage is exactly what portion of the property is deemed to be the product itself and which portion is deemed to be outside of the product itself.

In *East River*, companies that chartered oil transporting supertankers brought an action under maritime law seeking to hold a turbine manufacturer strictly liable in tort for income losses and repair costs resulting when a defective part of the supertankers' turbine damaged other parts of the turbines. Upholding the economic loss rule, the Court held that a manufacturer in a commercial relationship has no duty under either a negligence or strict product liability theory to prevent a product from injuring itself. *Id.* at 871. The Supreme Court determined that the defective part of the turbine had been so integrated into the turbine that it lost its separate identity, and thus the manufacturer was not strictly liable in tort for injury the component part caused to the greater turbine.

The *East River* decision examined the characteristics of highly mechanized products with potentially thousands of parts and determined: "Since each turbine was supplied [by defendant] as an integrated package, each is properly regarded as a single unit. 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." *Id.* at 867 (internal quotations and citations omitted).

In addition, the Supreme Court provided a compelling policy rationale for the economic loss doctrine:

> 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. The tort concern with safety is reduced when an injury is only to the product itself. When a person is injured, the cost of an injury and the loss of time or health may be an overwhelming misfortune, and one the person is not prepared to meet. In contrast, when a product injures itself, the commercial user stands to lose the value of the product, risks the displeasure of its customers who find that the product does not meet their needs, or, as in this case, experiences increased costs in performing a service. Losses like these can be insured. Society need not presume that a customer needs special protection. The increased cost to the public that would result from holding a manufacturer liable in tort for injury to the product itself is not justified.

Id. at 871–72 (internal citations and quotations omitted).

The United States Supreme Court slightly refined its analysis in *Saratoga Fishing Company v. J.M. Martinac & Company*, holding that where a ship's hydraulic system failed, causing damage to the ship itself, recovery for damage to the ship as a whole was barred. However, the plaintiff was permitted to recover for physical damage to other equipment that the plaintiff affixed to the ship after purchase. *See Saratoga Fishing Company v. J.M. Martinac & Co.*, 520 U.S. 875, 877, 117 S. Ct. 1783 (1997) (allowing recovery in tort solely for "other property," which included extra equipment added to the ship such as a skiff, a fishing net, and spare parts). *Saratoga Fishing Company* held that items added to the product by the initial (or a subsequent) user constitute "other property," which, if damaged, could trigger strict product liability. *Id.* at 879. The United States Supreme Court thus articulated the "product sold" test for determining what constitutes damage to "the product" and what constitutes damage to "other property."

The "Product Purchased" Analysis

Another method by which courts have defined the concept of a product is the product that is purchased by the plaintiff (as opposed to the product sold by the defendant). *See Casa Clara Condominium Association, Inc. v. Charley Toppino and Sons, Inc.*, 620 So. 2d 1244, 1247 (Fla. 1993) (rejecting homeowner's argument that damages caused to a condominium by defective concrete was damage to other property because the plaintiffs purchased finished homes, not component parts); *see also Oceanside at Pine Point Condominium Owners Association v. Peachtree Doors, Inc.*, 659 A.2d 267, 271 (Me. 1995) (no recovery for damages caused by defects in windows because the plaintiffs purchased finished condominium units, not individual components of the units); *and see Easling v. Glen-Gery Corp.*, 804 F. Supp. 585, 590 (D. N.J. 1992) (building damage caused by defective bricks barred as economic loss because the commercial purchaser bought a completed apartment complex, not a load of bricks).

Courts analyzing the product as that which is purchased by the plaintiff generate rulings that are considered more favorable to defendants seeking protection from tort recovery under the economic loss doctrine. The practical implication of the "product purchased" test is that the manufacturer of a component part will receive the protection afforded by the economic loss doctrine when its product is integrated into a condominium unit, helicopter, home, or transatlantic vessel, even in situations where its component part can be shown to have caused damage to other parts integrated into the larger product.

The theory underlying the economic loss doctrine is that the failure of a product or service to live up to expectations is best relegated to contract law and to warranty, either express or implied. *See Gunkel*, 822 N.E.2d at 155. Under this concept, a buyer and seller are able to allocate these risks and price the product or service accordingly. The Supreme Court of Indiana has described the "product purchased" analysis as follows:

> Only the supplier furnishing the defective property or service is in a position to bargain with the purchaser for allocation of the risk that the product or

> service will not perform as expected. If a component is sold to the first user as a part of the finished product, the consequences of its failure are fully within the rationale of the economic loss doctrine. It therefore is not "other property". But property acquired separately from the defective good or service is "other property", whether or not it is, or is intended to be, incorporated into the same physical object. Although we express our reasoning slightly differently, we align ourselves with the courts that have concluded that the "product" is the product purchased by the plaintiff, not the "product" furnished by the defendant.

See Gunkel, 822 N.E.2d at 155.

Has the Sun Set on the Economic Loss Doctrine in California?

The courts of California consistently reject the "product purchased" approach, and thus California courts offer less protection to defendants seeking to benefit from the economic loss doctrine. In *Jimenez v. T.M. Cobb Company*, 58 P.3d 450 (Cal. 2002), the Supreme Court of California held that the manufacturers of windows that are installed into mass produced homes are subject to strict product liability in tort when their defective windows cause harm to other portions of mass produced homes. The court further held that the economic loss rule does not necessarily bar tort recovery for damage that a defective product causes to other portions of a larger product into which the former has been incorporated. The Supreme Court of California rejected the defendant window manufacturer's argument that the "product" at issue was the entire house into which their windows were installed, and that the damage caused to other parts of the house by the allegedly defective windows was damage to the product itself within the economic loss rule, thus precluding application of strict liability.

The rationale supporting the *Jimenez* decision is that the duty of a product manufacturer to prevent property damage does not end when the product is incorporated into a larger product, and therefore recovery in tort is warranted for damage that defective windows caused to other parts of the home into which they were installed. *See id.* at 484; *see also Stearman v. Centex Homes*, 78 Cal. App. 4th 611 (2000) (builder strictly liable in tort for damages that a defective foundation caused to the interior and exterior of a home); *and see Casey v. Overhead Door Corp.*, 74 Cal. App. 4th 112 (affirming non-suit, but specifically upholding plaintiff's right to recover in tort where defective windows caused damage to other portions of a house, such as drywall and framing). It should be noted that the Supreme Court of California specifically limited the *Jimenez* holding to component parts such as windows, and left open the issue of whether defective raw materials included in house construction should be treated in the same manner as component parts, meaning that raw materials could still gain the protection afforded by the economic loss doctrine. *See Jimenez v. T.M. Cobb Company*, 58 P.3d. at 484.

California courts may likely further evolve their interpretation of the economic loss doctrine, as Justice Kennard, the author of the *Jimenez* decision, also authored a concurring opinion offering dicta further explaining the rationale for the decision. In the concurrence, Justice Kennard explained that California adopts the Restatement (Third) of Torts' method of determining whether a component manufacturer is strictly liable for harm that its defective product causes to a larger object of which it is a component:

> [T]he pertinent inquiry is whether the component has been so integrated into the larger unit as to have lost its separate identity. If so, strict liability is improper. But if the component retained its separate identity, so that it may be readily separated from the overall unit, the component manufacturer may be strictly liable for damages to the larger unit.

See id. at 487.

The above-cited dicta by Justice Kennard makes sense in the abstract, however, it may be difficult to apply to the reality of products and buildings with thousands of raw materials, components, and parts. A rather simple example is provided by the myriad of electrical wiring and gas tubing that is required in each new home construction. Equally persuasive arguments could be made that the wiring and tubing always remain distinct from other components of the house, or that the wiring and tubing loses its individual character once it is placed behind sheetrock and run throughout a new home.

Should Residential Home Purchasers Be Treated Differently?

Courts have been repeatedly asked to make an exception to the economic loss doctrine for homeowners. Numerous courts have commented that purchasing a house is the largest investment many consumers ever make, and homeowners are an appealing and sympathetic class. When a house causes economic disappointment by failing to meet a purchaser's expectations, should the failure to receive the benefit of the bargain be transformed from a core concern of contract to tort law? In *Casa Clara Condominium Assoc., Inc. v. Charlie Toppino & Sons, Inc.*, 620 So. 2d 1244 (Fla. 1993), the Supreme Court of Florida refused to remove the purchase of a home from the realm of contract law. The *Casa Clara* decision reasoned:

> There are protections for homebuyers, such as statutory warranties, the general warranty of habitability, and the duty of sellers to disclose defects, as well as the ability of purchasers to inspect houses for defects. Coupled with homebuyers' power to bargain over price, these protections must be viewed as sufficient when compared with the mischief that could be caused by allowing tort recovery for purely economic losses. Therefore, we again hold contract principles more appropriate than tort principles for recovering economic loss without an accompanying physical injury or property damage. If we held otherwise, contract law would drown in a sea of tort. We refuse to hold that homeowners are not subject to the economic loss rule.

Id. at 1247. The Supreme Court of Florida further commented that the "product purchased" test clearly dictates that the economic loss doctrine should apply to home buyers: "Generally, house buyers have little or no interest in how or where the individual components of a house are obtained. They are content to let the builder produce the finished product, *i.e.*, a house. These homeowners bought finished products—dwellings—not the individual components of those dwellings. They bargained for the finished products, not their various components. The concrete became an inte-

gral part of the finished product and, thus, did not injure 'other' property." *See id.* at 1247. (Where no injury to person or damage to other property occurred, economic loss rule barred the homeowner's recovery under negligence theory against supplier of concrete which, because of high salt content, caused reinforcing steel to rust, which, in turn, caused concrete to crack and break off).

Replacement Component Parts Are Considered Part of the Greater Product

Courts have also analyzed the use of replacement component parts as part of the greater product itself. In *Sea-Land Service, Inc. v. General Elec. Co.*, 134 F.3d 149 (3d Cir. 1998), the plaintiff shipping company alleged that a replacement component part of a diesel engine—a connecting rod—was defective and claimed the profit it lost while the ship was inoperable. *See id.* The United States Court of Appeals for the Third Circuit analyzed whether replacement parts should be viewed as integrated into the engine for purposes of the economic loss doctrine. The plaintiff argued that the subsequently purchased replacement connecting rods caused damage to the original property (the engine itself), and therefore the economic loss doctrine did not bar recovery in negligence and strict liability. The Third Circuit rejected the plaintiff's argument, and held that there was no reason to deviate from the integrated product rule simply because the defective component happened to be a replacement part instead of the part originally supplied with the product. *See id.* at 154. The *Sea-Land Service* decision reasoned that because all commercial parties are aware that replacement parts are necessary, the integrated product should encompass those replacement parts when they are installed in the engine. *See id.* at 154. *See also Exxon Shipping Co. v. Pacific Resources, Inc.*, 835 F. Supp. 1195, 1201 (D. Haw. 1993) (rejecting the distinction between a separately purchased replacement part and the originally supplied component as irrelevant to determining whether "other property" has been damaged).

The United States District Court for the District of Massachusetts, in *Sebago, Inc. v. Beazer East, Inc., et al.*, 18 F. Supp. 2d 70 (D. Mass. 1998), held that under both Massachusetts and Maine law, the product at issue for purposes of the economic loss doctrine was the completed building, thus the economic loss doctrine barred recovery on negligence or strict liability claims by purchasers of a building containing allegedly defective foam roof installation against the manufacturers of the foam roof installation. The *Sebago* decision specifically rejected the plaintiff's argument that since the installation foam was purchased as a replacement part, it was not part of the completed building originally purchased by the plaintiff. The court's rationale for refusing to adopt that theory was that the foam was purchased to be installed and to become integrated into the building, and thus it is a component of the building without any use otherwise. *See id.* at 93. Thus, the U.S. District Court for the District of Massachusetts held that under the "purchaser's perspective test," the result is the same whether the integrated part is viewed as a component part or a replacement component part.

Looking toward the Future

The boundaries of the economic loss doctrine's protection are still shifting, especially as appellate courts reconsider the scope of prior decisions and carve out exceptions that benefit plaintiffs seeking to sue in tort. Ironically, just as the economic loss doctrine was first viewed as a bulwark to keep contract law from drowning in a sea of tort, commentators and courts have recently derided the doctrine as a "tort eating monster." *See* Paul Schwiep, *The Economic Loss Rule Outbreak: The Monster That Ate Commercial Torts*, Fla. Bar J. (1995). In 2004, the Supreme Court of Florida limited its application of the economic loss doctrine in service contexts, acknowledging that the economic loss rule has become a "confusing morass" and a rule "that has been stated with ease but applied with great difficulty." *Indemnity Ins. Co. of N.A. v. American Aviation Co.*, 891 So. 2d 532, 544 (Fla. 2004) (Cantero, J., concurring). Fortunately for product manufacturers, recent decisions such as *American Aviation Co.* have reaffirmed the recognition of the economic loss rule in the context of product liability actions. *See id.* at 543. In addition, the increased number of lawsuits (such as residential or commercial fire cases) where product manufacturers are brought in as third-party defendants by home builders or contractors seeking indemnity or contribution will provide fertile ground for additional development and interpretation of the doctrine.