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The Application of North Carolina's Economic Loss Rule to Commercial Construction Projects

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This article addresses recent developments in North Carolina law regarding the economic loss rule, explores the application of the economic loss rule to commercial construction projects in light of those developments, and provides a few pieces of practical advice based on the application of the economic loss rule to commercial construction projects.

North Carolina's Economic Loss Rule in Commercial Construction

North Carolina's economic loss rule addresses the intersection between contract remedies and tort remedies. Under the economic loss rule, purely economic losses that arise out of a contractual relationship are ordinarily not recoverable under a tort theory of liability, such as negligence. Economic loss refers to purely financial losses that can be measured on a balance sheet. On the other hand, non-economic loss refers to items such as pain, suffering, and emotional distress.

Examples of economic loss that can arise on a construction project include the cost to repair or replace defective work or defective materials, the loss of past and future earnings due to the inability to use the building while it is being repaired, and the loss of business opportunities or other work due to the time and resources expended on repairing the defects.

Under the economic loss rule, a claimant must rely on the rights and remedies it bargained for in its contract and may not recover economic losses in tort that differ from the remedies afforded by the contract. The underlying purpose of the economic loss rule is to allow the law of contract to govern disputes involving contracts and to prevent tort law from displacing the bargained for liabilities, remedies, and obligations to which the parties agreed.

The primary exception to the economic loss rule is that claimants may maintain a negligence action alongside a breach of contract action where the negligence claim arises from the breach of a legal duty of care that is separate and distinct from the duties and obligations at issue in the applicable contract.

The economic loss rule is particularly relevant to commercial construction projects and disputes given the highly contractual nature of such projects. In a typical commercial construction project, the owner or general contractor contracts with an architect, the owner contracts with the general contractor, the general contractor contracts with first-tier subcontractors, first-tier subcontractors contract with second-tier subcontractors, and

so on.

Every relationship in the construction chain is governed by a contract. The parties' contracts define their relative rights and responsibilities and allocates among them the risks, rewards, and liabilities. Thus, the economic loss rule is a defense to tort claims asserted in construction disputes where contracts usually govern the subject matter of the dispute and provide for how risk of loss will flow between the parties involved in the construction project.

The *Crescent* Decision

In December of 2020, the North Carolina Supreme Court issued a landmark decision regarding the economic loss rule in a case involving a commercial multi-family construction project: *Crescent Univ. City Venture, LLC v. Trussway Mfg., Inc.*, 376 N.C. 54 (2020).

The dispute in *Crescent* arose from the construction of a multi-building student housing apartment complex near the University of North Carolina at Charlotte (the "project"). After the project was completed and residents were living in the complex, the floors in two of the apartments began sagging. Investigation revealed that the floor trusses underneath the apartments were defective.

The project owner was required to complete costly repairs and then brought a negligence claim against the subcontractor that manufactured and supplied the floor trusses for the project (whom the owner did not have a direct contract with). The owner sought to recover economic losses, including the costs to repair the defective trusses and expenses associated with providing displaced residents temporary housing, transportation, and storage. The owner simultaneously pursued a breach of contract claim against the general contractor it contracted with for the Project.

The Court addressed the issue of whether the owner could seek to recover purely economic losses in tort from the subcontractor even though it possessed a bargained for means of recovery against the general contractor by virtue of the prime contract.

The Court ultimately held that the economic loss rule barred the negligence claim asserted by the owner against the subcontractor where the owner had a bargained for means of recovery against the general contractor and the subcontractor did not owe the owner an extra-contractual duty of care imposed by law. Key to the Court's holding was the fact that the owner was sophisticated, had a bargained-for means of recovery against the general contractor, and had the opportunity to negotiate risks related to subcontractors hired by the general contractor into its contract with the general contractor.

Critically, the fact that there was no direct contract between the owner and the subcontractor did not bar the application of the economic loss rule since the owner still had a bargained for means of recovery. Instead, the Court stated that the lack of contractual privity is irrelevant in the commercial construction setting where the existence of subcontractors and other participants in the project is readily known and can be taken into consideration and accounted for in the sophisticated contracts executed by the parties.

In the wake of *Crescent*, North Carolina courts will likely apply the economic loss rule to bar tort claims seeking recovery of purely economic losses raised by construction contractors, subcontractors, suppliers, and owners against each other and will likely hold them to their bargained for means of recovery. This is so based on the reasoning, set forth in *Crescent*, that **owners, contractors, and subcontractors participating in a commercial construction project are deemed to be sophisticated parties and have the opportunity to bargain for remedies and allocate risk of loss in their contracts.**

The Architect/Engineer Exception to the Economic Loss Rule

Crescent, however, does not completely foreclose the possibility of viable tort claims for economic losses on commercial construction projects. The *Crescent* court recognized a long-standing exception to the economic loss rule that permits negligence claims that are based on the violation of an extra-contractual duty of care.

This exception is particularly relevant and applies most saliently to engineers and architects who owe a professional duty of care under North Carolina law.

Specifically, North Carolina law recognizes architects and engineers as professionals with special knowledge and skill and corresponding professional duties and imposes on architects and engineers a legal duty of care to all persons who reasonably rely upon their professional performance.

In fact, North Carolina courts, including the Business Court in *Crescent*, have previously recognized that general contractors and subcontractors who do not have a direct contractual relationship with the architect or engineer on a commercial construction project may sue the architect or engineer in negligence for economic loss that foreseeably results from the architect's breach of its common law duty of care in the performance of its contract with the owner.

Additionally, two post-*Crescent* federal decisions applying North Carolina law held that the **economic loss rule does not bar negligence claims** asserted against architects or engineers arising from alleged breaches of their professional duty of care.

Specifically, in *U.S. for use & benefit of Schneider Elec. Bldg. Americas, Inc. v. CBRE Heery, Inc*., the court held that HVAC and plumbing subcontractors who had a direct contract with the project architect/design-build contractor ("design-builder") stated a viable negligence claim against the design-builder for alleged architectural malpractice, despite the direct contracts, where the subcontracts did not implicate the architect's architectural services and the architect's professional duty of care was independent from its duties under the subcontracts. (E.D.N.C. July 26, 2021. Case published on Westlaw, subscription required.)

In *Walbridge Aldinger LLC v. Cape Fear Eng'g, Inc.*, the court held that a consulting subcontractor stated a cognizable negligence claim against an engineering company based on allegations that the drawings and design plans the engineering company provided for the project were defective and breached the engineering company's professional duty of care by failing to properly highlight and note that the plans did not use the standard elevation measurements applicable in the industry.

Thus, cases applying North Carolina law suggest that negligence claims against architects or engineers based on the breach of the architect or engineer's professional duty of care remain viable in the wake of *Crescent.*

But, in *New Dunn Hotel, LLC v. K2M Design, LLC*, another federal court applying North Carolina law held that a negligence claim by a limited liability company formed to operate a hotel that had yet to be constructed ("operator") against an architectural firm with whom the operator had a direct contract for the design of the hotel was barred by the economic loss rule because of the direct contract between the operator and the architect for design services. The court reasoned that the architect's professional duty of care to the hotel operator was not separate and distinct from the duties it owed the operator under its design services contract and held that the exception to the economic loss rule did not apply.

The *New Dunn* court also analyzed a negligence claim by a separate limited liability company who owned the property (the "owner") that the hotel was going to be constructed on. The owner alleged a negligence claim against the architect based on breaches of its professional duty of care in designing the hotel. There was no contract between the owner and the architect. Further, the owner had no contract or warranty remedy for the

damages it suffered.

The court held that the owner's negligence claim was not barred by the economic loss rule because the architect owed the owner a professional duty of care, there was no contract between the owner and the architect, and the owner had no contract or warranty remedy to redress the damages it suffered.

Thus, *New Dunn* and *Schneider* read together suggest that parties who contract directly with architects or engineers for professional design services will be limited to the contractual remedies they bargained for in their contracts with the architect or engineer and will not be able to pursue negligence claims against the architect or engineer. It is important, however, to recognize that these are non-binding federal cases, so North Carolina courts faced with similar legal issues may reach different conclusions.

Notably, the *New Dunn* court focused its economic loss rule analysis almost entirely on the question of whether the claimant had a basis for recovery in contract or warranty. In light of *Crescent*, this appears to be an erroneous approach to the economic loss rule.

In *Crescent,* the Court affirms the reasoning of the Business Court and expresses that, to escape the bar of the economic loss rule, negligence claims are required to be based upon an extra-contractual duty imposed by operation of law. The *Crescent* Court does not appear to require that negligence claims both (a) be based on an extra-contractual duty of care and (b) that the claimant have no other basis to recover damages in contract or warranty. Instead, the focal point of the analysis is whether the negligence claim is based on an extra-contractual duty separate and distinct from any contract that the claimant may also have a claim under.

Thus, *Crescent* appears to allow for a scenario where a claimant can pursue a contract claim for damages and a negligence claim for damages, so long as the negligence claim is based on a duty of care separate and distinct from the contractual duties owed to the claimant. Since *Crescent* is a North Carolina Supreme Court case its analysis is controlling. Nonetheless, the outcome in *New Dunn* would arguably be the same under the *Crescent* approach and is informative to the issues discussed herein.

One question that remains is whether an owner in a design-build contract setting who does not have a direct contract with the architect or engineer can assert a viable negligence claim against the architect or engineer that is not barred by the economic loss rule. In this scenario, the owner has a good argument that it should be able to rely on the extra-contractual professional duty of care owed by the architect or engineer (just as contractors and subcontractors are permitted to do) because the owner does not have a direct contract with the architect or engineer and it appears the duty of care owed by the architect or engineer is separate and distinct from the contractual duties owed by the design-build contractor.

The architect or engineer, however, is likely to argue that the sophisticated owner should be limited to the remedies contained in its contract with the design-build contractor who hired the architect or engineer.

One way for owners to avoid this issue is to **include a clause in your design-build contract that states that the contract does not in any way alter or limit the professional duty of care owed to you by the architect or engineer hired by the design-build contractor**.

Conclusion

The economic loss rule is a complex legal rule the contours of which continue to be developed under North Carolina law. Based on the above, current North Carolina case law suggests the following with respect to the application of the economic loss rule to commercial construction projects:

- Owners, contractors, and subcontractors will, in most cases, be required to rely upon their contractual rights and remedies to recover for purely economic losses arising from the construction project. Courts are unlikely to permit tort claims against non-professionals who owe no extra-contractual duty of care to the claimant, holding claimants to their bargained for rights and remedies;
- Contractors and subcontractors can allege viable negligence claims against engineers and architects when the engineer or architect breaches its duty of care in performance of its work on the relevant project and the contractor or subcontractor suffers foreseeable economic loss and (1) does not have a direct contract with the architect or engineer or (2) has a direct contract with the architect or engineer that does not implicate professional services or the architect or engineer's professional duty of care.

In light of the foregoing, parties engaged in commercial construction should carefully review their contracts before executing them to ensure they provide adequate protections and risk shifting.

Parties to commercial construction contracts should expect that in the event they suffer only economic losses they will be limited to only those remedies provided in their contracts.

Additionally, engineers and architects should maintain strong professional liability policies to insure against the risk of tort claims that might arise from the breach of their professional duty of care on commercial construction projects.

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