

# The Economic Loss Rule and Why It Matters in Construction Litigation

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March 20, 2019



**In its broadest sense, the 'economic loss rule' prohibits recovery in tort for purely economic loss incurred under contract law.**

The *Merriam-Webster Dictionary* online defines tort as "a wrongful act other than breach of contract for which relief may be obtained in the form of damages or an injunction."

Negligence, the most common tort claim, is the failure to exercise the care that a reasonably prudent person would exercise in similar circumstances. Thus, where a contract exists governing the subject matter of the dispute, claims between the parties must be based on the contract terms, and a tort-based claim between the parties will typically be barred.

The rationale for the economic loss rule is that where a contract exists, the parties have freely negotiated to include or exclude terms governing the parties' respective rights, obligations, and remedies. If a party to that contract could extend its remedies beyond those set forth in the contract, this would effectively allow the party to obtain something more than (or inconsistent with) what they bargained for in the contract. This is especially true in the products liability context, where the economic loss rule first arose.

In 1978, some twelve years prior to the express adoption of the economic loss rule, the North Carolina Supreme Court addressed the essential elements of the rule (without referring to it by name in the decision) in a dispute between an owner and general contractor. The case, *North Carolina State Ports Authority v. Lloyd A. Fry Roofing Co., et al.*, 294 N.C. 73, 240 S.E.2d 345 (1978), involved a claim for damages arising from leaking roofs. The owner, the North Carolina State Ports Authority, asserted two claims against the general contractor, as well as other project participants. One claim was for breach of the construction contract, the other for negligence in constructing and installing the roofs. The Court found that a tort claim is unavailable "against a promisor for his simple failure to perform his contract, even though such failure was due to negligence or skill."

The North Carolina Court of Appeals expressly adopted the economic loss rule in a 1990 products liability case, *Chicopee v. Sims Metal Works*, 98 N.C. App. 423, 391 S.E.2d 211 (1990). Since *Chicopee*, case law has intertwined the concepts set forth in *Ports Authority and Chicopee* and extended the economic loss rule to a number of other substantive areas.

There are exceptions to the economic loss rule. *Ports Authority* identifies the following exceptions:

1. The promisor's negligent act or omission in the performance of the contract caused injury to the person

or property of someone other than the promisee. By way of example, if a crane falls over and injures a third party who had no connection to the promisee, a claim for negligence brought by the third party against the crane supplier would not be barred by the economic loss rule, as there was not a contract between the crane supplier and the third party.

2. The promisor's negligent, or willful, act or omission in the performance of his contract, caused injury to property of the promisee other than the property which was the subject of the contract, or personal injury to the promisee. Thus, if a crane fell over and damaged the utility lines of the building and the contract with the crane supplier did not involve work on the utility lines, a claim for negligence against the crane supplier for damage to the utility lines would not be barred by the economic loss rule. This makes sense as the contract with the crane supplier did not include or govern the utility lines and, therefore, there was not a contract that applied to the specific subject matter of the dispute (the utility lines that were damaged).
3. The promisor's negligent, or willful, act or omission in the performance of his contract, caused loss of or damage to the promisee's property, which was the subject of the contract, and the promisor had a legal duty, as a matter of public policy, to use care in the safeguarding of the property from harm, as in the case of a common carrier, an innkeeper or other bailee.
4. The injury caused by the promisor to the promisee was a willful act.

In applying and, in many cases, expanding these exceptions, the relevant inquiry under North Carolina law is whether the injured party has a basis for recovery in contract or warranty. If there is a basis for recovery under a contract or warranty provision, then the Court will generally recognize and apply the economic loss rule, provided that there is not an independent legal duty which is identifiable and distinct from the contractual duty. See, *Bradley Woodcraft, Inc. v. Boddin*, 795 S.E.2d 253, 258-59 (2016). By way of example, an architect is held to a professional standard of care. While this professional standard of care may be referred to in the contract between owner and architect, the duty to adhere to a professional standard of care is an independent legal standard and the owners' tort claims against the architect are not barred by the economic loss rule. Put simply, the architect cannot contract away its obligations to perform at a minimum professional standard of care.

In *Bradley Woodcraft*, the homeowner entered into a contract with the general contractor to undertake some interior finish work and kitchen remodeling. The homeowner became dissatisfied with the contractor's work. After meeting with the contractor the homeowner paid the contractor an additional sum, using two credit card transactions. The homeowner testified that payment was made with the understanding that the contractor would complete the project. The contractor took the funds but never returned to the job. The homeowner disputed the two credit card charges, which were reversed by the credit card company. The contractor sued the homeowner for breach of implied and express contract, and the homeowner counterclaimed, alleging among other claims, breach of contract and fraud. The homeowner argued that their fraud claim should survive the economic loss rule defense. The Court agreed, "...while claims for negligence are barred by the economic loss rule where a valid contract exists between the litigants, claims for fraud are not so barred..." *Bradley Woodcraft* at 259. *Bradley Woodcraft* seems to suggest that a tort claim, other than negligence, will survive in an otherwise clear contractual dispute and not be subject to the economic loss rule.

Fortunately, a 2018 federal case rejected the broad statement that the economic loss rule barred only negligence claims and distinguished *Bradley Woodcraft* by stating that the proper inquiry is whether there is an independent legal duty, which is identifiable and distinct from the contractual duty. *Legacy Data Access, Inc. v. Cadrillion, LLC*, 889 F.3d 158, 166 (4th Cir. 2018).

An earlier construction case, *Lord v. Customized Consulting Specialty, Inc.*, 182 N.C. App. 635, 643 S.E.2d 28 (2007), allowed the owners of a home to pursue a tort claim against a subcontractor, holding the economic

loss rule did not bar claims of negligence given the particular facts of the case. In this case, the homeowners (Lords) discovered the trusses used to construct their home were defective. The Lords sued their contractor (Customized Consulting Specialty, Inc.) and the subcontractor who designed the trusses. The claims against the subcontractor included a negligence claim. The subcontractor argued the economic loss rule applied to bar the homeowners' negligence claim, relying on the holdings from several cases involving damage resulting from the use of synthetic stucco, some decided in Federal Court. The North Carolina Court of Appeals rejected the subcontractor's arguments. The Court found that no contract existed between the subcontractor and the homeowners, that the economic loss rule did not apply and that the economic loss rule did not operate to bar the homeowners' negligence claim.

In summary, while the economic loss rule does not provide an absolute defense to all tort claims, it must certainly be considered in litigation that involves claims sounding in both contract and tort.

More importantly, the protection of the economic loss rule begins with the contract itself. Creating, maintaining, and properly executing well-drafted contracts is a foundational requirement to controlling and allocating risk in the construction industry. If you give less attention to your contracts than you do other details of a project, you are placing your company at risk, as you may find yourself defending both contract and tort claims.

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