The Economic Loss Rule - Recently Refined or Redefined by the North Carolina Supreme Court

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Recently, the North Carolina Supreme Court issued a decision impacting the application of the economic loss rule in commercial settings, particularly construction.

This article provides a refresher on the economic loss rule before turning to an overview of the Court's decision and its potential impact.

The economic loss rule is a legal construct designed to prohibit recovery under a tort theory of liability, like negligence, for purely economic losses that arise out of a contractual relationship. The overarching premise behind the rule is that parties to a contract are presumed to have considered and contracted for how risk and loss flowing from the contract's subject matter is to be allocated. In other words, allowing a party to a contract to pursue remedies it did not bargain for in negotiating its contract would effectively allow that party to get more than its bargained-for exchange.

As with most rules of law, the economic loss rule is not without its exceptions. For example, personal injury claims are not barred, and there are other limited exceptions. For more on the origin and history of North Carolina's economic loss rule and the general exceptions to its application that North Carolina courts have traditionally applied, our partner Bill Durr's article on the subject, titled "The Economic Loss Rule and Why It Matters in Construction Litigation," is instructive.

In December 2020, in a case captioned *Crescent Univ. City Venture, LLC v. Trussway Manu., Inc. et al.*, 2020 WL 7415061 (N.C. December 18, 2020), the North Carolina Supreme Court entered a decision impacting the application of the economic loss rule.

The *Crescent* lawsuit involved a dispute between a commercial owner/developer who contracted with a general contractor to build apartments near the University of North Carolina at Charlotte. In turn, the general contractor entered into contracts with several subcontractors to facilitate the project's construction. One of the subcontractor's scopes of work entailed procuring and installing floor and roof trusses for the apartments. The trusses were manufactured by Trussway Manufacturing, Inc. pursuant to a purchase order executed by the subcontractor charged with installing the trusses. After the apartments were built and occupied, reports of cracked and sagging ceilings began to occur. An investigation identified defective floor trusses as the culprit, and litigation ensued. One of the claims the owner brought in the litigation was a negligence claim against Trussway Manufacturing for its alleged negligent manufacturing of the trusses.

Trussway Manufacturing contended that the duties it had purportedly violated arose out of a contractual relationship rather than by operation of law (*i.e.,* not as an independent legal duty), and therefore, the economic loss rule barred the owner's negligence claim against it. The Business Court agreed with Trussway Manufacturing's position that the economic loss rule applied and the owner's negligence claim was barred as a matter of law. Notably, the Business Court applied the rule in reaching its decision even though the owner did not have a contract with Trussway.

On appeal, the North Carolina Supreme Court upheld the Business Court's ruling. In reaching its decision, the Court agreed that the economic loss rule "requires negligence claims to be based upon the violation of an extra-contractual duty imposed by operation of law" in order to survive the application of the rule. *Crescent*, 2020 WL 7415061 *1 (N.C. December 18, 2020). The Court went on to reject the argument that application of the economic loss rule requires the existence of a contract between a plaintiff and a defendant. This is perhaps the most important aspect of the Court's decision. In commercial construction litigation, project owners routinely brought direct claims against subcontractors for negligence, especially when there was concern that the general contractor was financially unsound or its insurance company was denying coverage. The rationale was that because the project owner did not have a contract with the subcontractors, such negligence claims were not barred by the economic loss rule.

The Supreme Court rejected that rationale and applied the economic loss rule to bar such negligence claims. The Court reasoned that the potential existence of subcontractors is readily known in the context of sophisticated construction contracts and that the owner negotiated its contract with the general contractor with full knowledge of and power to control the acquisition and engagement of subcontractors.

The Court, however, was careful to distinguish the *Crescent* case from those involving residential construction. In residential construction, subsequent purchasers of a home are generally allowed to maintain a negligence claim against the original builder and subcontractors. In addition, homeowners have been allowed to bring direct negligence claims against subcontractors of the builder even when the homeowners have a contract with the builder. These extra-contractual remedies are largely based on public policy considerations to protect ordinary home purchasers who are not as sophisticated as commercial developers.

In short, *Crescent* makes clear – at least in the context of commercial construction involving sophisticated parties – that the law in North Carolina is now such that a project owner who has a bargained-for contract with a general contractor may not seek recovery of purely economic loss against the general contractor's subcontractors in tort. In other words, tort claims that may once have been available against subcontractors with whom privity of contract was lacking may now be subject to the economic loss rule if they arise out of or stem from the underlying owner-general contractor contract, except if the tort claim is one founded on an extra-contractual, independent legal duty. *Crescent* leaves intact the exception to the economic loss rule for tort claims based on the breach of an extra-contractual duty, relationship, or bailment.

Against this backdrop, parties navigating the complexities of commercial construction projects would be well-served to revisit the scope and limitations of their contractual rights and remedies to gauge whether appropriate protections are in place to compensate them for potential economic losses. For example, an owner may want to ensure that any subcontractor warranties extend to and are enforceable by the owner directly. An owner could also require the general contractor to include in its subcontracts a provision making the owner an intended third-party beneficiary of the subcontracts (or certain provisions of the subcontracts relating to the subcontractors' performance) as well as an additional insured under the subcontractors' general liability insurance policy. If the solvency of the general contractor is a concern, the owner could require the general contractor to provide payment and performance bonds. General contractors may want to ensure similar language and protections are included in all lower-tier subcontracts to protect against defaults by second and third-tier subcontractors. Subcontractors, on the other hand, will want to be mindful of contractual language and provisions that give the owner a direct remedy against the subcontractor.

Ward and Smith attorneys in the Firm's Construction Practice Group are experienced in and can assist with evaluating and drafting your commercial construction contracts.

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 For further information regarding the issues described above, please contact Evan M. Musselwhite or Amy H. Wooten.