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Construction Projects, Economic Loss and the Integrated Product Doctrine

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The Construction Law and Litigation Committee consists of lawyers who represent general contractors, design/build firms, subcontractors, construction lenders, architects, engineers and owners. The Committee provides an opportunity to keep up to date on the latest developments in construction law, as well as a good networking and referral source for experienced construction litigators throughout the country. Members can also obtain information on liability and damage experts with e-mail inquiries to the Committee. Learn more about the Committee at www.iadclaw.org.
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The economic loss rule and the integrated product doctrine are important defenses in construction litigation for developers, architects, contractors, subcontractors, product manufacturers, and suppliers. These legal defenses are recognized by the majority of federal and state courts, and, when properly used, serve two important functions: first, they limit damages to those measures prescribed by the parties' contracts; and second, they preclude certain types of less-predictable tort causes of action. For these reasons, the economic loss rule and the integrated product doctrine are critical insofar as they allow parties to predict and control, to a degree, their potential risks, and thereby contribute to the maintenance of stable construction markets.

This article will explain these rules in broad terms and through examples, and will look at some recent challenges to their viability. Finally, we offer some simple strategies for successfully employing these defenses.

The Economic Loss Rule

Conceptually, the economic loss rule is fairly easy to state: parties are not allowed to turn what should be breach of contract claims into tort claims.

Tort claims typically allow for a wider array of, and potentially much larger, damages. As a result, plaintiffs frequently attempt to state their claims in terms of tort law. This, of course, begs the question: where is the line between tort and contract law? Again, the basic answer is relatively straightforward. Most jurisdictions accept as a matter of common law that you may be subject to tort liability for your actions that result in physical injury to others or to "other property." Stated another way, you have a duty to avoid injuring others or their property. On the other side of the line between tort and contract law, there is no general common law protection against purely economic losses. Therefore, if you agree to do a task but do it poorly, albeit without injuring anyone or their property, then you may be sued for breach of contract for recovery of your "economic losses" but, typically, you are not exposed to tort damages.

The following example is illustrative. If a building's brick façade collapses, injuring the building's owner or damaging her car, then the owner can likely sue the builder in tort. If, on the other hand, the façade collapses but only damages other parts of the building, then the owner will likely be limited to a breach of contract action.

Difficulty in Application

While the general rule can be explained easily, it can be uncommonly difficult to apply. This is due in part to significant differences in how the rule is enforced in different jurisdictions. Examples from two states serve to make this point.

Consider purchasing a home in Virginia. The home is built by a design-build firm and includes a pool. Construction of the pool is subbed out to a specialty contractor who signs a subcontract with the builder but not the purchaser. After the purchase, the pool develops leaks, causing damage to the home's foundation. In Virginia, the owner, generally speaking, cannot successfully pursue a tort claim against the pool contractor because this claim is barred by the economic loss rule. *See Sensenbrenner v. Rust, Orling & Neale, Architects, Inc.*, 374 S.E.2d 55 (Va. 1988). Moreover, the owner does not have a contract with the pool contractor; so, absent a warranty, the owner cannot sue the pool

contractor for breach of contract. The only option for the owner in this case is a breach of contract suit against the builder. Your lawsuit options are even more limited if you are the second owner of the home. In this case, absent a warranty from the contractor or subcontractor, your only option would likely be to sue the person from whom you bought the home for breach of contract. Of course, your ability to recover against the seller in this case is typically very limited by the terms of the purchase and sale agreement.

Now, consider a similar home built in North Carolina. North Carolina has created an exception to the economic loss rule that protects downstream home purchasers. As a result, in North Carolina the first purchaser of the home could likely sue the pool contractor in tort. Moreover, subsequent purchasers of the home could potentially sue both the builder and the pool contractor in tort. *See Ellis v. Louisiana-Pacific Corporation*, 699 F.3d 778, 2012 U.S. App. LEXIS 22588, *3-20 (4th Cir. 2012).

These cases illustrate the way in which different states have taken widely-divergent approaches to the economic loss rule, and the need to do a close analysis of the law in a particular jurisdiction before attempting to apply the rule.

Recent Limitations on the Economic Loss Rule

Plaintiffs' attorneys have recently advanced a number of arguments that would limit the impact of the economic loss rule and expand the class of cases sounding in tort. The most successful of these efforts has been the "sudden" or "potential risk" exception to the rule. *See U.S. Gypsum Co. v. Mayor and City Council of Baltimore*, 647 A.2d 405, 410 (Md. 1994) ("Even where a recovery, based on a defective product, is considered to be for purely economic loss, a plaintiff may still recover in tort if the defect creates a substantial and unreasonable risk of death or personal injury."); *Northern Power & Engineering Corp. v. Caterpillar Tractor Co.*, 623 P.2d 324 (Alaska 1981) (permitting a tort action if: (1) the allegedly defective product creates a potentially dangerous situation to persons or other property, and (2) the alleged loss is a proximate result of that danger and occurs under dangerous circumstances).

These arguments were exemplified in thousands of Chinese drywall cases filed in many states over the last several years. Plaintiffs in these cases typically claim potential damage or threatened injury related to their family's health and safety due to alleged defects in the specific type of drywall installed in their homes. Significantly, despite a lack of physical injury, a number of judges have declined to apply the economic loss rule as a bar to claims in these cases. *See, e.g.,* In re: Chinese Manufactured Drywall Prods. Liab. Litig., MDL No. 2047, 680 F. Supp. 2d 780 (2010).

While the "sudden" or "potential risk" exceptions may have appeal in terms of protecting public safety, these unfortunately are exceptions that have the potential to swallow the rule, in-so-far as a sharp attorney can argue that nearly any defective product or workmanship has the potential to create a substantial risk of personal injury.

Another developing argument undercutting the economic loss rule is the suggestion that whether the rule applies depends on whether a contract exists between the parties. *See Ellis*, 2012 U.S. App. LEXIS 22588, *12-13 (analyzing and citing to relevant cases). While a contract between parties is clearly a prerequisite for a contract claim, the absence

of a contract should not, alone, justify allowing a tort claim. Analyzing the applicability of the economic loss rule solely in terms of the existence of a contract has the potential to open every human endeavor not involving a contract to tort standards of care, and could have the perverse effect of discouraging contracts.

The Integrated Product Doctrine

The integrated product doctrine is really a component of the economic loss rule. As noted above, most jurisdictions allow tort actions where the allegedly defective work or product results in physical injury to "other property." This raises a critical and heavily-litigated question: what constitutes "other property"?

The integrated product doctrine and the issue of what constitutes "other property" were addressed by the U.S. Supreme Court in *East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858 (1986), the now-seminal case on this issue. In that case, Transamerica manufactured propulsion systems. When these systems ultimately failed as the result of certain defects, only the system itself was damaged. East River Steamship sued Transamerica under negligence and products-liability tort-law theories. The District Court found that the claims did not sound in tort because the propulsion system injured only itself. Therefore, the claims sounded in warranty (contract) rather than tort. *See East River Steamship Corp. v. Transamerica Delaval Inc.*, The Oyez Project at IIT Chicago-Kent College of Law, http://www.oyez.org/cases/1980-1989/1985/1985_84_1726 (last visited December 21, 2012).

On appeal, the U.S. Supreme Court considered the following question: "when a product fails as a result of design and manufacturing flaws, damaging only itself and causing only economic harm, can the owner of the product bring suit against the manufacturer under the negligence or products-liability doctrines of tort law?" *Id.* The Court held no, and concluded "that when a defective product injures only itself and causes only economic harm, tort law claims do not apply." *Id.*

The rationale behind this holding is that when a product causes damage only to itself, "the reasons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong." *Id.* While the U.S. Supreme Court in *East River* dealt with a purely commercial dispute, the majority of courts have applied this rule to individual plaintiffs. *See Alloway v. General Marine Industries*, 695 A.2d 264 (N.J. 1997) (collecting majority and minority rule cases). As a result, if defective work or a defective product injures only itself, tort claims are generally not permitted.

How to Define the Product

The key to dealing with the integrated product doctrine is defining the product. For purposes of determining whether "other property" was damaged, courts typically define the "property" as the property purchased by the plaintiff. Variations on this test exist, but an example may prove helpful in explaining the concept:

A light switch in a building is alleged defective and claimed to be the cause of an electrical fire that destroyed the entire building. The switch was an original part of the building, as constructed by the general contractor and its subs. The plaintiff was the

original owner of the building. The switch cost less than a dollar for ABC Switch Co. to manufacture. Replacement value would be slightly higher. The completed building, however, was worth several hundred thousand dollars. Unlike traditional product liability cases, there was no personal injury. Plaintiff, the owner of the building, sues the manufacturer of the light switch in tort seeking to collect the full replacement value of the building. In this situation, the court would likely define the integrated product or the "property" as the building because that is what the plaintiff purchased. The light switch was one of countless components of the building. As a result, with regard to this plaintiff, nothing was damaged other than the product itself (i.e., the building). As a result, tort claims against the light switch manufacturer are barred, and the plaintiff is limited to contract or warranty claims. *See, e.g., Sea-Land Service, Inc. v. General Electric Co.*, 134 F.3d 149 (3d Cir. 1998).

Of course, who the plaintiff is in this scenario makes all the difference. If the plaintiff is the contractor who purchased the switch, then arguably, "other property" has been damaged and the plaintiff may pursue a tort claim against manufacturer or supplier.

Recent Construction Industry Challenges to the Integrated Product Doctrine

A hot topic with regard to the integrated product doctrine is whether a person's home should be considered a single integrated product for purposes of manufacturers and suppliers raising this defense. *See Dean v. Barrett Homes, Inc.*, 8 A.3d 766 (N.J. 2010) (rejecting the integrated product doctrine defense in finding that the particular siding at issue was not integrated into plaintiffs' home).

In *Dean*, the manufacturer of an allegedly defective Exterior Insulation and Finishing System ("EIFS") argued that because EIFS is an integrated part of a home, the economic loss rule and integrated product doctrine shielded it from liability for mold damage that the plaintiffs claimed the EIFS caused to their home. The trial court agreed, awarding summary judgment to the EIFS manufacturer, and the Appellate Division affirmed. The New Jersey Supreme Court reversed, however, finding that the EIFS was not "sufficiently integrated into the home to become a part of the structure for purposes of broadly applying the economic loss rule." *Id.* at 775-76. This departed from existing New Jersey and federal case law, including an Appellate Division opinion in *Marrone v. Greer & Pollman Construction Inc.*, 964 A.2d 330, 336 (N.J. Super. App. Div. 2009), which held that the integrated product doctrine shielded a manufacturer of EIFS from liability for damage to the plaintiff's home because "the house is the 'product,' and it cannot be subdivided into component parts for purposes of supporting a [Product Liability Act] cause of action."

The *Dean* court attempted to explain its rationale for departing from the existing case law: "Particularly in the case of houses, a product that is merely attached to or included as part of the structure is not necessarily considered to be an integrated part thereof." *Id.* at 775. The New Jersey Supreme Court relied, in part, on asbestos cases in which courts have taken the position that contamination constitutes harm to the building as other property, and also two cases from the California Supreme Court holding that the integrated product doctrine did not bar recovery for structural damages to houses caused by defective windows and a faulty foundation. *Id*. at 775-76.

One year later, in *Adams Extract & Spice, LLC v. Van De Vries Spice Corp.*, Civ. No. 11-720, 2011 U.S. Dist. Lexis 147851 (D.N.J. Dec. 23, 2011), a federal district court in New Jersey narrowly interpreted the New Jersey Supreme Court's decision in *Dean* and accepted the integrated product doctrine defense by a third-party defendant in a case relating to a food manufacturer's claim for damages resulting from a recall of a blend of spices sourced by multiple suppliers. Despite the *Dean* decision, the district court in *Adams* found the spice blend to be an integrated product, *id*. at *10-*11, *15, and found *Dean* clearly distinguishable, noting that the *Dean* opinion itself stated that houses are particularly unique. *Id*. at *12. While *Adams* was not a construction industry case, it provides a clue that other courts also may narrowly interpret *Dean* as applying only to homes and permit the broad protections of the economic loss rule and integrated product doctrine as a viable defense for a wide range of other construction projects and products.

Defense Strategies

Because states have varying applications of these defenses, the first step in determining whether your client has a viable economic loss rule or integrated product doctrine involves determining which jurisdiction's law will apply and then becoming intimately familiar with the application of and exceptions to the rule in that jurisdiction.

If you conclude that your situation may be within the ambit of these rules, then you will likely need to determine how to define the product to your client's advantage. Next, there is a timing issue to be considered in terms of when to raise these defenses. The timing issue is best discussed with clients as soon as you determine that the defenses apply. In some jurisdictions, these defenses may be considered affirmative defenses, and as such, need to be identified in your answer, if you are aware of them at that time. In other jurisdictions, it may be possible to wait. In either case, you will ultimately need to decide when and how to seek dismissal of the claims subject to these defenses. Raising the economic loss rule or integrated product doctrine early on may be appealing to a client who is not eager to pay litigation costs for a year or more of fact discovery. If all goes well, advising a plaintiff's attorney of these defenses early in a case or even pre-litigation can result in a swift and inexpensive defense victory. Unfortunately, raising these defenses too early in a case where the facts do not unequivocally support these defenses may simply give plaintiff the opportunity to amend its complaint to defeat the defenses or to fit its claims into the narrow exceptions recognized in some jurisdictions (as discussed above). In such cases, skilled defense counsel should choose to make use of early fact discovery to lock-in plaintiff's position and to obtain testimony from non-parties with relevant information. Once these facts have been "locked-in" – and ideally after the time for the plaintiff to amend the Complaint has long passed – the defense may safely move for summary judgment pursuant to the economic loss rule and integrated product doctrine. The downside with this strategy is increased defense costs in discovery.

The last reasonable time to raise these defenses before trial is usually the deadline for dispositive motions. Plaintiff, of course, cannot object to the timing of a summary judgment motion at this stage. Unfortunately, the defendant by this point has expended significant funds in defending the case, although far less than if the case proceeds to trial.

In any event, in the process of determining when to raise the economic loss rule or integrated product doctrine, it is essential to engage the client in an early discussion analyzing the potential viability of these defenses and the cost of related discovery. Ideally, the scope of discovery and timing of any dispositive motions based on these defenses should be set forth in a litigation plan, so as to avoid any misunderstanding regarding the pros and cons of pursuing these defenses.

Conclusion

The economic loss rule and the integrated product doctrine play a key role in limiting damages to contractual measures and precluding more unpredictable tort causes of action. While both doctrines can be easily summarized, they can be uncommonly difficult to apply. As a result, it is necessary to undertake a close analysis of the law in the potentially relevant jurisdictions before attempting to apply these rules.

Finally, issues with regard to when to raise these defenses can be significant. In some cases raising them early can end the litigation; in others, raising them too early serves only to afford the plaintiff an opportunity to develop effective counter-arguments. In any event, in the process of determining when to raise the economic loss rule or integrated product doctrine, it is essential to engage the client early in a discussion analyzing the potential viability of these defenses and the cost of related discovery. A sound litigation plan, with the client's informed input, will allow you to make the most effective use of these defenses while limiting, as much as possible, the client's litigation expenses.

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