

# THE ECONOMIC LOSS DOCTRINE IN BLUEGRASS CONSTRUCTION CASES

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The economic loss doctrine is a misunderstood creature, an enigma of the law, which first was adopted by the U.S. Supreme Court in 1986 in the context of admiralty law.<sup>1</sup> If properly utilized, the economic loss doctrine is one of the most powerful defenses of any tort case, and especially appropriate in the realm of construction law.

Under the economic loss doctrine, privity of contract, or alternatively, a nexus sufficient to establish a substitute for parties entering into an actual contract, is required where a plaintiff sues a defendant for purely economic loss. Courts hold that recovery for economic loss is solely the subject for contract negotiation and breach of contract suits. Three policies support applying the economic loss doctrine to commercial transactions: (1) it maintains the historical distinction between tort and contract law; (2) it protects parties' freedom to allocate economic risk by contract; and (3) it encourages the party best situated to assess the risk of economic loss, usually the purchaser, to assume, allocate, or insure against that risk.<sup>2</sup>

Courts frequently disagree as to the scope of the doctrine, and only recently has the doctrine been applied to construction cases in the state of Kentucky. Indeed, it was just five years ago that Kentucky Supreme Court chartered "a course in what commentators and courts across the country have referred to as the 'choppy waters' of the economic loss rule."<sup>3</sup>

## What is Economic Loss?

"Economic loss" in tort claims is generally defined as "damages for inadequate value, costs of repair and replacement of the defective product, or consequent loss of profits-without any claim of personal injury or damage to other property [and] also encompasses the diminution in the value of the product because it is inferior in quality and does not work for the general purposes for which it was manufactured and sold."<sup>4</sup>

In the context of construction, "economic loss" includes "the cost to repair or replace defective materials, damage to a structure, diminution in value of a damaged structure not repaired, loss of use or delay in utilizing property for its intended purposes, and related lost profits, lost revenue, and costs."<sup>5</sup>

In sum, economic losses are intangible losses that do not arise from tangible physical harm to persons or property.

## Adoption of the Doctrine in Kentucky

In 2011 the Kentucky Supreme Court, for the first time in its history, explicitly adopted the economic loss doctrine. In *Giddings & Lewis, Inc. v. Indus. Risk Insurers*, Ingersoll Rand bought a Diffuser Cell System used to cut and shape metal parts from Giddings & Lewis, Inc.<sup>6</sup> After seven years of virtually continuous operation and after the express warranty expired, an incident occurred in which the clamp, the pallet, and a large chunk of spinning metal flew off the vertical turning lathe and catapulted around the workspace in Rand's plant in "spectacular fashion." For perspective, the clamp weighed 3,400 pounds, the pallet 1,500 pounds, and the chunk of metal approximately 300 pounds. No one was injured and damage to property beyond the Diffuser Cell System itself, if any, was minimal.

In turn, Rand engaged Giddings to rebuild the System and filed a claim with Rand's insurers, which paid \$2,798,742.00 for repairs to the damaged machinery, overtime payments to employees, and related expenses. The insurers then sued Giddings to recover the amounts expended, claiming breach of implied warranty, breach of contract, negligence, strict liability, negligent misrepresentation, and fraud by omission.

The Kentucky Supreme Court reaffirmed the ruling of the trial court, granting summary judgment to Giddings on the tort claims, ruling the tort claims (except fraud by omission) were barred by the economic loss rule. According to the

Court:

"Today we hold that the economic loss rule applies to claims arising from a defective product sold in a commercial transaction, and that the relevant product is the entire item bargained for by the parties and placed in the stream of commerce by the manufacturer. Further, the economic loss rule applies regardless of whether the product fails over a period of time or destroys itself in a calamitous event, and the rule's application is not limited to negligence and strict liability claims but also encompasses negligent misrepresentation claims. As for the impact of the rule on fraud claims, that issue awaits another case because the plaintiffs in this case pled fraud by omission, a claim that is unsustainable on the record before us, irrespective of the economic loss rule."<sup>7</sup>

In this case, all or virtually all of the damages which the insurers sought to recover were economic losses, i.e., repair/replacement costs for the Diffuser Cell System, costs associated with Rand's contracting work to outside companies, in-house overtime, and other miscellaneous costs. Accordingly, the trial court correctly concluded the negligence and strict liability claims seeking those types of damages should have been dismissed based on the economic loss doctrine.<sup>8</sup>

## Application of the Doctrine to Construction Cases

Although an unpublished case of limited precedential value, in *Cincinnati Ins. Cos. v. Staggs & Fisher Consulting Engineers, Inc.*, a Kentucky court for the first time held the economic loss doctrine applies in the context of construction litigation.<sup>9</sup> That case involved a



construction project in Nunn Hall on the campus of Northern Kentucky University. The Commonwealth of Kentucky contracted with Omni Associates to design the project, and Omni subcontracted with S&F to work on the project. The Commonwealth separately contracted with Messer Construction for the construction of the project. Messer Construction then entered into a subcontract with Banta for the electrical work on the project.

Nunn Hall incurred damage attributable to Banta's electrical work. As a result, Banta's insurer, Cincinnati Insurance Companies, paid the Commonwealth \$18,460.19 for property damage.

Cincinnati filed suit against Omni and S&F, claiming their negligent installation of a faulty transformer caused the damage to the transformer in Nunn Hall. Cincinnati sought recovery of the amount it was required to pay on behalf of Banta. Omni and S&F filed a motion to dismiss for failure to state a claim, contending the economic loss rule precluded the legal action. The trial court agreed, granting the motion and dismissing Cincinnati's complaint.

The Court of Appeals affirmed, reasoning the Commonwealth's contracts with Omni and S&F were entirely separate from its contracts with Messer and Banta. As such, there could be no contractual relationship or privity between Banta and either Omni or S&F. As the subrogee, Cincinnati "stepped into the shoes" of Banta. Accordingly, "since Banta would be prohibited by the economic loss rule from pursuing a negligence claim for economic damages against Omni or S&F, Cincinnati is similarly prohibited."<sup>10</sup>

## Future Use of the Doctrine in Construction Cases?

How Kentucky courts will interpret and apply the economic loss doctrine in the world of construction litigation remains unclear.<sup>11</sup> Indeed, the "choppy waters" alluded to earlier is on point. Various Kentucky state and federal courts have referenced several potential limitations

and exceptions to the doctrine, noted below:

• **The "Other Property" Exception:** Absent contractual privity, recovery for economic loss under tort theories is legally justified if economic loss is a consequence of a tortious invasion of legally cognizable personal or property rights causing personal injury or property damage to "other property."<sup>12</sup> This exception focuses on the scope of claimed damage. If the product in question is not only defective, but also caused personal injury or additional property damage to property other than just the product in question, the doctrine may not apply. However, as noted in *Giddings*, the other property damage must be more than "minimal" to escape the doctrine.

• **The "Special Relationship" Exception:** Absent contractual privity, recovery for economic loss under tort theories is legally justified if there is a legally protected "special relationship."<sup>13</sup> What exactly a special relationship is remains unclear. However, this exception could be especially important on a construction site. For instance, if a subcontractor or design professional is given power to control or stop a project, a special relationship may be present.

In sum, the economic loss doctrine is a powerful tool to limit and potentially eliminate damages in any tort lawsuit where privity of contract between the parties is lacking. The doctrine is especially useful in the world of construction litigation.

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<sup>1</sup> *East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 866, 106 S. Ct. 2295, 90 L. Ed. 2d 865 (1986).

<sup>2</sup> *Giddings & Lewis, Inc. v. Indus. Risk Insurers*, 348 S.W.3d 729, 739 (Ky. 2011).

<sup>3</sup> *Id.*

<sup>4</sup> *Hack v. Lone Oak Dev., Inc.*, 2008 Ky. App. LEXIS 188, \*22 (Ky. Ct. App. June 13, 2008).

<sup>5</sup> 6 Bruner & O'Connor Construction Law § 19:10 (2012).

<sup>6</sup> 348 S.W.3d 729 (Ky. 2011).

<sup>7</sup> *Id.* at 733.

<sup>8</sup> *Id.* at 739.

<sup>9</sup> 2013 Ky. App. Unpub. LEXIS 227 (Ky. Ct. App. Mar. 15, 2013).

<sup>10</sup> *Id.* at \*10.

<sup>11</sup> *NS Transp. Brokerage Corp. v. Louisville Sealcoat Ventures, LLC*, No. 3:12-CV-00766-JHM, 2015 U.S. Dist. LEXIS 28314, 2015 WL 1020598, at \*5 (W.D. Ky. Mar. 9, 2015) (finding the economic loss doctrine does not apply to construction service contracts to prepare and then sealcoat and stripe the surface of a large asphalt lot).

<sup>12</sup> *Cincinnati Ins. Cos. v. Staggs & Fisher Consulting Engineers, Inc.*, 2013 Ky. App. Unpub. LEXIS 227 (Ky. Ct. App. Mar. 15, 2013).

<sup>13</sup> *Id.* See, e.g., *Clevecon, Inc. v. Northeast Ohio Regional Sewer Dist.*, 90 Ohio App.3d 215, 628 N.E.2d 143 (1993) ("The power of the architect to stop the work is tantamount to a power of economic life or death over the contractor. It is only just that such authority, exercised in such a relationship, carry commensurate legal responsibility"); *Nicholson v. Turner/Cargile*, 107 Ohio App. 3d 797, 669 N.E.2d 529 (1995) (a design professional who exercises "excessive control over the contractor" through the power to stop the work and give orders about the project is liable for such economic damages).

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