

# **ECONOMIC LOSS RULE UPDATE**

## **2015 ANNUAL CONSTRUCTION SYMPOSIUM**

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# WHAT IS THE ECONOMIC LOSS RULE?

In Texas, the economic loss rule has been applied to preclude tort claims in two related contexts: (1) where the losses sought to be recovered are the subject matter of a contract between the parties; and (2) when the claims are for economic losses against the manufacturer or seller of a defective product where the defect damaged only the product and did not cause personal injury or damage to other property.

# DAMAGES

- “Economic damages”
  - Defined as compensatory damages intended to compensate for actual economic or pecuniary loss.
  - It does not include exemplary damages or non-economic damages.
  - An example of economic damages are a plaintiff’s actual medical expenses incurred that relate to the cause of action.

# THE ELR IN CONSTRUCTION DEFECT LITIGATION

- The Rule has been used as a shield by subcontractors from liability in litigation
- Subs generally have no privity of contract with a plaintiff
- Increasingly, subs have sought the ELR as a defense by having the damages sought claimed as a “economic” and having the tort claims dismissed

# ECONOMIC LOSS RULE v1.0

- Traditionally, the rule was used in products liability cases
- Application in products context is not difficult to understand

# APPLYING ELR TO CONSTRUCTION DEFECT LITIGATION

- Texas Supreme Court first applied the rule in a construction defect case in the 1986 Jim Walter Homes v. Reed decision



# JIM WALTER HOMES V. REED

In *Reed*, the plaintiffs were dissatisfied with the quality of a house they had contracted to buy from the builder and sued for actual and exemplary damages, alleging breach of warranty (contract theory) as well as negligent supervision of construction (tort theory). *Id.* In reversing an award of exemplary damages to the plaintiffs, the Texas Supreme Court held that if the injury is only the economic loss of the bargained-for subject of a contract, the action is in contract alone.

# LOUISIANA EX. REL. GUSTE V. M/V TESTBANK

The Fifth Circuit held that the “economic loss” rule precluded businesses along the Mississippi River from recovering lost profits when a spill from the defendant's ship blocked traffic on a portion of the River. The plaintiffs did not suffer property damage or personal injury.



# LOUISIANA EX. REL. GUSTE V. M/V TESTBANK

The most important fact of the *Testbank* decision is the fact that none of the parties were in contractual privity with one another. The Fifth Circuit had applied the “pure economic loss” rule that was born of products liability towards that case involving the secondary economic losses suffered from a chemical spill in the Mississippi River by businesses who were affected by the cessation of river traffic during cleanup.

## **The 2000s: *Reed* and *Testbank* Doctrines Merged**

**In the early 2000s, the *Reed* and *Testbank* interpretations were morphed together by various decisions of the intermediate Texas courts of appeals.**

**These cases held that the economic loss doctrine does not apply only to bar claims against those in a direct contractual relationship; it also applies to preclude tort claims between parties who are not in privity, provided that the ultimate source of the loss involved a contract upon the plaintiff can seek recovery.**

# ***The American Aviation Decision***

The first application of the *American Aviation* interpretation of the rule regards the general prohibition against tort actions to recover solely economic damages for those in contractual privity. The case stated that this rule is designed to prevent parties to a contract from circumventing the allocation of losses set forth in the contract by bringing an action for economic loss in tort. *American Aviation, Inc.*, 891 So.2d at 536. Citing *Ginsberg v. Lennar Fla. Holdings, Inc.*, 645 So.2d 490, 494 (Fla. 3d DCA 1994) (“Where damages sought in tort are the same as those for breach of contract a plaintiff may not circumvent the contractual relationship by bringing an action in tort.”).

# Economic Loss Rule v2.0

- By the beginning of the 2010s, the ELR had grown well beyond the simple product liability doctrine or even what seemed contemplated by the *Reed* decision
- The rules from the various Courts of Appeal had crafted a “new” ELR
- This new version would be tested by the *Sharyland* case

# SHARYLAND WATER SUPPLY

- Sharyland Water Supply Corporation v. City of Alton, Carter & Burgess, Inc., Cris Equipment Company, And Turner, Collie & Braden, Inc.
- Decided October 21, 2011
- Several Issues Before The Court Including Governmental Immunity, Chapter 33, Joint and Several, and Interpretation of 30 TAC 317.13



# FACTS

- Early 1980's-Alton constructed a potable water distribution system for residents
- Water supply agreement -- Alton conveyed water distribution system to Sharyland which would maintain system and provide water to residents
- 1994 -- Alton received grant for construction of sanitary sewer

# FACTS

- Alton contracted with Carter & Burgess; Turner, Collie & Braden and Cris Equipment to build a sanitary sewer system
- 1999 -- Construction completed
- 2000 -- Sharyland sues claiming sewer lines installed in violation of state regulations with respect to proximity and location of sewer lines to water lines

# TRIAL COURT

- Jury found Alton breached agreement and that three contractors breached their contracts and Sharyland was a third-party beneficiary
- Jury awarded identical damages for each of three claims: \$14,000 in past damages and \$1,125,000 in future damages

# COURT OF APPEALS

- Court of appeals held Alton waived immunity but that damages were not for “balance due and owed” local gov’t code 271.153) and Sharyland could only recover attorneys’ fees for declaratory judgment action (re application of 30 TAC 317.13) against Alton

# COURT OF APPEALS

- Court of appeals concluded that economic loss rule barred Sharyland's negligence claims and that Sharyland was not a third-party beneficiary for the contractors' breach
- Also held that where there is an absence of privity of contract or an absence of third-party beneficiary status, economic damages are not recoverable unless they are accompanied by actual physical injury or property damage



# COURT OF APPEALS

- The Court of Appeals decision took the ELR further than ever
- Note, Sharyland Water was not a party at all to the project to build the sewer – it complained that it was a stranger
- The Court held that since no physical damage occurred, these were economic losses barred by the ELR
- No court ever said that before

# SUPREME COURT DECIDES

- In October 2011, the Supreme Court issued its first major decision on the ELR since 1991 in the appeal of the Sharyland case

# DISCUSSES THE PURPOSE AND HISTORY OF THE ELR

- The Court analyzed the entire line of cases discussing the economic loss rule and concluded that the ELR was overused as a shield from liability leaving no recourse for parties who have been injured by others in the market place.

# SUPREME COURT ON THE SCOPE OF THE ELR

- The Court went into an in depth criticism of the Court of Appeals reasoning stating:
- “Merely because the sewer was the subject of a contract does not mean that a contractual stranger is necessarily barred from suing a contracting party for breach of an independent duty. If that were the case, a party could avoid tort liability to the world simply by entering into a contract with one party.”

# SUPREME COURT CRITICISM

- “The court of appeals’ blanket statement also expands the rule, deciding a question we have not—whether purely economic losses may ever be recovered in negligence or strict liability cases.”
- Clearly the Court appeared to be heading towards a major rollback of the ELR, when...



# SUPREME COURT REVERSES ON LIMITED GROUNDS

- The Court held that the scope of the ELR was not at issue in the case:
- “This is an area we need not explore today, however, because the Court of Appeals erred in concluding that Sharyland’s water system had not been damaged”

# BASIS BEHIND REVERSAL

- Supreme Court's only basis for reversal was that they believed that the need for Sharyland to replace or retrofit their water lines was property damage that is not the subject matter of any contract for the "product."
- Thus, the decision can easily be reconciled with *Reed*

# Reaction to Sharyland

- *Sharyland* seemed to definitely signal the beginning of a shift towards reigning in the ELR
- However, *Sharyland* attempted to reconcile its holding with Reed
- It never sought to overturn it
- Regardless, observers believed that the time was right to reign in the ELR

# The *Eby* Decision: Back to the Future?

- In the post-*Sharyland* context the Supreme Court once more issued a major ELR holding in 2014
- In *LAN/STV v. Martin K Eby Construction* the Court was asked to resolve the question of whether contractors could directly sue an owner's design firm when faulty plans result in delay damages

# Eby Facts

- Claim for negligent misrepresentation
- Eby, the general contractor, recovered from LAN delay damages for design errors on a DART project
- Claimed damages for out of pocket expenditures based upon reliance on the plans
- Trial court found LAN negligently misrepresented the plans through errors



# Court of Appeals

- In 2011, the Dallas Court of Appeals heard LAN's appeal
- LAN relied upon the ELR
- Dallas Ct determined that since the out of pocket expenses were independent of any breach of contract claim Eby had against DART
- Declined to use ELR; very similar holding to Sharyland

# Economic Loss Rule v3.0?

- Texas Supreme Court elects to apply the ELR in Eby
- Goes through another long historical analysis of ELR
- Notes that even though Eby and LAN are contractual strangers, there is a joint project relationship

# Restatement Approach

- Rather than reliance on caselaw as in Sharyland, an effort is made to rely upon the Restatement (Third) of Torts
- The Court found that this scenario created a form of “unintentional infliction of economic loss”
- The Court declined to accept this quasi cause of action

# Practical Considerations

- The Court was highly concerned about the nature of a construction project, which consists of a “silo of vertical contracts”
- This distinguished Sharyland by essentially creating a form of vertical contractual privity between the contractor and the design professional
- This was done to avoid risk of all contractors/stakeholders suing up the chain for delay damages

# Implications

- For construction claims – this means that the ELR is alive and well
- Sharyland is likely restricted solely to entities with claims that are outside of the project entirely
- Any end of reliance on ELR will probably have to come from a reversal of the Reed decision



# For More Information...

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