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Shifting Sands beneath the Economic Loss Doctrine in Washington

For more than a decade, design professionals in Washington have been able to rely upon the economic loss doctrine as a bulwark against many third party claims and certain types of negligence claims from their clients. However, two recent Washington State Supreme Court decisions have created great uncertainty about the future of the economic loss doctrine in this state. As a consequence, design professionals are advised to re-evaluate their risks of claims in the near term.

Background

The economic loss doctrine (ELD) is a policy adopted by the courts to determine the parameters for assessing claims that may be asserted in either tort or contract. The doctrine has evolved over the past few decades to the form we know today. It was originally conceived of and applied in the context of consumer protection cases, but was subsequently applied in other areas of the law, including, and specifically, construction law. Various states accept the doctrine, and Washington has been among those with a long -- and strong -- history of recognizing the ELD with a particular emphasis in enforcing it in the construction arena.

Courts have historically considered the nature of claimed damages -- whether the damages are purely "economic" in nature or whether they involve injury to persons or other property -- in deciding the proper boundaries for tort and breach of contract claims. In Washington and most other jurisdictions recognizing the ELD, when the damages sought are essentially economic in nature (i.e., lost profits, cost overruns, project delays) and the parties have allocated the risk of economic loss in their contracts, the courts have held that only a breach of contract claim is permitted; as a consequence, only a party in contractual privity may recover from the party alleged to be at fault. On the other hand, when a claim involves an injury to a person or damage to other property, any injured party may assert a tort claim, such as professional negligence, against the responsible party, regardless of whether any contractual relationship exists between the two.

By way of differentiating "economic" damages from those that are not, one early court considering a consumer product safety claim used the hypothetical of a consumer who has purchased a defective lawn mower to illustrate how the economic loss rule should work. In this hypothetical, if the lawn mower doesn't work because it fails to mow the grass, or if the engine malfunctions and is ruined, the consumer has lost the benefit of the bargain in purchasing the faulty equipment and may sue the store that sold the lawnmower for *breach of contract*; the consumer, however, is barred from suing the manufacturer (with whom the purchaser had no contract at all) in tort for negligently building the machine. Why? Because damage that is limited to only the thing itself, and which is the subject of the seller/purchaser contract, is "economic" damage; and as a matter of policy, economic damage is compensable only through a breach of contract claim.

If, on the other hand, the defective lawnmower explodes and not only damages itself, but also

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injures someone, or damages other property besides the lawnmower, then as a matter of policy, the consumer may sue *in tort* for the *negligent* construction of the machine. Moreover, the consumer may sue both the seller *and* the manufacturer, even absent any contract between the consumer and manufacturer. The policy is commonsensical: injuries that include bodily harm or damage to other property properly fall within the basic duty we all have to each other to use reasonable care in our dealings.

This same analysis has been applied to the construction industry in Washington and many other states. Contracts are intended to address the *financial* expectations of the parties; accordingly, a remedy pursuant to contract is the proper means by which to address disputes about purely economic issues. However, when a construction project results in damage to persons (i.e., injured worker or third party) or other property (i.e., neighboring property damage), then the courts permit a tort claim to be asserted to protect those interests.

Consequently, for purely economic losses, third parties, such as contractors not in contractual privity with a design professional, have been barred from asserting tort claims. Moreover, even a party in privity with a design professional, such as a project owner, can only bring a breach of contract claim when the damages at issue are economic in nature. So, for example, in the traditional "design-bid-build" model, where an architect has a contract with an owner, who in turn has a contract with the builder, the builder is barred from asserting a claim directly against the architect for economic damages, such as undue delay or cost overruns. Likewise, in such contracts, the owner in privity with the architect is limited to contractual remedies only -- the owner is barred from pursuing a *tort* claim for economic losses.

The policy rationale behind the ELD makes sense especially in the construction industry. Typically in this area of commerce, sophisticated parties have negotiated an agreement which allocates risks and rewards fairly and knowingly. The contract between parties creates a legal relationship to each other that makes risks more predictable and, thus, reasonably quantifiable. In one of Washington's leading cases, *Berschauer/ Phillips Constr. Co. v. Seattle School Dist. No. 1*, decided in 1994, the state Supreme Court went to great lengths to specifically endorse this policy for the construction industry as a means of achieving the goals of reasonable risk allocation, price certainty and greater commercial security for parties to construction projects.

It was this very certainty that for several years has provided design professionals both stable predictability in contracts and, equally important, an effective shield in litigation from certain tort claims brought by owners and contractors alike.

What has changed?

In November, the Washington Supreme Court issued decisions in two cases: *Eastwood v. Horse Harbor Foundation, Inc., et al*, and *Affiliated FM Insurance Co. v. LTK Consulting Services, Inc.* Both cases address the economic loss doctrine in Washington. At best, these cases have significantly muddied the waters about how this doctrine will work going forward; at worst, these cases raise serious questions of whether the doctrine even exists anymore.

Much of the confusion is created by the fact that neither case contains a decision by the majority of the court; each is a "plurality" decision. Thus, there are questions about the extent to which these decisions will be precedent for subsequent cases and how these cases will be applied by the lower courts. In *Eastwood*, the "lead" opinion was joined by only two other justices; another opinion was signed by four justices, and concurred only in the result but not the analysis of the lead opinion; and the third opinion was signed by two justices, but concurred in part and dissented in part with the lead opinion. In *Affiliated FM*, there was a similar split of 2-4-3. Collectively, these varied plurality opinions present a fractured and unclear jumble of views about the reach and effect of the ELD in Washington going forward.

The first problem for design professionals now in evaluating their risks is that there is no clear rule to rely upon. Second, it appears from reading the various opinions that a majority of the court believes that Washington should no longer use the economic loss doctrine, but should apply a different test, known as the "independent duty" rule (discussed below). Finally, notwithstanding the plurality opinions and the ostensible rejection of the ELD, what is both hopeful, yet confusing, is that the court *did not reverse <u>any</u> of the previous cases that had applied the economic loss doctrine specifically in the construction area*.

As a consequence, we are left with two decisions that purport to substantially alter the ELD in Washington, yet don't disturb previous ELD decisions.

Eastwood v. Horse Harbor Foundation, Inc., et al

Eastwood involved a horse farm owner who leased a portion

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of his property to the defendant, a non-profit organization that rescued and cared for abused horses. Over the course of the lease, the defendant allowed the leased premises to fall into substantial disrepair and unsanitary conditions. The plaintiff ultimately sued for breach of the lease and for violation of Washington's "waste" statute, a legislatively-created tort. The waste statute imposes a duty on tenants to avoid unreasonable and improper use of rented space resulting in a landlord suffering material damage to property. At trial, the court found the defendants liable for both breach of the lease (a contract) and the tort of waste; the court further found that the defendants were "grossly negligent" in committing waste. The defendants appealed the gross negligence finding.

Although neither party raised the issue at the trial, the Court of Appeals chose to apply the ELD to find that the plaintiff's waste claim was barred. The appellate court reasoned that because the property damage was only to the thing itself -- the premises that was subject to a written lease -- the plaintiff's tort claim for waste was barred. The court relied on the fact that the plaintiff was able to successfully bring its breach of contract claim under which it could recover damages.

On appeal to the Supreme Court, all three plurality opinions rejected the Court of Appeals' application of the ELD under these facts. The "lead" opinion and one of the two concurring opinions argued that the blanket application of the economic loss rule to any case merely because of purely economic damages was improper and that a case-by-case analysis is more appropriate pursuant to the "independent duty rule." The second concurring/dissenting opinion argued that it was unnecessary to go that far, because the tort of "waste," as a legislative creation, cannot be barred by the economic loss doctrine, which is a judicial creation.

The key point from *Eastwood* worth noting is that between the lead opinion and the other concurring opinions, six of the nine justices supported application of the independent duty rule. As expressed in *Eastwood*, the independent duty rule would conceptually replace the economic loss doctrine regarding whether a tort claim may be brought by shifting the question from "whether damages are purely economic in nature" to "whether there is an independent tort duty to exercise due care outside of contractual obligations." To accomplish this analysis, the *Eastwood* justices advocate that the courts apply on a case-by-case basis "considerations of logic, common sense, justice, policy and precedent."

As mentioned above, what is both confusing, yet encouraging, is that the authors of the plurality opinions, who advocate applying "independent duty" analysis, actually discussed prior construction law cases where the ELD was applied as a bar to tort claims and nonetheless agreed that all of these cases were correctly decided. They also argued, however, that going forward, courts should not only not use the phrase "economic loss doctrine" and/or consider the nature of damages, but should apply an "independent duty" analysis to determine whether, regardless of contractual terms, a tort claim may properly lie.

Affiliated FM Insurance Co. v. LTK Consulting Services, Inc.

It is in *Affiliated FM* that *Eastwood*'s plurality endorsement of the independent duty rule is applied as a guiding principle.

The *Affiliated FM* case involved a fire on a crowded Seattle Monorail train in 2004 that necessitated a dramatic evacuation 50 feet above street level. No one was injured, but the monorail train sustained substantial damage. The lawsuit arising from this incident was brought by an insurance company that paid a property damage claim to the City (as owner of the monorail) and to a vendor. This vendor had contracted with the City to operate the monorail. Earlier, improvements and modifications to the monorail had been designed by the defendant engineer and these were alleged to have caused the fire. The vendor sought to recover lost profits from the engineer as a result of the monorail being out of service for repairs. The engineer asserted that because the damages were only to the thing itself (the monorail), and no person was hurt and no other property damaged, the vendor, who was not in privity with the engineer, was barred from asserting a professional negligence claim pursuant to the ELD.

This case was brought in federal court because the parties were based in different states. The federal trial court agreed with the engineer, applying Washington's ELD, and dismissed the vendor's negligence claim. The vendor appealed to the U.S. Ninth Circuit Court of Appeals, and that court elected to "certify" a question to the Washington Supreme Court, asking it to clarify how the ELD should work under these facts.

This case gives credence to the old legal adage that "bad facts make bad law." Most of the Supreme Court justices in this case were plainly troubled by the fact that a catastrophic tragedy had nearly occurred and were disinclined to consider barring a tort claim merely because the actual damages suffered were limited to the monorail. The lead opinion declared that because a fire broke out on the monorail allegedly because of bad engineering, it is appropriate for a third party not in privity with the engineer to be able to bring a tort claim for the lost

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business expectancy attributable to the engineer's negligent work. The lead opinion's logic is that because fires endanger the public and engineers should design to avoid fires, the engineer's independent duty to protect the public from safety hazards gives rise, as a matter of policy, to a right to sue for negligence, even when the claimant is not suing about bodily injury, but because it lost money.

What's a design professional to think?

These cases have created great uncertainty. Indeed, in the first two weeks since their issuance, we have seen opposing parties in two of our active cases assert that the economic loss doctrine is now dead and gone in Washington. It is plain that counsel for owners, contractors and other potential third party claimants will closely look for opportunities to bring negligence claims against design professionals that previously had been barred. Likewise, given the confusing nature of these decisions, there will very likely be a lack of predictability at the trial court level as various judges try to figure out whether the economic loss doctrine still exists and if so, in whatever form, how is it applied under this "independent duty" analysis. No doubt some courts will conclude the doctrine is indeed gone and perform its own independent duty analysis to reach its own conclusions as to whether a tort claim may lie against a design professional.

Although these recent decisions leave us with more questions than answers, we can predict that:

- In cases involving serious personal injuries or the risk of serious personal injuries, the design professional will be found to have an "independent duty" and will be exposed to a negligence claim, either from a party in contract or from a third party.
- In cases involving catastrophic damage to property other than the project itself, the design professional will be found to have an "independent duty" and will be exposed to a negligence claim, either from a party in contract or from a third party.
- In cases involving damage to the project property, uncertainty will reign as to whether the design professional will be exposed to tort claims from a party with whom he/she/it has contracted, in addition to the remedies and limitations in the contract, or from claims brought by a third party, especially the construction contractor.
- Even in cases with purely economic damages, aggrieved third parties will contrive to articulate theories intended to implicate some "independent" duty by which a tort claim can be asserted which was previously barred in this state.

It is too early to tell if we now face a sea-change in tort law exposure for design professionals.

- We recommend that all firms review their insurance programs with these new risks in mind. This review should extend not only to the forms and policy limits of professional liability insurance, but also to available general commercial liability coverage that may be available from owners and contractors and for which design professionals can be named as "additional insureds."
- Design professionals should also be mindful of builder's risk coverage and pay careful attention to subrogation clauses in these policies. The *Affiliated FM* case was actually a subrogation claim by a property carrier, who had paid on the property damage claim and then stood in the shoes of the vendor to bring the negligence claim against the engineer.
- Design professionals should pay careful attention to all indemnity and other risk-shifting clauses to be sure they comport with Washington law. This is especially true for limitation of liability and indemnity clauses.
- Probably the best defense against these risks is to pay careful attention to quality assurance in all aspects of the work of the firm. Most negligence-based claims can be avoided in the first place by instituting and maintaining the quality assurance/quality control practices and adhering to them.

Terence J. Scanlan

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Terence J. Scanlan will present a more detailed discussion on these two new cases and implications for design professionals at an ACEC-Washington breakfast seminar on Wednesday, January 12, 2011. Please contact Loy Young at ACEC-Washington (425-453-6655 or loy@acec-wa.org) for registration information.