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Drowning in a Sea of Confusion: Applying the Economic Loss Doctrine to Component Parts, Service Contracts, and Fraud

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DROWNING IN A SEA OF CONFUSION: APPLYING THE ECONOMIC LOSS DOCTRINE TO COMPONENT PARTS, SERVICE CONTRACTS, AND FRAUD

I. INTRODUCTION

The economic loss doctrine bars tort claims, and the broader damage awards associated with tort law,[1] when economic losses arise from a contractual relationship.[2] The doctrine was judicially developed to protect the right to allocate economic risks in contract.[3] By reinforcing the basic legal policy of forcing injured parties to pay for their own loss if no duty was breached, the doctrine maintains a fundamental distinction between tort and contract law.[4] It encourages commercial purchasers to consider and protect against economic risks because they are in the best position to consider the risk of loss associated with their use of a product or service.[5]

The economic loss doctrine has existed for more than forty years. Yet judges, lawyers, legal scholars, and practitioners spend countless hours arguing over its meaning, application, and scope. One of the reasons the doctrine causes such great confusion is that its application is not contained within any single discipline of the law. Economic loss functions where tort meets contract law, plays a major role in directing insurance and warranty law, applies to both strict liability and negligence, and affects cases both large and small.

Due to the doctrine's wide-ranging impact, courts struggle to find a universal definition and litigators frequently challenge its boundaries.[6] The vast confusion over this area of the law is demonstrated not only by the

1. RESTATEMENT (SECOND) OF TORTS § 901 (1979). Different purposes underlie damage awards in tort and contract law. While contract law seeks to put an individual in the place they would have been had the contract been performed, tort law seeks to put a person in a position equal to the state of affairs before the tort was committed. *Id.* at cmt. a. Tort law also seeks to punish wrongdoers, deter wrongful conduct, and vindicate parties; thus, punitive damages are appropriate. RESTATEMENT (SECOND) OF TORTS § 901(c)(d) (1979).

2. Digicorp, Inc. v. Ameritech Corp., 662 N.W.2d 652, 659 (Wis. 2003).

3. *Id.*; State Farm Mut. Auto. Ins. Co. v. Ford Motor Co., 592 N.W.2d 201, 204 (Wis. 1999).

4. East River S.S. Corp. v. Transamerica Deleval, Inc., 476 U.S. 858, 866 (1986).

5. *Digicorp*, 662 N.W.2d at 659.

6. Christopher W. Arledge, *Is the California Supreme Court Confusing the Boundaries of the Economic Loss Rule?*, 47 MY ORANGE COUNTY LAW. 22, 23 (2005). Arledge notes that the dividing line is challenged frequently in areas such as defective product litigation where tort law and contract law have traditional and substantial roles. *Id.*

language commentators use to describe the doctrine,[7] but also by the number of cases appealing misapplications of the doctrine.[8] Even in California, where the theory adopted by a majority of courts was first articulated,[9] on four occasions in the last seven years, cases reached the state's supreme court to clarify its dimensions.[10] Within this time, California appellate courts have aggravated the problem by reaching conclusions that are unsupported and contrary to the policy behind the economic loss doctrine.[11] In the end, even practiced litigators in this area find that these cases "leave[] lower courts and litigants with little understanding as to where the economic loss rule ends and standard tort law begins."[12]

Unfortunately, this very confusion destroys the societal value of the doctrine. Tort law is designed to maximize public welfare; thus, a law denying recovery when a competitive business suffers losses is a more efficient solution than allowing recovery under a negligence theory.[13] Where uncertainty leads to unnecessary lawsuits and settlements based on fear rather than an understanding of the law, the goals of tort law are defeated. The problem can be best illustrated by considering the most common situation where economic loss claims are raised.

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7. The economic loss rule has been called "one of the most confusing doctrines in tort law," R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789, 1789 (2000), "obscure," John J. Laubmeier, *Demystifying Wisconsin's Economic Loss Doctrine*, 2005 WIS. L. REV. 225, 225 (2005), and "a confusing morass," Indem. Ins. Co. of N. Am. v. Am. Aviation, Inc., 891 So.2d 532, 544 (Fla. 2004) (Cantero, J., concurring).

8. *See* Laubmeier, *supra* note 7, at 225 (finding that the doctrine was the subject at issue in forty-seven cases between 2000 and 2004 in either the Wisconsin Court of Appeals or the Wisconsin Supreme Court). Recent cases have also clarified elements of the economic loss doctrine in jurisdictions around the country. Me. Rubber Int'l v. Envt'l Mgmt. Group, Inc., 298 F. Supp. 2d 133 (D. Me. 2004); Indem. Ins. Co., 891 So.2d at 544; Prendiville v. Contemporary Homes Inc., 83 P.3d 1257 (Kan. Ct. App. 2004).

9. Christopher Scott D'Angelo, *The Economic Loss Doctrine: Saving Contract Warranty Law from Drowning in a Sea of Torts*, 26 U. TOL. L. REV. 591 (1995). *See also East River*, 476 U.S. at 868 (recognizing Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965), as the case that created the economic loss rule).

10. Robinson Helicopter Co., Inc. v. Dana Corp., 102 P.3d 268 (Cal. 2004); Jimenez v. Superior Court, 58 P.3d 450 (Cal. 2002); Aas v. Superior Court, 12 P.3d 1125 (Cal. 2000); Erlich v. Menezes, 981 P.2d 978 (Cal. 1999).

11. *See infra* notes 51–55 and accompanying text.

12. Arledge, *supra* note 6, at 22.

13. William Bishop & John Sutton, *Efficiency and Justice in Tort Damages: The Shortcomings of the Pecuniary Loss Rule*, 15 J. LEGAL STUD. 347, 347–48 (1986). The denial of damages is more efficient because allowing recovery would have an ultimate result of deterring conduct. If we assume that individuals contract only when the contract provides benefits in excess of not contracting, deterrence of desired terms is inefficient.

The economic loss doctrine is usually raised as an early defense to tort claims when the contracted-for work of the defendant disappoints the plaintiff. The plaintiff files suit and claims entitlement to both contract and tort remedies. The defendant responds by noting the terms of a warranty and moves to dismiss the plaintiff's tort claims because tort damages are not available due to the economic loss doctrine.[14] Negotiations ensue, but the parties cannot reach a settlement because the expectations of the plaintiff based on potential tort remedies greatly exceed the defendant's offer based only on contractual damages.[15] Although this simple example suggests that precedent would eventually find an efficient outcome, the fact-specific variations to the problem have made universal understanding an elusive goal. The scope of the economic loss doctrine is continually relitigated because of the value difference between contract and tort remedies,[16] as well as the confused body of case law.

The application of the economic loss doctrine determines the default remedies in a contractual relationship. Therefore, a universal understanding of the doctrine promotes informed negotiations and the best available outcome. Nonetheless, the contrast between the historical underpinnings of the doctrine and recent decisions demonstrates the difficultly in achieving this efficient result.

This Note suggests a conceptual model for uniform application of the doctrine, and it argues that categorical standards based on the scope of the contract, rather than the type of contract, should be employed unless the contract is voidable.[17] Using this standard, this Note defines the limitations

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14. KB Home v. Superior Court, 5 Cal. Rptr. 3d 587, 597 (Cal. Ct. App. 2004) (finding that the economic loss rule can be the "functional equivalent of a common law motion for judgment on the pleadings."). In many cases the economic loss doctrine is used to dismiss tort claims from the complaint before the case reaches trial. *See id.*

15. Along with a significant decrease in the risk, many cases that only claim damages based on contract claims will be dismissed completely, or settled quickly, because the warranty often excludes the damages asserted by the plaintiff. Additionally, the defendant is willing to pay the cost of the warranty rather than fees associated with defending the case.

16. The value of tort and contract damages may be significantly different because although punitive and emotional loss damages are generally not available in contracts, those damages are potentially available in tort. *Compare* RESTATEMENT (SECOND) OF CONTRACTS §§ 353, 355 (1981) *with* RESTATEMENT (SECOND) OF TORTS § 901 (1979). Furthermore, the standard of proof for contract damages is significantly more restrictive than the standard in tort cases. *Compare* RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981) ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.") *with* RESTATEMENT (SECOND) OF TORTS § 912 (1979) (requiring as much certainty as the nature of the tort and the circumstances permit).

17. Erlich v. Menezes, 981 P.2d 978, 986 (Cal. 1999). *See also infra* notes 125–28 and accompanying text. *Erlich* held that tort damages are permitted for a breach of contract duty in California only when "the duty that gives rise to tort liability is either completely independent of the

and exceptions to the economic loss doctrine, such as the "other property" exception,[18] the service exception,[19] and the fraud and intentional misrepresentation exception.[20] Finally, this Note will present an understanding of the economic loss doctrine that combines the theoretical underpinnings of the law with the practical necessity for settled law. This Note will suggest a universally applicable doctrine based on categorical balancing that furthers the goals of efficiency.

II. HISTORY

The economic loss doctrine originated in strict liability cases as a defense to tort liability when parties had allocated risk through contract with specific warranty provisions covering potential product defects.[21] The doctrine developed in 1965 when the Supreme Court of California ruled in

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contract or arises from conduct which is both intentional and intended to harm." *Id*. Torts are considered independent either when they are outside the realm of contract or when they make the contract voidable and leave the parties to deal with tort law. *Id*.

18. *See* Flintkote Co. v. Dravo Corp., 678 F.2d 942 (11th Cir. 1982) (applying Georgia law). *Flintkote* explains that in the case of injury to other property, that is, property *not* included in the contract, the duty breached arises independently of the contract. *See infra* notes 50–60 and accompanying text.

19. *See* Daniel Rapaport et al., *Tort Killer: The Applicability of the Economic Loss Doctrine to Service Contracts*, 20 ME. BAR J. 100 (2005). *See also infra* notes 61–82 and accompanying text.

20. *See* Robinson Helicopter Co., Inc. v. Dana Corp., 102 P.3d 268 (Cal. 2004) (finding tort recovery available when a parts manufacturer falsely certified the quality of metal used before distributing a part to be used in constructing helicopters). *See also infra* notes 82–95 and accompanying text.

Some jurisdictions once recognized a public safety exception to economic loss. Northridge Co. v. W.R. Grace & Co., 471 N.W.2d 179 (Wis. 1991). The public safety exception was similar to the "sudden and calamitous loss" exception, which was also used in some jurisdictions. *See* D'Angelo, *supra* note 9, at 601. Most courts have now rejected exceptions based on judicial determinations of danger because these exceptions base the risk and responsibility associated with an accident on the results of the accident. *Id*. at 601–03. Although the exception is now recognized as a circular methodology for determining responsibility, Alaska, Arizona, Arkansas, Illinois, Kansas, Maryland, Oregon, and West Virginia all espoused such exceptions at one time. *Id*. at 601 n.88.

21. Strict products liability grants recovery in tort to the purchaser of an unsafe product. RESTATEMENT (SECOND) OF TORTS § 402A (1979). It was the first comprehensive theory to overcome the traditional barriers to imposing liability for injuries caused by defective products. MATTHEW BENDER & CO., INC., 1–6 PRODUCTS LIABILITY PRACTICE GUIDE § 6.04 (2005) [hereinafter PRODUCTS LIABILITY PRACTICE GUIDE]. Strict liability overcame both the inability to trace a defect to specific misconduct of the manufacturer and the lack of privity between the purchaser and manufacturer. *Id*. Furthermore, it provided an incentive for the manufacturer, the party with the most knowledge and control over the product, to insure against the risk of loss. *Id.*

The policy concerns supporting strict products liability did not apply in cases where sophisticated parties negotiated the risk of loss. Thus, the economic loss doctrine limited the scope of strict liability to those cases where the policy behind the law was applicable. *See infra* notes 24–33, 39 and accompanying text.

Seely v. White Motor Co.[22] that tort liability was not appropriate under a strict liability theory for the losses maintained when a truck overturned without injuring anyone.[23] The court reasoned that the buyer of the truck suffered losses only because the truck failed to perform up to expectations; thus, tort damages were not appropriate.[24] Because the losses were economic in nature, Justice Roger Trayor[25] explained that the claim was grounded in contract and that consumers can "be fairly charged with the risk that the product will not match . . . [their] economic expectations unless the manufacturer agrees that it will."[26]

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22. 403 P.2d 145 (Cal. 1965).

23. *Id.* at 150. In *Seely*, the plaintiff purchased a truck that bounced violently when it was used for heavy duty hauling. *Id.* at 147. After many unsuccessful attempts to fix this problem under warranty, the plaintiff encountered even greater problems when the brakes failed during a turn. *Id.* The truck overturned and was damaged in the amount of $5,466.09, but the plaintiff was not injured. *Id.* After the accident, the plaintiff stopped making payments on the truck and the truck seller repossessed the vehicle. *Id.* The plaintiff then brought action against the seller and the truck manufacturer seeking damages for repair of the truck, lost profits, and loss of use. *Id.* at 147–48.

The trial court found that the manufacturer was liable for breach of warranty for payments made on the defective truck. *Id.* at 148. The manufacturer, however, could not be held liable for tort damages under a strict liability cause of action because the plaintiff was unable to prove causation in the accident. *Id.* On appeal, the California Supreme Court affirmed this decision, holding that the law of warranty governs the economic relations between parties. *Id.* at 152.

24. *Id.* at 151. The buyer had purchased the truck under a contract with a specific warranty provision relating to the risk of loss. *Id.* The California Supreme Court did not consider the possibility that warranty damages were appropriate on appeal because the trial court determined that the plaintiff could not prove the causation necessary to establish fault for warranty coverage. *Id.*

25. Roger J. Traynor served as the California Supreme Court's Chief Justice from 1964–1970, after serving as an Associate Justice from 1940–1964. Justice Traynor was recognized not only as the greatest judge in the history of California courts, but also as one of the greatest in the history of the United States. LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 688 (1985). Justice Traynor was so well respected in the legal community that he "was often called one of the greatest judicial talents never to sit on the United States Supreme Court." Les Ledbetter, *Roger J. Traynor, California Justice*, N.Y. TIMES, May 17, 1983, at B6. He is credited with developing the doctrine of strict liability, the cause of action for intentional infliction of emotional distress, the "moderate and restrained interpretation" doctrine for resolving conflict-of-laws problems, and the rule that majority shareholders of closely held corporations have a duty to not destroy the value of minority shares. At the same time, Justice Traynor is credited with abolishing the doctrine of sovereign immunity and the defense of recrimination in the context of divorce. *See* J. Edward Johnson, *Roger J. Traynor, in* HISTORY OF THE SUPREME COURT JUSTICES OF CALIFORNIA: VOLUME II, 1900–1950, 182, 182 (J. Edward Johnson ed., 1966); G. Edward White, *Introduction, in* THE TRAYNOR READER: A COLLECTION OF ESSAYS BY THE HONORABLE ROGER J. TRAYNOR, (1987). *See also* Henry J. Friendly, *Ablest Judge of His Generation*, 71 CAL. L. REV. 1039, 1039 (1983).

26. *Seely*, 403 P.2d at 151. Justice Traynor further explained that between a consumer and the manufacturer the consumer should be charged with the risk of commercial loss for the product's performance. *Id.* The reasoning employed in the *Seely* opinion directly contradicted an opinion on the same topic handed down in the same year by the New Jersey Supreme Court. *See* D'Angelo, *supra* note 9, at 593. The New Jersey case, *Santor v. A & M Karagheusian, Inc.*, 207 A.2d 305 (N.J. 1965), found strict liability in a case where only the product was injured. *Id.* at 312–13. In *Santor*, the court reasoned that the responsibility of a manufacturer does not change regardless of whether the damage is limited to the articles sold or spreads to other consumer property. *Id.* at 312.

The reasoning used by Justice Traynor drew from both his own concurring opinion in *Escola v. Coca Cola Bottling Co.*[27]—where he reasoned that a strict liability scheme was more efficient and fair than negligence when the manufacturer was in the best position to control risk and insure against loss[28]—and from the warranty provisions of the Uniform Commercial Code, which allow limitations to damages through warranty only in the case of commercial loss.[29] Considering both of these principled rules of law, Justice Traynor concluded that warranty law and contract remedies should govern the economic relations between the parties unless the product caused "personal injury"[30] or "physical injury to the plaintiff's property."[31] While applying the rule in a strict liability context, he noted that a manufacturer's liability should be limited in the same way for actions in negligence.[32] Significantly, this case reached a decision that may have unfairly denied a remedy to an individual who suffered loss due to no fault of his own. But the overall social welfare and the preservation of warranty law for commercial transactions outweighed the reimbursement interests of the individual plaintiff.[33] This policy preference underlies the categorical balancing in the cases that developed the economic loss doctrine.

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27. Escola v. Coca Cola Bottling Co., 150 P.2d 436, 443 (Cal. 1944) (Traynor, J., concurring).

28. *Id*. at 441 ("The cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business."). The reasoning used by Justice Traynor in this opinion has been cited throughout tort law as the persuasive rationale for upholding a strict liability scheme. PRODUCTS LIABILITY PRACTICE GUIDE, *supra* note 21, § 6.04. The California courts finally adopted strict products liability in *Greenman v. Yuman Power Prods., Inc.*, 377 P.2d 897 (Cal. 1963). Within two years the doctrine was promulgated by the American Law Institute in the Restatement (Second) of Torts. Soon thereafter a majority of jurisdictions adopted the rationale. *Id.* Today, strict liability is the prevailing approach for product defect law. *Id.*

29. *Seely*, 403 P.2d at 152. Limitations to damages are prima facie unconscionable when personal injury is involved, but otherwise, parties are free to allocate the risk of loss through warranty and contract. *Id.*

30. *Id.* at 152. In cases of physical injury, the manufacturer can appropriately be held liable because of her responsibility to create products that do not create unreasonable harm. *Id*. at 151.

31. *Id.* at 152. To conclude that damage to a person's property is equivalent to physical injury, Justice Traynor cited Prosser's reconceptualization of tort law, entitled *The Assault Upon the Citadel*. William L. Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099, 1143 (1960). This extension of tort principles simply concludes that if tort law is intended to ensure safety and social welfare, the pure chance that damage is caused to property rather than person is not a sound principle upon which to base differences in remedies. *Seely*, 403 P.2d at 149–50. Justice Traynor summed up the conclusion by simply saying, "Physical injury to property is so akin to personal injury that there is no reason for distinguishing them." *Id*. at 152.

32. *Id*. at 151 ("Even in actions for negligence, a manufacturer's liability is limited to damages for physical injuries and there is no recovery for economic loss alone.").

33. *See id.* at 151.

In 1986, the United States Supreme Court, sitting in maritime jurisdiction, adopted Traynor's persuasive reasoning. In *East River S.S. Corp. v. Transamerica Deleval, Inc.*,[34] a transport company sued a ship manufacturer when a design defect in a turbine engine caused damage to the rest of the turbine.[35] After the lower federal courts dismissed the tort claims,[36] Justice Blackmun reasoned that the economic loss doctrine presented the most efficient solution considering the policies at issue.[37] Justice Blackmun rejected ad hoc balancing tests because he reasoned such tests unjustifiably increased costs for the public.[38] Furthermore, the Court dismissed theories that depended on how the property was damaged because tort law awards relief based on efficient social outcomes rather than the extent of the resulting loss.[39] The Court concluded that "[w]hen a product injures only itself the reasons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong."[40]

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34. 476 U.S. 858 (1986).

35. *Id.* The shipbuilding company contracted with Transamerica "to design, manufacture, and supervise the installation of turbines" that would serve as the engines for new supertankers. *Id.* at 859. After completing the supertankers, the owner chartered each ship to the East River S.S. Corp., which took full responsibility for the ships and repairs for a period of twenty or twenty-two years. *Id.* at 860. It was soon found that the turbine engines had a faulty component that "caused additional damage to other parts of the turbine." *Id.* The turbines were repaired by East River S.S. Corp., which subsequently brought suit against the turbine manufacturer seeking strict liability damages from the alleged design and manufacturing defects that caused the malfunction. *Id.* at 861–62.

36. East River S.S. Corp. v. Delaval Turbine, Inc., 752 F.2d 903, 907–10 (3d Cir. 1985). The District Court granted summary judgment for the turbine manufacturer and the Third Circuit affirmed, holding that "damage to a defective product is actionable in tort unless the design defect creates an unreasonable risk of harm to persons or property other than the product itself." *Id.* at 908. The Third Circuit added that disappointments over the product's quality are protected by warranty law. *Id.* at 909.

37. *East River*, 476 U.S. at 868–70 (citing Seely, 403 P.2d 145). An easily determined rule was necessary for companies to structure their business activity. This consideration has weighed strongly toward the adoption and extension of the economic loss doctrine in a number of contexts.

38. *Id.* at 868–69 (discussing the minority position described in *Santor v. A & M Karagheusian, Inc.*, 207 A.2d 305 (N.J. 1965), for the proposition that "a manufacturer's duty to make non-defective products encompassed injury to the product itself, whether or not the defect created an unreasonable risk of harm"). Blackmun also discussed an intermediate position followed by a number of jurisdictions that permitted tort actions for products liability under certain circumstances when a product injured only itself. *Id.* at 869. These courts allowed endangered users to recover in tort, while holding disappointed users to contract remedies. *Id.* at 870. Users were categorized as endangered or disappointed based on "the nature of the defect, the type of risk, and the manner in which the injury arose." *Id.* at 870. *See also* Penn. Glass Sand Corp. v. Caterpillar Tractor Co., 652 F.2d 1165, 1173 (3d Cir. 1981). Justice Blackmun found these minority and intermediate positions "unsatisfactory" because intermediate positions were "too indeterminate to enable manufacturers easily to structure their business behavior," and minority positions had less powerful arguments about theories for restricting products liability. *East River*, 476 U.S. at 870.

39. *East River*, 476 U.S. at 870. The Court explained that even in an accident-like event, the repairs, lost profits, and decreased value are "essentially the failure of the purchaser to receive the benefit of its bargain . . . ." *Id.*

40. *Id.* at 871.

Thus, "the increased cost to the public that would result from holding a manufacturer liable in tort for injury to the product itself is not justified."[41]

Significantly, Justice Blackmun discussed the scope of the economic loss doctrine by describing property that should be protected only by warranty law.[42] Although a party may seek and recover damages for property as well as physical injury in a products liability claim,[43] he concluded that the economic loss doctrine is properly applied in cases involving property damage unless the damage extends to "other property."[44] The Court reasoned, "Since all but the simplest machines have component parts a contrary holding would require a finding of 'property damage' in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability."[45] Thus, a plaintiff could obtain tort remedies if a product defect caused damage to "other property," but expenses for repairs, lost profits, and decreased value to the product itself would be

41. *Id.* at 872. This quotation based its language on a comparison to the Second Circuit's decision in *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947), which adopted the negligence standard and became the underlying reasoning for a dramatic change in tort law.

42. *East River*, 476 U.S. at 866–67.

43. This extension of products liability protection to personal property was based on the idea that "public policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market." Escola v. Coca Cola Bottling Co., 150 P.2d 436, 440 (Cal. 1944) (Traynor, J., concurring). Justice Blackmun again related this concept back to *Seely*, where Justice Traynor found, "Physical injury to property is so akin to personal injury that there is no reason for distinguishing them." Seely v. White Motor Co., 403 P.2d 145, 152 (Cal. 1965).

Extensions of product liability coverage to damage to property were widely accepted based on the idea that responsibility should attach whenever fixing responsibility could reduce hazards to life and health. *Escola*, 150 P.2d at 440. But cases supporting this proposition had previously only considered damage that went beyond the product sold. *See East River*, 752 F.2d at 867 (citing Marsh Wood Products Co. v. Babcock & Wilcox Co., 240 N.W. 392, 399 (Wis. 1932) and Genesee County Patrons Fire Relief Ass'n v. L. Sonneborn Sons, Inc., 189 N.E. 551, 553–55 (N.Y. 1934)).

44. *East River*, 476 U.S. at 909–10. The Court found that the damage was not damage to "other property" because each turbine was supplied as an integrated package that could be properly regarded as a single unit. *Id.*

The line between property properly protected only by contractual remedies and "other property," which should theoretically proscribe tort remedies, has proven difficult to define. Cases subsequent to *East River* debated how "other property" should be defined. *See, e.g.*, KB Home v. Superior Court, 5 Cal. Rptr. 3d, 587 (Cal. Ct. App. 2003). Jurisdictions around the country set different standards until the United States Supreme Court returned to the language of *East River* and defined "other property" as property outside of the scope of the original contract. Saratoga Fishing Co. v. Marco Seattle, Inc., 520 U.S. 875 (1997). For a more complete discussion of the "other property" exception, see *infra* notes 50–60 and accompanying text.

45. *East River*, 476 U.S. at 867 (quoting N. Power & Eng'g Corp. v. Caterpillar Tractor Co., 623 P.2d 324, 330 (Alaska 1981)). This language has been often cited as one of the core concepts delineating the scope of the economic loss doctrine.

limited to remedies defined in the warranty.[46] Although the Court's decision in maritime jurisdiction was not mandatory authority for state tort law, this reasoning convinced almost all United States jurisdictions to adopt the economic loss doctrine as described by Justice Blackmun.[47] Some courts even reversed earlier rulings that had rejected the doctrine.[48]

The persuasive reasoning developed by Justice Traynor and Justice Blackmun led to the doctrine's immediate growth beyond products liability into situations not originally considered. Although the basic premise of the economic loss doctrine has been almost universally accepted,[49] a number of these outgrowths and interpretations have confused the scope of the doctrine. Inconsistent exceptions have developed in its application to component parts, service contracts, and fraud claims. Each of these exceptions will be considered in turn. Part A will deal with the "other property" exception for component parts, Part B will consider exceptions for service contracts, and Part C will describe exceptions for fraud and misrepresentation.

A. The "Other Property" Exception to Economic Loss

One debate regarding the economic loss doctrine arises from the "other property" language that was used in *East River*.[50] Some cases suggest that

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46. *Id.* at 870.

47. D'Angelo, *supra* note 9, at 593. Because the United States Supreme Court sat in maritime jurisdiction in *East River*, Justice Blackmun's opinion did not set precedent for any other jurisdictions. Nonetheless, the respect for the Supreme Court and the reasoning employed by Justice Blackmun was enough to convince those courts not persuaded by Justice Traynor's original explanation in *Seely*. *Id.* "[T]he rule took a giant step toward the nearly universal acceptance it now enjoys when the U.S. Supreme Court applied it in *East River Steamship Corp. v. Transamerica Delaval, Inc*." *Id.* at 593.

48. *See id.* at 595–96. Some courts overruled previous court decisions while other jurisdictions enacted statutes to change the application of the economic loss doctrine. *Id.* at 595 (citing Casa Clara Condo. Ass'n v. Charley Toppino & Sons, Inc., 620 So. 2d 1244 (Fla. 1982), which overruled Drexel Props., Inc. v. Bay Colony Club Condo., Inc., 406 So. 2d 515 (Fla. Dist. Ct. App. 1981)). *See also* Wash. Rev. Code § 7.72.010(4), (6) (1992) (discarding the previous rule established in *Berg v. General Motors Corp.*, 555 P.2d 818 (Wash. 1977)).

Despite being the leader of the conflicting minority approach, even New Jersey adopted an understanding of the economic loss doctrine that matches the reasoning of *Seely* and *East River*. D'Angelo, *supra* note 9, at 595–96. D'Angelo explains that New Jersey limited its approach, which held manufacturers liable for damage even to the product itself, to non-commercial transactions. Later the court held that the "Uniform Commercial Code provides a consumer buyer the exclusive remedy for direct economic loss resulting from conduct that constitutes the breach of express or implied warranties." D'Angelo v. Miller Yacht Sales, 619 A.2d 689, 691 (N.J. Super. Ct. App. Div. 1993). Thus, New Jersey eventually reached the same result as that endorsed by *East River*. D'Angelo, *supra* note 9, at 596.

49. D'Angelo, *supra* note 9, at 593.

50. *Compare* KB Home v. Superior Court, 5 Cal. Rptr. 3d 587 (Cal. Ct. App. 2003), *with* Saratoga Fishing Co. v. J.M. Martinac & Co., 520 U.S. 875, 883 (1997).

if damage extends beyond the defective part, the economic loss doctrine is not applicable. For example, in *KB Home v. Superior Court*,[51] a California appellate court held that when a component of a product injures another component of the product, the injured component is other property if it is "a sufficiently discrete element of the larger product that it is not reasonable to expect its failure invariably to damage other portions of the finished product."[52] While this holding can be read in a manner consistent

51. 5 Cal. Rptr. 3d 587 (Cal. App. 2003). KB Home sued a furnace manufacturer for the cost of repairing and replacing defective furnaces. *Id.* at 587. The furnace manufacturer supplied approximately 2200 furnaces for installation in homes built by KB Home. *Id.* at 590–91. As part of the contract, the furnace manufacturer equipped each furnace at issue with a NOx rod before selling them to KB Home in order to meet California air quality standards in certain metropolitan areas. *Id.* A defect in the NOx rods generated excess heat that damaged other parts of the furnaces, creating a "substantial risk of fire." *Id.* at 590–92. Due to the risk caused by the defective furnaces and inaction on the part of the furnace manufacturer, KB Home replaced the defective and damaged furnaces at a cost of $3 million before bringing suit against the furnace manufacturer. *Id.* at 591–92.

52. *Id.* at 596. To support this contention the court cited a California Supreme Court decision which said, "The concept of recoverable physical injury or property damage" has over time "expanded to include damage to one part of a product caused by another, defective part." *Id.* at 595–96 (quoting Jimenez v. Superior Court, 58 P.3d 450, 457 (Cal. 2002) (quoting Aas v. Superior Court, 12 P.3d 1125, 1130 (Cal. 2000)).

It seems that reliance on the language used in *Jimenez* was misplaced in the *KB Home* analysis. *Jimenez* concluded that a window manufacturer is still strictly liable when that window is incorporated into a larger, mass-produced product and the entire product is sold to a consumer. *Jimenez*, 58 P.3d at 455. The conclusion reached in *Jimenez* was based on reasoning that the economic loss doctrine does not expand beyond the product created just because it is incorporated into a larger product by another party. *Id.* at 456–57. Seen from this perspective, the quote used in *KB Home* about the limitations of the *Jimenez* holding suggests that there may be times when the economic loss doctrine extends contract remedies and precludes tort remedies beyond the scope of the product produced. Rather than suggesting an expansion to the scope of torts, the line used by the court in *KB Home* suggests that there may be instances where the scope of torts is further limited due to the economic loss doctrine and the policy preference for contract remedies.

Additionally, *KB Home* makes the determination that "other property" should be interpreted expansively based on the idea that *Jimenez* "did not provide any direct guidance as to how that crucial evaluation was to be made . . . ." *KB Home*, 5 Cal. Rptr. 3d at 595. Although *Jimenez* does not give specific direction as to how to determine the defining line between the product itself and other property, this is because the boundaries were not an issue. In *Jimenez* the windows were "designed, developed, manufactured, produced, supplied, and placed into the stream of commerce" by the window manufacturer. *Jimenez*, 58 P.3d at 452. This language, when considered along with California cases delineating between contract and tort, suggests that "other product" refers to property not considered within the agreement.

In the end, the California Supreme Court's emphasis on duty and breach independent of the contract, the isolation of social policy from the "mini-universe" of contract, and the goals considered in the economic loss doctrine suggests that the California Supreme Court would adopt an approach similar to that adopted by the United States Supreme Court, not the approach suggested in *KB Home*. Although the *KB Home* interpretation is arguably a misapplication of the economic loss rule, the determination has been used by plaintiffs' attorneys to defeat dismissal as a matter of law and undermine the effectiveness and purpose of the economic loss rule. *See, e.g.*, Croman Corp. v. Gen. Elec. Co., No. 2:05-CV-0575-GEB-JFM, 2005 U.S. Dist. LEXIS 39408, at *5 (E.D. Cal. Sept. 12, 2005).

with other California authority,[53] may be based on misinterpretations of previous case law,[54] and possibly has been limited by later cases,[55] it indicates that courts are still attempting to clearly define "other property."[56]

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53. *KB Home*, 5 Cal. Rptr. 3d at 590–92. The decision could be read to suggest that the component in question was a separate item from the contracted property because the component was "an after-market add-on . . . ." *Id.* In this case the damage would be other property according to the majority interpretation of the doctrine.

54. *KB Home* cites *Jimenez* to support the proposition that whether the damage is caused to other property is a matter for the trier of fact to determine; but the passage cited does not consider who is to determine the nature of the product. *Compare KB Home*, 5 Cal. Rptr. 3d at 590, *with Jimenez*, 58 P.3d at 456–57. In fact, the passage in *Jimenez* cited by *KB Home* considers two situations in which decisions as to whether "other property" is damaged as a matter of law arise. *Jimenez*, 58 P.3d at 456–57. The passage explains that, in *Aas v. Superior Court*, 12 P.3d 1125, 1129 (Cal. 2000), the trial court barred the introduction of evidence that had not caused injury, and the California Supreme Court upheld this decision. *Jimenez*, 58 P.3d at 456. The *Jimenez* court then used California decisional law to support its conclusion that installing a product into a home does not eliminate the product manufacturer's strict product liability. *Id.* at 457. Contrary to the conclusion in *KB Home*, both of the examples represent instances of a judicial decision about what constitutes a product as a matter of law.

Determining what constitutes a product as a matter of law conforms to the California Supreme Court's direction that "[w]hether a defendant owes a duty of care is a question of law." Erlich v. Menezes, 981 P.2d 978, 983–84 (Cal. 1990) (quoting Burgess v. Superior Court, 831 P.2d 1197, 1200 (Cal. 1992)). When the damaged item is "*other than the product itself*," a party has a duty to not cause harm under tort law. *See Jimenez*, 58 P.3d at 456–57. On the other hand, when the damaged item is part of the defective product, the contracting party owes no such duty outside of contract provisions. *Id.* Thus, the nature of the product is necessarily a determination of whether a defendant owes a duty of care, which is a question of law. Moreover, the nature of the product at hand must be a question of law because the distinction defines the line between tort and contract law under the economic loss doctrine. The court or the legislature, not a jury or trier of fact, must ultimately decide the boundaries between tort and contract law. Thus, *KB Home* misuses the language of *Jimenez* to support a proposition contrary to California law.

55. *See supra* note 52. The potential reach of *KB Home* may have been subsequently eliminated by the California Supreme Court's re-explanation of the economic loss doctrine in *Robinson Helicopter Co., Inc. v. Dana Corp*., 102 P.3d 268 (Cal. 2004). Although *Robinson Helicopter* does not address the exact issue decided in *KB Home*, it can be read to contradict the holding and may have been motivated by the misinterpretations. *Id.*

56. The only reported case to have cited *KB Home* is *Croman Corp*., 2005 U.S. Dist. LEXIS 39408 at *5. The *Croman Corp*. decision denied a motion to dismiss based on the proposition that whether damaged property is other property is a matter of fact to be decided at trial. Although *KB Home* directly supports this outcome, this conclusion conflicts with the theory underlying the economic loss doctrine and undermines the ability of product manufacturers to rely on contract.

Furthermore, the conclusion relies in part on a minority opinion. In *Jimenez*, 38 P.3d at 458–59, Justice Kennard's concurring opinion argued that the scope of the economic loss doctrine should be based on whether a product is

> so integrated into the larger unit as to have lost its separate identity. If so, strict liability is improper. But if the component retains its separate identity, so that it may be readily separated from the overall unit, the component manufacturer may be strictly liable for damages to the larger unit.

Id. at 459. Justice Kennard argued that this standard was in line with both the standard set by the United States Supreme Court in *Saratoga Fishing Co. v. J.M. Martinac & Co.*, 520 U.S. 875 (1997), and the Restatement (Third) of Torts, Products Liability. *Jimenez*, 58 P.3d at 458–59.

Recently, in *Saratoga Fishing Co. v. J.M. Martinac & Co.*,[57] the United States Supreme Court provided its own analysis of the distinction between "the product itself" and "other property" by defining a product as the item placed in the stream of commerce by the manufacturer and distributors. In *Saratoga Fishing*, a second-hand boat owner claimed tort damages when the boat's original hydraulic system failed, sinking the boat and causing damage to items installed by the first owner.[58] In an opinion written by Justice Breyer, the Court held that the second-hand boat owner could recover in tort for damages to products added by the initial owner.[59] The Court reasoned that "initial users . . . typically depend upon, and likely seek warranties that depend upon, a manufacturer's primary business skill, namely, the assembly of workable product components into a marketable whole."[60] Under this reasoning, contract remedies should cover all damages caused by goods acquired under the contract and tort remedies should only apply to items not contemplated in the contract. Plaintiffs would be left to their warranty rights or rights against the manufacturer of the component part.

B. The Service Contract Exception to the Economic Loss Doctrine

Another recent outgrowth that has sparked controversy about the boundaries of the economic loss doctrine is its application to service contracts.[61] Traditionally, the economic loss doctrine is a "goods" doctrine because it grew out of products liability law and was based partially on the

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Justice Kennard's explanation did not consider differences in the doctrine based on the party subject to the suit. *Id.* In *Jimenez*, the suit was brought against the component part manufacturer whose product injured the whole, but in *Saratoga Fishing*, the plaintiff sued the seller of the whole product. *Saratoga Fishing*, 520 U.S. at 877–78. This difference may better explain the difference in reasoning behind the outcomes than an approach based on whether the product was part of the integrated whole.

57. 520 U.S. 875, 883 (1997). Just as in *East River*, the decision of the United States Supreme Court was not binding on other jurisdictions because the court sat in maritime jurisdiction.

58. *Id.* at 877. J.M. Martinac & Co. constructed a ship and sold it to its initial owner. *Id.* The first owner added equipment and parts, and used the ship for tuna fishing. *Id.* The owner then sold the ship to the Saratoga Fishing Company, and Saratoga continued to use the ship for fishing. *Id.* About fifteen years after the initial sale, a defect in the hydraulic system, installed during original construction by J.M. Martinac, caused an engine-room fire that led to the sinking of the ship. *Id.* The Saratoga Fishing Company filed an action in admiralty, and the trial court awarded tort damages for the destruction of property added by the initial user. *Id.* at 877–78. The Ninth Circuit reversed the decision, finding that even the property added to the ship was part of the product; thus, tort damages could not be recovered under the economic loss doctrine. Saratoga Fishing Co. v. Marco Seattle Inc., 69 F.3d 1432, 1445 (9th Cir. 1995), *cert. granted Martinac*, 519 U.S. 926 (1996).

59. *Saratoga Fishing*, 520 U.S. at 875.

60. *Id.*

61. Rapaport et al., *supra* note 19, at 100.

assumptions and remedies available under the UCC.[62] Nonetheless, the underlying policy convinced some courts to extend the doctrine's reasoning to service contracts. Although the supreme courts of Illinois,[63] Utah,[64] Ohio,[65] Washington,[66] Rhode Island,[67] Colorado,[68] and Virginia[69] have approved of the use of the economic loss doctrine in service contracts, the Wisconsin Supreme Court recently rejected this approach.[70]

The Utah Supreme Court explained that the economic loss rule is appropriate for service contracts because tort law does not impose standards on the performance of contracts.[71] Rather, tort law is concerned only with safety of products and actions.[72] Parties need to be able to allocate risk through contract, or tort law would result in "liability in an indeterminate amount for an indeterminate time to an indeterminate class."[73] These rationales become particularly important where detailed and comprehensive contracts are the core of an industry,[74] or when there are tangible elements to the contract that can be studied by the parties.[75] According to this logic, a provider of services has an important interest in being able to establish the terms of a relationship with a client;[76] therefore,

62. *See* Ins. Co. of N. Am. v. Cease Elec. Inc., 688 N.W.2d 462 (Wis. 2004).

63. Fireman's Fund Ins. Co. v. SEC Donohue, Inc., 679 N.E.2d 1197, 1200–01 (Ill. 1997).

64. Am. Towers Owners Ass'n, Inc. v. CCI Mech., Inc., 930 P.2d 1182, 1190 (Utah 1996).

65. Floor Craft Floor Covering, Inc. v. Parma Cmt'y Gen. Hosp. Ass'n, 560 N.E.2d 206, 212 (Ohio 1990).

66. Berschauer/Phillips Const. Co. v. Seattle Sch. Dist. No. 1, 881 P.2d 986 (Wash. 1994).

67. Boston Inv. Prop. No. 1 v. E.W. Burman, Inc., 658 A.2d 515 (R.I. 1995).

68. Grynberg v. Agri Tech, Inc., 10 P.3d 1267, 1269 (Col. 2000).

69. Blake Const. Co., Inc. v. Alley, 353 S.E.2d 724, 726 (Va. 1987).

70. Ins. Co. of N. Am. v. Cease Elec. Inc., 688 N.W.2d 462 (Wis. 2004). The service contract debate has been most relevant in dealing with construction contracts. *See* Kevin J. Breer & Justin D. Pulikkan, *The Economic Loss Rule in Kansas and its Impact on Construction Cases*, 74 J. KAN. B.A. 30 (2005).

71. Am. Towers Owners Ass'n, Inc. v. CCI Mech., Inc., 930 P.2d 1182, 1190 (Utah 1996). In *American Towers Owners Ass'n*, the court granted summary judgment to a mechanical subcontractor under the economic loss doctrine when a condominium association brought suit for alleged design defects in the construction of the condominium building. *Id.* at 1184–85.

72. *Id.*

73. Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931).

74. *Id.* This is true in the construction industry where contracting parties structure their relationships in order to meet individual expectations. Anthony Meagher & Michael O'Day, *Who is Going to Pay for My Impact? A Contractor's Ability to Sue Third Parties for Purely Economic Loss*, CONSTRUCTION LAW., Fall 2005, at 27, 28–30.

75. Fireman's Fund Ins. Co. v. SEC Donohue, Inc., 679 N.E.2d 1197, 1200–01 (Ill. 1997).

76. Fireman's Fund Ins. Co. v. Childs, 52 F. Supp. 2d 139, 145 (D. Me. 2004). In *Fireman's Fund Ins. Co.*, the district court reiterated the important interests of a service provider and paralleled these to the interests of parties involved in a contract for goods. The case facts surrounded a storm that caused severe water damage in a hotel, resulting in the owner losing use of the property. *Id.* at 141. The plaintiff insurance company paid $200,000 for the damages, but then brought a subrogation action against the builder of the hotel. *Id.* at 140–41. The complaint alleged that the builder negligently

a service provider should be able to define duties and risks in contract to predict the cost of doing business.[77]

The Wisconsin Supreme Court specifically addressed and rejected this approach in *Insurance Co. of North America v. Cease Electric Inc.*[78] In *Cease Electric*, an insurance company sued an electric company in tort for improperly installing a ventilation system in an insured's barn.[79] The court examined the split of authority on the issue, along with the policy underlying the doctrine, and found that the doctrine should not apply to

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constructed the masonry façade and weep holes so that drainage water did not have adequate paths during foreseeable weather conditions, failed to train employees during the construction of the building, and did not warn the plaintiff insurance company of the condition. *Id.* at 141. The defendant builder moved to dismiss the action under the economic loss doctrine, and the plaintiff opposed, arguing that the doctrine did not apply to service contracts. *Id.* at 141–42.

The arguments were submitted in dicta because, as a matter of first impression that would decide a diversity case, the presiding judge certified a question as to whether Maine law would apply the economic loss doctrine in the service contract context. Rapaport et al., *supra* note 19, at 102. Despite deferring the decision to the state court, Judge Carter, a senior district judge who previously served as an associate justice for the Maine Supreme Court, constructed persuasive arguments for the application of the economic loss doctrine in such situations. *Id.*

77. *Fireman's Fund Ins. Co.*, 52 F. Supp. 2d at 145.

78. 688 N.W.2d 462, 464 (Wis. 2004).

79. *Id*. The barn owner raised chickens to produce eggs. In order to decrease costs, the barn owner purchased an upgraded ventilation system for his barn. The ventilation system was needed to bring fresh air and oxygen into the barn to keep the chickens alive. *Id.* The new system replaced a manual ventilation system, which operated numerous individual fans with their own thermostats, with a computer-controlled unit designed to operate all fans in stages according to a single temperature measurement. *Id.* at 465.

After purchasing the control unit from a third party, the barn owner contracted with an electric company to install the new system. *Id.* The job included wiring the primary fan control and the backup thermostat, a safety device designed by the product manufacturer to take over in the event that the primary fan control failed. *Id.* A schematic provided by the manufacturer recommended that the backup thermostat be wired to a separate power source in case the first power source failed. About half a year after the new system was installed the ventilation systems failed, causing damage for loss of the chickens and for the loss of income. *Id.*

The insurance company paid the barn owner $40,704.89 for the chickens and $118,339.20 for the loss of income and then brought an action against the electric company alleging that the ventilation system failure was due to the company's negligence in performance of services. *Id.* In an investigation of the system malfunction conducted less than a week after the loss, the independent investigator concluded that the system had been improperly wired because the main fan control unit was on the same power circuit as the backup thermostat. *Id.* He also concluded that the electric company failed to test the new system and that a test would have revealed that the backup thermostat was not functioning. *Id.*

Following a jury trial, the trial court found that the electric company was negligent and entered judgment for the amount of damages plus double costs according to Wisconsin statute. *Id.* On appeal, the electric company argued that the economic loss doctrine precluded the negligence action because they had provided a product to the barn owner and the loss was only one of disappointed expectations. *Id.* at 465–66. The court of appeals affirmed the trial court judgment holding that the electric company had provided only services and that the economic loss doctrine did not apply to service contracts. *Id.* at 466.

service contracts.[80] The court noted that the doctrine was not historically designed for service contracts, and it reasoned that the doctrine should not be extended because the UCC, which does not apply to service contracts, "serves as one of the critical rationales underlying the economic loss doctrine."[81] Because service contracts lack well-developed remedies, rights, and guarantees, the Court found that tort law was better suited for dealing with economic loss in service contracts than contract law.[82]

C. The Application of Economic Loss to Fraud and Negligent Misrepresentation Claims

Another recent confusion regarding the scope of the economic loss doctrine centers on the application of the doctrine to fraud and negligent misrepresentation claims. In this area, courts again have struggled to find a consistent and universal application of the doctrine.[83] The disparate treatment of the economic loss doctrine in fraud and negligent misrepresentation cases is best exemplified by the variety of results individual jurisdictions have reached in fire-retardant-treated plywood (FRT) cases.[84] In each of these cases, the defendant's claim that the economic loss doctrine barred tort recovery conflicted with the plaintiffs' claims that fraud and negligent misrepresentation overcame this limitation.[85] When faced with this conflict, Maryland courts dismissed negligent misrepresentation claims,[86] Michigan courts dismissed fraud

80. *Id.* at 467 ("There is a split among the jurisdictions as to whether the economic loss doctrine applies to contracts for services."). For a further discussion of the split of authority see PHILIP L. BRUNNER AND PATRICK J. O'CONNOR, JR., BRUNNER & O'CONNOR ON CONSTRUCTION LAW § 19:10, n.14 (2004).

81. *Cease Elec.*, 688 N.W.2d at 469. Under the UCC, manufacturers have a right to restrict liability and disclaim warranties. *Id.* For contracts involving goods, the court recognized that if the economic loss doctrine did not preclude tort and limit purchasers to contract damages, the UCC provisions governing disputes would be completely circumvented and rendered meaningless. *Id.*

82. *Id*. at 469–70.

83. R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789, 1790 (2000). *See also* All-Tech Telecom, Inc. v. Amway Corp., 174 F.3d 862, 867 (7th Cir. 1999) (noting the various applications of the economic loss rule to misrepresentation claims).

84. Barton, *supra* note 83, at 1790. Four jurisdictions have reached verdicts in cases involving fire-retardant-treated plywood roofs. *Id.* at 1791. After learning of defects to the FRT plywood, manufacturers continued to sell the material without notifying purchasers. *Id.* at 1790. Roofs made with the material deteriorated, and homeowners and builders sued to recover the cost of repairing or replacing the roofs. *Id.* at 1791. Plaintiffs who suffered losses due to defects in the FRT plywood brought actions claiming fraud and negligent misrepresentation, and defendants claimed protection from tort remedies because the damage was only economic loss. *Id*.

85. *Id*.

86. Morris v. Osmose Wood Preserving, 639 A.2d 624, 631 (Md. 1995) (involving a

claims,[87] Florida courts allowed negligent misrepresentation and fraud claims,[88] and Virginia courts allowed fraud claims while barring negligent misrepresentation claims.[89]

Outside of the FRT plywood context, courts have developed three main approaches to deal with conflicts between the economic loss doctrine and allegations of fraud or negligent misrepresentation.[90] The first approach treats fraud as an exception to the economic loss doctrine because (1) fraud claims rest on a defendant's conduct rather than the underlying contract, which makes the nature of the injury irrelevant;[91] (2) tort law historically imposes an independent duty to refrain from fraudulently inducing contract;[92] and (3) the measure of damages for fraud is the "loss of the bargain," which is based on purely economic expectations.[93] The second approach grants no exception to the economic loss doctrine for fraud because the doctrine bars from tort purely economic damages.[94] The third approach determines whether to impose a tort duty based on

homeowner's claim to recover for necessary roof repairs). Maryland law would have allowed tort recovery under the "other property" exception if the roof had caused damage to other parts of the home. Barton, *supra* note 83, at 1791.

87. Citizens Ins. Co. v. Osmose Wood Preserving, Inc., 585 N.W.2d 314, 316 (Mich. Ct. App. 1998) (finding remedies under the UCC exclusive).

88. Pulte Home Corp. v. Osmose Wood Preserving, Inc., 60 F.3d 734, 738 (11th Cir. 1995) (finding that the plaintiff failed to prove misrepresentation claims even though they were not barred by the economic loss doctrine).

89. *See* Barton, *supra* note 83, at 1792. The unsuccessful nature of the negligent misrepresentation claims may explain the apparent contradictions in application. The Maryland and Michigan courts may have used the economic loss doctrine as a gatekeeper against the negligent misrepresentation claims because they perceived the claims as meritless.

90. *See id*. at 1803–12.

91. Kahn v. Shiley, Inc., 266 Cal. Rptr. 106, 112 (Cal. Ct. App. 1990) (finding that fraud remedies include purely economic losses because the type of damage is not considered in fraud).

92. Robinson Helicopter Co., Inc., v. Dana Corp., 102 P.3d 268 (Cal. 2004) (holding that fraud and misrepresentation claims were independent of the contract breach and that tort damages were appropriate for such an independent duty). *See also* Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc., 960 S.W.2d 41, 46 (Tex. 1998) (finding that the economic loss doctrine did not limit damages based on duties "separate and independent from the duties established by the contract itself").

93. *See* Moorman Mfg. Co. v. Nat'l Tank Co., 435 N.E.2d 443, 453. If the measure of damages is based purely on economic expectations, then application of the economic loss doctrine would eliminate all damages. The economic loss doctrine would eliminate fraud as a cause of action in contract-related cases. Since the economic loss doctrine could not have been intended to eliminate fraud as a cause of action, fraud must be an exception to the rule.

94. Barton, *supra* note 83, at 1811–12. Although Barton also recognizes an intermediate approach adopted by the Michigan courts that excepts fraud from the economic loss doctrine if the defendant's misrepresentations do not concern the matter of the contract, he recognizes that "the practical effect of the additional requirement has rendered the exception a nullity." *Id.* at 1808.

Additionally, Florida courts seem to apply the economic loss doctrine to fraudulent inducement claims on a case-by-case basis because there is a lack of clarity in the economic loss rule. *Id*. at 1808–10. *See also* Force v. ITT Hardford Life & Annuity Ins. Co., 4 F. Supp. 2d 843, 852 (D. Minn. 1998) (applying Florida law).

apportioning risk according to the supply of information before contracting.[95] In this case, the court will separately analyze the relationship between parties and determine if the party supplying information assumed the duty to provide accurate information. If such a duty existed, the court will allow tort remedies.[96] In all, courts are far from reaching a universal approach to the conflict between the economic loss doctrine and fraud or negligent misrepresentation claims.

Most recently, the California Supreme Court attempted to explain its interpretation of the economic loss doctrine while dealing with claims of fraud and misrepresentation in *Robinson Helicopter Co., Inc. v. Dana Corp.*[97] In *Robinson Helicopter*, the court held that fraud and

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95. Barton, *supra* note 83, at 1813–23. This approach mimics the contract interpretation approach of reading into the contract what the parties would have done if they were provided perfect information.

96. *Id.* at 1816–19. *See also* Congregation of the Passion v. Touche, Ross & Co., 636 N.E.2d 503, 515 (Ill. 1994). This approach is based on the concept that the law imposes a legal obligation on those in positions to supply information that will be reasonably relied on by contracting parties. Justice Cardozo described this approach in *Glanzer v. Shepard*, 135 N.E. 275, 275–76 (N.Y. 1922). Barton, *supra* note 83, at 1813–14. The result of this approach is an ad hoc balancing test in cases where the economic loss doctrine and allegations of fraud or negligent misrepresentation conflict.

97. 102 P.3d 268 (Cal. 2004). In *Robinson Helicopter*, a helicopter manufacturer contracted with a subcontractor for the production of a safety component called the sprag clutch, which allows the rotor to continue turning and the pilot to maintain control if the helicopter loses power during flight. *Id.* at 270. The contract was subject to Federal Aviation Administration guidelines that do not allow changes to the design of an aircraft from the issued "type certificate" without approval from the FAA. *Id.*

The contract and FAA "type certificate" required the sprag clutches to be ground at a specific level of hardness described as "50/55 Rockwell." *Id.* at 270–71. For a period of twelve years, Robinson Helicopter purchased 3707 sprag clutches at this level of hardness and experienced cracking in only three clutches, a 0.03% failure rate. *Id.* at 271. Then, without notifying Robinson Helicopter or the FAA, the sprag clutch manufacturer changed the clutches to "61/63 Rockwell," a higher level of hardness. *Id.* Pursuant to the contract, the sprag clutch manufacturer continued to provide written certificates that the clutches had been manufactured to Robinson Helicopter's standards. *Id.* During the short period that the clutches were manufactured at the 61/63 level, Robinson Helicopter experienced a failure rate of 9.86%. *Id.* Fortunately, the clutch failures did not cause any injury or damage to other property, but, after learning of the change in hardness, Robinson Helicopter was required to recall and replace all 990 of the clutch assemblies that employed the harder level. *Id.*

Attempts to identify the defective clutches for replacement were delayed when the manufacturer of the clutches refused to provide the necessary serial and lot numbers for the parts until more than two months after the initial request. *Id.* Since the manufacturer was the only company equipped to make the piece on short notice, Robinson Helicopter submitted an order for the required replacements and requested that the cost be left for a later determination. *Id.* The sprag clutch manufacturer denied any wrongdoing and only delivered the parts on a COD basis. *Id.* Without any other alternative, Robinson Helicopter replaced the sprag clutches on their own at a cost of $1,555,924 and then brought suit. *Id.*

Robinson Helicopter claimed breach of contract, breach of warranty, and negligent and intentional misrepresentations. *Id.* at 272. At the trial court level, a jury returned a verdict granting full compensatory damages to Robinson Helicopter based on the breach of contract along with a $6 million punitive damage award for the fraudulent misrepresentation claim. *Id.* The court of appeals affirmed the compensatory damage finding but, based on the economic loss doctrine, ruled that tort damages

misrepresentation claims were independent of the contract breach and that tort damages—in this case the punitive award—were appropriate for such an independent duty.[98] The California Supreme Court cited its previous decisions in *Jimenez v. Superior Court*,[99] *Aas v. Superior Court*,[100] and *Erlich v. Menezes*[101] as support for the contention that "[c]onduct amounting to a breach of contract becomes tortious only when it also violates a duty independent of the contract arising from the principles of tort law."[102]

The decision in *Robinson Helicopter* continued the California Supreme Court's attempt to clarify the economic loss doctrine and to define when tort remedies would be available despite an underlying contract.[103] Although the Court did not give a specific definition for which duties are independent of contracts, it gave content to the distinction with examples of both non-independent and independent duties.[104] The court found that

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were inappropriate, reversing the punitive damages. *Id.*

98. *Id.* at 272–73.

99. 58 P.3d 450 (Cal. 2002). In *Jimenez*, the California Supreme Court ruled that a plaintiff could maintain a strict liability action against a window manufacturer for damage to the rest of the house caused by defective windows. *Id.* at 457. The court gave content to the "other property" exception. *See supra* notes 50–60 and accompanying text.

100. 12 P.3d 1125 (Cal. 2000) (applying the economic loss rule to negligent action in a home construction contract).

101. 981 P.2d 978 (Cal. 1999). In *Erlich*, the California Supreme Court held that emotional distress tort damages were not available for the negligent breach of a home construction contract. *Id.* at 979.

102. *Robinson Helicopter*, 102 P.3d at 273.

103. The California Supreme Court had previously dealt with these issues. *See Jimenez*, 58 P.3d 450 (providing content to the "other property" exception in a strict products liability context); *Aas*, 12 P.3d 1125 (applying the economic loss rule to negligent action in a home construction contract); *Erlich*, 981 P.2d 978 (holding that emotional distress tort damages were not available for the negligent breach of a home construction contract); Freeman & Mills, Inc. v. Belcher Oil Co., 44 Cal. Rptr. 2d 420, 433 98 (Cal. Ct. App. 1995) (concluding that, in order to apply tort law to a contractual relationship the risk and social benefit must overcome the contract policy considerations which strongly favor denying tort recovery); Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 28 Cal. Rptr. 2d 475, 487 (Cal. Ct. App. 1994) (stating that for a breach of contract to become tortious the action must violate an independent duty arising from principles of tort law).

104. *Robinson Helicopter*, 102 P.3d at 273. After specifically identifying three situations where breach of contract could entail the breach of independent tort duties, the court mentioned that "[f]ocusing on intentional conduct gives substance to the proposition that a breach of contract is tortious only when some independent duty arising from tort law is violated." *But see* Arledge, *supra* note 6. Arledge countered that *Robinson Helicopter* failed to "articulate[] a coherent test for determining whether a tort is independent or not." *Id.* at 25. Although Arledge argues persuasively using language that the court used to describe why intentional misrepresentation claims are independent, his analysis fails to recognize that previous case law gives a great deal of content to the definition of "independent tort duties."

Arledge compares the assertions of the California Supreme Court in *Robinson Helicopter* to possible arguments by a plaintiff trying to evade the economic loss rule based on a negligent breach of contract. *Id.* at 25. But, considering the previous decision of the California Supreme Court in *Erlich*,

tort damages were appropriate when the breach causes physical injury, when an insurance contract breaches the covenant of good faith and fair dealing, and when the contract was fraudulently induced.[105] On the other hand, the court approved case law that did not allow tort damages for negligent breach of contract because, if every negligent breach of a contract gave rise to tort damages, the limitation provided by the economic loss doctrine as well as the distinction between tort and contract law would be meaningless.[106] In the end, the court concluded that if a contract establishes the relationships of the parties, tort remedies are only available if the breach of contract is accompanied by a tort, accomplished in a tortious manner, or intentionally committed in a manner that will knowingly cause severe harm.[107] According to this approach, fraud is an independent tort that gives rise to tort remedies.

III. ANALYSIS

The economic loss doctrine developed alongside strict liability law under the direction of the same well-respected judge;[108] therefore, the parallel growth lends insight into its application in problematic areas. The comparison reveals that loss compensation interests are secondary to the freedom to contract until tort law intervention is needed to deter an equilibrium of inefficient conduct. Furthermore, the comparison highlights the idea that tort law can serve as insurance that is passed along to customers as a cost of doing business,[109] but passing on this cost must be balanced against the value of allowing individuals the freedom to contract.[110] In the end, if we are to fully accept the role of tort and contract

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which *Robinson Helicopter* cites approvingly, it is clear that negligent breach of contract does not fit within the category of "independent tort duties." Although the Court did not lay down a hard and fast rule for determining which tort duties are independent of contractual relationships, the boundaries of this category can be ascertained from previous case law and the examples used in *Robinson Helicopter*.

105. *Robinson Helicopter*, 102 P.3d at 273. These conclusions were based on the determinations reached in prior California Supreme Court decisions.

106. *Id.* at 273–74.

107. *Id.* "[T]ortious breach of contract . . . may be found when (1) the breach is accompanied by a traditional common law tort, such as fraud or conversion; (2) the means used to breach the contract are tortious, involving deceit or undue coercion; or (3) one party intentionally breaches the contract intending or knowing that such a breach will cause severe, unmitigable harm in the form of mental anguish, personal hardship, or substantial consequential damages." *Id.*

108. *See supra* notes 25–33 and accompanying text.

109. *See supra* note 28.

110. The law of contracts "attempts the realization of reasonable expectations that have been induced by the making of a promise." 1 CORBIN ON CONTRACTS § 1.1 (Joseph M. Perillo ed., 1993). Furthermore,

law in providing a default structure and an ability to structure relationships for the most efficient commercial interactions, the economic loss doctrine must pay heed to the concepts of efficient breach[111] and bounded rationality.[112]

Seen as a balance between the conflicting standards of tort and contract, the economic loss doctrine, then, must deny tort remedies with respect to all elements that were or should have been considered in the bargaining process. Contract law must govern any element built into the cost of the agreement, such as the reputation of the supplier and the risk allocation between parties for potential loss. Otherwise, there is a disincentive to contract between parties because the individual value set during the bargaining process could be set aside in court. Additionally, the law must be steadfast in its protection of contract rights[113] as long as there is no socially recognized reason for voiding the contractual agreement.[114] When bounded rationality suggests that an outcome is beyond the scope of the contractual agreement, tort law should not impose a duty to protect the other party's business interests even if these business interests involve potentially risky uses of products or services.

> [a]greements can accomplish little, either for their makers or for society, unless they are made the basis for action. When business agreements are not only made but are also acted on, the division of labor is facilitated, goods find their way to the places where they are most needed, and economic activity is generally stimulated.

Lon L. Fuller & William R. Perdue, *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52, 59–62 (1936). Because of these interests, there is a high value placed on enforcing the will of parties as outlined in contracts. For this reason, tort law serves as a default rule in our society. When the relationship between two parties is outlined in a contract, tort remedies are unavailable unless the contract is unenforceable.

111. The concept of efficient breach suggests that a rational actor will not perform contract obligations when the costs of performance exceed the benefits to all parties. By enforcing contract remedies, the law encourages efficient breach and reaches the outcome with greatest societal value. *See* Lillian R. BeVier, *Reconsidering Inducement*, 76 VA. L. REV. 877 (1990); William M. Landes & Richard A. Posner, *Joint and Multiple Tortfeasors: An Economic Analysis*, 9 J. LEGAL STUD. 517, 552–55 (1980); Gary Myers, *The Differing Treatment of Efficiency and Competition in Antitrust and Tortious Interference Law*, 77 MINN. L. REV. 1097 (1993).

112. The concept of bounded rationality suggests that there is a limit to the concepts and possible situations that we can consider when forming a contract due to a finite limit to our cognitive abilities. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1471 (1998).

113. The goals and purposes of law and government can be best met "by establishing a judicial and administrative system that acts with a reasonable degree of uniformity." 1 CORBIN ON CONTRACTS § 1.1 (Joseph M. Perillo ed., 1993).

114. Misrepresentation, duress, and undue influence are the three most common reasons to set aside a contract. RESTATEMENT (SECOND) OF CONTRACTS §§ 164, 175, 177 (1981). Other reasons that contracts are voidable or unenforceable include abuse of a fiduciary relationship, restraint of trade, impairment of family relations, contractual interference, and impracticability. *See id.* §§ 173, 186–91, 194, 261, 266.

In order to serve its role as a limit to tort remedies when the underlying relationship between parties is established by contract, a proper application of the doctrine should also consider whether a categorical or ad hoc balancing test should be used to define its scope.[115] Based on the initial reasoning of Justice Blackmun,[116] categorical balancing seems more appropriate. Furthermore, if the economic loss doctrine functions as a default rule when parties have a contractual relationship, employing the economic loss doctrine on a categorical basis is the only method that preserves the general tort rule of not transferring losses unless social policy demands it.[117] Often this consideration differentiates between the individual consumer and the commercial business because sophisticated parties are more likely to consider risk of loss in warranty provisions.[118] But the law must be careful not to limit the contractual power of individuals operating outside the commercial context. For these reasons, a categorical rule that provides default terms to contractual relationships seems to provide the best method of balancing the social consequences and contractual rights involved. The only question then is where to draw the categorical line.

A. The "Other Property" Exception to Economic Loss

Under the economic loss doctrine, at least two viable definitions of "other property" currently exist. Under the system endorsed by the United

115. A categorical approach may define groups that are both under- and over-inclusive, but this failure to reach an ideal result in individual cases is preferred because of the predictability of the rule. Although an ad hoc approach allows the court to reach the correct result in each individual case, the cost to society of finding this may make the categorical approach more efficient over the long term. The determination of which approach creates a better social standard is determined by how accurate categories of conduct can be defined and an evaluation of the cost of over- and under-inclusion.

116. *See supra* note 38 and accompanying text. Justice Blackmun found that rules requiring judicial determinations on a case-to-case basis were "too indeterminate to enable manufacturers easily to structure their business behavior." East River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 870 (1985).

117. An ad hoc balancing rule would force sellers of goods and services to predict the potential problems of their customers and insert specific wording into contracts to deal with these issues because the sellers, as potential defendants, would need to provide language that demonstrated that the risk of each specific loss was considered in this specific basis. Unlike in strict products liability, the purchaser and potential plaintiff is the party in the best condition to know the risk of loss in a contractual arrangement.

118. Robinson Helicopter Co., Inc. v. Dana Corp., 102 P.3d 268, 272 (Cal. 2004) (explaining that the economic loss doctrine "hinges on a distinction drawn between transactions involving the sale of goods for commercial purposes where economic expectations are protected by commercial and contract law, and those involving the sale of defective products to individual consumers who are injured in a manner which has traditionally been remedied by resort to the law of torts" (quoting Neibarger v. Universal Coops., Inc., 486 N.W.2d 612, 615 (Mich. 1992))).

States Supreme Court in *Saratoga Fishing*,[119] manufacturers and component suppliers can allocate potential liability for a product that does not work. Thus, the buyer can depend on or obtain warranties for the whole product purchased, and "component suppliers have appropriate incentives to prevent component defects that might destroy the product."[120] In that case, economic loss limitations protect the manufacturer only from liability concerning the product that they inject into the stream of commerce.[121] According to the United States Supreme Court, the product itself is defined by the original contract for sale.[122]

The other possible rule for "other property" is to allow tort damages when one component of a product injures another component that is sufficiently discrete from the component causing harm.[123] If a law defined "other property" in this way, courts would be given the role of interpreting what is sufficiently discrete. Such a determination would require a hearing as to the facts surrounding the component and how it is integrated into the whole. Furthermore, case law would need to develop a judiciable standard for the meaning of sufficiently discrete.

The contrast between these two approaches is similar to the debate between categorical and ad hoc balancing tests. Although ultimate justice on the individual level is best served by balancing the facts in each individual case, the law is sometimes better served on a macro level by making decisions based on well-defined categories. The developmental arguments presented by Justices Traynor and Blackmun suggest that the goals of the economic loss doctrine are better served by a rule that does not require litigation over case-specific facts. Furthermore, applying the economic loss doctrine in an ad hoc fashion fails to recognize the value of a supplier's expertise in assembling all of the components of a system.[124]

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119. Saratoga Fishing Co. v. J.M. Martinac & Co., 520 U.S. 875, 883 (1997). The United States Supreme Court defined the product itself as the product injected into the stream of commerce by the original manufacturer. *See supra* note 57–60 and accompanying text.

120. *Id*. at 884.

121. *Id.*

122. *Id.* This conclusion squares with the idea that the economic loss doctrine is the boundary between contract and tort law. Regardless, some jurisdictions have concluded that the product is defined by the most recent sale rather than the original sale. *See* Sullivan v. Young Bros. & Co., Inc., 91 F.3d 242, 249–50 (1st Cir. 1996) (holding that under Maine law a secondary purchaser would likely have a claim against the seller of the product).

123. *See supra* note 51–54 and accompanying text. *KB Home* established that component-to-component damage could justify tort damages if a component damaged another component that was "a sufficiently discrete element of the larger product that it is not reasonable to expect its failure invariably to damage other portions of the finished product." KB Home v. Superior Court, 5 Cal. Rptr. 3d 587, 598 (Cal. Ct. App. 2003).

124. *Supra* note 57–60 and accompanying text.

Thus, individual fact-specific determinations, such as those required by defining "other property" as suggested in *KB Home*,[125] are inefficient. A definition of "other property" that allows tort recovery for component-to-component damage expands an exception to the point that it swallows the underlying purpose of the law.

B. The Service Contract Exception to the Economic Loss Doctrine

There are two major arguments against applying the economic loss doctrine to service contracts. First, applying the doctrine to limit remedies is discouraged by the fact that many service contracts are oral. Second, there is no equivalent to the Universal Commercial Code for the interactions of parties in a service industry. On the other hand, service providers argue that the economic loss doctrine should be applied because they need some protection to ensure that they can properly predict the cost of their actions.

Cease Electric categorically eliminated service contracts from the protection of the economic loss doctrine,[126] but such an approach may not achieve the most efficient result on the macro level. Although limiting the application of the economic loss doctrine to contracts for goods may force a service provider to disclose potential risks that are not apparent to the customer, this approach seems to misallocate the risk of loss in a contractual situation where the customer better understands how the service performed will affect his business. Under this arrangement, a service provider will be held responsible for damages to the business of the recipient that result from the provider's work, whether or not such responsibility is warranted under the task assigned. The only way to avoid such risk would be to have the recipient of services specifically decline this right to damages, thus forcing the service provider to anticipate the risk of his work to each individual and expressly contract for the assumption of these risks. It seems more appropriate to have the party looking for a service provider to assume risks inherent in the project unless he obtains warranties and pays for the cost of providing such guarantees.

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125. *Supra* note 51–54 and accompanying text.
126. *See supra* note 78–82 and accompanying text.

C. The Application of Economic Loss to Fraud and Negligent Misrepresentation Claims

Finally, in the field of fraud and intentional misrepresentation, the economic loss doctrine is best looked at through the limits of enforceability on contract. Although defining an independent tort may be difficult if based solely on the potential exceptions of the economic loss doctrine,[127] the concept embodied by *Robinson Helicopter* suggests that a proper boundary for the economic loss doctrine may be found not in specific definitional characteristics, but rather in the underlying concepts of tort and contract law. With this in mind, there is a difficulty in properly articulating the scope and purpose of the economic loss doctrine because the goals and purposes of two foundational areas of law cannot be simply stated. Nonetheless, the standards imposed by requiring an "independent" tort are not without definition. Previous case law, and the provisions that make contracts voidable, accurately describe what actions should be considered outside the protections and limitations to remedy espoused in contracts.[128]

IV. PROPOSAL

The underlying purpose of striving for efficiency in tort and valuing the intentions of parties in contract highlights the importance of a uniform law that is easily predictable for the parties involved. Although an ad hoc determination may seem worthwhile due to the relative ability of parties to compensate for loss, judicial decisions based on this philosophy fail to recognize the social value of efficiency and settled law. When judges make exceptions to the doctrine in order to meet individual concepts of fairness, they create an amorphous mass of case law, and attorneys everywhere struggle to determine when the rule applies and when exceptions are appropriate.[129] Furthermore, the adjustment of damage awards, based on the level of fault of the tortfeasor and the idea that breaking a contract should lead to tort damages, directly conflicts with the contract principle of efficient breach.

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127. *See supra* note 104 and accompanying text.

128. *See supra* notes 104 and 114 and accompanying text.

129. Sandrac Ass'n v. W.R. Fizzell Architects, Inc., 609 So. 2d 1349, 1352 (Fla. Dist. Ct. App. 1992).

A. The "Other Property" Exception to Economic Loss

Applying these principles to the problematic scenarios of the economic loss doctrine noted in the case history above, it seems that "other property" should be defined by the product injected into the stream of commerce, following the approach taken by the United States Supreme Court in *Saratoga Fishing*.[130] The rule would serve as a default mechanism when contracts do not specifically prescribe another method of insuring loss; thus, parties would be encouraged to include the value of individual expertise in the contract price.[131] Defendants would be protected from double liability, and plaintiffs would get the value placed on the contract at the time of negotiation. The economic loss doctrine could efficiently serve its role as a threshold determination because a hearing would not be necessary, thereby serving the goals initially articulated by Justice Traynor and Justice Blackmun.[132] As long as both parties have access rights to information regarding the negotiations, this approach allows both parties to seek information and reach the most efficient outcome.

B. The Service Contract Exception to the Economic Loss Doctrine

The arguments regarding the application of the economic loss doctrine to service contracts suggest a need for properly defined default rules for service contracts, such as those established by the UCC for transactions involving goods. Default rules would force proper risk disclosures and encourage informed negotiations for service contracts. In order to establish a set of default rules, a consumer's knowledge of his own risk and the service provider's proper disclosure of abilities should be considered. If the economic loss rule is not applied in the context of service contracts,

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130. *Supra* note 57–60 and accompanying text.

131. A rule like the one forwarded in *KB Home* cannot properly protect the interests of contract law because an individual's reputation and skill as an assembler of components into a complete product is lost in the court valuation of contract coverage. *See* KB Home v. Superior Court, 5 Cal. Rptr. 3d 587, 598 (Cal. Ct. App. 2003). This in turn will give advantage to individuals who do not have skill and will force professionals to eschew the value of training in a contract price.

132. *See* East River S.S. Corp. v. Transamerica Delaval, 476 U.S. 858, 867 (1985). Justice Blackmun implied that the scope of "other property" should be the integrated package supplied by the manufacturer, arguing

> [s]ince all but the very simplest of machines have component parts, [a contrary] holding would require a finding of "property damage" in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability.

Id. (quoting N. Power & Eng'g Corp. v. Caterpillar Tractor Co., 623 P.2d 324, 330 (Alaska 1981)).

potential liability makes it more difficult for service providers to perform functions at prices that the whole society can afford. Additionally, providers are forced to take exorbitant risks with their business in every service contract. This risk, in turn, falls disproportionately on the smallest businesses, thereby granting a monopoly on the service industry to established businesses with the wherewithal and protection from such suits. Such developments could have extremely harmful effects on competition in our service economy.

C. The Application of Economic Loss to Fraud and Negligent Misrepresentation Claims

Finally, for fraud and misrepresentation claims, it seems that the economic loss doctrine is better analyzed by considering rules regarding the enforceability and voidability of contracts. If the contract is voidable, it seems that a party should be able to resort to tort remedies for damages because the limited remedies of contracts are eliminated and damage exists that should be remedied for the good of society. The language in *Robinson Helicopter* provides a helpful analysis by suggesting that tort remedies are available when the breach is intended or fraudulent. But, this approach must find its place between the business community's general rejection of the justifications provided by the theory of efficient breach[133] and contract law's limitation to compensatory damages.[134] Potentially, the burden of proving international breach and the requirement that a distinct tort duty is breached provides the protection to contracting parties that would eliminate the need for the economic loss doctrine. Unfortunately, this solution simply forces plaintiffs to allege intent and creates a tort duty to circumvent one of the purposes of the doctrine, but it seems to be the best solution on the margin.

V. CONCLUSION

There is a great value in defining the economic loss doctrine according to the underlying principles of contract and tort law. The value of defining the doctrine has increased as tort remedies and the fear of tort damages has increased, but pervasive misunderstandings still exist. Evaluations should adhere more completely to the theory, history, and principles behind the doctrine. This approach would lead to defining "other property" according

133. CORBIN ON CONTRACTS, *supra* note 113, § 55.15.
134. *Id.* §§ 55.8, 55.11.

to the item injected into the stream of commerce, applying the economic loss doctrine to service contracts, and following contract enforceability rules for fraud or misrepresentation claims.

Unfortunately, because it is impossible to predict all of the situations that may arise under the doctrine, it becomes the duty of lawyers and judges alike to understand what is at stake in litigating the doctrine. To this end, the Restatement of Products Liability must readdress the issue of the economic loss doctrine and specifically deal with the scenarios presented.

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