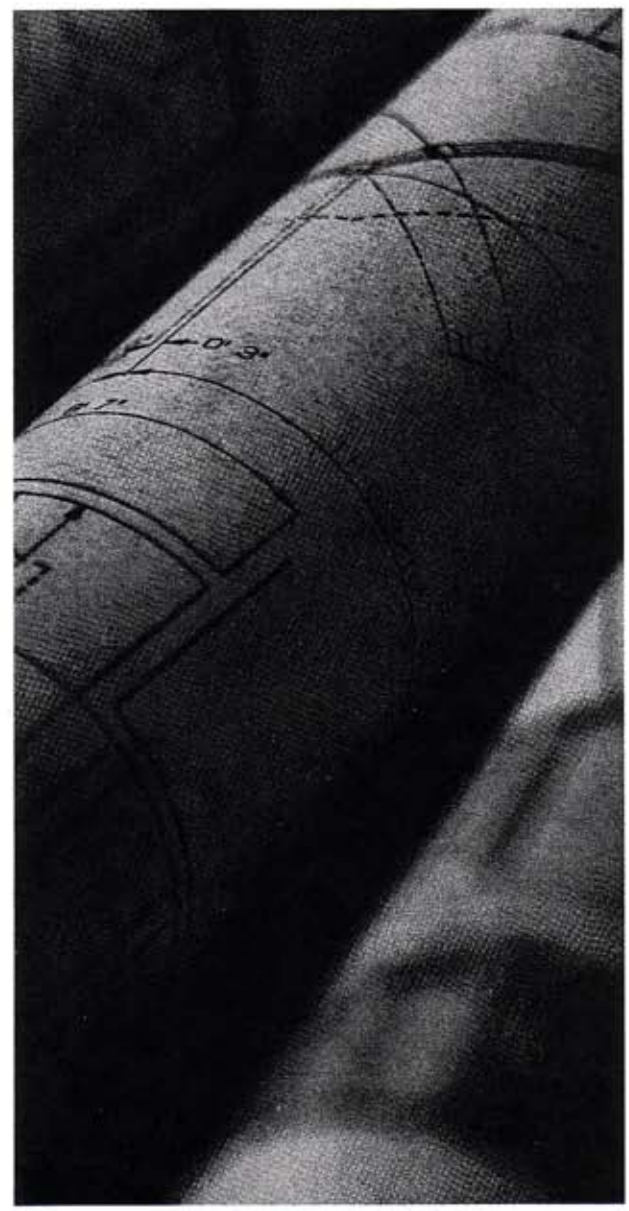
The Economic Loss Rule & Construction Defect Litigation



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The construction industry continues at full speed to keep pace with the influx of new residents at the rate of 5,000 people per month in Las Vegas alone. Therefore, it is not surprising that construction defect litigation has become big business in Nevada.

It is also no secret that construction defect attorneys from surrounding states, particularly California, are flocking to Nevada to join the construction boom that has led to a proliferation of construction defect cases.

These construction defect cases have become the latest battleground for the application of what has become known as the Economic Loss Rule.

The Economic Loss Rule is a creation of the courts used to express the demarcation between tort and contract law. Broadly speaking, the Rule precludes tort recovery for purely economic losses. Originally, the Rule arose in the context of cases involving strict products liability. Accordingly, concepts of strict products liability and economic loss are often linked, and more often confused. While the Economic Loss Rule is an often misunderstood and difficult concept, it is extremely important for lawyers and others involved in the construction industry to understand its implications. In *Calloway v. City of Reno*, the Nevada Supreme Court recently adopted a broad application of the Economic Loss Rule effectively foreclosing the use of standard tort remedies in construction defect cases. In contrast, other states, such as California, are still struggling with the concept and application of the Rule.

While the courts are sorting out the remedies available for construction defects, another battle is taking place regarding the funding of litigation, settlements and judgments. Ultimately, insurers will be called upon to fund the defense and indemnity of developers and subcontractors who are being sued for damages that may be characterized as economic loss. However, the extent of coverage provided by comprehensive or commercial general liability ("CGL") policies for construction defects and resulting damage is a matter of much debate.

ECONOMIC LOSS: WHAT IS IT?

The so-called "Economic Loss Rule" in its present form was first articulated by a landmark California strict liability case that has since achieved national influence.[I] The Economic Loss Rule is a judicially created rule of law that limits recovery of certain types of damages in tort. As stated above, the Rule purports to set forth a line of demarcation between tort and contract damages.

One of the difficulties in applying the Rule is that there is very little agreement on exactly what constitutes economic loss. For example, two commentators in 1980 opined that "[t]here is no sound rationale for distinguishing property damage from economic loss, and the line between physical damage to property and economic loss due to product failure has proven impossible to draw."[II] One court has described "economic loss" as "a poor choice of words—all the losses for which tort victims sue are economic."[III] Another court has stated that, "economic loss generally means pecuniary damage that occurs through loss of value or use of the goods sold or the cost of repair together with consequential lost profits *when there has been no claim of personal injury or damage to other property*." [IV]

Nonetheless, courts generally agree that some limitation on tort recoveries for solely economic losses is necessary to prevent the law of tort from completely subsuming the law of contracts. In *East River Steamship Corp. v. Transamerica Delaval, Inc.*,[V] the United States Supreme Court describes the rationale for the Economic Loss Rule as follows:

> "The distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the 'luck' of one plaintiff in having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his product. [Citation omitted.] When 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."

While its genesis may have been in strict products liability, the Economic Loss Rule has been applied more broadly to claims of negligence. The California Supreme Court noted that 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."[VI] While this one sentence statement was dicta, the inclusion of negligence claims within the scope of the Economic Loss Rule was recognized by other courts, including the Supreme Court in *East River*.

While there are legitimate concerns warranting the application of the Economic Loss Rule in strict products liability cases, controversy has arisen over whether the Rule should be applied in claims for negligence and particularly with regard to defective construction of personal residences. Depending upon how viewed, the Economic Loss Rule may be applied in a number of ways to construction defect claims. Under a broad view, the Rule may preclude negligence and strict liability claims for any damage to the structure itself as well as the existence of defects that have not yet resulted in damage. A strict view of the Rule precludes recovery when only the product itself is damaged but allows recovery when other component parts are injured. Under either view, the most common type of economic loss in the construction arena is a technical building code violation that has not resulted in any damage to a building structure. Examples are: inadequately constructed and connected shear walls, inadequate fire protection measures in common walls, and electrical, plumbing and mechanical installations that do not meet building, mechanical or electrical codes.[VII]

THE ECONOMIC LOSS RULE IN NEVADA

In *Local Joint Executive Board of Las Vegas, Culinary Workers Union, Local No. 226 v. Stern*,[VIII] the Nevada Supreme Court specifically adopted the Economic Loss Rule holding that purely economic loss is not recoverable in negligence or strict liability. The viability of the Rule in Nevada was later confirmed in *Central Bit Supply, Inc. v. Waldrop Drilling & Pump, Inc.*[IX]

After *Stern* and *Central Bit*, Nevada started to chip away at the Rule creating a seemingly broad exception in cases of defective construction. In *Charlie Brown Construction Co. v. City of Boulder City*, the Court had held that the application of the Economic Loss Rule was tied to foreseeability.[X] Since the economic injury alleged by the plaintiffs in *Charlie Brown* was found to be foreseeable, the Court held that tort recovery was available. Then in *National Union Fire Insurance Company of Pittsburgh, PA v. Pratt and Whitney Canada, Inc.*, the Nevada Supreme Court held:

> [T]he economic loss doctrine was never intended to apply to construction projects that reflect the products and efforts of so many different manufacturers, laborers, crafts, supervisors and

inspectors in the creation of an essentially permanent place of habitation.[xi]

The plaintiff in *Pratt and Whitney* argued that the Economic Loss Rule did not bar a tort claim for property damage to an airplane when its engine caused the airplane to crash. Even though one component part damaged another, the Court applied the Rule and held that the product (the airplane) had only injured itself.[xii]

In 1997, the Nevada Supreme Court decided *Calloway v. City of Reno* ("*Calloway I*").[xiii] In *Calloway I*, the primary issue presented to the Court was whether the Economic Loss Rule precluded homeowners' claims for strict liability and negligence against subcontractors based upon defective framing of their townhouses causing water damage. The trial court summarily dismissed the plaintiffs' negligence and strict liability claims finding that they were barred by the Economic Loss Rule. The Court in *Calloway I* reversed.

After reciting the Economic Loss Rule and its rationale, the Court in *Calloway I* noted that "strong policy considerations support allowing owners of newly constructed homes to recover in tort for damages to their homes from entities that negligently construct their homes."[xiv] The Court found that holding subcontractors liable in tort for construction defect would not subject them to unforeseen and unlimited liability.[xv] The Court then crafted an exception to the Rule holding that the subcontractors may in fact have tort liability when plaintiffs are unable to pursue traditional contract remedies.

While *Calloway I* clearly recognized an exception to the Economic Loss Rule, the Court refused to create a broad exception for defective construction. Further, the application of the exception was predicated upon the absence of contract remedies against the developer. Inevitably, the application of the exception to the Rule as set forth in *Calloway I* would require findings of fact regarding such amorphous concepts as "good faith." The Court went on to hold that subcontractors could not be held strictly liable for construction defects and resulting damages.[xvi] *Calloway I* did not squarely address the application of strict liability for developers; however, it did note that other states, "particularly California," had adopted this rule.[xvii]

On December 3, 1998, the Nevada Supreme Court granted a rehearing of *Calloway I* in order to "promote substantial justice."[xviii] Thus, the stage was set to create a firm rule regarding economic loss, deal with the strict liability issue and put to rest the seeming inconsistencies between *Calloway I* and past Nevada Supreme Court precedent.

The Nevada Supreme Court's decision in *Calloway v. City of Reno* ("*Calloway II*")[xix] can be argued to have slammed the door on tort claims for garden-variety construction defect claims. In *Calloway II*, the Nevada Supreme Court swept away prior precedent and adopted a strict "no exceptions" approach to the Economic Loss Rule. The Court reversed itself and affirmed the trial court's dismissal of the plaintiffs' negligence and strict liability claims. In so doing, the Court overruled and/or disapproved of the exceptions to the Economic Loss Rule as indicated by its earlier decisions in *Oak Grove*, *Pratt and Whitney*, and *Charlie Brown*. Recognizing a need to maintain the distinction between tort and warranty theories of recovery, the Court unequivocally stated that economic losses could not be recovered under a tort theory.[xx] The Court went on to note that the Economic Loss Rule applies outside of the products liability context.[xxi] The Court concluded that "economic losses from a defective building are just as offensive to tort law as damages sought for economic losses stemming from a defective product."[xxii] In reaching this result, the Court adopted the reasoning of the Florida Supreme Court and held that a house that does not meet the purchaser's economic expectations is matter of contract not tort.[xxiii]

After disposing of the plaintiffs' economic loss arguments, the Court addressed their strict liability claims. The Court first noted that plaintiffs' damage claims would fall within the Economic Loss Rule thereby precluding any claims for strict liability.[xxiv] The Court went on to agree with the trial court in finding that the townhouses were not "products" and then agreed with the reasoning of other courts that have concluded that strict products liability does not apply to buildings. Leaving open a limited ability to make a strict liability claim, the Court acknowledged that "certain products may be installed in a building and may retain their separate identities as products, without becoming an integrated part of the structure."[xxv]

Based on *Calloway II*, if a building damages itself, the owner has no cause of action for negligence or strict liability against the developer or subcontractors. The *Calloway II* decision, however, left open the issue of when a separate product becomes part of the structure. *Calloway II* also did not address whether the builder that sells the separate product (e.g. an installed water heater) becomes a "seller" of that product so as to be subject to strict products liability when the building is sold. *Calloway II* also does not effect any applicable contractual claims or claims for intentional tort.

In sum, *Calloway II* significantly limits the ability of homeowners to recover for construction defects. Nonetheless, *Calloway II* was not a unanimous decision and strong concurring and dissenting opinions accompanied the Majority. It is certainly possible that given the past struggle of Nevada, and other courts, with the Economic Loss Rule, different facts may lead to a different result.

It is noteworthy that the facts giving rise to *Calloway I* and *Calloway II* predated the adoption of N.R.S. § 40.600 et seq. ("Chapter 40") that outlines certain remedies for homeowners that are facially inconsistent with the recovery limitations imposed by *Calloway II*. As the Court did not consider the application of Chapter 40, it is unclear what effect this statutory scheme will have on the holdings of *Calloway II*. While N.R.S. § 40.635 states that the remedies provided for in Chapter 40 "do not create a new theory upon which liability may be based," it is likely that the Legislature presupposed the existence of common law claims as opposed to an exclusively contractual remedy for construction defect claims. Nonetheless, it remains unanswered whether *Calloway II* applies to claims subject to Chapter 40 and, if it does, whether Chapter 40 controls. It can therefore be anticipated that the apparent conflict between *Calloway II* and Chapter 40 will be the subject of future litigation.

INSURANCE COVERAGE ISSUES

As indicated above, when the Economic Loss Rule precludes tort claims, plaintiffs are generally left with warranty/contract claims. Therefore, a finding that damages constitute purely economic loss raises two primary insurance coverage questions. First, does the policy provide coverage for breaches of contract? Second, do the damages constitute "property damage" as the term is defined in the particular policy? However, neither the insurance industry nor courts interpreting policy language maintain consistent positions regarding these issues.

The insuring language of a "typical" CGL policy provides coverage for all sums that the insured becomes "legally obligated to pay as damages" because of "property damage." For years, a number of insurers argued that this insuring provision applied

only to tort claims and not contract claims. However, in the most recent decision by a state high court, the California Supreme Court held that "legally obligated to pay as damages" referred to "any obligation which is binding and enforceable under the law, whether pursuant to contract or tort liability."[xxvi]

In Nevada, there is little law on this subject. However, one federal court has held very generally that a CGL policy does not "cover a loss caused by breach of contract, breach of warranty, poor workmanship or improper design."[xxvii] This decision, however, dealt with a situation where the court found no "property damage." A number of other Nevada coverage cases have involved claims for breach of contract but did not provide any discussion regarding the applicability of liability coverage for contract claims. Therefore, the coverage for breach of contract issue is technically unanswered in Nevada.

There is also a somewhat widely held misconception that if no "property damage" occurs sufficient for tort liability, there can be no "property damage" for purposes of insurance coverage. As discussed above, the Economic Loss Rule may result in finding that a plaintiff is left only with contract remedies. However, the absence of a tort remedy does not dictate whether there is or is not property damage. Ultimately, whether construction defects and resulting damage constitute "property damage" as the term is used in CGL policies is not a matter of contract or tort but of policy interpretation.

Standard CGL policies generally define "property damage" as follows:

> a. Physical injury to tangible property, including all resulting loss of use of that property.
> b. Loss of use of tangible property that is not physically injured.

The coverage debate relating to construction defects falling within the Economic Loss Rule centers primarily on what has become known as the "incorporation doctrine." In short, the question is whether the incorporation of a defective component into a larger product causes physical injury to the larger product by its mere incorporation. One point of view on this subject holds that mere defective incorporation of a defective component does not constitute "physical injury to tangible property."[xxviii] In another view, "property damage" occurs when the defective component has been physically linked with a greater structure or product; thus requiring removal in order to prevent the danger from materializing that is caused by the presence of the component.[xxix]

The Nevada Supreme Court has held that the "mere presence" of a defective component can constitute "property damage."[xxx] Specifically, the Court held that the presence of defective cement weakened a structure as a whole thereby causing "injury" to tangible property.[xxxi] However, in one unpublished decision, the U.S. District Court has held that defective construction causing diminution of value does not constitute "property damage."[xxxii]

While the breach of contract and property damage coverage issues have drawn the most attention from the courts, proper evaluation of coverage requires a review of the entire policy. For instance most CGL policies contain common exclusions which could have a direct bearing on the availability of coverage for economic loss resulting from defects. These exclusions include, exclusion (l), Damage to Your Work and, exclusion (m), Damage to Impaired Property or Property Not Physically Injured.[xxxiii] The existence of "broad form" coverage will also be an important consideration as well as the potential application of "personal injury" coverage. Accordingly, the specific facts of the case and the policy language at issue will ultimately dictate the existence and scope of coverage. Therefore, it should never be taken for granted that an insurance policy either covers or excludes a particular risk.

CONCLUSION

The law regarding economic loss in construction defect cases and associated insurance coverage issues is in a state of flux. The recent *Calloway II* decision can certainly be viewed as limiting the available remedies in construction defect actions. However, the possible application of Chapter 40 and the Nevada Supreme Court's prior willingness to carve out exceptions to the Economic Loss Rule indicate that the rules regarding tort recovery for economic loss in the construction defect arena may be subject to abrupt change.

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Nancy Quon, a partner at Mainor and Harris in Las Vegas, contributed a Nevada perspective to this article.

i *Seely v. White Motor Co.*, 63 Cal.2d 9, 403 P.2d 145, 45 Cal.Rptr. 17 (1965).

ii Rabin & Grossman, *Defective Products or Realty Causing Economic Loss: Toward a Unified Theory of Recovery*, 12 Sw.U.L.Rev. 5, 21 (1980-1981).

iii *Eljer Mfg., Inc. v. Liberty Mutual Ins. Co.*, 972 F.2d 805 (7th Cir. 1992).

iv *San Francisco Unified School Dist. v. W.R. Grace & Co.*, 37 Cal.App.4th 1318, 1327, fn. 5, 44 Cal.Rptr.2d 305, 310 fn.5 (1995).

v 476 U.S. 858 (1986).

vi *Seely, supra*, 63 Cal.2d at 18, 403 P.2d at 151, 45 Cal.Rptr. at 23.

vii *See, e.g., Aas v. Superior Court*, 64 Cal.App.4th 916, 75 Cal.Rptr.2d 581 (1998) *as mod.* (Jun 12, 1998) and *review granted* and *opn. superseded*, 78 Cal.Rptr.2d 523, 962 P.2d 885 (Cal. 1998); *Stearman v. Centex Homes*, 78 Cal.App.4th 611, 92 Cal.Rptr.2d 761 (2000).

viii 98 Nev. 409, 659 P.2d 637 (1982).

ix 102 Nev. 139, 717 P.2d 35 (1986).

x 106 Nev. 497, 508-509, 797 P.2d 946, 952-953 (1990).

xi 107 Nev. 535, 539, 815 P.2d 601, 603 (1991)(citing *Oak Grove Investors v. Bell & Gossett Company*, 99 Nev. 616, 668 P.2 1075 (1983)(defective heating and plumbing systems causing water damage throughout apartment complex does not cause purely economic loss)).

xii 107 Nev. at 539-540, 815 P.2d at 603-604 (citing *East River S.S. Corp. v. Transamerica Delaval*, 476 U.S. 858, 860 (1985)).

xiii 113 Nev. 564, 939 P.2d 1020 (1997).

xiv 113 Nev. at 571-572, 939 P.2d at 1025.

xv *Id.* at 573-574, 939 P.2d at 1026.

xvi 113 Nev. at 575, 939 P.2d at 1027.

xvii *Id.* at 574, 939 P.2d at 1026-27 (citing *Kriegler v. Eichler Homes, Inc.*, 269 Cal.App.2d 224, 74 Cal.Rptr. 749 (1969)).

xviii *Calloway v. City of Reno*, 114 Nev. 1157, 971 P.2d 1250 (1998).

xix __ Nev. __, 993 P.2d 1259 (2000).

xx *Calloway II*, 993 P.2d at 1264 (citing *Seely v. White Motor Company*, 63 Cal.2d 9, 45 Cal.Rptr. 17, 409 P.2d 145 (1965)). *See, also, Erlich v. Menezes*, 21 Cal.4th 543, 981 P.2d 978, 87 Cal.Rptr.2d 886 (1999)(rejecting claim for emotional distress arising from defective construction).

xxi 993 P.2d at 1266.

xxii 993 P.2d at 1266.

xxiii *Id.* (quoting, *Casa Clara v. Charley Toppino and Sons*, 620 So.2d 1244, 1247 (Fla. 1993)).

xxiv 993 P.2d at 1270.

xxv 993 P.2d at 1272, fn.5. (overruling *Worrell v. Barnes*, 87 Nev. 204, 484 P.2d 573 (1971)).

xxvi *Vandenberg v. Superior Court*, 21 Cal.4th 815, 982 P.2d 229, 88 Cal.Rptr.2d 366 (1999)

xxvii *Aetna Casualty and Surety Co. v. McIbs, Inc.*, 684 F.Supp. 246, 249 (D. Nev. 1988), *aff'd. Aetna Casualty & Surety Co. v. ARC Metals*, 878 F.2d 385 (9th Cir. 1989).

xxviii *New Hampshire Insurance Company v. Vieira*, 930 F.2d 696 (9th Cir. 1991).

xxix *Eljer Manufacturing Inc. v. Liberty Mutual Ins. Co.*, 972 F.2d 805 (7th Cir. 1992).

xxx *United States Fidelity & Guaranty Company v. Nevada Cement Company*, 93 Nev. 179, 561 P.2d 1335 (1977).

xxxi *Id.*

xxxii *Weast v. Travelers Casualty and Surety Company*, no. CV-S-98-496-PMP (RJJ)(D. Nev. March 22, 2000).

xxxiii *See, e.g.*, ISO form CG 00 01 11 88.