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ECONOMIC Loss Rule: "The principle that a plaintiff generally cannot recover [in tort] for financial harm that results from injury to the person or property of another."[1]

The Economic Loss Rule, a seemingly impenetrable barrier to tort claims for purely financial loss, has been riddled with exceptions since its advent.[2] The issue of whether one of these exceptions should include a third party contractor's (herein, a contractor who is not in a contract with the tortfeasor) ability to recover economic losses from a design professional who has negligently misrepresented construction plans to the contractor has split both state and federal courts alike.[3] On June 20, 2014, the Texas Supreme Court handed down a ruling that cemented Texas's stance on the issue.[4] In *LAN/STV v. Martin K. Eby Construction Co.*, the Texas Supreme Court held that the economic loss rule precluded a third party contractor who relied on the designs of the project architect when submitting its bid to the project owner from recovering economic losses from the architect in tort—losses that were caused solely by flaws in the design.[5] While the facts of the case are simple and the holding narrow, the implications are far-reaching as they seemingly strip contractors of every practical recourse for economic loss suffered as a result of their reliance on flawed plans when not in contractual privity with the design professionals who created them.

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1. Black's Law Dictionary 626 (10th ed. 2014).

2. Jim Wren, *Applying the Economic Loss Rule in Texas*, 64 Baylor L. Rev. 204, 206 (2014).

3. Bilt-Rite Contractors, Inc. v. Architectural Studio, 866 A.2d 270, 274 (Pen. 2005).

4. LAN/STV v. Martin K. Eby Const. Co., Inc., 435 S.W.3d 234 (Tex. 2014).

5. *Id.* at 235-36.

In *Eby*, the Dallas Area Rapid Transportation Authority (DART) contracted with LAN/STV, a joint venture hired to create plans for DART's new rail line.[6] In its contract with DART, "LAN/STV agreed to 'be responsible for the professional quality, technical accuracy, and . . . coordination of all designs, drawings, specifications, and other services furnished', and to be 'liable to the Authority [DART] . . . for all damages to the Authority caused by [LAN/STV's] negligent performance of any of the services furnished.' "[7] Using the designs created by LAN/STV, DART solicited competitive bids for construction of the rail line.[8] After reviewing the designs, Martin K. Eby Construction Co. (Eby), submitted its bid and was selected to construct DART's rail.[9] Only a few days after breaking ground on the project, Eby, a contractual stranger to LAN/STV, discovered that 80% of LAN/STV's plans were flawed and would have to be redrawn, a process that would cause substantial delays in construction.[10]

Upon projecting substantial losses as a result of the delays in construction, Eby sued DART in federal court.[11] The case was dismissed on procedural grounds.[12] Eby later settled with DART in an administrative proceeding for $4.7 million, which is a little over 25% of its total loss.[13] Seeking recovery for the remainder of its losses, Eby then sued LAN/STV for negligence and negligent misrepresentation.[14] The case advanced to trial on Eby's negligent misrepresentation claim alone—"that LAN/STV negligently misrepresented the work to be done in its error-ridden plans."[15] After the jury apportioned liability amongst the parties, the trial court awarded Eby $2.25 million plus interest.[16] On appeal, the judgment was affirmed and both Eby and LAN/STV petitioned for review.[17] The Texas Supreme Court reversed, holding that the economic loss rule precluded a contractor from suing a design professional in tort for losses due to negligently misrepresented construction plans when the two parties lacked privity of contract.[18]

In holding that the economic loss rule precludes a contractual stranger from bringing a negligent misrepresentation claim against the project architect for losses incurred as a result of construction delay, the Texas Supreme Court stressed the two fundamental rationales behind the rule: (1) to provide a barrier between contract and tort law and (2) to limit the unforeseeable ripple effect of economic liability due to a tortfeasor's ac-

6. *Id.* at 236.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.* at 238.
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.* at 236.

tions.[19] Accentuating these rationales, the RESTATEMENT (THIRD) OF TORTS "concludes, [that] while there is 'no general duty to avoid the unintentional infliction of economic loss', the duty may exist when the rationales . . . for limiting recovery are 'weak or absent.'"[20] For example, the Texas Supreme Court has held that in the case of accountants and attorneys, third party reliance is limited and foreseeable and, thus, liability for economic loss caused by negligent misrepresentations *is* imposed on these professionals.[21] However, the court concluded in *Eby* that construction projects, which include multiple tiers of interconnected contracts, are fundamentally distinguishable and that the underlying rationales should preclude negligent misrepresentation claims made by contractual strangers against project architects.[22] Thus, unless a third party contractor negotiates a term into the contract that requires the project owner to indemnify the contractor against any losses incurred as a result of the design professional's negligent misrepresentation of project designs, or purchases insurance that covers the same, the contractor will have to bear the risk of loss in Texas.[23]

To better understand the holding in *Eby*, it is worthwhile to look at the split among state high courts regarding the application of the economic loss rule to third party contractors' negligent misrepresentation claims against design professionals. Jurisdictions that apply the economic rule in this context include Colorado, Illinois, Nevada, Ohio, Utah, Virginia, Washington, Wyoming, and, after *Eby*, Texas.[24] These courts have relied on the underlying principles of the economic loss rule in holding that no tort remedy exists for economic damages suffered by a contractual stranger due to the negligent misrepresentation of plans by a design professional.[25] In applying the economic loss rule, these states have arbitrarily distinguished architects and engineers from other professionals and have explicitly and intentionally chosen to "diverge from the *Restatement*" in the construction design context.[26]

The rationale behind the divergence from the RESTATEMENT appears to focus on the unique characteristics of construction projects versus financial investments and legal counseling, areas where courts have not ap-

19. *Id*. at 240-41.

20. *Id.* at 241 (quoting RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 1 CMT. D.) (Tentaive Draft No. 1, 2012).

21. *Id.* at 243-45.

22. *Id.* at 246-47.

23. *Id.* at 247.

24. *See* BRW, Inc. v. Dufficy & Sons, Inc., 99 P.3d 66 (Colo. 2004); Fireman's Fund Ins. Co. v. SEC Donohue, Inc., 679 N.E.2d 1197 (Ill. 1997); Terracon Consultants Western, Inc. v. Mandalay Resort Grp., 206 P.3d 81 (Nev. 2009); Floor Craft Floor Covering, Inc. v. Parma Cmty. Gen. Hosp. Ass'n, 560 N.E.2d 206 (Ohio 1990); SME Indus., Inc. v. Thompson, Ventulett, Stainback & Assocs., Inc., 28 P.3d 669 (Utah 2001); Blake Constr. Co., Inc. v. Alley, 353 S.E.2d 724 (Va. 1987); Berschauer/Phillips Constr. Co. v. Seattle Sch. Dist. No. 1, 881 P.2d 986 (Wash. 1994); Excel Constr., Inc. v. HKM Eng'g, Inc., 228 P.3d 40 (Wyo. 2010).

25. *See*, *e.g.*, *BRW, Inc.*, 99 P.3d at 76 (finding that the economic loss rule bars the negligent misrepresentation claim).

26. *Eby*, 435 S.W.3d at 246-47.

plied the economic loss rule.[27] These unique characteristics include the structure of construction projects and the parties who rely on a design professional's plans.[28] Texas and other states that apply the economic loss rule recognize that construction projects are composed of a "web of contracts," and these courts argue that risk allocation for economic loss is best handled within this web.[29] Thus, these courts rely on the first economic loss rule rationale, providing a barrier between tort and contract law, in the construction context. As for the second rationale, that is limiting unlimited liability, courts applying the economic loss rule argue that while an accountant's report or attorney's opinion is relied upon by "only those to whom it is more specifically directed . . . the architect's plans are no more an invitation to all potential bidders to rely."[30] Thus, courts applying the rule argue that both rationales for limiting recovery are present within the construction project context and, therefore, no exception should exist.[31]

The Court in *Eby* explicitly acknowledged its divergence from the RESTATEMENT when it applied the economic loss rule to third party contractors' claims against project architects.[32] However, when viewing the actual language of the RESTATEMENT, this "divergence" appears to be nothing less than complete disregard. As discussed above, one of the grounds the court used in holding that the economic loss rule would apply to the architect-contractor context is unique in that it is a "web of contracts [that] would be disrupted by tort suits between" the parties.[33] RESTATEMENT COMMENT B explicitly negates this argument, explaining that "[a]llowing a suit against the architect of a project by a party who made a bid in reliance on a defective plan does not create comparable problems [e.g., disturbing the web of contracts]."[34] Furthermore, the court explicitly *agreed* with the language of the RESTATEMENT that says:

> [t]he plans drawn by the architect are intended to serve as a basis for reliance by the contractor who forms a bid on the basis of them and is then hired to carry them out. The architect's plans are analogous to the audit report that an accountant supplies to a client for distribution to potential investors—a standard case of liability [for negligent misrepresentation].[35]

Yet, just a few paragraphs later, the court chose to distinguish architects and engineers from other professionals by arguing that the former's liability is unknown and unlimited, ultimately concluding that a contrac-

27. *Id.*
28. *Id.*
29. *Id.* at 246 (citing RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 6 CMT. B (2012)).
30. *Id.* at 247.
31. *Id.* at 235-236.
32. *Id.* at 246-47.
33. *Id.* at 246 (quoting RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM, § 6 CMT. B (Tentative Draft No. 2, 2014)).
34. *Id.* at n.51.
35. *Id.* at 246-47.

tor can better allocate risk through its contract or business insurance.[36]

On the other side of the debate are those states refusing to distinguish architects and engineers from other professionals on whom courts across the nation impose liability. The states that provide for a negligent misrepresentation action under the RESTATEMENT include Arizona, Florida, Massachusetts, Minnesota, Rhode Island, Pennsylvania, South Carolina, and West Virginia.[37] These courts refuse to apply the economic loss rule:

> in cases where information is negligently supplied by one in the business of supplying information, such as an architect or design professional, and where it is foreseeable that the information will be used and relied upon by third persons, even if the third parties have no direct contractual relationship with the supplier of information.[38]

While courts applying the economic loss rule distinguish architects from other professionals in that the parties who rely on the contractor's plans are unknown and unlimited, the courts that do not apply the rule argue that "[t]he contractor is a member of a limited class compiled of those contractors bidding on a particular project."[39] Courts allowing recovery against architects for purely economic loss further acknowledge that this liability "places the duty of care on the party who is in the best position to guard against [negligent misrepresentations in the plans and specifications]."[40] The courts refusing to diverge from the RESTATEMENT appear to recognize an injustice in allowing design professionals to shield themselves from liability resulting from the failure to properly and diligently perform their job.[41]

As the law in Texas currently stands, the economic loss rule precludes recovery for negligence in two circumstances: (1) when damages arise out of the subject matter of the contract between two contractual parties and (2) when a defective product causes damage to itself, but does not injure any person or other property.[42] However, as noted above, many exceptions exist to the broad applicability of the rule.[43] In *Federal Land Bank Ass'n of Tyler v. Sloane*, *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, and *Grant Thornton v. Prospect High Income Fund, Ltd.*, the Texas Supreme Court has allowed non-contractual third parties to sue lenders, lawyers, and accountants, respectively, for economic losses

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36. *Eby*, 435 S.W.3d at 247.

37. *See* Sullivan v. Pulte Home Corp., 306 P.3d 1 (Ariz. 2013); A.R. Moyer, Inc. v. Graham, 285 So.2d 397 (Fla. 1973); Craig v. Everett M. Brooks Co., 222 N.E.2d 752 (Mass. 1967); Prichard Bros., Inc. v. Grady Co., 428 N.W.2d 391 (Minn. 1988); Forte Bros., Inc. v. Nat'l Amusement, Inc., 525 A.2d 1301 (R.I. 1987); Bilt-Rite Contractors, Inc. v. Architectural Studio, 866 A.2d 270 (Pa. 2005); Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc., 463 S.E.2d 85 (S.C. 1995); Eastern Steel Contractors, Inc. v. City of Salem, 549 S.E.2d 266 (W.Va. 2001).

38. *Bilt-Rite Contractors*, 866 A.2d at 287.

39. *Eastern Steel*, 549 S.E.2d at 275.

40. *Id.*

41. *See id.* at 275-76.

42. Jim Wren, *Applying the Economic Loss Rule in Texas*, 64 BAYLOR L. REV. 204, 233-34 (2014).

43. *Id.* at 206-07.

due to negligent misrepresentations.[44] The court noted that allowing such an action was consistent with the RESTATEMENT.[45] As noted and agreed on in *Eby*, an architect's plans are no different than an auditor's report to investors as the plans will be relied upon by a limited number of contractors who will place bids on the project.[46] Furthermore, illustration 8 of the RESTATEMENT contains an identical fact pattern as that presented in *Eby*, and, although noting contractual recourses, explicitly recognizes the design professional's potential liability for the negligent misrepresentation of project plans to contractual strangers.[47] However, when deciding whether such an action could be brought against a design professional by a third party contractor, the Texas Supreme Court cast aside the RESTATEMENT and side-stepped its growing list of professional exceptions, ultimately holding that recovery in that case would be precluded.[48]

Although the Texas Supreme Court is not alone in holding that the economic loss rule precludes a contractor from bringing a negligent misrepresentation claim against a project architect for economic losses, the court's rationale becomes muddled when looked at in practice. After analyzing the facts surrounding *Eby* under the two rationales for the economic loss rule, the court concluded that the risk of such economic loss is better allocated through negotiated contract provisions or business protection insurance.[49] What the Texas Supreme Court failed to address or consider in handing down its ruling was the lack of bargaining power a competitive bidder in the construction industry actually has and the difficulty of obtaining business protection insurance that covers economic losses due to negligent misrepresentations. Instead, based on abstract reasoning, the court veered harshly from its prior holdings, cast aside the RESTATEMENT, and left third party contractors with little practical recourse in the event they rely on a design professional's flawed plans and suffer only economic damages as a result.

The impracticality of the Texas Supreme Court's holding is highlighted when one looks at the recourses a third party contractor now has when faced with economic loss as a result of construction delays from relying on a design professional's faulty design. According to the court, a third party contractor may either negotiate into its contract with the project owner a term that requires the owner to indemnify the contractor against economic loss due to faults in the architect's plans or purchase business protection insurance that insures against the same.[50] However, when applied to real world scenarios, both avenues appear impractical. For example, a contractor who attempts to inject more liability for the project

44. Lan/STV v. Martin K. Eby Const. Co., Inc., 435 S.W.3d. 234, 244-45 (Tex. 2014) (briefly discussing all three cases).

45. *Id.* at 244-46.

46. *Id.* at 246-47.

47. *See id.* at 247 n.55 (quoting RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM §3 CMT. F (Tentative Draft No. 1, 2012)).

48. *Id.* at 246-47.

49. *Id.* at 247.

50. *Id.* at 248.

owner into the contract may be passed up for one of many other competitive bidders in line behind him. Further diluting the bargaining power of a contractor, a recent Texas Supreme Court case, *El Paso Field Services, L.P. v. MasTec North America, Inc.*, made it clear that "Texas courts will likely enforce broadly and literally any attempt by an owner to shift to the contractor responsibility for defects in the design."[51] As discussed in the Construction Litigation Reporter, the *MasTec* court found that the project owner included in the contract an obligation for the contractor to familiarize itself with the plans and the site; thus, the court held that neither the project owner nor architect were liable for the nearly 800 flaws in the project survey.[52] *MasTec* seemingly strips the contractor of any residual bargaining power and makes it clear which party Texas will continue to support in construction project related disputes.

As for business protection insurance, such a policy would be difficult and expensive to obtain as "almost all forms of builders' risk policies and other traditional property damage coverages do not cover economic loss caused by delay and business interruption."[53] Although enhanced coverage may be purchased, these endorsements may still not cover economic loss caused by the negligent misrepresentation of plans by the project architect or engineer.[54]

Despite their lack of bargaining power and the impracticality of business protection insurance for negligent misrepresentations, almost every other state but Texas automatically offers contractors one additional recourse for economic losses due to construction delays caused by the faulty designs of a contractual stranger—the implied warranty of design.[55] Under the implied warranty of design, "between two innocent parties—the owner and the contractor—the economic consequences of implementing a defective design falls upon the owner, the party who had hired the architect."[56] However, case law in Texas remains split as to whether a contractor is afforded the protection of this implied warranty of design.[57] Thus , a contractor accepting a job in Texas does so at its own risk, for a court might rightfully find that under current case law contractors "accept a contract and its design at their peril and, as a matter of law, the specifications are not guaranteed by the owner."[58]

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51. 35-9 Construction Litig. Rep. (Thomson Reuters) 4 (2014) (discussing El Paso Field Servs., L.P. v. MasTec North America, Inc., 389 S.W.3d 802 (Tex. 2012)).

52. *Id.*

53. *See* FRED MUSE & EDMUND M. KNEISEL, CONSTRUCTION BUSINESS HANDBOOK § 4.03 [A] (Aspen Publishers 2004).

54. *See id.* (not including negligent misrepresentation in a list of causes of economic loss that may be covered by enhanced coverage).

55. 35-9 Construction Litig. Rep. (Thomson Reuters) 4 (2014).

56. *Id.*

57. Compare Lonergan v. San Antonio Loan & Trust Co., 101 Tex. 63 (Tex. 1907) with Shintech, Inc. v. Group Constructors, Inc., 688 S.W.2d 144 (Tex. App—Houston [14th Dist.] 1985, no pet.).

58. *Id.*

The Texas Supreme Court's holding in *Eby* is bound to cause much debate in Texas construction law. Instead of recognizing the clear, limited, and foreseeable class of potential contractors who would rely on project designs in placing bids, the Court has ignored the RESTATEMENT and many of its sister jurisdictions in concluding that the web of contracts is too intricate, and liability too limitless, to allow claims by a contractual stranger against design professionals for economic loss. As a result, contractors in Texas are left with only two impractical solutions: imposing an indemnification provision on the project owner to cover economic losses that the contractor suffers, or purchasing costly and likely non-existent business protection insurance to cover economic losses caused by construction delays due to a design professionals negligent misrepresentation. It is apparent that Texas favors protection of professionals in the construction context over those relying on the professionals to be diligent in their professional work.[59] *Eby* puts contractors, subcontractors, homebuilders, and nearly every other third party who relies on a construction professional's work at substantial risk for unrecoverable economic loss. Furthermore, the case opens the door for surveyors, environmental inspectors, and other professionals on whom non-contractual third parties rely to claim shelter from economic liability caused by their own negligent misrepresentations. Thus, until an avenue is created that imposes liability on the professional for correctly performing his job, contractual strangers relying on professional work-product must do so at their own peril.

59. *Id.*