

Sextant or Kaleidoscope?

Court of Appeals Applies Contract Constraint Limitation Version of Economic Loss Rule in Construction Defect Case

By GREGORY L. SHELTON

Introduction

Shots ring out once again in the narrow borderland between contract and tort. In its recent decision in **Lord v. Customized Consulting Specialty, Inc.**, 643 S.E.2d 28 (N.C. App. April 17, 2007), the Court of Appeals of North Carolina held that the economic loss rule did not bar a negligence claim by the original purchaser of a home against the first-tier truss manufacturer. This seemingly straightforward holding encompasses numerous “subholdings” that require examination. If the examination is effective, you will not understand North Carolina’s economic loss rule when you finish this article.

Facts and Procedure

Customized Consulting Specialty, Inc. (“Customized Consulting”), as general contractor, contracted with the Lords, as owners, to sell a lot and construct a home upon it. Customized Consulting purchased the trusses from 84 Lumber. After moving into the home, the Lords claimed that the trusses were sagging. The Lords filed a lawsuit and, after a series of procedural adjustments, went to trial asserting contract claims against Customized Consulting and a negligence claim against three 84 Lumber entities (collectively “84 Lumber”).

At the close of the Lords’ evidence, 84 Lumber moved for a directed verdict arguing that the economic loss rule barred the Lords’ negligence claim. The trial court denied the motion. The jury then returned a verdict in favor of the Lords and against 84 Lumber in the amount of \$42,000.00. The jury also ruled against the Lords on their contract-based claims against Customized Consulting.

On appeal, the Court of Appeals of North Carolina affirmed the denial of 84 Lumber’s motion for directed verdict, concluding that the economic loss rule “has not ‘expanded to preclude all claims in tort for economic damages in the absence of a contract, or, more narrowly, outside the products liability context.’ ” *Id.* at 32 (quoting **Ellis-Don Constr., Inc. v. HKS, Inc.**, 353 F.Supp. 603, 606 (M.D.N.C. 2004)) (emphasis in original). Reading this language in converse, the economic loss rule precludes all claims in tort for economic damages in the *presence* of a contract. In their comprehensive treatise on

construction law, Bruner and O’Connor refer to this rule as the “contract constraint” limitation on tort damages. Philip L. Bruner & Patrick J. O’Connor Jr., *Bruner & O’Connor on Construction Law* § 19:9 (2002).

On its surface, the Court of Appeals’ written opinion presents a seemingly straightforward analysis of existing precedent. However, attorneys familiar with the economic loss rule will recognize the palpable tension lurking within the nooks and crannies of the opinion as the Court of Appeals grapples with conflicting legal and public policy issues. Much of the tension arises from the doctrinal differences between the damages-based economic loss rule (the “real” economic loss rule) and the duty-based economic loss rule.

A Tale of Two Rules

The duty-based economic loss rule (a misnomer) examines the duty owed by the defendant to the plaintiff. This approach stems from **Ports Authority v. Lloyd A. Fry Roofing Co.**, 294 N.C. 73, 240 S.E.2d 345 (N.C. 1958), where the Supreme Court observed that “[o]rdinarily, a breach of contract does not give rise to a tort action by the promisee against the promisor.” *Id.* at 350. The Supreme Court further observed that a party to a contract may be liable in tort for “personal injury or damage to property” resulting from the promisor’s “negligent, or willful, act or omission in the course of his performance of his contract.” *Id.* (citations omitted). North Carolina courts frequently cite **Ports Authority** as an economic loss rule case. However, **Ports Authority** actually represents an excellent summary of traditional common law duties in both contract and tort.

The damages-based economic loss rule examines the nature of the plaintiff’s damages, not the duty of the defendant. “Losses not caused by personal injury or damage to other property (property that is not the subject of the contract) are economic losses, and economic losses fall within the realm of contract law.” Gregory L. Shelton, *The Economic Loss Rule in North Carolina: Time to Wake the Sleeping Giant*, 10 N.C. Bar J. 27, 28-31 (Fall 2005).

The Court of Appeals applied the damages-based economic loss rule in **Moore v.**

Coachmen Industries, Inc., 129 N.C.App. 389, 499 S.E.2d 772 (1998). In that case, a fire allegedly caused by an electrical converter destroyed a recreational vehicle (“RV”) but caused no personal injuries. The owners of the RV, the Moores, sued the manufacturer, Coachmen Industries, Inc. (“Coachmen”), and Coachmen’s subsidiary, Sportscoach Corporation of America (“Sportscoach”). The Moores also sued MagneTek, Inc. (“MagneTek”), the supplier of the RV’s electrical system. The Moores lacked privity of contract with MagneTek. The Moores alleged claims of negligence and breach of implied and express warranties against Coachmen and Sportscoach, and claims of negligence and breach of the implied warranty of merchantability against MagneTek.

The trial court entered summary judgment against the Moores on the grounds that the economic loss rule barred the Moores’ claims. The Court of Appeals affirmed, stating that “North Carolina has adopted the economic loss rule, which prohibits recovery for economic loss in tort. Instead, such claims are governed by contract law—in this case, the UCC.” **Moore**, 499 S.E.2d at 401-02.

Following on the heels of **Moore**, courts in North Carolina, both state and federal, applied the damages-based economic loss rule in a series of synthetic stucco cases. See **Wilson v. Dryvit Sys., Inc.**, 206 F.Supp.2d 749 (E.D.N.C. 2002), *aff’d* 71 Fed.Appx. 960 (4th Cir. 2003); **Higginbotham v. Dryvit Sys., Inc.**, No. 1:01CV0424, 2003 WL 1528483, 2003 LEXIS 4530 (M.D.N.C. Mar. 20, 2003); **Land v. Tall House Bldg. Co.**, 165 N.C.App. 880, 602 S.E.2d 1 (2004). In these cases, homeowner plaintiffs sued the manufacturer of synthetic stucco systems for damages resulting from water infiltration and resulting damage to their homes. The negligence claims failed because the respective courts in those cases held that the plaintiffs’ damages did not result from personal injury or damage to “other property.”

Strict adherence to the common law principles in **Ports Authority** would render the damages-based economic loss rule a distinction without a difference. However, the rules produce dif-

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ferent results when tort law ventures into the realm of contract law. In such cases, the damages-based economic loss rule quickly identifies, and prevents, such encroachment.

Analysis of the Analysis

In **Lord**, the court viewed **Ports Authority** and **Moore** as links in a continuing chain of economic loss rule cases in North Carolina. Yet the result in **Lord** contradicts both **Ports Authority** and **Moore**, as both cases would bar the Lords' negligence claim against 84 Lumber.

The Court of Appeals references **Ports Authority** only in passing, quickly turning its attention to the Supreme Court's "more relevant" decision in **Oates v. JAG, Inc.**, 314 N.C. 276, 333 S.E.2d 222 (1985). **Lord**, 643 S.E.2d at 31. In **Oates**, the plaintiff homeowner brought negligence claims against the builder for defective construction. The plaintiff was not the original purchaser and, therefore, lacked privity with the builder. The Supreme Court permitted the negligence claim, holding that "a subsequent purchaser can recover in negligence against the builder of the property if the subsequent purchaser can prove that he has been damaged as a proximate result of the builder's negligence." **Oates**, 333 S.E.2d 226.

The **Oates** court, quoting language from Florida's First District Court of Appeal, acknowledged a policy issue that often collides with the economic loss rule and traditional common law tort principles: "We must be realistic. The ordinary purchaser of a home is not qualified to determine when or where a defect exists. Yet, the purchaser makes the biggest and most important

investment in his or her life and, more times than not, on a limited budget." *Id.* at 225-26 (quoting **Simmons v. Owens**, 363 So. 2d 142 (Fla. 1st DCA 1978)). The Florida District Court further observed that "[t]he purchaser can ill afford to suddenly find a latent defect in his or her home that completely destroys the family's budget and have no remedy for recourse." *Id.*

The **Lord** court then turned its attention to **Moore** and the subsequent stucco cases. As part of its appeal, 84 Lumber argued that **Moore**, as controlling authority, mandated application of the economic loss rule to the Lords' negligence claim. Indeed, both **Moore** and **Lord** involved negligence claims by plaintiffs lacking privity with a manufacturer. The Court of Appeals rejected 84 Lumber's argument, distinguishing **Moore** as a "products liability" case with no application to the construction of homes. **Lord**, 643 S.E.2d at 32. *But see Swaney v. Penden Steel Co.*, 259 N.C. 531, 131 S.E.2d 601 (1963) (applying products liability concepts in case where worker injured as a result of defectively constructed truss).

The court then rejected the federal synthetic stucco cases mentioned above as not controlling and distinguished its own decision in **Tall House** on the grounds that **Tall House** involved indemnity and contribution claims rather than negligence claims. **Lord**, 643 S.E.2d at 31. However, the court cited with approval the Middle District's decision in **Ellis-Don Constr., Inc. v. HKS, Inc.**, 353 F.Supp.2d 603, 606 (M.D.N.C. 2004). In that case, the Middle District stated in dicta that the economic loss rule applied only in products liability cases and had not been "expanded to

preclude all claims in tort for economic damages in the absence of a contract, or, more narrowly, outside the products liability context." **Ellis-Don**, 353 F.Supp.2d at 606.

The court concluded that 84 Lumber owed a duty to use reasonable care "in performing its promise to provide reliable trusses to Customized Consulting for use in the construction of the Lords' residence." **Lord**, 643 S.E.2d at 33. The court then applied the contract constraint limitation (though not by name), stating that "[b]ecause there was no contract between the Lords and the 84 Lumber Defendants, we further find that the economic loss rule does not operate to bar the Lords' negligence claims." *Id.*

As is frequently the case with economic loss rule decisions, **Lord** invites many questions. For example, what constitutes a "products liability" or UCC case in a construction dispute? Also, does the duty to use reasonable care apply to the performance of *all* contractual promises? Arguably, under the reasoning in **Lord**, a subsequent purchaser could sue a painting subcontractor in negligence because the subcontractor failed to apply the color required under the original plans and specifications. **Lord** blurs the line between contract and tort, because in **Lord**, the sagging trusses did not cause personal injury or damage to "other property."

Consequently, **Lord** leaves open the possibility of negligence claims by strangers to a commercial transaction for "negligent breach" of any or all contractual promises. Not bound by contractual remedies or the benefit of the bargain measure

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relational tensions and communications pitfalls. We can do that by (a) listening closely to our clients, the better to help them determine their objectives and decide whether they need a champion or a counselor, a warrior or a peacemaker; (b) communicating honestly and professionally with opposing counsel, maintaining objectivity where our clients may be struggling to do so due to their understandable emotional involvement; and (c) bringing a solution-oriented approach that is sensitive to the client's bottom line. Often, we earn our keep when we simply step into the process on either side of a dispute and facilitate or

reinstate communication that is dead or dying. Equipped with the factual background provided by our clients, a well-honed working knowledge of the applicable legal principles, and a better understanding of the ins and outs of relational styles and communication principles discussed herein, we are uniquely positioned to help our clients realistically evaluate and choose different courses of action. And occasionally, we may have the privilege of helping a ship that was once headed way off course right itself, patch up the dings and leaks that it has weathered in a storm of conflict, and set sail back on track towards the destination intend-

ed by all its passengers from its launch. And that, my friends and colleagues, is a good feeling, no matter what the relational context. □

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of damages, the outsiders to the transaction could recover broad tort damages as long as the damages were “proximately caused” by the breach.

Finally, **Lord** leaves the meaning and application of the economic loss rule in North Carolina open to speculation and litigation. North Carolina litigators may enjoy double the pleasure, as there appear to be two distinct economic loss “rules” in North Carolina. In products liability cases (except perhaps products liability cases involving construction), the damages-based economic loss rule at play in **Moore** appears intact. In all other cases, the contract constraint limitation to damages continues to masquerade as the economic loss rule.

Conclusion

Lord raises many important issues which may soon be answered by the Supreme Court of North Carolina. 84 Lumber filed a petition for discretionary review on May 8, 2007. (The petition was pending when this article was submitted to *Change Order*). If these issues remain unanswered, North Carolina construction lawyers can look forward to navigating into and out of the economic loss rule in stormy seas. □

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