

A Texas Framework For Extending The Economic Loss Rule

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Construction contractors have long tried to directly sue the owners' professional design firms when faulty plans or related services cause economic losses such as increased costs from delays and disruptions and out-of-pocket costs, usually without success. At least two Texas cases in recent years brought contractors hope that there might be a viable path to professional designers' checkbooks through tort claims like negligent misrepresentation. A unanimous Texas Supreme Court, however, just took this hope away in *LAN/STV v. Martin K. Eby Constr. Co.*[1]

The Texas Supreme Court's ruling in *Eby* sheds considerable light on the boundary between claims based on torts and contracts on the same facts. To do so the Supreme Court examined the economic loss rule ("ELR") the underlying purpose of which is "to preserve the distinction between contract and tort theories in circumstances where both theories could apply." [2] The Supreme Court began answering the previously unanswered question about the extent to which Texas precludes the recovery of economic damages in a negligence suit between contractual strangers.[3] The Supreme Court did not, however, pronounce a bright-line test. It looked instead at the particular circumstances presented in the *Eby* case (i.e., a construction contractor recovering delay damages from the owner's design professional) and found the rationales for applying the economic loss rule supported. The breadth of the ruling in other particular circumstances remains to be seen, but the depth of the Supreme Court's analysis will undoubtedly provide a map to attempted application of the ELR in other circumstances.



John R. Hawkins

Two 2011 Opinions Gave Construction Contractors a Path to Suing Design Professionals

In 2011, the Houston Court of Appeals, First District, in *CCE Inc. v. PBS&J Constr. Svs. Co.*[4] reversed the summary judgment obtained by PBS&J, the engineering firm that contracted with the owner, the Texas Department of Transportation ("TxDOT"). The summary judgment was granted based upon PBS&J's argument that CCE, the contractor, sought only benefit-of-the-bargain damages through its negligent misrepresentation claim against the PBS&J.[5] The Houston Court concluded that the damages of CCE "are actually for its 'pecuniary loss suffered otherwise as a consequence of [CCE's] reliance upon the misrepresentation[s]' of PBS&J," which were alleged errors in plans.[6] The Houston Court concluded these were "reliance damages as measured by [CCE's] out-of-pocket expenditures and consequential

losses, not damages for the benefit-of-the-bargain on its contract with TxDOT as measured by lost sales or profits.”[7] Accordingly, the Houston Court found the trial court erred in granting summary judgment for PBS&J on the ground that the economic loss rule barred CCE’s recovery of such damages on its negligent misrepresentation claim.[8]

Later in 2011, the Dallas Court of Appeals in *Martin K. Eby Constr. Co. v. LAN/STV*[9] affirmed a judgment in which the contractor, Eby, recovered on its negligent misrepresentation claim against the project engineering firm, LAN/STV, retained by the owner, Dallas Area Rapid Transit (“DART”). DART built a rail line extension. The contractor, Eby, claimed delay and disruption damages caused by errors in the LAN/STV’s plans and specifications. Eby sued DART in district court for breach of contract and misrepresentation, and that claim was ultimately settled.[10] Eby then sued LAN/STV for negligence and negligent misrepresentation trying to recover what Eby characterized as out-of-pocket expenditures and consequential losses suffered by relying on the plans and specifications. The trial court entered a judgment against LAN/STV based upon the jury’s finding of LAN/STV’s negligent misrepresentation in the form of errors in its plans and specifications.[11]

Both parties appealed. The Dallas Court of Appeals rejected Eby’s attempt to have the jury’s comparative negligence findings disregarded.[12] The court also decided against LAN/STV on its cross-appeal and affirmed. One of the cross-appeal issues, whether the trial court erred in not applying the economic loss rule to bar the contractor’s recovery of economic damages, became the decisive issue at the Texas Supreme Court.[13] The Dallas Court of Appeals found the CCE case similar and instructive.[14] Like CCE, Eby presented evidence that its out-of-pocket expenses were incurred in addition to the damages caused by inaccuracies in the bid documents prepared by LAN/STV, thus establishing an injury that is independent of CCE’s breach of contract claim against DART.[15] The Dallas Court of Appeals observed that Eby’s damages were measured by its out-of-pocket expenses, “not what is defined as economic loss.”[16]

The ELR issue in both of these cases turned principally on whether the monetary losses were characterized as contract benefit-of-the-bargain damages or out-of-pocket damages in addition to contract damages. The Texas Supreme Court did not use or comment on this distinction in types of losses and used a different analysis.

The Eby Case Extended the Reach of the ELR

The question presented to the Texas Supreme Court in *Eby* was whether the ELR permits a construction contractor to recover economic loss (increased costs of performing its contract with the owner) in a tort action against the designer, whose contract is with the owner, for negligent misrepresentation in the form of errors in the designer’s plans and specifications.[17] The Supreme Court concluded that the ELR does not allow such recovery, reversed the Dallas Court of Appeals and rendered judgment for LAN/STV.[18] The *Eby* opinion traces the history of the ELR over more than 80 years and provides an analytical framework for its extension in particular circumstances beyond the issue decided.

Incredibly, the *Eby* decision is apparently the first Texas Supreme Court decision to address the ELR in a case involving the recovery of economic loss in a negligence suit between contractual strangers.[19] The *Eby* case provided an opportunity for the Texas Supreme Court to further address the interaction of the ELR and torts left unexplored in another 2011 case, *Sharyland Water Supply Corp. v. City of Alton*. [20] The Supreme Court in *Sharyland* observed that it has only applied the ELR in pecuniary loss cases involving defective products or failure to perform a contract.[21] The Supreme Court observed that the court of appeals in *Sharyland* crafted a second kind of economic loss rule. This second kind of ELR held

that one can never recover economic loss from a tort claim, a “rule” that the Supreme Court found overstated and oversimplified.[22] The Supreme Court observed, however, that it has not addressed a third formulation of the ELR, whether purely economic losses may ever be recovered in negligence.[23]

The Supreme Court stopped well-short of formulating such an ELR of the third kind. Instead, Eby adopted a measured, analytical approach. The Supreme Court did make clear, however, that the ELR should not apply differently to negligence and negligent misrepresentation in the same situation because both are based on the same logic,[24] but the bright lines fade beyond that point. As it observed, the ELR:

'[D]oes not lend itself to easy answers or broad pronouncements.'[25] Rather, [the] application of the rule depends on an analysis of its rationales in a particular situation.[26]

The Supreme Court found the principal rationales for the ELR well-summarized in the Restatement (Third) of Torts: Liability for Economic Harm.[27] The two rationales quoted in Eby at length can be fairly summarized.

1. Indeterminate and disproportionate liability: Economic losses grow more easily than losses usually associated with torts, injury to the body or property of another. The physical forces that cause personal injury and property damage spend themselves in predictable ways, but economic harm is not self-limiting. The indeterminate liability of economic loss may be out of proportion with the culpability.[28]
2. Deference to contract: Risks of economic loss are especially well-suited to allocation by contract. Contracting parties can assess the risks before signing a contract and agree to allocate the risk through insurance, indemnities and the like.[29]

The Restatement concludes:

[W]hile there is 'no general duty to avoid the unintentional infliction of economic loss,'[30] the duty may exist when the rationales just stated for limiting recovery are 'weak or [absent].'[31]

The Supreme Court explored the rationales for applying the ELR in the particular circumstances of construction contracts. It observed that construction contracts operate principally by silos of vertical contracts among stakeholders. Setting aside for the moment the question of application to design professionals, as a general rule, construction stakeholders cannot recover from each other absent a contract. If, for example, a roofing subcontractor could sue a foundation subcontractor for delays, the risk of liability for all construction project stakeholders would be magnified and indeterminate.[32] Indeed, Texas courts have repeatedly invoked the ELR to disallow recovery of purely economic losses in an action for negligent services not involving professional services.[33]

The Supreme Court went on to consider the application of the ELR to design professionals, architects and engineers. Eby argued that the ELR should not apply in the Eby case when it was not applied to bar recovery in the court's other negligent misrepresentation cases involving licensed professionals.[34] The cases discussed were *McCamish Martin Brown & Loeffler v. F.E. Appling Interests (lawyers)*[35] and *Grant Thornton LLP v. Prospect High Income Fund Ltd. (accountants)*. [36]

The Supreme Court observed that in both of these cases negligent misrepresentation claims were upheld but only in narrow, limited circumstances. The real issue is whether design professionals should be treated differently from nonprofessional service providers. Again, the court agreed with Restatement. The construction contractor's principal reliance must be on the presentation of the plans and specifications by the owner with whom it will enter an agreement, not with the designer with whom it has no agreement. The professional designer's plans "are no more [than] an (sic) invitation to all potential bidders to rely." [37]

The Supreme Court found that the rationales for the ELR supported its application in Eby to preclude a construction contractor from recovering delay damages from the owner's designer. [38]

How Far Will the ELR Extend?

Cases that follow Eby will undoubtedly seek to limit or expand its holding. There are already questions about its proliferation even in a construction context. The contracts in Eby to which the Texas Supreme Court deferred in applying the ELR were for a design-bid-build project. This traditional construction delivery method is characterized by having the three principal stakeholders — owner, contractor and designer — that set up the two separate lines of contracts, with the owner a party to each. The analysis in Eby might well also apply when the construction delivery method is construction management as an adviser or is construction management at risk because there are typically two or more lines of contracts that resemble design-bid-build. In contrast, the usual arrangement in design-build delivery would include a contract between the designer and contractor as a single design-build team. Further on the spectrum is true integrated project delivery which operates under a single contract to which the owner, contractor, designer and others are all parties. The court's method of analysis in Eby, which focuses on the particular circumstances of contractual strangers fighting, promises to be well-suited for responding to these different circumstances.

—By John R. Hawkins, Porter Hedges LLP

John Hawkins is a partner in Porter Hedges' Houston office, where he is a member of the firm's construction litigation practice group.

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[1] No. 11-0810, 2014 WL 2789097 (Tex. June 20, 2014).

[2] See Id. at *3-*4 (citations omitted).

[3] Id. at *5.

[4] No. 01-09-00040-CV, 2011 WL 345900 (Tex. App.—Houston [1st Dist.] January 28, 2011, pet. denied)(mem. op.)

[5] Id. at *8.

[6] Id. (quoting the Restatement (Second) of Torts Sec. 552B(1)(b) 1977).

[7] Id.

[8] Id.

[9] 350 S.W.3d 675 (Tex. App. – Dallas 2011), rev'd sub nom., LAN/STV v. Martin K. Eby Constr. Co., No. 11-0810, 2014 WL 2789097 (Tex. June 20, 2014).

[10] Id. at 679.

[11] Id.

[12] Id. at 678.

[13] Id. LAN/STV also asserted that it enjoyed derivative sovereign immunity as a contractor of DART, which barred tort claims against it. It presented this issue in its appeal to the Texas Supreme Court, which was not addressed. Eby 2014 WL 2789097 at *2.

[14] Id. at 687.

[15] Id. at 688.

[16] Id. (citation omitted).

[17] Eby, 2014 WL 2789097 at *1.

[18] Id.

[19] See Id. at *5.

[20] 354 S.W.3d 407 (Tex. 2011).

[21] Id. at 418.

[22] Id.

[23] Id. at 419.

[24] Eby, 2014 WL 2789097 at *7.

[25] Id. at *7 (quoting Sharyland, 354 S.W.3d at 419).

[26] Id.

[27] Id. at *5 (citing Restatement (Third) of Torts: Liability for Economic Harm § 1 cmt. c (T.D. No. 1 2001)).

[28] Eby, 2014 WL 2789097 at *4.

[29] Id. at *4-*5.

[30] Id. at *5 (quoting Restatement (Third) of Torts: Liability for Economic Harm § 1 (T.D. No. 1 2001)).

[31] Id. (quoting Restatement (Third) of Torts: Liability for Economic Harm § 1 cmt. d (T.D. No. 1 2001)).

[32] Eby, 2014 WL 2789097 at *10.

[33] Id at *6.

[34] Id at *7.

[35] 825 S.W.2d 439 (Tex. 1991).

[36] 314 S.W.3d 913, 920 (Tex. 2010).

[37] Eby, 2014 WL 2789097 at *8 (quoting Restatement (Third) of Torts: Liability for Economic Harm § 6 cmt. b (T.D. No. 2 2002)).

[38] Id. at *10.