

Yacht Club II: Charting the Shoals of the Economic Loss Rule

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In a series of recent decisions, the Colorado Supreme Court expressly recognized the "economic loss rule" (the "Rule") applied the doctrine to bar tort claims in both a public works and a commercial construction dispute, and then reaffirmed non-application of the Rule in a residential construction dispute. This article examines the genesis of the Rule, the principles underlying the Rule, its application to various construction disputes, and unanswered questions that practitioners representing property damage claimants may face.

Genesis of the Rule.

The economic loss rule is intended to maintain the boundary between contract and tort law, and typically applies when a contracting party seeks to use a tort theory to recover damages arising from a commercial product or service. The Rule originated during the emergence of strict product liability claims in the 1960's for the purpose of distinguishing compensable property damage and bodily injury losses from non-compensable commercial losses.

In *Hiigel v. General Motors Corp.*,¹ the Colorado Supreme Court endorsed the principles underlying the economic loss rule in declining to extend the strict product liability doctrine as a vehicle to recover commercial or business losses. Thirteen years later, in *Jardel Enterprises, Inc. v. Triconsultants, Inc.*,² the Colorado Court of Appeals applied the

Rule in refusing to permit a restaurant owner to bring a negligence claim against a subcontractor for lost profits resulting from the delayed opening of the restaurant, where the subcontractor misread the building plans and mislocated the building's foundation. However, not until twenty-five years after *Hiigel*, in *Town of Alma v. Azco Construction, Inc.*,³ did the Colorado Supreme Court expressly recognize the Rule.

Purpose of the Rule

In *Town of Alma*, the court noted that the essential difference between tort and contract obligations is the source of the duties between the parties. Tort law is designed to protect citizens from the risk of physical harm to their persons or their property, and legal duties of care arise without regard to any agreement or contract. Conversely, contract obligations arise from promises made between parties, and contract law is intended to enforce the expectancy interests created by the parties' promises so that they can allocate risks and costs during their bargaining.

Town of Alma noted that limiting tort liability when a contract exists between parties generally is proper because a product or service's nonperformance can be adequately addressed by rational actors bargaining at arms length to shape the terms of the contract, such as by requiring additional or fewer

warranties in exchange for a higher or lower price. Because the Rule's principal purpose is to enable parties confidently to allocate their risks and costs in a bargaining situation, and commercial transactions do not involve large disparities in bargaining power, courts are reluctant to intrude into the contracting parties' allocation of the bargain's economic risks.

Public Works Construction Contracts

While the Rule implies that the focus of the inquiry is on the type of damages suffered, application of the Rule turns on the source of the duty breached rather than whether the damages are physical or economic. *Town of Alma* held that a party suffering only economic loss from the breach of an express or implied contractual duty may not assert a tort claim for such breach absent an independent duty of care under tort law. The court explained that, generally, economic loss involves damage other than physical harm to persons or property. Thus, where a town and individual homeowners sought damages for the cost to repair and replace malfunctioning water lines installed pursuant to a water system installation contract, no independent duty supported the plaintiffs' negligence claim and the Rule barred the claim.

Town of Alma noted that maintaining the focus on the source of the duty preserves a proper demarcation between

tort and contract law. Some special relationships, such as attorney-client, physician-patient and insurer-insured, by their nature automatically trigger a tort duty of care even when the parties have entered into a contractual relationship. Thus, in some cases, contract and tort duties exist simultaneously. The Rule also does not apply to tort claims that are expressly designed to remedy economic loss independent of a breach of contract, such as common law fraud and negligent misrepresentation. And, due to myriad factors leading Colorado courts to find a public policy favoring non-negligent residential construction, the Rule is inapplicable to claims against builders arising from faulty home construction.

In *Town of Alma's* sister case, *Grynsberg v. Agri-Tech, Inc.*,⁴ investors in a cattle program asserted negligence claims to recover for their disappointed expectations and resulting lost investment due to mismanagement. The court held that the Rule barred the investors' tort claims because no legal duty independent of that found in the parties' express and implied contracts existed. The court found that all of the defendants' actions were called for in, and governed by, the contracts between the parties, and the defendants did not provide any services to the plaintiffs that the terms of the contracts did not require. Three factors that aid in determining the source of the duty at issue informed the court's decision in *Grynsberg*: whether the relief sought in negligence is the same as the contractual relief; whether there is a recognized common law duty of care in negligence; and whether the negligence duty differs in any way from the contractual duty.

Whether an independent tort duty exists in a particular case turns on the ageless question whether the plaintiff's interest that has been infringed by the defendant's conduct is entitled to legal protection, separate from any governing contract provisions. The answer to that

question in any particular case is shaped by policy considerations weighed by courts. Some of these factors include: the risk involved; the foreseeability and likelihood of injury as weighed against the social utility of the defendant's conduct; the magnitude of the burden of guarding against injury or harm; and, the consequences of placing the burden upon the defendant.⁵ Courts also tend to focus on three additional and important, but not dispositive, factors in analyzing the Rule's application to specific transactions: the occurrence of arms-length bargaining preceding entry into the contract; a disparity of knowledge between the contracting parties as to the subject matter of the contract; and whether physical injury to the aggrieved person or his or her property resulted from the alleged breach of the duty.

Commercial Construction Contracts

In *BRW, Inc. v. Dufficy & Sons, Inc.*,⁶ the Colorado Supreme Court again explained that the Rule requires courts to focus on the parties' contractual relationship, and not their professional status. Thus, the court held that the Rule barred a painting subcontractor's negligence claims for losses arising from the project architect's alleged deficient specifications because the claims arose out of an interrelated series of construction and design services contracts of which all the parties had notice. The court noted that the architect's contractual duties were practically identical to its common law tort duties of care. The court also held that the Rule barred the subcontractor's negligent misrepresentation claim because a previous decision allowing such a claim, *Keller v. A.O. Smith Harvestore Products, Inc.*,⁷ concerned misrepresentations made *before execution* of any agreement, while *BRW* involved misrepresentations made *after* execution of the contracts and *during* their performance. The *BRW* court noted that the subcontractor could still sue the project's owner for breach of the

owner's implied warranty that its plans and specifications were adequate and, thus, the subcontractor could potentially recover for economic loss due to the allegedly faulty specifications. It is not clear from the opinion whether any liability limitations or disclaimers in the owner's contract would bar such a claim.

Residential Construction Contracts. Most recently, the Colorado Supreme Court held that the Rule did not prevent a tort claim by a homeowner against various subcontractors allegedly responsible for a home's defective construction. In *A.C. Excavating v. Yacht Club II Homeowners Association, Inc.*,⁸ ("*Yacht Club II*") the court noted that under *Cosmopolitan Homes, Inc. v. Weller*,⁹ the law imposes a duty of care on builders, independent of any contractual obligations, to build homes without negligence.

In *Cosmopolitan Homes*, the court found that the following factors militated towards recognizing such an independent legal duty: (1) the homebuyer's relative lack of knowledge and sophistication regarding home construction; (2) the homebuyer's lack of access to the underlying structural work; (3) the homebuyer's inability to detect latent defects which, by their nature, are hidden or slow to manifest; (4) the significant risk to homebuyers presented by latent defects that could completely destroy the family budget, inasmuch as the purchase of a home typically is the largest single investment most Coloradans make in their lives; and, (5) the mobility of most potential homebuyers, with the foreseeable result that a home will be sold to subsequent purchasers, and that any structural defects are as certain to harm a subsequent purchaser as the first. The Colorado Court of Appeals' opinion, affirmed by *Yacht Club II*, suggests the addition of the following factors to the list: (6) the homebuyer's typical exclusion from the process of selecting the

responsible subcontractors, including design professionals, and most building materials and products; and, (7) the twin goals of discouraging misconduct and providing an incentive for avoiding preventable harm.¹⁰

Yacht Club II noted that even before *Cosmopolitan Homes*, as far back as 1978, in *Driscoll v. Columbia Realty-Woodland Park Co.*,¹¹ the Colorado Court of Appeals had recognized the existence of an independent duty of care on the part of subcontractors to build a home in a non-negligent fashion. *Yacht Club II* based its holding, in part, on the fact that the Colorado General Assembly both expressly and impliedly recognized the existence of an independent duty of care on the part of builders and subcontractors in passing the Construction Defect Action Reform Act (CDARA) in 2001, and amending and expanding it in 2003; in adopting the Colorado Common Interest Ownership Act (CCIOA) in 1991; and, in approving Colorado's real property improvement statutes of limitation and repose, C.R.S. § 13-80-104, which was amended in 2001.

Tort or Contract?

If permissible, most practitioners will want to pursue both tort and contract claims as each has its advantages and disadvantages. Trying contract versus negligence claims presents significant differences in proof, affirmative defenses and recoverable damages. Negligence in tort must establish defects in workmanship, supervision, or design as a responsibility of the individual defendant. Unlike a breach of implied warranty claim, proof of a defect alone is not enough to establish a negligence claim. Contract damages are typically limited to those within the contemplation of the parties at the time of contracting, while negligence damages generally include all foreseeable damages.¹² Punitive damages are available in tort but not contract actions.

Contract claims and damages may be restricted by liability limitations, warranty disclaimers, claim waivers and similar clauses. However, even if a contract exists between a negligence claimant and a defendant, the claimant's negligence claims may not be limited by such clauses due either to limitations on the reach of exculpatory clauses or on public policy grounds.¹³ Affirmative defenses vary greatly between contract and tort claims, including differing statutes of limitations,¹⁴ and the likely inapplicability of the comparative negligence, and pro rata and nonparty reduction of liability statutes to contract claims.

Unanswered Questions

The *Town of Alma*, *BRW*, and *Yacht Club II* trilogy certainly places plaintiffs' lawyers on notice that the economic loss rule is firmly a part of Colorado's common law and that it serves to maintain a clear boundary between tort and contract claims. Except where the law recognizes an independent legal duty of care, courts are likely to dismiss negligence claims where the losses that are the subject of the claims are expressly or impliedly contemplated by the parties' contract, or any interrelated series of contracts involving the parties. The Rule will have the greatest force in disputes between commercially sophisticated contracting parties where the damages consist of dashed economic expectations, and the least force in disputes involving parties of unequal bargaining power or knowledge where the damages consist of injury to person or property. For plaintiffs' lawyers, the key to avoiding the bar of the economic loss rule will be identification of a legal duty that exists independent of any direct or derivative contractual relation.

Practitioners may find the Rule asserted more frequently in cases involving physical injury to goods, property and products and work-pro-

duct. *Hiigel v. General Motors Corp.*¹⁵ strongly suggests that physical injury to or loss of the use of goods, property, products, or work-product that is the subject of a contract likely is actionable in tort, most especially as to consumer goods, property, products, or work-product. In *Hiigel*, the subject matter of the suit was a motor home that was damaged when some lug bolts fell off while it was being used during two business trips. The Colorado Supreme Court held that "damage to the product sold is covered under the doctrine of strict liability," noting that since, under the Restatement of Torts (2d) § 402A, "the burden of having cast a defective product into the stream of commerce falls upon the manufacturer," that it would be "inconsistent to limit his responsibility to property other than the product sold."¹⁶

The source of independent duties may lie in the state's public policy, in statute, in the relationship between the parties, or in the nature of the wrong. Courts recognize that the risk of physical injury to a person or his or her property is not likely to be the subject of informed consumer analysis as part of the purchase of property, goods or services. Coupling this factor with the individual consumer's relative lack of bargaining power and knowledge, the widespread availability of liability insurance covering property damage and bodily injury, and business's ability to spread the risk of loss across the market through pricing, suggests that courts will be strongly inclined to recognize an independent tort duty in cases of a physical injury to a consumer's person or his or her property.

Where the legislature imposes a statutory duty or standard of care, the chances of a court recognizing an independent legal duty of care should increase.¹⁷ Thus, it seems unlikely that a landlord could successfully rely on the existence of a negotiated and comprehensive lease contract to assert the

economic loss rule as a defense to a negligence claim falling within the scope of Colorado's Premises Liability Act, C.R.S. § 13-21-115.

Similarly, significant unequal knowledge between contracting parties regarding the subject matter of their agreement may help persuade a court to recognize an independent tort duty. Thus, because homebuilders and subcontractors know more about the condition of hidden structural elements than homebuyers; because doctors and lawyers know more about medicine and law than their patients and clients; and, because insurers know more about the complicated process of analyzing and processing insurance claims than policyholders, Colorado recognizes the existence of independent tort duties of care running from each of the former to the latter.

Defendants may argue that some older Colorado cases recognizing independent tort duties should be subject to re-analysis in light of the Colorado Supreme Court's express adoption of the economic loss rule.¹⁸ *Yacht Club II* made clear, however, that the court is not inclined to step back from almost thirty years of precedent recognizing independent duties of care, as in the case of homebuilders and their subcontractors.

Conclusion

Town of Alma, *BRW*, and *Yacht Club II* provide a framework for analyzing application of the bar of the economic loss rule to negligence claims in various settings. The contours of the Rule cannot fully take shape until it is applied to the many, disparate circumstances in which negligence claims are asserted against the back-drop of a pre-existing contractual relationship among the disputing parties. Where the duty breached exists independent of the contract, a negligence claim will lie. Factors important to establishing the existence of such an independent duty include the factors historically considered in analyzing recognition of a "legal

duty," i.e., the sum total of those policy considerations that lead courts to conclude that a particular person is or is not entitled to protection from the harm alleged. The following factors appear to take center stage at the economic loss rule debate, and the presence of any one of these factors may bar the Rule's application: the commercial sophistication and relative bargaining power of the contracting parties; whether a special relationship exists between the parties such that one has superior knowledge of the subject matter of the contract; and, whether physical injury to the plaintiff's person or property, rather than mere economic loss, resulted from the alleged breach of duty, even if such person or property is the subject of the contract itself.

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Endnotes

¹ *Hügel v. Gen. Motors Corp.*, 544 P.2d 983 (1975).

² *Jardel Enters., Inc. v. Triconsultants, Inc.*, 770 P.2d 1301 (Colo. App. 1988).

³ *Town of Alma v. Azco Constr., Inc.*, 10 P.3d 1256 (Colo. 2000).

⁴ *Grynberg v. Agri-Tech, Inc.*, 10 P.3d 1267 (Colo. 2000).

⁵ See *Taco Bell, Inc. v. Lannon*, 744 P.2d 43 (Colo. 1987); cf. *Univ. of Denver v. Whitlock*, 744 P.2d 54 (Colo. 1987) (list of factors not intended to be exhaustive and does not exclude consideration of other, relevant factors based upon the competing individual, public and

social interests implicated in each case's facts).

⁶ *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66 (Colo. 2004).

⁷ *Keller v. A.O. Smith Harvestore Prods. Inc.*, 819 P.2d 69 (Colo. 1991).

⁸ *A.C. Excavating v. Yacht Club II Homeowners Ass'n, Inc.*, 114 P.3d 862 (Colo. 2005).

⁹ *Cosmopolitan Homes, Inc. v. Weller*, 663 P.2d 1041 (Colo. 1983).

¹⁰ Cf. *Yacht Club II Homeowners Ass'n, Inc. v. A.C. Excavating*, 94 P.3d 1177 (Colo. App. 2003), *aff'd*, *A.C. Excavating*, 114 P.3d 862.

¹¹ See *Driscoll v. Columbia Realty-Woodland Park Co.*, 590 P.2d 73 (Colo. App. 1978).

¹² See *Vanderbeek v. Vernon Corp.*, 50 P.3d 866 (Colo. 2002).

¹³ See, generally, *Jones v. Dressel*, 623 P.2d 370 (Colo. 1981) (limits on exculpatory clauses).

¹⁴ See *Hersh Cos. v. Highline Vill. Assoc.*, 30 P.3d 221 (Colo. 2001) (C.R.S. § 13-80-101, statute of limitations for contract actions, rather than C.R.S. § 13-80-104, contractors' statute of limitations, applies to claim for breach of express warranty to repair or replace defective work).

¹⁵ *Hügel*, 544 P.2d 983.

¹⁶ *Id.* at 989. The United States District Court for Colorado has strictly limited *Hügel's* application to consumer transactions. See *Richard O'Brien Cos. v. Challenge-Cook Bros., Inc.*, 672 F. Supp. 466, 471 (D. Colo. 1987).

¹⁷ See *Stanley v. Creighton Co.*, 911 P.2d 705, 706-07 (Colo. App. 1996) (codification of legal standard of conduct confirms that matter is issue of public concern).

¹⁸ See generally, Craig K. Lawler, *Foreseeability and the Economic Loss Rule—Part I*, 33 COLO. LAW. 81 (July 2004); *Part II*, 33 COLO. LAW. 71 (Sept. 2004).