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The Economic Loss Rule: A Case Of Jekyll And Hyde?

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In the past year, the Colorado Supreme Court has issued two major decisions regarding the Economic Loss Rule. First, in October of 2004, the Court decided the case of *B.R.W., Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66 (Colo. 2004). In that case, the Court held that a subcontractor on a commercial construction project may not pursue claims of negligence against the design engineer for purely economic losses on the project. The Court specifically held that the Economic Loss Rule bars such claims. Second, in June of 2005 the Court decided the case of *A.C. Excavating v. Yacht Club II Homeowner's Association, Inc.*, 114 P.3d 862 (Colo. 2005). In the *Yacht Club* case, the Court decided that homeowners may pursue claims in negligence against contractors and subcontractors, and that the Economic Loss Rule does not bar such claims.

At first blush, these decisions seem completely inconsistent, and at a certain level they are inconsistent. The key distinguishing factor is that *Dufficy* involved a commercial construction project while *Yacht Club* involved a residential construction project. One might argue that the Colorado Supreme Court has decided to treat commercial construction cases very much as it might treat any commercial transaction in which relationships are largely defined by contracts. In the commercial setting, principles of contract generally are honored and claims. In the residential setting, however, the Court followed earlier decisions that recognize that a builder's duties to homebuyers are broader than the duties created solely in contract.

Defining the Economic Loss Rule

The Economic Loss Rule probably defies simple definition. According to the *Yacht Club* case, "The Economic Loss Rule is 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 a breach absent an independent duty of care under tort law." Basically, "economic loss" is a loss of benefits expected under a contract. For example, if a building is constructed in a shoddy manner, the owner has experienced an economic loss in the sense that it has not gotten the benefit of what it bargained for. Or if a design is defective, it may cost a builder more to build than the builder reasonably expected under its contract. Economic losses do not include personal injuries or damage to other property that might be a result of shoddy construction.

The purpose of the Economic Loss Rule is "to maintain the sometimes blurred boundary between tort law and contract law". The distinction matters for several reasons. First, tort law typically provides for a greater

range of damages than contract law. Second, the parties to a contract may agree to limit damages in ways that would not be recognized in tort law. Third, contract claims typically may be brought only by parties who are "in privity" with the other party. In other words, such claims may only be brought by another party to the contract. Tort claims are not limited by privity, and people who are a stranger to the commercial relationship might be able to bring claims in tort.

The Dichotomy Between *Dufficy* and *Yacht Club*

As noted above, there is a degree of inconsistency between *Dufficy* and *Yacht Club*. In *Dufficy*, a subcontractor sued a design engineer with whom it had no contractual relationship. The gist of the claim was that the design was defective, and that the job cost the subcontractor more than it should have because of the defects. The Court held that in a commercial construction setting such claims cannot stand. The relationships of the various parties were defined by contracts, and the duties that they owed to each other (or did not owe to each other) were defined by contracts. In that circumstance, the Court held that contract principles control. Because the subcontractor had no contract with the design engineer – in other words, they were not in privity – the design engineer owed no contractual duty to the subcontractor and there were no other, independent, sources of the duty between the engineer and the subcontractor. Thus, the Economic Loss Rule barred the subcontractor's claims, which could only be brought in tort due to the lack of privity.

By contrast, in *Yacht Club*, the Colorado Supreme Court held that a homeowner's association could bring negligence claims for defective construction against subcontractors with whom it had no contractual relationship. The claimed damages were for economic loss in the form of allegedly shoddy construction of residences. The Economic Loss Rule bars such claims when a contract is the only source of duty from a contractor. In the case of residential construction, however, the Court held that builders have "an obligation to act without negligence in the construction of a home **independent of contractual obligations.**" In fact, earlier decisions by the Colorado Supreme Court have described this same duty, which appears to be based largely upon public policy considerations. Because of that, it was not particularly surprising that the *Yacht Club* case, involving residential construction, was decided differently than the *Dufficy* case, which involved commercial construction.

Yacht Club demonstrates that homebuyers continue to be a favored group with the Colorado courts, and likely will be for the foreseeable future. At the same time, *Dufficy* shows that the Economic Loss Rule still applies to commercial projects.

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