Kentucky Adopts Economic Loss Doctrine but Specific Application to the Construction Industry Remains Unsettled

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On June 16, 2011, Kentucky’s highest court officially adopted the economic loss doctrine, joining a majority of states that have done so. To be sure, this doctrine is not pertinent only to the construction industry and is frequently thought to have the greatest impact on manufacturing. The doctrine holds that when a product causes only damage to the product itself, with no personal injury or physical harm to other property, the owner of the product cannot bring tort claims but is limited to the recovery allowed under its contract with another party. Negligence claims and strict liability claims are prohibited in this circumstance. See Giddings & Lewis, Inc. v. Industrial Risk Insurers, __ S.W. 3d ___, 2011 WL 2436154 (Ky. 2011).

In Giddings, an insurer of a diffuser cell system attempted to recover amounts paid to the owner of the product from the manufacturer of the system based on breach of contract, negligent strict liability, negligent misrepresentation and fraud by omission. The court rejected the tort-based claims and damages, including economic loss for lost profits, costs for repair and replacement of the defective commercial product. Recovery was allowed only under the terms of the parties’ contract, which could include express or implied warranties negating certain types of damages.

This case is of potential importance to the construction industry. While the Giddings’ case dealt with a product, a number of cases have applied the economic loss doctrine to construction processes and services. In Indianapolis – Marion County Public Library v. Charlier Clark & Linard, P.C., 929 N.E. 2d 722 (Ind. 2010), Indiana’s highest court applied the economic loss doctrine to services performed in connection with engineering, administration and design work for a library building. This decision outlines a number of cases where homeowners and other building owners were not allowed to sue a contractor for economic loss and were limited to their contractual remedies. The Indiana court specifically held that engineers and design professionals can invoke the economic loss rule as a defense. The Arizona Supreme Court has adopted the same rule. Flagstaff Affordable Housing Limited Partnership v. Design Alliance, Inc., 223 P.3d 664, 673 (Ariz. 2010). In West Ridge Group LLC v. First Trust Company of Anaga, 414 Fed. Appx. 112, 2011 WL 635567 (10th Cir. 2011) (applying Colorado law), the
Tenth Circuit Court of Appeals held that Colorado law applied the economic loss doctrine to the appraisal process used in a real estate transaction.

Since the Kentucky Supreme Court just adopted the economic loss doctrine, Kentucky courts have not yet had an opportunity to address the possible application of this doctrine to claims concerning “processes” or “services”, including those frequently performed in the construction industry. However, in Presnell Construction Managers, Inc. v. EH Construction LLC, 134 S.W.3d 575 (Ky. 2004), a concurring opinion by Justice Keller asserted that the owner’s common law negligence claim against the contractor in a construction case for negligent supervision should be barred by the economic loss doctrine. Justice Keller urged the Court to adopt the economic loss doctrine in order to encourage contracting parties to allocate risks amongst themselves. Presnell involved a claim by a contractor against the construction manager and did not involve any particular product, but instead involved construction management services and the construction process. The Kentucky Supreme Court’s decision in Giddings expressly recognized Justice Keller’s analysis in Presnell.

It will certainly be argued that the policies underlying application of the economic loss doctrine in commercial transactions should have equal application regardless of whether a product, a process or a service is involved. The three policies recognized by the Giddings Court in its adoption of the doctrine were: (1) maintaining the historical distinction between tort and contract law; (2) protecting the parties’ freedom to allocate economic risk by contract; and (3) encouraging the party best situated to assess the risk of economic loss, usually the purchaser, to assume, allocate or insure against that risk. Based on the potential application of the economic loss doctrine in the construction setting, and these policies focused on controlling risk by contract rather than tort law, contractors should promptly and thoroughly review contracts with owners, suppliers, and subcontractors to determine the availability of contractually authorized remedies, absent any personal injury or damage to other property. Those contract-based remedies will have greater importance and potentially could prove to be the sole remedies available in the future.