

Avoiding Tort Liability in Breach of Contract Actions

Leveraging the Independent Tort and Economic Loss Doctrines
and Mitigating Risk with Effective Contract Provisions

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DISTINGUISHING BETWEEN A TORT AND CONTRACT CLAIM

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Contract or Tort – How to Distinguish?

Macro Level

- Contracts facilitate and enforce transactions of bargained-for exchanges.
 - Rules established by parties.
- Torts allocate responsibility and loss on a social compact, large scale level.
 - Rules based on societal standards, i.e., reasonable person.

Contract v. Tort – How to Distinguish?

Micro Level – Elements

- Contracts
 - Enforceable Contract
 - Breach of the Contract
 - Harm caused by breach
- Tort
 - Duty
 - Breach
 - Causation
 - Harm

The Elements in a Nutshell -- Similarities

- In essence, both claims involve same general elements
 - Duty
 - Breach
 - Causation
 - Harm
- Academic difference only?
 - Proof for breach and causation is of same type for either claim

The Elements in a Nutshell -- Differences

- Stark differences arise when examining duty and harm prongs
 - Duty
 - Contracts – arises from the bargained-for exchange.
 - Torts – arises from common-law societal standards.
 - Harm
 - Contracts – apportions risk of subject of contract.
 - Torts – looks at harms that are reasonably foreseeable and caused by Defendant's conduct.

Legal Doctrines for Distinguishing Torts from Contracts

- Economic Loss Rule (focus on harm/damages)
 - Traditionally speaking, if product fails, not entitled to economic losses.
 - Ex.: defective hot dog stand – no lost profits, etc.
 - Exception when product damages other property or causes injury.
- Independent Tort Doctrine (focus on duties)

Legal Doctrines for Distinguishing Tort from Contracts

- Modern Approach
 - Two factor analysis
 - **Source of the Duty** – if claim exists independently of fact contract exists, the claim may sound in tort.
 - **Nature of the Injury** – plaintiff's claim normally contract if the only loss or damage is the subject matter of the contract; if damage is beyond subject matter, the claim sounds in tort.

The Independent Tort Duty Rule

Overview and Illustrative Examples



GENEVA | HOUSTON | KANSAS CITY | LONDON | MIAMI | ORANGE COUNTY | PHILADELPHIA | SAN FRANCISCO | TAMPA | WASHINGTON, D.C.

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What is the Independent Tort Duty Rule?

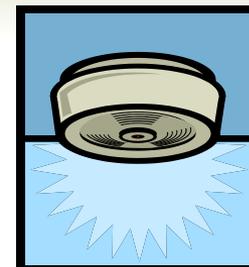
- You can't commit a tort without breaching a duty imposed by tort law
- If the duty flows only from contract, you cannot be liable in tort
 - No such thing as a “negligent” breach
- Look to the source of the duty
- Tort and contract are historically distinct areas of law. The Independent Tort Duty Doctrine keeps them that way

Example!

You hire an alarm company to install an alarm

- Man off the street has no duty to walk inside your house and install an alarm system.
 - That duty flows only from the contract you two signed
- Installer had no existing duty to walk inside your house and install the alarm
- If he negligently installs the alarm, you look to the **contract** to provide damages
- But if while he is installing your alarm he decides to smash your computer with a hammer—that's a tort
 - Everyone has an independent tort duty not to destroy property or harm people
- **Look to the source of the duty**

Contract



Tort →



Tort and Contract Protect Different Interests

Tort

- Duty imposed by law
- Involuntary
- Enforces social norms
- Punishes socially reprehensible conduct—*but only when society (not individuals) is harmed*
- Compel performance or punish breaching party
- Goal: Ensure standards of conduct in society

Contract

- Duty bargained for by parties
- Parties choose to be bound
- Enforces agreements
- Enables commerce (socially desirable conduct)
- Compensate for any loss due to breach
- Goal: Ensure freedom to contract and sanctity of contracts

So Who Cares?

Why is it important to distinguish tort and contract?

(1) Permit Freedom of Contract

- Bedrock principle of capitalism
- Keep courts from rewriting contracts or enforcing policy concerns in private economic transactions
 - Contract law has its own set of safeguards in place
 - E.g. Unconscionability, consequential damages

(2) Limit Liability

- Confusion nullifies a principal purpose of contracting—limiting liability
 - Punitive damages

(3) Promote Economic Efficiency

- Breach is a Breach is a Breach
 - Contract law does not get hurt feelings when something goes wrong
 - Does not assign fault
 - Idea of “efficient breach”
 - Parties define consequences of the breach
 - Quantify risk and limit liability

Evolution: How Courts Have Tried to Isolate Tort and Contract Law

Economic Loss Rule (“ELR”)

- Bars suits in tort for injuries to product caused by the product itself that didn't injure persons or other property (“economic loss”)
- **Goal: prevent contract from “drowning in a sea of tort”**
 - Rationale: this type of injury (to the product itself) should be covered by a manufacturer's warranty and thus the consumer is limited to recovery under that warranty
 - *Cannot recover for lost expectation damages based on your business losing money when your truck's engine breaks down*
 - Rationale: if manufacturers faced tort liability for purely economic loss, prices would skyrocket
- ELD began expanding, barring suits beyond product liability
 - E.g. fraudulent inducement, negligent misrepresentation, consulting contracts, investment programs, and construction project administration
 - Courts began to think this approach unwieldy
- Natural progression to return ELR to its original place as limitation of products suits
 - How do we stop every contract action from being infused with tort?

Sample Evolution: ELR to Independent Tort Duty

Case Study—Florida

- Origin (1965)
 - Traditional Economic Loss Rule—bound tort and contract regimes, limit tort suits in product liability
- Contractual Privity ELR (1987)
 - Mostly what we are talking about
 - Parties to contracts have defined limitation of liability through bargaining, risk acceptance, and compensation detailed in contract—can't sue in tort when you already have a contract
- “Unprincipled Expansion” (1990s – 2013)
 - Courts permitted actions in tort even in presence of contractual privity
 - Fraud in the inducement, nonprofessional service contracts, negligent misrepresentation, “other property” exception,
- Reigning in: Back to Strict Products Liability (2013)
 - Realizing the ELR is running wild, the Court in *Tiara Condominium Ass'n., Inc. v. Marsh & McLennan Cos., Inc.* recedes from precedent and determines the doctrine again only applies in products liability
 - Independent tort doctrine now sole gatekeeper of tort suits (outside products liability as ELR originally intended)

Enter the Independent Tort Duty Rule

- ITD is in some ways an exception to the ELR
 - Preserves tort suits that may otherwise be barred by the economic loss rule
 - If the tort claim arises from a duty existing independently of the duty owed under the contract, a claim for non-economic losses may proceed
- Concern—not enough tort?
 - Courts concerned that an “unprincipled expansion” of the ELR was improperly proscribing business torts
- Now, we look to origin of the duty
 - If the breach arises as a result of the contract—no tort liability
 - If the breach results from an independent common law duty—tort

Recent Cases: New York

New York requires breach of an independent tort duty to bring suit outside the contract:

- *Nirvana Int'l., Inc. v. ADT* (2012)
 - Theatrical jewelry store burglary where ADT-installed motion detector failed to detect burglars removing nearly \$2 million from safe in back room where motion was located. District court granted ADT's motion to dismiss, rejecting arguments that limitations in contract did not apply because customer's signature on back page of contract accepting provisions was a forgery. Second Circuit affirmed.
- *Abacus Federal Savings Bank v. ADT* (2012)
 - Bank sued alarm monitoring companies alleging breach of contract and gross negligence resulting from overnight burglary. Court held that breach of contract occurring as a result of gross negligence does not give rise to a duty independent of the contractual relationship.
- Contrast *Abacus* with *Sommer v. Fed. Signal Corp.* (1992)
 - Where alleged failure to act affects a significant public interest independent of defendant's contractual obligations, action may sound in tort.

California

California allows tort claims and contract claims for the same acts only when the acts violate independent duties

- *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, 7 Cal. 4th 503 (1994)
 - “Conduct amounting to a breach of contract becomes tortious only when it also violates an independent duty arising from principles of tort law.”
 - “punitive damages may not be awarded for breach of contract ‘even where the defendant’s conduct in breaching the contract was willful, fraudulent, or malicious.’”
- California does permit punitive damages for bad faith breaches of insurance contracts
 - Tort recovery is allowed because insurance companies owe an independent duty of good faith to society beyond the four corners of the insurance agreement:
 - “unlike most other contracts for goods or services, an insurance policy is characterized by elements of adhesion, public interest, and fiduciary responsibility.”

Colorado

Colorado's Unique Position

- Willful-and-Wanton Rule
 - *Giampapa v. American Family Mut. Ins. Co.*, 64 P.3d 230 (Colo. 2003)
 - Noneconomic damages arising from breach of contract are available if the breach is willful and wanton
 - Concurring opinion notes that “using a standard of culpability such as willfulness to determine liability in a contract case undermines the doctrine of efficient breach.”
- **In Colorado, parties are free to contract around the Independent Duty Rule**
 - **Colorado courts look only to whether a duty exists *independent of the contract*. So a duty written into the contract is no longer an independent duty.**
- *Town of Alma v. AZCO Construction, Inc.*, 10 P. 3d 1256 (Colo. 2000)
 - CO recognized the “independent duty rule” approach to the economic loss rule and held that tort claims could only be brought if the defendant violated a duty imposed by law, not one found only in the contract
 - In *Town of Alma*, plaintiffs contracted with defendant construction company to install a water distribution system. The lines developed leaks and the plaintiffs sued, alleging negligence, breach of contract, and breach of implied warranty. The court applied the economic loss rule to bar the plaintiffs’ claims because the contract already imposed a duty of care for installing water lines, therefore precluding the similar independent duty in tort.
- *BRW v. Inc. v. Dufficy & Sons, Inc.*, 99 P. 3d 66 (Colo. 2004)
 - Court introduced a two-step approach to economic loss rule as seen in *Alma*:
 - (1) look to contractual relationships among parties to determine whether duty breached arises in contract; (2) if no contractual duty, use *Taco Bell v. Lannon* factors: “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].”
 - The Court also incorporated three factors from *Alma's* sister case, *Grynberg v. Agri Tech, Inc.*:
 - (1) whether the relief sought in negligence is the same as the contractual relief; (2) whether there is a recognized common law duty of care in negligence; and (3) whether the negligence duty differs in any way from the contractual duty.

Where Do We Go From Here?

- Courts should strongly endorse the independent tort duty rule
- Promotes freedom of contract, economic efficiency, and social policy
- Prevents introduction of messy tort theories into straightforward breach of contract cases
 - Prevents punitive damages from crippling businesses
- Push for a policy based approach to examining the underlying duty

Economic Loss Doctrine

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Economic Loss Doctrine: Overview

- What is it?
 - Purpose
 - Origin
 - Scope
- How does it work?
- What are the exceptions?
- Current status: eroding?

Economic Loss Doctrine: What is it?

- Economic loss doctrine bars tort claims seeking purely economic losses
 - Commercial or economic losses may be recovered under a contract theory
 - Tort recovery, however, is available only for personal injury or non-economic losses
- Economic loss is the diminution in value of the product itself and the consequential damages (e.g., lost profits) resulting from the defective product

Economic Loss Doctrine: What is it?

- What does it mean that the economic loss doctrine bars tort claims seeking purely economic losses?
 - Different things depending upon your jurisdiction
 - No recovery in tort for purely economic loss, even if no contractual relationship
 - No tort recovery for economic loss when injury is identical to injury from breach of contract
 - No tort recovery for economic loss to the product itself
 - Attempt to draw a bright line between contract and tort

Economic Loss Doctrine: Purpose

- Economic loss doctrine is based upon three fundamental principles
 - Maintain distinction between tort and contract law
 - Protect parties' freedom to allocate risks by contract
 - Encourage parties to assume, allocate or insure risk
- Contract and tort law have cross purposes
 - Contract: parties create obligations where there were none
 - Tort: based upon policy concerns (*i.e.*, safety)
- Economic loss doctrine permits commercial parties to allocate risks and limit liability when safety concerns are not implicated

Economic Loss Doctrine: Origins

- *Seely v. White Motor Co.*, 403 P.2d 145 (Cal. 1965)
 - Accident resulted from a defect in the truck, causing only property damage to truck itself
 - California Supreme Court held that truck manufacturer was liable only for commercial or economic loss based upon contract/warranty
 - No tort liability because no personal injury or damage to property other than truck
- *East River Steamship Corp. V. Transamerica Delaval Inc.*, 476 U.S. 858 (1986)
 - Valve defect damaged ship's turbine causing damage to the ship
 - U.S. Supreme Court barred tort claim because plaintiff incurred only economic loss and there was no personal injury or damage to other property

Economic Loss Doctrine: Scope

- Since *East River Steamship*, most states have adopted the economic loss doctrine in one form or another
 - May apply differently, depending upon the state
 - Arkansas and Montana have declined to adopt it
 - Other states Supreme Courts have not adopted it, but appellate courts apply it (Pennsylvania, North Carolina, Maryland, Iowa)
- It has been expanded and also limited in several ways
- In short, it's application is confusing and depends greatly on the jurisdiction and facts of the case

Economic Loss Doctrine: How does it work?

- Differentiate between economic loss and non-economic loss

Economic Loss	Non-Economic Loss
Loss to product	Personal injury
Lost profits; lost productivity	Real property damages
Repair and replace costs; cover	“Other” property damages
Disappointed expectations	

Economic Loss Doctrine:

“Other property”

- Integrated system rule: if defective product is part of an integrated system, other components of system are considered product itself and economic loss doctrine bars recovery for damage
- *Saratoga Fishing v. J.M. Martinac*, 520 U.S. 875 (1996):
 - Defect in boat’s hydraulic system caused fire in engine room
 - Owner added equipment to boat after purchase
 - Supreme Court concluded that equipment added after purchase was “other property” and owner could recover in tort for damage to the added equipment
- Holding reflects policy considerations relating to product safety

Economic Loss Doctrine: Disappointed expectations

- Example:
 - Breach of requirements contract
 - Plaintiff alleged defendant breached contract by using product in ways restricted by contract
 - Plaintiff then added fraud claim alleging that defendant committed “fraud in performance” of contract by not revealing the ways it was using the product
 - Defendant moved for summary judgment on fraud claim based on economic loss doctrine since injury from “fraud” was exactly the same as injury from breach

Economic Loss Doctrine: Exceptions

- Fraud
 - Inducement
 - Extraneous
- Danger
 - Intrinsically dangerous substance
 - Sudden and calamitous event
- Independent duty
 - Special relationship
 - Unique circumstances
- Torts that cause economic harm
 - Tortious interference
 - Negligent misrepresentation
 - Consumer fraud/deceptive trade practices

Economic Loss Doctrine: Exceptions -- Fraud

- Example 1:
 - Same case as “fraud in the performance” claim
 - Fraudulent inducement claim alleging defendant never intended to limit use of product as set forth in contract
 - Economic loss doctrine did not apply to that claim
- Example 2:
 - Contract for repair services
 - Defendant fraudulently concealed material information to induce plaintiff to agree to additional, unnecessary repairs
 - That fraudulent inducement claim is not barred by economic loss doctrine

Economic Loss Doctrine: Exceptions -- Danger

- These exceptions reflect policy concerns relating to product safety
- Intrinsically dangerous substance
 - Asbestos
- Sudden and calamitous event
 - Also reflects issues relating to foreseeability

Economic Loss Doctrine: Exceptions

- Economic loss doctrine generally does not apply to torts that by definition cause only economic loss
 - Tortious interference with contractual relations or prospective business relations
 - Negligent misrepresentation
 - Consumer fraud or deceptive trade practices
 - Breach of fiduciary duty
- These torts usually involve some special relationship or independent duty

Economic Loss Doctrine: Eroding?

- Florida recently limited economic loss doctrine to product liability cases: *Tiara Condo Ass'n.*, 110 So.3d 399 (Fla. 2013)
- Texas refused to expand economic loss doctrine to bar recovery for purely economic loss in negligence claim between non-contracting parties: *Sharyland Water Supply*, 354 S.W.3d 407 (Tex. 2011)
- California permitted recovery of punitive damages when party falsely certified compliance with contractual provision: *Robinson Helicopter.*, 102 P.3d 268 (Cal. 2004)

Tort v. Contract: Practical implications

- Why does it matter?
 - Statutes of limitation
 - Insurance implications
 - Allocation of liability and risk

Tort v. Contract: Practical implications

- Contractual limitations or disclaimers
 - Carefully draft provisions
 - Know the law of your jurisdiction
 - Limits on damages vs. limits on liability
- No matter how your contract is drafted probably cannot avoid liability for fraudulent inducement or fraud extraneous to contract