



The Economic Loss Rule: Protection and Pitfalls to the Contractor

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It is important for contractors to have a basic understanding of the Economic Loss Rule and its exception. Generally, a construction contract sets forth within its specific language the rights, obligations, duties and potential liabilities between contracting parties. The failure of any party to perform within the parameters of the contract can lead to a breach of contract action. A contractor is also susceptible to tort liability to both the contracting parties and third parties. Tort liability can arise from a contractor's negligent actions causing property damage or personal injury.

The Economic Loss Rule generally states that a defendant in a tort action, as opposed to a contract action, does not owe a tort duty to prevent economic loss, such as lost earnings/lost profits to third parties in the absence of property damage or personal injury.

In 2007, a construction contractor negligently started a fire on Catalina Island, causing significant disruption to businesses on the island, including the suspension of ferryboat access for tourists for one week. The ferryboat company sued the contractor for more than \$1.7 million in lost earnings and profits. The fire did not cause any physical damage to any of the boats or docking facilities, but the ferryboat company was able to establish a well-documented claim based solely on lost profits. A summary judgment motion by the contractor resulted in the entire claim being thrown out based on the Economic Loss Rule.

The ferryboat company did argue the one significant exception to the Economic Loss Rule. The exception to the rule allows for a tort duty to be owed by a contractor to a third party for recovery of loss profits in the absence of any property damage if the third party can establish a "special relationship" between the contractor and the damaged third party.

To establish a special relationship, the third party must show that the contractor was aware of the third party and that the contractor's activities were intended to effect the third party, though not in a negative way. The exception also requires that the third party show that harm might occur and that there be certainty that the party actually suffered economic damage. The factors also include moral blame on the contractor and public policy considerations.

For example, a construction contractor was involved in a partial building remodel where the tenant was a restaurant. All parties and the restaurant were aware that there would be, to an extent, a disruption in the business of the restaurant. However, the actual business disruption far exceeded what had been anticipated. It was determined that the exceptional business interruptions were caused by a lack of diligence on the part of the contractor. In this unique set of circumstances, a contractor could be held responsible for a third party's loss of profits and business absent the contractor causing any property damage or personal injury.

While it is difficult for a third party in an action against the contractor to establish the parameters of the special relationship exception to the Economic Loss Rule, the Court has set forth clear guidelines as to those factors. For this reason, the prudent contractor must be aware of the totality of circumstances of both his contract and the impact of his work on all third parties, and how those third parties might be affected by his work.

The Economic Loss Rule is a clear protection to potential third-party liability to a contractor for claims of lost earnings and lost profits. However, and with most rules, there are exceptions. The prudent contractor is well advised to understand the rule and the exception.

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