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Litigation: 6 defenses every inside counsel should know (Part 2)

Examining the cases behind the economic loss rule

BY JONATHAN B. SHOEBOTHAM
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This is the second of a six-part series on liability defenses that every inside counsel should know. Based on more than 30 years of litigation practice, this series discusses the liability defenses I have found to most often result in successful summary judgments or dismissals, providing the best potential to end expensive and time-consuming litigation. This installment focuses on the “economic loss rule.”

The U.S. Supreme Court and numerous jurisdictions across the United States have adopted the economic loss rule to bar plaintiffs from recovering tort damages for purely economic losses. This rule can and should be used to obtain dismissal of tort claims that are inappropriately pled in many cases involving commercial transactions. The dismissal of these inappropriate claims is important because there are certain types of damages, most notably punitive damages, that are typically recoverable based only upon tort claims.

The economic loss rule precludes tort claims in two situations, which often overlap in an individual case: (1) where the economic loss that the plaintiff seeks to recover is the subject of a contract; and/or (2) where tort claims arise from an alleged defect in a product that fails and then damages only the product itself and does not cause either personal injury or damage to other property.

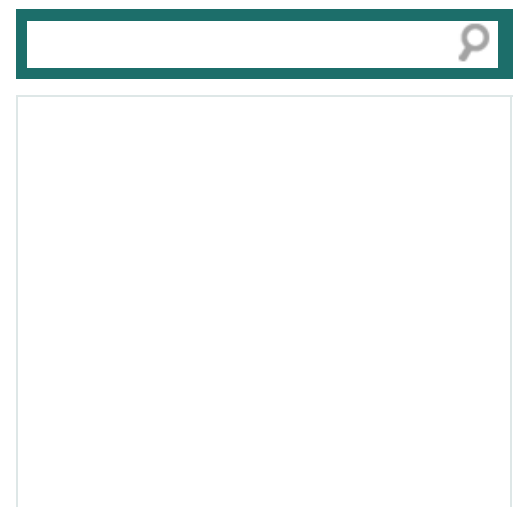
With regard to the first situation, when the claimed injury is only economic loss tied to a contract, then contract law, rather than tort law, prevails. The parties to a contract are free to agree on warranties, remedies, limitations and disclaimers, which means the economic loss rule dictates that any lawsuit to recover for economic loss caused by the failure to perform such a contract must be based upon breach of contract or breach of warranty, and not tort law.

In the second situation, the economic loss rule bars tort claims against a manufacturer or seller of a product that fails but causes damage to only the product itself. One of the leading discussions of this application of the economic loss rule is the opinion of the U.S. Supreme Court in *East River S.S. Corp. v. Transamerica Delaval, Inc.*

In *East River*, the U.S. Supreme Court held that the economic loss rule bars tort claims arising out of the failure of a product that causes damage only to the product itself without causing personal injuries or damage to other property. The U.S. Supreme Court explained that damages to the product alone are the essence of a warranty action, through which a contracting party can seek to recoup the benefit of its bargain. Such damage means simply that the product has not met the customer’s expectations; in other words, that the customer has received insufficient product value. Contract law, and the law of warranty in particular, is best suited to commercial controversies of this sort because the parties set the terms of their own agreements. The U.S. Supreme Court found “no reason to intrude into the parties’ allocation of the risk” by allowing a tort claim in addition to a claim for breach of contract or breach of warranty.

Courts in numerous jurisdictions follow the economic loss rule. The Texas Supreme Court explained in *Mid-Continent Aircraft Corporation v. Curry* that courts must adhere to the economic loss rule in order to give effect to the purpose of Article 2 of the Uniform Commercial Code concerning sales of products:

“The Uniform Commercial Code was adopted by the Legislature as a comprehensive and



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integrated act to facilitate the continued expansion of commercial practices. For sales of products the above purpose is carried out by Article 2 of the Code, which supplies a complete framework of rights and remedies for transacting parties. In light of the Code's scope and purpose, its terms should not be nullified by applying strict liability when the parties have contracted otherwise. Such an expansion of strict liability would frustrate the Code's purposes of codifying the law of commercial transactions by displacing its applicability in all cases where the sale of faulty products is involved."

In the *East River* case, the U.S. Supreme Court found that the economic loss rule bars tort claims when the failure of a component part has caused the loss of the finished, integrated product, ruling:

"Since all but the very simplest of machines have component parts, [a contrary] holding would require a finding of 'property damage' in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability."

Courts across the nation have adopted the reasoning in *East River* by applying the economic loss rule to bar tort claims against manufacturers of allegedly defective component parts that cause only the loss of the finished product into which they are integrated. Many courts even apply the economic loss rule to replacement parts that are later added to a finished integrated product. These courts bar tort claims for economic losses caused by the failure of component or replacement parts if the damages sought are limited to the loss of the finished integrated product.

The economic loss rule can and should be used to obtain dismissal of inappropriate tort claims that are often added to commercial lawsuits for economic losses arising from breach of contract or breach of warranty, or arising from the loss of a product. In these circumstances it can and should also be used to obtain dismissal of damage claims that are based only on tort law.

Part 1 of this 6-part series can be found [here](#).

About the Author



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Attorney *Jonathan B. Shoebottom* is a partner in the Houston office of *Thompson & Knight*, where he leads the firm's Complex Tort and Product Liability Practice. He focuses his practice on litigation matters involving product liability, environmental law, commercial torts, pharmaceutical liability and medical device liability. Mr. Shoebottom has handled three separate cases recognized by The National Law Journal among the nation's top defense verdicts of the

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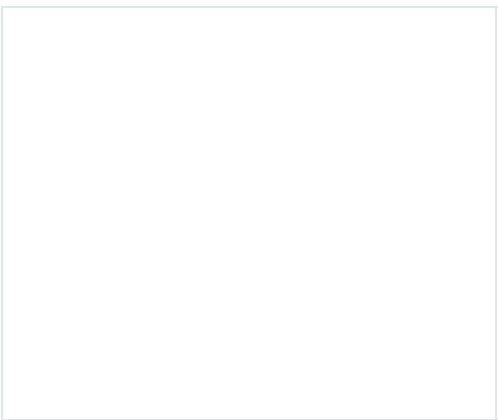
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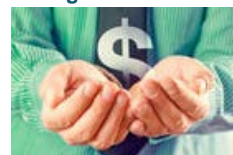
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