By John Patrick Sullivan

The Economic Loss Rule and Defective Product Components

In many instances, parties to product sales can more appropriately allocate risk and liability through contract and warranty law than courts can through tort law. Indeed, the availability of tort remedies for business losses can result in less efficient transactions by creating unpredictability, duplication, and unnecessary complexity. *See All-Tech Telecom, Inc. v. Amway Corp.*, 174 F.3d 862, 865-66 (7th Cir. 1999) *see also East River S.S. Corp. v. Transamerica Delaval*, 476 U.S. 858, 866 (1985) (barring tort claims over what are essentially contract disputes necessary to prevent contract law from "drown[ing] in a sea of tort[.]"). Tort law is intended to compensate for injuries not arising out of contractual obligations; on the other hand, transacting parties are aware of the kinds of potential product defects that can occur and the types of losses that can results from those defects, and adjust the transaction's terms accordingly. Contract law is thus better suited to govern these kinds of losses.

The economic loss rule encourages risk allocation by the parties by limiting the kind of "for-want-of-a-nail-the-kingdom-was-lost" liability that can be imposed by tort law. *Rardin v. T&D Mach. Handling, Inc.*, 890 F.2d 24, 28 (7th Cir. 1989); *see Mt. Lebanon Personal Care Home, Inc. v. Hoover Universal, Inc.*, 276 F.3d 845, 848 (6th Cir. 2001) (purposes of the economic loss rule are to maintain the separation of tort and contract law, to allow the parties to allocate risk by contract, and to encourage the parties best suited to assume or insure against the loss to do so).

The name of the rule is a misnomer in that to some extent, all losses are economic. Perhaps "commercial loss rule" would be more fitting (*cf.* Conn. Gen. Stat. §52.572n(c)), but that phrase hasn't caught on outside of the Nutmeg State. Regardless, the economic loss rule provides that a defective product is not unreasonably dangerous and tort remedies are unavailable if the defect only poses a risk to the product itself and not to persons or other property. *See Russell v. Deere & Co.*, 61 P.3d 955, 958 (Or. Ct. App. 2003).

Background of the Economic Loss Rule

One of the earliest decisions applying the economic loss rule was *Seely v. White Motor Co.*, 403 P.2d 145 (Cal. 1965). In a case involving a defective truck, the plaintiff sought damages in strict liability for both the purchase price of the truck and lost profits. The court rejected the attempt to recover in strict liability, holding that a seller "can appropriately be held liable for physical injuries caused by defects [but] cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands." *Id.* at 151.

State law on the economic loss rule continued to develop, and the defense's parameters became more specifically defined by the Supreme Court in its *East River* decision, perhaps the most widely-cited decision on the economic loss rule. In *East River*, the Supreme Court considered admiralty law claims involving defects in ship turbines. Admiralty law incorporates principles of both tort and contract law, and the issue was whether the damage alleged—the cost of repairing the ships and lost income while the ships were out of service—gave rise to tort claims. Surveying the law outside of admiralty on this issue, the Court held that claims for damage to the product itself are more akin to warranty than to tort claims, and should be governed by the law of the former:

> Damage to a product itself is most naturally understood as a warranty claim. Such damage means simply that the product has not met the customer's expectations, or, in other words, that the customer has received 'insufficient product value.' *See* J. White and R. Summers, Uniform Commercial Code 406 (2d ed. 1980). The maintenance of product value and quality is precisely the purpose of express and implied warranties. *See* UCC §2-313 (express warranty), §2-314 (implied warranty of merchantability), and §2-315 (warranty of fitness for a particular purpose).

476 U.S. at 872 (footnotes omitted).

Though an admiralty law case, *East River* has been widely followed in the product liability context and incorporated into the Restatement (Third) of Torts:

> For purposes of this Restatement, harm to persons or property includes economic loss if caused by harm to:
> a) The plaintiff's person; or
> b) The person of another when harm to the other interferes with an interest of the plaintiff protected by tort law; or
> c) The plaintiff's property *other than the defective product itself.*

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Restatement (Third) Products Liability §21 (1997) (emphasis added).

The applicability *vel non* of the economic loss rule can be critical in litigation because parties subject to it are thus limited to contractual and warranty remedies; tort claims are barred. Courts recognize this limitation because "[a] party to a contract who attempts to circumvent the contractual agreement by making a claim for economic loss in tort is, in effect, seeking to obtain a better bargain than originally made." *Indemnity Ins. Co. of N. Am. v. Am. Aviation, Inc.*, 891 So.2d 532, 536 (Fla. 2004).

Clear-cut legal principles are salutary but rare, and the economic loss rule is not one of the outliers. Some courts and defense counsel have concluded that "[t]he economic loss rule has become a confusing morass." *Id.* at 544 (Canterro, J., concurring). Others are less charitable: "[T]he most quickly and confoundingly expanding legal doctrine is… the economic loss rule. Like the ever-expanding, all-consuming alien life form portrayed in the 1958 B-movie classic 'The Blob,' the economic loss doctrine seems to be a swelling globule on the legal landscape[.]" *Grams v. Mild Prods., Inc.*, 699 N.W.2d 167, 180 (Wis. 2005) (Abrahamson, C.J., dissenting). This throwing up of hands is perhaps the result of judicial recognition of a number of case-specific exceptions over the last decade or so. *See* A. Niblett, R. Posner, and A. Schleifer, "The Evolution of a Legal Rule," 39 *J. Legal Stud.* 325, 330 (June 2010). Part, however, may be that as the economic loss rule has evolved, plaintiffs are less likely to make use of it except in novel cases. *See id.* at 346; *cf. id.* at 352 (states with higher caseloads have a lower incidence of economic loss rule exceptions). Whether a defect causes personal injury is straightforward. Less so is whether it causes injury to "other property." That often depends on whether the defective product and the item damaged are considered parts of an integrated product.

Integrated Products and the Economic Loss Rule

Saratoga Fishing

Saratoga Fishing Co. v. J.M. Martinac & Co., 520 U.S. 875 (1992), was, like *East River*, an admiralty case, but it provided a degree of High Court imprimatur to a body of developing state law, holding that damage caused by a defective product component to other components of the same product was damage to the product itself—an integrated product—and thus recovery for such damage could not be sought in tort. The decision itself allowed tort claims, but importantly, the Court held that it was improper to assess the product and other property distinction at the component part level lest tort recovery be allowed in most cases, which would effectively eliminate the line between tort and warranty. *Id.* at 883–84. The integrated product analysis essentially extends the economic loss rule to situations when a defective product is incorporated into another product, which it damages. Under this rule, components integrated into a product do not constitute other property, and tort claims involving damage to such components are barred by the economic loss doctrine. *N.H. Ins. Co. v. Dielectric Commc'ns., Inc.*, 872 F. Supp. 2d 458, 462 (E.D. Pa. 2012). The integrated product analysis is "a corollary to the economic loss rule" that bars tort claims when the defective product is incorporated into another product, which it damages. *Hehr Intl. V. Sika Corp.*, No. 12-1624 (FSH), 2013 U.S. Dist. Lexis 27305, at *7–*8 (D.N.J. 2013) (citing *Dean v. Barrett Homes*, 8 A.3d 766 (N.J. 2010)).

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Extension of *Saratoga Fishing* to Integrated Products

Whether components are part of an integrated product sounds simple enough to determine. Indeed, some courts and the Restatement have taken an almost tautological approach to the issue. *See Dean v. Barrett Homes, Inc.*, 8 A.3d at 744 (applicability of economic loss rule to components of a product depends on whether the final product containing the defective product is a single "integrated whole." (quoting Restatement (Third) of Torts: Product Liability §21)).

In *Linden v. Cascade Stone Co.*, 699 N.W.2d 189 (Wis. 2005), the Wisconsin Supreme Court nicely explained the integrated product aspect of the economic loss rule. In affirming an award of summary judgment in a case involving defective exterior stucco to a home plaintiffs purchased, the court stated the following regarding the integrated product limitation:

> A product that fails to function and causes harm to surrounding property has clearly caused harm to other property. However, when a component part of a machine or a system destroys the rest of the machine or system, the characterization process becomes more difficult. When the product or system is deemed to be an integrated whole, courts treat such damage as harm to the product itself. When so characterized, the damage is excluded from the coverage of [the Restatement of Torts]. A contrary holding would require a finding of property damage in virtually every case in which a product harms itself and would prevent contractual rules from serving their legitimate function in governing commercial transactions.

Id. at 197 (quoting *Wausau Tile, Inc. v. Cnty. Concrete Corp.*, 593 N.W.2d 445, 452 (Wis. 1999) (quoting Restatement (Third) of Torts §21 cmt. e (1997))). *See also Westfield Ins. Co. v. Birkey's Farm Store, Inc.*, 924 N.E.2d 1231, 1243 (Ill. App. Ct. 2010) ("[I]f the parties bargained for a fully integrated product, the product and the component part constitute one product and the economic loss doctrine bars any recovery in tort for the damage to that product. Moreover, the economic loss doctrine also bars tort recovery for any type of damage that one would reasonably expect as a direct consequence of, or incidental to, the failure of the defective product." (citations omitted)).

In determining whether components are part of an integrated product and subject

to the economic loss rule, most courts have used an "object of the bargain" approach, with some variations depending on the circumstances. These will be discussed in the text that follows.

Object of the Bargain

The object of the bargain approach examines what the plaintiff purchased—that is, what the plaintiff bargained for. And what the plaintiff bargained for is typically a final product, not its individual components. In, for example, *Marrone v. Greer & Polman Constr., Inc.*, 964 A.2d 330, 340 (N.J. Sup. Ct. App. Div. 2008), the plaintiffs brought product liability claims for defective siding that was part of the home they purchased. In rejecting the product liability claims based on the economic loss rule, the court concluded: "[Plaintiffs] bought a house. They cannot maintain a [product liability] claim by attempting to break the house down conceptually into its component parts and suing in strict-liability for defects in the components." Courts addressing product liability claims involving components of homes or condominium units have generally agreed, *see Davencourt at Pilgrims Landing Homeowners Ass'n v. Davencourt at Pilgrims Landing, LC*, 221 P.3d 234, 243-44 (Utah 2009) (damage to condominium units and common areas caused by defective roofs, foundations, and siding, was not damage to other property); *Bay Breeze Condo. Ass'n v. Norco Windows, Inc.*, 651 N.W.2d 738 (Wis. Ct. App. 2002) (condo's suit against window manufacturer relating to leakage and wood rot barred by economic loss doctrine); *Casa Clara Condo. Ass'n, Inc. v. Charley Toppino & Sons, Inc.*, 620 So.2d 1244, 1247 (Fla. 1993) (purchasers of homes and condominium units typically bargain for finished products, not individual components), but there are wrinkles to be mindful of. In *Wyman v. Ayer Props, LLC*, 11 N.E.3d 1074 (Mass. 2014), the court viewed a condominium complex's common areas and individual condominium units as separate property for purposes of the economic loss rule. In *Dean v. Barrett Homes*, the New Jersey Supreme Court ultimately declined to decide whether to generally adopt the integrated product aspect of the economic loss rule as New Jersey federal courts have done because it concluded that exterior stucco was not sufficiently integrated into a home as to become part of it. 8 A.3d at 776. *See also Gunkel v. Renovations, Inc.*, 822 N.E.2d 150, 153–56 (Ind. 2005) (exterior stone and masonry was other property because plaintiff contracted separately for it).

The object of the bargain analysis is usually a legal determination by the court, although it can consider extrinsic evidence if needed to determine the scope of the parties' contract. *Exxon Shipping Co. v. Pacific Res., Inc.*, 835 F. Supp. 1195, 1200 (D. Haw. 1993). Generally, the analysis is broader than just determining whether the components were sold under the same contract. *Id.* at 1201. Indeed, items listed separately on a purchase order or acquired in a series of transactions from different sellers can be considered an integrated product. *See Albers v. Deere & Co.*, 599 F. Supp. 2d 1142, 1160–64 (D.N.D. 2008) (applying an object of the bargain approach, the court found that a header and gasoline were integrated into a combine even though each item was listed separately on a purchase order); *Exxon Shipping*, 835 F. Supp. at 1201 (the object of the bargain is the completed product even if accomplished through a series of transactions with different sellers). Components of automobiles and aircraft are thus considered parts of an integrated product under the object of the bargain approach. *See American Eagle Ins. Co. v. United Techs. Corp.*, 48 F.3d 142, 145 (5th Cir. 1995) (engines were attached to aircraft when purchased by plaintiff and thus airframe was not other property); *see also Petroleum Helicopters, Inc. v. Avco Corp.*, 930 F.2d 389, 393 (5th Cir. 1991); *In re Gen. Motors Corp.*, 383 F. Supp. 2d 1340 (W.D. Okl. 2005); *McKernan v. United Techs. Corp.*, 717 F. Supp. 60, 62–63, 65–66 (D. Conn. 1989); *Trans States Airlines v. Pratt & Whitney Canada, Inc.*, 682 N.E.2d 45, 52–59 (Ill. 1997); *Dairyland Ins. Co. v. Gen. Motors Corp.*, 549 So. 2d 44, 46 (Ala. 1989).

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An issue that sometimes arises is whether a component that is added to a product after the date it is purchased is part of the integrated product or separate property. Replacement parts are generally treated as part of the original bargain. *See Sea-Land Serv. v. Gen. Elec. Co.*, 134 F.3d 149, 154 (3d Cir. 1998) (commercial parties are aware of the need for replacement parts for some products, and thus they are part of the original bargain and not other property for purposes of the economic loss rule). Things become more confusing when items that do not come from the original seller are added to the product. A strict object of the bargain approach would lead to a finding of separate property, but courts generally do not apply such an overly-formalistic analysis. *See Exxon Shipping*, 835 F. Supp. at 1201; *see also Fireman's Fund Ins. Co. v. Sloan Valve Co.*, No. 2:10-cv-01816-MMD-VCF, 2012 U.S. Dist. Lexis 148472, at *11–*12 (D. Nev. Oct. 16, 2012) (economic loss rule and integrated product analysis unaffected by when defective component installed into product);

Foreseeable Additions and Disappointed Expectations

With many products, it is foreseeable to the parties at the time of sale that other components will be integrated into them at a later time. In such cases, those components will be treated as part of the integrated product, and tort claims relating to them will be barred by the economic loss rule. In *Rockport Pharmacy, Inc. v. Digital Simplistics, Inc.*, 53 F.3d 195 (8th Cir. 1995), the Eighth Circuit considered a negligence claim brought by a pharmacy that purchased a customized computer system for its pharmaceutical and insurance records. At trial, the pharmacy was awarded damages on that claim based on evidence that it lost data that it installed in the computer system after purchase. *Id.* at 198. The court reversed the judgment on this claim based on the economic loss rule, finding that the data was integrated into the computer system. *Id.* at 198–99. It was clearly foreseeable to the parties that data will be integrated into a computer system, and thus

loss of data was "nothing more than 'commercial loss for inadequate value and consequent loss of profits.'" *Id.* at 198 (quoting *R.W. Murray Co. v. Shatterproof Glass Corp.*, 697 F.2d 818, 829 n.11 (8th Cir. 1983)). *See also Petroleum Helicopters, Inc. v. Avco Corp.*, 930 F.2d at 393 (rejecting argument of a buyer of several helicopters with identical flotation devices and warranties that, by exchanging flotation devices between helicopters, it avoided the application of the economic loss rule and was entitled to bring tort claims). As one court noted, ignoring the foreseeability of the later addition of a component in the integrated product analysis would unduly elevate form over substance. *OneBeacon Ins. Co. v. Deere & Co.*, 778 F. Supp. 2d 1005, 1010–11 (E.D. Mo. 2011).

The Sixth Circuit, in a case applying Michigan law, took an even broader approach to foreseeability. In *Detroit Edison Co. v. NABCO, Inc.*, 35 F.3d 236 (6th Cir. 1994), a section of pipe in a utility facility exploded. Seventeen people were injured, the pipe was damaged, and nearby equipment and facilities were also damaged. The plaintiff claimed that a manufacturing defect in the pipe caused the explosion. The plaintiff filed a product liability action for the various property damages.

The court recognized that the type of damage alleged implicated the kinds of concerns implicated by tort law. *Id.* at 242. Nonetheless, because the parties were commercial entities capable of allocating risk and passing on their respective costs, and because the damages were the foreseeable result of a defective pipe, the court affirmed the district court's award of summary judgment based on the economic loss doctrine. *Id.* A federal court in New Jersey also took this approach to foreseeability, looking to whether the kind of harm incurred was foreseeable at the time of the transaction. *See Int'l Flavors & Fragrances, Inc. v. McCormick & Co., Inc.*, 575 F. Supp. 2d 654, 659-63 (D.N.J. 2008) (damage to a final product by a defective ingredient is foreseeable and not actionable in tort); *see also Capricorn Power Co. v. Siemens Westinghouse Power Corp.*, 324 F. Supp. 2d 731, 741-42 (W.D. Pa. 2004) (court reconsidered prior denial of summary judgment and granted it based on reasoning that redesigned blades were sufficiently integrated into a generator as to the part of the object of the bargain; "Under the rationale for the economic loss rule… [,] we believe distinguishing between 'other property' and the defective product itself in a case involving component-to-component damage requires a determination whether the defective part is a sufficiently discrete element of the larger product that it is not reasonable to expect its failure invariably to damage other portions of the finished product.").

> Indeed, items listed separately on a purchase order or acquired in a series of transactions from different sellers can be considered an integrated product.

Some courts have taken a disappointed expectations approach to the economic loss rule and integrated product analysis. In *Grams v. Milk Prods., Inc.*, 699 N.W.2d 167 (Wis. 2005), the plaintiff farmers alleged that the milk replacer they bought from the defendants damaged their calves' immune systems. The court acknowledged that the integrated product analysis did not fit well in all situations in which the economic loss rule should apply. *Id.* at 175. The plaintiff urged the adoption of a bright-line rule that would allow tort claims whenever damage extended beyond the physical dimensions of the purchased product. *Id.* at 178. But the court reasoned that the damage was within the scope of the parties' bargaining, and was the result of the failure of the product to perform as expected. *Id.* at 175–76. The court declined to adopt a rule along the lines of the one proposed by the plaintiff for fear that it would inject undue formalism into the law and erode the UCC. *Id.* at 178.

Whether viewed in terms of object of the bargain, foreseeability, or disappointed expectations, the key takeaway for defense counsel is to assess whether the type of defect that occurred and the harm it caused were in the scope of the parties' transaction; that is, whether the parties allocated the risk of such events or should have allocated that risk. If so, courts will be more receptive to an economic loss rule argument. Because the applicability of the economic loss rule is a legal issue, it should be raised early by motion.

Conclusion

The economic loss rule is a valuable defense to tort claims arising out of product sales. When it applies, the plaintiff will be limited to contract and warranty claims. Rarely, however, will a defective product component damage only itself, and it is a rare product that contains only one component. As a result, the economic loss rule has evolved to cover components of integrated products. And "product" as used in the economic loss rule is not limited to personalty. Real property such as homes, condominium units, and warehouses can fall within its scope.

To determine whether components of a product are integrated such that the economic loss rule precludes the plaintiff from bringing tort claims, courts commonly employ an object of the bargain analysis, which looks to what product the plaintiff purchased. If the plaintiff purchased a car, damage to any part of the car by a defective component thereof will be considered damage to the product itself, and the plaintiff's claims will be limited to contract and warranty. Similarly with the purchase of a home, a claim for damage to a component of the home by another defective component thereof will be cognizable in contract and warranty, but not in tort. Some courts find that later additions or replacements to a product are not part of the integrated product for purposes of the economic loss rule, but more commonly, additions or replacements are part of the integrated product if they are foreseeable at the time of the sale.

If the complaint is sufficiently specific, defense counsel are advised to challenge tort claims with the economic loss rule by a motion to dismiss in order to posture the case more favorably for discovery and settlement. Otherwise, targeted written discovery and depositions designed to pin down the particulars needed for the defense can be used for an early motion for summary judgment on the issue.