

APPLICATION OF THE ECONOMIC LOSS RULE TO CONSTRUCTION ACTIVITIES...AN EVOLVING DOCTRINE

In the January/February 1999, August/September 1999, and January/February 2005 issues of the Engineering Professional publication of WSPE, I discussed the growth of the economic loss rule in Wisconsin and its application to design and construction contracts. In the January/February 2005 issue, I discussed the recent Wisconsin Supreme Court decision in *Insurance Company of North America v. Cease Electric* where the Court held that the economic loss doctrine did not apply to contracts for construction services. The economic loss rule precludes a disappointed owner from suing the manufacturer of a product for negligence where the product simply fails, disappointing the owner. The rule limits the disappointed owner to a breach of contract action against the manufacturer and prohibits the owner from suing the manufacturer in tort for negligence. Breach of contract damages are generally defined as the loss of the bargain and do not include damages otherwise recoverable in tort that naturally flow from negligent conduct.

Past decisions of the Wisconsin Supreme Court suggest that design professionals can be sued either in contract or tort. However, the growth of the economic loss rule in Wisconsin has been steady, and the Court may eventually conclude that where the owner's grievance is only that the building does not work correctly, the owner is confined to pursuing damages for breach of contract and not for tort. Tort damages would include consequential damages that might not be available in a breach of contract action.

In the *Cease Electric* case, the Wisconsin Supreme Court held that electrical construction services performed by Cease Electric were not subject to the economic loss rule because no product was involved. Therefore, Cease Electric was liable to a disappointed owner for tort damages as well as contract breach damages. That was bad news for contractors because it appeared to subject them to both contract damages and tort damages for defective construction.

However, the economic loss rule is an ever growing and changing legal doctrine and the Court has recently modified its decision.

In *1325 North Van Buren, LLC v. T-3 Group Ltd.*, decided by the Wisconsin Supreme Court on July 11, 2006, the Court held that a project owner for a building renovation who had brought an action against a general contractor to recover for breach of construction contract and negligence in carrying out professional services, could not sue in tort for the negligence of the contractor because the building renovation contract was a mixed contract predominantly for a product rather than for services and thus the economic loss doctrine applied to bar negligence claims against the contractor. Obviously, since the *Cease Electric* case held that the electrical contractor could be sued in tort for negligently providing electrical construction services while the *1325 North Van Buren* case held that a general contractor cannot be sued for negligently providing general construction services in a building renovation project, the application of the economic loss rule to the rendition of construction services remains somewhat in doubt.

In *1325 North Van Buren*, the construction contract entered into between the contractor and the owner called for the renovation of a warehouse into condominiums. The construction contract contained 102 pages allocating the risk of loss between the parties and provided for express warranties, insurance and bonding requirements, a broad form indemnification agreement, authority of the owner's architect to reject nonconforming construction work, the right to withhold compensation in the event of a termination of the contract and other risk allocation provisions. The Supreme Court observed that this extensive written construction contract between two sophisticated parties containing all the bargained-for risk allocation should call for the application of contract law rather than tort law. However, the Court observed that if a contract is purely a service contract, the economic loss doctrine does not apply and tort actions

may be brought against the contractor, citing the *Cease Electric* case. The Supreme Court then observed that if a contract is a mixed contract for products and services, whether the economic loss doctrine applies depends upon whether the contract is predominantly for a product or for services. The defendant, T-3 Group, argued that the contract was mixed in nature and was predominantly for the providing of a product and therefore subject to the economic loss doctrine. The owner argued that the contract was purely a service contract and was controlled by the holding in *Cease Electric*.

The Wisconsin Supreme Court held that the contract was a mixed contract rather than a pure service contract such as in *Cease Electric*. In distinguishing the *Cease Electric* case, the Supreme Court held that the electricians were hired to wire a ventilation system supplied by the customer and the contract was a simple oral contract growing out of a longstanding informal business relationship. Furthermore, the Court noted that the electricians were paid by the hour, and all they had to do was to follow a one-page wiring schematic. The Supreme Court held that under those circumstances it had little difficulty in concluding that the contract was purely for services.

The Court held that it would apply a predominant purpose test to determine whether under the totality of the circumstances the predominant purpose of the construction contract was to provide a product rather than a service. The Court observed that the parties had used an AIA standard form agreement where the contractor is also acting as construction manager and where the general contractor enters into direct subcontracts with subcontractors. The Court noted that AIA comments suggested that when the owner enters into such a contract, the contractor becomes contractually bound to provide labor and materials for the project.

Further, the Supreme Court noticed that the general conditions of the contract called for total construction of the work including that provided by subcontractors, encompassing all labor and materials, equipment and services. The Court held that was different from the *Cease Electric* case where only services were rendered. Accordingly, the Supreme Court held that under such circumstances of a mixed contract that included obligations to provide a constructed building through the rendition of all the services necessary to provide it, the contract was a mixed contract and that the economic loss rule would apply prohibiting the disappointed owner of defective construction services from suing the contractor in tort for all the damages naturally flowing from the defective construction, and limited the disappointed owner to the damages that the parties had agreed to in the construction contract.

Most construction projects call for the providing of labor and materials with the objective of constructing a real estate improvement that could be regarded as a product. Since the Wisconsin Supreme Court in its decision in *1325 North Van Buren* held that the renovated building was a product and that the owner could not therefore sue the contractor responsible for defective work for negligence but only for breach of contract, and recover only the damages permitted under the contract, it follows that work performed under construction contracts will be regarded as the providing of a product as well as a service and therefore subject owners to the economic loss rule which prohibits the disappointed owner from suing a contractor in negligence for consequential damages arising out of defective construction work.

Design professionals who provide only a professional service are nonetheless liable to a client for professional negligence and can be sued both for breach of contract and tortious negligence. It is doubtful that the economic loss rule will ever apply to design professionals because they provide a service rather than a product. Yet, it can be argued that architectural and

engineering plans are products, and where those products are defective causing an owner to be disappointed, the economic loss rule applies. Only time will tell whether such an argument is adopted in Wisconsin.