The Economic Loss Rule
Applied to Negligence Claims
Against Construction Managers
— Does One Size Fit All?

by W. Henry Parkman*

Introduction
The modern formulation of the economic loss rule grew from the 1965 products liability case of Seely v. White Motor Co., 63 Cal.2d 9, 45 Cal.Rptr. 17, 403 P.2d 145 (1965). Stated simply, the economic loss doctrine “bars the use of negligence or strict liability theories of recovery of economic losses arising out of commercial transactions where the loss is not a consequence of an event causing personal injury or damage to other property.” Phillip L. Bruner & Patrick J. O’Connor, Jr., 6 Bruner and O’Connor on Construction Law § 19:10 at 50 (2002). The economic loss rule “is stated with ease but applied with great difficulty,” especially in the context of the construction industry. Presnell Construction Managers, Inc. v. EH Construction, LLC, 134 S.W.3d 575, 584 n.12 (Ky. 2004) (concurrence).

Courts and lawyers have wrestled with the economic loss doctrine in the clash between contract and tort law. The doctrine has spawned hundreds of law review articles and legal commentaries. Some courts treat the doctrine as a vital tool to stop the spread of negligence claims that run afoul of contractual duties and expectations. East River Steamship Corp. v. Transamericia Delaval, Inc., 476 U.S. 858, 866, 106 S.Ct. 2295, 2300, 90 L.Ed.2d 865 (1986) (“[I]f this development [allowing tort claims for economic losses] were allowed to progress too far, contract law would drown in a sea of tort.”). Other courts liken the doctrine to The Blob, an “ever-expanding, all-consuming alien life form,” with jurisprudence that “continues to devour unsuspecting tort claims that it finds in its path.” 1325 North Van Buren, LLC v. T-3 Group, Ltd., 2006 WI 94, 293 Wis. 2d 410, 716 N.W.2d 822, 841 (2006) (dissent). One commentator has noted that a rule-based approach to economic loss claims is seductive because it promises predictability and judicial economy. It also seems to offer a workable answer to a crucial question of tort policy: Where should tort liability stop? … These desires for predictability, regulation of unduly widespread tort liability, and a clear boundary between tort and contract occupy a central role in the leading cases that proclaim a broad tort principle against purely economic claims. Too often, however, those cases uncritically transfer the rationale for the economic loss rule of products liability law into a construction industry context.

Carl J. Circo, Placing the Commercial and Economic Loss Problem in the Construction Industry Context, 41 John Marshall L. Rev. 39, 98 (Fall 2007). Professor Circo criticizes a per se rule barring economic loss claims in construction litigation without consideration of the commercial context in which they arise—a typical construction project inherently creates an environment of economic interdependence that should impose a duty of care on some participants to avoid causing economic loss to others.” Id. at 99. “Modern tort theory and policy provide no logical reason to preclude recovery for purely economic loss in construction cases altogether. … Even in jurisdictions that proclaim a broad economic loss rule [in construction cases], the exceptions threaten to swallow the rule.” Id.

The economic loss doctrine continues to be applied to limit tort liability in the context of construction litigation. This article reviews different applications of the economic loss rule and its exceptions in the construction industry con-

* W. Henry Parkman is a partner with Sutherland, resident in its Atlanta office. He has practiced construction law for 24 years, focusing on mediation, litigation, and arbitration of disputes arising from industrial, highway, and other complex projects. He acknowledges the research assistance of Trent Myers, currently a third-year student at the University of Georgia School of Law.
text, with a specific focus on claims against construction managers.

The Shifting Scope of the Economic Loss Rule and Its Application to the Array of Construction Management Services

Over the last three decades, the use of construction managers has greatly increased. John I. Spangler & William M. Hill, The Evolving Liabilities of Construction Managers, 19 Construction Lawyer 30 (Jan. 1999). The roles and contractual duties assumed by construction managers can greatly vary. Initially construction managers served in the role of owner’s agent, with no accountability for the budget and schedule. Adrian MacDonald & Tom Stabile, Contractors Call Construction Management an Ever-Riskier Proposition, 54 New York Construction News 2 (Sept. 2006). In such a “pure agency CM” role, construction managers perform duties similar to contract administration services performed by architects. In the early 1990s a new breed of owners began to require construction managers to take on risk and to assume responsibility for construction costs and completion dates. In such a CM-at-risk role, construction managers more closely resemble general contractors. Both construction management models are currently in operation, with leading construction managers offering “a menu of methods ranging from traditional general contractor to owner’s representative – applying whichever best matches the project’s demands.” Id. The breadth of services that construction managers may provide on various projects suggests that one legal rule does not fit all situations of economic loss.

Whether (and to what extent) the economic loss rule should apply to construction management services turns on both the type of services provided and each jurisdiction’s view of the doctrine. The complexity of the economic loss rule in construction management litigation is demonstrated by the number of exceptions to the rule. This article next addresses some of these exceptions.

Negligent Misrepresentation Exception

The most recognized exception to the economic loss rule is that, in the absence of privity, a foreseeable plaintiff may pursue an action for economic damages against a negligent supplier of information. Accordingly, many jurisdictions have adopted Section 552 of the Restatement (Second) of Torts and applied it in the construction context. See Bilt-Rite Contractors, Inc. v. The Architectural Studio, 581 Pa. 454, 866 A.2d 270, 287 (2005), McElwee Group, LLC v. Municipal Auth. of the Borough of Elverson, 476 F.Supp.2d 472 (E.D. Pa. 2007), and Robert & Co. Assocs. v. Rhodes-Haverty P’ship, 250 Ga. 680, 300 S.E.2d 503 (1983). Section 552 provides:

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

Applying this theory of liability, some courts have found that the economic loss doctrine does not bar claims for economic damages where a contractor acted in reliance upon information negligently supplied by an agency CM. For example, in John Martin Co. v. Morse/Diesel Inc., 819
S.W.2d 428 (Tenn. 1991), a subcontractor on a fast track project claimed that its delays and additional costs were attributable to faulty plans and the construction manager’s negligent supervision. The Tennessee Supreme Court decided that lack of privity was no bar to the subcontractor’s negligence claim against the construction manager, observing that there was little reason to shield architects, engineers, and construction managers from liability where the duty to exercise “reasonable care and competence” had been imposed on other professions, such as title examiners, surveyors, and attorneys. “The Restatement makes no distinction based upon the nature of the profession. Neither do we.”  Id. at 434. The Morse/Diesel court specifically allowed the subcontractor’s negligent supervision claim: “We hold that a subcontractor, despite a lack of privity, may make [a tort claim for economic loss] against the construction manager based upon negligent misrepresentation, whether the negligence is in the form of direction or supervision.”  Id. at 429 (emphasis added).

Even though the Morse/Diesel court allowed the negligent supervision claim to proceed under Section 552 as part of the negligent misrepresentation claim, subsequent courts have generally applied the economic loss rule to bar claims of negligent supervision. For example, in Gulf Contracting v. Bibb County, 795 F.2d 980 (11th Cir. 1986), the architects and engineers were found to owe a duty to the successful bidder for negligently failing to disclose certain subsurface debris in the project plans and specifications. Other claims, however, which were based on the architects’ and engineers’ negligent failure to supervise the county’s separate grading contractor and their failure to approve change orders and additional compensation for work performed by the successful bidder, were barred: “None of these acts and omissions fall within the privity exception for negligent misrepresentation.”  Id. at 981 n.2.

Similarly, in Malta Construction Co. v. Henningson, Durham & Richardson, Inc., 694 F.Supp. 902 (N.D. Ga. 1988), the contractor’s claim that the engineer provided deficient plans and drawings was not barred by the economic loss rule, but the contractor’s claims that “HDR’s fail[ure] to promptly and adequately review shop drawings” was barred: “HDR’s alleged negligent review of drawings is not like negligent misrepresentation or supply or omission of information. Instead, such acts are like the alleged negligent failure to supervise and to approve change orders that the Gulf Contracting court held did not fall within the privity exception for negligent misrepresentation.”  Id. at 907.

Georgia courts have recently relied on the economic loss rule to summarily dispose of claims that construction managers were negligent in their contract administration duties. In J. Kinson Cook of Georgia, Inc. v. Heery/Mitchell, 284 Ga.App. 552, 644 S.E.2d 440 (2007), the contractor alleged that the construction manager was negligent by breaching its contractual duties: “failing to make clear and timely decisions, ... making decisions that materially changed the scope of [the contractor’s work], failing to process approved change orders, and failing to process pay requests.” The Georgia Court of Appeals noted that the construction manager owed no legal duty independent of the contract and held that, because the contractor’s claims did not allege negligent misrepresentation, “the exception to the privity requirement does not apply.” 644 S.E.2d at 556.

In Carolina Casualty Ins. Co. v. R.L. Brown & Assocs., No. 1:04-CV-3537-GET, 2006 WL 2842733 (N.D. Ga. Sept. 29, 2006), the general contractor’s surety, in its own right and by subrogation, asserted claims of negligent misrepresentation and professional negligence against the program manager. The county Board of Education had contracted with the program manager to oversee $400 million in construction projects. The program manager agreed to act as the Board’s agent and to “perform all Services at a level, and to a standard of care, consistent with the standards and quality prevailing among first class, nationally recognized program and construction management firms of superior knowledge, skill and experience engaged in programs of similar size and complexity.”  Id. at *3. The surety completed
the project after the general contractor was defaulted for defective work. The surety alleged that the program manager owed a “professional obligation,” which was breached “by inappropriately certifying [contractor] pay applications and permitting release of contract funds for work which was defective or nonconforming…” Id. at *7. The court held that the professional negligence claim could not survive because Georgia courts have not recognized any exception to the strict privity requirement for “claims alleging negligent failure to supervise a project.” The negligent misrepresentation claim failed because the surety could not show that the alleged negligent certification of pay applications was made for the purpose of inducing the surety to rely and act upon the representation. Further, there was no evidence that the surety actually relied on the program manager’s alleged negligent certification of the contractor’s pay applications.

In Presnell Construction Managers, Inc. v. EH Construction, LLC, 134 S.W.3d 575 (Ky. 2004), the Kentucky Supreme Court adopted Section 552 of the Restatement (Second) of Torts and found that the plaintiff contractor could maintain an action for negligent misrepresentation against the construction manager despite an absence of contractual privity. The Kentucky Supreme Court, however, rejected the portion of the contractor’s claim based on the construction manager’s negligent supervision, even though the court of appeals did not treat the claims separately. Id. at 578 n.6. Moreover, the contractor likely did not segregate portions of economic loss attributable to negligent misrepresentation from those attributable to negligent supervision: the contractor alleged that the construction manager “failed to properly stage and time the work involved for the Project and that as a result [the contractor] was required to redo much of the work that it had already completed. … Additionally, [the contractor] alleged that [the construction manager] was careless and negligent in coordinating the Project, and supplied faulty information and guidance and supervision to the contractors working on the Project.” Id at 578] Thus, under Presnell the construction manager owed a tort duty not to supply false information to the contractor, but owed no independent tort duty to perform other duties, such as supervision, scheduling, and coordination, non-negligently.

Following Presnell, the Kentucky Court of Appeals rejected a plumbing contractor’s negligent misrepresentation claim against the architect and a parallel prime contractor because the complaint failed to allege the supply of any false information. H&R Mech. Contractors, Inc. v. Codell Construction Co., 2005 WL 3487870, *3 (Ky. App. 2005). The dissenting judge wrote of the difficulty in resolving the appeal because of the lack of factual detail in Presnell to explain which types of negligent conduct are within (or without) the scope of Restatement Section 552. The description of the contractor’s claims “appears to be virtually identical to the facts described as supporting the claims in Presnell.” Id. at *4 (dissent). “Surely, one of the Defendants’ duties under the contract was to supply correct information. Therefore if they negligently supplied incorrect information, they violated not only their contractual duties, but the tort duties imposed by Restatement Section 552.” To attempt to avoid the economic loss bar to claims of negligent supervision, contractors will continue to characterize claims that the construction manager negligently performed its contract administration duties as negligent misrepresentation.

**Special Relationship Exception**

Courts have allowed negligence claims by contractors against architects or engineers where there is a special relationship between the parties. Those jurisdictions that recognize a tort duty owed by design professionals arising from a special relationship may rely on the following cases to extend the “special relationship” exception to agency construction managers.

In Atkins v. Debow, 208 W.Va. 486, 541 S.E.2d 576 (2000), the Supreme Court of West Virginia wrote:
an individual who sustains purely economic loss from an interruption in commerce caused by another’s negligence may not recover damages in the absence of physical harm to that individual’s person or property, a contractual relationship with the alleged tortfeasor, or some other special relationship between the alleged tortfeasor and the individual who sustains purely economic damages sufficient to compel the conclusion that the tortfeasor had a duty to the particular plaintiff and that the injury complained of was clearly foreseeable to the tortfeasor.

Id. at 589. Recognizing that such a special relationship exists between contractors, architects and engineers, the West Virginia Supreme Court found that a contractor may recover “purely economic damages in an action alleging professional negligence on the part of a design professional.”

Eastern Steel Constructors, Inc. v. City of Salem, 209 W.Va. 392, 549 S.E.2d 266, 275 (2001). The court noted that, given the nature of construction projects, contractors must rely upon design documents to bid upon and complete their projects. Additionally, a design professional may provide project oversight during the actual construction phases.

In Mid-State Surety Corp. v. Thrasher Eng’g, Inc., No. 2-04-0813, 2006 WL 1390430, *4 (S.D.W. Va. May 16, 2006), the court found that a special relationship existed between a contractor’s surety and a project engineer, despite the lack of privity. The court noted that it was foreseeable that a contractor’s surety “would suffer harm as a result of the engineer’s failure to properly monitor the progress of a contractor”. Id. at *5. Moreover, the court found that the surety reasonably relied upon the engineer’s payment procedures and duties outlined in the contractual provisions between the engineer and the owner.

By contrast, in Plourde Sand & Gravel, 154 N.H. 791, 917 A.2d 1250, 1255-57 (2007), the New Hampshire Supreme court declined to extend the special relationship exception to economic loss recovery in the context of construction because it would “disrupt the contractual relationships between and among the various parties.”

Functional Equivalent of Privity Exception

Some courts allow plaintiffs to assert negligence and misrepresentation claims in the absence of privity if the relationship between the parties supplies the “functional equivalent of contractual privity.” Under New York law, such a relationship exists where (1) a defendant knows that its services will be used for a particular purpose by a known plaintiff; (2) the known plaintiff relies upon the services for that particular purpose; and (3) the conduct between the parties evidences an understanding of this reliance. The New York Court of Appeals adopted this standard in Ossining Union Free School District v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 541 N.Y.S.2d 335, 539 N.E.2d 91 (1989), finding the functional equivalent of privity for an owner’s claim against a consulting engineer.

In Travelers Casualty & Surety Co. v. Dormitory Auth. of the State of New York, No. 04 Civ.5101(HB), 2005 WL 1177715 (S.D.N.Y. May 19, 2005), the federal district court found that a sufficiently close relationship existed between a contractor and an architect to allow the contractor’s surety to proceed with its negligence claim. The court noted that the architect’s contract with the owner required the architect to examine the contract bids and to inspect and oversee the construction work to ensure that all contractors adhered to the architect’s designs. The close communications and “direct dealings” between the architect and contractor evidenced a sufficiently close relationship to establish the “functional equivalent of privity of contract.” Id. at *4. Therefore, the contractor’s surety was allowed to bring its claim against the architect in spite of the economic loss doctrine. See James McKinney & Son, Inc. v. Lake Placid 1980 Olympic Games, Inc., 92 A.D.2d 991, 461 N.Y.S. 2d 483 (1983), modified on other grounds, 61 N.Y.2d 836, 473 N.Y.S.2d 960, 462 N.E.2d 137 (1984) (construction management duties held to inure to benefit of subcontractor).

Other jurisdictions are more restrictive. See, e.g., Corporex Dev. & Construction Mgmt., Inc. v. Shook,
Duty Arising from the Architect’s Control Over a Construction Project

Some jurisdictions allow contractors to allege economic loss claims against architects in the absence of privity of contract where the contractor is able to demonstrate that the architect had considerable control over the construction project. In Ellis-Don Construction v. HKS, Inc., 353 F.Supp.2d 603 (M.D.N.C. 2004), a district court in North Carolina found that the economic loss doctrine did not bar a claim against an architect that prepared construction plans, coordinated construction efforts of various contractors, supervised their work, and administered the contracts with each contractor. The contractor alleged that the architect (which provided planning and design work, construction administration, and inspection services) negligently performed its duties, resulting in delays and cost overruns. The court noted that an architect with the “power of economic life or death” over a contractor owes a duty of care that flowed from the parties’ working relationship. Id. at 605 (quoting United States ex rel. Los Angeles Testing Laboratory v. Rogers & Rogers, 161 F.Supp. 132, 136 (S.D. Cal. 1958)).

By contrast, in D.I.C. Commercial Construction Corp v. Broward County, 668 So.2d 697 (Fla. App. 1996), the court held that the economic loss rule barred a contractor from bringing an action for professional negligence against an architect with broad powers of contract administration. The dissent noted that the architect had authority to stop the construction work and that this level of supervision demonstrated control sufficient to take the case out of the economic loss rule. See Mosser Construction, Inc. v. Waterproofing Co., No. L-05-1164, 2006 WL 1944934, *4 (Ohio App., 6th Dist. July 14, 2006) (insufficient showing of authority where the architect “only acted as an intermediary between” parties and could authorize only minor changes in the plans).

While these cases applying the “control” exception involved claims against design professionals, they may provide authority in litigation involving construction managers.

Services Exception

Under Wisconsin law, economic claims based upon negligent performance of services are not barred if they were provided under a contract predominately for services. The economic loss rule, however, applies to bar claims for negligence if the services were incidental to the delivery of a finished product. In one recent case, the viability of a negligence claim against an at-risk construction manager was determined by defining the predominant purpose of the contract. 1325 North Van Buren, LLC v. T-3 Group, Ltd., 2006 WI 94, 293 Wis. 2d 410, 716 N.W.2d 822 (2006). If the predominant purpose of the contract was to provide construction management services, the economic loss rule would not have been a barrier. Because the predominant purpose of the contract was to provide a finished product (a 42-unit condominium complex), however, the economic loss doctrine barred the tort claims.

Does the Line Drawing Make Sense?

The cases discussed in this article exemplify the line-drawing pattern of courts dealing with negligence claims of economic loss arising from construction projects. Construction managers and design professionals are declared in some cases to owe duties to third parties, whereas in other cases they owe duties only to other parties to their contracts. Negligent misrepresentation claims are generally allowed, whereas negligent supervision claims are disallowed.

Most of the cases lack principled discussion as to why negligent misrepresentation claims are not barred by the economic loss rule, but claims alleging negligent supervision (or negligent contract administration) are barred by the rule. The representations and information supplied by a construction manager are services provided pursuant to the construction manager’s contract, just as contract administration
(processing of pay applications and change orders, for example) is a service provided pursuant to the very same contract. Why should the law distinguish between these services as they relate to rights afforded foreseeable persons adversely affected by the performance of these services?

Even where some jurisdictions enforce the economic loss rule, these same jurisdictions will allow homeowners and subsequent purchasers to bring negligent construction claims against contractors and builders despite a lack of privity. See Olson v. Richard, 120 Nev. 240, 89 P.3d 31 (2004) (under residential construction statute economic loss doctrine does not bar a homeowner’s negligence claim against a subcontractor) and Rousseau v. K.N. Construction, Inc., 727 A.2d 190, 193 (R.I. 1999) (economic loss doctrine is not applicable to purchaser’s negligence claims against an engineer).

Although Georgia courts apply the economic loss rule to bar negligent supervision claims against construction managers, another line of cases allows negligence claims against contractors. See, e.g., Rowe v. Akin & Flanders, Inc., 240 Ga.App. 766, 525 S.E.2d 123, 126 (1999): a “negligent construction claim arises not from a breach of contract but from breach of a duty implied by law to perform the work in accordance with industry standards.” In Stancliff v. Brown & Webb Builders, Inc., 254 Ga.App. 224, 561 S.E.2d 438 (2002), the court allowed subsequent purchasers to assert a claim against the builder for negligent construction, negligent supervision of subcontractors, and negligent failure to adhere to industry standards.

We are left, in at least one jurisdiction, with one rule prohibiting contractors from bringing negligence supervision claims against construction managers and another rule allowing a subsequent purchaser of a residence to pursue a negligent supervision claim against the builder.

**Conclusion**

With the growth of construction managers in the industry and the increasingly varied range of services they provide, the limits of the economic loss rule will continue to be tested in litigation. Construction managers in their role of managing schedules and processing pay applications and change order requests have much of the same economic power that has prompted courts to recognize duties that architects and engineers owe to contractors, despite the lack of privity. Given the similarity of construction administration services provided by architects and by construction managers, case law established in the design professional context will be relied upon by those asserting negligence claims against construction managers.

This article suggests that the economic loss rule should not be applied inflexibly, but should be adapted to the economic realities and complexities of construction projects with an understanding of the interrelatedness of the project participants, the functions they serve, and their contractual duties and risk assumptions. Against this background, an application of traditional legal principles—duty, foreseeability, and reliance—to negligence claims should not lead to expanded tort liability. In perhaps the leading construction manager liability case, the Tennessee Supreme Court responded to the concern that restricting the breadth of the economic loss rule would lead to an explosion of tort claims:

The burden is always upon the plaintiff to establish that the supplier violated his duty to exercise due care and competence in obtaining or information and reliance by the user of the information are importance safeguards. Negligence by the user of the information may be a bar to recovery. Each of these principles provides reasonable protection against the proliferation of litigation in this area of tort. The Restatement (2d) provisions … suggest a properly balanced approach.

Morse/Diesel, 819 S.W.2d at 435.