

# Nevada Supreme Court Reinigorates Economic Loss Doctrine<sup>1</sup>

## Introduction

The economic loss doctrine is often cited as one of the most confounding legal principles in contract law. Its scope and application vary widely from state to state. In Nevada, the confusion is exemplified by the *Calloway* cases, in which the Supreme Court announced a decision, then withdrew and replaced it. *Calloway v. City of Reno*, 113 Nev. 564, 939 P.2d 1020 (1997) (*Calloway I*); 116 Nev. 250, 993 P.2d 1259 (2000) (*Calloway II*).

The Court revisited the doctrine recently in *Terracon Consultants Western, Inc. v. Mandalay Resort Group*, --- Nev. ---, 206 P.3d 81 (2009). There, the question was whether design professionals can be sued for professional negligence in commercial construction cases. Some states have carved out an exception to the economic loss doctrine to permit such claims. Other states (including Nevada now under *Terracon*) enforce the doctrine and bar such claims. *Terracon* is an obvious victory for engineers and architects, but it has broader relevance, as it clarifies and consolidates Nevada law.

## Terracon's Statement of Nevada Law and Public Policy

*Terracon* traces the historical development of the economic loss doctrine and outlines the underlying public policies considerations. Most simply put, "the doctrine generally provides that purely economic losses are not recoverable in tort absent personal injury or property damage...." 206 P.3d at 87. "Purely economic loss" is "the loss of the benefit of the user's bargain...including...pecuniary damage for inadequate value, the cost of repair and replacement of [a] defective product, or consequent loss of profits...." *Id.* at 83, quoting *Calloway II*.

The purpose of the doctrine is to "mark[] the fundamental boundary between contract law, which is designed to enforce the expectancy interests of the parties, and tort law, which imposes a duty of reasonable care and thereby [generally] encourages citizens to avoid causing physical harm to others." *Id.* at 86.

Defining the boundary between contract and tort liability serves several purposes. The doctrine balances "the need for useful commercial economic activity" with "the desire to make injured plaintiffs whole." *Id.* at 87. In so doing, the doctrine "works to reduce the cost of tort action, but still provides tort victims with a remedy...." *Id.* at 88. The doctrine limits liability by attempting to "balance the disproportion between liability and fault." *Id.*

## Exceptions to the Rule

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The rule and its policies are simply stated. The exceptions, however, are the source of most of the confusion. In some jurisdictions, the exceptions have seemingly swallowed the rule. In Nevada, however, *Terracon* reinvigorates the doctrine by declining to find a new exception.

Under *Terracon*, the universe of exceptions should not be expanded unless there is a strong public policy rationale to do so. *Id.* at 88. Where the relationship between the plaintiff and defendant arises from a contract, and where the plaintiff's claims center around the defendant's alleged breach of obligations contained in that contract, there generally is no rationale and, therefore, tort liability should be unavailable.

Given these considerations, the Court concluded that the doctrine bars professional negligence claims against engineers, architects, and other design professionals. *Id.* at 89. In this context at least, contract law is "better suited" to adequately address the risks associated with construction projects. Without the doctrine, design professionals would be exposed to seemingly endless liability. *Id.*

### Questions Remain

*Terracon* left open the question of whether the doctrine would apply if economic loss is *accompanied* by property damage and/or personal injury. *Id.* at fn. 5. It is not hard to imagine a scenario in which professional negligence not only causes economic loss, but damage to the property itself. Even in *Terracon*, the building suffered damage to its foundation due to settling, which required repair. *Id.* at 84.

Another important question not answered is whether the doctrine would bar *all* forms of fraud. *Terracon* cites *Barber Lines A/S v. M/V Donau Maru*, 764 F.2d 50 (1<sup>st</sup> Cir. 1985), as a source for potential exceptions, including negligent and intentional fraud.

In reconciling the many possible exceptions, *Barber Lines* found a common theme:

These exceptions seem designed to pick out broad categories of cases where the "administrative" and "disproportionality" problems intuitively seem insignificant or where some strong countervailing consideration militates in favor of liability.

764 F.2d at 56.

Using similar guidelines, the Ninth Circuit has declined to deem "fraud in the execution" of a contract to be a tort that falls within the exception. *See Giles v. General Motors Acceptance Corp.*, 494 F.3d 865, 871 (9th Cir. 2007). *Giles* relied heavily on *Calloway II* and distinguished "fraud in the inducement" from "fraud in the execution." Whether intentional or not, the former is not barred by the economic loss doctrine, while the latter would be. *Id.* at 880.

In reaching this result, *Giles* concluded that courts must "examine in each case 'the relevant policies in order to ascertain the proper boundary between the distinct civil law

duties that exist separately in contract and tort.”” *Giles* at 878, quoting *Calloway II*. Based on the general principle that mere breaches of contract should not be converted into tort claims, the Court effectively found that fraud claims are barred under the economic loss doctrine where the *gist of the action* is breach of contract. A plaintiff cannot disguise its contract claim by calling it fraud. See *Bulbman, Inc. v. Nevada Bell*, 108 Nev. 105, 112, 825 P.2d 588, 592 (1992)

### Conclusion

*Terracon* is important for a variety of reasons. For design professionals in particular, *Terracon* is reassurance that they should only be liable in contract, and not tort, to those with whom they have a valid contract. This distinction can be very important from a monetary/damages perspective. In addition, the contract should control. Thus, it is more likely that provisions in the contract will be enforced, such as those governing the claims process, defining relative duties, and limiting consequential damages.

*Terracon* also consolidates Nevada law and thus is useful outside the context of commercial construction. Although questions remain about how far the Court has closed the door on expanding the universe of recognized exceptions, *Terracon* represents, at the very least, a reinvigoration of the doctrine.