Economic Loss Rule Applied

A judicially created doctrine, the Economic Loss Rule, shields a party from tort liability when damages are purely economic and without accompanying personal injury or property damage. The disparate judicial interpretation and application of the Economic Loss Rule in jurisdictions across the nation have created much uncertainty regarding the risk of parties conducting business. This tends to undermine the purpose of the rule in protecting the parties’ contractual expectations in negotiated risk. The extension of this rule to construction cases operates to avoid a party’s unfettered liability for tort damages. Recently, in a narrowly focused opinion, the Nevada Supreme Court answered a certified question from the U.S. District Court of Nevada and held that the Economic Loss Rule shields design professionals, who provide services in the commercial property development or improvement process, from negligence-based claims for purely financial losses. *Terracon Consultants v. Mandalay Resort Group, et al.* 206 P.3d 81 (Nev. 2009).

Factual Background

In *Terracon*, Mandalay Bay sought $60 million dollars in damages from Terracon, its geotechnical engineer subcontractor, who prepared a geotechnical exploration report for the construction of the $1 billion dollar Mandalay Resort and Casino in Las Vegas, Nevada. Terracon was ultimately paid $29,180 to provide geotechnical engineering advice about the subsurface soil conditions and to recommend a foundation design for the hotel-casino.

During the construction of the tower of the project in 1998, Mandalay alleged that the soil settled approximately eighteen inches or over five times the amount than predicted in Terracon’s engineering analysis, causing substantial damages to the structures and hotel rooms. Due to the imminent threat to the structural integrity of the project, the local jurisdictional authority required Mandalay to repair and reinforce the foundation before proceeding with the remaining work. In 2004, Mandalay sued Terracon in state court for damages; Terracon removed the case to federal court.

In seeking clarification of the scope of Nevada’s Economic Loss Rule, the U.S. District Court submitted two certified questions to the Nevada Supreme Court:

1. Does the economic loss doctrine apply to contractors who solely provide services in construction defect cases?

2. Does the economic loss doctrine apply in construction defect cases to design professionals, such as engineers and architects, who solely provide services, regardless of whether the services are rendered before or during construction?

The Nevada Supreme Court accepted the referral of the certified two-part question but narrowly reframed it, acknowledging that the term “contractors” was not defined by the District Court and limiting its analysis to the legal issues presented by the pleadings of the parties:

Does the economic loss doctrine apply to preclude negligence-based claims against design professionals, such as engineers and architects, who provide services in the commercial property development or improvement process, when the plaintiffs seek to recover purely economic losses?

The Nevada Supreme Court responded that the economic loss rule applied to the owner’s claims.

Purpose of the Rule

Acknowledging that the U.S. District Court had already decided that Mandalay’s damages
were purely economic, the Nevada Supreme Court discussed the Economic Loss Rule. The Economic Loss Rule, absent any exceptions, “bars unintentional tort actions when the plaintiff seeks to recover purely economic losses.” The court reasoned that the rule’s purpose, is “to shield defendants from unlimited liability for all of the economic consequences of a negligent act, particularly in a commercial or professional setting, and thus to keep the risk of liability reasonably calculable.” The court further reasoned that “[t]he economic loss doctrine marks 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.”

Exceptions to the Rule

In analyzing whether an exception to the rule should be applied, the court will assess the policies underlying the rule and any countervailing policy considerations that weigh against imposing liability. The policy considerations underlying the economic loss rule include: (1) balancing the desire to make injured plaintiffs whole with the need for useful commercial economic activity; (2) financial considerations in dispelling the fear of victim compensation costs that are unnecessarily high; and (3) balancing the disproportion between liability and fault.

To that end, the Nevada Supreme Court opined that “cutting off tort liability at the point where only economic loss is at stake without accompanying physical injury or property damage ‘provides . . . incentives and disincentives to engage in economic activity or to make it safer.’” Imposing unfettered tort liability for pure financial harm could result in insurance premiums that are too expensive to afford by the average party.

Several examples of exceptions in other jurisdictions permitting recovery for purely economic losses against design professionals were cited by the Nevada Supreme Court. Those courts have reasoned that (1) the rule does not apply to negligently rendered services because the rule applies to the sale of goods; (2) recovery is permissible when design professionals owe duties beyond the terms of the contract such as a professional duty or a special relationship; or (3) claims that are foreseeable.

Specifically to Nevada, the court noted several exceptions in certain categories of cases, such as negligent misrepresentation and professional negligence actions against attorneys, accountants, real estate professionals, and insurance brokers. Nevada statutory law also creates a right to sue for losses related to construction defects in residential properties.

Mandalay’s Negligence Claim

The court concluded that the claim against Terracon did not fall within the scope of any exception and also declined to create a new exception. The Terracon Court held that the Economic Loss Rule barred Mandalay’s negligence claim against design professionals, such as architects and engineers who have provided services in commercial property construction or development. The Nevada Supreme Court concluded that the rule applies to commercial activity for which contract law is better suited to resolve professional negligence claims and stated that the “legal line between contract and tort liability promotes useful commercial economic activity, while still allowing tort recovery when personal injury or property damage are present.”

In support of its conclusion, the court recognized that the work provided by construction contractors or the services rendered by design professionals in the commercial building process are “both integral to the building process and impact the quality of building projects. Therefore, when the quality is deemed defective, resulting in economic loss, remedies are properly addressed through contract law.” The Nevada Supreme Court did not find a distinction between design professionals rendering advice in the commercial development process and contractors and subcontractors involved in physically constructing improvements to real property. In the commercial property development and improvement process, only the contract prescribes the duties of a design professional. Indeed, the court stated that the parties had addressed economic losses in their contract. The specific nature of those contract provisions was not set forth in the opinion.

Comment

It is important to recognize that Terracon is an isolated decision. The Nevada Supreme Court noted that Mandalay had alleged that Terracon’s negligence caused damage to the resort structure itself but that this aspect of Mandalay’s claim was not considered because the federal district court
had only asked whether tort recovery is permitted assuming the losses are purely economic. Thus, had personal injury or property damage been a part of the court’s consideration, the rule would not have barred Mandalay’s negligence claim against Terracon.