

Change Order

Published by the Construction Law Section of the North Carolina Bar Association • Section Vol. 28, No. 1 • July 2013 • www.ncbar.org

The Immediate Past Chair's Comments



Bolick

I have been honored to serve as your chair during this remarkable year in our section's history. I am certain this is not the first time that the Chair's Comments began with an expression of surprise at how quickly the year has passed. It truly has been a pleasure.

This has been an exciting time for our section. Our members have been especially active in the construction industry educating owners, lenders and contractors, suppliers and designers about the dramatic changes to North Carolina's lien law. We are now more than two full months past the effective date. While we all have tales of unexpected bumps encountered along the way, thus far it appears everyone is learning to navigate the new requirements, thanks in large measure to the tremendous efforts of our section members in helping to frame the legislation and educating the public about its contents.

I would like to thank everyone whose leadership has made our section shine during this process. In particular, thanks again to Keith Coltrain for steering the Lien Law Committee as we moved from brain storming sessions to a fully enacted lien law. Thanks also to Jason Herndon, who took the reins of Lien Law Committee during this past year as technical corrections were made to the lien law in the General Assembly.

In the midst of the historic revisions to the lien law, we celebrated our own history last September. Thanks again to Nan Hannah, Perry Safran, Jude Starrett and everyone else who worked to make our 25th Anniversary Celebration and CLE such a success.

Finally, I would like to thank Julianne Dambro, our "new" NCBA liaison, who took over this past year from

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Loss Rule Defining "Other Property" in Construction Claims

By Nicole B. Slaughter

Construction law practitioners familiar with North Carolina's economic loss rule understand the challenges of applying this rule in construction defect cases. Marking the boundaries between contract and tort claims, the economic loss rule prohibits tort recovery for purely economic damages caused by improper performance of a contract. Personal injuries and damage to other property are not excluded by the rule and are still recoverable in tort.

Defining what is and what is not "other property" is no easy task in construction cases. Construction contracts are complex, involving both services provided by contractors and multiple products purchased by contractors in the course of performing their services. These multiple products are then installed into a single property.

A number of decisions, both state and federal, have endeavored to define "other property" without necessarily evaluating the unique aspects of construction contracts. It is unclear whether North Carolina courts, at this time, have settled on a definition of "other property" in the context of construction claims.

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North Carolina’s “Other Property” Exception to the Economic Loss Rule

North Carolina adopted the economic loss rule in 1978 in **North Carolina State Ports Authority v. Lloyd A. Fry Roofing Co.**, a case involving both contract and negligence claims against a builder and his roofing subcontractor for improper roof installation. 294 N.C. 73, 240 S.E.2d 345 (1978). **Ports Authority** established the general rule that “a breach of contract [ordinarily] does not give rise to a tort action by the promisee against the promisor.” *Id.* at 81, 240 S.E.2d at 350. In dismissing negligence claims against both the builder and the roofing subcontractor, the court recognized the “other property” exception to the economic loss rule, but found it inapplicable because the damages sought included only repairs to the defective roof, moving expenses and costs. *Id.* at 82, 240 S.E.2d at 350.

In **Warfield v. Hicks**, the court applied the economic loss rule to bar initial purchasers of a home from recovering in negligence for damages caused by the builder’s use of beetle infested decorative beams and other defective construction. 91 N.C. App. 1, 10, 370 S.E.2d 689, 694 (1988), *rev. denied*. 323 N.C. 629, 374 S.E.2d 602 (1988) (confirming that the economic loss rule applied to initial purchasers of a building). The court pointed out that the homeowners had *not alleged or proven* “any injury other than the injury to the property itself arising from the contractor’s alleged failure to adequately perform its contract or to satisfy express and implied warranties.” *Id.* at 10, 370 S.E.2d at 694.

The economic loss rule and “other property” exception were addressed in the product liability context for the first time in **Chicopee, Inc. v. Sims Metal Works, Inc.**, 98 N.C. App. 423, 391 S.E.2d 211 (1990). A textile manufacturer and owner of two drying ranges that each contained 40 pressure vessels sued the manufacturer of the pressure vessels in negligence to recover damages caused by the defective vessels. Holding that the textile manufacturer could not recover for the damage to replace the defective pressure vessels because it was economic loss, the court allowed recovery for damage to other component parts of the drying ranges caused when one of the defective pressure vessels exploded. *See Id.* at 431-32, 391 S.E.2d at 216-17.

Gregory v. Atrium Door & Window Co. addressed whether the economic loss rule applied to construction products purchased by a homeowner for use in the construction of his home. 106 N.C. App. 142, 415 S.E.2d 574 (1992). In this case, a homeowner purchased doors and windows from a distributor for use in the construction of his home. He sued the manufacturer in negligence when the doors and windows malfunctioned. *Id.* at 142, 415 S.E.2d at 574. Accepting without analyzing the trial court’s description of damages, the **Gregory** court stated: “The trial court’s findings reflect that only economic loss resulted from the alleged breach in the form of malfunctioning and deteriorating doors, along with some water damage to flooring.” *Id.* at 144, 415 S.E.2d at 576. It is unclear from the language used whether the court considered “water damage to the flooring” to be a part of the economic loss or simply in addition to the economic loss.

Reece v. Homette Corp. established that the “other property” exception does not encompass damage to the interior of a mobile home caused by defective construction of other parts of the mobile home. 110 N.C. App. 462, 466, 429 S.E.2d 768, 770 (1993). In analyzing a statute of limitations issue for a mobile home owner seeking recovery for water damage and staining to the interior of the mobile home, the **Reece** court viewed the entire mobile home as one product.

Here, plaintiffs’ claim seeks recovery only for damage to the mobile home, the very product manufactured by defendant. This claim is substantially different from a claim arising from a factual situation where the manufactured product causes physical injury to a person or to property other than the manufactured product itself.

Id.

Another product liability case, **Moore v. Coachman Indus.**, made it clear that “other property” did not include parts of a finished product damaged by a defective component. 129 N.C. App. 389, 499 S.E.2d 772 (1998). The **Moore** court used the economic loss rule to bar recovery in negligence for the loss of a recreational vehicle resulting from a fire started by a malfunctioning power converter. *Id.* at 401-02, 499 S.E.2d at 780. Despite acknowledging that the “other property” exception to the economic loss rule allows recovery in negligence for damage to property that is not the subject of the contract, the **Moore** court refused to allow the RV owners to recover in negligence for damage to their satellite dish, receiver box and other personal property in the RV. *Id.* at 401-02, 499 S.E.2d at 780. The court reasoned that the owners could not recover in negligence for this damaged personal property because the applicable express limited warranty for the recreational vehicle specifically excluded incidental and consequential damages. *Id.*

It was the U.S. District Court for the Eastern District of North Carolina that first expanded the product-component analysis used in product liability cases like **Chicopee** and **Moore** to construction claims. In **Wilson v. Dryvit Sys., Inc.**, the court determined that damage to a house caused by defective DEFS cladding was not damage to “other property,” because the DEFS cladding, known as Fasttrak System 4000, was “an integral component” incorporated into the house. 206 F. Supp. 2d 749, 753-54 (E.D.N.C. 2002), *aff’d* 71 F. App’x 960 (4th Cir. 2003). In making this leap, the court noted that “North Carolina courts have *indicated* that when a component part of a product or system injures the rest of the product or the system, only economic loss has occurred.” *Id.* at 753 (emphasis added). Without analyzing the many differences between products and buildings or determining whether some construction products are “integral components” of buildings and some are not, the court cited the common law of other states to support the idea that the product-component analysis should be applied to buildings. *Id.* at 754.

It should be noted that the **Wilson** court, in ruling on Dryvit’s mo-

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tion for summary judgment, did not have the benefit of analysis on this issue from the point of view of the homeowner plaintiffs, because plaintiffs failed to respond to Dryvit’s motion for summary judgment. *Id.* at 752. The Fourth Circuit affirmed this decision, without analyzing the merits, on the basis that plaintiffs’ failure to respond to the summary judgment motion waived any grounds for appellate review. **Wilson v. Dryvit Syst., Inc.**, 71 F. App’x 960 (4th Cir. 2003).

Despite the circumstances under which it was decided, the North Carolina Court of Appeals followed **Wilson** in a construction case involving the same stucco manufacturer and the same stucco product. In **Land v. Tall House Bldg. Co.**, the assignee of homeowners, whose home was damaged by Dryvit’s Fastrak System 4000 DEFS cladding, asserted indemnity and contribution claims against Dryvit. 165 N.C. App. 880, 881-82, 602 S.E.2d 1, 1-2 (2004). Giving great weight to the fact that **Wilson** involved the same stucco product, the court in **Land** found that the DEFS product was an “integral component” of the home and that damage caused by the DEFS was not damage to “other property.” *Id.* at 884, 602 S.E.2d at 4.

However, subsequent decisions have limited the applicability of **Land**. The court in **Ellis-Don Constr., Inc. v. HKS, Inc.**, flatly rejected the argument that **Land** expanded North Carolina’s economic loss rule to prohibit *any* recovery in tort for economic loss. 353 F. Supp. 2d 603 (M.D.N.C. 2004). Noting the absence of any decision by the North Carolina Supreme Court enlarging the economic loss rule to preclude contractor negligence claims against design professionals, the court stated:

[I]t is indisputably true that the [economic loss] rule operates to preclude recovery in tort for purely economic damages when a contract or the UCC operates to allocate the risk of such damages. That does not mean, however, that the doctrine has expanded to preclude all claims in tort for economic damages in the absence of a contract, or, more narrowly, outside the products liability context. The economic loss rule, even as stated in the cases cited by CRZ, in no way undermines or overturns the twenty-five years of case law recognizing the type of tort claim Plaintiff brings here.

Id. at 607.

The North Carolina Court of Appeals followed suit in **PVC, Inc. v. McKim & Creed, P.A.**, refusing to follow **Land** or expand the economic loss rule to apply to contractor claims against design professionals. No. COA07-311, 2008 N.C. App. LEXIS 296, *5-*8 (Feb. 5, 2008), *rev. denied*, 362 N.C. 473, 2008 N.C. LEXIS 1224 (Aug. 26, 2008).

Dispelling the idea that the economic loss rule applies equally in product liability and construction cases, the court in **Lord v. Customized Consulting Specialty, Inc.** not only limited **Land**, but refused to adopt **Wilson**’s rationale that a building is no different than a product. 182 N.C. App. 635, 643 S.E.2d 28 (2007), *rev. denied*, 361 N.C. 694, 652 S.E.2d 647 (2007). Concluding that homeowners could sue

in negligence the designers and manufacturers of defective trusses installed in their home despite a lack of privity, the court recognized an important distinction between product liability and construction cases.

[O]ur Legislature has specifically acted to limit liability for purely economic loss in the case of products such as the recreational vehicle in **Moore**. See North Carolina Products Liability Act, N.C.G.S. §99B-2(b) (2005) (eliminating the privity requirement for an action against manufacturers, but only for breach of warranty actions seeking recovery for personal injury or property damage) . . .

The Legislature has taken no such action in the construction of homes, and we find compelling in that context our Supreme Court’s adoption of the following language:

The ordinary purchaser of a home is not qualified to determine when or where a defect exists. Yet, the purchaser makes the biggest and most important investment in his or her life and, more times than not, on a limited budget. The purchaser can ill afford to suddenly find a latent defect in his or her home that completely destroys the family’s budget and have no remedy for recourse. This happens too often. The careless work of contractors, who in the past have been insulated from liability, must cease or they must accept financial responsibility for their negligence. In our judgment, building contractors should be held to the general standard of reasonable care for the protection of any one who may foreseeably be endangered by their negligence.

Oates, 314 N.C. at 280-81, 333 S.E.2d at 225-26 (quoting **Navajo Circle, Inc. v. Dev. Concepts Corp.**, 373 So. 2d 689, 691 (Fla. Dist. Ct. App. 1979).

Lord, 182 N.C. App. at 642-43, 635 S.E.2d at 32-33 (emphasis added).

By determining that the economic loss rule did not prevent homeowners from recovering in negligence from manufacturers of defective construction products in the absence of contract, the court sidestepped the issue of how to define “other property” when applying the rule to construction cases. This holding appeared to signal a new way of analyzing construction defect suits in that damage to other parts of the building caused by a defective building product would be recoverable in negligence from a remote product manufacturer.

Applying the analysis used in **Lord**, the court in **Hospira, Inc. v. AlphaGary Corp.**, refused to apply the economic loss rule in a product liability case, allowing the manufacturer of a medical device known as sight chambers to pursue negligence claims against a manufacturer of a defective component part because there was no privity. 194 N.C. App. 695, 704-05, 671 S.E.2d 7, 14 (2009).

In 2009, the U.S. District Court for the Eastern District of North Carolina specifically rejected the analysis in **Lord** and **Hospira**. **Kelly**

v. **Georgia Pacific, L.L.C.**, 671 F. Supp. 2d 785, 796 (2009). In **Kelly**, a homeowner brought claims, including a negligence claim, against the designer and manufacturer of PrimeTrim, an exterior trim product used by the homeowner's builder in constructing the home. *Id.* at 787-788. The homeowner alleged that PrimeTrim degraded and permitted water intrusion that damaged the PrimeTrim and "the structure in which it was installed." *Id.* at 788.

Although the homeowner did not have a contract with either the designer or manufacturer of PrimeTrim, he submitted a claim under the manufacturer's 30-year limited warranty. The homeowner and manufacturer were not able to resolve the warranty claim and the homeowner contended that recovery under the limited warranty would not make him whole. *Id.* at 788-89.

The **Kelly** court held that North Carolina's economic loss rule prevented the homeowner's recovery in negligence, despite the lack of privity between the homeowner and manufacturer, and that the homeowner's only recourse against the manufacturer was through the limited warranty. *Id.* at 796. Analyzing North Carolina's economic loss rule, the **Kelly** court applied the product-component analysis from North Carolina's product liability cases and concluded that damage to a building caused by a defective component is only economic damage. *Id.* at 793. Following the holdings in **Wilson, Land** and North Carolina's product liability cases, the **Kelly** court concluded:

Accordingly, in this case, the economic loss due to the alleged defective component (i.e. the PrimeTrim) includes damages to the whole product (i.e. the home) caused by the defective component (i.e. the PrimeTrim). *See, e.g. Moore*, 129 N.C. App. at 402, 499 S.E.2d at 780.
Id.

The **Kelly** court explained that, "as a federal court sitting in diversity," it refused to expand North Carolina law by following **Land** and **Hospira**. *See Id.* at 796. However, it appears that this court did effectually expand North Carolina's law defining what is and what is not "other property."

Since **Kelly**, only one unpublished North Carolina Court of Appeals decision has applied the economic loss rule in the context of construction claims. In **Ford v. All-Dry of the Carolinas, Inc.**, a homebuyer contracted with a repair contractor for the installation of a foundation pier system. No. COA10-931, 2011 N.C. App. LEXIS 713 (N.C. App. 2011). The homebuyer received an unsigned express warranty for this work. *Id.* at *1-*2. After the pier system was installed, the homeowner experienced problems including, difficulty opening windows and doors, cracks in plaster walls, nail pops in ceilings and walls, spaces in window and door trim, changes to the slope of floors, increased size of cracks in the basement and outside foundation walls, tilting kitchen appliances, shifting stairs and wall separation. *Id.* at *3. Following the rationale in **Wilson** and **Land**, the court determined that the homeowner's negligence claim was barred by the economic loss rule because the homeowner alleged only damage to the house itself and not "other property." *Id.* at *8.

The Dilemmas Caused by Classifying an Entire Building as a Product

Whether **Lord** and **Hospira** opened the door to a new way of evaluating the economic loss rule and defining "other property" in the construction context remains to be seen. But, the decisions in **Wilson, Land** and **Kelly** adopted a way of defining "other property" in construction cases without taking into account the many differences between a building and a manufactured product.

Builders do not have the same opportunity as product manufacturers to evaluate construction materials for defects in order to appropriately allocate risk. Unlike a manufactured product, building construction involves products "furnished by different manufacturers and suppliers [that] are often incorporated into real property by several contractors specializing in different trades." H. Hugh McConnell, "The Other Property Problem – Applying the Economic Loss Rule to Construction Contracting Claims," *The Florida Bar Journal*, Vol. LXXIV, No. 6 (June 2000). Product manufacturing "involves the mass production of products from unique components designed specifically for that product," whereas construction contracts typically involve assembling multiple construction materials into a unique building according to an architect's plans and specifications. J. Brandon Sieg, "Tort, Not Contract: An Argument for Reevaluating the Economic Loss Rule and Classifying Building Damage as "Other Property" When it is Caused by Defective Construction Materials," *53 Wm. & Mary L. Rev.* 275, 297 (2011).

The manufacturing process therefore places a manufacturer in the best position to inspect this multitude of products, and their component parts, for defects before releasing the completed product en masse to the unsuspecting public.

The Contractor, who purchases construction materials on the market, simply does not have the same opportunities for product evaluation. . . . Although the Construction Team is appropriately required to inspect, and sometimes test, the construction materials, the Contractor is ultimately an assembler, not a manufacturer. **It is therefore unreasonable to interpret the Contractor's warranty as providing the exclusive remedy for hidden defects generated by the construction material manufacturer.**

Id. (emphasis added).

Unlike a purchaser of a manufactured product, who has the opportunity to look at the product and negotiate risk directly with the seller, a building owner is only party to a portion of the many construction contracts and is rarely a party to the sales contract for construction materials. A building owner therefore lacks any meaningful capacity to negotiate risk directly with a manufacturer or supplier. *Id.* at 292.

Another reason buildings and manufactured products should be treated differently for the purposes of applying the economic loss rule was noted in **Lord**. The North Carolina Legislature specifically acted to limit economic losses caused by defective products by enacting the North Carolina Products Liability Act, N.C.G.S.

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§99B-2(b) (2005), but took no action to limit economic losses resulting from defective home construction. See **Lord**, 182 N.C. App. at 642-43, 635 S.E.2d at 32-33. The North Carolina Products Liability Act does not apply to buildings. See N.C.G.S. §99B-1 (2013). Likewise, North Carolina’s Uniform Commercial Code applies to “goods,” including products, but not to building construction. See N.C.G.S. §§ 25-2-102, 25-2-105 (2013). Purchasers of products are protected by the risk allocation measures afforded by these laws and have a means of recourse against manufacturers of defective products. See **Ellis-Don**, 353 F. Supp. at 607; **Lord**, 182 N.C. App. at 642-43, 635 S.E.2d, at 32-33. Because the same risk allocation measures are not afforded to building owners, remote manufacturers of defective building products are unfairly insulated from responsibility when damage to a building caused by a defective building product is defined as economic loss. See **Sieg**, *supra* at 302 (“Looking to the greater context of a construction project to distinguish ‘other property’ from economic loss particularly insulates the Supply Team from liability because construction materials are intended for specific applications, notwithstanding the contractual arrangement used to purchase them.”).

Defining damage to a building caused by a defective building product as economic loss results in unequal application of the economic loss rule based upon the scope of a particular construction contract. For example, damage to surrounding walls caused by a defective window would be construed as economic loss if the window is purchased by a contractor in the course of constructing a new house. However, damage to surrounding walls caused by a defective window would be construed as damage to “other property” if the homeowner purchased the window in the course of renovating a portion of his home. *Id.*

The line of demarcation between economic loss and damage to “other property” under this construction of the economic loss rule becomes fuzzy when applied to construction renovation projects. If a contract covers renovations for a portion of a warehouse only, would damage to another portion of the warehouse that was not being renovated still be considered economic loss because it is damage to a building? See **McConnell**, *supra*. If economic loss includes damage to a building caused by a defective construction product, would damage to personal property in the area of a construction repair project also be considered economic loss? See *Id.* (citing **Comptech Int’l, Inc. v. Milam Commerce Park, Ltd.**, 24 Fla. L. Weekly at S509 (Fla. Oct. 28, 1999)), where the Florida Supreme Court determined that damage to computers resulting from construction of tenant improvement was “other property” and noted that the term “other property” is not truly applicable where the subject of the contract is a service).

Do Lord and Hospira Signal a Change to North Carolina’s Economic Loss Doctrine?

By refusing to adopt the holding of **Wilson** and limiting the applicability of **Land**, was the North Carolina Court of Appeals in **Lord** and **Hospira** signaling a change in North Carolina’s economic loss doctrine or merely trying to stop its unharnessed expansion? Recently, at least two other state courts have limited or scrapped the eco-

nomic loss doctrine altogether in favor of another test to determine tort liability for economic damages.

In **Tiara Condominium Association, Inc. v. Marsh & McLennon Companies, Inc.**, ___ So. 3d ___, 38 Fla. L. Weekly S151, 2013 WL 828003 (Fla. Mar. 7, 2013), the Florida Supreme Court restricted the application of the economic loss rule to product liability cases only, overturning prior decisions that applied the rule outside the context of product liability. In explaining its decision, the court stated,

Our experience with the economic loss rule over time, which led to the creation of the exceptions to the rule, now demonstrates that expansion of the rule beyond its origins was unwise and unworkable in practice. Thus, today we return the economic loss rule to its origin in products liability.

Id. 2013 WL 828003 at *7.

Washington also recently revised its application of the economic loss rule. See Terence J. Scanlan, “Shifting Sands beneath the Economic Loss Doctrine in Washington,” *Pacific Northwest Design Professional Legal Update*, Winter 2010. In a pair of decisions, a plurality of the Washington Supreme Court determined that “the blanket application of the economic loss rule to any case merely because of purely economic damages was improper and that a case-by-case analysis is more appropriate pursuant to the ‘independent duty rule.’” *Id.* at 3 (citing **Eastwood v. Horse Harbor Foundation, Inc.**, 241 P.3d 1256 (2010) and **Affiliated FM Insurance Co. v. LTK Consulting Services, Inc.**, 243 P.3d 521 (2010)). The “independent duty” test changes the question from whether damages are purely economic to whether an independent tort duty exists, outside of contractual obligations, to exercise due care. *Id.*

In North Carolina, the decisions in **Ellis-Don, PVC, Inc.**, **Lord** and **Hospira** clearly halt the expansion of the economic loss doctrine in situations where privity is lacking. Where the parties are in privity, however, economic losses in construction cases still are not recoverable in tort unless the damage was to “other property.” The federal court in **Kelly** predicted that North Carolina would determine that “other property” does not include damage to a building caused by a defective product installed in that building. Given the language in **Lord** distinguishing product liability and construction claims, it is unclear whether North Carolina would interpret “other property” in the same way as the federal court or adopt another approach to defining economic damages like Florida or Washington. At present, the definition of “other property” appears to be an open question under North Carolina law. •

Nicole Slaughter practices with Hamlet & Associates, P.L.L.C. in Wilmington, North Carolina, concentrating in litigation of commercial and construction matters. Slaughter received her B.B.A. from the University of Memphis (f/k/a Memphis State University) and her J.D. from the University of Tennessee. She is licensed to practice in North Carolina, Tennessee and Georgia.