



Texas Supreme Court Applies Economic Loss Rule to Limit Tort Claims by Contractors Against Owner's Design Professionals

In a June 20 decision, the Texas Supreme Court applied the economic loss rule to preclude a direct claim for negligent misrepresentation by a construction contractor against an owner's architect based on flawed design documents. *LAN/STV v. Martin K. Eby Constr. Co.*, No. 11-0810, 2014 Tex. LEXIS 509, at *1-2 (Tex. Jun. 20, 2014). After undertaking an in-depth examination of the normative principles forming the backbone of the economic loss rule, the court departed from the Restatement of Torts ("the Restatement") and ultimately concluded that the economic loss rule barred recovery against the architect—notwithstanding the fact that the architect knew its plans would be relied upon by the general contractor in preparing and submitting its bid. In reaching its holding, the court reasoned that risk allocation in most construction situations is better left to the realm of contract law and to negotiations between the participants involved in the project.

The *Eby* decision is good news for design professionals, as the court ruled decisively on an issue that divides courts across the country.¹ Still, the decision reinforces the need for design professionals, as well as owners and contractors, to address practical considerations concerning contract drafting and negotiation at the front end of the process, in order to avoid unintended consequences when a dispute arises. Indeed, *Eby* makes clear that parties are free to agree on a potentially different outcome than would result from the Texas Supreme Court decision by modifying contractual language. Therefore, it remains important that design professionals, owners, and contractors review contract language to ensure that construction contracts and professional services agreements contain no surprises or unintended consequences.

¹ According to the *Eby* decision, courts across the country that have considered the issue are divided 10–8 on whether the economic loss rule applies to bar the claims brought by the contractor against the design professional. *Eby*, No. 11-0810, 2014 Tex. LEXIS 509, at *47 & n.60. Jurisdictions applying the economic loss rule on these facts to preclude such claims include Colorado, the District of Columbia, Illinois, Nevada, Ohio, Utah, Virginia, Washington, Wyoming, and now Texas. *Id.* at n.60. Jurisdictions refusing to apply the rule include Arizona, Florida, Massachusetts, Minnesota, Pennsylvania, Rhode Island, South Carolina, and West Virginia. *Id.*

Background of the *Eby* Dispute

In 1997, the Dallas Area Rapid Transportation Authority (“DART”) contracted with LAN/STV to prepare plans, drawings, and specifications for the construction of a light rail transit line running from Dallas’s downtown West End to the American Airlines Center. LAN/STV agreed to “be responsible for the professional quality [and] technical accuracy ... of all designs, drawings, specifications, and other services furnished,” and to be “liable to [DART] ... for all damages to [DART] caused by [LAN/STV’s] negligent performance of any of the services furnished.” DART incorporated LAN/STV’s plans into a solicitation for competitive bids to construct the transit line, which was awarded to the low bidder, Martin K. Eby Construction Company, in 2002. Importantly, this was a traditional design-bid-build project where LAN/STV as the architect was in contractual privity with DART as the owner, and DART was in contractual privity with Eby as the contractor. Eby and LAN/STV, however, had no contract with one another.

Just days after beginning construction, Eby discovered that architectural plans provided by LAN/STV were replete with errors. According to Eby, 80 percent of the architect’s drawings had to be changed, which disrupted the construction schedule and forced Eby to provide additional labor and materials. Eby filed a breach of contract action against DART as the owner, which was initially dismissed for failure to follow the contract’s claim procedures. Eby continued to pursue its claim against the owner through the administrative claim process, seeking \$21 million in damages. However, the administrative officer rejected Eby’s claim and awarded the owner \$2.4 million in liquidated damages. Eby filed an administrative appeal and eventually obtained a \$4.7 million settlement in its favor.

Eby opened a second front in its battle to recover its claimed damages by filing a separate tort action against LAN/STV. Eby alleged that the architect had been negligent and had negligently misrepresented the work to be done. Only the negligent misrepresentation claim was presented to the jury, which found that LAN/STV was liable and assessed Eby’s damages at \$5 million. (The amount was later reduced to \$2.25 million under the Texas proportionate responsibility scheme.) Both parties appealed, and, following the appellate court’s

affirmance, both petitioned for review. LAN/STV argued that the economic loss rule applied and that allowing tort recovery here—where relationships are contractual and certainty and predictability in risk allocation are crucial—would be highly disruptive to the construction industry. Eby argued that the economic loss rule did not apply to actions for negligent misrepresentation, as in the case at hand.

Normative Principles of the Economic Loss Rule

Before analyzing the issues presented, the *Eby* court first examined the history of the economic loss rule in Texas. In its analysis, the Texas Supreme Court recognized the absence of one rigid rule and instead identified the series of normative principles shaping the economic loss rule:

- First, there is “no general duty to avoid the unintentional infliction of economic loss,” with recovery of purely economic loss based on a negligence theory permitted in only limited circumstances. *Eby*, No. 11-0810, 2014 Tex. LEXIS 509, at *20 (quoting Restatement (Third) of Torts: Liability for Economic Harm § 1 (Tentative Draft No. 1 2011) [hereinafter Restatement, T.D. 1]).
- Second, courts are concerned about the “[i]ndeterminate and disproportionate liability” that can arise for purely economic losses unaccompanied by personal injury or property damage. *Id.* at *11-*19 (quoting Restatement, T.D. 1, § 1 cmt. d).
- Third, economic loss is well suited to allocation by contract, including by insurance and indemnity clauses, so courts should give deference to contracts and should be reluctant to upset the allocation of risk made by a contract. *Id.* at *18-*19 (quoting Restatement, T.D. 1, § 1 cmt. d).

Application of the Economic Loss Rule to Contractor Claims Against Architects

With these principles in mind, the *Eby* court turned to the matter at hand and examined the two issues in dispute: (i) whether application of the economic loss rule should turn on whether the claim is for negligent misrepresentation as opposed to negligent performance of services; and (ii) whether a claim involving an architect in a construction setting should be

treated differently because the plans drawn by the architect are intended to be relied upon by the contractor when preparing a bid to be submitted to the owner.

With regard to the first issue, the court noted that both the torts of negligence and negligent misrepresentation are based on the same logic and that the general theory of liability is the same. The court therefore concluded that “[t]he economic loss rule should not apply differently to these two tort theories in the same situation.” *Eby*, No. 11-0810, 2014 Tex. LEXIS 509, at *38. Accordingly, under Texas law, a contractor will not be able to pursue a direct claim against the owner’s architect on facts similar to those in *Eby* merely because the claim is framed as one for negligent misrepresentation rather than negligence.

As to the second issue, the court commented on the traditional contractual relationships in construction projects:

Construction projects operate by agreements among the participants. Typically, those agreements are vertical: the owner contracts with an architect and with a general contractor, the general contractor contracts with subcontractors, a subcontractor may contract with a sub-subcontractor, and so on. The architect does not contract with the general contractor, and the subcontractors do not contract with the architect, the owner, or each other.

Id. at *36. Setting aside the architect, the court broadly stated that “[w]e think it beyond argument that one participant on a construction project *cannot* recover from another ... for economic loss caused by negligence. If the roofing subcontractor could recover from the foundation subcontractor damages for extra costs incurred or business lost due to the latter’s negligent delay of construction, the risk of liability to everyone on the project would be magnified and indeterminate....” *Id.* (emphasis added).

The court examined the underlying assumptions that are viewed differently in jurisdictions across the country when it comes to whether the economic loss rule precludes direct negligence claims by a contractor against the owner’s design professional. The Restatement and some jurisdictions find it

significant that design documents are prepared by design professionals with the knowledge that bidders, and ultimately the selected contractor, will be required to rely on them. According to the Restatement, “the architect’s plans are analogous to the audit report that an accountant supplies to a client for distribution to potential investors—a standard case of liability [for negligent misrepresentation].” *Id.* at *38-39 (quoting Restatement, T.D. 2, § 6 cmt. b).

Interestingly, the Restatement distinguishes between negligence claims against subcontractors and those against architects. On the one hand, the Restatement indicates that an owner may not sue a subcontractor for negligence and one subcontractor may not sue another subcontractor for economic loss: “A subcontractor’s negligence in either case is viewed just as a failure in the performance of its obligations to its contractual partner, not as the breach of a duty in tort to other subcontractors on the same job, or to the owner of the project.” *Id.* at *37 (quoting Restatement, T.D. 2, § 6 cmt. b). In this setting, according to the Restatement, “the rule of no liability is made especially attractive by the number and intricacy of the contracts that define the responsibilities of subcontractors on many construction projects,” and allowing such tort actions would disrupt this “web of contracts.” *Id.* at *37-38 (quoting Restatement, T.D. 2, § 6 cmt. b).

On the other hand, the Restatement reaches a different conclusion when it comes to contractor claims against architects: “Allowing a suit against the architect of a project by a party who made a bid in reliance on a defective plan does not create comparable problems.” *Id.* at n. 51 (quoting Restatement, T.D. 2, § 6 cmt. b). Under this reasoning, the economic loss rule’s fundamental objective—avoiding liability in an indeterminate amount for an indeterminate time to an indeterminate class—is not implicated because the only claim allowed is the contractor’s claim against the design professional.

The Texas Supreme Court, however, took the opposite view, diverging from the Restatement on this point, and sided with other jurisdictions holding that the economic loss rule precludes direct claims by contractors against subcontractors. The *Eby* court focused less on the foreseeability that the architect’s plans will be reviewed and relied upon by the

contractor, but rather on the contractual position of the parties. According to the *Eby* court, “the contractor’s principal reliance must be on the presentation of the plans by the owner, with whom the contractor is to reach an agreement, not the architect, a contractual stranger. The contractor does not choose the architect, or instruct it, or pay it.” *Id.* at *39.

In discussing its rationale, the court noted that the Restatement, which would permit direct claims against architects in negligence, notes that if this is not desirable by the parties to the project, “they are free to change it in the contracts that link them.” *Id.* (quoting Restatement, T.D. 2, § 6 cmt. b). The Restatement worries that were the rule otherwise, unsophisticated parties might be left without a remedy because they did not have the foresight to address this contractually. *Id.* at *42 (citing Restatement, T.D. 1, § 3, reporter’s note to cmt. f). The *Eby* court simply disagreed with this assumption: “We think it more probable that a contractor will assume it must look to its agreement with the owner for damages if the project is not as represented or for any other breach.” *Id.* The court recognized that “[t]hough there remains the possibility that a contractor may not do so, we think the availability of contractual remedies must preclude tort recovery in the situation generally because, as stated above, ‘clarity allows parties to do business on a surer footing.’” *Id.* at *42 (quoting Restatement, T.D. 2, § 6 cmt. b).

Interestingly, neither the *Eby* court nor the Restatement discusses the distinction between public and private contracts and how the negotiation process plays out in the real world. Construction contracts on public works contracts oftentimes must be awarded to the lowest responsible bidder, and the contract language, which is distributed with the invitation for bid, is not subject to traditional negotiation.

While the *Eby* decision brings a degree of clarity to the Texas construction landscape in situations like those that confronted the court, there are still circumstances where contractors may try to assert direct claims against an owner’s design professionals. First, *Eby* does not address whether claims for fraud or intentional misconduct by design professionals are precluded by the economic loss rule (many courts carve out an exception for these claims and allow them to be

brought by contractors, although there are many challenges to asserting such claims).

Second, *Eby* does not address how the decision will affect Integrated Project Delivery (“IPD”) agreements where the owner, contractor, and design professional all sign a single contract. It remains to be seen whether Texas courts will be more inclined to permit direct claims against an architect by a contractor who is a party to an IPD contract along with the owner and the architect, should the contract itself not expressly foreclose such claims.

Third, the contractor in *Eby* did not allege that it was a third-party beneficiary of the agreement between the architect and the owner, so this issue was not addressed. *Id.* at n.6. Where the professional services contract contains an express disclaimer of third-party beneficiaries, design professionals have some extra protection from these types of direct claims that are not based on tort theories.

Implication for Drafting and Negotiating Construction Contracts

With the Texas Supreme Court’s clear emphasis on the parties’ bargained-for agreements, it is more important than ever for parties to focus on the drafting and negotiation of their construction contracts for traditional design-bid-build projects. Design professionals, owners, and contractors should keep the following practical considerations in mind.

Design Professionals’ Perspective. There are two important provisions that design professionals like in their contracts with owners, which limit the ability of construction contractors to bring direct claims. First, design professionals like to include a contractual provision that disclaims any intent to create third-party beneficiaries. For example, Section 10.5 of the American Institute of Architects Form B201 (2007) (Standard Form of Agreement Between Owner and Architect) provides: “Nothing contained in this Agreement shall create a contractual relationship with or a cause of action in favor of a third party against either the Owner or Architect.” In the wake of the *Eby* decision, contractors will be incentivized to seek damages in contract that they can no longer seek in tort.

A disclaimer of third-party beneficiaries can help close the door to such an argument and ensure that the design professional limits its exposure to the extent possible. Second, design professionals are sometimes able to persuade owners to include a provision in the construction contract that expressly bars direct claims from contractors related to the design professional's performance of its contract with the owner (with potential carve-outs for personal injury claims and claims for damages to the contractor's property). Such a provision is in line with the *Eby* holding, but it may afford even broader protection to design professionals. Of course, owners are not always willing to insert such a provision into their construction contracts.

Owners' Perspective. The Texas Supreme Court suggests that the new *Eby* rule results in seamless liability: “[I]f the architect is contractually liable to the owner for defects in the plans, and the owner in turn has the same liability to the contractor, the contractor is protected.” *Eby*, No. 11-0810, 2014 Tex. LEXIS 509, at *39-41 & n.55. But there is not always true seamlessness, a situation to which owners must be alert. The contractor may be able to recover against the owner for breach of contract or breach of the implied warranty of the correctness of the plans and specifications where there is a defect attributable to the architect or engineer. The owner may then bring a claim against the design professional for indemnity or breach of the design professional's contract with the owner. However, the design professional's contract and indemnity provisions in favor of the owner may be worded to impose liability only to the extent the design professional fails to meet the standard of care for professional liability. This standard of care does not require perfection. Thus, a situation may arise where the owner is liable to the contractor because of a defective specification or design error, yet be unable to pass the liability on to the design professional where the design, though deficient, does not fall below the standard of care. When this happens, the owner is stuck holding the bag.

Because of this potential gap, owners may seek to impose as much contractual liability on the design professional as possible—including contractual liability not governed by the standard of care. Design professionals frequently claim that such contractual liability is not insurable and therefore

they cannot agree to accept liability beyond the standard of care. The *Eby* court does not address this dynamic when it relies on the Restatement, which suggests that a party to a construction contract “has a full chance to consider how to manage the risks involved, whether by inspecting the item or investment, obtaining insurance against the risk of disappointment, or making a contract that assigns the risk of loss to someone else.” *Eby*, No. 11-0810, 2014 Tex. LEXIS 509, at *18 (quoting Restatement, T.D. 1, § 1 cmt. c). Nonetheless, owners frequently try to expand the scope of the design professional's liability to better protect the owner and to narrow the potential gap between the owner's potential strict liability to the contractor for breach of contract or implied warranties, and what can be pushed back to the design professional due to its errors or omissions.

Contractors' Perspective. As the *Eby* decision notes, a contractor has a direct claim against the owner when there are defects in the design furnished by the owner. To the extent *Eby* cuts off under Texas law a contractor's ability to sue a design professional for negligence or negligent misrepresentation, contractors may look to explore whether the owner-design professional contract expressly denies third-party beneficiary status to contractors and whether pursuing such a claim is possible. In many cases, contractors are content to sue the owner directly and to wait and see whether the owner brings in the design professional, a development that contractors usually view as favorable as the owner and design professional end up pointing fingers at each other. On negotiated contracts, some contractors do not balk at including provisions that preclude direct claims against the owner's design professional because the contractor knows that it has a direct claim against the owner for defects in design.

Conclusion

The *Eby* decision provides clarity as to the application of the economic loss rule in Texas and puts a premium on the contract drafting process. Parties to construction contracts must review contracts carefully and negotiate accordingly.

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