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Economic Loss in New York Construction Litigation

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The economic loss doctrine preserves the basic distinction between tort and contract in construction litigation. A construction project involves complex relationships between numerous parties, such as the owner, architect, engineer, contractor, subcontractors and material suppliers. All of these separate relationships are usually governed by written contracts that define the parties' obligations and expectations, including their bargained-for economic risk. It is the parties' expectancy interest in these contracts that forms the basis for the economic loss doctrine, which provides that recovery for purely "economic loss" is limited to a contractual remedy. Conversely, the doctrine holds that absent personal injury or property damage, one may not recover for purely economic loss under a theory of negligence.[1]

In the construction litigation context, economic losses are typically defined as additional costs resulting from delays to the project schedule or the cost of repairing or replacing defective work that does not involve property damage. Since it is quite common for a construction project participant to suffer economic loss due to the actions of another with whom the participant does not have a contract, the courts are cognizant of the need to resolve these claims by enforcing the contracts that reflect the bargained-for risks. In that regard, New York courts have regularly dismissed third-party negligence claims for purely economic loss where there was no accompanying personal injury or property damage.[2] The New York Court of Appeals noted—in *532 Madison Avenue Gourmet Foods v. Finlandia Center*—that "at its foundation, the common law of torts is a means of apportioning risks and allocating the burdens of loss. In drawing lines defining actionable duty, courts must therefore be mindful of the consequential, and precedential, effects of their decisions." Following this reasoning, the economic loss doctrine has been used by the courts as a way to limit the potential class of third-party claimants by requiring personal injury or property damage as a precondition to recovery for nonintentional torts.

Limited Exception—Functional Equivalent of Privity

While privity of contract is a prerequisite to recovery for purely economic loss, the New York Court of Appeals has held in *Ossining Union Free School District v. Anderson LaRocca Anderson*[3] that a limited exception exists for negligent misrepresentation claims made against a design professional. In *Ossining*, a school district sued its architect and the engineering consultant retained by the architect for negligent misrepresentations that had been made regarding the structural integrity of a high school annex. The engineering consultant was retained by the architect specifically to address the structural issues and to report a recommendation to the school district. Significantly, the engineering consultant had direct contact with the school district and invoiced it directly. Although the school district did not have privity of contract with the engineering consultant, the court denied the consulting engineer's motion to dismiss on the ground that the relationship was so close as to approach that of privity (*i.e.*, "functional equivalent of privity"). In performing its analysis, the *Ossining* court applied the following criteria for liability: (i) awareness that the reports were to be used for a particular purpose; (ii) reliance by a known party in furtherance of that purpose; and (iii) conduct by the defendant linking it to the party and evincing the defendant's understanding of the reliance. Based upon the facts, the court reasoned that the tripartite standard had been met. Liability could be established where it was alleged that the engineering consultant had undertaken its work

knowing that it was for the school district alone, that the school district would rely upon it and that there was a direct contact between the engineering consultant and the school district.

Recent Southern District of New York Decision

Recently, the U.S. District Court for the Southern District of New York—in *Travelers Casualty and Surety Company v. Dormitory Authority of the State of New York*—addressed claims by a surety, standing in the shoes of its general contractor-principal, against an architect and construction manager seeking economic damages resulting from allegedly negligent work.[4] Since this was a public project that fell within the ambit of New York Wicks Law, the public owner entered into separate contracts with the contractor, architect and construction manager.

The surety alleged that the architect's negligence in failing to provide clear, coordinated and unambiguous bid documents caused numerous requests for information, change orders and delays on the project. The surety's claim was premised on negligent misrepresentation and that the "functional equivalent of privity" existed between the contractor and the architect. The court disagreed.

The court first pointed out that the tripartite standard is applied strictly by New York courts, and a plaintiff pursuing a negligent misrepresentation claim faces a heavy burden.[5] Based upon the record, the court ultimately concluded that the surety could not meet the tripartite standard. Focusing solely upon the second part of the standard, Judge Denise Cote held that the surety failed to adduce any evidence demonstrating that the contractor was "known" to the architect at the time the bid documents were issued. With respect to the bid documents, the surety did not present any evidence to show that the contractor was anything to the architect other than one of multiple potential bidders. The contractor was merely part of an indeterminate class of persons who, presently or in the future, might act in reliance on the architect's plans. Such reliance in the course of making a bid does not constitute the functional equivalent of privity.[6] Thus, a contractor cannot be considered a "known party" merely because it was a potential bidder.[7]

The surety also urged the court to consider the relationship between the contractor and the architect throughout the life of the project. The surety asserted that while construction activities were proceeding, the architect responded to more than 3,500 requests for information from the contractors and subcontractors, reviewed shop drawings submitted by contractors, and attended and participated in dozens of meetings with the contractors. While Judge Cote acknowledged that this "extensive communication" could constitute evidence that the contractor was a "known party" under the second prong and evidence of the "linking conduct" under the third prong, the surety failed to identify any contemporaneous misstatements during that time period that the contractor relied upon to its detriment. This could lead to the supposition that, in a proper case, if a contractor is able to establish a negligent misrepresentation made during the active construction phase of the project, it may be possible to establish an actionable negligent misrepresentation.

In granting the architect's summary judgment motion, dismissing the surety's tort claims, the court held that the economic loss rule requires the surety to seek its remedy—*e.g.*, enforce its contractual expectation interests—through a breach of contract claim against its counterparty, the owner, rather than against parties with whom the contractor did not enter into contracts.

Separately, the surety also alleged the identical cause of action for negligent misrepresentation against the construction manager. This claim also was summarily rejected by the court. First, with respect to any alleged misrepresentations made in the construction manager's contract, the court found that the second part of the tripartite standard was not met since the

contractor was not a "known party" to the construction manager at the time of the execution of the contract between the construction manager and the owner. Thus, even if the construction manager made negligent misrepresentations that were relied upon by the contractor, the surety could not demonstrate that the functional equivalent of privity existed. Second, with respect to the active construction phase of the project, the court held that the surety failed to identify any misstatements made by the construction manager that the contractor relied upon to its detriment.

Finally, the court held that to the extent the surety relied upon expert evidence that the construction manager negligently performed its work, the surety cannot recover because the law does not permit a stranger to a contract to sue a contracting party for negligent contract performance.

Conclusion

Economic losses in the construction arena continue to be solely recoverable by contract, subject to the limited exception of the functional equivalent of privity. Indeed, Judge Cote may have summarized it best when she wrote, "[b]y preventing the encroachment of tort law into the domain of contract, the economic loss doctrine protects parties' abilities to allocate risk by mutual agreement and thereby form reliable expectations about their potential financial exposure with respect to the duties and liabilities that they have contractually assumed."

James Lotito practices in the areas of construction and commercial litigation. He represents owners, developers, general contractors and trade subcontractors in disputes involving mechanic's liens, delay claims, surety bond claims, change orders, property damage, differing site conditions, utility interference, defaults, terminations and design defects. Mr. Lotito is also experienced in construction transactional matters, which include the preparation and negotiation of construction management agreements, architectural and engineering agreements and subcontracts, as well as counseling clients through contract administration.

Notes

1. Postner & Rubin, New York Construction Law Manual § 15:20 (2d ed. 2006).
2. *532 Madison Ave. Gourmet Foods, Inc. v. Finlandia Center, Inc*., 96 N.Y.2d 280 (2001).
3. *Ossining Union Free School District v. Anderson LaRocca Anderson*, 73 N.Y.2d 417 (1989).
4. *Travelers Casualty and Surety Company v. Dormitory Authority of the State of New York*, __ F. Supp. 2d __, 2010 WL 3199861 (S.D.N.Y. August 11, 2010).
5. *Securities Investors Protection Corp. v. BDO Seidman*, 222 F.3d 63, 73 (2d Cir. 2000); *see also Williams & Sons Erectors, Inc. v. S.C. Steel Corp*., 983 F.2d 1176, 1182 (2d Cir. 1993).
6. *Williams & Sons Erectors, Inc*., 983 F.2d at 1183.
7. *IT Corp. v. Ecology & Envtl. Eng'g, P.C.*, 275 A.D.2d 958, 960 (4th Dep't 2000).