Charting A Course After *Flagstaff:* Applying The Economic Loss Doctrine In Privity and Non-Privity Claims

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I. THE ECONOMIC LOSS DOCTRINE APPLIES TO ALL DESIGN AND CONSTRUCTION DEFECT CLAIMS

When Arizona's Supreme Court restated the economic loss doctrine in *Flagstaff Affordable Housing L.P. v. Design Alliance, Inc.,* 223 Ariz. 320, 223 P.3d 664, 575 Ariz. Adv. Rep. 31 (2010), it left no doubt that a design professional's client has only a contract remedy when a design defect causes economic loss but no physical injury to persons or other property. Flagstaff, ¶28, 223 P.3d at 670. However, the decision can be read more broadly to apply to economic loss claims against anyone involved in a construction project, including owners, prime contractors, or subcontractors. ¶¶25-26, 223 P.3d at 669. Tort law may no longer be used to displace or override contractual duties with a more generalized standard of care when "benefit of the bargain" damages are at issue. This ruling enables parties to design and construction contracts to negotiate with their counter-parties over what risks are assumed or disclaimed, how risk will be shared, shifted, or financed, and what remedies apply to economic damages.

A. The Court of Appeals inconsistently applied the economic loss doctrine

In the *Flagstaff* case, the developer of an apartment complex sued its architect for the cost of curing violations of the Americans with Disabilities Act and Fair Housing Amendments Act. The developer claimed that the architect and contractor's violation of accessibility standards under federal disability rights laws gave rise to a claim for damages under both contract and negligence law. The architect and contractor obtained dismissal of contract and warranty claims barred by Arizona's eight-year statute of repose, Ariz.Rev.Stat. § 12-552. The trial court also ruled that the economic loss doctrine required dismissal of the owner's negligence claims against the contractor and architect because the owner sought only money damages unrelated to personal injury or property damage. The Arizona Court of Appeals reversed the dismissal of the negligence claim against the architect on appeal, holding that the economic loss doctrine defense was not available to design professionals. That ruling left the architect exposed to a tort claim even though the contractor was protected from the same tort claim by the economic loss doctrine, and even though the owner could no longer sue either defendant for breach of contract.

B. The Supreme Court restored the focus on managing economic risks with contracts

The Arizona Supreme Court vacated the Court of Appeals decision, holding that the economic loss doctrine applies to design or construction defect cases without regard

to the profession or occupation of the parties. *Flagstaff,* ¶41, 223 P.3d at 672. Of interest to design professionals, the Court also held that an alleged violation of statutory duties (including here the Fair Housing Act's accessibility requirements) does not override the economic loss doctrine. *Id.,* ¶40. A property owner is "limited to its contractual remedies when an architect's negligent design causes economic loss but no physical injury to persons or other property." ¶1, 223 P.3d at 665. The term "economic loss" is defined in the decision to mean "pecuniary or commercial damage, including any decreased value or repair costs for a product or property that is itself the subject of a contract between the plaintiff and defendant, and consequential damages such as lost profits." ¶11, 223 P.3d at 667.

The Supreme Court charted a new course in *Flagstaff* by expressly rejecting its prior decisions in both *Woodward v. Chirco Construction Co.* 141 Ariz. 514, 687 P.2d 1269 (1984)[1], and *Salt River Project Agricultural Improvement and Power District v. Westinghouse Electric Corp.,* 243 Ariz. 368, 694 P.2d 198 (1984)[2] as precedents for the economic loss doctrine in design and construction defect cases between contracting parties. *Flagstaff,* ¶23, 223 P.3d at 669(rejecting *Woodward* and subsequent decisions including *Carstens* as a proper expression of the economic loss doctrine)*;* ¶32, 223. P.3d at 270 (rejecting *Salt River's* "three factor" test).

Echoing *1800 Ocotillo, LLC. v. The WLB Group, Inc.,* 219 Ariz. 200, 196 P.3d 222 (2008), which enforced contractual limitations on liability in design professional malpractice claims, the Supreme Court held that "in construction defect cases involving only pecuniary losses related to the building that is the subject of the parties' contract, there are no strong policy reasons to impose common law tort liability in addition to contractual remedies." ¶26, 223 P.3d at 669.

This underlying theme in *1800 Ocotillo* and *Flagstaff* of respecting the expectations of contracting parties, and refusing to substitute tort-based duties for the parties' own agreements on duties and remedies, will have considerable impact on future claims involving other design and construction contracts. Disputes between owners and prime contractors, primes and their subcontractors, and possibly claims involving those who furnish construction materials or equipment will also be affected by this new formulation of the economic loss doctrine involving parties in privity of contract.

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[1] The Court also rejected later cases that relied on *Woodward* , including *Carstens v. City of Phoenix*, 206 Ariz. 123, 126 ¶¶ 11-12, 75 P.3d 1081, 1084 (Ct. App. 2003); *Colberg v. Rellinger*, 160 Ariz. 42, 44, 770 P.2d 346, 348 (Ct. App.1988); *Nastri v. Wood Bros. Homes, Inc.,* 142 Ariz. 439, 444-45, 690 P.2d 158, 163-64 (Ct. App.1984) as precedent for the economic loss doctrine in construction defect cases.

[2] *Salt River* applied the economic loss doctrine in a case pitting products liability principles against UCC limitations on remedies.

II. ASSESSING THE IMPACT OF *FLAGSTAFF* ON FUTURE CASES

A. Balancing standard of care and contractual covenants

A question frequently asked after the *Flagstaff* decision is whether the standard of care will have any future role in determining whether a design professional is liable to its client for economic damages. The short answer is that the standard of care will be a factor in almost every case, although the focus on contractual remedies will also require consideration of the contract's impact, if any, on the standard of care. We suspect courts will also want to know whether the claim alleged is one of *non-feasance* (failure to perform) or *malfeasance* (unsatisfactory performance).

For example, if the contract require the production and delivery of plans and specifications for a construction project, and the design professional failed to deliver them by the contractual deadline, liability and damages might be determined simply by reference to the contract's terms. *Cf. Asphalt Engineers, Inc. v. Galusha*, 160 Ariz. 134, 770 P.2d 1180 (Ct. App. 1989) (where professional fails to perform its services timely, expert testimony not needed to establish fault).[3] On the other hand, if the claim alleged that the client's economic loss was caused by errors or omissions in the design professional's plans, the professional standard of care must be considered—in addition to the contract—to determine whether this *malfeasance* is so material that damages are recoverable under the contract.

Flagstaff's restatement of the economic loss doctrine did not re-write the fundamental principle that a design professional's duty is to exercise the degree of skill, care and diligence that design professionals ordinarily exercise under like circumstances. *National Housing Industries, Inc. v. E. L. Jones Development Co.*, 118 Ariz. 374, 378, 576 P.2d 1374, 1377 (App. 1978). Nor did this new decision repudiate the principle that the standard of care is not a standard of perfection; plans and specifications can have errors and omissions without breaching the standard of care. *Chaney Building Co. v. City of Tucson,* 148 Ariz. 571, 574, 716 P.2d 28, 31 (1984), citing *Donnelly Construction Co. v. Oberg/Hunt/Gilliland*, 139 Ariz. 184, 187, 677 P.2d 1292, 1295 (1984). Therefore, we expect to see continued reliance on proof of the professional standard of care in professional *malfeasance* cases to establish the fact of breach, while the terms of the contract, or principles of general contract law, will determine the legal consequences of that breach. The more complex cases will most likely be those in which the contract seeks to impose a performance obligation that is *different* than what the standard of care would otherwise require.

[3] It is beyond the scope of this paper to consider whether a preliminary expert's affidavit would still be needed to comply with Ariz.Rev.Stat. § 12-2602. Certainly, the certificate of merit act applies notwithstanding operation of the economic loss doctrine because it also does not distinguish based on the legal theory of liability asserted.

B. Assessing the potential impact on professional liability insurance coverage

We are also asked whether the Supreme Court's rejection of tort remedies in favor of contract remedies for economic loss claims by a design professional's client will have the unintended consequence of defeating coverage under a design professional's insurance coverage. The opinions of this author are his own and should not be considered the official position of any professional liability insurer. Since insurers were defending and settling professional liability claims, both in Arizona and other jurisdictions enforcing the economic loss doctrine, one should not expect a sudden change in coverage positions based solely on the *Flagstaff* decision.

Without attempting a detailed analysis of insurance coverage law, a claim alleging economic loss caused by *malfeasance* (and possibly *non-feasance*) in the performance of professional services should be covered under most professional liability policies. Typical insurance policy language illustrates the carrier's undertaking:

> We will pay on behalf of the "Insured" all sums in excess of the Deductible … that you are legally obligated to pay as "Damages" … provided that:
>
> A. ***the "Claim" arises out of an actual or alleged negligent act, error or omission with respect to "Professional Services" rendered or that should have been rendered*** by you or any entity for whom you are legally responsible…. (***Emphasis*** added.)

The carrier's duty to pay those damages for which its insured is "legally responsible" is triggered by the insured's negligent act or omission in performing professional services. No distinction is made as to the legal theory by which that claim is asserted. Therefore, coverage should not be defeated by *Flagstaff's* holding that the *remedy* for this breach of duty—as between contracting parties—will be determined the agreement and not tort law principles. In many professional liability cases, the design professional's contract must be consulted to determine the scope of the duty undertaken, as well as the remedies for breaching that duty.

To be sure, the design professional's contract may have a negative impact on coverage if the claim is premised on one of these grounds:

- The design professional completely fails to perform;
- The design professional breached a contractual *warranty* (which might include an elevated standard of care) or *guarantee*; or
- The contract imposes a duty the design professional would not otherwise have under the standard of care in performing its professional services.

Professional liability insurance policies almost always exclude coverage for express warranties or guarantees, and they exclude coverage for liabilities assumed by contract unless the insured would otherwise be liable for a breach of the standard of care in performing professional services. Some typical policy exclusions follow:

> ***IV. EXCLUSIONS***
>
> ***This policy does not apply*** to any "Claim" or "Claim Expenses" based upon or arising out of:
>
> H. any express ***warranty*** or ***guarantee***;
>
> I. ***liability of others assumed by*** you under any ***contract*** or agreement, ***unless such liability for "Damages" arises from your negligent act, error or omission*** in the rendering of or failure to render "Professional Services" or the negligent act, error or omission of your subconsultants….

Anecdotal evidence from our experience in defending professional liability claims suggests that most insurers will not rush to deny coverage for claims seeking "benefit of the bargain" damages simply because the economic loss doctrine prevents the claimant from suing in tort. So long as the claim does not involve breach of an express warranty or guaranty, and the insured would otherwise be liable *without regard to the contract* because it breached the standard of care in performing professional services, there should be coverage.[4]

C. *Flagstaff's* impact on claims by third parties who do not have a contract with the design professional is more uncertain

The Arizona Supreme Court took pains to note in *Flagstaff* that the economic loss doctrine does not bar tort claims by third parties where "applicable law" would allow the recovery of economic loss. Such claims were previously recognized under the *Donnelly* case. ¶¶37-38, 223 P.3d at 671. While it is disappointing that the Supreme Court did not include third-party claims in the scope of the economic loss doctrine, recognizing this limited exception does not assure that third parties will *always* have a tort remedy for economic loss. To the contrary, the Supreme Court directs litigants and lower courts to reexamine whether "applicable law" *allows* such claims under the specific facts of a given case. *Id.*

We thought that the Supreme Court might also delve into third party claims against design professionals in another key Court of Appeals case decided soon after the *Flagstaff* case. After announcing its decision in *Flagstaff*, the Arizona Supreme

[4] This abbreviated analysis also does not address the question of whether specific types of damages or expenses recoverable under the contract—such as liquidated damages or attorneys' fees—would be covered by the professional liability policy because these damages may be subject to the same exclusions or others found in most policies.

Court accepted review of last year's other notable economic loss doctrine case, *Hughes Custom Building, LLC. v. Davey, et al.*, 221 Ariz. 527, 212 P.3d 865 (Ct. App. 2009), in which a third party homebuilder sued a civil engineer for economic losses even though the builder had no contract with the engineer and had not received or relied upon the engineer's plans. *Hughes* appeared to present a perfect fact pattern in which to reconsider the *Donnelly* case allowing third-party, economic loss claims. Davey, the civil engineer sued in *Hughes,* had prepared a grading and drainage plan for its client, a surveyor who was platting a small residential subdivision. Hughes Custom Building, LLC had no contract or contact with this civil engineer or the surveyor; it simply bought finished lots from the original developer and built houses on them. When these houses later suffered settlement damage, Hughes repurchased one house and evidently paid damages to owners of the second, and then it sued Davey in tort to recover these economic losses. Davey sought, unsuccessfully, to bar this claim with the economic loss doctrine.

Hughes alleged that engineer Davey breached a legal duty to "ensure that the subdivision lots could be used for the construction of single family residences", and failed to determine whether the lots "met minimum requirements for compact[ion] and soil expansion." Hughes also alleged that Davey failed to "advise the public … of any conditions that would prevent the development of the lots as reasonably anticipated." Finally, Hughes alleged that Davey had breached an implied warranty "that [it had] exercise[d] [its] skill with care and diligence and in a reasonable non-negligent manner."[5] Davey denied having any involvement with either geotechnical issues or the marketing of the finished lots to subsequent purchasers. While the trial court agreed with Davey, the Court of Appeals held that the economic loss doctrine was not a valid defense to such a claim.

The Supreme Court sent *Hughes* back to Division Two of the Court of Appeals for reconsideration in light of *Flagstaff,* expecting the Court to provide further guidance on how and when third party claims for economic loss will be allowed. Unfortunately, Division Two could do no more than withdraw its unfavorable prior decision and return the case to the trial court again. Since the previous appeal had not presented the fundamental question of whether engineer Davey assumed a duty of care towards homebuilder Hughes, Division Two could not review whether the "applicable law" mentioned in the *Flagstaff* decision supported a third party tort claim for economic loss. For now, the extent to which third party claims for economic loss might be asserted against design professionals is open to further debate.

When presented with similar third party claims in the future, we expect defense counsel to distinguish *Donnelly* whenever possible, and argue that no duty of care is owed to third party claimants. They will argue that "special circumstances" rarely exist in which a design professional assumes a duty of care someone who is not a client.

[5] These allegations were recited in the Court of Appeals memorandum decision deciding the *Hughes* case a second time on reconsideration. See *Hughes Custom Building, L.L.C. v. Davey, et al.,* 2010 WL 1407999 (Ariz.App.Div.2) (April 8, 2010) at ¶6.

Design professionals, in general, do not owe a duty of care to anyone other than their clients. *See, Napier v. Bertram*, 191 Ariz. 238, 242, 954 P.2d 1389, 1393 (1998).

Donnelly recognized a limited exception to this general rule in cases where the design professional provides plans and specifications, or other factual information, with the expectation that third parties will use and rely on those plans in connection with the same project. Where the connection between a third party and the design professional is remote or incidental, as in the *Hughes* case, we believe courts should rule that there is no duty and, therefore, no legal basis on which third party may recover its economic losses.

Readers should not consider the new precedent set by the *Flagstaff* or *Hughes* cases to be limited only to claims against design professionals. Since the Supreme Court reaffirmed in *Flagstaff* that the economic loss doctrine is based on the nature of the damages sought, and not on the profession or occupation of the parties to the dispute, it should also apply to claims against subcontractors, suppliers, or persons performing a mix of design and construction such as design-builders. The net effect of re-stating the economic loss doctrine should be quite beneficial to all concerned. First, the economic loss doctrine provides a clear demarcation between tort and contract law applicable in design and construction defect cases. Second, it directs all concerned parties to better manage and price project risk through their contracts for more predictable outcomes in cases seeking economic damages.

III. APPLYING THE LESSONS OF *FLAGSTAFF* AND *HUGHES* IN CONTRACT NEGOTIATIONS

Design professionals and their counsel must also be on guard against efforts to undermine the beneficial effects of the *Flagstaff* decision. As noted, the contract will determine the nature of the duty and remedies afforded when the other party to that contract sues to recover its economic losses. If the contract is incomplete, one-sided, or ineffective in addressing this potential claim, one or both parties might be dissatisfied with the outcome.

If the contract also includes adverse terms and conditions, such as an elevated standard of care or presumption of breach triggered by cost overruns (or other conditions outside the design professional's control), the contract will provide an unsatisfactory remedy and put at risk coverage under the design professional's insurance policy.

The Supreme Court also left an opening for attorneys advising owners or lenders to seek a tort remedy in addition to the contract, when it said, "[T]he economic loss doctrine respects the expectations of the parties when … they have expressly addressed liability and remedies in their contract. Thus, the parties can contractually agree to preserve tort remedies for solely economic loss, just as they may otherwise specify remedies that modify common law recovery." *Flagstaff*, 223 P.3d at 670, ¶29. This portion of the holding is difficult to justify or interpret since the Court also ruled that, "[T]here are no strong policy reasons to impose common law tort liability in addition to contractual remedies." *Id.* 223 P.3d at 669, ¶26. Given the Supreme Court's intention to

write a new “bright line” standard in *Flagstaff* for determining when the economic loss doctrine bars tort claims against parties to a contract, this opening only invites future litigation. One can easily envision a case in which an attempt to layer tort remedies on top of—or at odds to—what the contract otherwise requires, might invalidate the contract for lack of mutuality. An over-reaching owner or lender might find that its efforts to preserve all conceivable means of recourse are unavailing, after incurring considerable litigation expenses to learn that hard lesson.

Nonetheless, design professionals should be alert for specialized contract terms intended to negate the economic loss doctrine. Such terms might resemble the following:

- “The parties to this contract expressly agree that all tort remedies for recovery of economic loss are preserved.”
- “The rights and remedies of this contract are cumulative with those allowed by tort law.”
- “The Design Professional expressly agrees to defend, indemnify and hold Client *[and others]* harmless from all direct, indirect, and consequential damages, losses, penalties, attorneys’ fees and expenses caused by Design Professional’s act or omission regardless of Client’s sole or partial fault.”

In providing these examples, we do not suggest that they are justified or legally enforceable. Where encountered, they should be deleted or modified to assure that the resulting contract expresses the design professional’s intent concerning the obligations assumed and remedies available in the event of default. Care should also be taken to base those obligations on the applicable standard of care—and to avoid any suggestion of a warranty or guarantee—so that coverage is preserved under the professional liability insurance policy.

Design professionals and their counsel must also avoid the usual minefield of contract issues that are likely to generate claims and disputes, or lead to extraordinary liability exposure when a dispute arises. The most common problem areas include:

- Vague or incomplete scope of services; one that is not properly qualified by exclusions or conditions to define the limits of the design professional’s undertaking. A proper scope statement will go far in avoiding unreasonable expectations of perfection or unintended duties.
- Elevated standard of care (i.e., “highest and best of its kind”, “first class in every respect”) that is often uninsurable.
- Duties assumed to third parties. Here the risk is that the list of potential claimants who will claim a duty—either under the contract or applicable tort law—may exceed the fee paid the design professional.
- Uncompensated risks. This is a catch-all category. Design professionals should perform a proper risk assessment as part of all contract negotiations. Reinstatement of the economic loss doctrine in Arizona did

nothing to rein in over-broad or uninsurable indemnity provisions such as the example given above.

- Presumption of fault from cost overruns. These *ipso facto* clauses—sometimes misleadingly called "safe harbor" provisions by owners' counsel—can result in a denial of insurance coverage and absolute liability caused by circumstances beyond the design professional's control.
- Contracts and claims assignable at will. Except for collateral assignments to lenders or investors, we recommend against giving the original client the option to assign the contract, or claims arising under the contract, to third parties.
- Client having the unlimited right to withhold payment. These terms also give the client the ability to exert undue leverage on the design professional whenever a dispute arises. Except for genuinely disputed billings, the client should continue to pay the design professional while a dispute is pending. Where the design professional has insurance to cover the claim, there is no justification for withholding more than the deductible amount that might be due from the insured design professional.
- Missing or inadequate limitations of liability. This is another catch-all category intended to include those contract terms that cap the design professional's liability, or at least bring it into a reasonable balance with the compensation to be earned under the contract. This category includes true risk allocation or limitation of liability provisions, as well as waivers of consequential damage or waivers of subrogation rights. While not feasible in all cases, a well-drafted limitation of liability should be included in most contracts.
- Schedule or delivery methods that invite disputes with the contractor. The design professional should not agree to an unrealistic performance schedule, or "fast track" design and construction for unsophisticated owners who do not understand the cost/benefit trade-off. Competitively-bid projects also provide an incentive for the low bidder—particularly in recession-era contracts—to assert claims and disputes that will involve the design professional. The contract should put appropriate limits and safeguards in place to protect the design professional against risks that are inherent in the owner's choice of project delivery method or schedule.

This brief "watch list" will not anticipate every problem likely to arise in negotiating contracts after *Flagstaff*, but it is a good start. Therefore, design professionals should redouble their efforts to negotiate fair contracts that reasonably apportion risk and benefit, because those contracts will better protect the firm against economic loss claims by clients and by third parties. A well-written contract is also essential to maintaining coverage under the firm's professional liability policy.

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From 1995 to 2001, Mr. Folk was the public member of Arizona's Board of Technical Registration by appointment of the governor. Mr. Folk is a past Chairman of the Construction Law Section of the State Bar of Arizona and an active member of the American Bar Association's Forum on the Construction Industry. Mr. Folk is a co-author of the *Arizona Construction Law Practice Manual* published by the State Bar of Arizona and co-editor of *Design Professional and Construction Manager Law* published by the American Bar Association Forum on the Construction Industry. Mr. Folk's *Design Professionals Survival Course*™ provides specialized training in business practices and legal strategies that minimize the risk of professional liability claims and litigation.

Folk & Associates, P. C. represents design professionals and contractors in professional liability claims, construction law disputes, bid protests, mechanics lien and bond claims, and government contracting issues. The firm also handles other complex commercial litigation, administrative law, and employment law matters. The firm embraces three guiding principles in every aspect of its services: *Professional Excellence, Practical Solutions,* and *Uncompromising Ethics*. These guiding principles are symbolized by the firm's three arrow logo.