



Assessing Risk:

The Economic Loss Rule and the Gist of the Action Doctrine

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All businesses want to prevent being sued because litigation is costly, time consuming, and contentious. Unfortunately, experience suggests that eventually every business will face a lawsuit of some kind. Because there are a great number of intricacies and many states do not permit corporate entities to represent themselves due to possible conflicts of interest, consulting with a lawyer as soon as you are sued is important. However, understanding several basic legal principals can help any business assess risk and plan accordingly.

Generally, there are two basic exposures for companies cleaning HVAC and air handling systems—one based in contract law and one based in tort law. Each one imposes a duty, and the difference lies in how that duty is created. Breach of contract actions arise when a party violates the terms of an agreement it has made with another party. Tort duties originate from a larger social obligation imposed by the Courts on individuals and businesses. While the law in both instances is designed to place the aggrieved party back into the same position they would have been in if the duty had not been breached, the scope of the damages to which the breaching party is exposed can vary significantly based upon the theory asserted against it.

This distinction often drives the allegations made in a Complaint because the theory used defines the damages to which a Plaintiff may have access. The economic loss rule and the gist of the action doctrine relate to the difference in the two concepts and create two primary categories about which contractors in the HVAC and air handling system cleaning industry should be aware. The first possible liability is caused by damage to a component part of or the entire HVAC or air handling system itself. The second problem results when a contractor's work or other actions causes personal injury or results in damage to another piece of property. The law considers the first category as a basis for a breach of contract action and the second category as a basis for a tort action.

The economic loss rule is a long standing principal in the law that generally stands for the proposition that when the damages caused by the breach are solely economic in nature (i.e. replacement cost, loss in value in the contract, or repair of defective work), a breach of contract action provides an adequate remedy. Essentially, it prevents a contract claim from being converted into a tort claim when the scope of the damages is limited to a component part or the entire HVAC or air handling system itself. Courts have traditionally held that the law of contract and warranty is better suited to address such problems. Commercial parties can negotiate contracts, which can include warranty related issues, while they are setting the terms for compensation. If a party chooses not to include such things in the contract, the courts generally assume it was not incorporated into the agreement for a reason and will not permit a subsequent claim which is properly brought as a breach of contract or breach of warranty action to be changed into a tort action without a showing of another type of injury. To the contrary, if damage is caused to another piece of property or to a person, tort law likely will apply.

Where the economic loss rule is being applied, the gist of the action doctrine is usually lurking. Under this judicial concept courts try to determine the "gist" of the case, or the true nature of the claim. The facts of each case give rise to the appropriate cause of action, and this principal prevents a party from shaping a complaint to meet its own criteria and pleading a cause of action that is not viable. In short, it prevents plaintiffs from calling a breach of contract action a tort action and a tort action a breach of contract action. The determination is made by reviewing the source of the duties imposed on the party being sued. If the duties arise predominately out of a contract, then a tort action is barred. Conversely, if the duties arise principally out of the social construct and a duty imposed by the courts, then a breach of contract action would be impermissible.

Perhaps the easiest way to understand the interplay between these concepts is by way of a practical analogy. To do so, we will consider the application of these principals to the following fact pattern.

Smith Corporation recently had several employees go home sick. When it investigated further by having the air conditioning system evaluated, it learned that some noxious fumes had entered the system and contaminated the duct work by adhering to the coating. While the system was operating it was dispersing noxious fumes throughout the building. As a result, Smith Corporation hired Duct Cleaning Service to clean the duct work and eliminate the problem. A contract is then signed between Smith Corporation and Duct Cleaning Service.

Thereafter, Duct Cleaning Service begins its work. During the course of cleaning the ducts, Duct Cleaning Service employees fail to follow NADCA standards and inadvertently cause a large portion of the coating in the duct work to flake off and become airborne in the system. Several days after the job is complete and the air conditioner has been operating, John Doe visits Smith Corporation on business and becomes violently ill when he has an allergic reaction to the airborne coating particles. He is hospitalized as a result and eventually loses his sight because of the allergic reaction.

Initially, Duct Cleaning Service would likely not be held liable for the employees that became sick as a result of the noxious fumes, as it had no role in their illness. However, this fact pattern does present several possible problems for Duct Cleaning Service. First, Smith Corporation could sue them for breach of contract. Duct Cleaning Service was hired to clean the ducts and failed to do so successfully. Although the problem may now be a different one, the failure to complete the terms of the contract would allow Smith Corporation to demand damages, the return of its money, and perhaps claim additional contractual compensation to repair the damage to the coating in the duct system. However, because the damage was done to the air conditioning system itself, in particular the coating in the ducts, the Court would not likely allow a claim for negligence by Smith Corporation against Duct Cleaning Service because there is an adequate remedy provided by way of a breach of contract action. Even if there were a valid tort claim, the Court may see it as minor and restrict any lawsuit filed against Duct Cleaning Service by Smith Corporation to breach of contract under the gist of the action doctrine.

If John Doe were to file suit though, the scenario would likely be different. Obviously, John Doe does not have a contract relative to this situation with anyone involved. However, as a visitor to the property he was injured as a result of the improper work done by Duct Cleaning Service. Since he is a third party (i.e. he is not the product which the contract related to) injured by the work done by Duct Cleaning Service, the economic loss rule does not preclude him from filing a tort action. If he decides to pursue his claims in court, it is likely that he would assert claims in negligence against Duct Cleaning Service and Smith Corporation. In addition, Smith Corporation would likely make a claim in the same case against Duct

Cleaning Service by asserting a breach of contract action and requesting indemnification from Duct Cleaning Service because it relied on Duct Cleaning Service to complete its work properly and its failure to do so resulted in the John Doe's injuries and claims against Smith Corporation. Such a scenario would be feasible under both the economic loss rule and the gist of the action doctrine.

With some foresight, Duct Cleaning Service can anticipate these possible outcomes and plan appropriately. Among the issues to consider are whether it should obtain insurance for such losses, and if so, should the coverage amount exceed the \$500,000 general liability coverage required of NADCA members. If so, are there other types of coverage more appropriate to the situation and what amount of coverage is appropriate given the level of risk involved? Another consideration is whether the work being performed is so difficult that it creates a higher likelihood of problems and necessitates a waiver of any claims against it before it starts the work. A higher price for the work is also often negotiated because of the substantial risk involved.

In addition to accounting for the risks, understanding these principals is important so that a company can properly collect the necessary information in the event

of a potential problem. In the above hypothetical, if the claim is for breach of contract only, then the focus of the investigation will be on the contract itself and the manner in which the work was performed. If a negligence claim is introduced into the situation, the focus changes slightly to who performed the work and how it was accomplished. Obviously, the nature of the damages also changes. The difference, again, lies in the source of the duty.

There are many issues to be considered when considering risks. Some can be dealt with contractually or with waivers. Others can be addressed through insurance or bonds. However, sometimes eliminating the risk entirely is simply impossible. In this day and age, when liability exposures can be large enough to put a company of any size out of business, the correct mix of risk assessment and planning is needed to prevent such a scenario. Understanding these legal concepts is an important first step. ●

DISCLAIMER: This article is written as a primer on the economic loss rule and the gist of the action doctrine to help members of NADCA. It is not intended to be, nor is it, legal advice. Neither Joshua C. Quinter, Esquire, nor the firm of Kaplin Stewart Meloff Reiter & Stein offer this article as formal legal advice. Each case is different and an attorney should be consulted to address all of your legal concerns.