Product Liability:
*Developments in the Economic Loss Rule and Warranty Law*

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I. Product Liability: Developing the Economic Loss Rule to Protect Warranty

This article and the accompanying presentation will help our fellow attorneys understand the economic loss rule. In product liability cases, many manufacturers and their defense counsel focus on the litigation tools of product inspections and testing and the typical battle of the experts; however, a legal defense known as the economic loss rule or doctrine has developed to protect manufacturers when the alleged damage is generally confined to the product itself and does not involve personal injury or damage to other property. The majority of federal and state courts across the country apply this doctrine to bar plaintiffs from recovering against manufacturers in tort, typically limiting a damage recovery (if any) to the terms of an express warranty or contract issued by the manufacturer.

The economic loss rule operates to control the available remedies in product liability actions. This article will assist practitioners in developing and applying product liability law in an effort to control the exposure of manufacturers and distributors. Practitioners will also gain understanding of the economic loss rule’s application to insurance coverage.

The economic loss rule is simple, but application of the rule proves more difficult. The rule is succinctly stated as follows: A manufacturer, distributor, or retailer of a defective product is strictly liable in tort for any resulting harm to person or property, other than the product itself. (Rest. 3d Torts, Products Liability, §21.) The difficulty in application of the rule has spawned serious debate and divergent results.

Perhaps the trouble begins with the amorphous title. The “economic loss doctrine or rule” provides no guidance to its purpose. The rule would be more appropriately stated as the “save contract from annihilation by tort doctrine,” since this is the intended goal. As stated by the U.S. Supreme Court in East River:

Products liability grew out of a public policy judgment that people need more protection from dangerous products than is afforded by the law of warranty. It is clear, however, that if this development were allowed to progress too far, contract law would drown in a sea of tort. (East River v. Transamerica Delaval (1986) 476 U.S. 858, 866.)

As more recently stated by the U.S. Court of Appeals:

Broadly speaking, the economic loss doctrine is designed to maintain a distinction between damage remedies for breach of contract and for tort. (Giles v. General Motors (2007) 494 F.3d 865, 873.)

In product liability cases, warranty law, whether express or implied, is the sole recourse for damage to the product itself. If warranty (or contract) law is not the limit of liability, plaintiffs can circumvent the warranty and proceed in tort for damage to the product itself. In other words, the basis of the bargain, which includes the agreement on product quality and performance, can be annihilated by tort.

Initially it seems clear, tort recovery is allowed for personal injuries and damage to “other” property, but not allowed to recover for damage to “the product itself.” Simple, right? Not so fast.

Defining what is “other property” versus what is “the product itself” proves to be very difficult. The U.S. Supreme Court provides sound guidance in Saratoga Fishing Vo. v. J.M Martinac (1997) 520 U.S. 875, but unfortunately, it has not been universally accepted.
Saratoga Fishing first recognizes the problem with identifying the product apart from its components. Quoting from East River, Saratoga states:

Since all but the simplest of machines have component parts, [a contrary] holding would require a finding of ‘property damage’ in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability. (Saratoga Fishing at 833.)

What the U.S. Supreme Court recognizes is that virtually all products are themselves made up of other products as component parts. If each component is considered a separate product, then a plaintiff can always pursue a tort action against a component part manufacturer for damage to the greater product. This power to define the component as the product is the power to destroy the economic loss rule.

In Saratoga Fishing, the Court provides guidance on how to recognize and define what is “the product itself” and differentiate it from “other property.” In Saratoga Fishing, a fishing vessel, the M/V Saratoga had a defectively designed hydraulic system that caused a fire that sunk the ship. The Court ultimately holds that equipment added to the ship (a skiff, a fishing net, spare parts) after its initial purchase by the end user is “other property,” and the ship, as it first entered the “stream of commerce,” is “the product itself.” Consequently, in the action against the designer of the hydraulic system, the M/V Saratoga owner could recover in tort only for the items added to the ship after purchase, and not for any part of the ship itself, as it was originally sold. In other words, the entire ship, as it was originally sold to the initial user, is “the product itself.”

Saratoga Fishing provides a clear rule for definition of “the product itself.” The product itself is not a component part (the hydraulic system), but the integrated product as placed in the stream of commerce by the manufacturer and its distributors (the entire vessel). Said more clearly, the product itself is what the seller sold and what the buyer bought, nothing else.

Unfortunately, state courts are not obligated to follow federal common law, especially when stated in the context of admiralty law. The states have proceeded to develop their own understandings of the economic loss rule, and definitions of “the product itself.”

In Jimenez v. Superior Court (2002) 29 Cal.4th 473, the California Supreme Court correctly states the issue, but gives no guidance on its resolution. The Court states:

To apply the economic loss rule, we must first determine what the product at issue is. Only then do we find out whether the injury is to the product itself (for which recovery is barred by the economic loss rule) or to property other than the defective product (for which plaintiffs may recover in tort). (Id. at 483.)

The remainder of the Jimenez majority opinion provides nothing to assist a practitioner in resolution of this threshold question. The author of the majority opinion files a concurring opinion, in which no justice joins. (Id. at 485 - 488.) Through this concurrence, the authoring justice, relying on the Restatement, argues that “the pertinent inquiry is whether the component has been so integrated into the larger unit as to have lost its separate identity.” (Id. at 487.)

In Florida, the economic loss rule “is a judicially created doctrine that sets forth the circumstances under which a tort action is prohibited if the only damages suffered are economic losses.” (Indem. Ins. Co. of North America v. Am. Aviation, Inc. (2004) 891 So.2d 532, 536.) The economic loss rule is the fundamental boundary between contract law, which is designed to enforce the expectancy interests of the parties, and tort law, which imposes a duty of reasonable care and thereby encourages citizens to avoid causing physical harm to others. (Casa Clara Condominium Ass’n, Inc. v. Charley Toppino and Sons, Inc. (1993) 620 So.2d 1244.)
In *Tiara Condo. Ass’n v. Marsh & McLennan Cos.* (2013) 110 So.3d 399, Florida adopted the products liability economic loss rule, precluding recovery of economic damages in tort where there is no property damage or personal property. Florida has not developed a definition of the product itself and provides little assistance in determining when there is property damage (damage to something other than the product itself).

In Texas, the economic loss rule has generally been applied to preclude tort claims in two related contexts; (1) where the losses sought to be recovered are the subject matter of a contract between the parties; and (2) when the claims are for economic losses against the manufacturer or seller of defective product where the defect damaged only the product itself and did not cause personal injury or damage to other property. (*Coastal Conduit & Ditching* (2000) 29 S.W.3d 282, 285.)

In North Carolina, the Courts apply the economic loss rule, barring recovery for damage to the product itself. However, where “other property” is also damaged, then damage to the product itself can be recovered. (*Lord v. Customized Consulting Specialty, Inc.* (2007) 643 S.E.2d 28.) North Carolina’s general statement is that the economic loss doctrine bars a tort action against a party to a contract who simply fails to properly perform the terms of the contract, even if that failure to properly perform was due to the negligence or intentional conduct of that party, when the injury resulting from the breach is damage to the subject matter of the contract. (*Spillman v. Am. Homes of Mocksville, Inc.* (1992) 108 N.C.App. 63, 65.) North Carolina provides no guidance on how to distinguish the product itself from other property, and thus provides little assistance in application of the economic loss rule.


The most frequently adopted exception has been the “sudden” or “potential risk” exception to the rule, *i.e.* tort law should be applied because the product posed a sudden risk to the plaintiff’s health or safety despite not causing any physical injury. (*U.S. Gypsum Co. v. Mayor and City Council of Baltimore, 647 A.2d 405, 410 (Md. 1994)) (“Even where a recovery, based on a defective product, is considered to be for purely economic loss, a plaintiff may still recover in tort if the defect creates a substantial and unreasonable risk of death or personal injury.”); (*Northern Power & Engineering Corp. v. Caterpillar Tractor Co.,* 623 P.2d 324 (Alaska 1981)) (permitting a tort action if: (1) the allegedly defective product creates a potentially dangerous situation to persons or other property, and (2) the alleged loss is a proximate result of that danger and occurs under dangerous circumstances).

Plaintiffs’ attorneys employed these arguments in countless Chinese drywall cases filed in many states over the last decade or so. Plaintiffs in these cases typically claimed potential damage or threatened injury related to the health and safety of their household due to alleged defects in the specific type of drywall installed in their homes. Despite a lack of physical injury, some courts have ruled that the economic loss doctrine does not bar tort claims in these cases. See, e.g., *In re: Chinese Manufactured Drywall Prods. Liab. Litig.*, MDL No. 2047, 680 F. Supp. 2d 780 (2010). Not only is this contrary to the very nature of tort law, it is also an attempt to create an exception that swallows the rule because a sharp attorney could argue that many products that allegedly malfunction causing damage to the product alone could, instead, have potentially injured people.

Similarly, at least one court reached the same result when addressing EIFS (exterior insulation and finishing system) product liability cases. See *Dean v. Barrett Homes, Inc.*, 8 A.3d 766 (N.J. 2010) (rejecting the...
economic loss doctrine defense in finding that EIFS, the particular siding at issue, was not integrated into the product at issue, the plaintiffs’ home).

In *Dean*, the manufacturer of an allegedly defective EIFS argued that because EIFS is an integrated part of a finished product, a home, the economic loss doctrine shielded it from liability for mold damage that the plaintiffs claimed the EIFS had caused to their home. The trial court agreed, awarding summary judgment to the EIFS manufacturer, and the Appellate Division affirmed. The New Jersey Supreme Court reversed, however, finding that the EIFS was not “sufficiently integrated into the home to become a part of the structure for purposes of broadly applying the economic loss doctrine.” *Id.* at 775-76. This departed from existing New Jersey and federal case law, including an Appellate Division opinion in *Marrone v. Greer & Pollman Construction Inc.*, 964 A.2d 330, 336 (N.J. Super. App. Div. 2009), which held that the economic loss doctrine shielded a manufacturer of EIFS from liability for damage to the plaintiff’s home because “the house is the ‘product,’ and it cannot be subdivided into component parts for purposes of supporting a [Product Liability Act] cause of action.” The *Dean* court attempted to explain its rationale for departing from the existing case law: “Particularly in the case of houses, a product that is merely attached to or included as part of the structure is not necessarily considered to be an integrated part thereof.” *Id.* at 775. The New Jersey Supreme Court relied, in part, on certain asbestos cases in which courts have taken the position that contamination constitutes harm to the building as “other property,” and also two cases from the California Supreme Court holding that the integrated product doctrine did not bar recovery for structural damages to houses caused by defective windows and a faulty foundation. *Id.* at 775-76.

While these lines of cases present a formidable challenge to the economic loss doctrine defense, they do not by any means foreshadow the end of economic loss doctrine in product liability actions. For example, despite the about-face ruling by the New Jersey Supreme Court in *Dean*, at least one federal district court in New Jersey predicted that the ruling would have no impact on products other than homes. See *Adams Extract & Spice, LLC v. Van De Vries Spice Corp.*, Civ. No. 11-720, 2011 U.S. Dist. Lexis 147851 (D.N.J. Dec. 23, 2011).

In *Adams Extract*, the district court narrowly interpreted the New Jersey Supreme Court’s decision in *Dean* and accepted the economic loss doctrine defense by a third-party defendant in a case relating to a food manufacturer’s claim for damages resulting from a recall of a blend of spices sourced by multiple suppliers. Despite the *Dean* decision, the district court in *Adams* found the spice blend to be an integrated product, *id.* at *10-*11, *15, and found *Dean* clearly distinguishable, noting that the *Dean* opinion itself stated that houses are particularly unique. *Id.* at *12. Thus, defense counsel should continue to consider the economic loss rule a viable defense in New Jersey and elsewhere, despite the narrow EIFS exception created by the *Dean* court.

The Restatement generally defines a product for the purpose of product liability law (Rest. 3d Torts, Products Liability, §19, p. 267), but this definition provides insufficient guidance for application of the economic loss rule. The Restatement says: “a product is tangible personal property distributed commercially for use or consumption.” (*Id.* §19(a).) Comment b. to §10 next defines component parts in a fashion that may cause more confusion, stating:

> Component parts are products, whether sold or distributed separately or assembled with other component parts. An assemblage of component parts is also, itself, a product. (§19, com. b, p. 268.)

One can safely assume the Restatement did not intend to create and destroy the economic loss rule in the same treatise. The Reporters’ note to comment b of §19 reveals the resulting widespread confusion among state courts on identifying “the product itself.” This confusion is because the definition of a product for the purpose of product liability (§19) is not the same as the definition of “the product itself” for purposes of the economic loss rule (§21).
At §21, the Restatement attempts to more specifically define “the product itself” in the context of the economic loss rule, stating:

e. *Harm to the plaintiff’s property other than the defective product itself.* A defective product that causes harm to property other than the defective product itself is governed by the rules of this Restatement. What constitutes harm to other property rather than harm to the product itself may be difficult to determine. A product that nondangerously fails to function due to a product defect has clearly caused harm only to itself. A product that fails to function and causes harm to surrounding property has clearly caused harm to other property. However, when a component part of a machine or a system destroys the rest of the machine or system, the characterization process becomes more difficult. When the product or system is deemed to be an integrated whole, courts treat such damage as harm to the product itself. When so characterized, the damage is excluded from the coverage of this Restatement. A contrary holding would require a finding of property damage in virtually every case in which a product harms itself and would prevent contractual rules from serving their legitimate function in governing commercial transactions. (Rest. 3d Torts, Products Liability, §21, p. 295 - 296.)

The Restatement recognizes that defining “the product itself” is the threshold issue, and that a failure to properly do so would annihilate the economic loss rule. However, defining the product as whether or not it is “an integrated whole” is entirely insufficient to protect contract from annihilation by tort. The Restatement fails to recognize that *East River* and *Saratoga* provide a bright line identification of “the product itself” capable of being applied by courts and practitioners.

In accordance with *East River* and *Saratoga*, there are two necessary inquiries: 1) who is suing; and 2) what did they buy? A plaintiff cannot be allowed to purchase a product and then sue a component part supplier of that product (in tort) for damage to the product purchased. As shown through *East River* and *Saratoga*, this would result in complete annihilation of the economic loss rule. [A purchaser could always avoid the terms of the warranty (or contract) by circumventing the seller of the product and instead suing a component part manufacturer in tort for damage the component caused confined the purchased product.]

Recent cases suggest a trend toward proper definition of “the product itself.” An airplane is “the product itself” and an airline cannot pursue either the engine manufacturer or the airplane manufacturer in tort for damage to the airplane caused by engine failure. (Isla Nena Air Services, Inc. v. Cessna Aircraft Co. (2006) 449 F.3d 85.) A homeowner cannot pursue tort recovery from a manufacturer of exterior siding when moisture infiltration damages nothing other than the house itself. (Dean v. Barrett Homes (2009) 406 N.J. Super. 453.) But the trend is slow, and conflicting decisions are numerous.

The only way to give life to the economic loss rule is to define the product as what the seller sold to buyer, and what the buyer bought from seller. If buyer purchased the integrated product, then that integrated product is “the product itself.” If the buyer purchased a component part that buyer then incorporated into a larger product, then as to this buyer, the component part is “the product itself.” Such buyer can proceed in tort for damage the component part caused to the integrated product, but not for damage to the component itself. In this way, the privity connection is protected from tort intervention.

Attorneys practicing product liability defense must develop the economic loss rule to afford manufacturers and distributors proper protection from tort interference with contract or warranty. *East River* and *Saratoga* provide the legal basis for developing the law as intended. The following rules will apply:

• Personal injury never implicates the protection of the economic loss rule. A person is always “other property.”
• A tort action can seek recovery for damage a product causes to other property, but tort recovery is precluded for damage to the product itself.

• Contract or warranty is the exclusive remedy for damage to the product itself.

• Determination of what is “the product itself” for purpose of application of the economic loss rule is the threshold question, and involves identifying the plaintiff and the product they purchased. If the plaintiff purchased the integrated product, the plaintiff cannot sue the seller (or any component part supplier) in tort for damage confined to the integrated product.

• The “product itself” is what the Seller sold and what the Buyer bought.

Once these matters have been determined, the plaintiff’s recovery for damage to “the product itself” will be limited to remedies available in contract or warranty.

In construction product cases, controlling the plaintiff’s remedies can have far reaching impact. If a manufacturer sells a construction product to a general contractor which is then incorporated into the finished project, the end user/owner cannot pursue tort recovery against the manufacturer for damage to the finished product. Instead, the end user/owner must pursue its contractual remedies.

Through proper application of the economic loss rule, manufacturers and distributors can enforce the basis of the bargain through contract or warranty. Without it, the contractual agreements on quality and performance of the product will be destroyed by tort. Developing the law to provide the protection intended by the economic loss rule will benefit product liability defense.

II. Insurance Coverage Considerations

Insurance coverage is often determined by application of the economic loss rule using different terms. Insurers deny coverage for “your work” or “your work product” which is similar to the product itself. Insurers do not provide coverage for breach of contract or damage the Insured’s product caused to itself. Coverage is allowed only for tort liability, damage your product caused to other property.

In product liability actions, Insurers will deny coverage if Plaintiff’s allegations seek only damage to the product itself. All insurers will at least reserve rights to deny coverage for “your work” and allow recovery only for personal injury or damage to other property recovered through a tort action. In this way, understanding and applying the economic loss rule has dramatic insurance implications.