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DEVELOPERS AND CONTRACTORS FOR NEGLIGENCE IN THE  
ABSENCE OF PROPERTY DAMAGE OR PERSONAL INJURY**

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## **The Supreme Court of California Reaffirms the Economic Loss Doctrine, Declines to Impose Tort Liability on Developers and Contractors for Negligence in the Absence of Property Damage or Personal Injury**

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In December 2000, the Supreme Court of California issued its long-awaited ruling in *Aas v. Superior Court*, regarding the extent to which developers, contractors and subcontractors can be held liable for tort damages for negligent home construction resulting in building code violations, where such defects had not caused personal injury or property damage. Because the case offered the Court the opportunity, which it ultimately did not take, to curtail sharply the state's economic loss doctrine, the case had been watched closely by both the building industry and homeowners' associations.

The matter came before the high court following the trial court's ruling to prohibit plaintiff homeowners from introducing at trial evidence of alleged construction defects that had not caused property damage or personal injury. The homeowners sought review by the California Court of Appeal, which denied the petitions and concluded that it was not error for the trial court to exclude the evidence. In reaffirming the economic loss doctrine first propounded in California in *Seely v. White Motor Company*, the Court's 5-2 decision reiterated that an alleged breach of duty causing only speculative harm or the threat of future harm is not typically sufficient to create a compensable cause of action in tort. The majority also rejected the dissenters' proposal for a judicially created rule that would provide compensation for "serious" defects, but not minor or "cosmetic" defects, and would require that the courts oversee the disbursement of damages to ensure that they are spent on remedying the alleged defects. Finally, the majority found irrelevant to its decision the "incorporation doctrine," which provides that for insurance purposes, property damage occurs when a defective component is incorporated into a structure.

The *Aas* decision is significant to developers and builders, as well as to manufacturers of products installed or incorporated into homes and other buildings. In light of the persuasive weight of decisions of the California Supreme Court in other jurisdictions, the California Court's reaffirmation of the economic loss doctrine and the demarcation between contract and tort liability, signals that the doctrine still provides significant protections against potentially crippling tort and punitive damages arising out of what might otherwise be more manageable breach of contract actions. The opinion also serves as a cautionary note, however, because the Court recognized that the state legislature has full authority to modify existing law and implement new rules as to liability and disbursement of damages. Thus, developers, builders and manufacturers need to monitor both judicial and legislative developments in the area of tort damages.

### **Background**

In *Seely*, the California Supreme Court adopted the economic loss doctrine and held that the plaintiff could not recover in strict liability or negligence for the cost of repairing a defective truck or for lost business income. The *Seely* principle has been reexamined,

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applied and cited in numerous subsequent cases in California and elsewhere. In the later case of *J'Aire Corp. v. Gregory*, however, the Court permitted a narrow exception to the economic loss doctrine where, among other factors to be considered, a "special relationship" existed between plaintiff and defendant.

*J'Aire* had allowed the tenant of a restaurant building to assert a negligence claim for economic (business) losses against a contractor hired by the building's owner to renovate the building when the contractor failed to complete the renovations with due diligence. The Court in *J'Aire* balanced six factors—including the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm, the degree of certainty that the plaintiff suffered injury and the policy of preventing future harm—and rejected arguments that the "special relationship" theory would impose liability for remote consequences and speculative damages.

The plaintiffs in *Aas* and a companion case on appeal, *Provencal Community Association v. William Lyon Company*, sued the developer, contractor and subcontractors of their subdivision and condominium complex, respectively, for alleged damages resulting from a variety of construction defects. Each group of plaintiffs sought, among other things, the cost of repairing the claimed defects and, in *Aas*, the diminished value of their homes. In each case, defendants moved to exclude evidence of alleged damages that had not caused property damage. No personal injury was claimed. Plaintiffs admitted that the defects had not caused property damage, but responded that some of the defects violated applicable building codes intended to protect life, health and property from, for example, fire and seismic forces. In each case, the trial court granted the motions as to plaintiffs' tort claims and excluded evidence of defects that had caused only economic loss but had not resulted in property damage or personal injury.

On appeal, plaintiffs argued their case as to negligence only, having abandoned their assertion that strict liability provided a remedy for construction defects that did not cause property damage. In order to overcome the economic loss doctrine, the *Aas* plaintiffs asserted that *J'Aire* displaced the general economic loss doctrine articulated in *Seely* and allowed a right to recover for economic losses where the parties occupied a "special relationship" to each other and where there is a duty to avoid negligently injuring a person's economic interests. Plaintiffs based their argument on the statement in *J'Aire* that where "the risk of harm is foreseeable . . . an injury to the plaintiff's economic interests should not go uncompensated merely because it was unaccompanied by any injury to his person or property."

## **Holding**

The California Supreme Court recounted the development of the economic loss doctrine in prior California decisions. In considering plaintiffs' argument based on *J'Aire*, the Court stated as an initial matter that the third *J'Aire* factor--the degree of certainty that plaintiff suffered an injury--posed an obvious obstacle to plaintiffs' claim, noting that defects that have yet to ripen into property damage do not fit the definition of "appreciable harm," long an essential element of a negligence claim. Further, the Court suggested that plaintiffs had confused the *measurement* of alleged damages--the cost of

repairs--with the ability to allege a tort action for damages in the first instance. In sum, the Court did not believe "that the *J'Aire* court intended to dispense with the rule that appreciable, nonspeculative, present injury is an essential element of a tort cause of action" and that without that "fundamental prerequisite to a tort claim, it is difficult to imagine what other factors, singly or in combination, might justify the court in finding liability."

In so holding, the Court also responded to the dissenters' view that the requisite property damage had occurred when allegedly defective building components or construction were incorporated into the plaintiffs' homes. This "incorporation doctrine" arose in another case in the context of interpretation of an insurance policy. The California Supreme Court noted that the doctrine addressed the interpretation of contractual language and did not address, much less provide, a rule of tort liability.

The Court acknowledged that the sixth *J'Aire* factor--the policy of preventing future harm--was plaintiffs' strongest argument. Nonetheless, the Court recognized that extending tort liability in *Aas* would likely increase the cost of housing by making builders the insurers of building code compliance even when noncompliance had not caused property damage or personal injury. The majority rejected the dissenters' proposal for addressing the competing policy concerns of preventing future harm and also preventing the escalation of housing costs to account for builders' increased liability risk.

The dissenters' suggested rule would provide that tort liability would be imposed for "serious" defects and code violations, but not for "minor" defects and violations. Further, the rule would require courts to supervise disbursement of damages to ensure that they were spent on making repairs. The majority identified three major flaws with the proposed rule. First, it lacked coherence, for it rejected the majority's expression of the economic loss rule, yet applied the doctrine to "minor" defects. Second, by distinguishing between "serious" and "minor" defects, the proposed rule would likely insulate every claim from demurrer and summary judgment by requiring expert testimony and factual resolution as to the seriousness of the defect. Third, the rule would sharply contrast with the customary understanding that courts do not typically mandate how winning plaintiffs spend their tort recoveries. Although the legislature was free to impose such a rule, the majority acknowledged, it was not the Court's rule to do so in its stead.

## **Analysis**

The *Aas* decision, while hailed as a victory for the construction industry, nonetheless sounds some cautionary notes.

First, the case is obviously significant for its strong reaffirmation of the economic loss doctrine first propounded in *Seely*. In that sense, *Aas* may be more important for what it did *not* say, for the case offered the Court the chance to revisit the doctrine entirely or to limit its breadth, an invitation the Court did not accept.

Second, given several passages in the opinion, including those quoted above, it is clear that not only developers, builders and contractors, but also manufacturers of products or

fixtures installed in buildings, can rely on the Court's reasoning and justifications in defending against tort claims for purely economic or business losses.

Third, the case demonstrates the Court's refusal to engage in policy making and judicial legislating and reaffirms the obvious demarcation between the judicial and legislative branches.

Nonetheless, some may consider the opinion disappointing insofar as it did not set aside the *J'Aire* case and its somewhat subjective six-factor test. Thus, defendants will likely continue to face allegations of a "special relationship" between plaintiff and defendant, and have to argue in demurrers or motions to dismiss that the claim does not fulfill the *J'Aire* standard for imposing tort liability. In addition, although the Court declined to encroach on the legislature's role, *Aas* invites the California legislature to consider the dissenters' policy proposal and adopt it if appropriate.

### **Recommendation**

Companies engaged in development, building and general contracting, as well as companies that manufacture products typically installed or included in buildings, should be aware that *Aas* strengthens the economic loss doctrine and bolsters defenses to tort liability. Such companies, therefore, should factor the Court's ruling into their analysis of litigation options and, where appropriate, into pre-litigation discussions or negotiations with an opposing party. In addition, such companies with a significant presence in California should monitor carefully that state's legislative debates and proposals to track whether the legislature considers the *Aas* dissenters' suggested rule.

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