ARIZONA'S "ECONOMIC LOSS RULE" AND FLAGSTAFF AFFORDABLE HOUSING

Thomas E. Lordan, Esq.[*]

One of the most interesting and significant developments in the common law in the last few decades has been the growth of the so-called "economic loss rule" or "economic loss doctrine" ("ELR").[1] The ELR,

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[*] J.D., University of Notre Dame Law School. Member of the Bars of Arizona, Ohio, the District of Columbia, and Maryland. Attorney with the Phoenix, Arizona, law firm of Wilenchik & Bartness, P.C.

[1] "It seems impossible to formulate a single economic loss rule. Instead, the problem of recovery for pure economic loss that is unaccompanied by physical harm to person or property occurs in a number of contexts that may invoke differing concerns of policy." Dan

when it applies, eliminates tort causes of action leaving the parties to their contract remedies, if any. It can radically alter the nature and scope of a case. The question is, when does the ELR apply? In 2010, the Arizona Supreme Court had occasion to re-visit, and re-affirm, the ELR for the first time since 1984 after much confusion as to the extent of its application under Arizona law by state and, especially, federal courts. In *Flagstaff Affordable Housing Ltd. Partnership v. Design Alliance, Inc.*, ("*FAH*") the Supreme Court held that 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, even when, as in *FAH* itself, the owner has no contract remedies.[2]

Considering the status of Arizona law on the ELR leading up to *FAH*, the case left many questions in its wake in what will be a fertile ground for appellate litigation over the next several years. To see what those questions are and how they may be resolved in light of *FAH*, we must look into the history of the ELR.

It is especially interesting to examine the history of the ELR in Arizona law because it shows the development of a significant modern common law

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B. Dobbs, *An Introduction to Non-Statutory Economic Loss Claims*, 48 ARIZ. L. REV. 713, 733 (2006).

Professor Dobbs posits two distinct rules that tend to limit recovery of what he calls "stand-alone economic loss":

> (1) Subject to qualifications, one not in a special or contractual relationship owes no duty of care to protect strangers against stand-alone economic harm; and (2) again subject to qualifications, those in a special relationship arising out of contract or undertaking may not owe a duty of care to each other; rather, each party is limited to the contract claim, with all its limitations.

Id. at 714. An example of the first type of case is a defendant who negligently drives his truck into a bridge, causing it to collapse and block access to the plaintiff's retail store, with concomitant loss in sales for the plaintiff. In such "stranger" cases, the plaintiff has no cause of action in tort against the defendant to recover his economic losses. And of course the plaintiff, who has no contractual relationship with the defendant, has no action in contract either. As the Arizona Supreme Court recently said: "Courts have not recognized a general duty to exercise reasonable care for the purely economic well-being of others, as distinguished from their physical safety or the physical safety of their property." DAN B. DOBBS, THE LAW OF TORTS § 452, at 329-31 (Supp. 2009); *see also* Lips v. Scottsdale Healthcare Corp., 229 P.3d 1008, 1010 (Ariz. 2010). It is the second situation, the one in which there is a contract somewhere in the picture, with which we are concerned in this article.

[2] Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc., 223 P.3d 664, 665 (Ariz. 2010).

legal doctrine in one jurisdiction, the origin of the development, the themes of the development, the causes of paradigm shifts in the development, and the struggle of the courts to come to terms with the unsettled law that accompanies any significant legal development as it is occurring.[3]

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[3] The secondary literature on the ELR is vast. In Arizona, two of the leading articles are Edward P. Ballinger, Jr. & Samuel A. Thumma, *The History, Evolution and Implications of Arizona's Economic Loss Rule*, 34 ARIZ. ST. L.J. 491 (2002), and their follow-up article, Edward P. Ballinger, Jr. & Samuel A. Thumma, *The Continuing Evolution of Arizona's Economic Loss Rule*, 39 ARIZ. ST. L.J. 535 (2007). Problems with the ELR in Arizona were suggested by the introductory paragraph of their 2007 article, in which they said that in their 2002 article:

> [W]e discussed the small number of cases applying Arizona's economic loss rule, highlighted some resolved and some unresolved issues under the doctrine and concluded that those cases "suggest that Arizona's economic loss rule is a comparatively clear, logical doctrine that is not shrouded by the confusion that, at times, has plagued the rule in other jurisdictions." In the years since, much has happened in the application of Arizona's economic loss rule, not all for the better.

Id. at 535. The Winter 2006 issue of the *Arizona Law Review* contained a "Symposium: Dan B. Dobbs Conference on Economic Tort Law," which featured articles on the ELR, including Ellen M. Bublick, *Economic Torts: Gains in Understanding Losses*, 40 ARIZ. L. REV. 681; Dan B. Dobbs, *An Introduction to Non-Statutory Economic Loss Claims*, 48 ARIZ. L. REV. 713; Richard A. Posner, *Common-Law Economic Torts: An Economic and Legal Analysis*, 48 ARIZ. L. REV. 735; and Robert L. Rabin, *Respecting Boundaries and the Economic Loss Rule in Tort*, 48 ARIZ. L. REV. 857. Other articles that may be of interest include: Gabriel Aragon, *Construction Defect: Crafting an Exception to Arizona's Economic Loss Rule to Permit Breach of Fiduciary Duty Tort Claims*, 38 ARIZ. ST. L.J. 337 (2006); Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 Wash. & Lee L. Rev. 523 (2009); Ralph C. Anzivino, *The Fraud in the Inducement Exception to the Economic Loss Doctrine*, 90 MARQ. L. REV. 921 (2007); and R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789 (2000). The American Law Institute ("ALI") has drafted provisions on the ELR for a Restatement on economic torts, but they have never been adopted. As the court noted in *Indianapolis-Marion Cnty. Pub. Library v. Charlier Clark & Linard, P.C.*, 929 N.E.2d 722, 727 (Ind. 2010), discussing the history of the rule, Professor Mark P. Gergen of the University of Texas School of Law, the ALI project's reporter, wrote that the "economic loss rule emerged alongside the modern negligence action" as courts wrestled with whether plaintiffs could bring "negligence claims for solely pecuniary harm." RESTATEMENT (THIRD) OF ECONOMIC TORTS & RELATED WRONGS § 8, Reporter's Note a (Council Draft No. 2, 2007).

> This project was commissioned by the ALI in 2005 to restate existing common law into a series of principles or rules as it relates to economic torts and the economic loss rule. Two drafts were submitted to the ALI's governing Council addressing the economic loss rule, but no part of the work was approved by the ALI. To accompany the ALI project, Professor Ellen M. Bublick organized a symposium, the "Dan B. Dobbs Conference on Economic Tort Law," at the University of

I. TORT AND CONTRACT

The ELR may be the latest battlefield in the age-old struggle between tort and contract, which has been a constant feature of our law since contract emerged from tort.

Shrouded in the mists of Early-Sixteenth century antiquity is the emergence of the common law form of action known as "Assumpsit," from its predecessor, "Trespass Upon the Special Case," which had itself emerged around 1400 from its original predecessor known as "Trespass."[4] "So continuous is legal history that the lawyers do not see that there has been a new departure until this has for some time past been an accomplished fact; their technical terminology will but slowly admit the fact that a single form of action has become several forms of action."[5] Trespass and Trespass Upon the Special Case were the origins of our modern actions in tort. Assumpsit, a "having undertaken," is the origin of our modern actions in contract. "Thus in diverse directions the law was finding materials for a generalisation, namely, that breach of an undertaking, an assumpsit, for which there was valuable consideration was a cause of action. Gradually the line between mis-feasance and non-feasance was transcended, and gradually lawyers awoke to the fact that by extending an action of tort they had in effect created a new action by which parol contracts could be enforced."[6] Assumpsit is extended from cases of express executory contracts to cases of contracts implied-in-fact. For example, actions for quantum meruit became actions upon quasi-contracts, "in which the element of contract is purely fictitious."[7]

As with the relationship of a child to a parent, so the relationship of contract to tort has not always been smooth, as contract has tried to establish its own identity. While a full history of the relationship between tort and

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> Arizona James E. Rogers College of Law. . . . Work on the ALI project was suspended in December 2007 following Professor Mark P. Gergen's resignation as reporter. *The ALI Reporter* (Winter 2008), http:// www. ali. org/_ news/ reporter/ winter 2008/10_ ALI_ Torts.htm (last visited Mar.14, 2010). Recently, Professor Ward Farnsworth of Boston University School of Law was named to succeed Prof. Gergen as reporter. *See* http:// www. ali. org/ index. cfm? fuseaction= projects. members& projectid= 15 (last visited Apr. 23, 2010).

Id.; 929 N.E. 2d at 727 n.5. If ALI ever succeeds in formulating a *Restatement* on the ELR, it will of course be very influential on Arizona courts.

[4] F.W. MAITLAND, THE FORMS OF ACTION AT COMMON LAW 44 (A.H. Chaytor & W. J. Whittaker eds., 1909).

[5] *Id.* at 43.

[6] *Id.* at 56.

[7] *Id.* at 57.

contract is beyond the scope of this article, it might be helpful to remember some of the basics of this relationship, which are integral to an understanding of the ELR.

To quote Prosser:

> The fundamental difference between tort and contract lies in the nature of the interests protected. Tort actions are created to protect the interest in freedom from various kinds of harm. The duties of conduct which give rise to them are imposed by the law, and are based primarily upon social policy, and not necessarily upon the will or intention of the parties. They may be owed to all those within the range of harm, or to some considerable class of people. Contract actions are created to protect the interest in having promises performed. Contract obligations are imposed because of conduct of the parties manifesting consent, and are owed only to the specific individuals named in the contract. Even as to these individuals, the damages recoverable for a breach of the contract duty are limited to those reasonably within the contemplation of the defendant when the contract was made, while in a tort action a much broader measure of damages is applied.[8]

Prosser recounts that when contract developed out of tort, "the more or less inevitable efforts of lawyers to turn every breach of contract into a tort forced the English courts to find some line of demarcation."[9] We will see that the ELR is a latter day fruit of the continuing attempt to find that "line of demarcation." But the line of demarcation which developed quite early was that between "nonfeasance" and "misfeasance."[10] "Much scorn has been poured on the distinction, but it does draw a valid line between the complete non-performance of a promise, which in the ordinary case is a breach of contract only, and a defective performance, which may also be a matter of tort."[11] "Where the defendant . . . is to be charged with a misfeasance, the possibility of recovery in tort is considerably increased."[12] Prosser says that "the American courts have extended the tort liability for

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[8] WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS § 92 (4th ed. 1971).
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*

misfeasance to virtually every type of contract where defective performance may injure the promisee."[13]

In the battle between tort and contract, contract is at a disadvantage. Where the facts make available to a plaintiff either an action in tort or one in contract, Prosser details the considerations that may lead the plaintiff to prefer one over the other, but he notes:

> Generally speaking, the tort remedy is likely to be more advantageous to the injured party in the greater number of cases, if only because it will so often permit the recovery of greater damages. Under the rule of *Hadley v. Baxendale*, the damages recoverable for breach of contract are limited to those within the contemplation of the defendant at the time the contract was made, and in some jurisdictions, at least, to those for which the defendant has tacitly agreed to assume responsibility. They may be further limited by the contract itself, where a tort action might avoid the limitation. . . . In the tort action the only limitations are those of "proximate cause," and the policy which denies recovery to certain types of interests themselves.[14]
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> The tort action may offer other advantages . . . . It may be open where the contract fails for lack of proof, for uncertainty, for illegality, for want of consideration, or because of the statute of frauds or the parol evidence rule. It may sometimes avoid some defenses . . . .[15]

Prosser notes that if an action may lie in either tort or contract, and inconsistent rules of law apply to the two actions, the question arises: may the plaintiff elect freely which he will bring or must the court decide whether, on the facts pleaded and proved, the "gist" or "gravamen" of his cause of action is one or the other.[16] He concludes that it is difficult to generalize.[17]

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[13] *Id.*; *see infra* Part X.C. discussion on *Barmat* and its progeny as to how Arizona resolves this and related issues.

[14] Thus it is often the case that defendants who thought they had carefully limited their liability exposure through carefully crafted contract provisions are frustrated by plaintiffs who have used tort claims to "get around" the contract.

[15] PROSSER, *supra* note 8, § 92.

[16] *Id.*

[17] *Id.*; *see infra* Part X.C. discussion on *Barmat* and subsequent cases as to how Arizona resolves this and related issues.

Several years ago, Professors Prosser and Keeton suggested the scope of the problem for which the ELR may be the solution:

> The distinction between tort and contract liability, as between parties to a contract, has become an increasingly difficult distinction to make. It would not be possible to reconcile the results of all cases. The availability of both kinds of liability for precisely the same kind of harm has brought about confusion and unnecessary complexity. It is to be hoped that eventually the availability of both theories–tort and contract–for the same kind of loss . . . will be reduced in order to simplify the law and reduce the costs of litigation.[18]

II. *SEELY V. WHITE MOTOR COMPANY*

In American law, some commentators trace the origins of the ELR back to *Seely v. White Motor Co.*, ("*Seely*"), a decision written by California Chief Justice Roger Traynor.[19] The rule emerged in *Seely* simply as a response to the development of a "super tort"–strict liability in tort–in the field of products liability. Strict liability overcame the limits on the older theories available to plaintiffs who suffered personal injuries or damage to other property caused by defective products, principally negligence and breach of warranty. Strict liability in tort, as formulated in section 402A of the *Restatement of Torts, Second,* imposed liability for physical harm thereby caused to the ultimate user or consumer or to his property on "[o]ne who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property," without the need for proof of negligence and without the need for any contractual relationship between the plaintiff consumer and the defendant seller.[20] This "super tort" leapt over the requirements of negligence and warranty to purposefully shift the burden of defective products onto those who could bear the cost: sellers and, ultimately, manufacturers. The question arose as to how far the new tort extended.

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[18] PROSSER & KEETON, THE LAW OF TORTS § 92.

[19] Seely v. White Motor Co., 403 P.2d 145, (Cal. 1965). "The economic loss rule is a judicially created doctrine, first articulated by the California Supreme Court in *Seely v. White Motor Co.*" R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Cases*, 41 WM. & MARY L. REV. 1789, 1794 (2000).

[20] RESTATEMENT (SECOND) OF TORTS § 402A(1) (1965).

Just two years before *Seely*, the California Supreme Court adopted strict liability in tort to impose liability on the manufacturer of a defective product that had caused personal injury.[21] *Greenman v. Yuba Power Products, Inc.* became the leading case and swept the country.[22] *Seely*, which involved a defective truck that caused only economic losses, confronted Justice Traynor and the rest of the California Supreme Court with the question of whether strict liability in tort would be available to plaintiffs in such cases.[23] In holding that it would not, Justice Traynor placed the economic loss rule into the stream of American jurisprudence.[24]

Justice Traynor's opinion in *Seely* explained the policy rationale for the Rule as well as it has ever been explained. The doctrine of strict liability in tort was designed, he said, not to undermine the carefully constructed warranty provisions of the sales act or of the Uniform Commercial Code ("UCC") but, rather, to govern the distinct problem of physical injuries.[25] Purely economic loss means that the plaintiff has lost the benefit of his bargain; the product plaintiff received is worth less than it was supposed to be, that is, the loss must turn on what the bargain was. The bargain will be unique to the case. The bargain a plaintiff strikes will be a function of the contract he made with, including the warranty he received from, the defendant. If he contracted and paid for a Grade A product, he is entitled to receive it. If he receives a Grade B product instead, he should have an action, based on his contract or his warranty, to recover his loss. But if he contracts and pays less for a Grade B product, he cannot complain if he gets a Grade B product. *Quality*, as opposed to *safety*, is a matter for *contract*, rather than *tort*. If the manufacturer of the defective truck in *Seely* were to be found strictly liable in tort for the ultimate user's commercial losses

> then it would be liable for business losses of other truckers caused by the failure of its trucks to meet the specific needs of their businesses, even though those needs were communicated only to the dealer. Moreover, this liability could not be disclaimed, for one purpose of strict liability in tort is to prevent a manufacturer from defining the scope of his responsibility for harm caused by his products. The manufacturer would be liable for damages of unknown and

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[21] Greenman v. Yuba Power Prods., Inc., 377 P.2d 897 (1963).

[22] WILLIAM L. PROSSER & JOHN W. WADE, CASES & MATERIALS ON TORTS 710, n.1 (5th ed. 1971).

[23] *See Seely*, 403 P.2d at 147-49.

[24] *See id.* at 151.

[25] *Id.* at 149.

> unlimited scope. Application of the rules of warranty prevents this result.[26]

Further, a manufacturer

> can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands. . . .
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> [The] rationale [in *Greenman*] in no way justifies requiring the consuming public to pay more for their products so that a manufacturer can insure against the possibility that some of his products will not meet the business needs of some of his customers.[27]

Thus, at its origin, the ELR was designed merely to restrict the application of a single tort–strict liability–in a single context–defective products cases–to the type of damages the tort was designed to protect against: personal injuries.

III. GRANT GILMORE AND "THE DEATH OF CONTRACT"

Another impetus to the ELR came in 1970, when Professor Grant Gilmore of the Yale Law School gave a series of lectures at the Ohio State University Law School later published as a book entitled *The Death of Contract*.[28]

Early in his first lecture on the origins of what he called the "pure" or "classical" theory of contract, Gilmore cited Professor Lawrence Friedman on the nature and purpose of the theory:

> The abstraction of classical contract law is not unrealistic; it is a deliberate renunciation of the particular, a deliberate relinquishment of the temptation to restrict untrammeled individual autonomy or the completely free market in the name of social policy. The law of contract is, therefore,

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[26] *Id.* at 150-51 (citation omitted).
[27] *Id.*
[28] *See* GRANT GILMORE, THE DEATH OF CONTRACT (Ronald K. L. Collins, ed., 1974).

> roughly coextensive with the free market. Liberal nineteenth century economics fits in neatly with the law of contracts so viewed.[29]

In other words, contract law grew out of classical political and economic liberalism. Its rationale was that individuals should be free to make their own bargains and to have those bargains upheld and enforced by the courts without any judicial second guessing or undermining in the name of some extra-contractual "policy."[30] This theme animates the ELR, a doctrine designed to prevent freely-contracted bargains from being undermined by social policy in the form of tort law.[31]

Gilmore was very skeptical that there really ever was such a thing as a separate body of law that could be called "Contract."[32] One of the themes of the lectures was that such distinction as there was between tort and contract was being blurred by the tendency of tort to overpower contract as a cause of action.

> Speaking descriptively, we might say that what is happening is that "contract" [which was born out of tort] is being reabsorbed into the mainstream of "tort." Until the general theory of contract was hurriedly run up late in the nineteenth century, tort had always been our residual category of civil liability. As the contract rules dissolve, it is becoming so again. It should be pointed out that the theory of tort into which contract is being reabsorbed is itself a much more expansive theory of liability than was the theory of tort from which contract was artificially separated a hundred years ago.

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[29] *Id.* at 7 (quoting LAWRENCE M. FRIEDMAN, CONTRACT LAW IN AMERICA: A SOCIAL AND ECONOMIC CASE STUDY, MADISON, WISCONSIN 20 (Univ. of Wis. Press 1965).

[30] *See id.* at 7 ("The law of contract is . . . roughly coextensive with the free market.") (quoting FRIEDMAN, *supra* note 32, at 20).

[31] *See* Seely v. White Motor Co., 403 P.2d 145, 151 (Cal. 1965).

[32] For example, Gilmore believed that the concept of consideration, which he viewed as the great wheel of contract theory, had been swallowed up by the concept of promissory estoppel. Gilmore's skepticism—not to say cynicism—at times produces very droll criticisms of what are often taken to be sacred legal doctrines. *See, e.g.*, GILMORE, *supra* note 28, at 55-56, 71 ("In the hundred odd years since the case was decided, the compendious formula of *Hadley v. Baxendale* has meant all things to all men." *or* "'[E]stoppel' . . . is simply a way of saying that, for reasons which the court does not care to discuss, there must be judgment for plaintiff.") (emphasis added).

> We have had more than one occasion to notice the insistence of the classical theorists on the sharp differentiation between contract and tort . . . . Classical contract theory might well be described as an attempt to stake out an enclave within the general domain of tort. The dykes which were set up to protect the enclave have, it is clear enough, been crumbling at a progressively rapid rate. . . . We may take the fact that damages in contract have become indistinguishable from damages in tort as obscurely reflecting an instinctive, almost unconscious realization that the two fields, which had been artificially set apart, are gradually merging and becoming one.
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> . . . I have occasionally suggested to my students that a desirable reform in legal education would be to merge the first-year courses in Contracts and Torts into a single course which we could call Contorts. Perhaps the same suggestion would be a good one when the time comes for a third round of Restatements.[33]

Gilmore noted "the California Supreme Court has unquestionably been the most innovative court in the country. . . [it] comes as close to an overt recognition of the process [of the fusion of tort and contract which Gilmore had been describing] as anything I have yet seen in the judicial literature."[34] Two of the California cases involved allegations of legal malpractice. The first such case, *Lucas v. Hamm*,[35] would have grounded liability in contract involving the third-party beneficiary doctrine. In the second such case, *Heyer v. Flaig*,[36] the court commented that the discussion of contract theory in *Lucas* had been "conceptually superfluous since the crux of the action must lie in tort in any case; there can be no recovery without negligence."[37] The court continued: "'It has been well established in this state that if the cause of action arises from a breach of a promise set forth in the contract, the action is ex contractu, but if it arises from a breach of duty growing out

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[33] GILMORE, *supra* note 28, at 95-96, 98.

[34] *Id.* at 99.

[35] Lucas v. Hamm, 364 P.2d 685, 686 (Cal. 1961), *cert. denied*, 368 U.S. 987 (1962).

[36] GILMORE, *supra* note 28, at 100 (quoting Heyer v. Flaig, 449 P.2d 161, 164 (Cal. 1969)).

[37] *Heyer*, 449 P.2d at 164.

of the contract it is ex delicto.'"[38] Gilmore commented: "At least in the golden state of California, ex delicto seems to be well on the way toward swallowing up ex contractu."[39] Arizona has recognized the same distinction as *Heyer*.[40]

Citing *Greenman v. Yuba Power Products, Inc.*[41] and *Seely*[42], Gilmore said: "One of the most interesting case law developments of recent years–one in which the California Court, once again, assumed a pioneering role–has been the expansion of a manufacturer's liability to remote users of his defective products–the so-called 'products liability' cases."[43] He went on to discuss the creation of the super tort of strict liability as another example of the predominance of tort over contract and warranty. "Here again, I suggest, we see an almost instinctive choice of tort over contract as the principle of liability in a rapidly developing field."[44]

Gilmore did not, however, anywhere address or even mention the ELR, even when he cited *Seely*. It seems fair to say, then, that he did not foresee the ELR as a doctrine with the potential to reverse or at least modify to some extent what he seemed to see as an irreversible slide of contract back into tort.

The conclusion to Gilmore's lectures is ambiguous. While he said that it may be "the fate of contract to be swallowed up by tort (or both of them to be swallowed up in a generalized theory of civil obligation),"[45] he suggested that the process of law may be subject to "alternating rhythms," as in literature and the arts.[46] Gilmore ended by saying: "Contract is dead–but who knows what unlikely resurrection the Easter-tide may bring?"[47]

Subsequent extensions of the ELR, including cases applying Arizona's version of the Rule, can be seen as responses to Professor Gilmore's academic challenge to prevent contract from being overwhelmed by tort.[48] Indeed, as we will see, several of the most important ELR cases cite Gilmore and his lectures by name.

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[38] *Id*. (quoting Eads v. Marks, 249 P.2d 257, 260 (Cal. 1952)) (emphasis omitted).

[39] GILMORE, *supra* note 28, at 100.

[40] *See, e.g.*, Barmat v. John & Jane Doe Partners A-D, 747 P.2d 1218 (Ariz. 1987), *see also infra* Part X. (discussing *Barmat* the context of *FAH*).

[41] Greenman v. Yuba Power Prods., Inc., 377 P.2d 897 (Cal. 1963).

[42] Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965).

[43] GILMORE, *supra* note 28, at 101.

[44] *Id.*

[45] *Id*. at 103.

[46] *Id*. at 111.

[47] *Id*. at 112.

[48] *See, e.g.*, E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858 (1986); Apollo Grp., Inc. v. Avnet, Inc., 58 F.3d 477 (9th Cir. 1995).

IV. EARLY ARIZONA CASES AND *SALT RIVER PROJECT*

The earliest Arizona cases applying the ELR, or appearing to apply the ELR, generally limited its application to that suggested by *Seely*. Thus the cases involved defective products or, similar to defective products, defective construction that caused solely economic losses. The cases held that tort causes of action in not just strict liability in tort but in negligence as well were precluded by the ELR. The cases did not call the Rule by name.[49]

The first Arizona Supreme Court case to adopt the ELR–and the only Arizona Supreme Court case on the ELR until *FAH*–was *Salt River Project Agricultural Improvement and Power District v. Westinghouse Electric Corp.*[50] ("*SRP*"). It, too, was a products liability case, in effect, Arizona's own *Seely*. A product manufactured and sold by Westinghouse to SRP, installed in a gas turbine generator unit (also manufactured and sold by Westinghouse to SRP) allegedly malfunctioned, damaging the unit.[51] The

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[49] Flory v. Silvercrest Indus., Inc., 633 P.2d 383, 388 (Ariz. 1981) (product liability case; strict liability in tort precluded; court cited *Seely*). The Flory court said:

> Although we allow recovery for "breach of implied warranty" without privity under the theory of strict liability, plaintiffs cannot recover purely economic damages under that theory. And although we allow recovery for purely economic damages for breach of U.C.C. warranties, plaintiffs cannot recover under that theory from Silvercrest due to their lack of privity with that defendant.

Id.

Arrow Leasing Corp. v. Cummins Ariz. Diesel, Inc., 666 P.2d 544, 546, 549 (Ariz. Ct. App. 1983) (product liability case; negligence and strict liability precluded; court cited *Seely*); Woodward v. Chirco Constr. Co., Inc., 687 P.2d 1269, 1271 (Ariz. 1984) (residential construction defect case; negligence precluded) The Woodward court said, in language to be often quoted in subsequent cases:

> We see no reason to preclude a purchaser from claiming damages in contract and in tort . . . . For example, if a fireplace collapses, the purchaser can sue in contract for the cost of remedying the structural defects and sue in tort for damage to personal property or personal injury caused by the collapse. Each claim will stand or fall on its own. . . .

Id.

Nastri v. Wood Bros. Homes, Inc., 690 P.2d 158, 164 (Ariz. Ct. App. 1984) (residential construction defect case; negligence and strict liability in tort precluded).

[50] Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp., 694 P.2d 198, 215 (Ariz. 1984), *abrogated on other grounds*, Phelps v. Firebird Raceway, Inc., 111 P.3d 1003 (Ariz. 2005).

[51] *Id.* at 203.

issue, as in *Seely*, was whether strict liability in tort was available to the plaintiff, SRP, or whether SRP was limited to its contract claim for breach of the implied warranty of fitness under the UCC.[52] This was an issue of no small moment to SRP, given that its damages were in excess of $1.9 million, and its warranty/contract claim had failed because Westinghouse had prevailed over SRP in a UCC "battle of the forms."[53]

SRP could have followed the lead of *Seely*, a case with which it was most familiar, citing it as the "genesis" of the ELR.[54] But where *Seely* had fashioned a *per se* rule denying the use of strict liability in tort to plaintiffs who suffered only economic losses from defective products, SRP took a more cautious approach, fashioning its own three-part test in which the ELR came into play only in the third part, as we will see.

The court first noted the distinction between the fundamental purpose of tort law in promoting the *safety* of persons and property and the fundamental purpose of contract law in protecting the *expectation interests*, or *benefit of the bargain*, of the parties:

> A basic policy of contract law [in contrast with tort law] is to preserve freedom of contract and thus promote the free flow of commerce. This policy is best served when the commercial law permits parties to limit the redress of a purchaser who fails to receive the quality of product he expected. When a defect renders a product substandard or unable to perform the functions for which it was manufactured, the purchaser's remedy for disappointed commercial expectations is through contract law.
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> Division One of the Arizona Court of Appeals has aptly summarized the difference between tort and contract: "[T]he rationale for making a distinction is that traditional contract remedies are designed to redress loss of the benefit of the bargain while tort remedies are designed to protect the public from dangerous products."
>
> To determine whether contract or tort law applies in a specific case, the court must consider the facts of the case, "bearing in mind the purposes of tort law recovery as contrasted with contract law." We agree . . . that no all-

[52] *Id.* at 205.
[53] *Id.* at 204.
[54] *Id.* at 209.

> inclusive rule governs this consideration. The cases and relevant literature indicate that three interrelated factors should be analyzed: the nature of the product defect that caused the loss to the plaintiff, the manner in which the loss occurred, and the type of loss for which the plaintiff seeks redress.[55]

In analyzing the three factors, the court noted that under the first factor the type of product that will trigger tort liability is one which is defective in a way that poses an unreasonable danger to those who use or consume it.[56] On the other hand, the type of product defect contemplated by contract law is a qualitative one. Contract law, which protects expectation interests, provides the appropriate set of rules when an individual wishes a product to perform a certain task in a certain way or expects or desires a product of a particular quality so that it is fit for ordinary use.[57] Where the potential for danger to person or property is absent, tort principles need not be invoked because the safety incentive policy of tort liability is not implicated.[58] Thus, where the defect involves only the quality of the product and presents no unreasonable danger to person or property, the contract remedy is ordinarily exclusive.[59]

Relative to the second factor, though the manner in which loss occurs will not often be determinative, in a particular case it may be relevant. Losses resulting from a sudden accident will usually evidence tort defects and thus call for tort remedies, whereas losses resulting from a slow process of deterioration will usually evidence commercial defects–a failure of the product to perform in conformity with the commercial agreement–and thus call for contract remedies.[60]

Relative to the third factor, the court outlined five hypotheticals to illustrate the problems to be addressed in determining whether certain types of loss should be recoverable in tort or under the UCC, the last two of which involved only economic losses.[61] The majority rule, said the court, held that such economic losses were not recoverable in tort.[62] "The rule denying recovery in tort for such losses [the ELR] had its genesis in *Seely v. White*

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[55] *Id.* at 206 (internal citations omitted).
[56] *Id.*
[57] *Id.* at 207.
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.* at 209.

Motor Co. and has been applied by courts to deny tort recovery for repair and replacement costs, as well as lost profits."[63] There was, however, a minority position, and the court adopted it:

> Rather than adopting the majority rule as a blanket disallowance of tort recovery for economic losses, we think the better rule is one which examines the loss in light of the nature of the defect that caused it, the manner in which it occurred, and the nature of any other contemporaneous losses. . . .
>
> Where economic loss, in the form of repair costs, diminished value, or lost profits, is the plaintiff's only loss, the policies of the law generally will be best served by leaving the parties to their commercial remedies. Where economic loss is accompanied by physical damage to person or other property, however, the parties' interests generally will be realized best by the imposition of strict tort liability. If the only loss is non-accidental and to the product itself, or is of a consequential nature, the remedies available under the UCC will govern and strict liability and other tort theories will be unavailable. The perfect example of this is *Posttape Associates v. Eastman Kodak Co.*, where scratches on film purchased by Posttape from Kodak made the motion picture shot on the film commercially worthless. . . .
>
> Unfortunately, few cases conform neatly to an "all or nothing" configuration. Each case must be examined to determine whether the facts preponderate in favor of the application of tort law or commercial law exclusively or a combination of the two.[64]

In applying the test to the facts of the case, the court held that the three factors militated in favor of the conclusion that tort theory *was* available to SRP.[65]

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[63] *Id.* (citation omitted).

[64] *Id.* at 209-10 (referring in part to Posttape Assocs. v. Eastman Kodak Co., 537 F.2d 751 (3d Cir. 1976)).

[65] *Id.* at 215.

The most interesting thing about *SRP* is the contrast between it and *Seely*. Whereas *Seely* had absolutely precluded strict liability in tort as a cause of action in a product liability case involving only economic losses, the Arizona Supreme Court devised a three-part test to determine whether strict liability or other tort liability could be available to a plaintiff in such a case. Only the third part of the test involved consideration of the *type* of loss, economic or non-economic. Under the *SRP* test, strict liability in tort could be available to recover purely economic losses resulting from a defective product, as was it found to be available in *SRP* itself. *SRP* thus took a narrower approach to the ELR than had *Seely* and staked out Arizona's own version of the Rule. And the nature of the three-part test itself suggested that it would be limited to cases involving products or other property alleged to be defective, so as not to stray beyond the two areas in which Arizona courts had up until *SRP* applied the ELR, namely, products liability and construction defects. As a different court was later to say in *Evans v. Singer*, "[o]n its face, the *Salt River Project* decision appears to be limited to cases where products are involved–principally because the court repeatedly framed its analysis in terms uniquely applicable to that context."[66]

V. *EAST RIVER STEAMSHIP*

If *Seely* was the *origin* of the American ELR, the case that really put the Rule on the legal map was a case in admiralty decided by the Supreme Court of the United States subsequent to *SRP*, in 1986, *East River Steamship Corp. v. Transamerica Delaval, Inc.* ("*East River*").[67] *East*

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[66] Evans v. Singer, 518 F. Supp. 2d 1134, 1141 (D. Ariz. 2007).

[67] E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858 (1986).

> In the United States, the single most influential case in defining the contours of the economic loss rule is the 1986 United States Supreme Court decision in *East River Steamship Corp. v. Transamerica Delaval, Inc.* Eloquently describing the different interests protected by contract law and tort law, a unanimous Court in *East River* declared that if tort law concepts 'were allowed to progress too far, contract law would drown in a sea of tort.' In the two decades following that decision, literally hundreds of federal and state courts have cited and followed *East River*. In fact, little more than a decade after that 1986 decision, it was observed that '[a] strong majority of courts follow the *East River* rule . . . .' Moreover, *East River* appears to have increased awareness of the economic loss rule, as demonstrated by the dramatic increase in the number of cases decided over the past few years that address the doctrine. Many jurisdictions had not expressly considered the economic loss rule–at least using that terminology–before *East River*.

River, like *Seely* and *SRP*, involved an allegedly defective product purchased in a commercial transaction that malfunctioned, injuring only the product itself and causing purely economic loss. The Court said, "charting a course between products liability and contract law, we must determine whether injury to a product itself is the kind of harm that should be protected by products liability or left entirely to the law of contracts."[68] This was the fighting issue, especially in view of the fact that the plaintiffs' damages were in excess of $8 million and their claims for breach of contract and warranty were dismissed with prejudice on statute of limitations grounds. Following the dismissal of the contract and warranty claims, the defendant moved for summary judgment on the remaining claim for strict tort liability, contending that the plaintiffs' actions were not cognizable in tort.

Citing *Seely* and Grant Gilmore's lectures, the Court said:

> 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 [strict liability in tort] were allowed to progress too far, contract law would drown in a sea of tort. We must determine whether a commercial product injuring itself is the kind of harm against which public policy requires manufacturers to protect, independent of any contractual obligation.[69]

The Court noted that the question had spawned a variety of answers, from *Seely*, the majority approach, at one end of the spectrum, to *Santor v. A & M Karagheusian, Inc.*, at the other end,[70] to cases in the middle.[71] Even though *East River* did not cite *SRP*, it described the intermediate cases as cases in which "[t]he determination has been said to turn on the nature of the defect, the type of risk, and the manner in which the injury arose," a category which would have included *SRP*.[72] The Court rejected the intermediate approach and so would have rejected *SRP* because:

Edward P. Ballinger, Jr. & Samuel A. Thumma, *The Continuing Evolution of Arizona's Economic Loss Rule*, 39 Ariz. St. L. J. 535, 537-38 (2007).

[68] *E. River*, 476 U.S. at 859.

[69] *Id.* at 866 (citations omitted).

[70] *See generally* Santor v. A&M Karagheusian, 207 A.2d 305 (N.J. 1965).

[71] *E. River*, 476 U.S. at 868-70.

[72] *Id.* at 870.

> the intermediate positions, which essentially turn on the degree of risk, are too indeterminate to enable manufacturers easily to structure their business behavior. Nor do we find persuasive a distinction that rests on the manner in which the product is injured. We realize that the damage may be qualitative, occurring through gradual deterioration or internal breakage. Or it may be calamitous. But either way, since by definition no person or other property is damaged, the resulting loss is purely economic. Even when the harm to the product itself occurs through an abrupt, accident-like event, the resulting loss due to repair costs, decreased value, and lost profits is essentially the failure of the purchaser to receive the benefit of its bargain-traditionally the core concern of contract law.[73]

The Court also rejected the minority view because it "fails to account for the need to keep products liability and contract law in separate spheres and to maintain a realistic limitation on damages."[74]

Ultimately the Court, having read Professor Gilmore and so being anxious to protect contract from tort, said: "[W]e adopt an approach similar to *Seely* and hold that a manufacturer in a commercial relationship has no duty under either a negligence or strict products-liability theory to prevent a product from injuring itself."[75] Damage to a product itself, the Court said, is most naturally understood as a warranty claim.[76] Such damage means simply that the product has not met the customer's expectations.[77]

> Contract law, and the law of warranty in particular, is well suited to commercial controversies of the sort involved in this case because the parties may set the terms of their own agreements. The manufacturer can restrict its liability, within limits, by disclaiming warranties or limiting remedies. In exchange, the purchaser pays less for the product. Since a commercial situation generally does not

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[73] *Id.* (internal citations omitted).
[74] *Id.* at 870-71.
[75] *Id.* at 871.
[76] *Id.* at 872.
[77] *Id.*

> involve large disparities in bargaining power, we see no reason to intrude into the parties' allocation of the risk.[78]

On the other side of the equation, "warranty law sufficiently protects the purchaser by allowing it to obtain the benefit of its bargain."[79] Finally, the Court noted that a warranty action, like any contract action, has a built-in limitation on liability through the agreement of the parties, the *Hadley v. Baxendale* principle, and the general requirement of privity, whereas "[a] tort action could subject the manufacturer to damages of an indefinite amount. . . . In products-liability law, where there is a duty to the public generally, foreseeability is an inadequate brake. Permitting recovery for all foreseeable claims for purely economic loss could make a manufacturer liable for vast sums."[80] To the extent that courts try to limit purely economic damages in tort, "they do so by relying on a far murkier line."[81]

In conclusion, the Court stated that under a contract theory, the only one that was available to the plaintiffs, the contracts in question provided that the plaintiffs "took the ships in 'as is' condition, after inspection, and assumed full responsibility for them, including responsibility for maintenance and repairs and for obtaining certain forms of insurance."[82] "The contractual responsibilities thus were clearly laid out. There is no reason to extricate the parties from their bargain."[83] The plaintiffs were out of luck.

East River thus adopted the approach taken by *Seely*, and rejected the approach taken by *SRP*. Moreover, being a case decided by the Supreme Court of the United States, *East River* gave the ELR a high-level boost.

VI. THE FEDERAL COURTS INTERPRET ARIZONA'S ELR

Up to this point, as we have seen, Arizona's ELR has only been applied in two types of cases, products liability and construction defects, and principally to tame the same tort with which *Seely* had been concerned, the

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[78] *Id.* at 872-73 (citation omitted).

[79] *Id.* at 873.

[80] *Id.* at 874 (citations omitted).

[81] *Id.* at 875. Here the Court cited *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931), a Cardozo opinion involving the issue of whether accountants can be liable to third parties for fraud or negligent misrepresentation causing economic losses, and voicing the same concern in holding that negligent misrepresentation is not sufficient to hold accountants liable to third-parties. Compare Cardozo's earlier opinion in *Glanzer v. Shepard*, 135 N.E. 275 (N.Y. 1922).

[82] 476 U.S. at 875.

[83] *Id.*

super-tort of strict liability. Furthermore, the principal Arizona case on the ELR, *SRP*, had taken a more conservative approach to the Rule than *Seely* or *East River*.[84]

In addition, there had been other cases in Arizona during this time in which plaintiffs had suffered only economic losses but had been allowed to bring tort claims, although these were cases in which the plaintiff and the defendant were not in privity of contract. The most important of these cases was *Donnelly Construction Co. v. Oberg/Hunt/Gilleland* ("*Donnelly*"), in which the Arizona Supreme Court had permitted a contractor to sue a firm of architects in tort for solely economic losses.[85] The architects had prepared plans for improvements to a school on which the contractor had relied in bidding the job. The plans were in error, and the contractor's costs significantly overran its bid. The contractor sued the firm of architects, with which it was not in privity of contract, for negligence and negligent misrepresentation. The fighting issue in the case was not the ELR, but whether, absent privity of contract, the architects owed a duty to the contractor for the breach of which the architects could be held liable in tort. The court, noting that there is no requirement of privity in Arizona to maintain an action in tort, found, on grounds the court later disapproved of in *Gipson*, that the architects did owe the contractor duties in tort.[86]

But now we come to one of those strange turns with which the law sometimes confronts us. *Apollo Group, Inc. v. Avnet, Inc.* ("*Apollo*") was the first of many cases in which federal courts sitting in diversity tried to determine the parameters of Arizona's ELR.[87] The court in *Apollo* interpreted Arizona's narrow ELR broadly, thereby, not surprisingly, broadening it. In *Apollo*, a buyer sued a seller alleging negligent misrepresentation, negligence, breach of warranty, and breach of contract in the purchase of computer hardware that was inadequate to the buyer's needs, seeking purely economic losses. Thus, the context and the torts went

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[84] One more Arizona case applying the ELR before 1995 should be mentioned, *Colberg v. Rellinger*, 770 P.2d 346 (Ariz. Ct. App. 1988), a residential construction defect case in which the only damages were pecuniary and in which the court held that the ELR precluded a claim for negligence.

[85] Donnelly Constr. Co. v. Oberg/Hunt/Gilleland, 677 P.2d 1292 (Ariz. 1984), *rejected on other grounds*, *Gipson v. Kasey*, 150 P.3d 228 (2007).

[86] *See also* St. Joseph's Hosp. & Med. Ctr. v. Reserve Life Ins. Co., 742 P.2d 808 (Ariz. 1987) ("*St. Joseph's Hospital*"), in which a hospital sued an insurance company for services rendered to a patient in reliance on a policy issued by the insurance company to the patient, which was later rescinded. The Arizona Supreme Court upheld the hospital's claim for negligent misrepresentation against the insurance company. Again, the plaintiff and defendant were not in privity of contract. Again, the ELR was not mentioned.

[87] Apollo Grp., Inc. v. Avnet, Inc., 58 F.3d 477 (9th Cir. 1995).

beyond previous applications of the ELR. The Ninth Circuit's opinion began by quoting the very first sentence in the "Introduction" to Professor Gilmore's *The Death of Contract*: "'We are told that Contract, like God, is dead.'"[88] Such an opening suggested a court intent on proving Gilmore wrong. Sure enough, the next sentence of the opinion stated: "In this computer age case, we learn that Contract, at least, is very much alive and well in the Ninth Circuit."[89]

The plaintiff argued that negligent misrepresentation was an exception to the ELR. The court said that while Arizona courts had yet to rule on this question, it nonetheless found *guidance* in the *SRP* decision:

> The language of that decision indicates that the court reads the "economic loss" rule broadly. . . . Moreover, the court's rationale in *Salt River Project* suggests that negligent misrepresentation is not an exception to the "economic loss" rule. As the court explained, "[w]here the potential for danger to person or property is absent, tort principles need not be invoked because the safety incentive policy of tort liability is not implicated." Apollo's claim in no way implicates the safety rationale underlying the law of tort. Apollo seeks to recover purely "benefit of the bargain" and consequential losses. Such foreseeable risks could have been–and indeed were–allocated by the parties in their contractual agreement.
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> Although Arizona has yet to decide this issue, the broad language of *Salt River Project*, when coupled with the rationale underlying that decision, persuades us that negligent misrepresentation–at least as represented by the

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[88] *Id.* at 478. Although only the first sentence is quoted in *Apollo*, the first few sentences from the "Introduction" to *The Death of Contract* are worth quoting:

> We are told that Contract, like God, is dead. And so it is. Indeed the point is hardly worth arguing anymore. The leaders of the Contract is Dead movement go on to say that Contract, being dead, is no longer a fit or worthwhile subject of study. Law students should be dispensed from the accomplishment of antiquarian exercises in and about the theory of consideration. Legal scholars should, the fact of death having been recorded, turn their attention elsewhere.

GILMORE, *supra* note 28, at 3.

[89] *Apollo*, 58 F.3d at 478.

> facts before this panel–would not be excepted from the "economic loss" rule by the Arizona Supreme Court.[90]

The court distinguished *Donnelly* and *St. Joseph's Hospital*, two cases in which the Arizona Supreme Court permitted plaintiffs to sue for economic losses in negligent misrepresentation, on the basis that both cases involved suits by plaintiffs against defendants with whom they were not in contractual privity. "This lack of privity limited the contractual remedies available to plaintiffs, rendering commercial law an inadequate framework in which to resolve plaintiffs' claims. By contrast, here the parties' relationship is clearly governed by the law of contract."[91]

The court also held that plaintiff's *common law* tort-based breach of warranty claim was precluded by the ELR: "Ultimately, Apollo has simply recast what would traditionally be a U.C.C. breach of warranty claim into what it calls a 'common law' tort-based breach of warranty claim to evade the preclusive effect of the 'economic loss' doctrine. Such effort fails. Contract lives!"[92]

As we have seen, *SRP* applied the ELR narrowly as one factor to be considered in a three-factor test in determining whether a claim arising from a defective product should be treated as a tort or contract claim. *Apollo* applied the ELR as a complete bar to tort claims (in a case that was itself beyond the usual products liability case) and to bar a very popular commercial tort, negligent misrepresentation, not previously barred in Arizona under the ELR. *Apollo*, which somehow read the *narrow* holding in *SRP broadly*, was soon followed by other federal courts supposedly interpreting Arizona law, but really interpreting *Apollo*, and similarly giving a *broad* reading to Arizona's ELR.[93]

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[90] *Id.* at 480 (internal citations omitted).

[91] *Id*. at 480 n.4.

[92] *Id.* at 481.

[93] *See* Pegasus Motion Control, LLC v. Heil Co., Inc., CV-96-2851 PHX-JWS (Doc. 148) (D. Ariz. Apr. 2, 1999) (adopting *Apollo*'s broad reading of *SRP* and applying Arizona's ELR to preclude the plaintiff's breach of fiduciary duty claim arising out of an alleged oral joint venture agreement); S.W. Pet Prods., Inc. v. Koch Indus., Inc., 89 F. Supp. 2d 1115 (D. Ariz. 2000), *aff'd in part, rev'd in part, on other grounds,* 32 F. App'x 213 (9th Cir. 2002) (unpublished) (sale of allegedly defective dog food; claims by buyer against seller for intentional misrepresentation, negligent misrepresentation, concealment, negligence, and intentional interference with a prospective economic advantage all precluded); *In re* Jackson Nat'l Life Ins. Co. Premium Litig., 107 F. Supp. 2d 841, 862 (W.D. Mich. 2000) (involving sale of life insurance; privity present; negligent misrepresentation and negligent supervision precluded; court said: "The Blisses' negligent misrepresentation claim does not grow out of circumstances independent of their contractual relationship with Jackson National. It is therefore barred under Arizona law by the economic loss rule."); Marks v. Citizens

VII. *CARSTENS* AND THE HIGH-WATER MARK OF THE ELR

The next major development–and, like *Apollo*, another strange turn in the law–came with a decision of Division One of the Arizona Court of Appeals, *Carstens v. City of Phoenix*, which further *broadened* the ELR, and left lawyers wondering just how far the ELR would extend.[94] William and Deborah Carstens sued the City of Phoenix and three of its building inspectors alleging that the inspectors were grossly negligent because they failed to discover serious construction defects in the house that the Carstens later purchased which caused economic losses.[95] The Court of Appeals found that, while the defendants did owe the plaintiffs a duty of care, the ELR precluded a tort claim.[96] *Carstens* broadened the ELR in the following ways:

First, the court formulated the ELR in very broad terms:

> *The economic loss rule bars a party from recovering economic damages in tort unless accompanied by physical harm, either in the form of personal injury or secondary property damage*. The rule stems from the principle that contract law and tort law each protect distinct interests. . . . The economic loss rule thus "serves to distinguish between tort, or duty-based recovery, and contract, or promise-based recovery, and clarifies that economic losses cannot be recovered under a tort theory."[97]

Read literally, as it was to be read by some subsequent courts, the ELR, as thus formulated, was a simple rule that barred *any* plaintiff from recovering *any* economic damages via *any* tort claim.

Second, *Carstens* applied the ELR to bar tort claims by plaintiffs against defendants with whom they were not in privity of contract, holding that the ELR would apply to bar tort claims even in cases in which the

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Commc'ns Co., 2003 WL 25712884, at *8, *9 (D. Ariz. 2003) (employment case; privity present; conversion precluded; court said, citing *In re Jackson*: "Because Mr. Marks' conversion claim 'does not grow out of circumstances independent of [his] contractual relationship with [Citizens] [,] [i]t is therefore barred under Arizona law by the [ELR]." The Court did not dismiss the plaintiff's fraud claim under the ELR in part because it did not have sufficient information to conclude whether "[t]he alleged fraud is intertwined with the alleged breach of contact . . . .").

[94] Carstens v. City of Phx., 75 P.3d 1081 (Ariz. Ct. App. 2003).

[95] *Id.* at 1082.

[96] *Id.* at 1085.

[97] *Id.* at 1083-84 (internal citations omitted) (emphasis added).

plaintiff did not have a contract claim against the alleged tortfeasor.[98] In *Carstens* itself, the plaintiffs did not have any contract claims against the defendants because there was no privity of contract between them. Explaining this point, and citing *Colberg*, the court again formulated the Rule in the broadest terms:

> Contrary to the Carstens' characterization, Arizona courts have never held that the application of the economic loss rule depends upon the plaintiff also having a viable contract claim against the defendant. Instead, irrespective of a plaintiff's contractual claims against a defendant, *the rule bars recovery of economic damages in tort because such damages are not cognizable in tort absent actual injury*. In this case, because the Carstens allege purely economic losses, their damages sound in contract, and, presumably, may be asserted against those defendants with whom the Carstens are in privity. Thus, the rule does not prevent the Carstens from recovering their economic losses, but merely restricts them to suits against those defendants actually liable in contract.[99]

The court's application of the ELR to parties not in privity of contract was a radical move. Of course parties not in privity would not have any contract claims as against each other. The purpose of the ELR was to limit parties to their contractual remedies where policy reasons justified such a limitation. What purpose was to be served by applying the ELR to parties who did not have a contractual relationship in the first place? *Carstens* apparently wanted to extend the ELR for a completely different purpose: to eliminate tort claims entirely between any parties, whether in a contractual relationship or not, where the damages sought were purely economic. This was consistent with *Carstens*'*s* formulation of the ELR. Such an application of the ELR, as later courts would see, would eliminate entire torts whose principal purpose is precisely to provide recovery for economic losses.[100]

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[98] *Id.* at 1085.

[99] *Id.* at 1085 (emphasis added).

[100] *Carstens* also went on the hold that the ELR is not limited to cases in which homeowners are faced with only non-dangerous defects. *Carstens* made it clear that the ELR was to be a "bright-line" rule: "because any construction defect can arguably be said to present a safety hazard, recognizing such an exception would undermine the bright-line test of actual injury set out by the economic loss rule." *Id.* at 1086 n.3. In these respects, *Carstens* took an approach contrary to *SRP*. Finally, again citing *Colberg*, *Carstens* also

A number of cases applying the ELR after *Carstens* still insisted on privity. But in any event, after *Carstens*, as after *Apollo*, courts interpreting Arizona's ELR read the Rule very broadly indeed.[101] This period may have been the high-water mark of the Arizona ELR.

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attempted to distinguish *Donnelly*. The distinction was less than clear. Part of the distinction was between the defendants in *Carstens*, who were City building inspectors, and the defendants in *Donnelly*, who were architects: "[W]e question whether the City building inspectors can be considered 'professionals' in the sense that architects are professionals." *Id.* at 1087 n.5. While the Court of Appeals in *FAH* also accepted this distinction, the Supreme Court in *FAH* rejected it. *See* discussion *infra* Part X.

[101] *See* Hayden Bus. Ctr. Condo. Ass'n v. Pegasus Dev. Corp., 105 P.3d 157 (Ariz. Ct. App. 2005), *disapproved on other grounds* Lofts at Fillmore Condo. Ass'n v. Reliance Commercial Constr., Inc., 190 P.3d 733 (Ariz. 2008) (construction defect case; no privity; negligence precluded); Precision Safety Innovations, Inc. v. Branson Ultrasonic Corp., 2005 WL 5801513 (C.D. Cal. 2005) (equipment lease; some parties in privity, some not; negligence precluded); Wojtunik v. Kealy, 2006 WL 2821564 (D. Ariz. 2006); Wojtunik v. Kealy, 394 F. Supp. 2d 1149 (D. Ariz. 2005) (sale of company and merger; no privity; negligent misrepresentation and common law fraud precluded; court said:

> Notwithstanding that Arizona recognizes a tort claim for negligent misrepresentation as set forth in RESTATEMENT (SECOND) OF TORTS § 552, Kealy argues, and the Court agrees, that the negligent misrepresentation claim is barred as a matter of law by Arizona's economic loss rule because it is in essence based on alleged non-performance under the Merger Agreement and is thus in reality a breach of contract claim masked as a tort claim.

394 F. Supp. 2d at 1171); QC Constr. Prod., LLC v. Cohill's Bldg. Specialties, Inc., 423 F. Supp. 2d 1008 (D. Ariz. 2006) (sale of product; privity present; interference with business relationships, fraud and deceit, and unfair competition precluded; court said:

> QC cites the unpublished decision [Aventis Tech. Corp. v. J.P. Morgan Chase Bank, 2004 WL 5137578 (D. Ariz. 2004)] for the proposition that the economic loss rule does not bar QC's fraud claim . . . . The *Aventis* court, however, did not recognize that an important aspect of the economic loss rule is privity . . . . In this case, however, there is a contract delineating the rights and duties of each party. Thus, the economic loss rule applies and QC may not assert tort claims for its purely pecuniary damages.

423 F. Supp. 2d at 1015, n. 7; Aspect Sys., Inc. v. Lam Research Corp., 2006 WL 2683642 (D. Ariz. 2006) (sale of parts and licensing; privity present; conversion and tortious interference with contract and with business expectancy precluded); Finepoint Innovations, Inc. v. A.T. Cross Co., 2006 WL 3313688 (D. Ariz. 2006) (pen license and supply agreement; privity present; intentional interference with business expectancy precluded).

VIII. THE FEDERAL BACKLASH

We have seen the ELR shift from a limited rule applied in products liability and construction defect cases to a limited number of torts, principally, strict liability and negligence, to an expansive rule applied in multiple settings to virtually every commercial tort. But now we encounter a backlash to the broad reading of the ELR given by *Apollo*, *Carstens*, and other courts. The backlash occurred in federal court cases, which was ironic, given that it had been the federal courts which had given the Arizona ELR the broadest readings.

As early as 2004, in *Aventis Technologies Corp. v. JP Morgan Chase Bank*, a case involving the provision of check processing services in which there was no privity, the court held that a claim of negligent misrepresentation was not precluded.[102] The court, while discussing *Carstens*, accepted *Donnelly*, a case in which tort claims had been permitted in the absence of privity, as an exception to the ELR, saying: "Claims of negligent misrepresentation are pursued in Arizona in cases where there is no personal injury or property damage. . . . In sum, this court concludes that claims seeking to recover purely pecuniary losses based on negligent misrepresentation are not foreclosed by the 'economic loss' rule."[103]

Then in 2006 and 2007, four particularly thoughtful district court opinions expressed concern over the breadth of interpretation given to Arizona's ELR: *Giles Construction, Inc. v. Commercial Federal Bank*[104]; *KD & KD Enterprises, LLC v. Touch Automation*[105]; *Moshir v. Patchlink Corp.*[106]; and *Evans v. Singer*[107]. These cases and *Aventis* had in common a concern that too broad an application of the ELR would in effect eliminate tort causes of action that were designed, at least in some circumstances, precisely to provide recovery for economic losses.

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[102] Aventis Tech. Corp. v. JP Morgan Chase Bank, 2004 WL 5137578 (D. Ariz. 2004).

[103] *Id.* at 3. *See* J-Squared Tech., Inc. v. Motorola, Inc., 364 F. Supp. 2d 449 (D. Delaware 2005) (involving an alleged breach of a computer manufacturers' representative agreement between Motorola and commissioned sales agents, in which privity was present, and in which the court held that negligent misrepresentation was not precluded by the ELR, saying: "the UCC does not apply. Furthermore, plaintiffs' claims for negligent misrepresentation are not in conflict with the parties' contract. . . . Therefore, plaintiffs' claim would not be covered by the contract and they could not bring it in a contract action." Motorola, 364 F. Supp. 2d at 454.).

[104] Giles Constr., Inc. v. Commercial Fed. Bank, 2006 WL 2711501 (D. Ariz. 2006).

[105] KD & KD Enter., LLC v. Touch Automation, LLC, 2006 WL 3808257 (D. Ariz. 2006).

[106] Moshir v. Patchlink Corp., 2007 WL 505344 (D. Ariz. 2007).

[107] Evans v. Singer, 518 F. Supp. 2d 1134 (D. Ariz. 2007).

Giles was a case in which a general contractor, Giles, sought compensation for construction and improvements to a medical facility.[108] Giles did not sue the owner of the facility with which it had contracted, however, but the construction lender, with which Giles was not in privity of contract.[109] The court said, "[T]he economic loss rule has received limited application in Arizona courts," having been recognized only in construction defect cases and as one factor to consider in determining whether a claim arising from a defective product should be treated as a contract or tort claim.[110] "Other than construction and product defect cases, however, the Arizona courts have not applied the economic loss rule as a bar to the recovery of economic damages in tort cases. To the contrary, Arizona courts have issued numerous decisions permitting the recovery of purely economic losses in tort actions."[111] In fact, federal courts "have construed Arizona's economic loss rule more broadly than the Arizona courts."[112] The court said that *Southwest Pet Products* and *Wojtunik* were "not firmly supported by Arizona law, however, and the district court in this case is not required to treat these cases as precedential."[113] The court accepted the recommendation of the Magistrate that, in part "[g]iven the discrepancy between Arizona and federal law on the application of the economic loss rule," the court not reach the issue of whether the ELR barred the plaintiff's recovery in the case.[114]

In *KD*, a case involving the sale of an automated DVD retail system from the defendant to the plaintiff, the court allowed a claim for fraud in the inducement where the parties were in contractual privity and the plaintiff experienced pure economic loss.[115] The court began by noting that the ELR had arisen in the context of tort claims for strict products liability and

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[108] *Giles*, 2006 WL 2711501, at *3.

[109] *Id.* at *3-4.

[110] *Id.* at *9 (citing Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp., 694 P.2d 198, 215 (Ariz. 1984)).

[111] *Id.* at *10 (citing Paradigm Ins. Co. v. Langerman Law Offices, P.A., 24 P.3d 593 (Ariz. 2001); St. Joseph's Hosp. & Med. Ctr. v. Reserve Life Ins. Co., 154 Ariz. 307, 742 P.2d 808 (1987); Donnelly Constr. Co. v. Oberg/Hunt/Gilleland, 677 P.2d 1292 (Ariz. 1984); Fillmore v. Maricopa Water Processing Sys., Inc., 120 P.3d 697 (Ariz. Ct. App. 2005); Kuehn v. Stanley, 91 P.3d 346 (Ariz. Ct. App. 2004); Luce v. State Title Agency, Inc., 950 P.2d 159 (Ariz. Ct. App. 1997); Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317 (Ariz. Ct. App. 1996)).

[112] *Giles*, 2006 WL 2711501, at *10 (citing Apollo Grp., Inc. v. Avnet, Inc., 58 F.3d 477 (9th Cir. 1995); S.W. Pet Prods., Inc. v. Koch, 32 F. App'x 213 (9th Cir. 2002); Wojtunik v. Kealey, 2006 WL 2821564 (D. Ariz. 2006)).

[113] *Id.*

[114] *Id.*

[115] KD & KD Enter., LLC v. Touch Automation, LLC, 2006 WL 3808257 (D. Ariz. 2006).

negligence, and under *SRP*, there was no blanket disallowance of tort recovery for economic losses but only a fact-specific inquiry to determine whether the facts preponderate in favor of the application of tort law or commercial law exclusively or a combination of the two.[116] The court continued:

> Because strict products liability and negligence are torts, defendants seek to extend the economic loss inquiry to all torts, even those, like fraud, specifically designed for economic harm. This logical leap would basically eviscerate the tort of fraud, for the only damages one has in fraud are economic. The law cannot be so twisted.
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> A broad application of the economic loss rule to preclude all tort claims, including fraud, as defendants urge, fails to recognize that both contract and fraud can arise out of commercial transactions, and that each serves a complementary, albeit distinct, purpose. The source and scope of the duty in tort and contract differ, as well as the basis for liability. . . . The tort of fraudulent inducement, for example, recognizes a duty to abstain from inducing another to enter into a contract through the use of fraudulent misrepresentations. This duty is separate, distinct, and in addition to, the duties established by the contract itself.
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> In addition, warranty claims may be disclaimed according to the negotiations of the parties in allocating risk of nonperformance. In contrast, the duty not to engage in fraud is imposed by law, regardless of the contract, and may not be disclaimed because parties cannot, and for public policy reasons should not, be expected to contemplate the risk of fraud in their negotiations. A party to a contract cannot reasonably calculate the possibility that the other party will deliberately misrepresent critical terms in that contract.[117]

The court noted that the key rationale underlying the ELR presupposes that there has been a fair and equitable negotiation of the allocation of risk

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[116] *Id.* at *1.
[117] *Id.* at *1-2 (internal citations omitted).

between the parties.[118] Assuming that, parties should be held to the terms of their agreement.[119] If a party is then allowed to sue in tort when the deal goes badly, it would effectively rewrite the agreement and allow that party to receive a benefit that was not part of the bargain.[120] Fraudulent misrepresentation, however, undermines the ability of parties to negotiate freely, and therefore negates the presumption that a fair and equitable negotiation has occurred.[121] It would be unreasonable to restrict a party to contractual limitations of liability when fraudulent misrepresentation resulted in an unequal and unfair bargaining process.[122] The court went even further, saying that fraud and contract claims are independent and compatible even when the fraudulent allegations concern the quality of the product.[123] The court concluded:

> In sum, elimination of fraud by the economic loss rule is not only unsupported by the principles underlying the economic loss rule, but is unsound for policy reasons. To hold otherwise would relieve a party of liability for its intentionally fraudulent behavior. We doubt that the Arizona Supreme Court would extend the economic loss doctrine beyond the rule's purpose. Its extension to the tort of fraud would eliminate the tort of fraud.[124]

In *Moshir*, the plaintiff was employed by the defendant as its President, and then terminated.[125] The dispute concerned plaintiff's severance payment.[126] The defendants sought the dismissal of a fraud claim on the basis of the ELR, which, they argued, "provides that 'an individual who suffers economic damages as a result of the conduct of another cannot recover those losses in tort.'"[127] The opinion in *Moshir*, as in *KD*, was written by Judge Martone, who echoed the same themes.[128] He noted that Arizona courts had applied the ELR in the context of construction liability, and federal courts had extended it to non-products liability tort claims and

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[118] *Id.* at *2.
[119] *Id.*
[120] *Id.*
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] *Id.* at *3.
[125] Moshir v. Patchlink Corp., 2007 WL 505344, at *1 (D. Ariz. 2007).
[126] *Id.*
[127] *Id.* at *5.
[128] *See id.* at *1.

used it to foreclose claims of negligent misrepresentation.[129] However, citing *SRP*, he said in Arizona there is no "'blanket disallowance of tort recovery for economic losses.'"[130] Citing his own opinion in *KD*, Judge Martone said:

> Central to our conclusion is the fact that contractual remedies for fraud will be either insufficient, or, more likely, unavailable. In order to recover in contract on a fraud claim based on a promise made without present intention to perform, a party must first foresee, and then contract around, the very fraudulent statements that induced it into the contractual relationship. To impose that sort of foresight on contracting parties is both impractical and unreasonable. The economic loss rule has no logical application to the tort of fraud, which by its very nature is designed for stand alone economic injury. Therefore, we conclude that Arizona's economic loss rule does not bar plaintiff's fraud claim, and deny defendants' motion on this ground.[131]

Evans, written by Judge Bolton, presented a very thorough and scholarly review of the development of Arizona's ELR, with the ultimate goal of determining if it precluded a claim of negligence brought by purchasers of commercial real estate against their own real estate agent and the seller's broker, who were both employed by defendant Realty Experts, Inc.[132] The court noted the principle benefit of an ELR is "to prevent tort law from intruding on and potentially enveloping contract law."[133]

However, the court, as in *Aventis*, *Giles*, *KD*, and *Moshir*, expressed a concern over extending the ELR to in effect wipe out all tort claims for economic losses.[134] "It is easy to see . . . that the economic loss rule cannot simply be applied as a blanket restriction precluding tort-based lawsuits by plaintiffs who have suffered solely economic loss."[135] The court cited the Ninth Circuit's similarly thorough opinion in *Giles v. General Motors*

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[129] *Id.* at *5.
[130] *Id.* (quoting Salt River Project v. Westinghouse Elec. Corp., 694 P.2d 198, 209 (Ariz. 1984)).
[131] *Id.* at *6.
[132] Evans v. Singer, 518 F. Supp. 2d 1134 (D. Ariz. 2007).
[133] *Id.* at 1138-39.
[134] *Id.* at 1139.
[135] *Id.*

Acceptance Corp.,[136] applying Nevada law, explaining that "'[t]ort law has traditionally protected individuals from a host of wrongs that cause only monetary damage,'" including, for example, professional negligence actions, such as legal malpractice, and business torts.[137] The court noted that the defendants had cited in their motion to dismiss numerous recent Arizona federal court decisions extending the reach of the ELR:

> After a thorough review of the controlling state law, the Court concludes that Arizona courts do not read the economic loss rule as broadly as some of the recent federal district court decisions have asserted. While the Arizona Supreme Court may choose at some future date to give a broad reading to the economic loss rule, it has yet to do so. In situations "'[w]here the state's highest court has not decided an issue, the task of the federal courts is to predict how the state high court would resolve it.'" However, "[i]n assessing how a state's highest court would resolve a state law question-absent controlling state authority-federal courts look to existing state law *without predicting potential changes* in that law."[138]

> Recently, the Ninth Circuit observed that "outside the product liability context, [economic loss] doctrine has produced difficulty and confusion." . . . It seems that with the recent flurry of Arizona federal district court decisions, Arizona may find itself in an equally precarious quagmire [like that into which the Florida courts had sunk] absent an authoritative pronouncement by its appellate courts. To fully understand how Arizona courts and Federal courts have drifted apart in their handling of this issue, it is necessary to briefly examine the evolution of the rule.[139]

The court then proceeded to do just that, in meticulous detail. The court noted that no reported Arizona state appellate court decision had ever applied, or even discussed, the ELR outside of the areas of products liability or construction defects.[140] The court said:

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[136] Giles v. Gen. Motors Acceptance Corp., 494 F.3d 865, 875 (9th Cir. 2007).
[137] *Evans*, 518 F. Supp. 2d at 1139 (quoting *Giles*, 494 F.3d at 875).
[138] *Id.* (internal citations omitted).
[139] *Id.* at 1140 (internal citations omitted).
[140] *Id.* at 1142.

> The independent development of the economic loss rule case law in the distinct areas of construction defects and products liability demonstrates that economic loss is not a concept that easily migrates from one unique factual circumstance to another. Rather, it is a precise tool used to uphold traditional separation between contract and tort in areas of the law that are particularly susceptible to blurring of the two.[141]

While approving the result reached in *Apollo*, the *Evans* court criticized the language and rationale of that case, which referred to the "'broad language of *Salt River Project:*'"

> yet provided no citation to this "broad language," leaving this Court to ponder precisely where such language is found. . . . *Salt River Project* provided anything but a broad reading of the economic loss rule. . . . in a 2007 case construing Nevada's economic loss jurisprudence, the Ninth Circuit reflected on the uneccessarily confusing state of the economic loss rule in many jurisdictions. Pointing to overly broad statements as a cause of such confusion, it singled out Apollo as a chief contributor to the difficulty. . . . [T]he court opined, "such broad statements are not accurate. Tort law has traditionally protected individuals from a host of wrongs that cause only monetary damages."
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> . . . .
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> . . . the tort cause of action brought in Apollo–negligent representation–is different from that asserted in Salt River Project – strict products liability–and thus the three-part test, which was intended to apply to defective products, was inapposite.[142]

Evans noted that in the wake of *Apollo*, U.S. District Courts had issued no fewer than thirteen decisions discussing Arizona's ELR, "many of them expanding the application of the rule beyond those limited circumstances articulated in *Salt River Project* and *Woodward*."[143]

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[141] *Id.*

[142] *Id.* at 1142-43 (quoting Apollo Grp., Inc. v. Avnet, Inc., 58 F.3d 477, 480 (9th Cir. 1995)) (internal citations omitted).

[143] *Id.* at 1143-44 (citing and discussing *Aventis*, *KD*, *Moshir*, and *Giles*).

The court noted that the defendants in *Evans* had asked the court to "'make an exception to the [ELR] for negligence claims against a real estate salesperson.'"[144] The court's reading of the history of the ELR led it to reject that argument, saying instead that:

> In reality, Plaintiffs are not seeking an exception because, as the Arizona Supreme Court has observed, in Arizona there is no "blanket disallowance for tort recovery for economic losses." Instead it is the Realty Defendants who seek an exception in the form of an expansion of existing state law. Thus, the Court will address whether such an expansion is warranted.[145]

In the end, the court decided that "such an expansion"[146] was not warranted.[147] The difficulties faced by courts in deciding whether to apply the ELR *circa* 2007 may be sensed from *Evans*' ultimate decision in the case before it. After reviewing and analyzing the history of the ELR at length, weighing the parties' respective arguments, and criticizing courts which had applied the Rule broadly, the court ultimately made its decision quickly and briefly, as follows:

> While both parties have made reasonable aruments based upon the somewhat contradictory case law, this Court cannot expand state law based on what amounts to merely a somewhat persuasive argument. If the court were convinced that the Arizona Supreme Court would expand the economic loss rule under these circumstances, then applying the rule to bar Plaintiffs' claim would be appropriate. However, the Court is unconvinced that, given these circumstances, the Arizona high court would greatly expand the purview of the rule beyond the two distinct areas found in the cases. Therefore, faced with a line of state precedent encompassing two decades of limited application, the Court adopts Arizona's narrow view of the

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[144] *Id.* at 1145 (quoting John and Jane Doe Wee, Richard and Jane Doe Hanten, and Realty Experts, Inc.'s Reply in Support of its Motion to Dismiss Count VI of Plaintiffs' Second Amended Complaint, at 1-2, Evans v. Singer, 518 F. Supp. 2d 1134 (D. Ariz. 2007) (No. 2:06-cv-00706-SRB), 2007 WL 5239163.

[145] *Evans*, 518 F. Supp. 2d at 1145 (internal citations omitted).

[146] *Id.*

[147] *Id.* at 1147.

> economic loss rule, and finds that Plaintiffs have stated a claim for negligence against the Realty Defendants.[148]

While the criticisms leveled by these *federal backlash* cases at an overbroad application of the ELR can themselves be read broadly, the holdings of the cases were of course limited to their facts. What is more, the Arizona Supreme Court remained silent on the issues raised by the cases, and other cases still applied the ELR broadly, and so many questions remained unresolved.

IX. OTHER CASES IN 2007-2009

A number of other cases involving the ELR were decided in the period from 2007 to 2009, and reached disparate results.[149]

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[148] *Id.*

[149] Hall Family Props., Ltd. v. Gosnell Dev. Corp. of Ariz., 2007 WL 1238923 (D. Ariz. 2007) *rev'd*, 331 F. App'x 440, 2009 WL 1241664 (9th Cir. 2009) (citing *Pegasus*, the Bankruptcy Court held that the ELR precluded a claim for breach of fiduciary duty in this partnership litigation. On appeal, citing *Pegasus*, *Apollo*, *Carstens*, and *Hayden*, the District Court affirmed.). On further appeal, the Ninth Circuit reversed, stating:

> To date, Arizona appellate courts have not addressed whether the economic loss rule could bar a breach of fiduciary duty claim. However, the Court of Appeals of Arizona has on several occasions permitted a partner to recover (or at least pursue) solely pecuniary damages from another partner that breached his or her fiduciary duty to the partnership, while acting under an oral or written partnership agreement, with no mention of the economic loss rule. At the same time, Arizona state courts have limited application of the economic loss rule to product liability and construction defect cases. We find no basis for believing that the law of Arizona currently allows a broader application. Nor do the principles behind the rule urge its application here.

331 F. App'x at 441 (citations omitted); *In re* Don's Making Money, LLP v. Estate of Deihl, 2007 WL 2784351 (D. Ariz. Bankr. Ct. 2007) (negligent misrepresentation precluded); Best Buy Stores, L.P. v. Developers Diversified Realty Corp., 2007 WL 4191717 (D. Minn. 2007) (leases of real estate; privity present; fraud not precluded); Tulsa Propulsion Engines, Inc. v. Honeywell Int'l, Inc., 2007 WL 4345207 (E.D. Okla. 2007) (breach of sales contract; privity present; negligence precluded); Mear v. Sun Life Assurance Co., 2008 WL 245217 (D. Mass. 2008) (sale of annuities; privity present; negligence and negligent misrepresentation precluded); Arce-Mendez v. Eagle Produce P'ship Inc., 2008 WL 659812, at *4 (D.Ariz. 2008) (employment case; privity present; fraud precluded; court said: "These losses are identical to the losses Plaintiffs seek to recover under their breach-of-contract claim. Consequently, the claim for fraudulent misrepresentation is barred by the economic loss doctrine."); Cumis Ins. Soc'y, Inc. v. Merrick Bank Corp., 2008 WL 4277877 (D. Ariz. 2008) (data security breach case; negligent misrepresentation, negligence, and conversion not precluded); Frank Lloyd Wright Found. v. Kroeter, 2008 WL 5111092 (D. Ariz. 2008)

One of the cases decided during this period deserves special mention. In *Valley Forge Insurance Co. v. Sam's Plumbing, LLC* ("*Valley Forge*"), Division Two of the Court of Appeals reversed the trial court and held that a subrogated negligence claim was not precluded by the ELR.[150] The court embraced *SRP*, and rejected *Carstens*, which had been decided by Division One of the Court of Appeals.[151] The court noted that while *Seely* and *East River* had adopted a *per se* rule for determining whether a claim sounds in tort or contract, *SRP* had expressly rejected that approach in favor of a case-by-case analysis.[152] The court said, "[t]hus, *Carstens* not only set forth an economic loss rule at odds with the analysis required by our supreme court in *Salt River*, but it anchored its reasoning in a stream of legal authority expressly rejected in *Salt River*, " and concluded that "Sam's Plumbing had a general duty under tort law, separate from any contractually assumed obligation, to exercise reasonable care in any work undertaken." [153]

Another case decided before *FAH* was *1800 Ocotillo, LLC v. The WLB Group, Inc*.[154] The issue presented in the case was whether a liability limitation clause in a professional services agreement was enforceable.[155] *Ocotillo* was not an ELR case, but in upholding the clause, it captured the then spirit of the ELR:

> Courts . . . are hesitant to declare contractual provisions invalid on public policy grounds. Our law generally presumes, especially in commercial contexts, that private parties are best able to determine if particular contractual terms serve their interests. Society also broadly benefits from the prospect that bargains struck between competent parties will be enforced. Accordingly, absent legislation specifying that a contractual term is unenforceable, courts should rely on public policy to displace the private ordering of relationships only when the term is contrary to an

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(intellectual property licensing agreement; privity not present; fraud not precluded); Ares Funding, L.L.C. v. MA Maricopa, L.L.C., 602 F. Supp. 2d 1144 (D. Ariz. 2009) (commercial mortgage brokerage case; fraud in the inducement and conversion not precluded; tortious interference with contract precluded; civil conspiracy to commit fraud and conversion not precluded; civil conspiracy to commit tortious interference precluded).

[150] Valley Forge Ins. Co. v. Sam's Plumbing, L.L.C., 207 P.3d 765 (2009).

[151] *Id.*

[152] *Id.* at 769.

[153] *Id.* (internal citations omitted).

[154] 1800 Ocotillo, L.L.C. v. WLB Grp., Inc., 196 P.3d 222 (Ariz. 2008).

[155] *Id.*

> otherwise identifiable public policy that clearly outweighs any interests in the term's enforcement.[156]

X. FLAGSTAFF AFFORDABLE HOUSING

The difficulty courts have with the application of the ELR can again be seen in the history of the *FAH* case itself, where the Supreme Court reversed the Court of Appeals, which had reversed the trial court.[157]

To briefly give the facts of the case, the plaintiff-owner, Flagstaff Affordable Housing Limited Partnership, entered into a contract with the defendant-architect, Design Alliance, Inc., for the design of apartments.[158] The apartments were constructed in accordance with the architectural plans and specifications.[159] However, subsequent to construction, the U.S. Department of Housing and Urban Development filed a complaint against the owner for housing discrimination, claiming that the design and construction of the apartments violated certain Fair Housing Design Construction requirements.[160] The owner was forced to incur substantial expense to remedy the design deficiencies.[161] The owner sued the architect alleging breach of contract and professional negligence.[162] No personal injury or property damage had occurred, and the owner sought only economic losses as damages.[163] The owner subsequently agreed to withdraw its breach of contract claim because of the statute of repose, but argued that the ELR did not apply to professional negligence claims.[164]

A. FAH: The Trial Court

The trial court granted the architect's motion to dismiss, distinguishing *Donnelly* on the basis that in *FAH*, the parties were in privity of contract, so that "*Donnelly's* reasoning and allowance of a claim based in negligence does not apply."[165] The trial court cited as persuasive authority Judge Rosenblatt's decision in *Wojtunik v. Kealy*, even though it was based on a

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[156] *Id.* at 224 (internal citations omitted).
[157] Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc., 223 P.3d 664, 673 (Ariz. 2010).
[158] *Id.* at 665.
[159] *Id.*
[160] *Id.*
[161] *Id.* at 666.
[162] *Id.* at 665.
[163] *Id.* at 666.
[164] *Id.*
[165] *Id.* at 127 (citing Donnelly Constr. Co. v. Oberg, 677 P.2d 1292, 1294 (Ariz. 1984).

claim of negligent misrepresentation, not professional negligence, and found that no "special [professional] relationship" exception to the ELR applied.[166]

B. FAH: The Court of Appeals

The Court of Appeals reversed the trial court.[167] The court argued that while federal courts applying Arizona law had applied the ELR in a wide variety of contexts, Arizona courts had applied the ELR in only two categories of disputes, construction defects and products liability.[168] The court drew a distinction between cases involving actual defects in the physical construction of a home or building, and a professional negligence action arising from the alleged negligent *design* of apartments.[169] "This is neither a construction defect case nor a products liability case."[170] The Court of Appeals held that the ELR did not apply to this claim for professional negligence against a design professional.[171]

The fundamental reason for the Appellate Court's reluctance to apply the ELR to the case before it was its understanding of the essential nature of actions to recover for breach of a professional's duties.[172] According to cases like *Barmat v. John & Jane Doe Partners A-D*, such cases do not "aris[e] out of contract," that is, the breach of promises made by one party to the other, but rather arise out of tort, that is, the breach of legal duties imposed by law.[173] Therefore it would be anomalous to apply the ELR to them.

C. Barmat *and Its Progeny: An Interlude*

While *Barmat* dealt with the more limited issue of whether a legal malpractice action "arises out of a contract" so as to be eligible for an award of attorney's fees pursuant to A.R.S. § 12-341.01(A), it spoke in broad terms.[174] It began by drawing a distinction between contracts "implied in fact" and those "implied in law."[175] The former are true contracts.[176] The

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[166] *Id.* (citing Wojtunik v. Kealy, 394 F. Supp. 2d 1149 (D. Ariz. 2005)).
[167] *Id.*
[168] *Id.* at 128.
[169] *Id.*
[170] *Id.*
[171] *Id.* at 128-29.
[172] *See id.* at 129.
[173] Barmat v. John & Jane Doe Partners A-D, 747 P.2d 1218, 1222 (Ariz. 1987).
[174] *Id.* at 1220 (citing ARIZ. REV. STAT. ANN. § 12-341.01(A) (2010)).
[175] *Id.*

distinction between an "express contract" and a contract "implied in fact," the court said, is that in the former "the undertaking is made by words written or spoken, while in the latter conduct rather than words conveys the necessary assent and undertakings."[177] In contrast, contracts "implied in law" are not true contracts at all, but obligations created by the law without regard to expressions of assent by either words or acts to achieve a just result in a case.[178] They are legal fictions, "quasi contracts."[179] *Barmat* gives as an example of such a "contract" in the professional services area *Cotnam v. Wisdom*, in which a physician treated an injured, unconscious patient.[180] Since A.R.S. § 12-341.01(A) covers actions arising out of either express or implied contracts, there is some doubt, *Barmat* said, as to whether the term "implied contract" includes those that are only a legal fiction.[181]

Barmat said that in certain relationships–contracts arising from relationships between professionals and their clients, and other special relationships long recognized at common law, such as those between innkeeper and guest, common carrier and passenger, bailor and bailee–the law imposes special duties to all within the foreseeable range of harm as a matter of public policy, regardless of whether there is a contract, express or implied, and generally regardless of what its covenants may be, citing *SRP* as an example of the reluctance of the law to uphold contractual provisions that negate tort duties.[182] *Barmat* continued:

> As a matter of public policy, attorneys, accountants, and other professionals owe special duties to their clients, and breaches of those duties are generally recognized as torts. The essential nature of actions to recover for the breach of such duties is not one "arising out of contract," but rather one arising out of tort-breach of legal duties imposed by law. The cause of action for malpractice would exist even if the client or patient had expressly declined the professional's services. In these cases, where the cause of action does not depend on the existence of a contract, express or implied in fact, the "but for" test of *Sparks* is not

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[176] *Id.*
[177] *Id.* (citing 1 A. CORBIN, CORBIN ON CONTRACTS § 18, at 39 (1963)).
[178] *Id.* (citing 1 A. CORBIN, CORBIN ON CONTRACTS § 19, at 44 (1963)).
[179] *Id.* at 1221.
[180] Cotnam v. Wisdom, 104 S.W. 164, 165 (Ark. 1907).
[181] *Barmat*, 747 P.2d at 1221 (citing ARIZ. REV. STAT. ANN. § 12-341.01(A) (2010)).
[182] *Id.*

> satisfied. Accordingly, we hold that A.R.S. § 12-340.1(A) is not applicable to such actions.[183]

Barmat accepted the view taken by *Lewin v. Miller Wagner*:

> The rationale there, as we read the opinion, is that where the implied contract does no more than place the parties in a relationship in which the law then imposes certain duties recognized by public policy, the gravamen of the subsequent action for breach is tort, not contract. . . .We approve that view.[184] Courts in other states have reached similar conclusions. . . . [185]

But, we might ask, what about express or implied in fact promises made in the context of professional relationships?

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[183] *Id.* at 1222 (internal citation omitted).

[184] *Id.* (citing Lewin v. Miller Wagner & Co., Ltd., 725 P.2d 736 (Ariz. Ct. App. 1986); Western Techs., Inc. v. Sverdrup & Parcel, Inc., 739 P.2d 1318 (Ariz. Ct. App. 1986)) (citations omitted).

[185] *Barmat*, 747 P.2d at 1222 (citation omitted). It is not clear why *Barmat* bothered to draw the distinction between contracts "implied in fact" and contracts "implied in law." There certainly is such a distinction. The former are true contracts. As RESTATEMENT (SECOND) CONTRACTS § 4 puts it: "A promise may be stated in words either oral or written, or may be inferred wholly or partly from conduct." Comment *a* states: "*a. Express and implied contracts*. Contracts are often spoken of as express or implied. The distinction involves, however, no difference in legal effect, but lies merely in the mode of manifesting assent." Comment *b* states:

> *b. Quasi-contracts*. Implied contracts are different from quasi-contracts, although in some cases the line between the two is indistinct. . . . Quasi-contracts have often been called implied contracts or contracts implied in law; but, unlike true contracts, quasi-contracts are not based on the apparent intention of the parties to undertake the performances in question, nor are they promises. They are obligations created by law for reasons of justice. Such obligations were ordinarily enforced at common law in the same form of action (assumpsit) that was appropriate to true contracts, and some confusion with reference to the nature of quasi-contracts has been caused thereby. They are dealt with in the Restatement of Restitution.

Id.

But the distinction between contracts "implied in fact" and contracts "implied in law" is not really relevant to the point *Barmat* went on to make, namely, that in certain relationships, the law "implies" or imposes certain duties and that these are tort, not contract, duties. They are *duties* "implied in law," but they are not *contracts* "implied in law," "quasi contracts." Quasi contracts arise neither in tort or in contract.

> Where . . . the duty breached is not imposed by law, but is a duty created by the contractual relationship, and would not exist "but for" the contract, then breach of either express covenants or those necessarily implied from them sounds in contract. . . . The essence of such actions arises "out of a contract," eligible for an award of fees under the statute.[186]

But could we not say that the duty to perform professional services in a competent manner is a promise *implied in fact* in every contract for professional services? If the answer to that question is in the affirmative, does that not make a hash of the court's distinction between duties arising out of tort and duties arising out of contract in professional services contracts? The court, while not addressing itself specifically to this question, implied that it was aware of its existence:

> We are well aware of the ambiguities in the distinction drawn above between tort actions ineligible for an award of fees under § 12-341.01(A) and contract actions that are eligible. The ambiguities exist simply because the "distinction between tort and contract liability has become an increasingly difficult distinction to make." Basically, contract law consists of enforcing the intention of the parties manifested through promises expressly made or implied from conduct. Tort law, on the other hand, is a matter of imposing duties to be recognized or not depending upon three primary considerations.
>
> These considerations are: (1) the nature of the defendant's activity such as a builder or a manufacturer-seller of a product; (2) the relationship between the parties, such as occupier of land and business guest; and (3) the type of injury or harm threatened. The obligations which give rise to tort actions and which are imposed on the basis of the three factors just mentioned are created primarily on the basis of policy reasons of one kind or another apart from enforcing a commitment of an intention to do or not to do something in the future. These obligations, commonly referred to as [tort] duties, are often owed to all those within the range of harm or at least to some considerable class of people that can include parties to a contract.

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[186] *Id.* (internal citations omitted).

> Duties that are essentially contractual in nature, however, are generally owed only to the contracting parties.
>
> We are also aware that the application of these general principles will not permit the formulation of any bright line test and that each class of case will have to be considered and ruled upon. Perhaps the best we can say is that, as with pornography, we cannot define a tort but can recognize one when we see it. The legislature clearly did not intend that every tort case would be eligible for an award of fees whenever the parties had some sort of contractual relationship or ingenious counsel could find authority for an implied-in-law contractual claim. Thus, we see no alternative but to attempt to draw the line on the basis of the principles set forth above. As difficult as line-drawing may be in general, we have no doubt that professional malpractice cases, such as the case before us, fall outside the line of eligibility. Absent some special contractual agreement or undertaking between those in the professional relationship, therefore, a professional malpractice action does not "arise" from contract, but rather from tort. . . . It follows that the award of fees made by the court of appeals in the present case was improper.[187]

While beyond the scope of this article, a full consideration of *Barmat*, its progeny, and its implications is obviously of great importance in any consideration of the ELR in the context of professional service relationships.[188] For example, *Collins v. Miller & Miller, Ltd.* involved a suit for legal malpractice.[189] There was a written agreement between the parties pursuant to which the law firm agreed to provide "reasonable and necessary legal services" to the clients.[190] The question in *Collins* was whether this sort of general language gave the clients a breach of contract action in addition to a negligence action.[191] The court held that it did not, stating:

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[187] *Id.* at 1222-23 (internal citations omitted). It is interesting to note that the three "considerations" cited in *Barmat* bear some similarity to the three-factor test formulated by the same court, and the same Justice, Feldman, in *SRP*.

[188] *See id.* at 1220-21.

[189] Collins v. Miller & Miller, Ltd., 943 P.2d 747, 749 (Ariz. Ct. App. 1996).

[190] *Id.* at 755.

[191] *Id.*

> [E]ven where there is an express contract between the professional and the client, an action for breach of that contract cannot be maintained if the contract merely requires generally that the professional render services. Only if there is a specific promise contained in the contract can the action sound in contract, and then only to the extent the claim is premised on the nonperformance of that promise.
>
> . . . .
>
> The agreement to provide "reasonable and necessary legal services" is nothing more than a general promise which encompasses the basic duty imposed by law to provide reasonably competent legal services. It clearly lacks the specificity required for a breach of contract action. The only specific promise made in the contract is that the firm will represent the clients in litigation, a promise that Miller fulfilled. That he may have done so in a negligent manner, in violation of the duty imposed on him by law to represent his client in accordance with the applicable standard of care, does not change the gravamen of the action from tort to contract.[192]

The distinction drawn by *Collins* is a somewhat difficult one to draw. *Keonjian v. Olcott* stated, "[t]he key word in the *Collins* opinion is 'nonperformance,' and the distinction to be drawn is that between nonfeasance and malfeasance."[193] *SRK Consulting, Inc. v. MMLA Psomas, Inc.* noted that *Asphalt Engineers, Inc. v. Galusha* reached a different conclusion than *Collins* in a legal malpractice case on the basis that the promises at issue were more specific.[194]

The court in *Ramsey Air Meds, L.L.C. v. Cutter Aviation, Inc.*, noted that "[a] claim may still arise 'out of a contract' for professional services when the contract imposes *additional* duties beyond those implied by law."[195] However,

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[192] *Id.* (internal citations omitted).

[193] Keonjian v. Olcott, 169 P.3d 927, 931 (Ariz. Ct. App. 2007).

[194] SRK Consulting, Inc. v. MMLA Psomas, Inc., 2009 WL 2450490, at *7 (D. Ariz. 2009) (citing Asphalt Eng'rs, Inc. v. Galusha, 770 P.2d 1180 (Ariz. Ct. App. 1989)).

[195] Ramsey Air Meds, L.L.C. v. Cutter Aviation, Inc., 6 P.3d 315, 320 (Ariz. Ct. App. 2000).

> when a contractual duty, either express or implied-in-fact, merely repeats the duty already imposed by law, a breach of that duty does not create a claim "arising out of a contract" under A.R.S. § 12-341.01(A). On the other hand, when an implied-in-fact term creates an obligation in addition to those imposed by law, a breach of that obligation would arise from the contract.[196]

D. FAH: The Court of Appeals (Continued)

To return to *FAH*, the Court of Appeals there, citing *Barmat*, said that the owner's claim against the architect for professional negligence is based in tort, not contract.[197]

> Because Architect's professional duties arise independently of any contract, the purpose of the economic loss doctrine–maintaining a distinction between tort and contract actions–is not implicated. . . .
>
> . . . If we were to limit actions against architects to solely breach of contract in the absence of personal injury or physical harm to property, we would be ignoring the origin of the duty to use ordinary skill, care, and diligence. Application of the economic loss doctrine in this context would have the effect of eroding this implied duty. We reject such an approach.[198]

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[196] *Id.* at 322; *see also* Energex Enters., Inc. v. Shughart, Thomson & Kilroy, P.C., 2006 WL 2401245 (D. Ariz. 2006); Premium Cigars Int'l, Ltd v. Farmer-Butler-Leavitt Ins. Agency, 96 P.3d 555 (Ariz. Ct. App. 2004), *abrogated*, Webb v. Gittlen, 174 P.3d 275 (2008); Resolution Trust Corp. v. Western Techs., Inc., 877 P.2d 294 (Ariz. Ct. App. 1994); Ponderosa Plaza v. Siplast, 888 P.2d 1315 (Ariz. Ct. App. 1993); Colberg v. Rellinger, 770 P.2d 346 (Ariz. Ct. App. 1988); Towns v. Frey, 721 P.2d 147 (Ariz. Ct. App. 1986).

[197] Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc., 212 P.3d 125, 129 (Ariz. Ct. App. 2009). Significantly, in *FAH*, the court noted that:

> The complaint does not allege the contents of the contract between Owner and Architect, nor does the record contain the contract, nor has either party claimed that the contract specified the applicable standard of care. We do not reach any issue that may be presented in claims arising out of specific language in a contract.

Id. at 129 n.4.

[198] *Id.* at 128. The architect in *FAH* also cited *SRP* in support of its contention that the remedy sought by the owner arose out of contract, not tort, but the court said that *SRP*

The Court of Appeals also said that application of the ELR to limit claims of professional negligence would be inconsistent with the public policy established by the statutes governing professionals, which support the conclusion that claims against professionals arise in tort and are not barred by the ELR.[199] "Application of the economic loss doctrine to limit claims of professional design negligence would be inconsistent with the public policy established by these statutes."[200]

Finally, the Court of Appeals noted that the ELR had not been applied to preclude actions against certain other professionals for purely economic damages, including attorneys and accountants.[201]

> The nature of professional services rendered by attorneys and accountants is such that personal injury or property damage is rarely a consequence of the negligent performance of these services, yet we do not preclude recovery against these professionals on the basis of the economic loss doctrine. It would be illogical and unjustifiable to prevent recovery for purely economic losses against architects but allow analytically similar recoveries against attorneys and accountants. Such an approach would impair the long-standing common law tort of professional negligence.[202]

> however, involved an allegedly defective product. The court in [*SRP*] was seeking to provide guidance for trial courts in determining whether to afford a remedy in strict liability for a defective product or a remedy under the Uniform Commercial Code for a product that failed to perform as expected. In the instant case, there is no issue concerning a defective product or strict liability. The nature of Owner's claim is professional negligence and, as discussed above, such a claim finds its basis in tort.

Id. at 129, n.5 (internal citation omitted).

[199] *Id.* at 130.

[200] *Id.*

[201] *Id.*

[202] *Id.* The court also said:

> Other courts have concluded that the economic loss doctrine should not be applied in an action against a design professional because of the existence of a "special relationship" between the parties. We do not decide the issue presented on this basis. The proper focus, we believe, is on the implied-in-law duty that exists on the part of the architect to act with the ordinary skill, care, and diligence of architectural design professionals.

While the Court of Appeals recognized that some courts in other jurisdictions had applied the ELR to bar professional negligence suits, reasoning that contract law provides the sole remedy for the failure of a product *or service* to perform as the parties expected, the court, however, said that an architect's professional duty to act with ordinary skill, care, and diligence is implied by law and traditional contract remedies may be an inadequate redress for a breach of these duties.[203]

The court distinguished *Woodward* on the basis that it involved construction defect claims, not professional negligence claims; rejected the architect's attempt to distinguish *Donnelly* on the basis of the lack of privity of contract in that case; and distinguished *Carstens* on the basis that it involved construction rather than design defects, and that the city inspectors in *Carstens* did not owe the plaintiffs a duty of care.[204] Some of these distinctions were difficult to discern.

The conclusion of the Court of Appeals' opinion in *FAH* was:

> Design professionals such as architects have a duty to use ordinary skill, care, and diligence in rendering their professional services, and this duty arises out of tort, not contract. The economic loss doctrine does not foreclose a cause of action for professional negligence against an architect, even though the claim seeks only economic damages.[205]

In a footnote, the court said: "We have not addressed whether the economic loss doctrine is applicable to claims against other 'professionals' or in other situations outside the context of construction defects or products liability."[206]

In short, the Court of Appeals took a restrictive view of the ELR, implying that it should be limited to cases of construction defects and products liability.[207] Even though the case arose in the context of the construction of a building, the court indicated that it was not a construction defect case, but a professional negligence case.[208] The court viewed

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Id. at 131, n.7 (internal citation omitted).

[203] *Id.*

[204] *Id.* at 128-31 (citing Donnelly Constr. Co. v. Oberg/Hunt/Gilleland, 677 P.2d 1292, 1295 (Ariz. 1984), Woodward v. Chiro Constr. Co., Inc., 687 P.2d 1269, 1270-71 (Ariz. 1984), Cartens v. City of Phx., 75 P.3d 1081, 1083 (Ariz. Ct. App. 2003)).

[205] *Id.* at 133.

[206] *Id.* at 133 n.8.

[207] *Id.* at 128.

[208] *Id.*

professional negligence claims as essentially alike, no matter the profession, and was very concerned that application of the ELR to such claims would eviscerate them, since, as *Barmat* taught, such claims sound in tort, not contract.[209]

We may put the issue even more starkly. A plaintiff may not have a contract claim in a professional negligence case, since, unless a plaintiff can point to a specific contract provision that was breached, such a case will sound exclusively in tort.[210] The specific contract provision may even have to be express, since, in the wake of *Barmat*, it is difficult to imagine what implied in fact contract provisions in professional services contracts will be enforced as such.[211] Damages in professional negligence cases, as the Court of Appeals in *FAH* noted, will usually be limited to pecuniary damages.[212] If the ELR eliminates tort claims in such cases, what claim will be left to the plaintiff? Here we would have a convergence of the ELR and *Barmat*, the effect of which would be the elimination of both tort and contract claims, leaving a plaintiff remedy-less, which seemed to be the animating concern of the Court of Appeals in *FAH*.[213]

The ELR eliminates tort claims. *Barmat* and its progeny eliminate contract claims.[214] Professor Gilmore might recognize *Barmat* as an example of tort returning to take its revenge against contract.[215]

E. Cases Decided Between the Court of Appeals' and the Supreme Court's Decisions in FAH

In *Hughes Custom Building, L.L.C. v. Davey*, the purchaser of two lots sued engineers over soil subsidence that had caused structural damage to the homes built on the lots.[216] The purchaser and the engineers were not in privity.[217] The court followed *FAH* (Court of Appeals), *Valley Forge*, and *SRP*, and rejected *Carstens*, holding that the ELR did not preclude the purchaser's claim against the engineers for negligence.[218] The Supreme Court ordered the case remanded to the Court of Appeals for

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[209] *Id.* at 129 (citing Barmat, 747 P.2d at 1221).
[210] *Id.* at 129 (citing Barmat, 747 P.2d at 1220-22).
[211] *Id.* at 129 (citing Barmat, 747 P.2d at 1220-22).
[212] *Id.* at 133.
[213] *Id.* at 129, 133 (citing Barmat, 747 P.2d at 1220-22).
[214] *Id.*
[215] *See* Barmat v. John & Jane Doe Partners A-D, 747 P.2d 1218, 1220-22 (Ariz. 1987).
[216] Hughes Custom Bldg., L.L.C. v. Davey, 212 P.3d 865, 867 (Ariz. Ct. App. 2009).
[217] *Id.* at 867.
[218] *Id.* at 869-74 (Ariz. Ct. App. 2009) (citations omitted).

reconsideration in light of its opinion in *FAH*.[219] The Court of Appeals, in a Memorandum Decision, relying on the Supreme Court's decision in *FAH*, held that the ELR did not apply to the case since there was no privity of contract.[220]

In *Vint v. Element Payment Services, Inc.*, plaintiff sued his former employer for fraud in connection with a Stock Repurchase Agreement ("Stock Agreement").[221] The court refused to dismiss the fraud claim under the ELR, saying:

> Defendants have not cited, and the Court has not found, any cases in Arizona or elsewhere using the economic loss rule to bar a claim for intentional misrepresentation. In fact, several jurisdictions have explicitly held that intentional misrepresentation falls outside the scope of the economic loss rule.
>
> In rare cases, the economic loss rule has been used to bar a party from seeking to enforce the terms of a contract through a claim for fraud. However, [these cases are] distinguishable from the present case because Plaintiff does not claim that terms within the Stock Agreement–the contract between parties–are the basis for his misrepresentation claims. Although Plaintiff would be required to use contract law to enforce the duties imposed on Defendants by the Stock Agreement, Plaintiff is entitled to use tort law, including a claim for intentional fraud, to enforce the separate legal duty on Defendants not to engage in deliberate fraud. Plaintiff states a plausible claim for relief because he alleges that Defendants, over and above the terms of the Stock Agreement, intentionally misrepresented that Element would continue making payments on the Note if Plaintiff assigned the Note to PFC [a third-party]. This claim is not barred by the economic loss rule.[222]

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[219] *Hughes Custom Bldg.*, 2010 WL 740139, at *1.
[220] *Id.* at *3.
[221] Vint v. Element Payment Servs., Inc., 2009 WL 1749605, at *1 (D. Ariz. 2009).
[222] *Id.* at *5-6 (internal citations omitted).

In *Valles v. Pima County*, plaintiffs purchased lots in a subdivision.[223] Hosack, a professional engineer employed by Desert Vista, was hired prior to the start of development to design tentative and final plats for the subdivision.[224] Plaintiffs sued Hosack and Desert Vista for negligence in the design. Hosack and Desert Vista moved to dismiss under the ELR.[225] The court noted that "[i]n general, the rule prevents plaintiffs from converting contract claims into tort claims."[226] The court noted that the Rule had received limited application in Arizona courts,[227] but broader application in federal courts.

The court noted that the plaintiffs were not in privity of contract with Hosack and Desert Vista, but, citing *Carstens*, found that lack of privity was not relevant.[228] The court rejected the plaintiffs' reliance on *Donnelly*, finding, *inter alia*, that it was not clear whether *Donnelly* had retained any precedential value after *Gipson*, and that in any event the ELR was not at issue in *Donnelly* and was never even mentioned in that case.[229] "Thus the Magistrate Judge concludes that Plaintiffs' negligence claim. . . is an attempt to circumvent contract remedies by re-casting their contract claims against WSP [the developer, which had gone into bankruptcy] as tort claims against Hosack and Desert Vista. As such, the claim is barred, as a matter of law, by the economic loss rule."[230] The court also denied the plaintiffs' request for leave to amend their complaint in order to state a third-party beneficiary contract claim against Hosack and Desert Vista in part on the basis of futility.[231]

In *Cunningham v. World Savings Bank*, the Bank disbursed funds in certain accounts opened by Ronald Milhausen, deceased, to Anne Heinkel.[232] The personal representative of the Milhausen Estate, Jackie Cunningham, sued the Bank for negligence, alleging that the Bank breached

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[223] Valles v. Pima County, 642 F. Supp. 2d 936, 942 (D. Ariz. 2009).
[224] *Id.* at 950-51.
[225] *Id.* at, 950.
[226] *Id.* at, 952.
[227] *Id.* at 953. The court said: "Other than construction and product defect cases, however, the Arizona courts have not applied the economic loss rule as a bar to the recovery of economic damages in tort cases. To the contrary, Arizona courts have issued numerous decisions permitting the recovery of purely economic losses in tort actions." *Id.* (internal citations omitted).
[228] *Id.* at 954 (citing Carsten v. City of Phx., 75 P.3d 1081, 1085 (Ariz. Ct. App. 2003)).
[229] *Id.* at 955 (citing Gipson v. Kasey, 150 P.3d 228, 231 (Ariz. 2007); Donnelly Constr. Co. v. Oberg/Hunt/Gilleland, 677 P.2d 1292, 1296 (Ariz. 1984)).
[230] *Id.* at 955-56.
[231] *See id.* at 956.
[232] Cunningham v. World Sav. Bank, FSB, 660 F. Supp. 2d 1078, 1080 (D. Ariz. 2009).

a duty of care it owed to the Estate when it disbursed the funds to Heinkel.[233] The court first said that it was unclear whether Cunningham's negligence claim alleged a breach of a duty which arose under the account agreements or whether it arose from the breach of the duty to exercise ordinary care, and that whether a bank exercised ordinary care is a fact issue normally precluding summary judgment.[234]

The court then turned to the Bank's argument that the negligence claim was barred by the ELR.[235] The court denied World Savings' motion for summary judgment as to Ms. Cunningham's negligence claim, in language evocative of the *FAH* Court of Appeals' concern over the ELR in light of *Barmat*.[236]

In *Shacknai v. Mathieson*, plaintiffs asserted tort and contract claims against Merrill Lynch and its employee, Mathieson, arising out of the sale of life insurance.[237] Defendants contended that the ELR barred plaintiffs' claims for negligent misrepresentation and negligent hiring, training, and supervision because plaintiffs also sought to recover the same economic damages under a purported oral contract. The court cited the Court of Appeals decision in *FAH* for the proposition that Arizona applied the ELR narrowly and rejected the defendants' argument.[238] Indeed, *Shacknai* read the Court of Appeals' decision in *FAH* as urging the use of the same three factors from *SRP* in both products liability and construction defects cases, the only cases in which, *Shacknai* said, Arizona courts had applied the ELR.[239]

F. FAH: The Supreme Court

As can be gathered from the foregoing, the Supreme Court's decision in *FAH* was much anticipated. We have followed the Arizona ELR on something of a roller coaster ride. At times the Rule was up, and at other times it was down. It is probably fair to say, however, that the trajectory of the Rule before the Supreme Court decision in *FAH* was down. This conclusion is based on a number of factors, foremost among them the Court

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[233] *Id.* at 1081.
[234] *Id.* at 1087.
[235] *Id.* at 1088-89.
[236] *Id.* at 1088-89.
[237] Shacknai v. Mathieson, 2009 WL 4673767, at *1 (D. Ariz. 2009).
[238] *See id.* at *3 (citing Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc., 212 P.3d 125, 128).
[239] *Id.* at *4. One other case decided during this period, *ING Bank, FSB v. Mata*, 2009 WL 4672797 (D. Ariz. 2009), mentioned the ELR but did not base any decision on it.

of Appeals' decision in *FAH* itself, but also *Valley Forge* and the *federal backlash* cases. Had the Supreme Court affirmed the Court of Appeals, the argument that the Arizona ELR is narrow would be hard to assail. The fact that the Arizona Supreme Court reversed the Court of Appeals gave new life to the ELR in Arizona, and, while the Supreme Court's opinion is nuanced, and while it does not necessarily give clear direction to the application of the rule in cases unlike the one before it, created room to argue about the extent to which the ELR may be applied in the future to cases where the parties are in privity of contract.

The Supreme Court held that 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.[240] The court said:

> In sum, in the context of construction defects, we adopt a version of the economic loss doctrine and hold that a plaintiff who contracts for construction cannot recover in tort for purely economic loss, unless the contract otherwise provides. The doctrine does not bar tort recovery when economic loss is accompanied by physical injury to persons or other property.[241]

The holding settles that point of law. But, as we have seen, the history of the ELR preceding *FAH* was tortuous, to say the least, involving many more questions than the one the court's holding settled. The court itself acknowledged the confusion, saying: "This Court has not addressed the economic loss doctrine since its decision in [*Salt River Project*]. In the absence of other decisions by this Court, the court of appeals and the federal courts have reached conflicting conclusions regarding the application of the doctrine under Arizona law."[242]

So what other questions did the court resolve, at least in *dicta*?

Well, to begin with, in addressing the "conflicting conclusions" cited in the paragraph above, the court sided with *Evans* against *Apollo* in finding that *SRP* did not apply the ELR broadly, and with *Valley Forge* against *Carstens* in finding that *Carstens* misconstrued *SRP*.

The key move the court made was to restore the concept of privity of contract to the central place it held in ELR jurisprudence prior to *Carstens*. The court rejected the "overly broad" statements of the ELR from *Carstens* on which subsequent courts relied in applying the ELR in non-privity

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[240] *Flagstaff Affordable Hous.*, 223 P.3d at 670.
[241] *Id.*
[242] *Id.* at 666 (citation omitted).

contexts, namely, that the ELR "bars a party from recovering economic damages in tort unless accompanied by physical harm,"[243] The court drew a distinction between claims involving contracting parties and claims involving non-contracting parties, saying that describing the ELR in an overly broad way:

> conflates two distinct issues: (1) whether a contracting party should be limited to its contract remedies for purely economic loss; and (2) whether a plaintiff may assert tort claims for economic damages against a defendant absent any contract between the parties. As explained below, we believe the economic loss doctrine is best directed to the first of these issues, and we use the phrase to refer to a common law rule limiting a contracting party to contractual remedies for the recovery of economic losses unaccompanied by physical injury to persons or other property.[244]

This distinction informed the court's definitions of "economic loss" and of the ELR itself: "'Economic loss,' as we use the phrase, refers to 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."[245] And, as indicated above, the court defined the ELR itself to mean "a common law rule limiting *a contracting party* to contractual remedies for the recovery of economic losses unaccompanied by physical injury to persons or other property."[246]

Indeed, the court said:

> The *principal* function of the economic loss doctrine . . . is to encourage private ordering of economic relationships and to uphold the expectations of the parties by limiting a plaintiff to contractual remedies for loss of the benefit of

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[243] *Id.* at 667. *See* Carstens v. City of Phx. 75 P.3d 1081, 1083 (Ariz. Ct. App. 2003) (noting that "[T]his formulation of the doctrine, however, is overly broad. In many contexts, tort recovery is available for solely pecuniary losses. *See also* Giles v. Gen. Motors Acceptance Corp., 494 F. 3d 865, 875 (9th Cir. 2007) (noting that "[t]ort law has traditionally protected individuals from a host of wrongs that cause only monetary damage"); Evans v. Singer, 518 F. Supp. 2d 1134, 1139 (D. Ariz. 2007).

[244] 223 P.3d at 667.

[245] *Id.* (emphasis added).

[246] *Id*. (emphasis added).

> the bargain. These concerns are not implicated when the plaintiff lacks privity and cannot pursue contractual remedies.[247]

We may draw the following conclusions from the court's formulation of the ELR:

> (1) Where parties are in privity of contract, the ELR *may* apply to preclude tort claims between them.
>
> (2) Where parties are not in privity of contract, the ELR *will not* apply to preclude tort claims between them, although there may be other reasons why tort claims will not be available.

Restricting the application of the Rule to contracting parties makes sense. If the purpose of the Rule is to limit parties to the "benefit of their bargain," the Rule should only apply where there is a bargain to which it might be applied. No bargain, no ELR. Furthermore, it is difficult enough to know when to apply the Rule even as between contracting parties, much less parties who have no contractual relationship. As we have seen, *Carstens* made a confusing Rule even more confusing. Finally, knowing that the ELR applies only as between contracting parties still does not tell us *when* it will apply between contracting parties, that is, in what *contexts* it will apply and to what *torts* it will apply.

In *FAH*, the court was faced with a dispute between *contracting parties*. In turning to the question of whether to apply the ELR in the case before it,[248] the court resurrected the case-specific approach it had adopted the last

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[247] *Id.* at 671 (emphasis added).

[248] *Id.* at 669. The court noted that the assumption was widespread that Arizona law applied the ELR to construction defect cases, in addition to products liability cases, but said that the only opinion by the court cited for this proposition was *Woodward v. Chirco Constr. Co.*, 141 Ariz. 514, 687 P.2d 1269 (1984). However, said the court, *Woodward* did not discuss the ELR:

> *Woodward* does not resolve whether the economic loss doctrine should apply to construction defects. Although several opinions by the court of appeals have concluded that the doctrine applies, those cases rely heavily on an interpretation of *Woodward* that we today reject.

223 P.3d at 667 (internal citation omitted). The court also said:

> Nor does the fact that the doctrine applies to product defects necessarily establish that it should also apply to construction defects. The economic loss doctrine may

time it considered the ELR, twenty-six years before, in *SRP*, saying: "The economic loss doctrine may vary in its application depending on context-specific policy considerations. To determine whether the doctrine should apply here, we must consider the underlying policies of tort and contract law in the construction setting."[249] In "consider[ing] the underlying policies of tort and contract law in the construction setting," the court focused on three factors:

First, the contract law policy of upholding the expectations of the parties. Here, the court found that this policy

> has as much, if not greater, force in construction defect cases as in product defect cases. Construction-related contracts often are negotiated between the parties on a project-specific basis and have detailed provisions allocating risks of loss and specifying remedies. In this context, allowing tort claims poses a greater danger of undermining the policy concerns of contract law. That law seeks to encourage parties to order their prospective relationships, including the allocation of risk of future losses and the identification of remedies, and to enforce any resulting agreement consistent with the parties' expectations.[250]

Second, the adequacy of contract remedies. The court stated:

> 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. When a construction defect causes only damage to the building itself or other economic loss, common law contract remedies provide an adequate remedy because they allow recovery of the costs of remedying the defects . . .

> vary in its application depending on context-specific policy considerations. To determine whether the doctrine should apply here, we must consider the underlying policies of tort and contract law in the construction setting.

Id. (internal citation omitted).

[249] *Id.*

[250] *Id.*

> and other damages reasonably foreseeable to the parties upon entering the contract.[251]

In this context, the court cited the rule of *Hadley v. Baxendale*, which had been adopted in Arizona in *Higgins v. Ariz. Sav. & Loan Ass'n*, for identifying damages recoverable in contract.[252]

Third, "The policies of accident deterrence and loss-spreading also do not require allowing tort recovery in addition to contractual remedies for economic loss from construction defects. These considerations have less force when parties to a site-specific construction contract have allocated the risk of loss and identified remedies for non-performance."[253] The court said that even in the case of a homeowner's purchase of a mass-produced home, "there is less reason to preserve tort remedies for purely economic loss, given that Arizona law allows home purchasers to bring contract claims for breach of the implied warranty of good workmanship and habitability even if they are not in privity with the builder."[254]

Given the court's analysis of the underlying policies of tort and contract law in the construction setting, the court concluded:

> in construction defect cases, the policies of the law generally will be best served by leaving the parties to their commercial remedies when a contracting party has incurred only economic loss, in the form of repair costs, diminished value, or lost profits. We accordingly apply the economic loss doctrine and hold that a contracting party is limited to its contractual remedies for purely economic loss from construction defects.[255]

Despite the court's general embrace of *SRP*, it specifically disapproved of two aspects of *SRP* that were part of the "narrowness" of its holding.

First, recall that after conducting its three-part analysis, the court in *SRP* held that a claim for strict liability in tort was available to SRP. Westinghouse then argued that SRP had waived any tort claims in its contract with Westinghouse. The court held that tort remedies may be waived, but remanded the case for a determination of whether the limitation

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[251] *Id.*

[252] *Id. See also* Hadley v. Baxendale, 9 Exch. 341, 156 Eng. Rep. 145 (1854); Higgins v. Ariz. Sav. & Loan Ass'n, 365 P.2d 476, 482-83 (Ariz. 1961).

[253] 223 P.3d at 667.

[254] *Id.* at 669-70 (citing Richards v. Powercraft Homes, Inc., 678 P.2d 427, 430 (1984).

[255] *Id.* at 670 (internal citation omitted).

of liability was actually bargained for.[256] In *FAH*, the court said that the question *SRP* dealt with, the requirements for the waiver of tort remedies, is a separate question from whether the ELR applies.[257] "*Salt River*'s requirements for an effective waiver do not determine whether a party is limited to contractual remedies for purely economic losses resulting from construction defects. Instead, a party will be so limited unless the parties have provided in their contract for tort remedies."[258] That is, if, upon analysis of the underlying policies of tort and contract law in the particular setting, a court concludes that the ELR applies to preclude tort claims as between contracting parties, the preclusion will apply no matter what the contract says, unless the contract specifically *allows* tort remedies. So the focus in contract negotiation must now shift from the usual concern of the seller to include a provision *waiving* tort liability to a concern on the part of the buyer to include a provision *allowing* it.

Second, we have seen that *FAH* appeared to embrace *SRP*'s conservative approach to the ELR. But in the end, *FAH* rejected that approach, at least in the case before it. The court noted that *SRP*'s three-factor test for determining, on a case-specific basis, whether to apply the ELR to claims involving a defective product, was a minority view that had been criticized as being too unpredictable and allowing non-contractual recovery when a purchaser has only been deprived of the benefit of the bargain.[259] For example, the court noted that *East River* had refused to apply a *SRP*-type approach to a products liability claim under admiralty law.[260] The *FAH* court said:

> Whatever the wisdom of continuing to apply *Salt River*'s three-factor test in products liability cases, we decline to extend it to construction defect cases. The economic loss doctrine appropriately applies in this context because construction contracts typically are negotiated on a project-specific basis and the parties should be encouraged to prospectively allocate risk and identify remedies within their agreements. These goals would be undermined by an approach that allowed extra-contractual recovery for economic loss based not on the agreement itself, but instead

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[256] *Id.*
[257] *Id.*
[258] *Id.*
[259] *Id.*
[260] *Id.*; *see also* E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 869-70 (1986).

> on a court's post hoc determination that a construction defect posed risks of other loss or was somehow accidental in nature.[261]

The court then turned to the owner's argument, accepted by the Court of Appeals, that even if the ELR applies to construction defect cases against those who construct buildings, it should not apply to professional negligence claims based on an architect's design.[262]

First, the Owner argued that applying the ELR would conflict with *Donnelly*.[263] The court rejected that argument on the basis that in *Donnelly*, there was no privity of contract between the plaintiff and the defendant, and hence the ELR did not apply at all.[264] The Supreme Court now upheld *Donnelly*, which had been called into question by other courts:

> Without discussing the economic loss doctrine, *Donnelly* correctly implied that it would not apply to negligence claims by a plaintiff who has no contractual relationship with the defendant.
>
> Although some courts have applied the doctrine in that context, we decline to do so. The principal function of the economic loss doctrine, in our view, is to encourage private ordering of economic relationships and to uphold the expectations of the parties by limiting a plaintiff to contractual remedies for loss of the benefit of the bargain. These concerns are not implicated when the plaintiff lacks privity and cannot pursue contractual remedies.[265]

The court had earlier indicated that the ELR would not be applied to preclude tort claims in cases absent any contract between the parties, and now said:

> Rather than rely on the economic loss doctrine to preclude tort claims by non-contracting parties, courts should instead focus on whether the applicable substantive law allows liability in the particular context. For example, whether a non-contracting party may recover economic losses for a

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[261] 223 P.3d at 670 (internal citations omitted).
[262] *Id.* at 671.
[263] *Id.*
[264] *Id.*
[265] *Id.* (internal citations omitted).

> defendant's negligent misrepresentation should depend on whether the elements of that tort are satisfied, including whether the plaintiff is within the limited class of persons to whom the defendant owes a duty.[266]

Second, the owner also argued that the ELR should not apply because the architect breached duties imposed by law, that is, tort duties.[267] The implication of this argument was what concerned the Court of Appeals greatly, as we have seen, namely, that since the duties in such a case will usually not arise out of contract, contract remedies will be unavailable, and, if the ELR precludes tort claims in the same case, owners will be left without a remedy in either contract or tort. How did the Supreme Court resolve this troubling issue?

That is not clear. Notwithstanding its earlier cases like *Barmat*, which seemed to say that lines could certainly be drawn between duties arising in tort and duties arising in contract, the court now said:

> Although architects have common-law duties of care, this case illustrates that it is often difficult to draw bright lines between obligations imposed by law and those arising from contract. Architect's duties with regard to Owner's project existed only because of the contract between the parties. Architectural contracts generally include compliance with applicable building codes and other legal design requirements as an implied term. Owner here alleges that Architect designed a building that did not conform to certain requirements of the federal Fair Housing Act; the complaint alleges that this conduct both breached Architect's contractual obligations and constituted professional negligence. Attempting to label claims by distinguishing between contractual and extra-contractual duties is an unduly formalistic approach to determining if plaintiffs like Owner should be limited to their contractual remedies for economic loss.[268]

The court now seemed to want to distance itself from *Barmat*, or at least limit *Barmat* to the precise issue with which it dealt:

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[266] *Id.* at 671-72 (internal citations omitted).
[267] *Id.* at 672.
[268] *Id.* (internal citation omitted).

> Courts have looked to the source of duties in determining whether a tort action "arises out of contract" and thus qualifies for an award of attorney fees under A.R.S. § 12-341.01 (2003). Rather than extend *Barmat*'s approach here, we think application of the economic loss doctrine should rest on explicit consideration of the relevant tort and contract law policies.[269]

How that answers the owner's concern–or the concern voiced by the Court of Appeals below-is not clear.

Third, the court also rejected another of the owner's arguments that had impressed the Court of Appeals, stating that the professional status of architects should not determine whether to apply the ELR.[270]

> The purposes of the doctrine are served by applying it to contracts entered by architects and design professionals, as other courts have recognized. Moreover, the fact that an architect, as a professional, has legally imposed duties of care does not displace the general policy concerns that parties to construction-related contracts should structure their relationships by prospectively allocating the risks of loss and identifying remedies.[271]

Finally, the owner argued that applying the ELR to architects would imply that it also applies to other claims for professional negligence, such as claims for legal malpractice.[272] The court rejected this argument as well, stating that

> Lawyers owe fiduciary duties to their clients and generally are barred from entering agreements that prospectively limit their liability. . . . We do not hold that the economic loss doctrine applies to architects because they are professionals, but instead because the policy concerns that justify applying the doctrine to construction defect cases do not justify distinguishing between contractors on the one hand and design professionals, including architects, on the other. Our adoption of the economic loss doctrine in

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[269] *Id.* at n.5 (internal citations omitted).
[270] *Id.* at 672.
[271] *Id.* (internal citation omitted).
[272] *Id.* at 673.

> construction defect cases reflects our assessment of the relevant policy concerns in that context; it does not suggest that the doctrine should be applied with a broad brush in other circumstances.[273]

This at least suggests that the ELR will not be applied to claims of legal malpractice, and other malpractice claims where a fiduciary relationship may be present, and that the ELR may not be applied to claims of breach of fiduciary duty between contracting parties generally.

Because the Court of Appeals had found that the ELR was inapplicable to the owner's negligence claim against the architect, the Supreme Court vacated the opinion below.[274] However, because a copy of the contract between the owner and the architect was not included in the record, the Supreme Court remanded the case to the superior court to determine whether the contract had in fact preserved tort remedies for purely economic loss.[275] "Although it seems unlikely that the contract would preserve tort remedies for purely economic loss, we will not make assumptions about its provisions."[276]

XI. ARIZONA ELR CASES POST-FAH

The ELR remains one of the hottest topics in Arizona law. Even though the Supreme Court's opinion in *FAH* was handed down in February of 2010, already there are a number of cases citing and discussing it, and there will be many more.

Diaz v. Phoenix Lubrication Service, Inc. was an opinion subsequent to *FAH* written by Judge Gemmill, the same Judge who wrote the Court of Appeals' opinion in *FAH*.[277] It involved a negligence claim brought by a plaintiff in privity of contract with the defendant. The issue was whether the defendant owed the plaintiff a duty under the law of negligence, not whether the claim was barred by the ELR. Nevertheless, the court's reasoning was informed by *FAH*.[278]

In *Henderson v. Chase Home Finance, LLC*, the plaintiffs obtained financing for their home from the defendant.[279] Allegedly as a result of

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[273] *Id.* (internal citations omitted).
[274] *Id.*
[275] *Id.*
[276] *Id.*
[277] Diaz v. Phx. Lubrication Serv., Inc., 230 P.3d 718 (Ariz. Ct. App. 2010).
[278] *Id.* at 722.
[279] Henderson v. Chase Home Fin., LLC, 2010 WL 1962530 (D. Ariz. 2010).

wrongful acts by Chase, the plaintiff's credit score decreased.[280] One of plaintiff's claims was for negligent misrepresentation.[281] Defendant argued that the claim was barred by the ELR.[282] Citing *FAH*, the court said: "The Arizona Supreme Court had occasion recently to discuss the economic loss doctrine, and in so doing, attempted to steer the lower courts in Arizona from the 'overly broad' formulation that 'the economic loss doctrine' bars a party from recovering economic damages in tort unless accompanied by physical harm."[283] With the principles of *FAH* in mind, the court found that the ELR did not bar the negligent misrepresentation claim.[284]

> Even assuming Plaintiffs and Defendant are contracting parties within the meaning of the economic loss doctrine, Plaintiffs are not seeking contract remedies in any of its claims, let alone its claim for negligent misrepresentation. . . . Plaintiffs are not seeking any damages that are themselves the subject of the contract between the parties. Rather, Plaintiffs are seeking damages for their lowered credit scores, loss of access to an otherwise available line of credit, and for late fees assessed as a result of the forbearance agreement. These are not remedies resulting from the parties contract that are cloaked to avoid the economic loss rule. As such, the economic loss doctrine does not preclude Plaintiffs' negligent misrepresentation claim.[285]

In *Colson v. Maghami*, Colson argued that the Maghami Defendants, who were in the high-end car business, were liable for misrepresentation and fraudulent concealment.[286] Colson alleged that Meghami misled him regarding the purchase of a Reventon by telling him that they had access to a Reventon when Lamborghini was telling them otherwise.[287] The court denied Colson's motion for summary judgment on these claims because there were genuine issues of material fact.[288]

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[280] *Id.* at *1.
[281] *Id.* at *5.
[282] *Id.*
[283] *Id.*
[284] *Id.* at *6.
[285] *Id.*
[286] Colson v. Maghami, 2010 WL 2744682 (D. Ariz. 2010).
[287] *Id.* at *1-3.
[288] *Id.* at *3.

The Maghami Defendants argued that these claims would be barred by the ELR.[289] Citing *FAH*, and its distinction between contracting and non-contracting parties, the court held that the ELR would bar Colson from recovering for misrepresentation and fraudulent concealment against Motor Sports of Scottsdale, Inc., the defendant with which he was in privity of contract.[290] However, since none of the other Maghami Defendants had been deemed contracting parties, the ELR was held not to bar Colson from recovering against them on tort theories.[291]

In *Ireland Miller, Inc. v. Shee Atika Holdings Phoenix*, Miller entered into an agreement to purchase real property from Shee.[292] Section four of the agreement required seller to deliver to purchaser a copy of any correspondence or notices from any governmental agencies concerning the property.[293] Seller failed to deliver certain tax reports.[294] The court dismissed the plaintiff's claim that defendants negligently failed to disclose the existence of the tax as duplicative of the plaintiff's breach of contract claim.[295] But the court went on to note that even if the negligence claims were not duplicative, they would be barred by the ELR.[296] "The negligence allegations in the complaint are addressed solely to an alleged breach of the parties' agreement and there is no allegation of physical injury to persons or property. Under these circumstances, Plaintiff cannot recover in tort."[297]

Sherman v. Premiergarage Systems, LLC arose out of a franchise agreement between plaintiffs-franchisees and defendant-franchisor.[298] The Shermans alleged tort claims for intentional misrepresentation and negligent misrepresentation against their franchisor.[299] Defendants contended that the Shermans' tort claims were barred by the ELR as predicated on allegations that defendants made misrepresentations regarding issues that were specifically addressed in the Dealer Agreements at issue.[300] The Shermans

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[289] *Id.* at *7.
[290] *Id.*
[291] *Id.*
[292] Ireland Miller, Inc. v. Shee Atika Holdings Phx. LLC, 2010 WL 2743653 (D. Ariz. 2010).
[293] *Id.* at *1.
[294] *Id.*
[295] *Id.* at *3.
[296] *Id.* at *4 n.8 (citing *FAH*).
[297] *Id.* at *3.
[298] Sherman v. Premier Garage Sys., LLC, 2010 WL 3023320 (D. Ariz. 2010).
[299] *Id.* at *3.
[300] *Id.*

argued that their claims were not barred because contract law and tort law seek to protect different interests.[301]

The court began "by noting that the scope of the economic loss doctrine in Arizona is by no means settled."[302] Defendants contended that, under *FAH*, the Shermans' claims were precluded because the Dealer Agreements allocated risks for relying on external representations and contained warranties for products purchased from defendants, which the court adressed as follows:

> Keeping the principles of tort and contract law set forth in *Flagstaff* in mind, the Court finds that the economic loss doctrine applies in this case to bar Shermans' fraud and negligent misrepresentation claims. Although it appears that the *Flagstaff* decision limited its expansion of the economic loss rule to construction defect cases, the Arizona Supreme Court retested its decision on the fact that "contracts often are negotiated between the parties on a project-specific basis and have detailed provision allocating risks of loss and specifying remedies. In this context, allowing tort claims poses a greater danger of undermining the policy concerns of contract law." Here, the Shermans negotiated and signed, not one, but two Dealer Agreements–one for the Panhandle area and one for the Orlando area–signed approximately eight months apart. The bases of the Shermans' fraud and negligent representation claims rest on statements made "regarding the profits Plaintiffs' PremierGarage franchises would generate and the quality and performance characteristics of PremierGarage's floor-coating materials." Similarly to the contract at issue in *Flagstaff*, the Dealer Agreements allocate risks of loss and specify remedies for both of these issues (external representations and product performance). . . . Given that the Shermans' are a contracting party, that they seek to recovery economic loses "in the form of repair costs, . . . or lost profits," and that they signed two separate Dealer Agreements, the Court finds that economic loss rule applies here in order to "uphold the expectations of the parties by limiting [the] plaintiff[s] to contractual remedies

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[301] *Id.*
[302] *Id.*

> for loss of the benefit of the bargain." Accordingly, Counts III (intentional misrepresentation/fraud) and IV (negligent misrepresentation) are dismissed.[303]

An interesting question under the ELR is the nature of the insurance relationship in cases to which the ELR applies. Generally speaking, the ELR eliminates tort claims and leaves contract claims. But what if there is a general liability insurance policy in the picture? Don't such policies usually answer to tort claims, but not contract claims? Won't the extension of the ELR then wipe out insurance claims that parties might otherwise have?

This issue arose in *Desert Mountain Properties Ltd. Partnership v. Liberty Mutual Fire Insurance Co*.[304] There, soil settlement caused cracks and other damage to fifty new homes.[305] Prompted by complaints from customers to whom it had sold the homes, the developer, Desert Mountain, paid an average of $200,000 per home to have the soil issues corrected and the damage repaired.[306] Desert Mountain paid the claims without having been sued by any of the homeowners.[307] Desert Mountain then sought reimbursement from its commercial general liability insurer.[308] The insurer denied reimbursement, and Desert Mountain brought an action against it alleging breach of contract and breach of the duty of good faith.[309]

Liberty Mutual promised in each of the two policies to "pay those sums that the insured becomes legally obligated to pay as damages because of . . . 'property damage' to which this insurance applies."[310] The policies did not define "legally obligated" or "damages."[311] The court found the language broad enough to encompass the payments made by Desert Mountain to the homeowners.

The court said that in *FAH*, the Arizona Supreme Court held that the ELR bars a building owner from recovering tort damages arising from faulty work by an architect that causes solely economic loss.[312] In such a circumstance, the court held, the building owner is limited to its contract remedies; however, given the policy language, the court said, "We decline

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[303] *Id.* (citing *Flagstaff*) (internal citations omitted).
[304] Desert Mountain Prop. Ltd. P'ship v. Liberty Mut. Fire Ins. Co., 236 P.3d 421 (Ariz. Ct. App. 2010).
[305] *Id.* at 424.
[306] *Id.*
[307] *Id.* at 425.
[308] *Id.*
[309] *Id.* at 426.
[310] *Id.* at 427.
[311] *Id.*
[312] *Id.* at 430.

to hold that as a matter of law, a [commercial general liability] policy does not cover liability arising out of contract." .[313]

It is likely that several related cases will reach decision prior to this article's publication, and readers should include those cases in taking positions relative to the ELR in Arizona.

XII. PRACTICAL CONCLUSIONS AND PRACTICE POINTERS

Looking back on the foregoing history of the ELR in Arizona, and on the Arizona Supreme Court's decision in *FAH* in particular, there are some things counsel should be cognizant of in cases involving economic losses.

First, the ELR currently exists, and by nature may necessarily continue to exist, in something of an "in-between" state. That is, if we eliminated the ELR entirely, no tort claim would be precluded on that basis in litigation between contracting parties involving solely economic loss. On the other hand, if the ELR was applied in the broadest manner possible, there would be no tort claims in such cases. It is probably desirable to have an ELR, and to use it as a mean, not as an extreme, for the policy reasons suggested by the cases. Having a rule of law with an in-between status–the application of which is dependent upon some sort of balancing test–is nothing new in the law. Such tests are necessary with rules like the ELR where there is a recognized need for such a rule, but where too broad an application of the rule would wipe out remedies in certain cases that have been firmly established at common law. But that is not to say the parameters of the ELR cannot be more clearly defined. Currently, while the ELR could have been severely restricted by the Supreme Court in *FAH*, it was instead given new life. Statements from *FAH* can support broader or narrower readings of the case and correlative arguments about the scope of the ELR, but until there is further appellate litigation in Arizona, especially at the Supreme Court level, many questions will remain.

Second, in any case involving parties in privity of contract in which the losses are purely economic, counsel should consider whether the ELR may apply to preclude tort claims. We might further distinguish two categories of such cases.

The first category is those kinds of cases in which there is firmly established precedent applying the ELR to certain tort claims. For example, the ELR will apply in products liability and construction defect cases to preclude claims for strict liability in tort and negligence, as it has from its beginnings, both within and without Arizona. Pursuant to *FAH*, *SRP*'s

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[313] *Id.* at 430-31.

three-factor test may or may not continue to apply in products liability cases, but it will not apply in construction defect cases. And, pursuant to *FAH* itself, the ELR will apply in cases involving certain kinds of professional relationships to preclude tort claims against the professionals.

The second category is those cases in which there may be precedent applying the ELR, but other precedent challenges its authority or there is contrary precedent as well. This is the "in-between" state. Remember also that there are Arizona cases allowing tort claims for purely economic losses in which the ELR is not even mentioned. This is a large category, as a reading of the summaries of the cases above demonstrates. The ELR may or may not apply. Counsel will have to consult all of the cases to try to match the case with which they are faced, the context in which the case arose, and the tort claims that have been or might possibly be brought in the case, to the kinds of cases and the kinds of torts involved in Arizona precedent. Considering that published federal district court cases applying Arizona law and discussing the ELR far outnumber Arizona appellate court cases on the ELR, most of the precedent will be from federal courts trying to discern the status of Arizona law. As we have seen, the federal courts themselves will not always agree as they participate in that difficult endeavor. However, there are some principles, factors, and questions to be gleaned from the cases cited above to guide counsel in arguing for or against the applicability of the ELR in a particular case. Some of these are as follows:

- As *FAH* itself said, the ELR may vary in its application depending on context-specific policy considerations. To determine whether the Rule should apply to a particular case, courts must consider the underlying policies of tort and contract law in the particular setting given by the case.
- As *FAH* also said, the principal function of the ELR is to encourage the private ordering of economic relationships and to uphold the expectations of the parties by limiting a plaintiff to contractual remedies for loss of the benefit of the bargain. Does the claim involve the expectation interests of the parties? The benefit of the bargain?
- Was the contract in question freely bargained between two parties relatively equal in bargaining power and sophistication?
- Can it be argued that any of the following factors were involved in the bargaining process or the

contract itself: misrepresentation, mistake, duress, undue influence, unconscionability, or violation of public policy?

- Is the contract in question a standard form contract?
- Does the contract in question contain detailed provisions allocating risks of loss and specifying remedies? Did the parties allocate the specific risk at issue in the contract?
- Does the claim concern the quality of the property that is the subject matter of the contract?
- Does the claim implicate safety considerations?
- Does the claim grow out of circumstances independent of the contractual relation?
- Is the proposed tort claim intertwined with a breach of contract?
- Is the claim based on alleged non-performance under the contract, and thus in reality a breach of contract claim masquerading as a tort claim? Is the claim for misfeasance (tort) or nonfeasance (contract)?
- Is the claim in conflict with the contract?
- Is the claim covered in some sense by the contract?
- Is the proposed tort one that has historically been used to recover economic losses?
- Did the duty alleged to have been breached arise out of the contract (promise-based duty)?
- Did the duty alleged to have been breached arise out of public policy (tort-based duty)?
- Are the losses plaintiff seeks to recover under its proposed tort claim the same as the losses that would be recovered under a contract claim?
- Is the field in which the claim arises one traditionally regulated by tort law?
- Are the damages plaintiff seeks themselves the subject of the contract?
- If the claim is for misrepresentation, are terms within the contract itself the basis for the claim of misrepresentation?
- To paraphrase the *SRP* three-part test, to the extent to which it may still be applicable: What was the

> nature of the defect that caused the loss? In what manner did the loss occur? What is the type of loss for which the plaintiff seeks redress?

Third, in cases in which the ELR applies, a party will be limited to its contract remedies *unless* the parties have specifically provided in their contract for tort remedies. This *FAH* twist may change the way in which contracts are drafted and negotiated in Arizona.

Fourth, where parties are not in privity of contract, the ELR will *not* be available to preclude tort claims between them even if the losses are purely economic. *FAH* in effect overruled *Carstens*, and upheld *Donnelly*. Counsel will have to consult the underlying substantive tort law to see if tort claims are available.

We might also note at least some of the areas where we are, and may for some time be, left with questions as to the applicability of the ELR. For example, the relationship between *FAH* and *Barmat* and its progeny is unclear. Determining the nature and scope of this relationship will be critical. To what extent may the two lines of cases converge to leave parties who contract with professionals remedy-less? For example, if the ELR does not apply in all professional relationship cases—as *FAH* itself said it would not apply to legal malpractice claims because of the fiduciary nature of the relationship—in what other professional relationship cases will it not apply?

We might also consider, whether it is possible to extract a simpler test from the cases to determine whether the ELR will apply, as opposed to having to conduct the kind of rigorous analysis of the underlying purposes of tort and contract law in each case seemingly required by *FAH*.

We might also ask, "How will the relationship between the ELR and those torts that were characterized by the "*federal backlash*" cases as having been designed precisely to address economic losses be resolved?" In particular, under what circumstances will courts permit claims for fraud, fraud in the inducement, negligent misrepresentation, and similar torts to prevail over the argument that they are precluded by the ELR?

XIII. CONCLUSION

The development and expansion of the ELR is perhaps the most significant common law development of the last few decades. The ELR is an important device to ensure that parties do not use tort claims to evade bargains freely-made. It fosters the spirit of classical liberalism, encouraging the private ordering of relationships. It protects contract law from that "sea of tort." As the court succinctly summarized the Rule in *Valles v. Pima County*, "In general, the rule prevents plaintiffs from

converting contract claims into tort claims."[314] At the same time, as our history has shown, it is not easy–it has never been easy since contract emerged from tort–to know what is solely a contract claim, what is solely a tort claim, and when there may be both. In the wake of the Arizona Supreme Court's decision in *FAH*, the Rule is very much alive in Arizona. Its continued development should be one of the hottest topics in appellate litigation for many years to come.

[314] Valles v. Pima County, 642 F. Supp. 2d 936, 952 (D. Ariz. 2009).