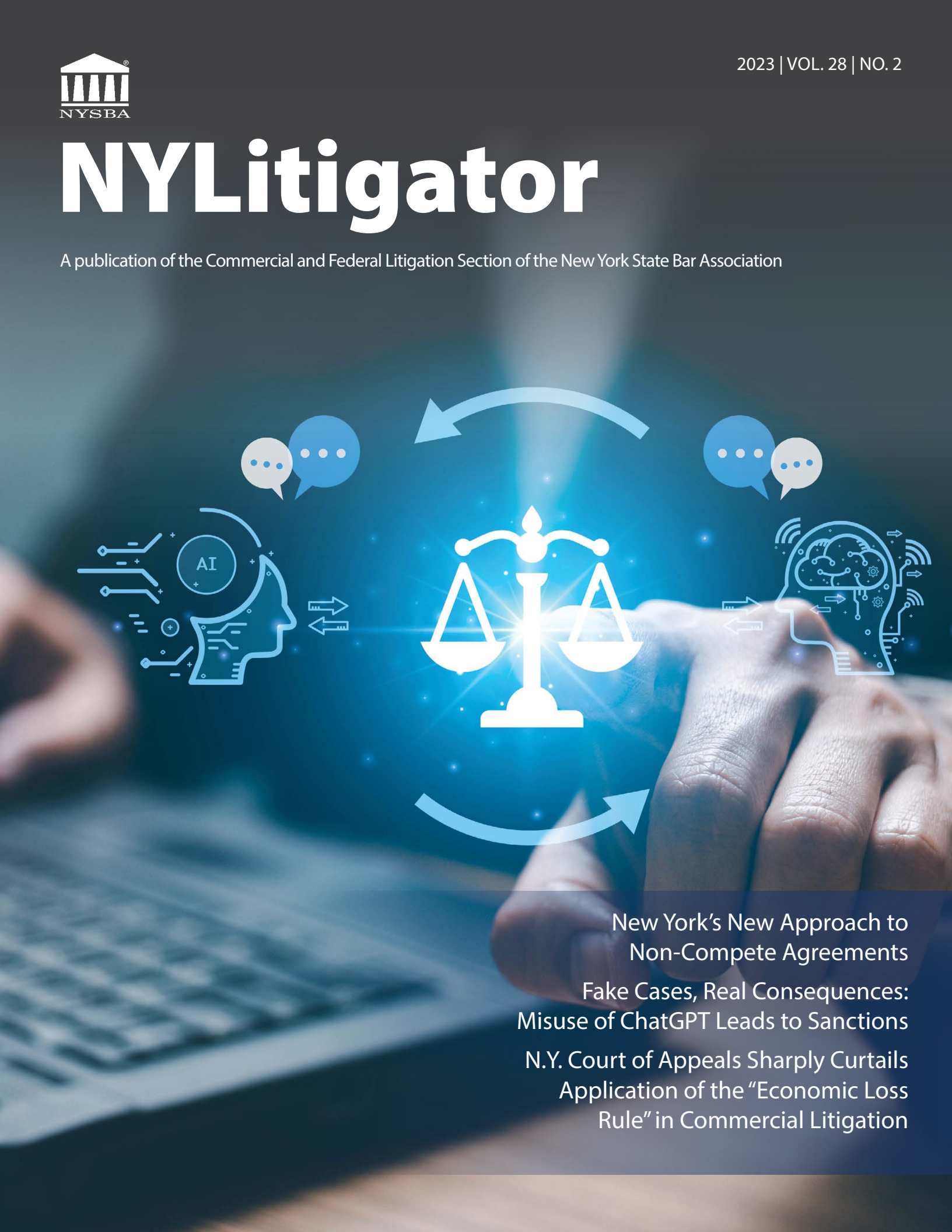
2023 | VOL. 28 | NO. 2

NYSBA

NYLitigator

A publication of the Commercial and Federal Litigation Section of the New York State Bar Association



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N.Y. Court of Appeals Sharply Curtails Application of the "Economic Loss Rule" in Commercial Litigation

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By Lauren Dayton

In *IKB International, S.A. v. Wells Fargo Bank, N.A.*, No. 51, 2023 WL 4002324 (N.Y. June 15, 2023), the New York Court of Appeals announced that the "economic loss rule" applies only in products liability cases. By limiting the rule to products liability, the Court of Appeals resolved the significant confusion among lower state and federal courts, some of which had applied the rule more broadly in commercial litigation, including in litigation involving indenture trustees.

The Court of Appeals also clarified that where (outside of products liability) courts had applied the economic loss rule, they should instead apply the test for duplicative tort and contract claims. Under the facts in *IKB*, the Court of Appeals easily found the claims duplicative. But the decision leaves open several questions about how that duplicative-claims test would apply in closer cases.

What Is the Economic Loss Rule?

As originally articulated by the Court of Appeals, under the economic loss rule, strict products liability does not apply where a customer's injury from a defective product can be satisfied with contractual remedies. Specifically, "where the claimed injury is solely to the product itself," rather than personal injuries or injury to property, and "the only damages sought are replacement costs," the plaintiff cannot recover tort damages under a strict liability theory.[1] The Court of Appeals explained that in disputes between commercial parties over a damaged product, where there is a "purely economic loss," there is no need to shift the loss to the manufacturer.[2] To the extent a plaintiff seeks to recover the loss of expectation damages from a contract, the rationale goes, a contract claim is the best mechanism to do so.

What Was the Confusion Before?

Over the last 30 years, both New York State and federal courts applied the economic loss rule beyond the products liability context to prohibit many other torts—including negligence, fraud, and fraudulent-inducement claims—whenever an express contract governed the parties' relationship.[3] Those courts concluded that the rule served a salutary purpose by limiting liability where (as a policy matter) foreseeability requirements alone would be insufficient, and by "disentangl[ing]" contract and tort law by "restrict[ing] plaintiffs who suffer economic losses to the benefits of their bargains."[4] The goal, these courts said, was to "keep contract law 'from drowning in a sea of tort.' "[5]

But some courts expressed reservations about extending the rule, and declined to apply it to specific types of actions, such as intentional torts,[6] or professional malpractice actions against an accountant or attorney.[7] And the Court of Appeals declined to apply the economic loss rule to tort claims arising out of a construction-related accident, suggesting that it was more limited.[8] But lower courts were still uncertain as to whether that refusal signaled that the doctrine would never apply in other contexts.

Is the Economic Loss Rule Different From the Economic Loss Doctrine?

As courts began to apply the economic loss rule more broadly, they also began to apply a related but distinct rule: a defendant is not liable in tort for a purely economic loss unless the plaintiff identifies a separate tort duty.[9] That rule, sometimes called the "economic loss doctrine," requires a party's tort claim to be based on a duty separate from the contract.[10]

Federal district courts considering claims in residential mortgage-backed securities cases in particular applied the doctrine to require a plaintiff bringing tort claims against a trustee to allege breach of a duty independent of the contract. For example, in one case the court concluded that a plaintiff had alleged a "non-waivable duty to exercise due care" in performing ministerial acts that was sufficiently independent from the contractual duties to avoid the economic loss doctrine.[11] Another court similarly concluded that an allegation that the trustee breached its duty to avoid conflicts of interest satisfied the independent-duty requirement.[12]

Separately, another split of authority developed in the Second Circuit as to whether, in addition to alleging breach of an independent duty, a party must also allege tort damages independent from contract damages. Some courts concluded that independent damages were required.[13] Others concluded that so long as the plaintiff had alleged that the defendant (usually an RMBS trustee) had breached a duty independent of the contract, those "extra-contractual allegations" were sufficient to foreclose the application of the economic loss doctrine.[14]

What Is the Law Now?

In *IKB*, the Court of Appeals cleared up some of the confusion. First, it clarified that the economic loss rule " 'stands for the proposition that an end-purchaser of a product is limited to contract remedies and may not seek damages in tort for economic loss against a manufacturer,' " and that it applies only in products liability cases.[15] In *IKB*, plaintiff investors sued RMBS trustees, alleging they had breached various contractual, fiduciary, and statutory duties that caused the plaintiffs' investments to become worthless during the 2008 financial crisis.[16] The Court of Appeals acknowledged that some federal and state courts had applied a version of the economic-loss rule—which it, curiously, referred to as both the "economic loss rule" and the "economic loss doctrine"—to these types of claims.[17] And it confirmed that the rule does not apply.

Second, the Court of Appeals made clear that the relevant inquiry is whether the tort claims are duplicative of the contract claims. But the court was not entirely clear about how to conduct that inquiry. It first said that "a legal duty independent of the contract itself " must have been violated—this is the rule that some courts had referred to as the economic loss doctrine. But the Court of Appeals then said that determining whether claims are duplicative requires courts to evaluate: (1) the nature of the injury, (2) how the injury occurred, and (3) the harm it caused.[18] Applying that three-prong test to the pleadings before it, the court concluded the plaintiff investors' tort claims for conflict of interest and breaches of fiduciary duty were duplicative.

Although the test set out by the Court of Appeals seems simple enough, the decision leaves many questions unanswered. Most obviously, the court never examined whether plaintiffs had stated a legal duty independent of the contract, even though its statement of the rule presented that as a threshold inquiry.[19] Some lower courts have concluded that conflict-of-interest claims and claims for post-event-of-default fiduciary duties are independent of contractual duties.[20] But the Court of Appeals might just as easily have skipped what it framed as a separate question because it concluded the claims before it otherwise failed the three-prong injury test.

The Court of Appeals also directed lower courts to "evaluate" three things related to injury and harm. But it did not say what the "nature of the injury" alleged or "how the injury occurred" would make a claim either sufficiently distinct or fatally duplicative. The case before it was easy: the plaintiffs had used the exact same language in the complaint to describe

both their contract and tort claims. The Court of Appeals did not elaborate on how the "nature" of the injury would have to be different if plaintiffs had pleaded a different basis for the tort claim.[21]

The case law the *IKB* court cited did not clarify its reasoning. In *Dormitory Authority*, the plaintiff's allegations also did not distinguish between damages applicable to the contract and tort claims. And *Sommer*, the source quoted in *Dormitory Authority*, involved a very different situation. There, the Court of Appeals focused on the nature of the services—fire alarms—and concluded that the damages sought for a fire that spread out of control were sufficiently different from benefit-of-the-bargain damages to render the tort claim not duplicative.[22] *Sommer* did not explain what circumstances would be sufficient to support a tort claim outside the context of "an abrupt, cataclysmic occurrence" that caused catastrophic property damage.[23]

The Court of Appeals was similarly opaque about how "the harm" must be different to support a separate tort claim. Because the plaintiff in *IKB* again used identical language to describe the harm for both the contract and tort claims, the Court of Appeals easily concluded that the claims were duplicative. But it did not specify what about the harm would have to be different for the claims to be unique. For example, the Court of Appeals did not specify whether it would be sufficient for a party to identify an additional amount of damages attributable to the tortious conduct, or whether a plaintiff would need to plead a different category of damages associated with a tort to avoid dismissal.

The *IKB* decision clears up some widespread confusion – the "economic loss rule" now applies only in the context of products liability. The decision also clarifies that the relevant inquiry is whether contract and tort claims are duplicative. But there remain open questions about how to apply the duplicative claims test, particularly outside the unique context of public-interest-imbued services like fire alarms. One thing is clear: using the exact same language to plead injury and harm for both a contract and tort claim is a recipe for getting the tort claim dismissed.

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Endnotes

1. *Bellevue S. Assocs. v. HRH Const. Corp.*, 78 N.Y.2d 282, 290, 574 N.Y.S.2d 165, 168 (1991).
2. *Id.*, 78 N.Y.2d at 293, 574 N.Y.S.2d at 169.
3. *See, e.g.*, *Cruz v. TD Bank, N.A.*, 855 F. Supp. 2d 157, 178 (S.D.N.Y. 2012), *aff 'd and remanded*, 742 F.3d 520 (2d Cir. 2013) (negligence); *Shred–It USA Inc. v. Mobile Data Shred*, 222 F. Supp. 2d 376, 379 (S.D.N.Y. 2002) (fraud); *Orlando v. Novurania of Am., Inc.*, 162 F. Supp. 2d 220, 225-26 (S.D.N.Y. 2001) (fraudulent inducement).
4. *King County v. IKB Deutsche Industriebank AG*, 863 F. Supp. 2d 288, 302 (S.D.N.Y. 2012), *rev'd in part on other grounds*, No. 09 Civ. 8387, 2012 WL 11896326 (S.D.N.Y. Sept. 28, 2012); *Hydro Invs., Inc. v. Trafalgar Power Inc.*, 227 F.3d 8, 16 (2d Cir. 2000) ("The economic loss rule's continuing role is based on the recognition that 'relying solely on foreseeability to define the extent of liability in cases involving economic loss, while generally effective, could result in some instances in liability so great that, as a matter of policy, courts would be reluctant to impose it.' ") (cleaned up) (quoting *5th Ave. Chocolatiere, Ltd. v. 540 Acquisition Co.*, 272 A.D.2d 23, 28 (1st Dep't 2000)).
5. *Carmania Corp., N.V. v. Hambrecht Terrell Int'l*, 705 F. Supp. 936, 938 (S.D.N.Y. 1989) (quoting *E. River S.S. Corp. v. Transamerica Delaval Inc.*, 476 U.S. 858, 866 (1986)).
6. *In re Gen. Motors LLC Ignition Switch Litig.*, 257 F. Supp. 3d 372, 433 (S.D.N.Y. 2017), *modified on other grounds*, No. 14 Misc. 2543, 2017 WL 3443623 (S.D.N.Y. Aug. 9, 2017).
7. *See, e.g.*, *17 Vista Fee Assocs. v. Tchrs. Ins. & Annuity Ass'n of Am.*, 259 A.D.2d 75, 83 (1st Dep't 1999); *Hydro Invs., Inc. v. Trafalgar Power Inc.*, 227 F.3d 8, 18 (2d Cir. 2000).
8. *532 Madison Ave. Gourmet Foods, Inc. v. Finlandia Ctr., Inc.*, 96 N.Y.2d 280, 288 n.1, 727 N.Y.S.2d 49, 53 n.1 (2001) (distinguishing the economic loss doctrine from the economic loss rule without referring to the doctrine by name).
9. *Finlandia Ctr.*, 96 N.Y.2d at 289-92, 727 N.Y.S.2d at 53-56; *Ambac Assurance Corp. v. U.S. Bank Nat'l Ass'n*, 328 F. Supp. 3d 141, 158-59 (S.D.N.Y. 2018).
10. *Id.* (emphasis added). Courts did not always distinguish between the two concepts or would use both terms to refer to only one concept or the other.
11. *Commerzbank AG v. U.S. Bank Nat'l Ass'n*, 277 F. Supp. 3d 483, 496-97 (S.D.N.Y. 2017).
12. *BlackRock Allocation Target Shares: Series S. Portfolio v. Wells Fargo Bank, Nat'l Ass'n*, 247 F. Supp. 3d 377, 399 (S.D.N.Y. 2017).
13. *See, e.g.*, *Blackrock Core Bond Portfolio v. U.S. Bank Nat'l Ass'n*, 165 F. Supp. 3d 80, 106 (S.D.N.Y. 2016).
14. *See, e.g.*, *Commerzbank AG*, 277 F. Supp. 3d at 496-97.
15. *IKB Int'l*, 2023 WL 4002324, at *6.
16. *Id.* at *1.
17. *Id.* at *6.
18. *Id.* (quoting *Dormitory Auth. v. Samson Constr. Co.*, 30 N.Y.3d 704, 711-13, 70 N.Y.S.3d 893, 898-99 (2018) (in turn quoting *Sommer v. Fed. Signal Corp.*, 79 N.Y.2d 540, 552, 583 N.Y.S.2d 957, 961 (1992))).
19. *Id.* (" '[A] simple breach of contract is not to be considered a tort unless a legal duty independent of the contract itself has been violated' and 'where plaintiff is essentially seeking enforcement of the bargain, the action should proceed under a contract theory' " (quoting *Dormitory Auth. v. Samson Constr. Co.*, 30 N.Y.3d 704, 711-13, 70 N.Y.S.3d 893, 898 (2018)). In *Dormitory Authority*, the Court of Appeals also presented the independent duty inquiry as separate from the three-prong injury/harm test. *See id.*, 30 N.Y.3d at 711, 70 N.Y.S.3d at 898 ("we have *also* evaluated the [three-prong test]" (emphasis added)). But in *Sommer*, which *Dormitory Authority* quoted for the rule, the court appeared to consider the first prong (nature of the injury) to decide whether there was an independent duty. *Sommer*, 79 N.Y.2d at 553, 583 N.Y.S.2d at 962 ("The nature of Holmes' services and its relationship with its customer therefore gives rise to a duty . . . that is independent of Holmes' contractual obligations.").
20. *See, e.g.*, *Commerzbank AG*, 277 F. Supp. 3d at 497 (concluding allegations of pre-EOD conflicts of interest and post-EOD breaches of fiduciary duty were independent of contractual claims); *Phoenix Light SF Ltd. v. Deutsche Bank Nat'l Tr. Co.*, 172 F. Supp. 3d 700, 718 (S.D.N.Y. 2016) (same); *Royal Park Invs. SA/NV v. HSBC Bank USA, Nat'l Ass'n*, 109 F. Supp. 3d 587, 609 (S.D.N.Y. 2015) (post-event of default breach of fiduciary duty).
21. *IKB Int'l*, 2023 WL 4002324, at *6-7.
22. *Sommer*, 79 N.Y.2d at 553, 583 N.Y.S.2d at 962.
23. *Id.*, 79 N.Y.2d at 552, 583 N.Y.S.2d at 961.