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SMB LEGAL NOTES

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Special Points of Interest:

- *Arizona's economic loss rule now applies as a bright-line rule to construction defect claims.*
- *Arizona's economic loss rule will still require a case-by-case analysis in products liability cases.*
- *California courts will continue to subject insurers' claims for equitable indemnity to a balancing of the equities test.*

ARIZONA COURT CREATES SECOND ECONOMIC LOSS RULE

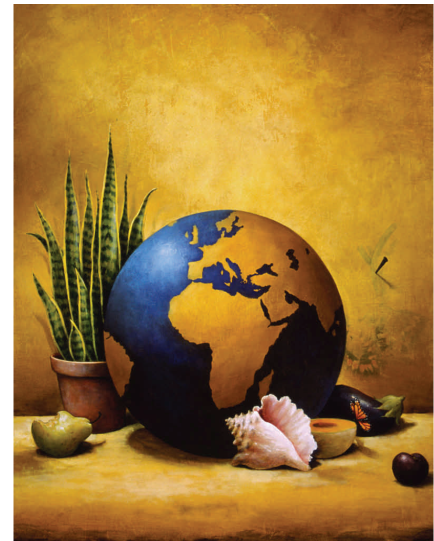
Arizona's Supreme Court has recently clarified the application of the so-called economic loss doctrine to construction defect litigation. Although the economic loss rule has been a part of common law since the 1800's, its application has always been problematic. If the doctrine applies in a lawsuit, the plaintiff will be limited to contract-based remedies, and cannot rely on tort law for a recovery. The Supreme Court's decision in *Flagstaff Affordable Housing LP v. Design Alliance, Inc*, will provide much-needed clarity to construction defect litigation in Arizona courts.

The *Flagstaff Affordable Housing* court cast aside the various definitions for economic loss created by the two divisions of the Arizona Court of Appeals, and concluded that economic loss "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." Division One of the Court of Appeals had earlier referred to this as the loss of the benefit of the contractual bargain in its influential *Carstens* decision.

From now on, according to the *Flagstaff Affordable Housing* court, the economic loss rule will apply to construction defect cases. However, the doctrine will apply differently for construction defect claims, as opposed to product liability claims. In product liability cases, the court must continue to use the three-part *Salt River* test, requiring it to first identify (1) whether the loss is "economic;" and then to inquire into whether (2) the defect was "unreasonably dangerous;" and (3) whether the loss occurred in a "sudden, accidental manner." Thus, the application of the economic loss doctrine in products liability cases will continue to depend upon a case-by-case analysis by the courts. If the doctrine is applied, the plaintiff will be limited to his or her contractual remedies, but if the doctrine is waived under the *Salt River* test, the plaintiff may also bring tort claims.

Presumably, where construction defect cases implicate suppliers and their products, the *Salt River* analysis will apply, allowing for tort recoveries in cases of building products supplied to the construction project that led to sudden and unreasonably dangerous occurrences. Otherwise, for claims against contractors and design professionals, for allegations of defective construction or design, the economic loss rule will apply automatically. Thus, only plaintiffs who do not have contractual relationships with the relevant contractors, engineers, and architects, will be permitted to bring tort claims. The Supreme Court's new ruling also clarifies that a non-party to the relevant contract *can* rely on tort law to recover for damages, even though the economic loss rule does not allow the parties to the contract to use non-contractual remedies.

Thus, there is still no single, bright-line rule for economic loss claims. The rule will be applied differently in Arizona construction cases depending upon whether the loss arises from construction defects or product defects, or whether the plaintiff is a contract privy with the defendant. However, parties now have more predictable guidance on when the economic loss rule applies.



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Arizona Economic Loss Decision 1

The Arizona Supreme Court has clarified the effect of the economic loss rule in construction cases

California Equitable Subrogation Case 2

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SMB was established in 1993 with the goal of providing experienced and efficient legal representation to businesses and individuals. SMB's litigation department is led by two AV-rated, certified specialists who are also members of the American Board of Trial Advocates. All partners and senior associates in SMB's litigation department have first-chair trial experience.

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The attorneys of SMB's construction litigation practice group are admitted to practice in both Arizona and California, allowing for **strategic representation** of the Southwest construction industry.

CALIFORNIA COURT ALLOWS INSURER'S SUBROGATION CLAIM

This past Monday, the San Francisco-based First District Court of Appeal of California reversed the San Francisco Superior Court's ruling against a general contractor's insurer in its attempt to obtain indemnity from a negligent subcontractor. The case of *Interstate Fire & Casualty Insurance Company v. Cleveland Wrecking Co.*, specifically concerned damages for personal injuries sustained during a worksite accident, however, the principles of indemnity and subrogation discussed in *Interstate Fire* should apply equally to all other types of damages arising from construction.

In *Interstate Fire*, the demolition subcontractor and steel stairway contractor were both contractually obligated to indemnify the general contractor, and were both obligated to provide insurance coverage to the general contractor, as an additional insured. When the employee of one subcontractor was injured by the operations of another, he sued both the general contractor and the demolition subcontractor. Ultimately, the general contractor's insurance carrier settled the claims against the general contractor, and the demolition subcontractor similarly settled claims against it. The issue on appeal was whether the general contractor's insurer could recover against the demolition subcontractor for the funding of the general contractor's settlement.

The *Interstate Fire* court began its analysis, noting that once the trial court has ruled that a tortfeasor's settlement was made in good faith, no party has an implied indemnity claim against that tortfeasor. However, the same protection does not apply to contractual indemnity obligations, which will continue even after a trial judge has certified the indemnitor's underlying settlement as made in good faith.

The *Interstate Fire* court confirmed that the general contractor's insurer had a claim for indemnity against a subcontractor who was contractually obligated to indemnify the insurer's insured, even though the subcontractor had settled its own liability. The court also went on to confirm that a balancing of the equities between the insurer and subcontractor would be necessary in order to rule on whether the insurer can claim equitable indemnity. In this case, the insurer was permitted to make the claim, but all future subrogation cases will still require a balancing of the equities.