

## Options Are Limited

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**O**regon Supreme Court recognizes negligent construction by declining to apply economic loss doctrine.

# Can the Defense Turn to Contract?

In Oregon's ongoing construction defect wars, plaintiffs appear to have won the battle over the economic loss doctrine. The tort of negligent construction is all but confirmed by the Oregon Supreme Court. *Harris v.*

*Suniga*, 344 Or. 301, 180 P.3d 12 (2008). After the Oregon Supreme Court's *Harris* decision, the main question is, can Oregon construction professionals limit their liability through contract?

### Oregon's Economic Loss Doctrine Saga Closes

Under Oregon's long-standing version of the economic loss doctrine a plaintiff may not recover in tort for purely economic losses unless the plaintiff and defendant have a special relationship. Economic losses are broadly defined in Oregon as "financial losses such as indebtedness incurred and return of monies paid, as distinguished from damages for injury to person or property." *Onita Pacific Corp.*, 315 Or. 149, 159, 843 P.2d 890 (1992). Economic losses can include lost profits, lost insurance proceeds, economic expectancy damages, investment losses, or money paid in settlement of personal injury claims. The kinds of relationships that qualify for recovery of economic

losses are those in which one participant in the relationship agrees to act for the benefit of the other, rather than at arm's length. *Id.* at 161-62. Examples of special relationships include the attorney-client, agent-principal, and some insurer-insured relationships.

While the economic loss doctrine has been applied in Oregon for decades, it only recently became significant to construction defect litigants. In July 2003, the Oregon Court of Appeals upheld a trial court dismissal of tort claims in favor of a construction contractor in *Jones v. Emerald Pacific Homes, Inc.* *Jones v. Emerald Pacific Homes, Inc.*, 188 Or. App. 471, 71 P.3d 574 (2003).

The *Jones* plaintiffs were homeowners who signed a custom-home construction contract with their builder, Emerald Pacific Homes (Emerald). The homeowners then "became dissatisfied with Emerald's alleged failure to meet its schedule and with the allegedly poor workmanship... in particular a leaky roof that caused damage to the interior finish." *Id.* at 473-74. The plaintiffs



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sued in contract and in tort, but the trial court and court of appeals found that because the homeowner-builder relationship was not special, the homeowners could not maintain a tort claim against Emerald.

Following *Jones*, contractors, insurers, and defense counsel thought they might finally have the case law support to win the debate over whether the economic loss rule

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trumps tort claims in Oregon construction defect cases. But after *Jones*, two problems arose, which were brought to the trial court judge's attention by plaintiffs' lawyers. First, and notable for a seminal economic loss case, the *Jones* court never mentioned the words "economic loss" in the opinion. Second, plaintiffs' counsel relied on an old Oregon Supreme Court case with some troublesome language, *Newman v. Tualatin Development Co.* *Newman v. Tualatin Dev. Co.*, 287 Or. 47, 597 P.2d 800 (1979). The *Newman* court relied on out-of-state cases in concluding that "we know of no reason" why the plaintiffs could not maintain a negligence claim for construction defects.

To counter these arguments, defense counsel pointed out that the *Jones* court relied on economic loss cases, and, as in those economic loss cases, the court had focused on the lack of a special relationship between the parties. Therefore, the argument went, *Jones* must have been an economic loss case. Moreover, it was argued that *Jones* simply signaled that Oregon would follow its neighbor Washington State in outlawing "negligent construction" based on the economic loss doctrine. *Atherton Condominium Apartment-Owners Ass'n v. Blume Dev. Co.*, 115 Wash. 2d 506, 799 P.2d 250 (1990).

For three and a half years, Oregon state and federal trial courts attempted to reconcile *Jones* and *Newman* with variable results. Some plaintiffs had their cases dis-

missed altogether based on the economic loss doctrine, while many others likely accepted discounted settlements to avoid the risk of a similar fate.

In 2006, the Oregon Court of Appeals accepted the opportunity to clear up the dispute over the interpretation of *Jones*, and the court did so in favor of the application of tort in construction defect actions in the case of *Harris v. Suniga*. *Harris v. Suniga*, 209 Or. App. 410, 149 P.3d 224 (2006). In reversing the trial court's tort claims dismissal under the economic loss doctrine, the court of appeals highlighted two problems with applying *Jones* to *Harris*-like situations. First, the court decided that *Jones* was not an economic loss doctrine case at all. Second, it decided that construction defect damages, such as dry rot, are not pure economic loss damages, but are, in fact, "property" damage.

As explained by the court of appeals, the issue in *Jones* was not economic loss damages, but rather whether a breach of contract could give rise to a separate tort claim for identical injuries. The *Harris* plaintiffs did not have a contract with the defendant builders in their case; they were remote purchasers. Moreover, the court of appeals agreed with the plaintiffs that *Newman*'s facts were materially indistinguishable from the facts in *Harris*, and therefore, *Newman* controlled.

In *Harris* the court of appeals indicated that it was mere coincidence that *Jones* involved construction defects. Instead, according to the court, *Jones* represented the application of a *different* long-standing rule of Oregon law, which, as with the economic loss doctrine, also requires a special relationship, and the modern lineage of which is traced through Oregon's economic loss doctrine cases. *See, e.g., Ore-Ida Foods v. Indian Head*, 290 Or. 909, 627 P.2d 469 (1981); *Conway v. Pacific University*, 324 Or. 231, 924 P.2d 88 (1996).

The actual rule applied in *Jones* holds that, under Oregon law, parties to a contract can maintain breach of contract and tort claims for the same wrongful acts in limited circumstances:

When the relationship involved is between contracting parties, and the gravamen of the complaint is that one party caused damage to the other by negligently performing its obligations under

the contract, then, and even though the relationship between the parties arises out of the contract, the injured party may bring a claim for negligence if the other party is subject to a standard of care independent of the terms of the contract.

*Georgetown Realty v. The Home Ins. Co.*, 313 Or. 97, 106, 831 P.2d 7 (1992).

Oregon courts determine whether the parties are subject to a standard of care independent of the terms of the contract by examining the dynamics of the relationship at issue. The Oregon Court of Appeals characterized this analysis as a two-step process:

Thus, to bring a tort claim based on conduct that is also breach of a contract, a plaintiff must allege, first, that the defendant's conduct violated some standard of care that is not part of the defendant's explicit or implied contractual obligations; and, second, that the independent standard of care stems from a particular special relationship between the parties.

*Strader v. Grange Mutual Ins. Co.*, 179 Or. App. 329, 333, 39 P.3d 903 (2002).

Construction defect cases in Oregon routinely involve issues of contract interpretation. And because the special relationship analysis is relevant to evaluating dual tort/contract claims (as in *Jones* and *Strader*), as well as the economic loss doctrine, it is easy to see how the standards could become intertwined. Moreover, the dual tort/contract claim rule lacks a distinguishing standard of care like "economic loss doctrine."

In March 2008, the Oregon Supreme Court affirmed the court of appeals' decision in *Harris*, largely reiterating the lower court's analysis. Both courts began their discussions with overarching statements regarding Oregon's negligence standard. Since the 1987 Oregon Supreme Court case *Fazzolari v. Portland School Dist. No. 1J*, Oregon has favored a "foreseeability analysis" over a more traditional duty and breach of duty analysis in negligence cases. *Fazzolari v. Portland School Dist. No. 1J*, 303 Or. 1, 734 P.2d 1326 (1987). "We begin with the general rule that all persons are liable in negligence if their conduct unreasonably creates a foreseeable risk of harm to others." *Harris v. Suniga*, 209 Or. App. 410, 415, 149 P.3d 224 (2006).

While affirming the prominence of the foreseeability standard for negligence, the Oregon Supreme Court in *Harris* also blew the last bit of dust off the *Newman* case. The tort of negligent construction was born, and construction defect damages are now defined as property damage rather than pure economic loss in Oregon.

At the end of the Oregon Supreme Court's *Harris* opinion, the court referenced a significant issue for defendants arguing in favor of the economic loss doctrine:

Several *amici* aligned with defendants argue that, because the original purchaser could bring only a contract, and not a negligence, action against the builder, to allow plaintiffs to maintain a negligence action here would lead to the anomalous result that a subsequent purchaser of the property would have "more" rights against the builder than the person for whom the builder constructed the building. They also assert, more generally, that a builder's obligations and the scope of its liability are better addressed through contractual terms, rather than post hoc litigation. . . . We decline to address those issues. Certainly, contracts between builders and initial purchasers (and between initial purchasers and subsequent purchasers) play a critical role in determining legal rights and liabilities, and contractual negotiations are a preferred method of establishing parties' respective obligations. This case, however, does not involve a contract, nor is it an action by an initial purchaser against a builder, and the arguments the various amici advance, while important and interesting, simply go beyond what is at issue here.

*Harris*, 344 Or. at 313. With this dictum, the court underlined the potential for disparate results for parties to construction defect actions when there is a contract between them. Clearly, defendants want to be in Emerald's position from *Jones*; plaintiffs will opt for *Harris* every time.

### **Harris v. Suniga Should Not Invalidate Existing Construction Contracts**

As in many parts of the country, builders and contractors in Oregon commonly offer customers a limited warranty. For builders, the limited warranty is typically included as part of a standard purchase and sale agree-

ment. The terms of the limited warranty may amount to a blanket one-year labor and materials guarantee and include an option to purchase an additional limited warranty for major systems extending over the duration of the statute of ultimate repose, or for up to 10 years. ORS 12.135. As part of the contract and limited warranty, however, the builder can limit its exposure by disclaiming other express or implied warranties, as well as tort liability. An important question for builders and homeowners after *Harris* is whether the terms of these commonly used contracts, if enforceable in other respects, are still valid.

Some construction defect plaintiffs with contracts with contractors may argue that after *Harris*, contractors must now specifically disclaim tort liability in contracts to avoid exposure for negligent construction. Disclaimers of tort liability and waivers of warranties in consumer contracts must be specific and conspicuous under Oregon law; attempted disclaimers of tort liability and waivers of warranties in consumer contracts regularly pose challenges to drafters and litigators. *K-Lines, Inc. v. Roberts Motor Co.*, 273 Or. 242, 541 P.2d 1378 (1975). If made in court, the argument that contractors must specifically disclaim tort liability in contracts to avoid exposure for negligent construction is probably unsound. *Jones* is good law, and the court of appeals in *Jones* rendered its decision in favor of the contractor without reference to disclaimers or attempted waivers of liability. The best interpretation of *Jones* after *Harris* is that the *Jones* court correctly recognized that the contractual duty established between contract parties supplanted the common law duty to build in a non-negligent manner. Furthermore, the contractual duty, according to the Oregon Supreme Court, has been around since *Newman*.

Similarly, plaintiffs may argue that *Harris* recognized a new *independent* duty to perform construction work in a non-negligent manner, and that the independent duty falls outside the relationship terms of the contract between the builder and purchaser, creating a special relationship. If a court agrees that an independent, concurrent duty exists and the parties to the contract have a special relationship, tort claims will survive. On the other hand, the notion that *Harris* created or recognized a new

independent duty for parties to construction contracts is also probably incorrect. In addition to *Harris*' affirmation of *Newman*, Oregon has long held that an obligation to perform construction work in a workmanlike manner is an implied term of every construction contract. *Beveridge v. King*, 50 Or. App. 585, 587, 623 P.2d 1132 (1981) (citing *Newlee v. Heyting*, 167 Or. 288, 117 P.2d 829 (1941)). The duty to perform the contract in a workmanlike manner is no different from a builder's general obligation to exercise care in construction work in a manner reasonably foreseeable to avoid damage to others; both obligations are objective standards based on the accepted standards in the construction industry.

Furthermore, the court of appeals in *Harris* clearly had the opportunity to overturn *Jones* and did not. The supreme court did not even mention *Jones* in its *Harris* opinion. The upshot is that a contractor's obligation to perform work in a non-negligent manner existed under any construction contract long before *Harris*; *Harris* simply confirmed a common law obligation which is not subject to the special relationship limitations of the economic loss doctrine and which favors remote purchasers. As long as a court clearly understands that the gravamen of the plaintiff's claim is negligent performance of work under a construction contract, *Jones* should benefit defendants with contracts.

### **Contractors and Subsequent Purchaser Claims after Harris**

Now more than ever, reducing contractor exposure in Oregon depends not only on the strength of contracts with direct customers, but in finding ways to bind subsequent purchasers to the original contract's terms. Because *Harris* is new, clear strategies for avoiding subsequent purchaser liability for construction defect claims are elusive. Short of a legislative remedy, builders' and contractors' only recourse against expanded subsequent purchaser claims may lie in incorporating limitations on liability with the deed to real estate.

### **Can Limitations of Liability in Subsequent Purchases "Run with the Land"?**

If beneficial terms of an original purchase and sale contract go, too, when title to real



property passes from the initial to subsequent purchaser, builders and contractors may not be able to avoid open-ended liability. Therefore, they may seek to incorporate terms limiting liability to subsequent purchasers into the deed in the same way as more common covenants, conditions and restrictions.

If, for example, a developer of a residential subdivision institutes an architectural review committee and as part of a homeowners' association, the restrictions imposed on the property owner by the process will generally be enforceable as restrictive covenants, running with the land. For a builder to pass on limitations of liability in the original purchase and sale agreement to

subsequent purchasers, the key terms similarly must be incorporated into the deed. If valid terms are not properly incorporated into the deed, an owner will argue that the contract terms were extinguished by the doctrine of merger. *Valenti v. Hopkins*, 324 Or. 324, 331, 936 P.2d 813 (1979).

General statements from the Oregon Supreme Court regarding the interpretation of covenants suggest that limitations on a builder's liability could run with the land. For example, in the 1922 case of *Pearson v. Richards*, the court stated:

When construing covenants in a deed, courts ought, if possible, to ascertain and give effect to the intention of the parties, and if it appears from the whole

tenor of the deed, the nature of the thing to be done, its relation to the property, the period of its continuance, and the like, that the parties intended that a covenant should run with the land, then in order to carry out such intention the covenant should ordinarily be construed as a real covenant, and therefore as one running with the land.

*Pearson v. Richards*, 106 Or. 78, 211 P. 167 (1922).

Although effectively incorporating limitations on liability into a deed as a covenant running with the land seems promising, it is an unproven defense strategy, and thus the construction fights in Oregon are likely to continue for the foreseeable future. 