The Economic Loss Doctrine and Consumers

By Gary M. Victor

Fast Facts

Consumers will generally be unable to pursue tort remedies if their losses regarding the sale of goods are purely economic in nature, but will only be able to utilize claims under the Uniform Commercial Code.

Fraud in the inducement—whatever that means—may be an exception allowing consumer tort remedies.

When the predominant nature of the transaction is for services, the economic loss doctrine does not apply.

The distinction between contract theory and tort theory can often be murky. Under certain circumstances, a potential plaintiff may be able to press contract claims, tort claims, or both. For example, the plaintiff buys a product that turns out to be defective and causes injury to person or property, the plaintiff makes a contract for services that are performed negligently, or the plaintiff is fraudulently induced to enter into a contract. The economic loss doctrine is a judge-made rule that, when applicable, eliminates a plaintiff's ability to seek tort remedies if, in the absence of the doctrine, both tort and contract claims would be viable.[1] Essentially, the doctrine holds that if a buyer's losses related to defective goods are only economic or commercial in nature, the buyer is limited to the contract remedies available under the Uniform Commercial Code (UCC).[2]

This may seem to be little more than a forced election of remedies. As will be seen in several of the leading cases discussed below, however, the issue often is not whether the plaintiff has to proceed under contract theory alone, but whether the plaintiff can proceed at all.[3] For example, the statute of limitations under

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the UCC is four years, which can be reduced to not less than one year by agreement of the parties.[4] The four years begin to run from the time of the breach "regardless of the aggrieved party's lack of knowledge of the breach."[5] The statute of limitations on products liability claims[6] is only three years,[7] but that period begins to run from the time the buyer discovers or should have discovered the defect.[8] Thus, if a purchaser fails to discover the product's defect within four years (or a shorter period of time if the statute of limitations is reduced by the parties), the economic loss doctrine leaves the purchaser with no remedy whatsoever.

As with any evolving principle of law, states have developed myriad approaches to the implementation of the economic loss doctrine. Given the Michigan courts' generally negative posture toward tort litigation over the last 20 years, Michigan courts have been adopting one of the more expansive uses of the doctrine. This short article will examine the leading economic loss doctrine cases as they relate to consumers.

The Cases and Other Issues

Neibarger v Universal Cooperatives, Inc— The Landmark Case

The case given credit for introducing, or at least solidifying, the economic loss doctrine as part of Michigan law is *Neibarger v Universal Cooperatives, Inc.*[9] *Neibarger* consolidated two cases in which dairy farmers brought actions in negligence and products liability against the designers and sellers of an allegedly defective milking system that caused the dairy farmers' animals to become ill, forcing plaintiffs to sell the animals for beef.[10] In each case, it was more than four years between the time of the installation and the discovery of the defects. The cases were filed within three years of the discovery of the defects and therefore within the tort statute of limitations.[11] Even so, the trial courts, relying on the economic loss doctrine, dismissed plaintiffs' claims, holding that plaintiffs were subject to the UCC four-year statute of limitations,[12] which had expired when their suit was filed.[13] In both cases, the Court of Appeals affirmed.

After an extensive analysis of the UCC, the distinctions between tort law and contract law, and the economic loss doctrine, the *Neibarger* Court held:

> We are convinced that the reasoning of those courts which have adopted the economic loss doctrine compels a similar conclusion on our part. In the absence of legislative direction, we believe such a rule is required to guide trial courts facing cases such as those before us which lie at the intersection of tort and contract. Accordingly, we hold that where a plaintiff seeks to recover for economic loss caused by a defective product *purchased for commercial purposes,* the exclusive remedy is provided by the UCC, including its statute of limitations.[14]

By its specific holding using the phrase "purchased for commercial purposes" as well as other language in its opinion,[15] the *Neibarger* Court gave the clear impression that the economic loss doctrine applied to the sale of goods for commercial purposes as opposed to the sale of goods to consumers. However one may feel about a judicially forced election of remedies, limiting the application of the economic loss doctrine to sales for commercial purposes is consistent with the differential approach to merchants under the UCC. Many UCC sections subject merchants to greater duties and responsibilities than those of ordinary consumers.[16] Had *Neibarger* been the end of the economic loss doctrine matter, this issue would be of little interest to consumers. Unfortunately, that was not to be the case. The Court of Appeals decided to expand the doctrine to consumer sales.

Sherman v Sea Ray Boats, Inc— The Economic Loss Doctrine Applied to Consumers

The first reported case to apply the economic loss doctrine to consumers was *Sherman v Sea Ray Boats, Inc.*[17] In *Sherman,* the plaintiff purchased a boat in 1985. In 1997, she found some decaying wood on the boat. After some initial repair, extensive "latent decay" was discovered in 1998 for which she received a repair estimate of nearly $40,000. She filed suit against the boat seller in 1999, alleging breaches of warranty and negligence and violations of the Magnuson Moss Warranty Act[18] and the Michigan Consumer Protection Act.[19] The trial court initially dismissed all of plaintiff's

claims except the negligence claim, and then dismissed that last claim on reconsideration.[20]

The *Sherman* Court ignored the "purchased for commercial purposes" holding in *Neibarger* and the Supreme Court's reasoning based on the commercial nature of the transaction in that case. Instead, the *Sherman* Court, relying primarily on the pre-*Neibarger* case of *Hart v Ludwig*[21] and selectively quoting from *Neibarger,* held that the economic loss doctrine applied to consumer sales and affirmed the trial court's dismissal.[22]

One commentator has maintained that conflating *Neibarger* and *Hart,* as the *Sherman* Court did, is "an important mistake in reading the law."[23] Be that as it may, unless and until the Michigan Supreme Court weighs in with a different conclusion, lower Michigan courts will apply the economic loss doctrine to the noncommercial sale of goods to consumers. When a consumer's losses are strictly economic and related to defects in the goods themselves, the economic loss doctrine will limit the consumer's remedies to those provided under the UCC. One possible exception is when fraud is involved; however, it must be a specific kind of fraud.

Huron Tool and Engineering Co v Precision Consulting Services, Inc—The "Fraud in the Inducement" Exception[24]

Among the states, there are three approaches to the question of whether fraud should be an exception to the economic loss doctrine: some states do not permit any type of fraud to be an exception to the doctrine, others allow any type of fraud to be an exception, and a small group of states have a narrow exception in the case of what is termed "fraud in the inducement."[25] In *Huron Tool and Engineering Co v Precision Consulting Services, Inc,*[26] Michigan became the third state to adopt the fraud in the inducement approach. *Huron Tool* is in many ways an anomaly, especially in that it applies the UCC to what appears to be a contract for services.[27] That incongruity aside, *Huron Tool* interpreted *Neibarger* as only applying to non-intentional torts and held fraud in the inducement an exception to the economic loss doctrine.[28] In explaining its fraud in the inducement exception, the Court made it clear that the exception will not apply if the misrepresentation relates only to "the quality or character of the goods sold,"[29] and that a buyer "may only pursue a claim for fraud in the inducement extraneous to the alleged breach of contract."[30]

Although the *Huron Tool* Court was somewhat articulate in explaining what types of fraud would be so intermingled with the performance of the contract as to fail to qualify for the exception to the economic loss doctrine, it was not very sanguine with examples of fraud in the inducement that would qualify. There are no Michigan cases providing further guidance on this issue.[31] In the two other states adopting this approach—Wisconsin and Florida—the reasoning in the single Wisconsin case and the few Florida cases on why, under the facts of those cases, the alleged fraud in the inducement was not interwoven with the contracts in question is murky at best.[32]

Unquestionably, this exception is quite narrow. Until additional cases provide further guidance, the question of to what extent consumers will be able to benefit by this fraud in the inducement exception is unclear.

Other Issues—Hybrid Contracts and Lack of Privity

Often, contracts contain some elements of goods and some of services. As noted in *Neibarger,* "It is difficult to imagine a commercial product which does not require some type of service prior to its purchase, whether design, assembly, installation, or manufacture."[33] In cases presenting tort claims for the service aspect of such hybrid contracts, the courts have generally applied the economic loss doctrine on the basis that the predominant nature of the contract was the sale of goods.[34] Consumers will be unlikely to avoid the application of the economic loss doctrine except when services clearly predominate over any sale of goods involved.[35]

Another issue is whether the economic loss doctrine applies to plaintiffs seeking tort remedies for economic losses against a party not in privity. In *Neibarger,* the suits were against both the seller and the remote designer or manufacturer. In affirming the lower courts' dismissal based on the economic loss doctrine, the Court appears to have applied that rule against the non-privity designers. However, the Court did directly discuss this issue. Several post-*Neibarger* cases have applied the economic loss doctrine in the absence of privity to a supplier or manufacturer,[36] but one case has held there must be some type of contract to support the use of the doctrine.[37]

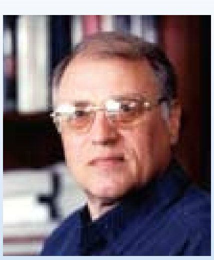
> If a purchaser fails to discover the product's defect within four years, the economic loss doctrine leaves the purchaser with no remedy whatsoever.

Summary and Conclusion

The economic loss doctrine is a judge-created rule that, in Michigan, is in a somewhat convoluted process of evolving. Under the economic loss doctrine adopted by the Supreme Court in *Neibarger v Universal Cooperatives, Inc,*[38] a buyer of defective goods may not pursue tort remedies if the buyer's losses are solely economic but may only seek remedies under the UCC. In many cases, this eliminates the buyer's remedies altogether because of the statute of limitations; in all cases in which the doctrine applies, the buyer would have no opportunity to recover exemplary damages. Even though the *Neibarger* Court held that the doctrine applies to goods "purchased for commercial purposes,"[39] the Court of Appeals in *Sherman v Sea Ray Boats, Inc*[40] applied the doctrine to the sale of goods to consumers. The only current exception to the doctrine, established in *Huron Tool and Engineering Co v Precision Consulting Svcs, Inc,*[41] is for fraud in the inducement "extraneous to the…breach of contract,"[42] whatever that might mean.

The doctrine does seem to apply to manufacturers and other remote sellers even in the absence of privity. Thus, a consumer suit against such parties in tort for purely economic losses will no longer be available. At least, the doctrine does not apply to purely service contracts but may apply to hybrid contracts when the predominant nature of the contract is the sale of goods.

As the theory is in the process of developing and the Supreme Court has not directly ruled on many of the issues regarding the doctrine's application, the future status of consumer tort suits for economic losses is not totally predictable. In the meantime, the doctrine will eliminate economic loss tort actions by consumers involving the sale of goods. ■



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FOOTNOTES

1. For a comprehensive analysis of the economic loss doctrine in Michigan, see Wellman, *Assessing the economic loss doctrine in Michigan: Making sense of the development of law,* 54 Wayne L R 791 (2008).
2. See *Neibarger v Universal Cooperatives, Inc,* 439 Mich 512, 520; 486 NW2d 612 (1992), quoting *Kershaw Co Bd of Ed v US Gypsum Co,* 396 SE2d 369 (SC, 1990), which in turn was quoting *Kennedy v Columbia Lumber & Mfg Co,* 384 SE2d 730 (SC, 1989).
3. See *infra,* the discussions of *Neibarger,* 439 Mich 512, and *Sherman v Sea Ray Boats, Inc,* 251 Mich App 41; 649 NW2d 783 (2002).
4. MCL 440.2725(1).
5. MCL 440.2725(2).
6. MCL 600.2945(h).
7. MCL 600.5805.
8. MCL 600.5833.
9. *Neibarger,* 439 Mich 512. It can be reasonably argued that the concept of disallowing tort claims in cases involving a failure to properly perform a contractual duty appeared as early as 1956 in *Hart v Ludwig,* 347 Mich 559; 79 NW2d 895 (1956). However, *Hart* and *Neibarger* are quite different; see Wellman, n 1 *supra* at 818–819.
10. *Neibarger,* 439 Mich at 516.
11. MCL 600.5833.
12. MCL 440.2725.
13. *Neibarger,* 439 Mich at 516–519.
14. *Id.* at 527–528 (emphasis added).
15. See *id.* at 520–521, 529–530.
16. See, e.g., MCL 440.2205 (Firm Offers), MCL 440.2207 (Additional Terms in Acceptance or Confirmation), MCL 440.2314 (Implied Warranty; Merchantability; Usage of Trade), and MCL 440.2603 (Merchant Buyer's Duties as to Rightfully Rejected Goods).
17. *Sherman,* 251 Mich App 41.
18. 15 USC 2301 *et seq.*
19. MCL 445.901 *et seq.*
20. *Sherman,* 251 Mich App at 42–43.
21. *Hart,* 347 Mich 559.
22. *Sherman,* 251 Mich at 53–54.
23. See Wellman, n 1 *supra* at 818–819.
24. For a lengthy discussion of fraud in the inducement and other types of fraud as an exception to the economic loss doctrine, see Anzivino, *The fraud in the inducement exception to the economic loss doctrine,* 90 Marq L R 921 (2007).
25. *Id.* at 931–933.
26. *Huron Tool and Engineering Co v Precision Consulting Services, Inc,* 209 Mich App 365; 532 NW2d 541 (1995).
27. See *id.* at 367.
28. *Id.* at 368. For the Court's reasoning, see *id.* at 370–371.
29. *Id.* at 373.
30. *Id.* at 374.
31. However, see *General Motors Corp v Alumi-Bunk, Inc,* 2007 WL 2118796, unpublished opinion per curiam of the Court of Appeals, issued July 24, 2007 (Docket No. 270430), *rev'd* by the Supreme Court on the basis of its dissenting opinion, 482 Mich 1080; 757 NW2d 859 (2008).
32. See Anzivino, n 24 *supra* at 935–936.
33. *Neibarger,* 439 Mich at 536.
34. See, e.g., *Bailey Farms, Inc v NOR-AM Chemicals, Co,* 27 F3d 188 (CA 6, 1994) and *Michigan Dessert Corp v A. E. Staley, Inc,* 2001 WL 1356231, unpublished opinion per curiam of the Sixth Circuit Court of Appeals, issued October 24, 2001 (Docket No. 00-1436). Michigan courts have thus far rejected the application of the doctrine to contracts for services alone. See *Higgins v Lauritzen,* 209 Mich App 266; 530 NW2d 171 (1995).
35. For example, contracts for automobile repair are generally viewed as predominantly for services even if they contain separate charges for parts.
36. See, e.g., *Citizens Ins Co v Osmose Wood Preserving, Inc,* 231 Mich App 40; 585 NW2d 314 (1998) and *Freeman v DEC Int'l Inc,* 212 Mich App 34; 536 NW2d 815 (1995). In each case the defendant was a supplier.
37. See *Quest Diagnostics, Inc v MCI WorldCom, Inc,* 254 Mich App 372; 656 NW2d 858 (2002).
38. *Neibarger,* 439 Mich 512.
39. *Id.* at 528.
40. *Sherman,* 251 Mich App 41.
41. *Huron Tool,* 209 Mich App 365.
42. *Id.* at 374.