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Suppose a taxi company purchased a fleet of energy efficient taxis in September, and when the weather turned cold, the cars no longer started due to a defective design. While the taxis were being repaired, the taxi company lost thousands of dollars in business. Should the taxi company have the ability to sue the distributor who sold the defective vehicles? Should the taxi company be able to sue the manufacturer for economic losses caused by the defective design of the taxis?

Traditionally, the economic loss rule[2] would bar recovery in tort for economic losses, such as lost profits, forcing the taxi company to rely on its contractual remedies. A judicially created doctrine, the economic loss rule prevents plaintiffs from recovering under tort law when the plaintiff only suffered economic damages, such as lost profits and the cost of repairs.[3] The economic loss rule, however, does not bar damages for personal injuries, which are still recoverable under tort law.[4] Courts use the economic loss rule to bar lawsuits that seek to redress monetary losses through claims of negligence.[5] Instead, the rule forces plaintiffs to rely on their contractual remedies, such as breach of warranty.[6] Courts justify the rule as a means of separating tort and contract law, which forces the parties to allocate risks in the contract and to rely on contractual remedies.[7] Across the nation, the economic loss rule has developed into a powerful tool for preventing negligence claims in cases in which the plaintiff suffers no physical injury.[8]

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2 Commentators have also referred to it as the economic loss doctrine. Since this Note focuses on Justice Keller's concurring opinion in *Presnell Construction Managers, Inc. v. EH Construction, LLC*, 134 S.W.3d 575, 583 (Ky. 2004) (Keller, J. and Graves, J., concurring), it will use the terminology Justice Keller employed.

3 *See, e.g.*, 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, 1794–96 (2000).

4 *See* Daanen & Janssen, Inc. v. Cedarapids, Inc., 573 N.W.2d 842, 845 (Wis. 1998).

5 *See* Barton, *supra* note 3, at 1793–96.

6 *See Cedarapids*, 573 N.W.2d at 846.

7 *Id.* at 845–46.

8 In other words, the economic loss rule is "[t]he principle that a plaintiff cannot sue

"I believe [the Kentucky Supreme] Court should expressly adopt the economic loss rule in order to encourage contracting parties to allocate . . . [their] risks" in a contract.[9] With this statement from the opening lines of his concurring opinion in *Presnell Constonstruction Managers, Inc. v. EH Construction, LLC*, Kentucky Supreme Court Justice Keller openly endorsed the economic loss rule for the first time in a Kentucky state court.[10] Unfortunately, the majority did not follow Justice Keller's lead and, as a result, federal courts sitting in Kentucky have since questioned the extent to which the economic loss rule should apply within the state.[11] This Note will show that the adoption of the economic loss rule by the Kentucky Supreme Court would benefit the commonwealth because it would not only protect the sanctity of contracts by keeping them separate from torts but also would provide guidance to federal courts sitting in Kentucky when determining Kentucky state-law issues.

Over the past forty years, the economic loss rule has become a prominent part of litigation across the nation, as indicated by its presence in the *Restatement (Third) of Torts: Products Liability*.[12] The rule initially faced opposition from the New Jersey Supreme Court in 1965, when it allowed recovery for economic loss when only the product itself was damaged.[13] Nevertheless, California developed the reasoning behind the economic loss rule that same year.[14] Although those courts initiated the debate over the economic loss rule, the United States Supreme Court later endorsed it in the maritime case of *East River S.S. Corp. v. Transamerica Delaval*.[15] Most jurisdictions have followed the lead of the Supreme Court by adopting the rule,[16] and Kentucky state courts have applied the principles behind the rule[17] without expressly adopting it.

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in tort to recover for purely monetary loss—as opposed to physical injury or property damage—caused by the defendant." BLACK'S LAW DICTIONARY 531 (8th ed. 2004).

9 Presnell Const. Managers, Inc. v. EH Const., LLC, 134 S.W.3d 575, 583 (Ky. 2004) (Keller, J. and Graves, J., concurring).

10 Federal District Courts in Kentucky had discussed the adoption of the economic loss rule prior to *Presnell*. *See infra* note 94 and accompanying text.

11 *See infra* notes 124–52 and accompanying text.

12 RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 21 (1998). *See generally* Christopher Scott D'Angelo, *The Economic Loss Doctrine: Saving Contract Warranty Law From Drowning in a Sea of Tort*, 26 U. TOL. L. REV. 591 (1995) (discussing the impact of the economic loss throughout the nation).

13 Santor v. A & M Karagheusian, 207 A.2d 305, 307 (N.J. 1965).

14 Seely v. White Motor Co., 403 P.2d 145, 151. (Cal. 1965)

15 E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858 (1986). Although tort issues generally arise under state law, the United States Supreme Court deals with economic loss in admiralty cases, where federal courts have jurisdiction.

16 Casa Clara Condo. Assoc., Inc., v. Charley Toppino & Sons, Inc., 620 So. 2d 1244, 1246 n.2 (Fla. 1993).

17 Presnell Const. Managers, Inc. v. EH Const., LLC, 134 S.W.3d 575, 583 (Ky. 2004)

After flirting with the economic loss rule for a couple of decades, the Kentucky Supreme Court had the opportunity to delineate its position on the subject in *Presnell Construction Managers, Inc. v. EH Construction, LLC.*[18] However, only Justice Keller's concurring opinion suggested that the court adopt the rule.[19] This failure of the Kentucky high court to adopt the economic loss rule has placed Kentucky's federal district courts in a quandary. When the federal courts apply Kentucky state law to the tort claims, they have little guidance on applying the economic loss rule, especially when it could extend to areas outside of products liability.[20] Kentucky should adopt the economic loss rule to resolve this ambiguity, as well as to keep contracts separate from torts.

Courts have supported adoption of the economic loss rule for various reasons, but the primary motivation remains separating contract law from tort law.[21] Courts have observed that when purely economic losses occur, the parties had the ability to allocate such losses through a contract.[22] Nevertheless, the economic loss rule has proven difficult to apply in a uniform fashion because questions arise concerning the extent to which the rule applies to areas outside products liability.[23] Exceptions to the rule, such as negligent misrepresentation, have also made consistent application of the rule more difficult.[24] Such exceptions permit lawsuits for tort claims tradi-

(Keller, J. & Graves, J., concurring) ("Kentucky appellate courts have implicitly applied [the economic loss rule] in the past.").

18 Presness Constr. Managers v. EH Constr., LLC, 134 S.W.3d 575.

19 *Id.* at 583 (Keller, J. & Graves, J., concurring).

20 *See infra* notes 124–52 and accompanying text.

21 *See* Casa Clara Condo. Assoc., Inc., v. Charley Toppino & Sons, Inc., 620 So. 2d 1244, 1246 n.2 (Fla. 1993) ("The economic loss rule has been adopted in a majority of jurisdictions."); Daanen & Janssen, Inc. v. Cedarapids, Inc., 573 N.W.2d 842, 846 (Wis. 1998). For cases that show the national acceptance of the rule, see also Minn. Stat. Ann. § 604.10 (West 1994); Exxon Shipping Co. v. Pacific Res., Inc., 835 F. Supp. 1195, 1199 (D. Haw. 1993); Airport Rent-A-Car, Inc. v. Prevost Car, Inc., 788 F. Supp. 1203, 1205–06 (S.D. Fla.1992) (Florida has adopted the economic loss rule but permits recovery in tort for economic losses under the "no alternate remedy exception," meaning that recovery is permissible "when there is no contract under which the party may recover for the loss of the product."); ERA Helicopters, Inc. v. Bell Helicopter Textron, Inc., 696 F. Supp. 1096, 1097–98 (E.D. La. 1987); Wellcraft Marine v. Zarzour, 577 So.2d 414, 418 (Ala.1990); Danforth v. Acorn Structures, Inc., 608 A.2d 1194, 1198 (Del.1992); Nelson v. Todd's Ltd., 426 N.W.2d 120, 123 (Iowa 1988); FMR Corp. v. Boston Edison Co., 613 N.E.2d 902, 903 (Mass. 1993); Oceanside at Pine Point Condo. Owners Ass'n v. Peachtree Doors, Inc., 659 A.2d 267, 270 (Me.1995); Prairie Prod., Inc. v. Agchem Div.-Pennwalt Corp., 514 N.E.2d 1299, 1304 (Ind. App. Ct. 1987); Elite Prof'ls, Inc. v. Carrier Corp., 827 P.2d 1195, 1202 (Kan. Ct. App. 1992). This list is by no means exhaustive. *See generally* RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 21 cmt. d (1998)

22 *Cedarapids*, 573 N.W.2d at 846; *see also* Detroit Edison Co. v. NABCO, Inc., 35 F.3d 236, 240 (6th Cir. 1994).

23 *See* Davis v. Siemens Med. Solutions USA, Inc., 399 F. Supp. 2d 785, 801 (W.D. Ky. 2005).

24 *See generally* Stewart I. Edelstein, *Beware the Economic Loss Rule: It Limits Recovery*

tionally barred by the economic loss rule.[25] Despite these drawbacks, the rule still provides a good incentive for the parties to allocate risks within the contract.[26] With the risks assigned in the contracts, parties can better predict future costs for liability, which allows them to minimize costs.[27]

The economic loss rule can benefit Kentucky by preventing tort recovery when the parties should have allocated their risks in a contract. While Kentucky state courts have used the ideas behind this rule in the past, the Kentucky Supreme Court should officially adopt it and apply it to areas outside of products liability. Further, acceptance of the economic loss rule at the state court level would also provide the federal courts sitting in Kentucky with clear guidelines on when and how to apply it.

In Part I, this Note will provide a brief history of the economic loss rule, examining its development at the national level and within Kentucky. Part II will examine *Presnell Construction Managers, Inc. v. EH Construction, LLC*,[28] in which Justice Keller recommended the adoption of the rule,[29] to show how this case has affected the application of the rule within the commonwealth. Next, Part III will highlight how other jurisdictions have applied the rule and discuss policy reasons for and against the economic loss rule, including some important exceptions. Although courts have applied the economic loss rule across a wide spectrum of legal fields, this Note focuses primarily on its application in the commercial context, where contractual remedies can easily apply.

I. HISTORICAL BACKGROUND OF THE ECONOMIC LOSS RULE

The rapid acceptance of the economic loss rule over the past thirty years illustrates its importance to American jurisprudence. Although the U.S. Supreme Court expressed the ideas behind the economic loss rule in the 1920s,[30] other courts did not formally adopt the doctrine for nearly half a century.[31] New Jersey's initial step in denying the economic loss rule quickly became the minority position.,[32] with California leading the way in developing the rule.[33] Finally, the U.S. Supreme Court adopted the eco-

for Commercial Economic Loss on Tort Theory, but Exceptions Provide Relief from Draconian Consequences, 42-JUN JTLATRIAL 42 (2006).

25 *See id.*

26 *See infra* notes 172–77 and accompanying text.

27 *See infra* notes 178–82.

28 Presnell Constr. Managers v. EH Constr., LLC, 134 S.W.3d 575 (Ky. 2004).

29 *Id.* at 583 (Keller, J. & Graves, J., concurring).

30 *See* Robins Dry Dock & Repair Co. v. Flint, 275 U.S. 303, 307 (1927).

31 *See* Seely v. White Motor Co. 403 P.2d 145, 147–52 (Cal. 1965).

32 *See* E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 869 (1986); Santor v. A & M Karagheusian, 207 A.2d 305, 309 (N.J. 1965).

33 *See Seely*, 403 P.2d at 150–51.

nomic loss rule in 1986.[34] Although Kentucky has not adopted the rule, the state appellate courts have implied it in a number of decisions over the years, leading to Justice Keller's concurrence in *Presnell*.[35]

A. Development of the Economic Loss Rule in the United States

In 1927, the U.S. Supreme Court became the first court to espouse the ideas behind the economic loss rule,[36] addressing the issue in *Robins Dry Dock & Repair Co. v. Flint*,[37] a maritime case in which the plaintiffs sought purely economic damages.[38] The defendant had negligently caused damage to the ship's propeller while the ship was docked, forcing the vessel to remain docked for repairs for two additional weeks. The plaintiffs sought recovery for the lost use of their ship while it underwent repairs.[39] While ultimately ruling for the defendant based on a lack of privity,[40] the Court did lay the groundwork for the eventual use of the economic loss rule.[41] Writing for the majority, Justice Holmes noted that "[t]he damage was material to [the plaintiff] only as it caused the delay in making repairs, and that delay would be wrong to no one except for the [defendant's] contract with the owners."[42] This language seems to indicate that, short of physical harm to the plaintiffs, the Court would refuse any recovery for purely economic damages, such as lost profits. While not expressly adopting the economic loss rule, Justice Holmes did propose the notion that tort law could not provide a remedy when only economic losses occur.[43]

The next major case regarding the economic loss rule came from the New Jersey Supreme Court, when the court allowed recovery for economic damages caused by a defective product in *Santor v. A & M Karagheusian*.[44] The plaintiff purchased carpet from a retailer, and soon after its installation, the plaintiff noticed and complained to the retailer about a defect in the carpet. The plaintiff then contacted the manufacturer, confirmed that he

34 *See E. River*, 476 U.S. at 871–72.

35 *See* Presnell Const. Managers, Inc. v. EH Const., LLC, 134 S.W.3d 575, 583 (Ky. 2004) (Keller, J. & Graves, J., concurring).

36 *Id.* at 307.

37 Robins Dry Dock & Repair Co. Flint, 275 U.S. 303.

38 While the Court properly refers to the parties as petitioner and respondent, this Note will refer to them as defendant and plaintiff respectively for an easier identification of the tortfeasor.

39 *Robins Dry Dock*, 275 U.S. at 307.

40 *Id.* at 307–08. The plaintiffs contracted the use of their ship to a third party, who had then employed the defendant's dock. Since the plaintiffs did not contract directly with the dock, the Court barred them from seeking damages.

41 *Id.* at 308–09.

42 *Id.* at 308.

43 *Id.*

44 Santor v. A & M Karagheusian, 207 A.2d 305 (N.J. 1965).

had received the correct grade of carpet, and obtained an assurance that the manufacturer would correct the problem. When the manufacturer failed to remedy the problem, the plaintiff filed suit claiming a breach of implied warranty of merchantability and a defective design in the carpet.[45]

Santor presented the New Jersey Supreme Court with the prerequisites for applying the economic loss rule: a defective product caused damage only to itself, and the injury resulted in only economic losses.[46] Typically, these facts would bar judgment for the plaintiff when applying the economic loss rule.[47] Nonetheless, the *Santor* court rejected the plaintiff's claims for breach of implied warranty of merchantability, reasoning that economic damages alone did not create an implied warranty.[48] Instead, the court allowed recovery under the tort claims.[49] In trying to avoid judicial waste,[50] the court opened the door for claims in which the only damage occurred to the product itself.

In the same year, California adopted the economic loss rule in *Seely v. White Motor Company*, stating that manufacturers are prevented from facing "liab[ility] for damages of unknown and unlimited scope."[51] In *Seely*, the plaintiff experienced trouble with a truck that he had purchased for business purposes and made several attempts with the retailer to repair the problem. Eventually, the brakes failed, causing the truck to flip over. While the plaintiff incurred no physical injuries, his truck was severely damaged, and he refused to make any further payments on the vehicle.[52] The plaintiff brought suit against the retailer and the manufacturer for the repair costs, for the amount paid on the purchase price, and for the profits he lost because he was unable to use his truck for its intended purpose.[53] After the plaintiff dropped the retailer from the suit, the trial court found the manufacturer liable for the amount the plaintiff had already paid and for the lost profits.[54]

Although the California Supreme Court agreed that the manufacturer had breached an express warranty,[55] the court also concluded that a tort

45 *Id.* at 307.

46 *Id.*

47 *See* E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 870–71 (1986).

48 *Santor*, 207 A.2d at 309 (The court "[saw] no just cause for recognition of the existence of an implied warranty of merchantability and a right to recovery for breach thereof . . . simply because loss of value of the article sold is the only damage resulting from the breach.").

49 *Id.*

50 *Id.* at 310.

51 Seely v. White Motor Co. 403 P.2d 145, 150–51 (Cal. 1965).

52 *Id.* at 147.

53 *Id.* at 147–48.

54 The trial court did not award damages for repairs due to the accident because the plaintiff could not prove that the "galloping" of the vehicle caused the accident. *Id.* at 148.

55 *Id.* at 150 (stating that the defendant "is responsible for these losses only because it warranted the truck to be 'free from defects in material and workmanship under normal use

claim for lost profits could not stand because "[t]he manufacturer would be liable for damages of unknown and unlimited scope."[56] The court noted that the policy supporting this decision was that "[t]he distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the 'luck' of one plaintiff in having an accident causing physical injury."[57] Instead, the court suggested that "[e]ven in actions for negligence, a manufacturer's liability is limited to damages for physical injuries and there is no recovery for economic loss alone."[58] The U.S. Supreme Court would weigh in on the issue twenty years later

The U.S. Supreme Court firmly established *Seely* as the majority position when it adopted the economic loss rule in *East River Steamship Corp. v. Transamerica Delaval, Inc.*[59] a maritime products liability case. In *East River*, a defective part caused engine failure in four different ships.[60] The plaintiffs sued not only for the cost of repairs but also for profits lost while the ships were out of service.[61] The Supreme Court explained that products liability had grown out of a need to protect individuals when their injuries exceeded bargained-for contractual remedies.[62] Nevertheless, if the Court extended this protection too far, then "contract law would drown in a sea of tort."[63] With this, the Court disallowed tort claims for products liability when no personal injury occurred out of the fear that tort law would reign supreme. This, in the Court's view, would place a burden on manufacturers who had no reason to expect such liability.[64] The Court stated, "When a product injures only itself the reasons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong."[65] These contractual remedies allow the parties to insure their products and not risk unexpected liability down the road.[66] After *East River*, the promi-

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and service'").

56 *Id.* at 150–51. The court added that the "[a]pplication of the rules of warranty prevents this result." *Id.* at 151. The court concluded that the truck was unsuitable for Seely's use, since it performed suitably under its next owner. Based on this premise, the court ruled that permitting tort claims where the product did not meet the expectations of the buyer would open a manufacturer to huge liabilities that it could not prevent since the buyer would only deal with a retailer and the manufacturer could not disclaim the proper liability. *Id.* at 150.

57 *Id.* at 151.

58 *Id.*

59 E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 860–61 (1986).

60 *Id.*

61 *Id.* at 861.

62 *Id.* at 866 ("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.").

63 *Id.*

64 *Id.* at 871.

65 *Id.*

66 *See id.* at 871–72.

nence of the economic loss rule grew as state and federal courts adopted the Supreme Court's reasoning to justify the application of the rule in their jurisdictions.

B. Development of the Economic Loss Rule in Kentucky

Before examining *Presnell*,[67] this Note will summarize a few important Kentucky state court decisions involving economic loss issues[68] which show the willingness of Kentucky state courts to apply the economic loss rule in principle, without addressing the issue outright.[69] Then this Note will address *Bowling Green Municipal Utilities v. Thomasson Lumber Co.*,[70] a federal district court case from the Western District of Kentucky in which the court decided that Kentucky state courts would likely accept the economic loss rule and accordingly applied the rule to the case at hand.[71] These cases set the stage for *Presnell*, a Kentucky Supreme Court case in which the majority opinion avoided the economic loss rule altogether and adopted the negligent misrepsentation exception to the rule instead.[72]

Since Kentucky has not specifically addressed the economic loss rule, the cases that involved economic loss issues have led to confusing, if not contradictory, results. In 1956, Kentucky's high court adopted the *Restatement (First) of Torts § 395*, which addressed the negligent manufacture of chattels.[73] The court found that this section covered damages when a product injured itself and other property,[74] contrary to the economic loss rule, which forbids recovery of damages for the defective product. When

67 Presnell Constr. Managers, Inc. v. EH Constr., LLC, 134 S.W.3d 575 (Ky. 2004).

68 *See infra* notes 73–84 and accompanying text. For a more in-depth discussion of Kentucky's history with the economic loss rule, see Thomas R. Yocum & Charles F. Hollis, III, *The Economic Loss Rule in Kentucky: Will Contract Law Drown in a Sea of Tort?*, 28 N. Ky. L. Rev. 456 (2001).

69 *See infra* notes 78–84 and accompanying text.

70 *Bowling Green Mun. Utils. v. Thomasson Lumber Co.*, 902 F. Supp. 134 (W.D. Ky. 1995).

71 *See infra* notes 85–92 and accompanying text.

72 *See Presnell*, 134 S.W.3d at 582.

73 C. D. Herme, Inc. v. R. C. Tway Co., 294 S.W.2d 534, 537 (Ky. 1956).

> A manufacturer who fails to exercise reasonable care in the manufacture of a chattel which, unless carefully made, he should recognize as involving an unreasonable risk of causing substantial bodily harm to those who lawfully use it for a purpose for which it is manufactured and to those whom the supplier should expect to be in the vicinity of its probable use, is subject to liability for bodily harm caused to them by its lawful use in a manner and for a purpose for which it is manufactured.

Id. (quoting Restatement (First) of Torts § 395 (1934)).

74 *C.D. Herme*, 294 S.W.2d at 537. A defective trailer pin snapped causing damage to the trailer itself. *Id.* at 535.

Kentucky adopted the *Restatement (Second) of Torts § 402A* in 1965,[75] retailers who sell products that cause physical injury to either a consumer or his property became subject to liability.[76] Unfortunately, the court did not elaborate on the meaning of "property" when adopting section 395, allowing later courts to interpret whether it should apply to the defective good itself.[77]

In 1990, the Kentucky Court of Appeals reexamined this issue in *Falcon Coal Co. v. Clark Equipment Co.*,[78] establishing that section 402A "impos[es] liability for physical harm . . . to the user or his other property, but not for harm caused only to the product itself."[79] The court even cited to the U.S. Supreme Court decision in *East River* as the reason for adopting this policy.[80] In 1994, the court addressed an issue similar that in *Presnell*[81] in *Real Estate Marketing, Inc. v. Franz*, in which a homeowner sued the builder for negligent construction.[82] The court "recognize[d] that tort recovery is contingent upon damage from a destructive occurrence as contrasted with economic loss related solely to diminution in value . . . ."[83] Although neither decision addressed the economic loss rule, the Court of Appeals clearly applied the principles behind the rule in both.[84]

In 1995, the Federal District Court for the Western District of Kentucky examined Kentucky's use of the economic loss rule and, despite a lack of guidance from the state courts, decided to implement the rule.[85] In *Bowling Green Municipal Utilities v. Thomasson Lumber Co.*, manufacturers of wooden utility poles failed to seal them properly, forcing the plaintiff to replace them.[86] When the plaintiff sued under negligence and contracts claims, the defendants moved to bar the tort claims under the economic loss rule.[87] The district court, "[b]eing reluctant to predict whether Kentucky courts would apply the economic loss rule[,] . . . certified the question to the Kentucky Supreme Court, which declined to hear the mat-

75 Dealers Transp. Co. v. Battery Distrib. Co. 402 S.W.2d 441, 446 (Ky. 1965).

76 RESTATEMENT (SECOND) OF TORTS § 402A (1965).

77 *See* Yocum & Hollis, *supra* note 68, at 461.

78 Falcon Coal Co. v. Clark Equip. Co., 802 S.W.2d 947, 948 (Ky. Ct. App. 1990).

79 *Id.*

80 *Id.* at 948–49.

81 Presnell Const. Managers, Inc. v. EH Const., LLC, 134 S.W.3d 575, (Ky. 2004).

82 Real Estate Mktg. Inc. v. Franz, 885 S.W.2d 921, 923 (Ky. 1994).

83 *Id.* at 926.

84 *Presnell*, 134 S.W.3d at 587 (Keller, J. & Graves, J., concurring) (In *Real Estate Marketing* and *Falcon Coal*, "the Court of Appeals adopted, albeit sub silentio, the economic-loss-rule principle that bars recovery for economic loss based upon strict liability in tort.").

85 Bowling Green Mun. Utils. v. Thomasson Lumber Co., 902 F. Supp. 134, 136–38 (W.D. Ky. 1995).

86 *Id.* at 136.

87 *Id.* at 135.

ter."[88] The District Court considered the various arguments for adopting the rule, such as requiring parties to allocate liability in their contracts and keeping contract law separate from tort law.[89] The court then fought its way through Kentucky's history of economic loss decisions,[90] and decided "that Kentucky would not allow recovery in tort under either theories of negligence or strict liability where the subject damage is limited to the product itself."[91] Unfortunately, because this opinion came from a federal court, it is not binding on Kentucky state courts. Nevertheless, it illustrates Kentucky's need to adopt the economic loss rule in order to end the confusion at both federal and state levels. Without this guidance, defendants in federal court could continue to face liability for cases involving economic loss.[92]

II. *PRESNELL CONSTRUCTION*: A MISSED OPPORTUNITY TO ADOPT THE ECONOMIC LOSS RULE

In *Presnell Construction Managers, Inc. v. EH Construction, LLC*,[93] the Kentucky Supreme Court was presented with the perfect opportunity to adopt the economic loss rule, since it only involved economic losses[94] and the plaintiff had signed a contract disallowing any damages for economic loss.[95] Instead, the Kentucky Supreme Court adopted negligent misrepresentation as an exception to the economic loss rule,[96] presenting the plaintiff with an opportunity to recover[97] though the contract would not have allowed it.[98] Justice Keller's concurring opinion, in which Justice Graves joined, recommended adoption of the economic loss rule, which would have barred the plaintiff's claim.[99] In the wake of *Presnell*, Kentucky federal district courts have been hesitant to apply the rule, especially when it would extend to areas beyond products liability.[100] This emphasizes the fact that Kentucky needs to adopt and apply the economic loss rule to areas outside products

88 *Id.*

89 *Id.* at 136–37.

90 *Id. See supra* notes 76–87 and accompanying text.

91 *Bowling Green*, 902 F. Supp. at 138 (noting that the Sixth Circuit had predicted the same in *Miller's Bottled Gas v. Borg-Warner, Corp.*, 955 F.2d 1043, 1049–50 (6th Cir. 1992)).

92 The U.S. Supreme Court's decision in *East River* only applies in admiralty cases.

93 Presnell Constr. Managers, Inc. v. EH Constr., LLC, 134 S.W.3d 575, 588 (Ky. 2004).

94 *Id.*

95 *Id.* at 577.

96 *Id.* at 582.

97 *Id.*

98 *Id.* at 577.

99 *Id.* at 583 (Keller, J. & Graves, J., concurring).

100 *See* Pioneer Res. Corp. v. Nami Res. Corp., LLC, No. 6:04-465-DCR, 2006 WL 1778318, at * 7 (E.D. Ky. June 26, 2006).

liability. Adoption of the economic loss rule would end the reluctance of federal courts in applying the rule and force parties in Kentucky to allocate their risks in the contract.

A. The Presnell *Majority Opinion's Avoidance of the Economic Loss Rule*

Presnell offered a perfect opportunity for Kentucky's Supreme Court to adopt the economic loss rule since EH Construction sought to recover economic damages due to losses from Presnell's negligent supervision of the work site.[101] In *Presnell*, a building owner (DeLor) entered into contracts with a construction manager (Presnell Construction)[102] and with a corporation (EH Construction) that provided labor for the building's renovation.[103] EH sued Presnell for negligent misrepresentation and negligent supervision,[104] claiming Presnell's lack of supervision had forced EH to redo some of the construction and thus lose profits.[105] Because Presnell and DeLor had signed a contract disclaiming any liability from third parties,[106] the trial court found that EH had no basis for a negligence claim against Presnell due to a lack of privity.[107] The Kentucky Court of Appeals, however, adopted *Restatement (Second) of Torts* § 552,[108] which describes negligent misrepresentation,[109] giving Presnell an independent duty to supervise the project

101 For a more detailed discussion of the construction implications of *Presnell*, see generally, Steven M. Henderson, *Walking the Line between Contract and Tort in Construction Disputes: Assessing the Use of Negligent Misrepresentation to Recover Economic Loss after* Presnell, 95 Ky. L.J. 145 (2007).

102 For an explanation of the construction terms, see *id.* at 145–46, nn. 4–6.

103 *Presnell*, 134 S.W.3d at 577.

104 *Id.* at 576. For more details regarding the construction aspects *see* Henderson, *supra* note 104, at 145–48.

105 *Presnell*, 134 S.W.3d at 578.

106 *Id.* at 577 The contract read, "Nothing contained in this Agreement shall create a contractual relationship with or a cause of action in favor of a third party against either the Owner or the Construction Manager." EH had also signed a similar agreement with DeLor limiting the liability of third party construction managers. *Id.*

107 *Id.* at 578.

108 *Id.*

109 Section 552, titled Information Negligently Supplied For The Guidance Of Others, provides:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) Except as stated in Subsection (3), the liability stated in

with reasonable care.[110] Presnell then appealed to the Kentucky Supreme Court,[111] giving the court an opportunity to accept the economic loss rule.

In taking the case, however, the Kentucky Supreme Court focused on negligent misrepresentation, because if Presnell owed no contractual duties to EH, it would leave EH without a remedy unless one existed under tort law. The court decided that "an independent duty" needed to exist in order for EH to bring a negligence claim against Presnell. The court reasoned that EH, as an incidental beneficiary to the contract between DeLor and Presnell, could not claim that Presnell owed it any contractual duties.[112] Since EH did not have a contractual relationship with Presnell, the court ruled that Presnell had no contractual duty to EH and therefore EH could not bring a claim.[113]

Having rejected EH's contractual claims, the Kentucky Supreme Court sought to create an independent duty for Presnell, and found such a duty in negligent misrepresentation.[114] In examining Kentucky's history with *Restatement (Second) of Torts § 552*, the court held that "negligent misrepresentation is actionable in Kentucky."[115] The court stated that "the tort of negligent misrepresentation defines an independent duty for which recovery in tort for economic loss is available."[116] Since EH had no contractual obligations with Presnell, and EH only sought economic damages, the court used negligent misrepresentation to avoid an unfortunate outcome for EH and established a significant exception to the economic loss rule.

Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

RESTATEMENT (SECOND) OF TORTS § 552 (1977).

110 *Presnell*, 134 S.W.3d at 578.

111 *Id.*

112 *Id.* at 579–80 (The court stated that "unless Presnell breached some duty to EH apart from its duties to DeLor under the contract—i.e an independent duty—EH, who was, at the most, an incidental beneficiary of the contract between DeLor and Presnell, cannot maintain an action in negligence against Presnell.").

113 *Id.* at 579.

114 *Id.* at 582.

115 *Id.* at 580–81 (Keller, J. & Graves, J., concurring).

116 *Id.* at 582.

B. Presnell's *Concurring Opinion Favoring the Adoption of the Economic Loss Rule*

While Justices Keller and Graves concurred with the majority's outcome, they also sought to instill the economic loss rule into Kentucky jurisprudence.[117] Justice Keller agreed with the majority's conclusion that EH did not have a negligence claim against Presnell and argued that the economic loss rule barred EH's claims as well.[118] Justice Keller then explored the history of economic loss across the nation and within Kentucky itself.[119] He concluded, "while neither [the Kentucky Supreme] Court nor the Court of Appeals has expressly articulated or relied upon the economic loss rule in a published opinion, both courts have applied the rule's principles without identifying their source."[120] Justice Keller then recommended that Kentucky adopt the economic loss rule because it would protect manufacturers and contractors from the unlimited and unpredictable liability found in tort law.[121] In the end, however, Justice Keller only applied the rule to EH's claims for negligence,[122] accepting the majority's adoption of section 552 allowing the claim for negligent supervision as an exception to the economic loss rule.[123]

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117 *Id.* at 583.

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> . . . EH's common law negligence claim against Presnell for negligent *supervision* of the project is barred not only by the rule that the majority applies, *i.e.*, "one who is not a party to the contract or in privity thereto may not maintain an action for negligence which consists merely in the breach of the contract," but also by the economic loss rule, which Kentucky appellate courts have implicitly applied in the past.

Id.

119 *Id.* at 583–90. Justice Keller paid particular attention to the Colorado Supreme Court's decision in *Town of Alma v. Azco Construction, Inc.*, 10 P.3d 1256 (Colo. 2000), stating, "I find the Colorado Supreme Court's articulation of the economic loss rule to be consistent with prior decisions of the Kentucky appellate courts, and I would therefore adopt it as the economic loss rule in this jurisdiction." *Id.* at 590. In *Alma*, the Colorado Supreme Court held that the economic loss rule does not apply when a duty existed independent of the contract. *Alma*, 10 P.3d at 1263. This is very similar to the reasoning behind the majority's decision in *Presnell*, which created an independent duty through the adoption of negligent misrepresentation. *Presnell*, 134 S.W.3d at 582 (majority opinion). *See* Henderson, *supra* note 101, at 164–67.

120 *Presnell*, 134 S.W.3d at 586 (Keller, J. & Graves, J., concurring); *see supra* notes 76–84 and accompanying text.

121 *Presnell*, 134 S.W.3d at 584 (Keller, J. & Graves, J., concurring).

122 *Id.* at 590.

123 *Id.*

*C. Federal Court in Kentucky Decisions Post-*Presnell

Following *Presnell*, the federal district courts in Kentucky have reexamined the status of the economic loss rule in Kentucky, leading to a general reluctance to apply the rule to fields outside of products liability.[124] In *Louisville Gas & Electric Co. v. Continental Field Systems*,[125] an electric company sought to recover damages from the replacement of a broken fan shaft and the resulting loss of revenue.[126] The defendants, subcontractors who were hired to provide maintenance services, asserted the economic loss rule, claiming that they had only provided repair services to the plaintiff.[127] While noting that the Western District had accepted economic loss in *Bowling Green Municipal Utilities v. Thomasson Lumber Co.*,[128] the court also acknowledged that "[n]othing in the state case law since has clarified the likely tendency of Kentucky courts" to accept or reject the economic loss rule.[129] Since the Kentucky Supreme Court did not adopt the economic loss rule in *Presnell*, the district court could only rely on *Bowling Green*.[130]

Since *Louisville Gas & Electric* involved a "provision of services,"[131] something new to Kentucky's economic loss jurisprudence and not the typical "selling of a product,"[132] the federal court had to break new ground without guidance from the Kentucky Supreme Court. The defendants argued that *Presnell* encouraged courts to expand the economic loss rule beyond its traditional role, which does not include service contracts.[133] Although the court agreed that Kentucky courts would apply the economic loss rule in its traditional capacity,[134] "it would be pure speculation to suggest that Kentucky courts would adopt the broader application of the rule discussed in the *Presnell* concurrence."[135]

A few months later, the same district court declined to apply the economic loss rule to an employment contract, opening the door for more tort claims. In *Davis v. Siemens Medical Solutions USA, Inc.*,[136] a former Siemens

124 *See infra* notes 125–52 and accompanying text.

125 Louisville Gas & Elec. Co. v. Cont'l Field Sys., 420 F. Supp. 2d 764 (W.D. Ky. 2005).

126 *Id.* at 765.

127 *Id.* at 768.

128 Bowling Green Mun. Utils. v. Thomasson Lumber Co., 902 F. Supp. 134 (W.D. Ky. 1995).

129 *Louisville Gas & Elec.*, 420 F. Supp. at 769.

130 *See supra* notes 85–92 and accompanying text.

131 *Louisville Gas & Elec.*, 420 F. Supp. at 769.

132 *Id.*

133 *Id.*

134 *Id.* at 770 (The Western District found "that it is on sound ground in predicting that Kentucky courts would apply the economic loss rule in its classic definition.").

135 *Id.*

136 Davis v. Siemens Med. Solutions USA, Inc., 399 F. Supp. 2d 785 (W.D. Ky. 2005).

employee sued for the additional compensation his employer had promised.[137] The defendant argued that the court should apply the economic loss rule to dismiss the claims of misrepresentation and that the plaintiff should rely on his contractual remedy.[138] The court countered, stating that "to date, no Kentucky court has held that the economic loss rule applies so expansively. Instead the economic loss rule has been limited to apply to products liability cases and to construction cases."[139] The court then concluded that "expand[ing] the rule so as to bar a fraudulent inducement claim in an employment contract without further guidance from the Kentucky courts would eviscerate the claim of fraudulent inducement and would contravene contrary Kentucky case law."[140] As in *Bowling Green*,[141] the Western District expressed a reluctance to extend the economic loss rule beyond products liability,[142] keeping the door open for tort claims of fraud and misrepresentation.

Following the leads of *Louisville Gas & Electric* and *Siemens*, the Eastern District of Kentucky has also limited the application of the economic loss rule to products liability claims. In *Pioneer Resources Corp. v. Nami Resources Co., LLC*,[143] the plaintiff entered into contracts for purchase of four gas wells from a natural gas company.[144] The plaintiff alleged fraud and underpayment in both the operation and the construction of these wells,[145] but the defendants asserted that the economic loss rule barred fraudulent underpayment claims because of a lack of privity.[146] Similar to the Western District,[147] the Eastern District recognized that Kentucky state courts had accepted the ideas behind the economic loss rule but that no state court had officially adopted the rule in claims other than those based on products liability.[148] The court then concluded that the Kentucky appellate courts typically applied the rule to products liability,[149] accordingly declined to

137 *Id.* at 789–90.

138 *Id.* at 801 ("Siemens argues that because Davis's misrepresentation claim is inseparable from his contractual claims, Davis's exclusive remedy is breach of contract.").

139 *Id.* (citations omitted).

140 *Id.*

141 Bowling Green Mun. Utils. v. Thomasson Lumber, 902 F. Supp. 134, 138 (W.D. Ky. 1995).

142 *Davis*, 399 F. Supp. 2d at 801.

143 Pioneer Res. Corp. v. Nami Res. Co., LLC, No. 6:04-465-DCR, 2006 WL 1778318 (E.D. Ky. June 26, 2006).

144 *Id.* at *1.

145 *Id.* at *2.

146 *Id.* at *6.

147 *See supra* notes 125–42 and accompanying text.

148 *Pioneer*, 2006 WL 1778318, at *6 (More specifically, the Eastern District Court noted that although "the Supreme Court of Kentucky has never expressly adopted the economic loss rule, a number of appellate decisions have implicitly applied it in the past.").

149 *Id.*

expand the reach of the economic loss rule.[150] Furthermore, the Eastern District found "that the Kentucky Supreme Court would likely not extend the economic loss doctrine outside the products liability, business purchases or construction cases."[151] Once more, a federal district court sitting in Kentucky failed to apply the economic loss rule because the Kentucky Supreme Court has not provided guidance.[152]

Presnell presented a great opportunity for the Kentucky Supreme Court to adopt the economic loss rule and establish its boundaries within the commonwealth. Unfortunately, the majority failed to do this and instead adopted an exception to the rule in the form of negligent misrepresentation.[153] Despite Justice Keller's strong argument for Kentucky's adopting the economic loss rule,[154] recent federal court decisions have shown that his concurring opinion had little effect on achieving this end.[155] Accordingly, parties in service contracts still face tort liability when their services do not meet the other party's expectations. Instead, parties should address this issue through their contracts and allocate their risks accordingly. Such reasoning forms the basis for the economic loss rule.

III. Policy Considerations Supporting Adoption of the Economic Loss Rule

Three important policy considerations support adoption of the economic loss rule. Most importantly, the rule distinguishes between tort and contract, allowing parties to allocate their risks through a contract and encourage them to insure against these risks.[156] In addition, the *Restatement (Third) of Torts: Products Liability* includes a section that addresses the economic loss rule,[157] showing the acceptance the rule has gained in American jurisprudence. Despite the reasons for adopting the rule, negligent misrepresentation and fraud have become powerful exceptions to the economic loss rule.[158] Finally, an intermediate approach to the economic loss rule also

150 *Id.* at *7 ("This Court, however, cannot conclude that the concurring opinion from *Presnell* is persuasive evidence that the Kentucky Supreme Court will expand the applicability of the economic loss rule to all types of cases.").

151 *Id.*

152 *Id.*

153 *See* Presnell Const. Managers, Inc. v. EH Const., LLC, 134 S.W.3d 575, 583 (Ky. 2004)

154 *Id.* at 583–91.

155 *See supra* notes 125–52 and accompanying text.

156 Daanen & Janssen, Inc. v. Cedarapids, Inc., 573 N.W.2d 842, 846 (Wis. 1998).

157 Restatement (Third) of Torts: Prod. Liab. § 21 (1998).

158 *See, e.g.*, Edelstein, *supra* note 24.

exists, which allows recovery for the defective product itself if the product had the potential to cause physical harm.[159]

A. Reasons for Adopting the Economic Loss Rule in Kentucky

While the economic loss rule has been adopted in a majority of jurisdictions,[160] the reasons for its acceptance have varied.[161] Different rationales for supporting the economic loss rule have arisen because the rule itself "is stated with ease but applied with great difficulty,"[162] as courts continue to debate the parameters of the rule.[163] The questions involved generally revolve around whether the rule should apply to the defective product itself,[164] or whether economic loss should be restricted to the field of products liability.[165] Nonetheless, courts have found significant value in applying it to avoid crossing the line that separates contract and tort law.[166] Otherwise, bargained-for contractual damages would be displaced, as any aggrieved party could sue under tort, regardless of any contractual limitations.[167]

The Supreme Court of Wisconsin articulated three reasons why contract law presents a more suitable remedy for cases involving purely economic damages.[168] The first follows the traditional argument that the economic

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159 Several variations of the intermediary positions have developed over the years. Although the Supreme Court did not adopt any of these positions in *East River v. Transamerica*, the Court did provide a brief summary of the seminal cases involved. E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 869–70 (1986).

160 D'Angelo, *supra* note 12, at 607.

161 For a broad overview of the economic loss rule and the reasons behind it, see generally Anita Bernstein, *Keep It Simple: An Explanation of the Rule of No Recovery for Pure Economic Loss*, 48 ARIZ. L. REV. 773 (2006); Dan B. Dobbs, *An Introduction to Non-Statutory Economic Loss Claims*, 48 ARIZ. L. REV. 713 (2006).

162 Sandarac Ass'n, Inc. v. W.R. Frizzell Architects, Inc., 609 So. 2d 1349, 1352 (Fla. Dist. Ct. App. 1992), *overruled on other grounds by* Stone's Throw Condo. Ass'n v. Sand Cove Apts., Inc., 749 So. 2d 520 (Fla. Dist. Ct. App. 1999).

163 *See E. River*, 476 U.S. at 868–70.

164 *See id.* at 871–75.

165 *See supra* note 149 and accompanying text.

166 *See infra* notes 169–71 and accompanying text.

167 *See* Daanen & Janssen, Inc. v. Cedarapids, Inc., 573 N.W.2d 842, 846 (Wis. 1998).

168

> Application of the economic loss doctrine to tort actions between commercial parties is generally based on three policies, none of which is affected by the presence or absence of privity between the parties: (1) to maintain the fundamental distinction between tort law and contract law; (2) to protect commercial parties' freedom to allocate economic risk by contract; and (3) to encourage the party best situated to assess the risk economic loss, the commercial purchaser, to assume, allocate, or insure against that risk.

Id.

loss rule preserves the line that courts have drawn between contract and tort law. The court reasoned that "[a]t the heart of the distinction drawn by the economic loss doctrine is the concept of duty."[169] The court explained that "[c]ontract law rests on obligations imposed by bargain" whereas "[t]he law of torts . . . rests on obligations imposed by law."[170] Thus, where contract law seeks to enforce promises, tort law looks to protect individuals and society from harm. The U.S. Supreme Court's similar sentiment in *East River* provides the cornerstone of the economic loss rule.[171]

The second reason supporting adopton of the economic loss rule is that it ensures each party has the "freedom to contract."[172] In theory, parties engaged in commercial activities have similar or equal bargaining power allowing them to allocate risks through disclaimers and warranties.[173] Nevertheless, "[i]f manufacturers are held liable to remote commercial purchasers under tort theories for frustrated economic expectations, all manufacturers would effectively be prevented from negotiating their liability through the bargaining process."[174] Commercial buyers can also purchase goods for a lower cost when there is no warranty, meaning that they have bargained for a less expensive good at the risk of the product not living up to their expectations.[175] Accordingly, allowing a consumer to sue under tort law for economic damages would give the plaintiff an unfair benefit and defeat the purpose of warranties in general.[176] Without the economic loss rule, tort law would supersede bargained-for contracts, and "contract law would drown in a sea of tort."[177]

In addition to maintaining the line courts have drawn between contract and tort, the economic loss rule also encourages parties to allocate their risks in the contract instead of relying on tort law.[178] This looks to the contracting parties and their ability to adjust price according to their respec-

169 *Id.*

170 *Id.*

171 E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 871 (1986).

172 *Cedarapids*, 573 N.W.2d at 847.

173 *Id.* at 848.

174 *Id.*

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> Courts should assume that parties factor risk allocation into their agreements and that the absence of comprehensive warranties is reflected in the price paid. Permitting parties to sue in tort when the deal goes awry rewrites the agreement by allowing a party to recoup a benefit that was not part of the bargain.

Stoughton Trailers Inc. v. Henkel Corp., 965 F. Supp. 1227, 1230 (W.D. Wis. 1997).

176 *Id.*

177 E. River S.S. Corp. v. Transamerica Delaval, 476 U.S. 858, 866 (1986).

178 *Cedarapids*, 573 N.W.2d at 849.

tive liabilities[179] This allows manufacturers and retailers to plan reasonably for future costs and liabilities.[180] Otherwise, tort liability creates the possibility of unforeseen risks and liabilities since later purchasers could have different expectations for the product.[181] Accordingly, manufacturers would suffer an injustice or, at the very least, have difficulty insuring themselves against these losses.[182]

To reinforce these reasons, other state and federal courts, have turned to the Uniform Commercial Code. The Michigan Supreme Court held 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 . . . ."[183] Courts have also suggested that plaintiffs look to their warranties, both implied and express, when the contract does not provide a sufficient remedy.[184] These implied warranties allow parties to get the proverbial "benefit of the bargain" when the product does not live up to their expectations.[185] Plaintiffs can only recover, however, if they can prove that they had a reasonable expectation to believe the product would perform in a certain way (e.g., they reasonably relied on an advertisement).[186] This puts the risk on the manufacturer or distributor but with reasonable limitations not found in tort law.

Viewing economic loss from an economic perspective, Judge Posner has also delineated three slightly different reasons for the application of the economic loss rule.[187] The first defines lost profits, like those typically found in economic loss cases, as "a 'private' rather than a 'social' cost,"[188] meaning that the losses do not pass on to the rest of society.[189] The second reason stems from the fact that the tortfeasor could never properly insure

179 *Id.* ("Commercial enterprises allocate the risk of loss due to nonperformance among themselves and pass this cost on to the other purchasers by way of higher prices.").

180 *Id.* (The court noted that adjusting liability through price allows "commercial risks and problems generally" to "be solved with predictable consequences.").

181 *Id.*; *see also* Seely v. White Motor Co., 403 P.2d 145, 150–51 (Cal. 1965).

182 *Cedarapids*, 573 N.W.2d at 849.

183 Neibarger v. Universal Coop., Inc., 486 N.W.2d 612, 618 (Mich. 1992).

184 Detroit Edison Co. v. NABCO, Inc., 35 F.3d 236, 240 (6th Cir. 1994) (Applying Michigan law, the Sixth Circuit stated, "[w]hen a product does not live up to the requirements of the sales contract, the UCC enables a purchaser to recover on the basis of implied warranties of fitness and merchantability, as well as on any express warranties created between the parties." (citation omitted)).

185 *Id.* (citing *Neibarger*, 486 N.W.2d at 615).

186 *See* U.C.C. § 2-314, 2-315 (1998).

187 Richard A. Posner, *Common-Law Economic Torts: An Economic and Legal Analysis*, 48 ARIZ. L. REV. 735, 736–40 (2006) (exploring the economic rationales behind the economic loss rule).

188 *Id.* at 736–37.

189 *Id.* at 737 ("A social cost is a diminution in the total value of society's economic goods; a private cost is a loss to one person that produces an equal gain to another. In other words, private costs result in a transfer of wealth but not a diminution of it.").

against lost profits, since it would be difficult, if not impossible to predict the losses.[190] The third reason notes the difficulty in establishing boundaries and limits for victims who suffer economic damages, as opposed to those who suffer physical ones.[191] While physical injuries are easily determined, the extent of the economic damages for which a defendant should be liable is much harder to assess.[192] Even from an economic viewpoint, the economic loss rule helps society as a whole by preventing parties from facing damages that they cannot predict or insure against.

The adoption of the economic loss rule by the *Restatement (Third) of Torts: Products Liability*[193] not only illustrates the growing influence of the rule but also presents another reason for its adoption. The economic loss rule falls under section 21, which states in part that "harm to persons or property includes economic loss if caused by harm to . . . the plaintiff's property other than the defective product itself."[194] This rule follows the classic economic loss rule language which forbids damages under a tort claim in cases where the only losses sustained were damage to the product itself.[195] The American Law Institute provided two reasons for adopting this rule, which emphasized the need to keep contract and tort law distinct.[196] The *Restatement* provides even more support for Kentucky's adop-

190 *Id.* at 737–38. On the one hand, "insurance can be purchased [by the tortfeasor] only if the insurance company can calculate the risk of loss, since without such a calculation there is no way to fix a premium." *Id.* at 738. On the other hand,

> each [plaintiff] business that might be affected by such an accident knows the value of its inventory and of its fixed assets, knows its customers' behaviors, the pattern of demands, staff expense, and so forth, and can use that information either to take precautions (the commercial equivalent of fastening one's seatbelt) that will minimize any business losses from an accident, or to buy insurance. For an insurance company should be able to calculate the risk of business loss from all accidents.

Id.

191 *Id.* at 739 ("The third economic reason for the economic-loss doctrine is that the determination of damages is more difficult when there is no physical connection to the injury because it is much harder to delimit the victims.").

192 *Id.* As Posner explains in his hypothetical, damages to the sidewalk in front of a store could extend beyond the store itself and include other nearby businesses as well as the customers inconvenienced by the accident. Once the proper parties are identified, the extent of the damages for which the defendant would be liable would still have to be determined.

193 RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 21 (1998). This section is titled "Definition Of 'Harm to Person or Property': Recovery For Economic Loss."

194 *Id.*

195 *See* RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 21 cmt. d (1998) (compiling cases that adopted the "product itself" position).

196 RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 21 cmt. a (1998) ("First, products liability law lies at the boundary between tort and contract.... Second, some forms of economic loss have traditionally been excluded from the realm of tort law even when the plaintiff has no contractual remedy for a claim.").

tion of the economic loss rule because it shows the general acceptance of the rule and emphasizes the important role the rule has in separating tort and contract law.

Aside from maintaining the distinction between contract and tort law, the reasons for adopting the economic loss rule are numerous and demonstrate that this policy would benefit parties to this type of litigation in Kentucky. Parties have the ability to allocate their risks within the contract, and the economic loss rule encourages this practice.[197] In fact, contracting parties often establish prices based on the liabilities they are willing to accept.[198] To allow parties to sue in tort when unexpected circumstances affecting performance arise would essentially nullify the contract and open defendants to liability they did not expect, could not foresee, and could not insure against.[199] Furthermore, the Uniform Commercial Code has provided potential plaintiffs with reasonable protections.[200] Kentucky needs to adopt the economic loss rule and apply it even to certain areas beyond products liability to protect future defendants from the otherwise unreasonable liability. Finally, Kentucky should follow the lead of the *Restatement (Third) of Torts: Products Liability*, which has already adopted the economic loss rule, showing the rule's prominence across the nation.

B. Exceptions to the Economic Loss Rule

Various judicially created exceptions poke holes through the otherwise worthy shield of the economic loss rule. Negligent misrepresentation stands as one of the biggest exceptions to the economic loss rule.[201] Fraud, an alternative to suing for negligent misrepresentation, has also arisen as a prominent exception.[202] The courts have carved out an exception for service contracts as well.[203] While other exceptions exist, the three discussed below represent the key exceptions recognized in most jurisdictions.[204]

Negligent misrepresentation presents one of the broadest exceptions to the economic loss rule. As discussed in *Presnell*,[205] negligent misrepresentation comes from the *Restatement (Second) of Torts § 552*.[206] The courts have applied negligent misrepresentation in a number of fashions.[207] The basic

197 *See supra* notes 172–77 and accompanying text.

198 *See supra* notes 178–82 and accompanying text.

199 *See supra* notes 178–82, 187–92 and accompanying text.

200 *See supra* notes 183–86 and accompanying text.

201 *See infra* notes 205–11 and accompanying text.

202 *See infra* notes 213–18 and accompanying text.

203 *See infra* notes 219–22 and accompanying text.

204 *See e.g.*, Edelstein, *supra* note 24.

205 *Presnell Constr. Managers, Inc. v. EH Constr., LLC*, 134 S.W.3d 575, 578 (Ky. 2004),

206 RESTATEMENT (SECOND) OF TORTS § 552 (1977).

207 *See* Edelstein, *supra* note 24, at 46 (listing four approaches: a blanket exception, an

principle, however, extends the exception to cases where the defendant's improper misrepresentation of facts resulted in the plaintiff's economic losses.[208] While some argue that the negligent misrepresentation exception is necessary to protect parties from fraudulent claims,[209] the parties still have the freedom to place penalties for fraud in their contracts.[210] Contracts containing penalty clauses for delays of service or ineffective products provide the buyer with sufficient protection from misrepresentation.[211] The economic loss rule does not need the negligent misrepresentation exception because parties can allocate that risk in their contracts, a goal of the economic loss rule.[212]

Courts have also found that fraud provides an exception to the economic loss rule and have listed several reasons why this exception should exist.[213] Proponents of this exception essentially argue that fraud is based

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exception "limited to defendants in the business of supplying information for the guidance of others," disallowing claims for negligent misrepresentation when privity exists between the parties, and finally permitting no exception for negligent misrepresentation).

208 *See id.; see also* Henderson, *supra* note 101, at 183 (arguing that "section 552 creates a duty, arising independently from any contractual obligations, upon design professionals to exercise reasonable care in supplying information for the guidance of other participants in the Constr. process").

209 *See* Edelstein, *supra* note 24, at 46.

210 *See* Matthew S. Steffey, *Negligence, Contract, and Architects' Liability for Economic Loss*, 82 Ky. L.J. 659, 683 (1994). *But see* Henderson, *supra* note 101, at 155 ("[S]tandard form contracts are widely used in the [construction] industry and their provisions typically favor design professionals. Thus, a conclusion that a contractor has the ability to freely bargain for available remedies may be a bit misleading.").

211 *See generally* Steffey, *supra* note 210, at 681–701.

212 *See* Daanen & Janssen, Inc. v. Cedarapids, Inc., 573 N.W.2d 842, 846 (Wis. 1998); *see also* Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931). Chief Judge Cardozo established that a defendant was not liable to a third party for misrepresentations to an employer on which the third party reasonably relied. The court stated,

> The defendants owed to their employer a duty imposed by law to make their certificate without fraud, and a duty growing out of contract to make it with the care and caution proper to their calling. Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself. A different question develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.

Id. (citations omitted).

213 Edelstein, *supra* note 24, at 45–46. *But see* Posner, *supra* note 187, at 745–47 (offering an explanation why punitive damages for "Bad-Faith Breach of Contract" should rarely be imposed).

in tort and is therefore separate and distinct from contract.[214] The Kentucky Supreme Court has also accepted this line of reasoning, stating that "[t]he idea that any person or industry or enterprise would be immune from liability for fraud and deceit is not acceptable."[215] The basis for this statement, however, came from a 1956 opinion by the Kentucky Court of Appeals, which found it against public policy to allow a contracting party to escape liability for fraud.[216] When the court first issued this statement against fraud, the Uniform Commercial Code and its full set of commercial remedies had not yet developed, and so commercial parties needed this type of protection.[217] Now, parties can sue to obtain the benefit of the bargain with other contractual protections in place.[218] Nevertheless, the punitive aspect of allowing parties to sue for fraud when economic losses occur does present a strong policy reason for allowing the exception, which would deter fraud.

Service contracts represent the third major judicially created exception to the economic loss rule, following the traditional line of thinking that the economic loss rule should apply only to products liability and should not apply to cases involving the performance of a service.[219] This argument, however, fails to recognize the reasons behind adopting the rule. The freedom of parties to allocate their risks in a contract can also apply to a service contract.[220] Nevertheless, such an exception could have a valid place in the world of professional contracts, where the parties have a higher duty of care.[221] Subjecting professionals such as lawyers and accountants to tort liability could deter future harm because of the personal liability at stake.[222]

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214 Edelstein, *supra* note 24, at 46.

215 Hanson v. Am. Nat'l Bank & Trust Co., 865 S.W.2d 302, 309 (Ky. 1993).

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> The law should not, and does not permit a covenant of immunity to be drawn that will protect a person against his own fraud. Such is not enforceable because of public policy. Language is not strong enough to write such a contract. Fraud destroys all consent. It is the purpose of the law to shield only those whose armor embraces good faith.

Id. at 309–10 (citing Bryant v. Troutman, 287 S.W.2d 918, 921 (Ky. 1956)).

217 *See supra* notes 183–86 and accompanying text.

218 *See supra* notes 172–82 and accompanying text. *But see* Ian Ayres & Gregory Klass, *New Rules for Promissory Fraud*, 48 ARIZ. L. REV. 957, 962 (2006); Jean Braucher, *Deception, Economic Loss and Mass-Market Customers: Consumer Protection Statutes as Persuasive Authority in the Common Law of Fraud*, 48 ARIZ. L. REV. 829, 832–33 (2006); Dobbs, *supra* note 161, at 728–30 (arguing against expansions of the economic loss rule that would forbid punitive damages when the defendant knowingly committed fraud).

219 *See* Edelstein, *supra* note 24, at 43–44.

220 *See* Farmers Alliance Mut. Ins. Co. v. Naylor, 452 F. Supp. 2d 1167, 1173–74 (D.N.M. 2006).

221 *See id.* at 1174; *see also* Edelstein, *supra* note 24, at 44.

222 *See* Edelstein, *supra* note 24, at 44.

Once again, contractual remedies seem sufficient when no higher duty of care is present, requiring no need for this exception to the economic loss rule.

C. The "Intermediate" Approach to the Economic Loss Rule

A third approach to the economic loss rule draws a line between the majority position in *Seely*[223] and the minority view in *Santor*[224] and examines whether the defective product had the potential to do physical harm.[225] As the Court stated, the post-*Santor* and post-*Seely* "cases attempt to differentiate between 'the disappointed users . . . and the endangered ones,' and permit only the latter to sue in tort."[226] The *East River* Court found these approaches to be "too indeterminate to enable manufacturers easily to structure their business behavior,"[227] which is a basic tenet of the economic loss rule. Although this segregated approach adopts the economic loss rule in theory, it would prove difficult to apply because plaintiffs would certainly argue that their defective products had potential to inflict damage.[228] Furthermore, it would wind up as another exception to the economic loss rule because, as the U.S. Supreme Court noted, it would hinder the ability of the parties to allocate risks in the contract.[229]

IV. Conclusion

Returning to the taxi company at the beginning of this Note, the need for the economic loss rule becomes clear. When selling the taxis, the retailer had no way of insuring against the lost profits that the taxi company might incur if the taxis did not perform properly. Furthermore, a rival cab company will reap the profits lost by the taxi company, and the impact on society will be minimal.[230] Applying the economic loss rule forces the taxi company either to insure itself against such disasters or to pay a higher price for the product and receive a contract with penalty provisions protecting their interests. The economic loss rule forces contracting parties to allocate their risks in a fashion that provides greater security for both and a lower cost for the consumer.

While the economic loss rule does not have a long history in United States jurisprudence, it has developed into a formidable tool for contract-

223 *See supra* notes 51–58 and accompanying text.

224 *See supra* notes 44–50 and accompanying text.

225 *See* E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 869–70 (1986).

226 *Id.* (quoting Russell v. Ford Motor Co., 575 P.2d 1383, 1387 (Or. 1978)).

227 *E. River*, 476 U.S. at 870.

228 *Id.*

229 *See id.*

230 *See* Posner, *supra* note 187 and accompanying text.

ing parties. Since its inception, courts have used it to separate the spheres of tort and contract to ensure that parties would avoid liability for damages not bargained for in their contracts. In utilizing the economic loss rule, courts have furthered several sound legal policies. When courts encourage parties to allocate their risks in a contract, it helps decrease costs because the manufacturer or service provider can adequately insure itself against future liability. While allowing certain exceptions might discourage parties from fraudulent conduct, most exceptions needlessly hinder the economic loss rule. With the adoption of negligent misrepresentation in *Presnell*, the Kentucky Supreme Court has already provided a significant exception to the economic loss rule—before the court had even adopted it. Nevertheless, the Kentucky Supreme Court should expressly adopt the economic loss rule, without exception, so that parties contracting in the commonwealth are forced to allocate their risks in their contracts, which will provide greater certainty of their liabilities and lower prices for consumers.