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THE CONTRACTUALLY BASED ECONOMIC LOSS RULE IN TORT LAW: ENDANGERED CONSUMERS AND THE ERROR OF *EAST RIVER STEAMSHIP*

*Mark A. Geistfeld**

INTRODUCTION

The rule of strict products liability has been widely adopted in the United States, subjecting manufacturers and other product distributors to strict tort liability for physical harms proximately caused by defective products.[1] The scope of strict products liability has also been widely limited to exclude tort recovery for cases in which the defect did not cause physical harm but only damaged the product itself, causing pure economic loss, such as repair costs and lost profits. These two rules pose a question that frames a confusing body of case law: Why does strict products liability permit tort recovery for physical harms and deny recovery for pure economic loss?

In cases of pure economic loss, a growing majority of courts have followed the approach charted by the U.S. Supreme Court in *East River Steamship Corp. v. Transamerica Delavel Inc.*, which barred tort recovery for all stand-alone economic harms to ensure that contract law does not "drown in a sea of tort."[2] As the Court explained, "damage to a product itself has certain attributes of a products-liability claim. But the injury suffered—the failure of the product to function properly—is the essence of a warranty action, through which a contracting party can seek to recoup the benefit of its bargain."[3] This contracting rationale has been regularly invoked by other courts, yielding a "high degree of agreement" that the resultant "economic

* Sheila Lubetsky Birnbaum Professor of Civil Litigation, New York University School of Law. This Article more rigorously develops an argument I previously made in MARK A. GEISTFELD, PRINCIPLES OF PRODUCTS LIABILITY 256–64 (2d ed. 2011). Both projects were supported by the Filomen D'Agostino and Max E. Greenberg Research Fund of the New York University School of Law.

1. *See* MARK A. GEISTFELD, PRODUCT LIABILITY LAW 1–67 (2012) (describing the development of strict products liability in the United States).

2. 476 U.S. 858, 866 (U.S. 1986).

3. *Id.* at 867–68.

loss rule" bars tort recovery for pure economic loss to maintain the boundary between contract and tort law.[4]

Pursuant to *East River Steamship*, courts only look at the form of the alleged injury (Is it for pure economic loss?) to determine whether the damages claim in a product case is governed by contract or tort law. The form of the alleged injury, however, does not adequately define the economic loss rule. By adopting this definition, *East River Steamship* has created problems.

Tort law recognizes a cause of action for pure economic loss in a wide variety of cases, including "negligent misrepresentation, defamation, professional malpractice, breach of fiduciary duty, nuisance, loss of consortium, wrongful death, spoliation of evidence, and unreasonable failure to settle a claim within insurance policy limits."[5] Many of these cases involve contractual relationships, yet plaintiffs recover tort damages for their pure economic losses. Why does contracting bar tort recovery for pure economic loss in product cases but not others involving contractual relationships? As one judge observed: "The inconsistent treatment of the doctrine by use of varying analytical frameworks, does not provide the bench and bar guidance in the proper application of the doctrine."[6] In the wake of *East River Steamship*, courts have "underscore[d] the desirability—perhaps urgency—of harmonizing the entire complex and confusing pattern of liability and nonliability for tortious conduct in contractual settings."[7]

The difficulty stems from the *East River Steamship* formulation of the economic loss rule, which relies on a contracting rationale that is not defined in substantive terms. Neither the form of the alleged injury nor the form of the parties' relationship—the mere fact that they could have contracted over liability for pure economic loss—necessarily bars tort recovery across the full set of cases, so why does the

4. Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 526 (2009). In contrast to the contractually based economic loss rule, "[a] minority of courts have stated an 'economic loss rule' to the effect that there is generally no liability in tort for causing pure economic loss to another." RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 1 cmt. b (Am. Law Inst., Tentative Draft No. 1, 2012). Most courts, however, limit the economic loss rule to contractual relationships, reasoning that the purpose of the doctrine is to police the tort-contract boundary. *See, e.g.*, Sullivan v. Pulte Home Corp., 306 P.3d 1, 2–3 (Ariz. 2013); Tiara Condo. Ass'n v. Marsh & McLennan Co., 110 So. 3d 399, 402–03 (Fla. 2013); Kreisers Inc. v. First Dakota Title Ltd. P'ship, 852 N.W.2d 413, 421 (S.D. 2014). For this and other reasons that will become evident, the contractually based economic loss rule in product and service cases fundamentally differs from the economic loss rule in ordinary tort cases.

5. Johnson, *supra* note 4, at 530–32 (footnotes omitted). **R**

6. Sapp v. Ford Motor Co., 687 S.E.2d 47, 52 (S.C. 2009) (Beatty, J., concurring).

7. Rardin v. T & D Mach. Handling, Inc., 890 F.2d 24, 30 (7th Cir. 1989) (Posner, J.).

contracting relationship bar tort recovery for pure economic loss in product cases? The answer requires a substantive rationale for the economic loss rule that does not simply depend on the formal properties of the parties' relationship and the alleged injury. Unless the economic loss rule is anchored by a substantive principle, judges will face difficulty in "chart[ing] a course in what commentators and courts across the country have referred to as the 'choppy waters' of the economic loss rule."[8]

Despite its importance, the contracting rationale for the economic loss rule has not been rigorously analyzed or systematically developed.[9] Doing so yields a well-defined decision rule for determining whether tort damages are available for pure economic losses in product and service cases.

Contrary to the reasoning in *East River Steamship*, a substantive contracting rationale for the economic loss rule does not justify barring tort recovery for all types of pure economic loss proximately caused by defective products. The formal category of pure economic loss encompasses substantively different types. Form often follows substance, in which case the *East River Steamship* rule yields the correct result. Form, however, does not always follow substance, in which case the *East River Steamship* rule bars tort recovery in a manner that cannot be substantively justified by the contracting rationale.

Frequently, a product defect that causes pure economic loss only implicates the consumer's economic expectations—the core concern of contract law. These defects frustrate consumer expectations by causing repair costs and lost profits, which were the types of loss at

8. Giddings & Lewis, Inc. v. Indus. Risk Insurers, 348 S.W.3d 729, 733 (Ky. 2011).

9. To be sure, scholars have discussed the role of contracting in policing the boundary line between contract and tort law. The most extensive analysis is provided by Johnson, *supra* note 4, at 553–83. His analysis, however, does not rigorously evaluate the contracting problem; it assumes, for example, that the absence of either privity or an actual contractual provision ordinarily forecloses a contracting rationale for limiting the tort duty with the economic loss rule. *See id.* at 539 (arguing that "the rule generally should not be an obstacle to recovery if the plaintiff was not a party to a contract with the defendant that is alleged to be the exclusive source of [the] duty," and that "hypothetical remedies under contracts that were never entered into should not bar recovery under [general] tort principles"); *see also* Anita Bernstein, *Keep It Simple: An Explanation of the Rule of No Recovery for Pure Economic Loss*, 48 ARIZ. L. REV. 773, 775 (2006) (rejecting the contracting rationale simply because "[s]ome economic-loss plaintiffs never could have achieved private ordering with the defendant yet lose anyway"). As shown in Part III, a rigorously specified contracting rationale can justifiably bar tort recovery under conditions lacking either privity or actual contract terms covering the economic loss in question. This specification also shows that the tort duty is not limited simply because the parties are in a web of contractual relationships. *Cf.* Jay M. Feinman, *The Economic Loss Rule and Private Ordering*, 48 ARIZ. L. REV. 813, 823–26 (2006) (criticizing justifications for the economic loss rule based on contracting and private ordering that make "market-focused subjects (contract and property) . . . primary" over the ordering mandated by tort law). R

issue in *East River Steamship*. In considering the allocation of liability for these economic losses, the ordinary consumer is sufficiently well informed to protect her interests by contracting. For cases involving these disappointed product users, the Court in *East River Steamship* defensibly concluded that the denial of a tort claim ensures that contract law does not "drown in a sea of tort."[10]

In other cases, though, a product defect causes a type of pure economic loss that implicates the consumer's interest in physical security—the core concern of tort law. The defect, for example, can cause the consumer to incur medical bills for monitoring a health condition (like cancer) threatened by the defect. As established by the widely adopted rule of strict products liability, contracting does not adequately protect poorly informed consumers from the threat of physical harm, creating a safety problem that provides the substantive policy rationale for a tort duty that overrides contractual limitations of a seller's responsibility for product defects. This same contracting problem plagues cases of pure economic loss that involve the financial expenditures required to protect endangered consumers from physical harms threatened by product defects. The inability of the ordinary consumer to make informed contractual decisions concerning liability for physical harms—the substantive rationale for strict products liability—justifies tort recovery for these types of pure economic loss.

When the economic loss rule is justified by a substantive contracting rationale, the availability of tort recovery for pure economic losses depends on whether the ordinary consumer has the requisite information to protect the relevant set of interests by contracting. The substantive contracting rationale justifies an intermediate economic loss rule that denies tort recovery for disappointed product users and permits endangered consumers to recover tort damages for certain types of pure economic loss.

The argument proceeds in three parts. The *East River Steamship* contracting rationale for the economic loss rule is described more fully in Part II. For reasons provided in Part III, this contracting rationale can be squared with the substantive rationale for strict products liability for contracting problems that only implicate the consumer's economic interests—the type of contracting problem involved in *East River Steamship*. But as Part III also shows, the contracting rationale does not justifiably bar tort recovery for a different type of contracting problem involving precautionary investments for reducing the unreasonable risk of physical harm posed by a product defect, a loss that

10. *E. River S.S.*, 476 U.S. at 866.

implicates the consumer's interest in physical security. The same general conclusions apply to service contracts. Based on this analysis, Part IV proposes a substantive reformulation of the economic loss rule that distinguishes between disappointed users and endangered consumers, uniformly barring only the former from tort recovery.[11] Part IV then shows that a strong majority of courts already recognize the properly formulated rule in cases involving pure economic losses of medical monitoring or the abatement of asbestos hazards. This contractually based intermediate economic loss rule explains the full body of case law while being substantively consistent with the widely adopted rule of strict products liability, unlike the *East River Steamship* formulation, which only looks at the form of the alleged injury to determine whether the claim is governed by contract law or tort law.

II. THE *EAST RIVER STEAMSHIP* CONTRACTING RATIONALE FOR THE ECONOMIC LOSS RULE

Within tort law, pure economic loss is conventionally defined as any "pecuniary or commercial loss that does not arise from actionable physical, emotional or reputational injury to persons or physical injury to property."[12] In product cases, a pure economic loss occurs when a defect only damages the product without otherwise causing compensable physical harm (bodily injury or damage to real or tangible property other than the product). Instead, the defect degrades product performance in a manner that causes foreseeable financial harms, like repair costs and lost profits. Whether plaintiffs can receive tort damages for these harms depends on whether damage to the product itself (the defect) can serve as a predicate harm that triggers tort liability for consequential economic losses.

To resolve this issue, courts regularly rely on *East River Steamship*, an admiralty case in which the U.S. Supreme Court concluded that federal maritime law incorporates the common law of strict products liability.[13] In *East River Steamship*, ships manufactured by the defendant had defective turbines that malfunctioned, causing the ships to operate at reduced capacity.[14] Plaintiffs sought tort damages for their repair costs and lost profits while the ships were out of service.[15] Be-

11. Some courts have adopted a similar intermediate rule, permitting endangered consumers to recover tort damages for pure economic losses, but they have not properly formulated the rule. *See infra* Part III.E.

12. Dan B. Dobbs, *An Introduction to Non-Statutory Economic Loss Claims*, 48 ARIZ. L. REV. 713, 713 (2006).

13. *E. River S.S.*, 476 U.S. at 865.

14. *Id.* at 859–60.

15. *Id.* at 861.

cause each defect only injured the product itself (the ship) and did not cause any bodily injury or damage to other real or tangible property, plaintiffs' tort claims were for pure economic loss. To determine whether plaintiffs could recover in tort, the Court considered how state courts applied their rules of strict products liability in cases of pure economic loss.[16] The Court identified three different approaches that had been taken by the state courts, ultimately "adopt[ing] a [rule] similar" to the one earlier formulated by the California Supreme Court in *Seely v. White Motor Company*,[17] "the case that created the majority land-based approach."[18] Both the rule and justificatory reasoning in *Seely* were largely adopted by *East River Steamship*, making it necessary to evaluate *East River Steamship* in relation to the California Supreme Court's approach in *Seely*.

In *Seely*, the plaintiff purchased a truck manufactured by the defendant that bounced violently when driven, "an action known as 'galloping.'"[19] The truck crashed once without causing injury to anything other than the truck itself, but the ongoing galloping problem finally induced the plaintiff to return the truck to the dealer and seek recovery for the repair costs that he incurred because of the crash, the purchase price, and "the profits [he] lost in his business because he was unable to make normal use of the truck."[20] The trial court awarded damages on the ground that the defendant breached an express warranty, but it denied tort recovery for repair costs because the accident in question was not caused by the defect. On appeal, the parties disagreed about the extent to which the contractual warranty claim was affected by the tort claim of strict products liability.[21] The California Supreme Court concluded that strict products liability "was designed, not to undermine the warranty provisions of the sales act or of the Uniform Commercial Code but, rather, to govern the distinct problem of physical injuries."[22] Because the plaintiff had not suffered physical injury, the defendant did not owe him a tort duty, barring tort recovery for the pure economic losses caused by the truck's defect.

In adopting this no-duty rule, the court relied on a contracting rationale that subsequently exerted considerable influence over other courts. After the plaintiff returned the truck, it was resold to another trucker who used it for different purposes, and that trucker did not

16. *Id.* at 873–75.
17. 403 P.2d 145 (Cal. 1965).
18. *E. River S.S.*, 476 U.S. at 868–71 (citation omitted).
19. *Id.* at 147.
20. *Id.* at 148.
21. *See id.* at 148–49.
22. *Id.* at 149.

experience any galloping. The truck, therefore, was suitable for a commercial use different from the commercial manner in which the plaintiff had used the truck. As the court observed, a product that meets the specific commercial needs of one type of consumer but not another is best handled by the contractual rules of warranty law:

> If under these circumstances defendant is strictly liable in tort for the commercial loss suffered by plaintiff, then it would be liable for business losses of other truckers caused by the failure of its trucks to meet the specific needs of their businesses, even though those needs were communicated only to the dealer. Moreover, this liability could not be disclaimed, for one purpose of strict liability in tort is to prevent a manufacturer from defining [under the product warranty] the scope of his responsibility for harm caused by his products. The manufacturer would be liable for damages of unknown and unlimited scope. Application of the rules of warranty prevents this result.[23]

Unlike strict products liability, warranty law permits the parties to contractually allocate responsibility for defects pursuant to their particular commercial needs. According to the court, this limited role for contracting is not inconsistent with the rule of strict products liability, which is premised on the inability of consumers to contract fairly over liability for physical harms:

> A consumer should not be charged at the will of the manufacturer with bearing the risk of physical injury when he buys a product on the market. He can, however, be fairly charged with the risk that the product will not match his economic expectations unless the manufacturer agrees that it will.
>
> . . . .
>
> Here, plaintiff, whose business is trucking, could have shopped around until he found the truck that would fulfill his business needs. He could be fairly charged with the risk that the product would not match his economic expectations, unless the manufacturer agreed that it would.[24]

This contracting rationale for barring tort claims of pure economic loss was subsequently adopted and further refined by the U.S. Supreme Court in *East River Steamship*.[25] As the Court explained:

> 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.
>
> The tort concern with safety is reduced when an injury is only to the product itself. . . . [W]hen a product injures itself, the commercial user stands to lose the value of the product, risks the displeasure

23. Seely v. White Motor Co., 403 P.2d 145, 150–51 (Cal. 1965) (citation omitted).
24. *Id.* at 151–52.
25. *E. River S.S.*, 476 U.S. at 868–71.

> of its customers who find that the product does not meet their needs, or, as in this case, experiences increased costs in performing a service. Losses like these can be insured.[26]

Like *Seely*, the reasoning in *East River Steamship* recognized that contracting for pure economic losses has distinct value, and consumers and manufacturers can fairly contract over this type of loss, even if they cannot do so with respect to physical harms.

In the decades that followed *East River Steamship*, the majority of appellate courts that considered the issue have adopted the *East River Steamship* contracting rationale. In doing so, these courts have often rejected intermediate rules that recognize "an exception to the economic loss doctrine based on unreasonably dangerous products; sudden, calamitous events; or both."[27] These courts have concluded that a duty encompassing pure economic loss is not justified by the need to protect endangered consumers, reasoning that "deterrence is adequately promoted by existing law that permits tort recovery for personal injury and damage to property other than the product itself."[28]

Even though the parties in these cases do not always have a direct contractual relationship, courts still invoke the contracting rationale to deny the tort claim. The plaintiff-consumer typically purchased the product from a retailer, whereas the defendant-manufacturer is usually an upstream supplier that may have directly contracted only with the retailer or other intermediate distributors. Even if there is no contractual privity between the consumer and the manufacturer, courts still recognize that the contracting rationale can justify barring tort recovery in cases of near privity. The parties are situated in a web of contractual relationships that permits the shifting of losses through indemnification agreements among or between the various parties in the chain of distribution, and the consumer can also look outside of this contracting family to seek protection by other means, such as purchasing insurance against pure economic losses or adopting other methods (like maintaining a supply of spare parts) for minimizing the pure economic losses caused by the defective product. The contracting rationale only requires near privity between the plaintiff and defendant, recognizing that the range of opportunities afforded by contracting in these contexts means that "the potential victim ordinarily is best able

26. *Id.* at 871–72.

27. *See, e.g.*, Giddings & Lewis, Inc. v. Indus. Risk Insurers, 348 S.W.3d 729, 733 (Ky. 2011); Dobrovlny v. Ford Motor Co., 793 N.W.2d 445, 449–50 (Neb. 2011); Lincoln Gen. Ins. Co. v. Detroit Diesel Corp., 293 S.W.3d 487, 492 (Tenn. 2009).

28. *See, e.g.*, *Lincoln Gen. Ins.*, 293 S.W.3d at 491.

to work out alternative protective arrangements and need not rely on tort law."[29]

Most courts have adopted the contracting rationale articulated by *East River Steamship*, making it the leading formulation of the economic loss rule.[30] As one federal court concluded in a case that required it to predict whether Pennsylvania law would recognize this rule:

> [*East River Steamship*] was not a paste and scissors job that set forth the diverse holdings in myriad cases and then arbitrarily opted for one view over the others. The Court heeded the teaching of Lord Mansfield: "The law does not consist in particular instances, though it is explained by particular instances and rules; but the law consists of principles, which govern specific and individual cases as they happen to arise." The Court identified, examined, and evaluated controlling dogma, doctrine, and fundamental principles of tort and contract remedies. For these reasons, we are convinced that the Pennsylvania Supreme Court will adopt the analysis of [*East River Steamship*].[31]

It is an open question, however, whether *East River Steamship* represents the triumph of substance over form. The Court in *East River Steamship* concluded that contracting and related measures adequately protect against all forms of pure economic losses threatened by defective products, eliminating any rationale for the tort duty. The Court, though, did not rigorously establish this conclusion, and no one else has systematically applied the contracting rationale to the different types of contracting problems in product cases.[32] To determine whether *East River Steamship* formulated the economic loss rule in a substantively defensible manner, we must analyze the contracting rationale across the full range of cases.

III. Contracting Over Pure Economic Loss

Courts have reasoned that a contracting rationale for the economic loss rule is consistent with the tort duty governing physical harms.[33] The difficulty posed by this reasoning is most easily illustrated by the

29. Rardin v. T & D Mach. Handling, Inc., 890 F.2d 24, 29 (7th Cir. 1989); *see* Grams v. Milk Prods., Inc., 699 N.W.2d 167, 171 (Wis. 2005) (stating that one of the fundamental premises of the economic loss rule is "to encourage the party best situated to assess the risk of economic loss, [that is], the commercial purchaser, to assume, allocate, or insure against that risk" (alteration in original)).

30. Restatement (Third) of Torts: Products Liability § 21 cmt. d (Am. Law Inst. 1998).

31. Aloe Coal Co. v. Clark Equip. Co., 816 F.2d 110, 118 (3d Cir. 1987) (quoting R. v. Bembridge, 22 How. St. Tr. 2, 155 (K.B. 1783)).

32. *See supra* note 9 and accompanying text.

33. *See supra* notes 23–28 and accompanying text.

rules governing contractual disclaimers or waivers of a product seller's tort liability for physical harms.

Courts have uniformly concluded that a contractual disclaimer or waiver of tort liability "is so inimical to the public good as to compel an adjudication of its invalidity."[34] As the *Restatement (Third) of Torts* explains, courts do not enforce these provisions because "[i]t is presumed that the ordinary product user or consumer lacks sufficient information and bargaining power to execute a fair contractual limitation of rights to recover."[35]

Contractual limitations of tort liability are contrary to public policy because they absolve product sellers of legal responsibility for supplying overly unsafe products to poorly informed consumers. Unless sellers are legally responsible for product safety, they predictably reduce safety investments to reduce their costs, yielding products with unreasonable dangers that cannot be adequately discerned by uninformed consumers. The resultant safety problem justifies a tort duty that makes sellers legally responsible for product safety independent from their contractual obligations.[36]

This substantive rationale for the tort duty poses an evident problem for the economic loss rule. Strict products liability is based on the rationale that consumers cannot execute fair contractual limitations of liability for physical harms, thereby justifying the imposition of a tort duty on product sellers that cannot be limited by these contracts. The economic loss rule, by contrast, limits the tort duty on the ground that consumers can fairly contract over limitations of liability in cases of pure economic loss. Can a rationale that rejects contracting over physical harms be squared with a rationale that accepts contracting over issues of pure economic loss?

In most cases, the informational problems that prevent consumers from executing fair contractual limitations of liability for physical harm do not prevent them from executing fair limitations of liability for pure economic loss. The structure of the contracting problem in these cases, however, does not encompass all forms of pure economic loss. In an important class of cases, contracting over pure economic loss is not substantively different from contracting over disclaimers or waivers of tort liability for physical harm. The same informational problem that justifies the tort duty for physical harms also justifies the

34. *See, e.g.*, Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69, 95 (N.J. 1960).

35. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 18 cmt. a.

36. MARK A. GEISTFELD, PRINCIPLES OF PRODUCTS LIABILITY 43–60 (2d ed. 2011) (explaining why a tort duty can be justified whenever information costs prevent the ordinary consumer from making informed decisions about product risks).

tort duty for this type of pure economic loss. A tort duty formulated in terms of the contracting rationale, therefore, does not bar tort recovery for all forms of pure economic loss, contrary to the *East River Steamship* formulation of the economic loss rule.

A. The Contracting Problem in Products Liability

To analyze the contracting problem involving pure economic losses caused by defective products, we must first isolate the relevant contracting issues. Products liability addresses issues pertaining to product safety and the compensation of product-caused injuries. Because manufacturers in mass product markets necessarily respond to aggregate consumer demand as opposed to the particular demands of individual consumers, the associated rules of products liability are defined by reference to the average or ordinary consumer.[37] For tort purposes, the contracting problem reduces to the question of how the average or ordinary consumer would contract with the manufacturer over issues of product safety and compensation for product-caused injuries.

Consider an ordinary consumer who has already decided to purchase a particular type of car. The only remaining decision is whether a particular safety device should be incorporated into the vehicle's design. Suppose the safety device (like an airbag) only affects the consumer (the purchaser and other users of the vehicle), eliminating the need to consider bystanders.[38] The consumer's decision of whether to purchase this safety device depends on its cost and expected safety benefits—the issues of relevance to products liability.

In deciding whether to purchase this safety device, the consumer accounts for its price and any other costs that she can expect to incur because of it, such as replacement or maintenance costs. The con-

37. *See id.* at 41–42; *see also, e.g.*, Johnson v. Am. Standard, Inc., 179 P.3d 905, 916 (Cal. 2008) (holding that the duty to warn in products liability cases "must be based on objective general predictions of the anticipated user population's knowledge, not case-by-case hindsight examinations of the particular plaintiff's subjective state of mind").

38. One who buys a product frequently expects that it will be used by others, such as family members or friends. In making the purchase decision, the buyer presumably gives equal consideration to the welfare of these other users. The interests of these parties coincide, making it defensible to conceptualize the consumer as including both the buyer and any reasonably foreseeable user of the product. Consequently, "the connotation of 'consumer' [is] broader than that of 'buyer.' He signifie[s] such a person who, in the reasonable contemplation of the parties to the sale, might be expected to use the product." *Henningsen*, 161 A.2d at 81. The consumer, by contrast, will not necessarily account for the interests of strangers when contracting over product safety, so any contracting rationale for the economic loss rule will be inapplicable to bystanders. *Cf.* GEISTFELD, *supra* note 36, at 309–20 (discussing the substantive differences between bystander claims and consumer claims). R

sumer adds up all of these costs to determine the total cost or burden (B) she would incur because of the safety device. The consumer also considers the safety benefit she would derive from this safety investment. Without the protection provided by the device, the consumer faces a higher probability of being injured in a crash and incurring the associated costs. Multiplying this probability (P) by the cost of injury or loss (L) yields the expected injury costs (PL) of not having this particular device. To decide whether she should purchase the device, the consumer compares the total cost or burden of the device with its safety benefit (the amount by which the device would reduce the consumer's expected injury costs). The consumer would find it worthwhile to demand that the automobile contain the safety device only if its total costs are less than the total safety benefits:

cost of safety device $B <$ *increased injury costs without the device* PL

The consumer must have adequate knowledge about both factors to make informed contracting decisions regarding product safety. For example, suppose the ordinary consumer is unaware of a risk that would be created by a design that does not incorporate a cost-effective safety device (one for which $B < PL$). If the consumer knew of the risk, she would want to purchase the device. Without knowledge of the risk, however, the ordinary consumer is unaware of the safety problem and unwilling to purchase the device ($B > PL = 0$). Why would one spend money to address a safety problem that she does not think exists?

Lacking consumer demand, the manufacturer will not incorporate the safety device into the design. The manufacturer could create demand for the device by voluntarily disclosing the associated risk to consumers, but doing so would only increase consumer estimates of product cost and decrease sales. What is the point of advertising negative product attributes to the consumer? The process of price competition predictably forces manufacturers to forego these types of safety investments, resulting in unreasonably dangerous products. The safety problems caused by uninformed consumer choice, therefore, justify the tort duty.[39]

The tort duty accordingly governs any risk of physical harm for which the ordinary consumer is unable to make an informed safety decision. By implication, the duty does not encompass safety deci-

39. GEISTFELD, *supra* note 36 at 43–48. **R**

sions that can be made by the ordinary consumer on an adequately informed basis.[40]

For these reasons, product sellers cannot disclaim tort liability under the product warranty. A contractual disclaimer or waiver of liability operates against a tort duty, which in turn applies only to contractual safety decisions that cannot be made by the ordinary consumer on an informed basis. The same safety problem that is combated by the tort duty would be recreated by a contractual waiver or disclaimer of the duty, justifying the judicial conclusion that these contractual provisions violate public policy because "[i]t is presumed that the ordinary product user or consumer lacks sufficient information and bargaining power to execute a fair contractual limitation of rights to recover."[41]

As illustrated by contractual waivers of tort liability, the same informational problem that justifies the tort duty with respect to physical harms extends to any other substantively identical contracting problem. Whether courts should enforce contractual limitations of liability for pure economic loss, therefore, depends on whether the contracting problem is substantively identical to the one implicated by the tort duty governing physical harms.

B. Contracting and the Ordinary Tort Duty in Cases of Physical Harm

So far the analysis has shown that a fully informed consumer will demand any safety device or precaution for which the cost or burden *B* is less than the safety benefit or associated reduction of risk *PL*. To ensure that a product conforms to this decision-rule and thereby satisfies the ordinary consumer's reasonable expectations of product safety, the tort duty obligates the product seller to incorporate safety precautions into the product whenever doing so is required by the risk-utility test.[42] The *risk* of a product design or warning that does not contain a particular safety precaution refers to the increased risk that the consumer will suffer injury due to this lack of protection—the risk term *PL* in our prior analysis. The *utility* of the existing design or warning refers to the savings that are created by the omission of the

40. *Id.* at 48–54, 125–35 (using case law on categorical liability and optional safety equipment to show why the tort duty does not apply to safety decisions that can be made by the ordinary consumer on an informed basis).

41. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 18 cmt. a (AM. LAW INST. 1998).

42. *Id.* §§ 2(b)–(c). For reasons implied by this discussion, the risk-utility test is substantively equivalent to the formulation of the consumer expectations test that considers product performance in relation to cost. *See* GEISTFELD, *supra* note 36 at 71–77. R

safety precaution in question, which is an amount equal to the total cost or burden B of the safety investment. Under the risk-utility test, the design or warning of a product is defective if the utility of not incorporating a particular precaution into the design or warning (the cost savings) is less than the risk that would thereby be eliminated: $B < PL$. Consequently, the risk-utility test deems a product defective if it does not contain the safety precautions that would be chosen by the ordinary consumer if she were well informed of the risk-utility factors.

For cases in which a product defect proximately caused physical harm—bodily injury or damage to real or tangible property other than the product itself—tort law provides the plaintiff with the greatest range of damage remedies. In these cases, the plaintiff can receive compensatory damages for the physical harm itself, consisting of both the monetary and nonmonetary injuries caused by the harm, such as medical expenses and pain and suffering.

Based on this specification of the tort duty, we can define the associated contracting problem. To do so, we must distinguish the economic or monetary losses proximately caused by the predicate physical harm ($L_{Economic|Physical}$) from the noneconomic or nonmonetary losses proximately caused by that predicate physical harm ($L_{Noneconomic|Physical}$). These two types of losses are encompassed by the ordinary tort duty in product cases involving physical harm, which can be compactly expressed in terms of the risk-utility test as requiring product sellers to make any safety investment (with a cost or burden B) that satisfies the following condition:

(1) $$B < P\,(L_{Economic|Physical} + L_{Noneconomic|Physical})$$

Any contractual disclaimer of this ordinary tort duty is unenforceable on the ground that the average consumer does not have sufficient information to execute a fair limitation of liability.[43] By implication, the average consumer will not have sufficient information to disclaim any other limitations of liability that turn on the same safety issue. The enforceability of contractual disclaimers for liability over pure economic loss depends on how the underlying contracting problem compares to the safety decision expressed by Equation 1.

43. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 18 cmt. a.

C. Contracting Over Liability for Pure Economic Loss

The contracting problem encompasses pure economic loss anytime a product risk threatens economic losses that are mutually exclusive of physical harm—only one or the other can occur, but not both. But even if the risk materializes into a pure economic loss, the amount of loss can still depend on a future risk of physical harm (the financial cost of repair, for example, can depend on the need to eliminate a risk of physical harm). For contracting purposes, a pure risk of economic loss is both mutually exclusive of physical harm in the first instance and is not dependent on any further risk that the product will cause physical harm.

For example, the high-pressure turbine of a ship at issue in *East River Steamship* malfunctioned during a storm in the Gulf of Alaska, causing the ship to lose normal power.[44] Despite this defect, the ship still had enough power to complete its lengthy journey to the Panama Canal and then to San Francisco.[45] The circumstances in which the defect first manifested itself only resulted in pure economic loss (the increased time to complete the voyage and the expense of repairing the turbine), but the outcome could have been different under another set of circumstances. If the storm had been sufficiently severe, the loss of normal power could have caused the ship to founder and sink, resulting in physical harm (bodily injury and damage to tangible property unrelated to the ship itself). Any safety investments that reduced the risk of a turbine malfunction, therefore, reduced both the risk that the defect would cause physical harm and the mutually exclusive risk that the defect would, instead, initially cause pure economic loss. If the total amount expended on repair only depended on the need to avoid further economic losses (the increased time to complete voyages), then the associated risk is one of pure economic loss for contracting purposes.

Under these conditions, the contracting problem involves a product risk that could cause the consumer to suffer either a physical harm (with probability P_1) or a pure economic loss (with mutually exclusive probability P_2) of an amount that can be determined without any further reference to the problem of physical harm ($L_{Economic}$). If the tort duty were to encompass this type of pure economic loss, the ordinary duty would be expanded from the risk of physical harm to include the additional risk that the defect might cause pure economic loss:

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

45. *Id.*

(2) $B < P_1 (L_{Economic|Physical} + L_{Noneconomic|Physical}) + P_2 (L_{Economic})$

This expanded duty can require more product safety than the ordinary duty, which is limited to cases of physical harm.[46] The more expansive duty, though, cannot be justified on the ground that the increased product safety is required to protect consumers from an unreasonable risk of physical harm. That protection is already provided by the ordinary duty governing physical harms.[47]

Because the ordinary tort duty fully regulates any safety problems pertaining to the unreasonable risk of physical harm, the consumer "has no duty to discover or guard against a product defect."[48] Freed from the need to consider product defects that might cause physical harm, the consumer's contracting decision is limited to cases in which such a defect only causes pure economic loss.

In contracting over losses of this type, the consumer can rely on the implied warranty, which guarantees that the product is capable of performing its intended function.[49] Although the seller can expressly disclaim the implied product warranty with clear and conspicuous language in the sales contract,[50] doing so can alert otherwise unwary consumers of the need to consider the problem of pure economic losses caused by a defect in the product.[51] The contractual transaction is further regulated in most states by consumer protection statutes that prohibit unfair and deceptive trade practices.[52] The transaction, therefore, is regulated in a manner that largely governs the safety dimensions of the product, reducing the consumer's contracting deci-

46. The added safety benefit for pure economic loss on the right-hand side of the equation can justify an increase in safety expenditures on the left-hand side.

47. *See supra* Part III.B; *cf.* Trans States Airlines v. Pratt & Whitney Can., Inc., 682 N.E.2d 45, 53 (Ill. 1997) ("[W]e believe that the incentive to manufacture safe products remains unabated under the [economic loss rule]. . . . Where the product causes personal injury or other property damage, the manufacturer may yet be subject to liability in tort. Because no manufacturer can predict with any certainty that the damage his unsafe product causes will be confined to the product itself, tort liability will continue to loom as a possibility. Therefore, in our view, the incentive to build safe products is not diminished.").

48. Gen. Motors Corp. v. Sanchez, 997 S.W.2d 584, 593 (Tex. 1999); *see also* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 17 cmt. d ("In general, [the] plaintiff has no reason to expect that a new product contains a [defect] and would have little reason to be on guard to discover it.").

49. U.C.C. § 2-314 (AM. LAW INST. & NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2014).

50. *Id.* § 2-316(2).

51. *Cf.* Hiigel v. Gen. Motors Corp., 544 P.2d 983, 989–90 (Colo. 1975) (requiring that a disclaimer be clearly brought to the attention of a noncommercial buyer to be enforceable).

52. 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, 830–31 (2006).

sion to issues concerning the amount of pure economic loss that could be caused by a defect and the methods for insuring or protecting against these losses.

In this limited respect, the ordinary consumer has better information than the product seller. The benefits that a consumer receives from the product depend on how the product is used. For example, a recording device can be used for capturing a mundane conversation or a musical performance with vast commercial potential. A defect that renders the device unable to perform the recording function would cause substantially different economic losses in the two contexts. In most cases, however, the manufacturer does not know how a consumer will use the product. By contrast, the consumer knows how the product will be used and has better information about the amount of financial harms, like lost profits, that could be caused by a product malfunction.

Consistent with this reasoning, courts bar tort recovery for pure economic losses caused by a product defect for the "basic reason" that the manufacturer "could not estimate the consequences of [its] carelessness."[53] The consumer's superior information about the extent of pure economic loss undergirds the contracting rationale for the economic loss rule.

Based on her superior information about economic loss, the ordinary consumer can adequately protect her interests by either contracting with the seller for more extended warranty coverage, purchasing other types of insurance, or obtaining other forms of protection, such as a supply of spare parts. The consumer may also have additional reasons for protecting against the risk of pure economic loss that are unrelated to the particular threat posed by a defective product. A commercial party, for example, worries about the prospect of lost profits caused by a variety of accidents (e.g., floods or fires), which often make it worthwhile to purchase business-interruption insurance.[54] The insurance decision does not ordinarily turn on

53. Rardin v. T & D Mach. Handling, Inc., 890 F.2d 24, 26 (7th Cir. 1989) (discussing the negligent performance of contracts more generally).

54. "Business interruption insurance is written to cover virtually any type of commercial business in existence today." David A. Borghesi, *Business Interruption Insurance—A Business Perspective*, 17 NOVA L. REV. 1147, 1149 (1993).

> [T]o have a recoverable business interruption loss under standard insurance contracts typically found today, five criteria must be met. The insured must have: 1) physical damage; 2) to insured property; 3) caused by a covered peril; 4) resulting in a measurable business interruption loss; 5) for the period required to expeditiously restore the damaged property.

Id. at 1151. The specifics of the policy determine whether a loss is covered, but some "not so unique loss experiences" include the case in which "[a] food manufacturer must shut down its

the incremental risk of lost profits caused by a defect in a particular product. In light of the threat of lost profits posed by the full range of other risks, it is either worth purchasing the insurance, or it is not. Under these conditions, the commercial party can adequately protect against the risk of lost profits without having to consider the risk posed by a particular defective product. But even when such a product risk merits separate consideration, the consumer has both the knowledge and opportunity to protect her pure economic interests by contracting and related protective measures.

Unlike cases of physical harm, insurance can adequately protect the consumer in cases of pure economic loss. Since at least the seventeenth century, the common law has defined an injury as being "irreparable" if it "cannot be adequately measured or compensated by money."[55] Physical harm is a type of irreparable injury, and, for centuries, the common law has recognized that the prevention of such an injury is better than imperfect compensation via the damages remedy.[56] Pure economic loss, by contrast, is the paradigmatic example of a harm that can be fully compensated by money. One dollar of lost profits can be fully indemnified by $1 of insurance coverage. Insurance provides an important reason why contracting can adequately protect the consumer's interest in avoiding pure economic losses, further explaining why a tort duty encompassing these harms is not needed to protect the consumer interests at stake.[57]

D. Contracting for the Provision of Services

In addition to governing product cases, the economic loss rule also bars tort recovery for "economic injuries resulting from the breach of

operations because of viral contamination." *Id.* at 1151–52. The source of a viral contamination could stem from a product malfunction, illustrating how the risk posed by a particular defective product can be a component of a larger insurance decision faced by a commercial actor.

55. Mark A. Geistfeld, *The Principle of Misalignment: Duty, Damages, and the Nature of Tort Liability*, 121 YALE L.J. 142, 159 (2011). *See generally Injury*, BLACK'S LAW DICTIONARY (10th ed. 2014).

56. *See* Geistfeld, *supra* note 55, at 145. **R**

57. This conclusion is not limited to commercial parties and does not depend on the consumer's wealth, making this contracting rationale for the economic loss rule more general than the one developed by William K. Jones, *Product Defects Causing Commercial Loss: The Ascendancy of Contract over Tort*, 44 U. MIAMI L. REV. 731, 794–97 (1990) (explaining why commercial parties are able to protect their pure economic interests by contracting, but concluding that when individual consumers are the buyers, "because of limitations on consumer knowledge and because of disparities in consumer wealth, it cannot be said that contractual reallocations of risk are economically efficient and socially acceptable in the general run of manufacturer-consumer transactions").

other sorts of contracts."[58] As one court explained, the principle that parties facing a risk of pure economic loss can protect these interests by contracting and related protective measures provides "ampl[e] support [for] applying the rule to products and services alike."[59]

The extension of the contracting rationale to service contracts is defensible for reasons made clear by the prior analysis of the contracting problem. That analysis does not depend on whether the risk is posed by a product or service, so the contracting conclusions applicable to product cases generalize to the provision of services.[60]

To be sure, product contracts are governed by the Uniform Commercial Code (U.C.C.), which includes the implied warranty that the product is fit for its intended purpose, whereas service contracts are not governed by the U.C.C. Due to this difference, some courts have refused to extend the economic loss rule from product contracts to contracts involving the provision of services.[61]

The consumer of a service contract, however, is still protected by other legal rules. For example, "the common law of contracts has well developed rules of interpretation and doctrines to protect the reasonable expectations of the parties."[62] More importantly for present purposes, the consumer of a service contract is protected by a tort duty requiring the seller to adopt reasonable precautions for reducing the risk of physical harm. These legal rules considerably simplify the consumer's contracting decision regarding pure economic loss.

As in product cases, the ordinary tort duty fully regulates the manner by which the contractual performance unreasonably threatens physical harm, limiting the consumer's contracting decision to whether it is worth taking measures to protect against such a negligent performance that only causes pure economic loss. As in product cases, the consumer in this limited respect ordinarily has enough information to rely on the contract or other measures like insurance to protect against the pure economic losses caused by such a negligent perform-

58. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 3 cmt. a (AM. LAW INST., Tentative Draft. No. 1, 2012).

59. Indianapolis-Marion Cty. Pub. Library v. Charlier Clark & Linard, P.C., 929 N.E.2d 722, 742 (Ind. 2010).

60. In the formal analysis developed in the prior section, the risk of product-caused injury (*P*) can be redefined as the risk of injury caused by performance of the service contract. Aside from the exceptions discussed in the text *infra*, the remainder of the analysis stays the same.

61. *See, e.g.*, Ins. Co. of N. Am. v. Cease Elec. Inc., 688 N.W.2d 462, 469 (Wis. 2004) (citing Cargill, Inc. v. Boag Cold Storage Warehouse, 71 F.3d 545, 550 (6th Cir. 1995) and McCarthy Well Co. v. St. Peter Creamery, Inc., 410 N.W.2d 312, 315 (Minn. 1987) as two courts in agreement with this decision)).

62. *Indianapolis-Marion Cty. Pub. Library*, 929 N.E.2d at 742.

ance. The contracting rationale for limiting the tort duty extends from product cases to service cases.

By implication, the contracting rationale does not justifiably bar tort recovery for pure economic loss if the ordinary consumer is not well informed about the relevant factors. Consider contracts for the provision of legal advice or other professional services that do not threaten physical harm. Because there is no risk of physical harm implicated by the contracting decision, the client cannot rely on the ordinary tort duty to guarantee that the professional will exercise reasonable care. The client must instead evaluate the entire risk that the professional will commit malpractice. According to the *Restatement (Third) of Torts*, "most clients do not know enough to protect themselves by inspecting the professional's work or by other independent means."[63] The ordinary client is unable to make adequately informed contracting decisions, justifying the rule that "[a] professional is subject to liability in tort for economic loss caused by the negligent performance of an undertaking to serve a client."[64]

The tort duty in malpractice cases effectively requires a professional to provide the quality of care that would be demanded by the ordinary, well-informed client. The duty is often described by courts "as a 'customary' or 'professional' standard of care."[65] This amount of care would presumably be chosen by the ordinary client if she were well informed about the matter, so the tort duty supports the contracting relationship by solving the informational problem. As illustrated by the tort duty governing professional malpractice, the contracting rationale does not uniformly bar tort recovery for pure economic loss but only applies when the ordinary client or consumer does not have the requisite information for protecting her interests by contracting.

E. Defects That Threaten Both Pure Economic Loss and Physical Harm

Recognizing that strict products liability "was designed . . . to govern the distinct problem of physical injuries,"[66] some courts have adopted an exception to the economic loss rule if the plaintiff alleges "facts that demonstrate that the product at issue creates a *dangerous condition*, one that gives rise to a *clear danger or death or personal*

63. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 4 cmt. a.
64. *Id.* § 4.
65. *Id.* § 4 cmt. c.
66. Seely v. White Motor Co., 403 P.2d 145, 149 (Cal. 1965).

injury."[67] This approach distinguishes between "disappointed users . . . and the endangered ones," permitting only the latter to recover tort damages for pure economic loss.[68]

This intermediate rule recognizes that claims by endangered consumers implicate their interest in physical security, making them substantively different from other claims for pure economic loss.

> The line that is drawn usually depends on the nature of the defect and the manner in which the damage occurred. Defects of quality, evidenced by internal deterioration or breakdown, are assigned to the economic loss category, while the loss stemming from defects that cause accidents "of violence or collision with external objects" is treated as physical injury. Tort law traditionally has redressed injuries properly classified as physical harm.[69]

This formulation of an intermediate rule cannot be squared with the contracting rationale. As established by the prior analysis, the ordinary consumer can adequately protect her interests by contracting over risks of pure economic loss that are both mutually exclusive of physical harm in the first instance and not dependent on any risk of future physical harm. These risk characteristics solely pertain to the type of economic loss and not the manner in which the defect causes injury. Regardless of how such a risk first materializes into injury—whether through gradual deterioration or a sudden accident—the ordinary consumer can adequately protect against these pure economic losses by contracting and related protective measures. A formulation of the economic loss rule that is wholly defined by the manner in which the loss occurs cannot be justified by the contracting rationale

It does not follow, however, that the contracting rationale can never justify tort recovery for the pure economic losses caused by a defective product. The analysis so far has only considered defects that pose a pure risk of economic loss—one that initially causes either physical harm or a pure economic loss that does not depend on a risk of future physical harm. A complete analysis of the contracting problem must address all types of economic loss, including those for which the amount of economic loss depends on a future risk of physical harm.

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67. Lloyd v. Gen. Motors Corp., 916 A.2d 257, 266 (Md. 2007) (relying on this rule to certify a class action for the cost of repairing an allegedly dangerous defect in automobiles).

68. Russell v. Ford Motor Co., 575 P.2d 1383, 1387 (Or. 1979).

69. Pa. Glass Sand Corp. v. Caterpillar Tractor Co., 652 F.2d 1165, 1169–70 (3d Cir. 1981), *abrogated by* Aloe Coal Co. v. Clark Equip. Co., 816 F.2d 110 (3d Cir. 1987) (footnotes omitted) (quoting Note, *Economic Loss in Products Liability Jurisprudence*, 66 COLUM. L. REV. 917, 918 (1966)).

F. Contracting Over the Financial Costs of Safety Protection

In cases involving a so-called "unmanifested" defect, the consumer purchases the product and subsequently learns about a defect that could cause physical harm; however, that event has not yet occurred—the defect has not yet manifested itself. The looming threat of physical harm can make it cost-effective to repair the defect or mitigate the risk with other precautionary measures. The contracting decision over responsibility for these costs fundamentally differs from the problem of contracting over disappointed economic expectations.

To see why, consider a class action suit filed against an automobile manufacturer seeking recovery for "the cost to repair defective seatbacks, which allegedly have a tendency to collapse in rear-impact collisions, causing, in some cases, serious bodily injury or death to drivers and/or passengers in the class vehicles."[70] To eliminate this risk, the defect in the seatbacks must be repaired. A well-informed consumer would want the manufacturer to repair the defect if the manufacturer was the least-cost avoider and the cost of repair was less than the risk that the defective seatbacks would cause physical harm in the event of an accident:

$$\textbf{(3)} \qquad B_{Repair} < P(L_{Economic\,|\,Physical} + L_{Noneconomic\,|\,Physical})$$

The consumer's repair decision is limited to the same substantive interests that are otherwise protected by the ordinary tort duty (compare Equation 1 and Equation 3). The defective seats work perfectly well in normal driving situations and do not disappoint the consumer's expectations in any respect other than the risk of physical harm; the defect is of concern only during crashes. The defect directly implicates the consumer's interest in physical security, not the economic interest pertaining to lost product value. The nature of the repair decision, therefore, is substantively equivalent to the safety decision governed by the ordinary duty of care.

Due to the substantive equivalence of these two safety decisions, contracting problems that plague one decision can extend to the other. As recognized by the substantive rationale for the ordinary tort duty governing physical harms, the consumer does not have the requisite risk-utility information for determining whether the car has defective seats at the time of purchase, which is why this particular safety decision is governed by the ordinary tort duty and not contracting.[71] If the

70. *Lloyd*, 916 A.2d at 262.

71. *See supra* Part III.A.

consumer does not know about the defective seats at the time of purchase, she also does not have the requisite risk-utility information to contract over responsibility for repairing an unknown defect that only becomes manifest after purchase. The contracting problem with respect to physical harms extends to repair decisions for preventing future physical harms—a form of pure economic loss.

For tort purposes, this type of contracting problem fundamentally differs from the one involving the risk of pure economic losses that can be determined without any reference to a further risk of physical harm (compare Equation 2 with Equation 3). In both cases, the two types of loss are mutually exclusive—the defect initially causes either physical harm or pure economic loss, but not both. This similarity, however, masks an important difference. In one case, the pure risk of economic loss involves an amount of loss that can be determined independently of physical harm, limiting the consumer's contracting decision to her economic expectations. But in the other case involving the economic loss of repair, the total amount of loss depends on the safety benefit of reducing the risk of future physical harm. The repair decision depends on the underlying risk of physical harm, so contracting over this form of pure economic loss necessarily implicates the consumer's interest in physical security.

Due to this difference in the substantive interests implicated by the contracting decision, the consumer's ability to execute fair contractual disclaimers for one type of economic loss does not enable her to execute fair contractual disclaimers with respect to the other type of economic loss. The contracting rationale for the economic loss rule, therefore, bars tort claims for one type of pure economic loss (e.g., lost profits) but not the pure economic loss of cost-effective or reasonable repair to prevent future physical harm.

Between these two extremes are "mixed" cases in which repair of the defect would reduce the risk of physical harm and any further economic losses that the consumer would otherwise incur due to the defect. Returning to the example provided by *East River Steamship*, repair of the defective turbine would enable the ship to operate at normal power, thereby reducing both the risk of physical harm (the chance that the reduced power of the ship could cause it to sink in a storm) and the economic losses stemming from the defect (the increased time of voyages caused by the reduced power).[72] For such a

72. *See supra* notes 14–16 and accompanying text (describing the defect at issue in *East River Steamship*).

mixed repair decision, the consumer's contracting problem takes the following form:

(4) $$B_{Repair} < P(L_{Economic|Physical} + L_{Noneconomic|Physical}) + L_{Economic}$$

In *East River Steamship*, the risk of physical harm was quite low. Because the shipper knew of the defect, it could avoid voyages into areas with impending storms, limiting the risk to the onset of severe storms that were unexpected. The amount of economic loss, by contrast, was quite large—all voyages would take considerably longer—and presumably sufficient to justify the repair:

(5) $$B_{Repair} < L_{Economic}$$

The shipper-consumer knew about the increased cost of longer voyages, and, in light of that cost, could determine how to contractually allocate responsibility for repair, eliminating the substantive rationale for a tort duty. For reasons illustrated by *East River Steamship*, the contracting rationale for the economic loss rule is valid in mixed cases of repair if the repair would be cost-effective without any consideration of the extent to which it would also reduce the risk of future physical harm.

As shown by the varied issues involving the repair of defective products that threaten physical harm, not all types of economic loss implicate the same contracting problem. Contracting over one type of pure economic loss implicates the same informational problem that justifies the tort duty in the first instance, whereas the other type does not. The contracting rationale permits tort recovery for the first category of economic harms and bars recovery for the second, justifying an intermediate rule formulated in this manner. For reasons established by the contracting rationale, the economic loss rule cannot bar recovery for all types of pure economic loss if consumers are to be adequately protected from the unreasonable risk of physical harm.

IV. THE CONTRACTUALLY BASED INTERMEDIATE ECONOMIC LOSS RULE

Under the majority rule governing product cases, "if a plaintiff suffers economic loss not caused by damage to the plaintiff's person or other property, that type of loss is to be governed by the U.C.C."[73] The majority rule bars tort recovery by looking only at the form of the

73. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 21 reporters' note, cmt. d (AM. LAW INST. 1998).

alleged injury, although courts have sought to substantively justify this rule with a contracting rationale for limiting the tort duty.[74]

Form, however, does not always follow substance in the realm of pure economic loss. The contracting rationale for a limited tort duty must be squared with the safety rationale for strict products liability, which rejects contractual limitations of the ordinary tort duty governing physical harms.[75] These disclaimers or waivers of tort liability are rendered unenforceable as a matter of public policy because consumers are unable to make informed contracting decisions about the risk of physical harm. The identical informational problem can also plague the ordinary consumer's contracting decisions regarding the financial costs of preventing future physical harms threatened by an "unmanifested" defect.[76] The contracting rationale for the limited duty is not valid in these cases, yet the majority rule bars tort recovery simply because the claim is for pure economic loss. The majority rule is substantively at odds with the safety rationale for strict products liability and unsupported by the contracting rationale for limiting the tort duty.

Some courts have recognized that the majority rule does not adequately protect endangered consumers, but they adopted an intermediate rule that is based on the manner in which the defect first becomes manifest rather than on the contracting rationale.[77] A different intermediate rule is regarded by the contracting rationale.

The appropriate intermediate rule has been implicitly recognized by most courts in adopting two important exceptions to the majority rule that purportedly bars recovery for all types of pure economic loss. In cases seeking tort recovery for the pure financial costs of either medical monitoring or asbestos abatement, courts do not bar the claims under the economic loss rule and often ignore the rule altogether. The mere fact that a defective product causes only pure economic loss in these two contexts does not bar tort recovery under the economic loss rule. Identifying the underlying logic of these widely recognized exceptions shows that courts have effectively adopted the appropriate contractually based intermediate rule across the full range of product and service cases.

74. *See supra* Part II.

75. *See supra* notes 34–36 and accompanying text.

76. *See supra* Part III.E.

77. *See supra* Part III.F.

A. Tort Claims for the Financial Cost of Medical Monitoring

Tort claims for the cost of medical monitoring involve product defects that have exposed the plaintiff-consumers to a significant risk of incurring future bodily injury. For example, in the cases involving the diet-drug combination popularly known as Fen-Phen, the defects involved the failure of the two drug warnings to disclose the risk that the drug combination might cause heart-valve damage.[78] Due to the nature of this risk exposure, a plaintiff who does not yet have heart-valve damage could suffer that injury in the future. To protect herself, the plaintiff must undergo periodic, costly medical testing. Consequently, the plaintiff seeks tort recovery for these medical monitoring costs on the ground that the need to incur these expenses was foreseeably caused by the defective warnings on the two drugs.

Without proof of an existing, compensable physical harm caused by the defect, the plaintiff's tort claim for the financial costs of medical monitoring is a form of pure economic loss that would seem to be straightforwardly barred by the majority rule. Nevertheless, recovery for these claims is permitted in about one-half of the jurisdictions that have addressed the matter.[79]

"Among the jurisdictions generally permitting recovery of medical monitoring in the absence of physical injury, there is little unanimity in terms of explanations for departing from the traditional physical injury rule."[80] These courts, however, all agree that these tort claims

78. *In re* Pa. Diet Drugs Litig., No. 9709-3162, 1999 WL 962583, at *2, *17 (Pa. Com. Pl. Mar. 12, 1999).

79. D. Scott Aberson, Note, *A Fifty-State Survey of Medical Monitoring and the Approach the Minnesota Supreme Court Should Take When Confronted with the Issue*, 32 WM. MITCHELL L. REV. 1095, 1114 (2006) ("Currently, courts in at least thirteen states plus the District of Columbia and Guam recognize medical monitoring absent present physical injury. [By contrast], courts in sixteen states plus the Virgin Islands appear to allow medical monitoring only if the plaintiffs can show present physical injury. The remaining jurisdictions either have not articulated a test or have not addressed the issue of medical monitoring."). Since this survey was completed, one of the states (Nevada) that previously rejected monitoring claims absent a present physical injury now recognizes those claims. *See* Sadler v. PacifiCare of Nev., Inc., 340 P.3d 1264, 1269–70 (Nev. 2014). Another state (New York) that had recognized those claims now rejects them. *See* Caronia v. Philip Morris USA, Inc., 5 N.E. 3d 11, 18–19 (N.Y. 2013). Courts from at least two other jurisdictions not accounted for in the survey now recognize these tort claims. *See, e.g.*, Donovan v. Philip Morris USA, Inc., 914 N.E.2d 891, 900–04 (Mass. 2009); Meyer *ex rel.* Coplin v. Fluor Corp., 220 S.W.3d 712, 717 (Mo. 2007) (en banc). However, the case law remains divided; courts in at least three other jurisdictions have rejected monitoring claims without proof of a present physical harm. *See, e.g.*, Parker v. Wellman, 230 F. App'x. 878, 881–84 (11th Cir. 2007) (applying Georgia law); Paz v. Brush Engineered Materials, Inc., 949 So.2d 1, 3, 5, 9 (Miss. 2007); Lowe v. Philip Morris USA, Inc., 183 P.3d 181, 186–87 (Or. 2008).

80. Lowe v. Phillip Morris USA, Inc., 142 P.3d 1079, 1083 (Or. Ct. App. 2006), *aff'd*, 183 P.3d 181 (Or. 2008).

implicate the interest in physical security—the core concern of tort law. As the court in a leading case explained:

> [I]n light of the *Restatement (Second) of Torts*' definition of "injury," we are not obliged to accept [defendant's] implicit claim that undergoing diagnostic examinations does not in itself constitute injury. The *Restatement* broadly defines injury as "the invasion of any legally protected interest of another." *It is difficult to dispute that an individual has an interest in avoiding expensive diagnostic examinations just as he or she has an interest in avoiding physical injury*. When a defendant negligently invades this interest, the injury to which is neither speculative nor resistant to proof, it is elementary that the defendant should make the plaintiff whole by paying for the examinations.[81]

The individual interest in avoiding periodic medical testing is no different from the interest in avoiding physical harm. Each involves the interest in physical security that clearly falls within the purview of tort law and not contract law. The tort-contract boundary is not implicated, rendering the economic loss rule irrelevant, even though the tort recovery is for the pure economic loss of medical monitoring.[82]

An instructive example is provided by California law. Recall that in *East River Steamship*, the U.S. Supreme Court extensively relied on the California Supreme Court's decision in *Seely* to support the rule barring tort recovery for pure economic loss in all product cases.[83] California law, however, permits tort recovery for the pure economic loss of medical monitoring under certain conditions.

According to the California Supreme Court, plaintiffs can obtain tort recovery for the financial costs of medical monitoring without having suffered a predicate compensable physical harm because: (1) "there is an important public health interest in fostering access to medical testing for individuals whose exposure to toxic chemicals creates an enhanced risk of disease, particularly in light of the value of early diagnosis and treatment for many cancer patients"; (2) "there is a deterrence value in recognizing medical surveillance claims";[84] and (3) "the availability of a substantial remedy before the consequences of the plaintiffs' exposure are manifest may also have the beneficial

81. Friends for All Children, Inc. v. Lockheed Aircraft Corp., 746 F.2d 816, 826 (D.C. Cir. 1984) (third emphasis added) (citation omitted).

82. *Cf.* Sapp v. Ford Motor Co., 687 S.E.2d 47, 48–49 (S.C. 2009) ("The purpose of the economic loss rule is to define the line between recovery in tort and recovery in contract. Contract law seeks to protect the expectancy interests of the parties. Tort law, on the other hand, seeks to protect safety interests and is rooted in the concept of protecting society as a whole from physical harm to person or property.").

83. *See supra* notes 17–27 and accompanying text.

84. Potter v. Firestone Tire & Rubber Co., 863 P.2d 795, 824 (Cal. 1993).

effect of preventing or mitigating serious future illnesses and thus reduce the overall costs to the responsible parties."[85] In recognizing these tort claims, the court neither mentioned the economic loss rule nor cited to its earlier opinion in *Seely*, which was "the case that created the majority land-based approach" to the problem of economic loss according to *East River Steamship*.[86] Unlike the *East River Steamship* formulation of the economic loss rule, California law does not always bar consumers from tort recovery for pure economic loss in product cases.

Courts that have rejected medical monitoring claims also do not invoke the economic loss rule. "Among the courts rejecting medical monitoring claims in the absence of an allegation or proof of physical injury, the analysis generally has been more uniform: such claims are inconsistent with the general rule of tort liability requiring proof of physical harm."[87] Some have rejected monitoring claims based on the policy concern that without an existing compensable physical injury, there could be a "potential flood of litigation stemming from unsubstantiated or fabricated prospective harms."[88] A related policy concern is that the standard for tort recovery is too vague, resulting in inconsistent or unpredictable outcomes.[89] Courts have also found monitoring claims to be problematic due to the possibility that these recoveries would "deplet[e] the purported tortfeasor's resources," which in turn "would lead to the inequitable diversion of money away from those who have actually sustained an injury as a result of the exposure."[90] This last policy concern is particularly interesting because it persuasively justifies the limitation of the tort duty for pure economic loss in *noncontractual* settings.[91] None of these policy con-

85. *Id.* (quoting Ayers v. T.W.P of Jackson, 106 N.J. 557, 604 (1987)).

86. E. River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 868 (1986).

87. Lowe v. Philip Morris USA, Inc., 142 P.3d 1079, 1084 (Or. Ct. App. 2006).

88. Wood v. Wyeth-Ayerst Labs., 82 S.W.3d 849, 859 (Ky. 2002); *see also, e.g.*, Metro-North Commuter R.R. Co. v. Buckley, 521 U.S. 424, 442–44 (1997) (rejecting plaintiffs' asbestos claim under the Federal Employers' Liability Act for a medical-monitoring remedy absent a present physical injury, in part, due to the concern that "tens of millions of individuals may have suffered exposure to substances that might justify some form of substance-exposure-related medical monitoring").

89. Adam P. Joffe, Note, *The Medical Monitoring Remedy: Ongoing Controversy and a Proposed Solution*, 84 CHI.-KENT L. REV. 663, 677 (2009).

90. Caronia v. Philip Morris USA, Inc., 5 N.E.3d 11, 18 (N.Y. 2013); *see also* Hinton *ex rel.* Hinton v. Monsanto Co., 813 So. 2d 827, 830–31 (Ala. 2001) (rejecting monitoring claims in part because of the possibility of "vast testing liability adversely affecting the allocation of scarce medical resources" (quoting *Metro-North Commuter R.R. Co.*, 521 U.S. at 442).

91. MARK A. GEISTFELD, TORT LAW: THE ESSENTIALS 161–72 (2008) (showing why tort recovery for pure economic loss or stand-alone emotional harms in noncontractual settings is justifiably limited by the categorical policy concern that these claims would deplete the ordinary

cerns address the importance of maintaining the boundary between tort and contract law. Courts that reject tort claims for medical monitoring do so without reliance on the economic loss rule, presumably because these tort claims so obviously implicate the plaintiff's interest in physical security and fall outside the purview of contract law.[92]

Indeed, the U.S. Supreme Court has also implicitly recognized that the viability of monitoring claims does not depend on the economic loss rule. In a case rejecting tort claims for medical monitoring, the Court did not discuss the economic loss rule or cite to its earlier decision in *East River Steamship*.[93] As the Court apparently recognized, the contracting rationale for the economic loss rule in *East River Steamship* is inapposite for medical monitoring claims—a conclusion confirmed by our prior analysis of the contracting problem for precautionary measures of this type.[94]

This split in case law concerning tort recovery for medical monitoring yields important insights as to how courts interpret the economic loss rule. The majority formulation of the economic loss rule would bar recovery in these cases because the form of the claim is only for a financial loss (the expense of medical monitoring), yet courts do not rely on this rule to evaluate the claim. By invoking other reasons, a strong plurality permits recovery while another denies the tort claim. In doing so, all of these courts have effectively recognized that the economic loss rule is not triggered simply because an endangered consumer seeks tort damages for the financial cost of protecting against

tortfeasor's assets and effectively prevent physically harmed victims from full recovery). This rationale is much less persuasive in contractual settings because the duty holder's expected tort liabilities are a cost of the contract that is included in the price. Unless the duty holder underprices the contract or otherwise purchases an insufficient amount of liability insurance, she would have sufficient resources to pay all valid tort claims.

92. Under the most expansive definition of the economic loss rule, the doctrine applies to the denial of any tort claim for pure economic loss. *See supra* note 4 and accompanying text. Under this definition, the doctrine necessarily encompasses the denial of tort claims for medical monitoring costs. The economic loss rule, however, does not explain the denial of these claims when more narrowly defined by its primary purpose of maintaining the tort-contract boundary—the definition employed throughout this Article and adopted by most courts. *See id.* R

93. *Metro-North Commuter R.R.*, 521 U.S. at 440–41.

94. *See supra* Part III.F. For reasons not yet recognized by the courts, the contracting rationale could be extended to monitoring claims. Medical monitoring expenditures could be covered by health insurance. In light of the federal mandate known as Obamacare, the average or ordinary consumer would probably purchase the requisite health insurance regardless of the risk posed by a particular product. *See generally* Tom Baker, *Health Insurance, Risk, and Responsibility After the Patient Protection and Affordable Care Act*, 159 U. PA. L. REV. 1577, 1580–92 (2011) (describing the federal law mandating health coverage). Insofar as the average or ordinary consumer would find insurance coverage to be worthwhile independent of the particular risks posed by a product defect, she can adequately protect her interests by contracting. *See supra* Part III.C.

future physical harms. To explain these cases, the economic loss rule must be formulated in an intermediate manner that can permit tort recovery for these endangered consumers and bar recovery for other types of disappointed product users.

B. Tort Claims for the Financial Cost of Asbestos Abatement

In response to the health hazards posed by asbestos, the federal government and many states have enacted statutes requiring the removal or segregation of asbestos-containing materials from schools and other public buildings.[95] Private homeowners have also undertaken these abatement measures to protect themselves from being exposed to the risk of incurring life-threatening asbestos-related injuries, such as asbestosis or mesothelioma. The abatement measures are quite expensive, leading property owners to seek tort compensation for the costs of reducing the unreasonable risks posed by defective asbestos-containing products.

In defending against these tort claims, asbestos manufacturers and suppliers have invoked the economic loss rule. The argument would seem to be incontrovertible. The asbestos-containing material is only a component of the building or product. Thus, the defect has damaged only the product itself (the building), which then caused the consequential economic harms of abatement costs. The same facts are present in *East River Steamship*, in which each defective turbine caused damage only to the product itself (the ship), which then caused consequential economic harms of repair costs. As in *East River Steamship*, the economic loss rule would seem to require dismissal of these tort claims.

"In fact, most courts have done just the opposite, freely allowing property owners to sue in tort by adopting a 'liberal' definition of physical injury."[96] By holding that asbestos-containing material damages other property instead of the product itself, these cases do not technically violate the economic loss rule; however, these holdings are unpersuasive because asbestos-containing products are usually components of an integrated final product (the building). Moreover, "asbestos-containing materials do not physically alter any part of the building or impair its structural integrity."[97] Indeed, the building materials containing asbestos continue to perform the intended function of being fire resistant. The only reason to remove asbestos-con-

95. The material in this paragraph is drawn from Richard C. Ausness, *Tort Liability for Asbestos Removal Costs*, 73 OR. L. REV. 505, 508–11 (1994).

96. *Id.* at 530.

97. *Id.* at 532.

taining materials is to reduce the substantial risk that occupants will suffer physical harm, not to restore the proper functioning of the building. Consequently, the asbestos-abatement cases effectively involve an exception to the majority rule on economic loss.

This exception to the economic loss rule is recognized by the *Restatement (Third) of Torts*:

> One category of claims stands apart. In the case of asbestos contamination in buildings, most courts have taken the position that the contamination constitutes harm to the building as other property. *The serious health threat caused by asbestos contamination has led the courts to this conclusion*. Thus, actions seeking recovery for the costs of asbestos removal have been held to be within the purview of products liability law rather than commercial law.[98]

By recognizing that the economic loss rule does not apply to asbestos-abatement cases, courts have effectively concluded that the rule is inapplicable to tort claims seeking to reasonably protect endangered consumers from future physical harm. Not only do consumers lack the information necessary to contract fairly with manufacturers over the allocation of these liabilities, they also cannot ordinarily procure insurance covering the cost of asbestos abatement.[99] The contracting rationale completely breaks down in these cases, explaining why courts have refused to invoke the economic loss rule to bar these tort claims.

To be sure, the courts in these cases did not explain why the contracting rationale permits tort recovery for the financial costs of asbestos abatement; instead, they permitted recovery by misapplying the economic loss rule to a defective component (the asbestos-containing

98. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 21 cmt. e (AM. LAW INST. 1998) (emphasis added).

99. For both first-party property insurance and third-party commercial general liability insurance, standard-form policies now contain the so-called "absolute or total pollution exclusion" clause that bars coverage for losses caused by pollutants, the definition of which encompasses asbestos. *See, e.g.*, Villa Los Alamos Homeowners Ass'n v. State Farm Gen. Insur. Co., 130 Cal. Rptr. 3d 374, 375 (Cal. Ct. App. 2011) (denying a property owner's claim for coverage under the property's policy for costs of asbestos abatement because asbestos is a pollutant that is excluded from coverage under the policy). Even if the policy does not contain such a pollution exclusion, a policyholder still faces significant obstacles in recovering from either a property or liability insurer. *See, e.g.*, Land O' Lakes, Inc. v. Emp'rs Ins. Co. of Wausau, 728 F.3d 822, 829, 831–32 (8th Cir. 2013) (holding that the owned-property exclusion in a commercial general liability insurance policy does not cover costs incurred by the policyholder to remediate contamination that is confined to the insured's property and unrelated to preventing off-site contamination); Port Auth. of N.Y. & N.J. v. Affiliated FM Insur. Co., 311 F.3d 226, 230 (3d Cir. 2002) (holding that the costs of asbestos abatement are not within the scope of a property insurance policy covering "physical loss or damage" unless "asbestos in a building was of such quantity and condition as to make the structure unusable").

material) integrated into a final product (the building).[100] Similarly, in the medical monitoring cases, courts rely on a range of reasons for either denying or permitting tort recovery, none of which involve the contracting rationale.[101] The case law accordingly appears to be in disarray, with courts effectively adopting unexplained exceptions to the economic loss rule.

C. Incorporating Endangered Consumers into the Economic Loss Rule

According to *East River Steamship*, the purpose of the economic loss rule is to ensure that contract law does not "drown in a sea of tort,"[102] thereby justifying a substantive formulation of the rule that asks whether the tort duty is unnecessary because contracting adequately protects the substantive interests that are implicated by the tort claim. When properly formulated in this substantive manner, however, the economic loss rule does not bar tort recovery for all types of pure economic loss. The contracting rationale justifies an intermediate rule that permits endangered consumers to recover under certain conditions.

The rule of strict products liability is based on the premise that the average or ordinary consumer does not have the information necessary to contract fairly over limitations of the seller's liability for physical harms, justifying a tort duty that protects the consumer's interest in physical security. This same property of the contracting relationship extends to certain cases of pure economic loss. To be substantively consistent with the rule of strict products liability, the economic loss rule must permit tort recovery for a pure economic loss foreseeably caused by a product defect if: (1) the damages remedy would compensate the plaintiff for the reasonable costs of preventing future physical harm and (2) this prevention would not otherwise be a cost-effective means for the plaintiff to reduce any other pure economic losses caused by the defect.[103]

100. *Cf.* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 21 cmt. e ("When the product or system is deemed to be an integrated whole, courts treat . . . damage [to a component part] as harm to the product itself. When so characterized, the damage is excluded from the coverage of this Restatement. A contrary holding would require a finding of property damage in virtually every case in which a product harms itself and would prevent contractual rules from serving their legitimate function in governing commercial transactions."). Because asbestos-containing materials are usually an integrated part of the building, the asbestos does not damage "other property" by damaging the building itself, which is why the *Restatement* recognizes that the asbestos-abatement cases provide an exception to the economic loss rule.

101. *See supra* Part IV.A.

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

103. *See supra* Part III.F.

When formulated in terms of the contracting rationale, the economic loss rule falls between the two extremes of either denying or permitting all tort recovery for pure economic loss. In practice, the *East River Steamship* formulation is also an intermediate rule insofar as the general bar to recovery is subject to the two largely unexplained exceptions of asbestos abatement and medical monitoring. The *East River Steamship* formulation, however, does not identify the general conditions under which an exception is warranted, whereas the contractually based intermediate economic loss rule incorporates the relevant criteria into the legal inquiry, thereby providing a complete rationale for the full range of cases that both permit and deny tort claims for pure economic loss.

The contractually based intermediate rule also differs from the other types of intermediate rules—rejected by most courts—that permit tort recovery for pure economic loss if the defect caused the product to fail in a calamitous manner or could have otherwise caused physical harm.[104] Neither condition is necessarily required by the contracting rationale, which permits tort recovery for only those cases in which contracting cannot adequately protect the consumer's interest in avoiding physical harm.[105]

To illustrate, consider the $1.1 billion settlement of tort claims filed by Toyota motor vehicle owners seeking recovery, in part. for the diminished product value caused by an alleged defect that could make the vehicle undergo "sudden, unintended acceleration."[106] The alleged defect threatened future physical harm,[107] making these claims eligible for tort compensation under the types of intermediate rules that permit recovery simply because the defect endangers consumers. Rules of this type are overbroad for reasons revealed by the contracting rationale. A compensatory damages award for diminished product value would not protect endangered consumers from being injured in the future. If the defect is not repaired, consumers will continue to drive the lower valued vehicle and face the risk of physical harm threatened by the defect. The tort damages are not formulated

104. *See supra* notes 67–69 and accompanying text.

105. *See supra* Part III.F.

106. For the factual allegations and legal claims at issue in the case, see *In re Toyota Motor Corp. Unintended Acceleration Marketing, Sales Practices & Products Liability Litigation*, 838 F. Supp. 2d 967, 971 (C.D. Cal. 2012). For a discussion of the settlement of these claims, see Mike Ramsey, *Toyota in $1.1 Billion Gas-Pedal Settlement*, WALL ST. J., Dec. 27, 2012, at A1.

107. The alleged defect had already caused physical harm to a different set of plaintiffs suing Toyota in a consolidated action. *See* Third Amended Complaint for Damages, *In re Toyota Motor Corp. Unintended Acceleration Mktg.*, 838 F. Supp. 2d 967 (Nos. 8:10ML02151 JVS (FMOx) and 2:10-cv-03899-JVS-FMO), 2011 WL 5061918.

to prevent future physical harm, so the tort claim would be barred by the contractually based intermediate economic loss rule, unlike the other intermediate rules that have been widely rejected by courts.[108]

The contractually based intermediate economic loss rule differs in another important respect from the intermediate rules rejected by the U.S. Supreme Court in *East River Steamship*. According to the Court, "intermediate positions, which essentially turn on the degree of risk, are too indeterminate to enable manufacturers easily to structure their business behavior."[109] In contrast to intermediate rules that rely on the *degree* of risk, the contractually based intermediate rule is based on the *type* of risk defined in terms of the substantive interests implicated by the damages claim. Rather than being indeterminate, this substantive reformulation of the intermediate rule makes the incidence of tort liability more predictable by explaining why courts permit tort recovery in some exceptional cases (e.g., medical monitoring and asbestos abatement) while denying recovery in most cases (e.g., those seeking damages for lost profits and diminished product value).

For this reason, the contractually based intermediate rule would also improve judicial decision making. Consider *Sapp v. Ford Motor Co.*,[110] in which the South Carolina Supreme Court adopted the *East River Steamship* formulation of the economic loss rule.[111] In doing so, however, the court decided not to overrule a prior case that permitted tort recovery for the pure economic loss of repairing a defective condition in a residential home, reasoning that this "narrow exception to the economic loss rule" is justified by the "unequal bargaining power between the parties."[112] A concurring opinion complained that by recognizing this exception to the economic loss rule, the court had employed "varying analytical frameworks" that resulted in the "inconsistent treatment of the doctrine," leaving "the bench and bar [with-

108. This reasoning does not imply that the settlement for lost value was unwarranted. The settlement included $500 million for the value lost by owners who sold or traded their cars and to owners whose brake systems could not be repaired. *See* Ramsey, *supra* note 106, at A6. Most of the claims, however, were also formulated in terms of fraud or deceptive practices. *See, e.g.*, Amended Economic Loss Master Consolidated Complaint, *In re* Toyota Motor Corp. Unintended Acceleration Mktg., at 347–58 (Nos. 8:10ML2151 JVS (FMOx)), 2010 WL 4257075 (alleging claims under Illinois law based on deceptive trade practices, breach of warranties, negligence, strict products liability, unjust enrichment, and fraud). Settlement for diminished product value may have been based on these allegations rather than the tort claims for pure economic loss based on diminished product value. R

109. E. River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 870 (1986).

110. 687 S.E.2d 47 (S.C. 2009).

111. *Id.* at 49.

112. *Id.*

out] guidance in the proper application of the doctrine."[113] Why employ the contracting rationale to reject tort claims for pure economic loss in product and service cases except for those involving residential homes? Is the bargaining relationship between consumers and product manufacturers somehow more equal than the bargaining relationship between homeowners and builders? If not, what explains why the former is subject to the economic loss rule whereas the latter merits an exception? Such an exception, as the concurrence rightly observed, is bound to create confusion. If the majority had instead adopted the contractually based intermediate rule, it could have explained why the contracting rationale barred recovery in the case at hand and permitted tort recovery in the prior case involving a residential home.

Sapp involved an alleged design defect in the cruise-control switch of a truck that caused each of the two plaintiffs' vehicles to catch fire but only damaged the trucks themselves.[114] The plaintiffs each sought tort recovery for the damage caused by the respective fires, which the court could have barred if it had adopted the contractually based intermediate rule. Presumably, the reasonable prevention of future physical harm would involve a repair or removal of the cruise-control switch. The plaintiffs, however, sought tort recovery for the full extent of fire damage to their trucks, so the damages claim could not be justified by the contracting rationale as a means for protecting endangered consumers from future physical harm. Moreover, the loss in question could be fully indemnified by automobile insurance, further undermining any contractual rationale for the tort duty.[115] For losses of this type, the average or ordinary consumer can adequately protect her interests by contracting and related measures, justifying a bar to tort recovery under the contractually based intermediate economic loss rule.

Different reasoning applies to the prior case involving a residential home, which *Sapp* did not overrule. In that case, the court held:

> A builder may be liable to a home buyer in tort despite the fact that the buyer suffered only "economic losses" where: (1) the builder has violated an applicable building code; (2) the builder has deviated from industry standards; or (3) the builder has constructed housing that he knows or should know will pose serious risks of physical harm.[116]

113. *Id.* at 52 (Beatty, J., concurring).

114. *Id.* at 48.

115. *Id.* (observing that one of the appellants received $7,000 of insurance coverage for repair costs of a vehicle that he had purchased for $5,000).

116. Kennedy v. Columbia Lumber & Mfg. Co., 384 S.E.2d 730, 738 (S.C. 1989).

Insofar as tort recovery in such a case would compensate endangered consumers for the reasonable costs of preventing future physical harms, it is not barred by the contractually based intermediate economic loss rule. The average or ordinary consumer, moreover, cannot purchase property insurance to cover these losses,[117] eliminating any other substantive reason for barring such a tort claim with a contracting rationale.

Thus, these two cases can be decided under a consistent analytical framework—an intermediate economic loss rule properly formulated in terms of the contracting rationale. Had *Sapp* adopted this rule, it would have "provide[d] the bench and bar guidance in the proper application of the doctrine" as desired by concurring opinion.[118]

The contractually based intermediate rule would also prevent courts from denying tort claims when doing so cannot be justified by the contracting rationale. In numerous cases, courts have invoked the economic loss rule to deny endangered consumers from recovering the reasonable financial costs of preventing future physical harms.[119] There may be good reasons for denying these tort claims (such as concerns about administrability and fraud), but the simplistic invocation of the economic loss rule is not among them. By focusing the inquiry on the appropriate substantive concerns, the contractually based intermediate rule will help ensure that courts rely on the proper reasons when resolving these tort claims.

V. CONCLUSION

For the 21st Annual Clifford Symposium addressing "The Supreme Court, Business and Civil Justice,"[120] the economic loss rule might seem to be of narrow interest. In *East River Steamship*, the Court developed a contracting rationale for the economic loss rule that had already been invoked by state courts to maintain the proper boundary

117. The standard-form homeowner's policy, for example, excludes coverage for damage caused by "defective . . . [m]aterials used in repair, construction, renovation or remodeling." HOMEOWNERS 3 – SPECIAL FORM HO 00 03 05 11, at 13 (2010), *reprinted in* KENNETH S. ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 186, 198 (6th ed. 2015).

118. *See* Sapp v. Ford Motor Co., 687 S.E.2d 47, 52 (S.C. 2009).

119. *See, e.g.*, Pfizer, Inc. v. Farsian, 682 So. 2d 405, 407–08 (Ala. 1996) (rejecting a tort claim for recovering the costs of surgically removing a defective heart valve that had not yet malfunctioned but might do so in the future simply because plaintiff's "concern that his heart valve, which is presently functioning normally, could later malfunction is not an injury recognized by Alabama [tort] law" and citing to three other cases in which "courts have refused to recognize a cause of action in similar" circumstances).

120. Symposium, *The Supreme Court, Business, and Civil Justice*, 64 DePaul L. Rev. 249 (2015).

between tort and contract law,[121] each of which is a form of civil justice. The economic loss rule as formulated by *East River Steamship* is neither new nor necessarily a form of civil injustice that unjustifiably elevates business interests over consumer interests. Nevertheless, *East River Steamship* has numerous attributes that make it quite interesting for purposes of this Symposium.

East River Steamship was decided in 1986, which was a time of particular importance for tort law in the United States.

> From 1984 to 1986 premiums for general liability insurance nearly tripled. Such insurance became unaffordable or unavailable for some, leading to the so-called "liability crisis" that appeared in myriad forms such as the closing of day-care centers and municipal swimming pools for reasons related to concerns about uninsured exposure to tort liability. The perception was that the courts had created the crisis by extending the tort laws too far, thereby producing an excessively costly tort system.
>
> Not surprisingly, calls for tort reform quickly followed. "Of the forty-six states holding legislative sessions [in 1986], forty-one enacted laws intended to slow the increase in insurance rates and costs." During this period there were also a number of federal legislative proposals aimed at products liability reform, and studies on tort and products liability reform were instituted by the United States Department of Justice, the American Law Institute, the American Bar Association, and others.[122]

As I have argued elsewhere, the 1980s spawned a variety of tort-reform measures that largely share two characteristics. First, many of the reforms are "neocontractual" in the sense that they "would reduce or allow for contractual reductions in manufacturers' tort liability. . . ."[123] In addition, "each reform shares the trait of significantly reducing systemic legal ambiguity, which in turn makes it easier for liability insurers to forecast their expected liabilities under a policy."[124] Tort reform measures with either of these characteristics reduce the cost of insuring against tort liabilities, thereby responding to the concern about the spike in these premiums that occurred during the 1980s.

When placed in this historical context, *East River Steamship* fully exemplifies the 1980s tort-reform movement. The contracting ratio-

121. See Part II, for a discussion of the contracting rationale.

122. Mark Geistfeld, *The Political Economy of Neocontractual Proposals for Products Liability Reform*, 72 TEX. L. REV. 803, 804–05 (1994) (alteration in original) (footnotes omitted) (quoting Glenn Blackmon & Richard Zeckhauser, *State Tort Reform Legislation: Assessing Our Control of Risks*, *in* TORT LAW AND THE PUBLIC INTEREST 272–73 (Peter H. Schuck ed., 1991).

123. *Id.* at 808.

124. Mark A. Geistfeld, *Legal Ambiguity, Liability Insurance, and Tort Reform*, 60 DEPAUL L. REV. 539, 569 (2011).

nale for the economic loss rule is a clear example of a neocontractual legal rule: the scope of the tort duty is expressly limited to facilitate contracting. According to *East River Steamship*, one of the primary justifications for this limitation of tort liability is to make it easier for product sellers (and by implication, their liability insurers) to predict their expected liabilities: "A warranty action . . . has a built-in limitation on liability [the contract itself], whereas a tort action could subject the manufacturer to damages of an indefinite amount."[125] As formulated by *East River Steamship*, the economic loss rule embodies the two properties characteristic of the proposals championed by tort-reform movement of the 1980s.

To be sure, the Court in *East River Steamship* did not necessarily embrace the tort-reform movement simply because it adopted a liability rule with these characteristics. Other aspects of the case, however, strongly suggest that it did.

As previously discussed, the facts of *East River Steamship* provide a paradigmatic instance of the type of economic loss that ought to be governed solely by contracting. The damages in that case involved nothing but lost profits and the repair costs necessary to cure the product defects and restore the products to their proper functioning. The defects did not significantly threaten plaintiffs with physical harm, thereby preventing them from recovering as endangered consumers.[126] Consequently, neither the litigants nor the petition for certiorari vigorously defended the proposition that the economic loss rule could be defensibly formulated to protect endangered consumers.[127] Nevertheless, the Court expressly rejected versions of the economic loss rule that were formulated to protect endangered consumers.[128] Why did the Court reach for this ruling when it could have denied the tort claim without resolving the largely unlitigated question of

125. E. River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 874 (1986).

126. E. River S.S. Corp. v. Delaval Turbine, Inc., 752 F.2d 903, 909 (3d Cir. 1985) (finding that product defects only created a risk that the products would operate at a lower capacity and did not otherwise threaten an unreasonable risk of physical harm).

127. *See* Respondent's Brief, *E. River S.S.* Corp., 752 F.2d 903 (No. 84-1726), 1985 WL 669142, at *i (defining the certified question as whether "petitioners, charterers of oil tankers, [could] maintain an action in tort under federal maritime law against the seller of main propulsion units for the tankers, arising from an alleged product defect, where the damage sustained was confined to the units themselves and consisted solely of internal deterioration and breakdown, and there was no unreasonable risk of harm to persons or other property"). Respondent extensively argued that the defects did not pose an unreasonable risk of harm. *See id.* at *11–13 (providing a summary of argument). Petitioners, by contrast, vigorously argued that "proof of actual damage to person or property, of an unreasonable risk of such harm, should not be an element" of the tort claim in admiralty. Brief of Petitioners, *E. River S.S.*, 752 F.2d 903 (No. 84-1726), 1985 WL 669141, at *8.

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

whether tort damages for pure economic loss can be justified by the contracting rationale in at least some cases involving endangered consumers?

In light of this question, the reasoning in *East River Steamship* takes on new meaning. Consider the Court's oft-repeated assertion that its formulation of the economic loss rule helps ensure that contract law does not "drown in a sea of tort."[129] To support this claim, the Court cited to *The Death of Contract* by Grant Gilmore.[130] As Gilmore famously argued in this book, the development of strict products liability fully illustrates a more general movement—an "explosion of liability" in which "it is the fate of contract" that it might "be swallowed up by tort (or for both of them to be swallowed up in a generalized theory of civilized obligation)."[131] By citing *The Death of Contract* to justify its formulation of the economic loss rule, the *East River Steamship* Court lent support to the proposition that the modern tort system is out of control and must be reined in.

East River Steamship is the proverbial canary in a coal mine. So interpreted, the case readily fits into a larger narrative concerning the ongoing efforts of the Court to curb tort liability and access to the civil justice system more generally, the topic of this Symposium. Such an extreme conception of modern tort liability also explains why *East River Steamship* adopted an overly extreme limitation of tort liability. As one judge observed after surveying the developments wrought by *East River Steamship*, "the economic loss doctrine may consume much of tort law if left unchecked."[132]

In practice, however, courts do not always limit the economic loss rule in the manner purportedly required by *East River Steamship*. Courts routinely ignore or otherwise misapply the economic loss rule to permit tort recovery for the pure economic losses involving medical monitoring or asbestos claims.[133] The defendants in these cases are responsible for exposing plaintiffs to an unreasonable risk of physical harm, and plaintiffs seek tort recovery for the financial costs of reducing the risk of those harms. These claims clearly implicate the core concern of tort law, explaining why courts are largely unconcerned about whether such a tort cause of action would unduly encroach on the domain of contract law. The identical substantive concern has led

129. *Id.* at 866.

130. *Id.* (citing GRANT GILMORE, THE DEATH OF CONTRACT 87–94 (1974)).

131. GILMORE, *supra* note 130, at 94. R

132. Grams v. Milk Prods., Inc., 2005 WI 112, ¶57, 283 Wis. 2d 511, 539, 699 N.W.2d 167, 180–81 (Abrahamson, C.J., dissenting).

133. *See supra* Parts IV.A–B.

courts to reject contractual allocations of product risk in favor of the widely adopted rule of strict products liability. As these cases show, the substantive logic of strict products liability yields a contractually based intermediate economic loss rule that permits tort recovery when reasonably necessary to protect endangered consumers from the unreasonable risk of physical harm threatened by product defects.

When formulated in this manner, the tort rule complements, rather than encroaches on, contract law. The rules of strict products liability share this same attribute by requiring the amount of product safety that would be contractually chosen by consumers if they were adequately informed about the relevant matters.[134] Strict products liability does not reject the values of contracting; it instantiates those values by remedying an informational problem that would otherwise prevent consumers from adequately protecting their interests through the private ordering of contracts. The fundamental error of *East River Steamship* ultimately resides in its mistaken conception of contemporary tort law.

134. *See generally* Mark A. Geistfeld, *The Value of Consumer Choice in Products Liability*, 74 BROOK. L. REV. 781 (2009) (arguing that the value of informed consumer choice explains both the substantive demands of strict products liability and its important limitations).