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When the Rule Invites the Exceptions: How the Arizona Supreme Court's Attempt to Clarify the Economic Loss Rule in Flagstaff Affordable Housing Has Led to Discontinuity in Subsequent Application

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WHEN THE RULE INVITES THE EXCEPTIONS: HOW THE ARIZONA SUPREME COURT'S ATTEMPT TO CLARIFY THE ECONOMIC LOSS RULE IN *FLAGSTAFF AFFORDABLE HOUSING* HAS LED TO DISCONTINUITY IN SUBSEQUENT APPLICATION

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I. INTRODUCTION

The economic loss rule ("ELR") is "a common law rule limiting a contracting party to contractual remedies for recovery of economic losses unaccompanied by physical injury to person or other property" not included in the contract.[1] The policy behind the ELR "is to encourage private ordering of economic relationships and to uphold the expectations of the parties by limiting a plaintiff to contractual remedies for loss of benefit of the bargain."[2] Application of the ELR depends "on context-specific policy considerations" including the competing policies underlying contract and tort law.[3]

In recent years, several Arizona state courts have impermissibly expanded the scope of the ELR beyond the limits set by the Arizona Supreme Court in the seminal ELR case *Flagstaff Affordable Housing Limited Partnership v. Design Alliance, Inc.*[4] This is not to say that the Arizona trial and appellate courts are at fault. Rather, the Arizona Supreme Court's imprecise opinion in *Flagstaff Affordable Housing* has injected unnecessary ambiguity into a complicated area of state law—particularly with regard to professional negligence claims against architects.

This Article contends that the decision in *Flagstaff Affordable Housing* should not be construed to turn the ELR into a complete bar to tort claims against architects, but rather should consider context-specific policy considerations before applying the ELR.[5]

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[1] Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc., 223 P.3d 664, 667 (Ariz. 2010).

[2] *Id*. at 671.

[3] *Id*. at 669.

[4] *See generally id.*

[5] *Id*. at 669.

II. THE ECONOMIC LOSS RULE GENERALLY

The ELR holds that a party with contract remedies who suffers only monetary injury due to another's conduct cannot recover those losses in tort.[6] The rationale is that tort theories should not be used to pursue damages based on nothing more than a breach of contract.[7] Arizona's courts disallow tort claims under these circumstances because permitting them would subsume contract claims into a "sea of tort."[8] Contract law, which is concerned with the individual arrangement and risk allocation between contracting parties, is the proper method for evaluating these claims, rather than tort, which addresses society's interest in freedom from harm when no bargained-for agreement exists.[9]

The Arizona Supreme Court first adopted the ELR in *Salt River Project Agricultural Improvement and Power District v. Westinghouse Electric Corp.*, which involved a strict product liability claim.[10] The *Salt River Project* Court cited *Seely v. White Motor Co.*[11]—also a products liability case—as the "genesis" of the ELR.[12] *Seely* established what has been recognized as a "per se" approach to the ELR, which completely bars tort recovery for plaintiffs who suffered only economic loss due to product defects.[13]

The *Salt River Project* court prescribed a more limited application of the ELR, noting that "[u]nfortunately, few cases conform neatly to an 'all or nothing' configuration."[14] The Court therefore held that in order to determine "whether a particular cause of action sounds in tort or contract, [the reviewing] court must consider the facts of the case while bearing in mind that tort law is designed to promote the safety of persons and property, whereas contract law is designed to protect the parties' expectations."[15] In deciding *Salt River Project*, the Arizona Supreme Court listed three interrelated factors that trial courts should analyze in determining whether a claim must be brought under tort or contract theories: (1) the nature of the defect that caused the loss to the claimant; (2) the manner in which the loss occurred; and (3) the type of loss for which the claimant seeks redress.[16] If the

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[6] Carstens v. City of Phoenix, 75 P.3d 1081, 1083 (Ariz. Ct. App. 2003); *see also* Apollo Grp. v. Avnet, Inc., 58 F.3d 477, 479 (9th Cir. 1995) (applying Arizona law).

[7] Sw. Pet Prods., Inc. v. Koch Indus., 89 F. Supp. 2d 1115, 1124 (D. Ariz. 2000) (applying Arizona Law) (stating that the purpose of the economic loss rule is to "prevent parties from undermining the certainty of contractual relationships by attempting to convert contract actions into tort actions"), *aff'd in part, rev'd in part on other grounds*, 32 F. App'x 213 (9th Cir. 2002).

[8] E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 868, 866 (1986).

[9] *See Carstens*, 75 P.3d at 1084.

[10] Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp., 694 P.2d 198 (Ariz. 1984).

[11] Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965).

[12] 694 P.2d at 209.

[13] *Seely*, 403 P.2d at 151; *see also* Valley Forge Ins. Co. v. Sam's Plumbing, L.L.C., 207 P.3d 765, 769 (Ariz. Ct. App. 2009).

[14] 694 P.2d at 210.

[15] Cook v. Orkin Exterminating Co., 258 P.3d 149, 152–53 (Ariz. Ct. App. 2011) (citing *Salt River Project*, 694 P.2d at 206).

[16] 694 P.2d at 210.

factors weigh toward a claim based in contract, the ELR applies and the tort claims are barred.[17] Conversely, if the factors weigh toward a claim based in tort, the ELR would not apply to preclude the asserted tort claims.[18]

After *Salt River Project*, the Arizona Supreme Court did not revisit the scope of ELR until *Flagstaff Affordable Housing*.[19] In the meantime (and despite the *Salt River Project* court's guidance), state and federal courts struggled to define the scope of Arizona's ELR. In *Carstens v. City of Phoenix*, Division One of the Arizona Court of Appeals, extended the ELR to bar tort claims from a plaintiff in the construction defect context who had *no* contractual relationship with the defendants whatsoever.[20] The *Carstens* court relied on the Arizona Supreme Court case of *Woodward v. Chirco Construction Co.*, [21] which was decided before *Salt River Project* and did not itself mention the ELR.[22] Later, in *Valley Forge Insurance Co. v. Sam's Plumbing*, Division Two of the Arizona Court of Appeals rejected the *Carstens* court's apparent adoption of the per se rule established in *Seely*, noting that it was rejected by the Arizona Supreme Court in *Salt River Project*.[23]

In *Apollo Group, Inc. v. Avnet, Inc.*, the Ninth Circuit, applying Arizona law, chose a broad application of the ELR—similar to that established in *Seely*—noting that it read *Salt River Project* to construe the rule "broadly."[24] However, some subsequent federal district courts that interpreted and applied the ELR from *Salt River Project* expressed concern that certain federal courts had interpreted the rule too broadly, and therefore in a manner inconsistent with Arizona state cases.[25]

As a consequence of the incongruous case law subsequent to *Salt River Project*, the ELR—which originated in the context of products liability claims[26]—was soon expansively applied by courts in general contract disputes[27] to preclude tort

[17] *See Id*.

[18] *Id*.

[19] Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc., 223 P.3d 664, 666 (Ariz. 2010).

[20] Carstens v. City of Phoenix, 75 P.3d 1081, 1085 (Ariz. Ct. App. 2003).

[21] Woodward v. Chirco Constr. Co., 687 P.2d 1269, 1269 (Ariz. 1984).

[22] *See generally Carstens*, 75 P.3d at 1084–85.

[23] Valley Forge Ins. Co. v. Sam's Plumbing, L.L.C., 207 P.3d 765, 769 (Ariz. Ct. App. 2009).

[24] Apollo Grp., Inc. v. Avnet, Inc., 58 F.3d 477, 480 (9th Cir. 1995).

[25] *See, e.g.*, Evans v. Singer, 518 F. Supp. 2d 1134, 1142–43 (D. Ariz. 2007) (questioning the *Apollo Grp.* court's broad reading of the ELR as explained in *Salt River Project*).

[26] Cook v. Orkin Exterminating Co., 258 P.3d 149, 152–53 (Ariz. Ct. App. 2011) ("The Arizona Supreme Court first adopted the ELR in *Salt River Project Agric. Improvement and Power Dist. v. Westinghouse Elec. Corp.*, 143 Ariz. 368, 694 P.2d 198 (1984), a case involving a claim for strict product liability.").

[27] *See* Sw. Pet Prods., Inc. v. Koch Indus., Inc., 89 F. Supp. 2d 1115, 1126 (D. Ariz. 2000) (citing *Apollo Grp.*, 58 F.3d at 480), *aff'd in part, rev'd in part on other grounds*, 32 F. App'x 213 (9th Cir. 2002).

claims in cases involving life insurance purchases,[28] the provision of services,[29] software consultation agreements,[30] and distributorship agreements.[31]

III. *FLAGSTAFF AFFORDABLE HOUSING LIMITED PARTNERSHIP V. DESIGN ALLIANCE, INC.*

Today, the leading ELR case in Arizona is *Flagstaff Affordable Housing Limited Partnership v. Design Alliance, Inc.*, which applied the ELR to claims based on construction defects resulting from professional negligence.[32] The court in *Flagstaff Affordable Housing* held "a plaintiff who contracts for construction cannot recover in tort for purely economic loss, unless the contract otherwise provides."[33] This holding "limited tort recovery involving 'contracts for construction' to those situations in which the plaintiff's economic loss was 'accompanied by physical injury to persons or other property.'"[34]

Flagstaff Affordable Housing concerned an owner who contracted with an architect to design eight apartment buildings as a low-income housing project.[35] "[T]he U.S. Department of Housing and Urban Development filed a complaint against the owner for violation of accessibility guidelines."[36] The owner then sued the architect, alleging negligence and breach of contract.[37] The architect argued that the ELR barred the owner's negligence claims under the Arizona Court of Appeals, Division One's decision in *Carstens*.[38]

The Supreme Court reaffirmed the narrow scope of the ELR established in *Salt River Project*, writing that whether the ELR applies may vary upon "context-specific policy considerations" and "the underlying policies of tort and contract law."[39] The Court expressly rejected *Carstens* for its mistaken reliance on *Woodward*, which the Court did not read as endorsing the ELR at all.[40]

The Court then analyzed the contract law policy of upholding the parties' expectations and found it particularly applicable in construction defect cases, where the relevant contracts are often specifically negotiated for each project and have

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[28] *See In re* Jackson Nat'l Life Ins. Co. Premium Litig., 107 F. Supp. 2d 841, 861–62 (W.D. Mich. 2000) (applying Arizona law).

[29] *See* Carstens v. City of Phoenix, 75 P.3d 1081, 1083 , 1087 (precluding tort claims against city building inspectors).

[30] *See* Huron Tool & Eng'g Co. v. Precision Consulting Servs., Inc., 532 N.W.2d 541, 543 (Mich. Ct. App. 1995); *see also Apollo Grp.*, 58 F.3d at 479 n.2, 481 (involving contract for computer hardware and consultation).

[31] Gen. Elec. Co v. Latin Am. Imps., S.A., 214 F. Supp. 2d 758, 764 (W.D. Ky. 2002).

[32] Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc., 223 P.3d 664, 665 (Ariz. 2010).

[33] *Id*. at 670–71.

[34] Shaw v. CTVT Motors, Inc., 300 P.3d 907, 909 (Ariz. Ct. App. 2013) (quoting *Flagstaff Affordable Hous.*, 223 P.3d at 669–70).

[35] *Flagstaff Affordable Hous.*, 223 P.3d at 665.

[36] *Id*.

[37] *Id*.

[38] *Id*. at 666. *See generally Carstens*, 75 P.3d 1081.

[39] *Flagstaff Affordable Hous.*, 223 P.3d at 669.

[40] *Id*. at 668–69.

detailed provisions allocating losses and remedies.[41] In contrast, the policy concerns of accident deterrence and loss-spreading did not warrant allowing tort recovery in addition to contract remedies because the parties had already made these contractual allocations.[42]

Additionally, the Court in *Flagstaff Affordable Housing* determined that, in construction defect cases involving only pecuniary losses related to the building that was the subject of the construction contract, there were "no strong policy reasons to impose common law tort liability in addition to contractual remedies."[43] The Court held that, given these considerations "in construction defect cases, 'the policies of the law generally will be best served by leaving the parties to their commercial remedies' when a contracting party has incurred only 'economic loss, in the form of repair costs, diminished value, or lost profits.'"[44]

After concluding that the ELR applies in construction defect cases, the Court went on to examine the homeowner's argument that the ELR "should not apply to professional negligence claims based on an architect's design."[45] The Court noted that, "[a]lthough architects have common-law duties of care, this case illustrates that it is often difficult to draw bright lines between obligations imposed by law and those arising from contract."[46] The Court held that "Architect's duties with regard to Owner's project existed only because of the contract between the parties[,]" explaining that "[a]rchitectural contracts generally include compliance with applicable building codes and other legal design requirements as an implied term."[47]

The Court reasoned that "[a]ttempting to label claims by distinguishing between contractual and extra-contractual duties is an unduly formalistic approach to determining if plaintiffs like Owner should be limited to their contractual remedies for economic loss."[48] The fact that architects owe legally imposed duties of care as professionals, the Court explained, "does not displace the general policy concerns that parties to construction-related contracts should structure their relationships by prospectively allocating the risks of loss and identifying remedies."[49]

The Court stated that it did "not hold that the economic loss doctrine applies to architects because they are professionals, but instead because the policy concerns that justify applying the doctrine to construction defect cases do not justify distinguishing" between contractors and architects in the construction defect context.[50]

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[41] *Id*. at 669.
[42] *Id*.
[43] *Id*.
[44] *Id*. at 670 (quoting *Salt River Project*, 694 P.2d at 209).
[45] *Id*. at 671.
[46] *Id*. at 672.
[47] *Id*.
[48] *Id*.
[49] *Id*.
[50] *Id*. at 673.

Thus, while *Flagstaff Affordable Housing* extended the ELR to construction defect cases, the Court also affirmed its commitment to a narrow construction of the ELR as established in *Salt River Project*, stating in summation that it did "not suggest that the [ELR] should be applied with a broad brush in other circumstances."[51]

IV. CONFLICTING ARIZONA CASE LAW POST-*FLAGSTAFF AFFORDABLE HOUSING*

The Arizona Supreme Court's holding in *Flagstaff Affordable Housing* has been applied differently in state courts than in federal courts applying Arizona law. State courts have been reluctant to examine whether the ELR applies outside of products liability and construction defect cases, while federal courts have suggested it should not apply to fiduciary duty claims.[52]

A. Arizona State Courts Applying *Flagstaff Affordable Housing*

Likely due to the Arizona Supreme Court's guidance in *Flagstaff Affordable Housing* that the ELR should not be applied broadly, Arizona state courts have been reluctant to extend the ELR outside of the products liability and construction defect contexts.[53] But there are some outlier decisions that inject uncertainty into the state of the ELR. Notably, Division One of the Arizona Court of Appeals in *Cook v. Orkin Exterminating Co*., ostensibly relying on *Flagstaff Affordable Housing*, applied the ELR to preclude claims for negligence, negligent and intentional misrepresentation, and common law fraud. *Cook* involved a claim by homeowners against a pest control company.[54] The *Cook* court determined that upholding contract expectations favored adherence to the remedies available under the parties' contract, holding that a fraud claim was unavailable for defendant's "alleged failure to adequately perform its promises under the Agreement."[55] The court also reaffirmed the importance of the policy justifications underlying the analysis of whether the ELR applies, writing "[a]s in *Flagstaff* [*Affordable Housing*], the contract law policy of upholding the parties' expectations favor limiting [plaintiffs'] claims to those in contract and, where there has been no injury besides that to the subject property, there is no strong policy reason to impose tort liability."[56]

In the federal diversity context, *Silverwood Real Estate Investments, L.L.C. v. Wickman-Kush*, which involved a dispute between investors in a proposed

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[51] *Id.* (citing Ellen M. Bublick, *Economic Torts: Gains in Understanding Losses*, 48 ARIZ. L. REV. 693, 701 (2006) (noting that not all economic loss cases invoke the same interests or call for the same treatment)).

[52] B2B CFO Partners, L.L.C. v. Kaufman, F. Supp. 2d 1084, 1096 (D. Ariz. 2012) (citing *In re* Gosnell Dev. Corp. of Ariz., 331 F. App'x. 440, 441 (9th Cir. 2009)); *Id.* (citing SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513, 2010 WL 5422505, at *9-11 (S.D.N.Y. Dec. 14, 2010)).

[53] *Id*.

[54] Cook v. Orkin Exterminating Co., 258 P.3d 149, 150-52. (Ariz. Ct. App. 2011).

[55] *Id*. at 153.

[56] *Id*.

country club, might be relevant to fiduciary duty claims.[57] There, plaintiff brought claims for breach of contract, breach of the covenant of good faith and fair dealing, breach of fiduciary duty, conversion, negligent misrepresentation, and fraud.[58] The breach of contract claim was dismissed before trial.[59] On appeal, the defendants argued that the ELR precluded recovery under tort absent physical harm or secondary property damage.[60] The court in *Silverwood Real Estate Invs., L.L.C.* noted: "We disagree with that application, particularly when the [trial] court found there was no contractual relationship between Silverwood and the Kush Defendants through which Silverwood could recover."[61]

In support of its conclusion, the court noted: "The function of the economic loss rule is 'to encourage private ordering of economic relationships and to uphold the expectations of the parties by limiting a plaintiff to contractual remedies for loss of the benefit of the bargain.'"[62] The court emphasized the direction provided by the Arizona Supreme Court in *Flagstaff Affordable Housing*: "Rather than rely on the economic loss doctrine to preclude tort claims by non-contracting parties, courts should instead focus on whether the applicable substantive law allows liability in the particular context."[63] The court in *Silverwood Real Estate Invs., L.L.C.* subsequently held: "Because we find [the defendant] had a fiduciary duty to Silverwood as a manager, and not arising from a contractual relationship, the economic loss rule does not preclude recovery."[64] It is unclear how the court would have applied the ELR had the fiduciary duty in question arisen from a contract.[65]

Unlike with breach of fiduciary duty claims, Arizona state courts have addressed the applicability of the ELR to claims for professional negligence. Most important of these cases is, as previously discussed, *Flagstaff Affordable Housing*.[66] The Arizona Court of Appeals has discussed the *Flagstaff Affordable Housing* opinion's discussion of professional negligence claims several times since the decision was rendered—each time noting that the opinion stands for the proposition that the ELR precludes claims for professional negligence in construction defect cases.[67]

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[57] Silverwood Real Estate Invs., L.L.C. v. Wickman-Kush, No. 1 CA-CV 14-0822, 2016 Ariz. App. Unpub. WL 3944548, ¶¶ 2–10 (Ct. App. July 19, 2016).

[58] *Id*. ¶ 5.

[59] *Id*. ¶ 6.

[60] *Id*. ¶ 21.

[61] *Id*.

[62] *Id*. (quoting Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc., 223 P.3d 664, 671 (Ariz. 2010)).

[63] *Id*. (quoting *Flagstaff Affordable Hous.*, 223 P.3d at 671).

[64] *Id*.

[65] *Id*.

[66] *Flagstaff Affordable Hous.*, 223 P.3d at 670–71 (Ariz. 2010).

[67] *See* Maricopa Inv. Team, L.L.C. v. Johnson Valley Partners LP, 1 CA-CV 12-0047, ¶¶ 7, 12 (Ariz. Ct. App. Nov. 23, 2012); Shaw v. CTVT Motors, Inc., 300 P.3d 907, 909 (Ariz. Ct. App. 2013).

B. Federal Courts Applying *Flagstaff Affordable Housing*

Federal courts applying Arizona law have been more willing to shed light on whether the ELR applies to fiduciary duty claims. The Arizona district court in *B2B CFO Partners, L.L.C. v. Kaufman* held that the ELR did not preclude claims for breach of fiduciary duty under Arizona law.[68] In doing so, the court looked at how federal courts outside of Arizona applying Arizona law had handled the issue. Specifically, the court cited to *In re Gosnell Development Corp. of Ariz*ona, in which:

> [T]he Ninth Circuit briefly reviewed Arizona cases in which the Arizona Court of Appeals "permitted a partner to recover (or at least pursue) solely pecuniary damages from another partner that breaches his or her fiduciary duty to the partnership, while acting under an oral or written partnership agreement, with no mention of the economic loss rule."[69]

The court in *In re Gosnell Development Corp. of Ariz*ona subsequently found "'no basis for believing that the law of Arizona currently allows a broader application' of the ELR such that it could be applied to cases that do not involve product liability or construction defects.'"[70]

The Arizona district court in *B2B CFO Partners, L.L.C.* noted that the Southern District of New York came to a similar conclusion in *SCF Ariz. v. Wachovia Bank, N.A.*[71] The court in *SCF Ariz.* "also declined to apply the economic loss rule to the plaintiff's breach of fiduciary duty claim."[72] "[T]he *SCF Ariz.* court determined the Arizona Supreme Court's reasoning in *Flagstaff Affordable Housing*,[73] 'in which the court discussed the economic loss rule at length, "indicates [the Arizona Supreme Court] would not extend the economic loss rule to breach of fiduciary duty claims."'"[74] This conclusion, the court in *SCF Arizona* held, was strongly supported by important public policy considerations.[75] Specifically, the court in *SCF Arizona* stated: "where a contract places the parties in a relationship in which the law then imposes certain duties recognized by public policy, the gravamen of the subsequent action for breach is in tort, not contract."[76]

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[68] *B2B CFO Partners, L.L.C. v. Kaufman*, 865 F. Supp. 2d 1084, 1096 (D. Ariz. 2012).

[69] *Id*. (quoting In re Gosnell Dev. Corp. of Ariz., 331 Fed. Appx. 440, 441 (9th Cir. 2009)).

[70] *L.L.C.Id*. *(quoting Gosnell, 331 Fed.Appx. at 441).*

[71] *L.L.C.Id*. (citing SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513(WHP), 2010 WL 5422505, *1, *9–11 (S.D.N.Y. Dec. 14, 2010)).

[72] *L.L.C.Id*.

[73] *Id*. (*quoting* Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc., 223 P.3d 664, 664 (Ariz. 2010)).

[74] *L.L.C.Id*. at 1096 (quoting *SCF Ariz.*, 2010 WL 5422505, *10) (S.D.N.Y. Dec. 14, 2010) (brackets original).

[75] *SCF Ariz.*, 2010 WL 5422505 at *11. (internal punctuation and citation omitted).

[76] *Id*.

The Arizona district court in *B2B CFO Partners, L.L.C.* found the reasoning in the *In re Gosnell Development Corp. of Ariz*ona and *SCF Arizona* decisions persuasive, and therefore held that the plaintiffs' claim for breach of fiduciary duty was not barred by the ELR.[77] Given language in post-*Flagstaff Affordable Housing* Arizona decisions, and the fact that the *B2B CFO Partners, L.L.C.*, *In re Gosnell Development Corp. of Ariz*ona, and *SCF Arizona* decisions all support the ELR not precluding breach of fiduciary duty claims, it is unlikely that an argument that the ELR bars breach of fiduciary duty claims will be successful.

V. ARIZONA'S ELR DOES NOT APPLY TO BREACH OF FIDUCIARY DUTY CLAIMS

Some may argue that the ELR precludes breach of fiduciary duty claims. But the holding in *Flagstaff Affordable Housing* is narrow and must be viewed as such in determining the current scope of Arizona's ELR. In *Flagstaff Affordable Housing*, the Arizona Supreme Court's application of the ELR was limited to the construction defect context—not construction cases generally. The Arizona Supreme Court was explicit in this limitation:

> We do not hold that the economic loss doctrine applies to architects because they are professionals, but instead because the policy concerns that justify applying the doctrine to construction defect cases do not justify distinguishing between contractors on the one hand and design professionals, including architects, on the other. Our adoption of the economic loss doctrine in construction defect cases reflects our assessment of the relevant policy concerns in that context; it does not suggest that the doctrine should be applied with a broad brush in other circumstances.[78]

But the *Flagstaff Affordable Housing* court did not adequately address the agency relationship between the architect and the client, nor did it address situations in which an architect owes a fiduciary duty to his or her client(s).[79] Where there are no construction defects in dispute, and the architect serves as the homeowner's agent or fiduciary to manage construction administration and other matters relating to the construction, the ELR should not apply. The Arizona Supreme Court acknowledged the material distinction in its decision: "[E]conomic loss doctrine should not apply to claims against lawyers and fiduciaries because '[w]hen you retain someone for the express purpose of being on your side, he cannot

[77] *B2B CFO PartnersL.L.C.*, 856 F. Supp. 2d at 1096.

[78] *Flagstaff Affordable Housing*, 223 P.3d at 673 (Ariz. 2010) (emphasis added).

[79] As leading commentators on the issue have stated, the impossibility of formulating a single economic loss rule stems in part from the reality that the various contexts implicated by the ELR invoke markedly difference policy concerns. Dan B. Dobbs, *An Introduction to Non-Statutory Economic Loss Claims*, 48 ARIZ. L. REV. 713, 733 (2006) ("It seems impossible to formulate a single economic loss rule. Instead, the problem of recovery for pure economic loss that is unaccompanied by physical harm to person or property occurs in a number of contexts that may invoke differing concerns of policy.").

rightly contract to be your adversary instead or to be on your side but free to be negligent.'"[80]

An argument that the ELR precludes a plaintiff's tort claims simply by virtue of defendant's status as an architect with contractual privity is incorrect. The ELR is "not a *per se* rule denying tort liability to all plaintiffs who suffer only economic losses."[81] As the court in *VFS Leasing Co. v. Silverado Stages Inc.* correctly held, "[T]here is little to support that the Arizona courts intended the doctrine to apply outside [product liability and construction defect] contexts . . . Indeed, a formulation of the economic loss rule that eliminates recovery under all tort theories is 'overly broad.'"[82]

The holding in *Cook*, *supra*, does not suggest a different conclusion. The Division One of the Arizona Court of Appeals upheld the trial court's denial of the Cooks' fiduciary duty claim on its merits, not under the ELR.[83] There was no analysis of the fiduciary duty claim in relation to the ELR.

There is no reported decision by any Arizona court denying a fiduciary duty claim on ELR grounds, and for good reason. The Arizona Supreme Court made clear in *Flagstaff Affordable Housing* that fiduciary relationships fall outside the scope of the ELR.[84]

The District Court of Arizona, which has addressed Arizona's ELR in several cases following *Flagstaff Affordable Housing*, has also explained that Arizona courts do not apply the ELR to fiduciary duty claims. In *B2B CFO Partners, L.L.C. v. Kaufman*, decided after *Cook*, the District Court described the landscape in declining to extend the ELR to fiduciary duty claims under Arizona law:

> Arizona courts have typically limited the application of the rule to product liability and construction defect cases. Defendant cites to no cases in which an Arizona court has applied the economic loss rule to a claim for breach of fiduciary duty, nor has Defendant offered any compelling arguments for extending the rule to bar Plaintiffs' claim for breach of fiduciary duty.[85]

[80] *Flagstaff Affordable Housing*, 223 P.3d at 673 (citing Dobbs, *supra* note 79, at 727).

[81] Jes Solar Co. v. Matinee Energy, Inc., 2015 WL 10943562 at *3 (D. Ariz. Nov. 2, 2015).

[82] VFS Leasing Co. v. Silverado Stages Inc., 2019 WL 3841015 at * 2–3 (D. Ariz. Aug. 15, 2019) (citing Firetrace USA, L.L.C. v. Jeslcard, 800 F. Supp. 2d 1042, 1052 (D. Ariz. 2010); *Flagstaff Affordable Housing*, 223 P.3d at 667).

[83] *See* Cook v. Orkin Exterminating Co., 258 P.3d 149, 151(Ariz. Ct. App. 2011) ("The Cooks Did Not State a Claim for Breach of Fiduciary Duty.") (capitalization in original).

[84] *See Flagstaff Affordable Housing*, 223 P.3d at 673.

[85] *B2B CFO Partners, L.L.C. v. Kaufman*, 856 F. Supp. 1084, 1096 (D. Ariz. 2012) (citation omitted).

Though Arizona state courts are silent on the issue, federal courts outside of Arizona have declined to extend the ELR to claims for breach of fiduciary duty under Arizona law.[86] In *In re Gosnell Development Corp. of Ariz*ona, the Ninth Circuit briefly reviewed Arizona cases in which the Arizona Court of Appeals "permitted a partner to recover (or at least pursue) solely pecuniary damages from another partner that breached his or her fiduciary duty to the partnership, while acting under an oral or written partnership agreement, with no mention of the economic loss rule."[87] That court subsequently found "no basis for believing that the law of Arizona currently allows a broader application" of the economic loss rule, such that it could be applied to cases that do not involve product liability or construction defects.[88]

Similarly, in *SCF Arizona*, the Southern District of New York also declined to apply the ELR to the plaintiff's breach of fiduciary duty claim.[89] The *SCF Arizona* court determined that the Arizona Supreme Court's reasoning in *Flagstaff Affordable Housing* "indicates [the Arizona Supreme Court] would not extend the economic loss rule to breach of fiduciary duty claims."[90] *SCF Arizona* court further noted that its conclusion was supported by policy considerations underpinning the ELR. The court found persuasive the reasoning in *In re Gosnell Development Corp. of Ariz*ona and *SCF Arizona.*

At bottom, the ELR does not preclude fiduciary duty claims under Arizona law and there is no contrary authority at this time.[91] For that reason, the Supreme Court's Decision in *Flagstaff Affordable Housing* should not be taken as a complete bar to tort claims against architects.

VI. *FLAGSTAFF AFFORDABLE HOUSING* IS NOT A COMPLETE BAR TO TORT CLAIMS AGAINST ARCHITECTS WITH CONTRACTUAL PRIVITY

Architects may contend that the ELR bars homeowners' claims for professional negligence against them. They would seemingly find support in *Flagstaff Affordable Housing*, which applied the ELR to claims based on

[86] *In re Gosnell Dev. Corp. of Ariz.*, 331 F. App'x. at 441–42; *cf.* SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513(WHP), 2010 WL 5422505, at *9–11 (S.D.N.Y. Dec. 14, 2010) (though Arizona courts are silent on the issue, courts outside of Arizona have declined to extend the economic loss rule to claims for breach of fiduciary duty under Arizona law).

[87] *Id.* at 441 (citations omitted).

[88] *Id.*

[89] SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513, 2010 WL 5422505, at *6 (S.D.N.Y. Dec. 14, 2010)

[90] *Id.* at *10 ("[W]here a contract places the parties in a relationship in which the law then imposes certain duties recognized by public policy, the gravamen of the subsequent action for breach is in tort, not contract.") (internal punctuation and citation omitted).

[91] Several state and federal courts outside Arizona have held the economic loss rule will not preclude claims for breach of fiduciary duty. *See In re* Heartland Payment Sys., Inc. Customer Data Sec. Breach Litig., 2011 WL 1232352 at *18 n.7 (S.D. Tex. Mar. 31, 2011) (citing eight cases from various jurisdictions that reject the application of the economic loss rule to breach of fiduciary duty claims).

construction defects.[92] The Court in *Flagstaff Affordable Housing* held "a plaintiff who contracts for construction cannot recover in tort for purely economic loss, unless the contract otherwise provides."[93] In doing so, the Court "limited tort recovery involving 'contracts for construction' to those situations in which the plaintiff's economic loss was 'accompanied by physical injury to persons or other property.'"[94] Further, the fact that architects owe legally imposed duties of care as professionals, the court reasoned, "does not displace the general policy concerns that parties to construction-related contracts should structure their relationships by prospectively allocating the risks of loss and identifying remedies."[95]

But the fact that there is some overlap between contract and professional liability should not preclude otherwise viable tort claims against architects. As the district court noted in *B2B CFO Partners, L.L.C. v. Kaufman*, "where a contract places the parties in a relationship in which the law then imposes certain duties recognized by public policy, the gravamen of the subsequent action for breach is in tort, not contract."[96]

Many architect agreements explicitly acknowledge the coexistence of contractual and professional responsibility, including the American Institute of Architects's ("AIA") oft-used AIA B101-2007 form contract, which provides: "The Architect shall perform its services with the professional skill and care ordinarily provided by architects practicing in the same or similar locality under the same of similar circumstances."[97] The AIA's published commentary for the AIA B101-2007 form contract explains the rationale behind its incorporation of this language:

> Generally speaking, like all professionals, an architect must perform its duties consistent with the degree of care and competence generally expected of a reasonably skilled member of the profession. *This standard of care applies in any professional activity an architect undertakes, regardless of whether or not the standard of care is stated in the contract for services.* . . . Additionally, the definition is sufficiently flexible to adapt to each state's particular standard of care. It is the AIA's intent that B101-2007 will provide the owner with a better understanding of the common law standard of care for an architect. Practically speaking, *however, the inclusion of this standard of care provision in the contract will have essentially no impact on the nature of the architect's services, as*

[92] Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc., 223 P.3d 664, 665 (Ariz. 2010).

[93] *Id*. at 670–71.

[94] Shaw v. CTVT Motors, Inc., 300 P.3d 907, 909-10 (Ariz. Ct. App. 2013) (quoting *Flagstaff Affordable Housing*, 223 P.3d at 670–71).

[95] *Flagstaff Affordable Housing*, 223 P.3d at 672.

[96] *B2B CFO Partners, L.L.C. v. Kaufman*, 856 F. Supp. 2d 1084, 1096 (D. Ariz. 2012).

[97] THE AM. INST. OF ARCHITECTS, AIA, B101-2007 STANDARD FORM OF AGREEMENT BETWEEN OWNER AND CONTRACTOR § 2.2 (2007).

> *those services have always been subject to a common law standard of care* definition similar to that set forth in B101.[98]

This guidance suggests the question of whether a plaintiff's claim against an architect for professional negligence sounds in tort or contract after *Flagstaff Affordable Housing* is in many cases a legal fiction. Indeed, the Arizona Supreme Court in *Flagstaff Affordable Housing* expressly approved of its earlier decision in *Donnelly Construction Co. v. Oberg/Hunt/Gilleland*,[99] which held that a lack of privity between a contractor and an architect did not bar claims for professional negligence.[100] The *Flagstaff Affordable Housing* court also recognized that the professional standard of care for architects is often an "implied term" in their contracts.[101] Therefore, after *Flagstaff Affordable Housing*, when a homeowner contracts with an architect and the ELR applies, a reviewing court would presumably apply the same standard of care that it would apply to tort claims against an architect by a plaintiff who lacks contractual privity, only the claim would technically sound in contract rather than tort.

But *Flagstaff Affordable Housing* did not adequately address a situation in the architectural context where the parties are in a legal relationship in which the law imposes, even absent a contract, certain duties recognized by public policy. As the court in *B2B CFO Partners, L.L.C. v. Kaufman* noted, "where a contract places the parties in a relationship in which the law then imposes certain duties recognized by public policy, the gravamen of the subsequent action for breach is in tort, not contract."[102] Examples of duties that may qualify for exemption from application of the ELR include professional duties of care that exist even absent a professional contract, which give rise to an action for breach in tort—not contract—and therefore fall outside the purview of the ELR.

Consider the following hypothetical: Plaintiff retains Architect not only to design her luxury custom home, but to serve as a fiduciary, Owner's representative, and agent to oversee and manage construction phase services—relatively common responsibilities for architects.[103] In this role, Architect recommends Contractor—a

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[98] THE AM. INST. OF ARCHITECTS, AIA, COMMENTARY: B101™-2007 3 (2007) (emphasis added).

[99] Donnelly Const. Co. v. Oberg/Hunt/Gilleland, 677 P.2d 1292, 1295–97 (Ariz. 2010).

[100] *Flagstaff Affordable Housing*, 223 P.3d at 671 ("Without discussing the [ELR], *Donnelly* correctly implied that it would not apply to negligence claims by a plaintiff who has no contractual relationship with the defendant.").

[101] *Id*. at 672.

[102] *B2B CFO Partners, L.L.C. v. Kaufman,* 856 F. Supp. 2d 1084, 1096 (D. Ariz. 2012) (quoting SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513, 2010 WL 5422505, at *11 (S.D.N.Y. Dec. 14, 2010)) (internal punctuation and citation omitted).

[103] *See, e.g.*, Dawn Zuber, *Six Services Architects Provide on Residential Projects*, AM. INST. OF ARCHITECTS, https://www.topicarchitecture.com/articles/74756-six-services-architects-provide-on-residenti (last visited July 24, 2020) (stating "your architect observes the pace and quality of construction. As your agent, your architect looks out for your interests, keeping you informed of the project's progress and overseeing any changes or problems that may arise. Construction phase services are helpful in keeping your project on track and within budget.").

lucrative business partner of Architect's—for the construction project and encourages Plaintiff to enter into a cost-plus contract with Contractor without characterizing it as such. Contractor begins to charge Plaintiff with ambiguous, unsupported fees for phantom "self-performed work," with no oversight by Architect.

Plaintiff alerts Architect when she becomes aware of the charges, but Architect abandons its duty to protect Plaintiff's interests in favor of its reliance on its friend and business partner, Contractor. When the issue of Contractor's overcharges comes to a head and litigation is being contemplated, Architect claims to be a neutral party unable to assist with resolution of the dispute. As a result of Architect's actions, and lack thereof, Plaintiff suffers damage beyond the scope of her contract in the form of significant overcharges.

In this situation, Architect should be estopped from denying his role as fiduciary, Owner's representative, and agent. Clearly, this hypothetical situation is distinguishable from disputes regarding contracts addressing a common service relationship with the Orkin man to spray for termites (*Cook*) or Fair Housing Act-compliant apartment designs (*Flagstaff Affordable Housing*). The crux of the hypothetical dispute is Architect abandoning his role as Plaintiff's agent in administering construction phase services and as fiduciary in looking out for, and acting to protect, the homeowner(s)'s best interests under a special relationship of trust and confidence.[104] Architect thought his abandonment of his construction phase responsibilities was acceptable because he trusted Contractor.

But as agent and fiduciary of Plaintiff, Architect did not have the luxury of sitting back and trusting that Contractor would do aspects of Architect's job to protect Plaintiff's interests for him. In failing to act as the necessary check on Contractor's nefarious actions, Architect violated his readily accepted professional and fiduciary duties, causing significant damage. Further, by Architect claiming to be a neutral party when Plaintiff's claims against Contractor came to light, Architect acted in direct contravention of his admitted agency role. Architect's actions and failures to act contravene the duties it owed to Plaintiff and led to Plaintiff suffering damage well beyond the scope of the architectural contract. A situation of the above type, which regularly happens in the luxury home construction space,[105] therefore creates liability separate and apart from the contract under duties created under the law.

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[104] *See, e.g.*, Sky Harbor Hotel Props., L.L.C. v. Patel Props., L.L.C., 443 P.3d 21, 23 (Ariz. 2019) ("[A]n agent is a fiduciary with respect to matters within the scope of his agency. . . . [and] the nature of the fiduciary relationship for agents includes a duty of loyalty, a duty of good faith, and a duty of care.") (internal citations omitted); Barmat v. John and Jane Doe Partners A-D, 747 P.2d 1218, 1222 (Ariz. 1987) ("As a matter of public policy, attorneys, accountants and other professionals owe special duties to their clients, and breaches of those duties are generally recognized as torts.").

[105] Mary Van Keuren, *How to Prevent Construction Fraud*, COVERAGE (July 8, 2020), https://www.coverage.com/insurance/home/ways-to-spot-construction-fraud/ (last visited July 27, 2020) ("According to the Better Business Bureau (BBB), residential contractor fraud is the number one complaint by homeowners.").

This conclusion is supported by the refusal of federal courts applying Arizona law to apply the ELR to usurp fiduciary and agency principles. Therefore, where an architect is entrusted with the responsibility to serve as the homeowner's fiduciary to safeguard his or her best interests and freely accepts this role, Arizona courts should not allow architects to use the ELR as a sword to preclude otherwise independently viable tort claims. As the Arizona Supreme Court acknowledged in *Flagstaff Affordable Housing*, the ELR should not be interpreted to preclude claims against those who are hired as fiduciaries and agents.[106] When you hire someone as your fiduciary and agent, "he cannot . . . be on your side but free to be negligent."[107]

Moreover, contract and negligence claims are not mutually exclusive under Arizona law.[108] "As a matter of public policy, attorneys, accountants and other professionals owe special duties to their clients, and breaches of those duties are generally recognized as torts."[109] In *Darner Motor Sales, Inc. v. Universal Underwriters Insurance Co.*, the court explained that "[t]he principle involved" in professional negligence claims "is simply that a person who holds himself out to the public as possessing special knowledge, skill or expertise must perform his activities according to the standard of his profession. If he does not, he may be held liable under ordinary tort principles of negligence for the damage he causes by his failure to adhere to the standard."[110]

Arizona courts have applied this principle to professionals other than lawyers and doctors, including engineers[111] and contractors.[112] In a factual situation where a defendant holds himself out to the plaintiff(s) as having special knowledge, skill, or expertise with regard to a certain trade, the defendant should be held to the applicable professional standard of care. As the courts in *B2B CFO Partners, L.L.C.* and *SCF Arizona* urged, when a contract, such as a professional services agreement, "places the parties in a relationship in which the law then imposes certain duties recognized by public policy [such as a fiduciary relationship or where a professional duty of care is owed], the gravamen of the subsequent action for breach is in tort, not contract."[113] As such, the hypothetical plaintiffs would have a viable cause of action for professional negligence against the hypothetical defendant(s).

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[106] *Flagstaff Affordable Housing*, 223 P.3d at 673.

[107] *Id*.

[108] *See* Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp., 694 P.2d 198, 209-10 (Ariz. 1984) ("Each case must be examined to determine whether the facts preponderate in favor of the application of tort law or commercial law exclusively or a combination of the two.").

[109] *Barmat*, 747 P.2d at 1222.

[110] Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 403 (Ariz. 1984).

[111] Joseph Painting Co. v. Larson Eng'g, Inc., Case No. 1 CA-CV 09-0327, 2010 WL 746173, at *2–4 (Ariz. Ct. App. Mar. 4, 2010).

[112] Hunter Contracting Co. v. Superior Court, 947 P.2d 892, 894–95 (Ariz. Ct. App. 1997).

[113] B2B CFO Partners v. Kaufman,L.L.C. 856 F. Supp. 2d 1084, 1096 (D. Ariz. 2012) ("[W]here a contract places the parties in a relationship in which the law then imposes certain duties recognized by public policy, the gravamen of the subsequent action for breach is in tort, not

In sum, an architect's professional duties do not exist "but for" the actual architect agreement, and Arizona courts should not hold otherwise despite the Arizona Supreme Court's unclear statements in *Flagstaff Affordable Housing*. Rather, these professional duties arise from common law and should not be superseded by an architect agreement. Arizona courts and federal courts applying Arizona law should reject attempts to preclude professional negligence claims based on an application of the ELR.

VII. CONCLUSION

When it first adopted the ELR in *Salt River Project*, the Arizona Supreme Court explicitly rejected the per se approach to the ELR and instead charted a course towards narrow, context-specific application of the rule. The Arizona Supreme Court expressly affirmed this narrow view in *Flagstaff Affordable Housing* yet cast unnecessary ambiguity on the professional duty architects owe to their clients and how a contractual relationship might affect this duty. At the same time, the Court recognized that the ELR should not be taken to preclude fiduciary duty claims, and federal courts applying Arizona law have held as such post-*Flagstaff Affordable Housing*. For the same reasons that the ELR should not apply to fiduciary duty claims, the ELR should not preclude viable tort claims against architects, regardless of whether they have contractual privity with the plaintiff, because they themselves owe similar duties recognized at common law.

Arizona courts should continue in their narrow application of the ELR, especially in situations where parties owe legal duties which go beyond the four-corners of a contract.

contract.") (quoting SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513, 2010 WL 5422505, at *11 (S.D.N.Y. Dec. 14, 2010) (internal punctuation and citation omitted).