# ECONOMIC LOSS RULE AND
# ITS IMPACT ON PROPERTY INSURANCE COVERAGE


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INSURANCE COVERAGE AND PRACTICE SYMPOSIUM

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## INTRODUCTION

Our tort system is based upon social duty. A tortfeasor who breaches that duty owes compensation to the wronged party. Unlike the tort system, our commercial relationships are based upon the terms and conditions of the parties' contract which in turn determine the contracting parties' duties. Allowing the parties, through contract, to determine their responsibilities is essential to creating certainty and predictability in any business environment.

Nowhere is the tension between these two loss allocation systems more evident than in the application of the economic loss rule. Applying the rule determines whether a wronged party can cross that dividing line between contractual and tort liability and seek the full panoply of remedies under the tort system.

In this paper, we will explore the application of this rule in the context of property losses. We hope to provide you with a framework of analysis so that you can avoid the potential minefields that exist on the borderline between contract and tort liability.

## WHAT IS THE ECONOMIC LOSS RULE?

Generally, the economic loss rule precludes tort recovery in negligence actions when damages are limited to monetary harm. Economic loss has been defined as “damages for inadequate value, cost of repair and replacement of the defective product or consequent loss of profits – without any claim of personal injury or damage to the other property …” Note, *Economic Loss and Products Liability Jurisprudence,* 66 Colum.L.Rev. 917, 918 (1966), as well as “the diminution in the value of the product because it is inferior in quality and does not work for the general purposes for which it was manufactured and sold.” Comment, *Manufacturer’s Liability Through Remote Purchases for “Economic Loss” Damages – Tort or Contract?* 114 U. Pa. L. Rev. 539, 541 (1966).

In the context of property damage, the economic loss rule is most frequently invoked where a product “injures itself.” Thus, the economic loss rule permits recovery for damages to property other than the product purchased but denies recovery for damages to the product itself. *Mt. Lebanon Personal Care Home, Inc. v. Hoover Universal, Inc., et al.*, 276 F.3d 845 (6th Cir. 2002). As the United States Supreme Court stated in *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 871 (1986), a manufacturer, in a commercial relationship, has no duty under negligence or strict liability theory to prevent a product from injuring itself. A product injures itself, at its most basic definition, when it is made by one manufacturer and does not work in the manner that it was designed to work. Under this scenario, a defect in the component of the machine is still the product itself “[s]ince all but the very simplest of machines have component parts, [and a contrary] holding would require a finding of ‘property damage’ in virtually every case where a product damages itself.” *Id.* at 874 (quoting *Northern Power & Engineering Corp. v. Caterpillar Tractor Co.,* 623 P.2d 324, 330 (Alaska 1981)). Damage to a product itself is understood to be a warranty claim. *Id.* at 877.

The economic loss rule precludes tort recovery, because a product injuring itself causes no damage to other property. Since the injury does not cause damage to other property, as in the traditional property damage cases, there is no basis to impose tort liability.

Contract law is well suited to many commercial controversies because the parties may set the terms of their own agreements. *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 872-73 (1986). The manufacturer can restrict its liability, within limits, by disclaiming warranties or limiting remedies. *Id.* It prevents the tortfeasor from exposure to limitless liability for economic loss. *Calloway v. City of Reno*, 993 P.2d 1259, 1263 n. 2, 1266 (Nev. 2000). This limitation comes from the agreement and “the requirement that consequential damages, such as lost profits, be a foreseeable result of the breach.” *East River*, 476 U.S. at 874; *See also Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854). If the tortfeasor could be held liable for all economic effects of their negligence “they would face virtually uninsurable risks far out of proportion to their culpability, and far greater than is necessary to encourage potential tort defendants to exercise care in their endeavors.” *In re Chicago Flood Litigation*, 680 N.E.2d 265, 274 (Ill. 1997).

Permitting companies to sue in tort for economic losses disrupts risk allocations that are set out in a contract. *See Trans-Gulf Corp. v. Performance Aircraft Serv. Inc.*, 82 S.W.3d 691, 695 (Tex. App. 2002). Usually, contract remedies give recognition to the manufacturer's bargain and protect the purchaser by allowing it to obtain the benefit of its bargain through warranty law. *East River*, *supra*, 476 U.S. at 873. Commercial situations generally do not involve large disparities in power so the courts usually do not need to intrude into the parties' allocation of risk. *Id.*

Most jurisdictions use the rule in some form but its scope and application varies in different jurisdictions. It still is most prevalent in products liability and products liability type negligence cases. *See, e.g. Calloway, surpa*, 993 P.2d at 1264. The economic loss rule can be used successfully against other claims depending on the jurisdiction. Some states have applied the economic loss rule to architects to bar recovery for purely economic losses resulting from professional negligence. *City Express, Inc. v. Express Partners*, 959 P.2d 836 (Haw. 1998); *But see Aldrich v. ADD, Inc.*, 770 N.E.2d 447, 455 (Mass. 2002) (holding that summary judgment could not be entered in architect's favor on the ground that plaintiff's claim was barred by the economic loss rule because there was an allegation of negligence that resulted in physical damage). Florida has adopted the economic loss rule in a variety of situations and has barred purely economic claims alleging breach of fiduciary duty, fraudulent inducement, and tortious interference. *See Excess Risk Underwriters, Inc. v. Lafayette Life Ins. Co.*, 208 F. Supp. 2d 1310 (S.D. Fla. 2002). Although Florida has liberally applied the economic loss rule, it has recognized that there are restraints, especially against professionals, because "actions against professionals often involve purely economic loss without any accompanying personal injury or property damage, [and] extending the economic loss rule to these cases would effectively extinguish such actions." *Moransais v. Heathman*, 744 So. 2d 973, 983 (Fla. 1999).

## THE STANDARD CGL POLICY

The risk intended to be insured in a CGL policy "is the possibility that the goods, product, or work of the insured, once relinquished or completed, will cause bodily injury or damage to property other than to the product or completed work itself, and for which the insured may be found liable . . . the coverage is for tort liability caused by an occurrence for physical damages to others and not for contractual liability of the insured for economic loss because the product or completed work is not for which the damaged person bargained." *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788, 791 (N.J. 1979); s*ee also R.N. Thompson & Assocs., Inc. v. Monroe Guaranty Ins. Co.*, 686 N.E. 2d 160, 162 (Ind. Ct. App. 1997).

The standard CGL policy language defines "property damage" as "physical injury to or destruction of tangible property." *Jacob v. Gilbert Russo*, 592 N.W.2d 271 (Wis. Ct. App. 1999); S*ee also Vogel v. Russo Builders*, 613 N.W. 2d 177, 185 (Wis. 2000) (holding that this language in a CGL policy covers only the collateral property damage associated with defective masonry work and does not include the defective masonry itself, the cost to repair it, or any effect on the home's value). The 1973 revision of the CGL policy inserted the modifier "physical" under the definition of property damage to restrict recovery for intangible losses. *See National Union Fire Ins. Co. v. Terra Indust.,* 216 F. Supp. 2d 899, 912 (N.D. Iowa 2002). The phrase "tangible property" in a CGL policy has repeatedly been interpreted to exclude coverage for economic interests or property rights such as lost profits, loss of goodwill, loss of the anticipated benefit of the bargain or loss of investment. *See Chatton v. National Union Fire Insurance Co.,* 10 Cal. App. 4th 846, 857-58 (Cal. Ct. App. 1992).

The extent of CGL coverage is based on the idea that an insured's contractor's work gives two types of risk. *R.N. Thompson & Associates, Inc., supra,* 686 N.E. 2d at 162. First, there is the risk that an employee's work will be faulty for which the customer can recover damages, under breach of warranty, for the cost of the replacement of the work from the contractor. *Id.* The second risk is that a contractor's work might injure people or damage property caused by faulty workmanship, which the CGL policy typically covers. *Id.* In order to have predictable and affordable insurance rates, the insurers' assumption of risk is usually limited to those out of the "effective control" of the insured. *Knutson Constr. Co. v. St. Paul Fire & Marine Ins.,* 396 N.W. 2d 229, 233-34 (Minn. 1986).

A prime example of what courts believe should be covered is the following:

> When a craftsman applies stucco to an exterior wall of a home in a faulty manner and discoloration, peeling and chipping result, the poorly performed work will perforce have to be replaced or repaired by the tradesman or by a surety. On the other hand, should the stucco peel and fall from the wall, and thereby cause injury to the homeowner or his neighbor standing below or to a passing automobile, an occurrence of harm arises which is the proper subject of risk sharing as provided by the type of policy before us in this case. The happenstance and extent of the latter liability is entirely unpredictable[;] the neighbor could suffer a scratched arm or a fatal blow to the skull from the peeling stonework. Whether the liability of the businessman is predicated upon warranty theory or, preferably and more accurately, upon tort concepts, injury to persons and damage to other property constitute the risks intended to be covered under the CGL.

*Weedo, supra,* 405 A.2d at 791-92.

In *Newark Insurance Co. v. Acupac Packaging, Inc.*, 746 A.2d 47 (N.J. Super. App. Div. 2000), the defendant insured incurred liability when the pacquettes that it manufactured leaked, causing damage to attached advertising cards. *Id.* at 49. In overturning summary judgment for the insurer, the court held that if it was inevitable that the cards would be destroyed once the pacquettes were attached to the cards, they were not required to actually attach the cards to cause property damage and trigger coverage. *Id.* at 55. The court stated that "if the risk involves injury to people or damage to property caused by faulty workmanship, the 'business risk' or 'work performance' exclusion does not exclude coverage." *Id.* at 51. The court further explained that the business risk exclusion "only applied regarding claims for damage to the insured's own work arising out of his faulty workmanship, and did not exclude damage to other property not manufactured or provided by the insured, yet caused by the insured's poor performance." *Id.* at 55.

In summary, the standard CGL policy is designed to cover faulty workmanship which causes an accident rather than the accident of faulty workmanship.

## <u>ANALYZING THE CLAIM – IS THERE COVERAGE?</u>

### A. Is There An Occurrence?

As the boundaries between contract and tort are sometimes blurred, so are the distinctions between the economic loss rule and the gist of the action doctrine. While the economic loss rule focuses on the nature of the loss, the gist of the action doctrine focuses upon the nature of the claim to determine the origin of the alleged wrong. Its analytical framework focuses upon whether the party's obligations are defined by the terms of the contract and not by the social duties imposed by tort law. *Bohler-Uddeholm Am., Inc. v. Ellwood Group, Inc.*, 247 F.3d 79 (3d Cir. 2001).

In order for a breach of a contract to give rise to an actionable tort, the wrong must be the gist of the action with the contract being collateral. *Closed Circuit Corp. v. Jerrold Electronics Corp.*, 426 F. Supp. 361 (E.D. Pa. 1977). Tort actions are for breaches of duty imposed by law as a matter of social policy while contract actions are based upon mutual consensus agreements between particular individuals. *Iron Mountain Security Storage Corp. v. American Specialty Foods, Inc.*, 457 F. Supp. 1158 (E.D. Pa. 1978). If there is no duty, there is no liability in negligence. *Trans-Gulf Corp. v. Performance Aircraft Services*, 82 S.W.3d 691, 694 (Tex. App. 2002). The Illinois Supreme Court has stated that tort law is appropriately suited for personal injury or property damage resulting from a sudden or dangerous occurrence whereas the remedy for a loss relating to a purchaser's disappointed expectations due to deterioration, internal breakdown or non-accidental cause lies in contract. *Moorman Manufacturing Co. v. National Tank Co.,* 435 N.E.2d 443, 450 (Ill. 1982).

Sometimes parties try to overcome the occurrence argument by alleging lack of privity. In *Trans-Gulf Corp., supra,* plaintiff sued in negligence seeking to be reimbursed for the cost of replacing the sealant and incidental costs associated with the replacement process. 82 S.W.3d at 693. Plaintiff purchased airplanes from Kingdom Holding Company, which had contracted with defendant to repair the aircraft. *Id.* After delivery of the aircraft, plaintiff discovered the alleged defects. *Id.* Plaintiff alleged that defendant was responsible because it used the wrong type of sealant in the fuel tanks. *Id.*

In arguing for tort remedies, plaintiff contended that because there was no privity of contract between the plaintiff and defendant, it should be entitled, like any other consumer, to seek recovery in negligence. *Id.* The court rejected the plaintiff's argument finding that regardless of the fact that plaintiff and defendant were strangers to the contract, plaintiff still only sought to recover economic damages. *Id.* at 695. Furthermore, the court rejected plaintiff's contention that an implied warranty of good and workmanlike performance attached to the repairs. *Id.* at 696. The economic loss rule precluded any action in tort and limited defendant's liability to the risk allocation contained in the contract. *Id.* at 697.

Because both the economic loss rule and the gist of the action doctrine are mechanisms for keeping the contract and tort "players" playing in their respective venues, it is not surprising that the courts often ignore the analytical frame work for each and use them interchangeably. Any practitioner faced with a situation involving a claim ostensibly based in contract or a claimant seeking reimbursement for a purely economic loss, must take the time to analyze the claim in terms of whether there is an occurrence and/or property damage.

Whether utilized in the economic loss rule or the gist of the action doctrine, analyzing a claim in terms of whether there was an occurrence has a distinct advantage since the insured has the duty to show that a claim is covered, the insured must establish that there is an occurrence to trigger coverage. This analysis is in stark contrast to the issue of economic losses, where the insurer has the burden to show that there was no property damage, as defined by the policy.

*Freestone v. New England Home,* 2003 Pa. Super. 24, 819 A.2d 550 (Pa. Super. 2003) is a prime example of the advantage of analyzing a claim in terms of occurrence versus economic loss. Here, the plaintiffs' home, furnishings and personal property were damaged due to the alleged breach of contract, breach of warranty and negligent advice of the insured who sold the plaintiff a log home kit. North River Insurance Company, the insurer, declined coverage and a default judgment in the amount of $338,994.32 was entered against the insured, New England Log Homes, Inc.

Even though plaintiffs alleged negligence, the Pennsylvania Superior Court found that there was no coverage. In holding for the insurer, the court found that the plaintiffs' claims, although couched in negligence, were in reality contract claims based upon the insured's alleged poor advice. Because the insured's poor advice cannot be considered an accident or an occurrence, the policy coverage was not triggered.

### B. Is There Property Damage?

Since the economic loss rule can be invoked where the product injures itself, many insureds argue that the damages they caused constitute "other property" and are, therefore, entitled to coverage. The courts have struggled with this concept in determining what constitutes "other property" when a product is the component of a larger product. *See Saratoga Fishing Co. v. JM Martinac & Co.*, 520 U.S. 875, 880-81 (1997); *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 871 (1986). In *East River*, the Court held that the plaintiff could not recover in tort on the grounds that the plaintiff was in a commercial relationship with the defendant, who was under no duty to prevent its product from injuring itself. *Id.* at 875. The Court stated that defective turbines were part of a single system and refused to characterize repair costs and income lost while the tankers were out of service as damage to "other property," leaving the damages to their bargained for exchange under a breach of warranty claim. *Id.*

In *Saratoga Fishing Co.*, *supra*, the Supreme Court revisited the issue of what constitutes the "product itself." The Court explained that "[w]hen a manufacturer places an item in the stream of commerce by selling it to an Initial User, that item is the 'product itself' under *East River*. Items added to the product by the Initial User are therefore 'other property,' and the Initial User's sale of the product to a Subsequent User does not change these characterizations." *Id.* at 879.

In *Mt. Lebanon v. Personal Care Home, Inc. v. Hoover Universal, Inc.*, 276 F.3d 845 (6th Cir. 2002), the plaintiff contracted with a builder to build a nursing home. Approximately 20 years after the building was constructed, a structural failure occurred in the cafeteria. *Id.* at 847. In response, Mt. Lebanon abandoned the cafeteria. *Id.* One year later, a second failure occurred and Mt. Lebanon abandoned the entire building. *Id.*

The failures were caused by fire retardant chemicals used to treat the lumbar in the building's trusses. *Id.* Hoover manufactured the chemicals and may have been responsible for the lumbar in the trusses. *Id.*

To overcome the application of the economic loss rule, plaintiff argued that the treated wood was the product because it was "put into the stream of commerce." *Mt.* Lebanon, 276 F.3d at 848. Since the wood was the product, damage to the building constituted other property. *Id.* at 849. Defendants argued that the wood used in the trusses was not the product because it was a basic component of the house. *Id.* at 849-50. To hold otherwise would ensure that virtually any component part could be a product and eviscerate the economic loss rule. *Id.* at 850.

The court accepted the defendants' argument holding that the economic loss rule applied because the building constituted the product. *Id.* at 851; B*ut see Anthem Electronics v. Pacific Employers Ins. Co.*, 303 F.3d 1049 ($9^{th}$ Cir. 2002) ruling that the damage to the scanners, caused by defective circuit boards incorporated into the scanners, was property damage and, therefore, refused to apply the economic loss rule.

Some courts have even gone as far as to state that the sophistication of the parties might determine whether the economic loss rule would apply. For example, in *Marvin Lumbar, et al. v. PPG Industries, Inc., et al.*, 223 F.3d 873 ($8^{th}$ Cir. 2000), Marvin Lumbar manufactured custom wood windows and doors. It contracted with the defendant to provide wood preservative for its product. *Id.* at 875. The product malfunctioned and Marvin Lumber's windows deteriorated and showed wood rot. *Id.* Marvin Lumbar sued both in tort and contract. *Id.* The defendant filed a motion to dismiss the tort claim arguing that the economic loss rule applied. *Id.*

In accepting the defendant's argument, the court stated that where a manufacturer with sophisticated knowledge of a component part purchases and incorporates that component into its product, the manufacture is not merely a dealer with respect to the finish product but with respect to the component part as well. *Marvin Lumber,* 223 F.3d at 884. That same issue was discussed in the *Mt. Lebanon* case, *supra*, where the court hinted that had the fire retardant chemicals in the lumbar been part of a home rather than a nursing home which was built by a sophisticated commercial purchaser, the court might have been reluctant to apply the economic loss rule. Thus, the sophistication of the parties might be a factor in determining whether the economic loss rule would apply.

The timing of the alleged loss may also be a critical factor in determining whether there is property damage. In *Esicorp v. Liberty Mutual,* 266 F.3d 859, 862-63 (8th Cir. 2001), a third party brought a claim against the insured. The claim was for losses from defective pipe welds, which were incorporated into a system, that the insured's testing failed to discover. *Id.* at 861. In determining that there was no property damage, the court felt that the critical fact was that the defectively welded pipe sections did not collapse or burst or cause any other damage to property because of the negligent inspection, and there was no physical injury. *Id.* at 862. The court concluded that the resultant expenses were repair costs and not covered property damage. *Id.* at 864.

The Illinois Supreme Court was confronted with a similar issue in *Travelers Ins. v. Eljer Mfg., Inc.,* 757 N.E. 2d 481, 496 (Ill. 2001). In this case, a faulty plumbing system was installed and subsequently leaked causing water damage. *Id.* at 486. The court ruled that the property damage did not occur until there was damage to other property by an actual leak and not at the time of installation. *Id.* at 502. Consequently, preemptive repair costs were not recoverable. *Id.* The court also noted that some of the older policies provided coverage for injury to tangible property and under that determination, it was possible that certain policyholders could establish they suffered tangible losses in value because of the leaks. *Id.* at 503.

In order to overcome these arguments, parties seeking coverage usually claim that inclusion of contaminated or potentially hazardous material in a product constitutes property damage. In *Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc.*, 93 Cal Rptr.2d 364, 374-76 (Cal. Ct. App. 2000), a processor supplied almonds that were contaminated with wood splinters. The product was used in making almond clusters for a cereal. *Id.* at 374. Because of the manner in which the clusters were made, it was not possible that the product could be "deconstructed." *Id.* at 377. The court found that there was property damage when a product causes loss to other products into which it is incorporated. *Id.* at 376-77.

In *National Union Fire Ins. Co. v. Terra Indus.*, 216 F. Supp. 2d 899, 912 (N.D. Iowa 2002), the issue was whether the integration of contaminated material into another product constitutes "property damage." Here, contaminated carbon dioxide was incorporated into carbonated beverages and could not be removed from the beverages. *Id.* at 915-16. In reaching its decision that this was property damage, the court concluded that there was physical injury under the policy. *Id.* at 917.

At least one court has stated that the "incorporation theory," which states that the incorporation of faulty workmanship into a project leads to covered property damage, is only viable in asbestos cases. *See Fidelity & Deposit Company of Maryland v. Hartford Casualty Ins. Co.*, 215 F. Supp. 2d 1171, 1181 (D. Kan. 2002). Asbestos cases generally stand apart from other types of cases because of the serious health threat caused by asbestos contamination. Restatement (Third) of Torts: Products Liability § 21 cmt. e. (1998). Most courts have held that the contamination of a building constitutes harm to "other property." *Id.*

Clearly, some courts are troubled by having a party's ability to sue in tort determined by the randomness of whether the party suffered property damage. In response, some courts have adopted the serious risk of danger exception. For example, Maryland does not usually allow tort claims for purely economic losses except when those losses are accompanied with a serious risk of death or personal injury resulting from a dangerous condition. Maryland created this exception to promote the correction of the dangerous condition. *Patty Morris v. Osmose Wood Preserving*, 667 A.2d 624, 632 (Md. 1995).

The Maryland courts use a two-part approach in which the courts examine the nature of the damage threatened and the probability of damage occurring. *Id.*

at 631. In *Patty Morris, supra,* the court found that there was no serious risk of death or injury when the defendants designed roofs that would not be able to withstand a heavy amount of snow. *Id.* at 633. The court distinguished this case from two previous cases where actions in tort were allowed without any physical injury. *See id.* at 631-32. In *Council of Co-Owners v. Whiting-Turner*, 517 A.2d 336 (Md. 1986), an action in tort was allowed when the defendants built a twenty-one story condominium without constructing vertical shafts that would be fire resistant for two hours, triggering the severity component and the serious risk of death.

In *U.S. Gypsum v. Baltimore,* 667 A.2d 624 (Md. 1995), the probability of physical injury prong was satisfied when the City of Baltimore sued several companies that were involved in the manufacturing and installation of asbestos. The Maryland courts have followed the reasoning of the Indiana courts which have stated that it is unfair to penalize those people that are alert and prevent injury while awarding those people that fail to anticipate the injury. *See Barnes v. Mac Brown & Company,* 342 N.E.2d 619 (Ind. 1976).

Whether the defective product can be extracted from the product in which it became part might be one of the key factors in determining coverage. *Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc.,* 93 Cal Rptr.2d 364, 376 (Cal. Ct. App. 2000). However, public policy concerns for safety might be sufficient to overcome this argument in favor of coverage.

### C. The Dilemma Of Intellectual Property – Is It Tangible Property?

Courts have repeatedly held that injury to ideas, information, designs, and concepts does not support liability coverage because there is no loss to tangible property unless there is actual damage to the medium in which they are conveyed. *See Peoples Tel. Co. v. Hartford Fire Ins. Co.,* 36 F. Supp. 2d 1335 (S.D. Fla. 1997) (holding that lists of electronic serial combinations and cellular phone identification numbers were not tangible property because they had no intrinsic value, and that the policy clearly excluded liability for such contingencies); *Schaefer/Karpf Prods. v. CNA Ins. Co.,* 76 Cal. Rptr. 2d 42 (Cal. Ct. App. 1998) (holding that a movie was not tangible for purposes of liability coverage when policyholder was sued for copying a children's program onto videocassettes containing pornographic material).

Where a liability policy's definition of "property damage" is qualified by the term "tangible . . . the definition contemplates only property damage which is physical, capable of being touched and objectively perceivable and not intangible property, such as property that represents value but has no intrinsic marketable value of its own (i.e. stock, investments, copyrights, promissory notes)." *TIG Ins. Co. v. Nobel Learning Cmtys., Inc.* 2002 U.S. Dist. LEXIS 10870, *18, *19. (E.D. Pa. 2002).

In *Security State Bank of Kansas City v. Aetna Casualty and Surety Co.*, 825 F. Supp. 944 (D. Kan. 1993), the issue was whether escrow payments are "tangible property." The term was not defined in the policy. *Id.* at 947. The court held that breached terms of an escrow agreement were not "property damage" because it was not capable of being destroyed. *Id.* at 948. The court also discussed that a stack of currency is tangible property while the destruction of checks and investment certificates is not destruction to tangible property. *Id.* at 947-48.

The Third Circuit has stated that, "[i]nsurance companies reasonably might want to exclude coverage for damage to such intangible interests because estimating the potential liability for purposes of setting the premium might be very difficult, or even if the premium could be calculated, insuring against such liability might expose the company to such increased costs because of a great variance in liability that a CGL policy might become prohibitively expensive." *Lucker Mfg. v. The Home Ins. Co.*, 23 F.3d 808, 819, n.13 (3d Cir. 1994) (holding that a design for a particular project, which was less valuable after a design defect was discovered in one of its parts, did not constitute tangible property).

A recent United States District Court case for the District of Virginia involved a internet service provider bringing suit against an insurance company because it would not defend what the insurer believed to be a contract claim. *America Online, Inc. v. St. Paul Mercury Ins. Co.*, 207 F. Supp. 2d 459 (E.D. Va. 2002). The insurance company argued that there was no physical damage to tangible property when the computer program damaged customers' computers, software, data and use of the computers. *Id.* at 466. Because tangible was not defined in the policy, the court relied upon its plain meaning and dictionary definition in holding that computer data and software were not tangible because they were not capable of being touched or perceptible to the senses. *Id.* at 468-69. The computer, however, was held to be a tangible item. *Id.* at 469. Ultimately, the court held that losses flowing from the computer crashes were purely economic and did not constitute loss to other property. *Id.* at 471.

Lastly, the court looked at whether the impaired property exclusion barred coverage of the plaintiff's loss of use of the computer claims. *America Online, Inc.*, 207 F.Supp.2d at 470. The policy excluded "property damage to impaired property or to property that isn't physically damaged that results from AOL's faulty or dangerous products or completed work or failure in fulfilling the terms of a contract or agreement." *Id.* The court held that this language was sufficient to bar the coverage because AOL's defective product caused the loss of computer use. *Id.* at 471. Had the claim been for damage to the computer, a tangible property, the result might have been different.

In *Retail Sys. v. CNA Ins. Co.*, 469 N.W. 2d 735, 736 (Minn. Ct. App. 1991), results of a survey were recorded on a computer tape and given to an insured company. The tape was then lost while the insured was remodeling its office. *Id.* The court stated that the term "tangible property" is ambiguous and, therefore, the term was construed in favor of the insured resulting in coverage under the policy for the computer tape and data. *Id.* at 737. The court reasoned that the data on the tape was permanent and integrated with the physical property of the tape. *Id.*

In *St. Paul Fire & Marine Ins. Co., v. Nat'l Computer Sys., Inc.*, 490 N.W. 2d 626, 627 (Minn. Ct. App. 1992), Boeing brought suit and claimed that the defendant misappropriated proprietary information. Boeing was not suing for misappropriation of the binders but for information that gave the defendant a competitive advantage. *Id.* at 631. Confidential information was lost and deprived Boeing of exclusive use of the information. *Id.* The court held that while the information was in tangible form, the information was not tangible itself. *Id.* Similarly, in *Old Republic Ins. Co. v. West Flagler Assocs., Ltd.*, 419 So. 2d 1174 (Fla. Dist. Ct. App. 1982), the court held that winning horse racing tickets that had diminished value due to the issuance of bogus tickets was not tangible.

In *Hou-Tex, Inc. v. Landmark Graphics*, 26 S.W.3d 103 (Tex. Ct. App. 2000), plaintiff, an oil gas company, contracted with Saguaro Seismic Surveys, L.C., a geological contractor, to assist it in selecting a site for a well to be drilled. Saguaro used computer software developed by Landmark Graphics to interpret seismic data in order to select a location for the new well. *Id.* at 106. Unknown to Saguaro, Landmark's computer program had a "bug" which caused the well to be drilled in an incorrect location resulting in a dry hole. *Id.* Hou-Tex sued Landmark on a negligence theory seeking to recover its costs for drilling a dry hole. *Id.* The court held that the economic loss rule precluded Landmark from any tort liability. *Id.* at 107.

When interpreting the tangible property provision, courts often turn to the dictionary to define the term "tangible." Recently, courts have ruled that data is not tangible property but the medium in which it is conveyed is tangible property. This issue is often litigated and it would be in the best interest of the drafters of an insurance policy to be as specific as possible in defining the word "tangible." It is very important that the destruction of data is covered in the policy so that future litigation may be avoided.

**MISREPRESENTATION AND FRAUD CLAIMS**

At the forefront of the battle over the application of the economic loss rule are misrepresentation and fraud claims. Those seeking to avoid the application of the rule, argue that the rationale underpinning the economic loss rule is lacking. Specifically, one cannot assume that the contracting parties properly allocated the risk because the misrepresentation and/or fraud prevented one party from making an informed decision and negotiating a fair contract. Thus, fraud and/or misrepresentation claims in the inducement of a contract should not be subject to the economic loss rule.

In perhaps the most far reaching decision on the subject, the Third Circuit Court of Appeals in *Werwinski v. Ford Motor Co.*, 286 F.3d 661 (3d. Cir. 2002), concluded that the economic loss rule can be used to bar misrepresentation, fraud and even intentional misrepresentation claims under the Pennsylvania Unfair Trade Practices and Consumer Protection Law. By so ruling, the court extended the reach of the economic loss rule to transactions between manufacturers and individual consumers.

The Third Circuit adopted a test for determining when the economic loss rule would apply to fraudulent inducement and/or misrepresentation claims. It applies the economic loss rule to any alleged fraud and/or misrepresentation that is interwoven with the breach of contract claim. *Id.* at 671-74, 677. A misrepresentation or fraud concerning the quality or character of the goods would fall within the scope of this rule. *Id.* Since the aggrieved party was free to negotiate warranty and/or other terms to account for possible defects in the goods, fraud and/or misrepresentation as to the quality or character of the goods would not leave that party without a remedy. *Id.* Without this limitation, the Third Circuit expressed the fear that every breach of warranty claim could amount to a tort and eliminate the concept of the economic loss rule. *Id.*

The economic loss rule would not apply to fraud or misrepresentations extraneous to the contract. Id. at 677. For example, a misrepresentation or fraud dealing with the corporate structure (partnership or corporation), insurance coverage or the financial condition of a company would be independent of the underlying contract. These circumstances present unanticipated developments for which the warranty or other terms of the contract could not protect the victim.

The court took its analysis one step further and applied it to statutory fraud claims. According to the *Werwinski* court, these claims are also barred because otherwise, the statutes are broad enough to encompass nearly every misrepresentation claim and eliminate the economic loss rule. *Werwinski*, 286 F.3d at 678, 681.

In reaching its decision, the Third Circuit, once again, reiterated the importance of the economic loss rule. *Id.* at 679. The rule was designed to establish clear boundaries between tort and contract. *Id.* at 680-81. Where a party can be made whole under contract or statutory law remedies, the economic loss rule should be invoked to protect that boundary. *Id.* To do otherwise would open the door to tort remedies and impose unnecessary additional costs upon society.

**CONCLUSION**

The economic loss rule remains a viable defense to claimants seeking to avail themselves of the remedies under our tort system. Successfully invoking the rule prevents a claimant from crossing over that borderline. Its application has broad implications for insureds seeking coverage under the standard CGL. By showing that coverage is not triggered by the insured's economic loss, the economic loss rule acts in concert with the terms and conditions of the standard CGL to keep closed a Pandora's box to uncertainty and unpredictability in our loss allocation systems.