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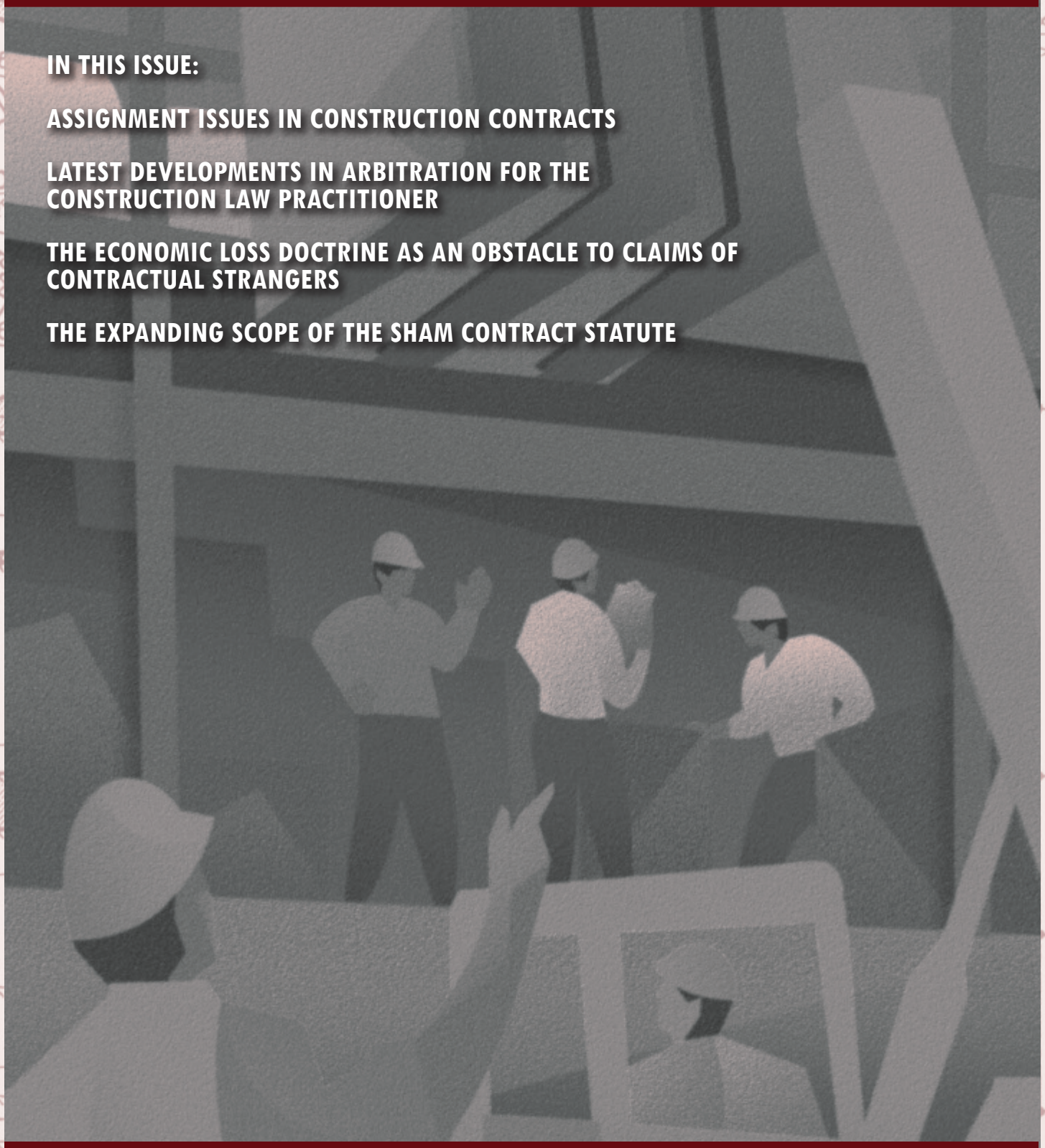
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THE ECONOMIC LOSS DOCTRINE AS AN OBSTACLE TO CLAIMS OF CONTRACTUAL STRANGERS[1]

INTRODUCTION

The most basic underlying purpose of the economic loss doctrine (or "economic loss rule") is to separate the application of tort law and contract law. More specifically, in the past, the doctrine has been the basis for precluding negligence claims in tort for purely economic losses arising from the failure of a contractual expectation associated with a product or service, if the loss is unaccompanied by any physical property damage or personal injury.[5] Allowing a contracting party or a stranger to a contract to impose tort liability for purely economic losses on another contracting party for its negligent performance undermines the risk allocation that parties related to the transaction should be managing contractually.[6]

Construction contracts are particularly prone to situations where disputes arise over economic losses due to someone's negligent performance of a contract.[7] One who acquires or sells goods or services on a construction project may become harmed by the negligent performance of a construction contract between two other project participants.[8] Several recent Texas cases have analyzed the economic loss doctrine and held that it bars a project participant who is a "stranger" to the contract between two other project participants from claiming in negligence for pecuniary losses arising from the negligent performance of the contract.[9] These cases are: *LAN/STV v. Martin K. Eby Construction Co., Chapman Custom Homes, Inc. v. Dallas Plumbing Co.*, and *Barzoukas v. Foundation Design, Ltd.*[10] This article focuses on how and when the economic loss doctrine applies to bar negligence claims by contractual strangers involved in construction projects and an unanswered question about the scope of damages that may be the subject of a negligence claim, despite the economic loss doctrine.[11]

[1] This article was previously published in the St. Mary's Law Journal. See Richard L. Reed and Richard L. Reed, Jr., *The Economic Loss Doctrine as an Obstacle to Claims of Contractual Strangers*, 46 ST. MARY'S L.J. 321 (2015).

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[4] Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 526-27 (2009).

[5] *See* Sharyland Water Supply Corp. v. City of Alton, 354 S.W.3d 407, 419–20 (Tex. 2011) (discussing the application of the economic loss rule before ultimately deciding that it does not apply when there is physical damage); Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617, 618 (Tex. 1986); Mid-Continent Aircraft Corp. v. Curry Cnty. Spraying Serv., 572 S.W.2d 308, 312 (Tex. 1978) ("When the injury is only the economic loss to the subject of a contract itself, the action sounds in contract alone."); Nobility Homes of Texas, Inc. v. Shivers, 557 S.W.2d 77, 83 (Tex.1977) (stating that a negligence cause of action is the appropriate remedy for economic loss for persons who are not in contractual privity); Montgomery Ward & Co. v. Scharrenbeck, 204 S.W.2d 508, 510 (1947) (declaring that a breach of contractual duty by way of negligence is an actionable cause).

[6] *See Sharyland Water Supply Corp.*, 354 S.W.3d at 420 ("[P]ermitting recovery in this case will upend the industry because construction contracts are negotiated based on anticipated risks and liabilities . . . .").

[7] *See generally* Barzoukas v. Found. Design, Ltd., 363 S.W.3d 829 (Tex. App.—Houston [14th Dist.] 2012, pet. denied) (discussing the economic loss rule with regards to negligent performance of a contract between contractors).

[8] *E.g.*, LAN/STV v. Martin K. Eby Constr. Co., 435 S.W.3d 234 (Tex. 2014) (exemplifying the potential harm someone who acquires services for a construction project may suffer by the negligence of another party to the construction project).

[9] This article is not intended to provide a complete treatise on the history and evolution of the economic loss doctrine in Texas. For a more complete overview refer to: Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 526 (2009).

[10] LAN/STV v. Martin K. Eby Constr. Co., 435 S.W.3d 234 (Tex. 2014); Chapman Custom Homes, Inc. v. Dallas Plumbing Co., 445 S.W.3d 716 (Tex. 2014); Barzoukas v. Found. Design, Ltd., 363 S.W.3d 829 (Tex. App.—Houston [14th Dist.] 2012, pet. denied).

[11] There are narrow exceptions to the economic loss doctrine. For instance, claims of fraud are not barred by the economic loss doctrine. *See* Sharyland Water Supply Corp. v. City of Alton, 354 S.W.3d 407, 418 (Tex. 2011) (citing Trenholm v. Ratcliff, 646 S.W.2d 927, 933 (Tex. 1983)). Contractual claims may also be assigned to a third party who may then seek to recover on the assignor's claim, subject to public policy constraints on the enforcement of Mary Carter Agreements. Elbaor v. Smith, 845 S.W.2d 240, 250 (Tex. 1992). Further, and discussed in more detail *infra*, a stranger to the contract may recover certain damages for physical loss or injury to its property notwithstanding the economic loss doctrine. *Cf.* CBI NA-CON, Inc. v. UOP Inc., 961 S.W.2d 336, 339–40 (Tex. App.—Houston [1st Dist.] 1997, writ denied) (citing Southwestern Bell Tel. Co. v. DeLanney, 809 S.W.2d 493, 494–95 (Tex.1991)) ("Every breach of contract should not become a tort action, particularly where . . . there is no fraud or personal injury, but only economic injury arising out of the very duties imposed by the contract."). Also, an intended third-party beneficiary is not a complete contractual stranger and thus may be able to sue on a contract between others. However, it is difficult to prove that one is a third-party beneficiary of a contract when the contract does not expressly confer such status on a non-contracting party. Third-party beneficiary status may be established only by clear evidence of an intent expressed in the contract itself to benefit the third party. *See* Business Staffing, Inc. v. Viesca, 394 S.W.3d 733, 743 (Tex. App.—San Antonio 2012, no pet.) ("Consumer status may be extended to third parties in very limited situations, 'as long as the transaction was specifically required by or intended to benefit the third party and the good or service was rendered to benefit the third party.'"); Thomson v. Espey Huston & Assocs., Inc., 899 S.W.2d 415, 419 (Tex. App.—Austin 1995, no writ) ("[A] property owner is ordinarily not a third-party beneficiary of a contract between the

To put this in context, consider the typical contractual arrangements for engaging the services of two typical participants on a construction project: design professionals and subcontractors. In the case of design services, the project owner often contracts with an architect or engineer to prepare plans, specifications, and other information about the project to be used to solicit bids from construction contractors. The accuracy and completeness of this owner-furnished information greatly influences whether the contractor can successfully complete the project on time and for the expected contract price. The contractor awarded the contract may suffer economic losses if the owner provides information from the owner's design professional that is incomplete or erroneous. The owner, design professional, and contractor have a triangular relationship in which both of the latter have separate contracts to the owner, but the contractor has no contractual privity with the design professional whose negligent performance causes the contractor to suffer economic loss. This was the contractual scenario in *LAN/STV*.[12] The contractor is said to be a stranger to the owner's contract with the design professional, and the economic loss doctrine bars the contractor's negligence claims against the design professional for purely economic losses.

In the case of subcontractor services, the owner's contractor often subcontracts portions of the work to be performed. The contract between the owner and contractor is separate from the subcontract between the contractor and subcontractor. This was the contractual scenario in *Barzoukas and Chapman*.[13] In this linear relationship, the owner has no contractual privity with the subcontractor, whose poor workmanship may cause the owner to suffer economic loss. The owner is said to be a stranger to the subcontract between the contractor and the subcontractor, and the economic loss doctrine bars the owner's negligence claims against the subcontractor for purely economic losses.[14]

In *LAN/STV*, the Texas Supreme Court ruled that a contractor must look to the owner to recover purely economic losses for the increased cost of construction due to insufficiency of the owner's design.[15] The contractor's negligence claim directly against the owner's design professional for such losses was barred. Similarly, with its denial of writ in *Barzoukas*, and its holding in *Chapman*, the Texas Supreme Court followed the precedent of its earlier holdings barring an owner's negligence claims for purely economic losses attributable to a subcontractor's negligence in failing to meet a contractual expectation.[16] In *Chapman*, however, the Court recognized an exception to the economic loss doctrine where the owner may directly sue a subcontractor in negligence for breach of the *implied duty of good and workmanlike performance*.[17] The facts of these recent cases give rise to practical implications for the various parties to construction contracts.

LAN/STV V. MARTIN K. EBY CONSTRUCTION CO.: NEGLIGENT PERFORMANCE OF A DESIGN PROFESSIONAL

In *LAN/STV*, the Dallas Area Rapid Transportation Authority (DART) contracted with LAN/STV, an architectural firm, to design a light rail transit line. LAN/STV was to prepare plans, drawings, and specifications for DART's project. LAN/STV agreed in its contract with DART to be liable to DART for all damages caused by negligent performance of its design services.[18] DART, as the owner, used the plans and specifications in its bid package to seek bids for construction services. Martin K. Eby Construction Co., Inc. (Eby), a general contractor, submitted a bid and was awarded a construction contract for the project.[19]

general contractor and a subcontractor."). Similarly, an owner's obligation to a general contractor to pay for the finished building only incidentally benefits a subcontractor and does not make the subcontractor a third-party beneficiary to the prime contract between the owner and the general contractor. *Thomson*, 899 S.W.2d at 419. When drafting a clause to extend a contractual benefit to a third party, the drafter should be mindful that many construction contracts include clauses that expressly bar third party beneficiary status for any non-signatory. Anthony L. Meagher & Michael P. O'Day, *Who is Going to Pay for My Impact? A Contractor's Ability to Sue Third Parties for Purely Economic Loss*, 25 CONSTR. LAW. 27, 29 (2005).

[12] *LAN/STV*, 435 S.W.3d at 235–37.

[13] *See Chapman*, 445 S.W.3d at 717–18 (addressing whether a subcontractor can be held liable to a homeowner through the subcontract with the contractor); *Barzoukas*, 363 S.W.3d at 833 (discussing the difference between the contract between the homeowner and contractor, and the subcontract between the contractor and the subcontractor).

[14] Thomson v. Espey Huston & Assocs., Inc., 899 S.W.2d 415, 419 (Tex.App.—Austin 1995, no writ).

[15] *LAN/STV*, 435 S.W.3d at 249.

[16] *See Chapman*, 445 S.W.3d at 718 ("We observed that a common law duty to perform with care and skill accompanies every contract and that the failure to meet this implied standard might provide a basis for recovery in tort, contract, or both under appropriate circumstances." (citing Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617, 618 (Tex.1986); Montgomery Ward & Co. v. Scharrenbeck, 146 Tex. 153, 204 S.W.2d 508, 510 (1947))).

[17] *See Chapman*, 445 S.W.3d at 718 ("[T]he plumber assumed an implied duty not to flood or otherwise damage the trust's house while performing its contract with the builder. Although the court of appeals views this property damage as a mere economic loss arising from 'the subject [matter] of the contract itself.'" (quoting Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617, 618 (Tex.1986))).

[18] *LAN/STV*, 435 S.W.3d at 236 (Tex. 2014).

[19] *Id.*

During construction, Eby discovered the plans were woefully insufficient.[20] Eby sued and claimed $21 million in damages against DART for the resulting delays, disruption to its construction schedule and the additional labor and materials required to complete the work, all of which were purely economic losses that Eby claimed to have sustained as a result of discrepancies in LAN/STV's design.[21] Eby chose to settle its claims against DART and pursue its remaining tort claims against LAN/STV.[22] A jury found LAN/STV negligently misrepresented the design by failing to accurately describe manhole and utility line locations, subsurface soil conditions, a retaining wall, bridge structures and other aspects of the project.[23] These errors caused the design to be insufficient for the work to be done. The jury found DART, a designated responsible third party, also negligent. It also found Eby guilty of contributory negligence. The jury, therefore, apportioned responsibility for Eby's damages as follows: 45% to LAN/STV, 40% to Eby, and 15% to DART.[24] The Court held the economic loss doctrine barred Eby from recovery of any damages against LAN/STV:

> DART was contractually responsible to Eby for providing accurate plans for the job....Had DART chosen to do so, it could have sued LAN/STV for breach of their contract to provide accurate plans. But Eby had no agreement with LAN/STV and was not party to LAN/STV's agreement with DART. Clearly, the economic loss rule barred Eby's subcontractors from recovering their own delay damages in negligence claims against LAN/STV. We think Eby should not be treated differently.[25]

Thus, DART, the owner with whom Eby had contracted, was the only party Eby could hold responsible for insufficiency of the plans and specifications. It was DART's responsibility to furnish sufficient plans and specifications for its contractor. The Court explained that, in the construction industry, it is common for multiple project participants to have contracts with the owner, and with each other, each having the opportunity through its own contract to bargain for and allocate the risk of economic loss as between them.[26] Recognizing that contractors may suffer from the negligence of an owner's design professional, the court stated "If contractors want to be protected, they can insist on that protection from the owner who will get protection from the architect."[27] The court declined to impose a "legal solution," concluding that it is more sensible in the context of the construction industry to require that contractors, even those less sophisticated, must bargain (or learn by experience that they must bargain) for the allocation of the risk of economic loss associated with a faulty design.[28]

BARZOUKAS AND *CHAPMAN*: NEGLIGENT PERFORMANCE OF A SUBCONTRACTOR

In *Barzoukas*, the Houston Court of Appeals reversed and remanded a trial court's no evidence summary judgment ruling that a homeowner could not maintain negligence claims against a third party engineer who recommended the use of short piers for the home's foundation, resulting in its rejection by city authorities.[29] None of the contract documents were included in the record, which the court of appeals found to be so deficient that it reversed and remanded to the lower court:

[20] *Id.* (explaining that being an experienced contractor, Eby anticipated about 10% of the plans might have to be altered in some fashion, but found later that nearly 80% of the plans required revisions.).

[21] *Id.* at 237.

[22] *Id.* at 236–37 (settling with DART for $4.7 million, Eby also sought recovery of $14 million in damages on its negligence and negligent misrepresentation claims).

[23] LAN/STV v. Martin K. Eby Constr. Co., 435 S.W.3d 234, 237 (Tex. 2014).

[24] *Id.*

[25] *Id.* at 249–50.

[26] *Id.* at 246.

[27] *Id.* at 248 (citing William Powers, Jr. & Margaret Niver, *Negligence, Breach of Contract, and the "Economic Loss" Rule*, 23 TEX. TECH L.REV. 477, 521 n. 205 (1992) (citations omitted).

[28] LAN/STV v. Martin K. Eby Constr. Co., 435 S.W.3d 234, 248 (Tex. 2014). Another recent case on the economic loss doctrine with facts similar to those in *LAN/STV* was pending before the Texas Supreme Court: CCE, Inc. v. PBS & J Constr. Servs., Inc., No. 01-09-00040-CV, 2011 WL 345900, at *1 (Tex. App.— Houston [1st Dist.] Jan. 28, 2011, pet. denied) (mem. op., not designated for publication). In *CCE*, an engineer's seal was placed on a Storm Water Pollution Prevention Plan ("SW3P") for a Texas Dept. of Transportation ("TxDOT") road project. TxDOT awarded CCE the contract to construct a new road. When silt discharged onto private land neighboring the project, CCE was ultimately declared in default. Subsequently, TxDOT found CCE in violation of the Clean Water Act and ordered CCE to halt operations. As a result, CCE incurred substantially increased costs to complete the project and filed suit for negligent misrepresentation against PBS&J, alleging that PBS&J made affirmative representations affirmative representations that among other things, the SW3P had been prepared by or directly under a professional engineer and that, upon sealing, engineers take full responsibility for the work, as provided in TEX. ADMIN. CODE § 137.33(a)(b) (2010). The Texas Supreme Court determined the effect of *LAN/STV* would be best addressed on remand in the trial court. Atkins North America, Inc. v. CCE, Inc., No. 11-0481, 2015 WL 3759707, at *1 (Tex. June 12, 2015).

[29] The *Barzoukas* case provides a helpful summary of the evolution of Texas common law on the economic loss doctrine prior to *LAN/STV*. *See* Barzoukas v. Found. Design, Ltd., 363 S.W.3d 829, 834–35 (Tex. App.—Houston [14th Dist.] 2012, pet. denied) (overviewing the economic loss rule in Texas).

Although areas of uncertainty exist under case law addressing the economic loss rule in Texas, at least one thing is clear: details matter.

It matters who contracted with whom to do what. It matters what the contracts say; what they cover; and what they do not cover. It matters what kind of damages are requested. It matters whether the requested damages are attributed to activities covered by the contracts. It matters whether and how multiple parties in a chain of contracts allocated among themselves the risk that participants in the chain would perform deficiently, along with the obligation to pay for deficient performance. It matters what kinds of claims are asserted and against whom they are asserted.

The details are largely missing here.[30]

The Houston Court of Appeals quoted the Texas Supreme Court's 2011 holding in *Sharyland*:[31]

> Merely because the [object of the negligent performance] was the subject of a contract does not mean that a contractual stranger is necessarily barred from suing a contracting party for breach of an independent duty. If that were the case, a party could avoid tort liability to the world simply by entering into a contract with one party. The economic loss rule does not swallow all claims between contractual and commercial strangers.
>
> [The supreme court has not yet decided] whether purely economic losses may ever be recovered in negligence or strict liability cases.[32]

Of course, the Houston Court of Appeals' decision in Barzoukas preceded the Texas Supreme Court's decision in *LAN/STV*. In denying writ in *Barzoukas*, just two months after its holding in *LAN/STV*, the Texas Supreme Court clearly agreed with the Houston Court of Appeals' assessment that it was not possible to rule out the presence of factual issues:

> [W]ith respect to the mechanism for and effect of design changes during construction under the Heights Development-Barzoukas contract; the identities of the parties to any subcontract concerning the foundation; the scope of work to be performed under such a subcontract; whether the piers are [twelve] feet deep; whether Smith's approval of changing the pier depth from [fifteen] feet to [twelve] feet was within the scope of any subcontract concerning the foundation; *and whether changing the pier depth caused a loss unrelated to a subcontract covering foundation plans and specifications*.[33]

Thus, the door remained open for owner's negligence claims against the subcontractor based upon a duty independent of any contract for *a loss unrelated to the subcontract*. What type of loss arising from negligent performance of a subcontract is unrelated to it? Enter *Chapman*.

In *Chapman*, the court "consider[ed] whether a homeowner ha[d] stated a cognizable negligence claim... allegedly caused by a plumber's negligent performance under its subcontract with the homeowner's general contractor."[34] Chapman Custom Homes, Inc. contracted to build a home and subcontracted with Dallas Plumbing Co., who improperly installed a water heater, resulting in a water leak that damaged the completed home.[35] The homeowner asserted tort claims against the plumbing subcontractor.[36] The trial court granted summary judgment against the owner, holding the owner's negligence claims were barred by the economic loss doctrine.[37] The Dallas Court of Appeals affirmed, seemingly consistent with *Sharyland* and *LAN/STV*.[38] Yet, the Texas Supreme Court reversed, because the owner's negligence claims were founded upon breach of an *independent duty* implied by

[30] Barzoukas v. Found. Design, Ltd., 363 S.W.3d 829, 834 (Tex. App.—Houston [14th Dist.] 2012, pet. denied).

[31] Sharyland Water Supply Corp. v. City of Alton, 354 S.W.3d 407 (Tex. 2011). In *Sharyland*, a water supply company sued the city and its sewer line contractor to recover the cost of repairing waterlines that were non-compliant with regulations regarding the proximity of water and sewer lines due to the contractor's negligent performance of its contract with the city. *Id.* at 409–11. The court held that the economic loss rule did not bar Sharyland's negligence claim against the contractor because the resulting non-compliance of the waterlines with state law did constitute property damage that excepted the case from the application of the economic loss rule. The court allowed Sharyland, a third party to the contract, to recover against the contractor for negligent performance of its contract with the city. *Id.* at 420, 424.

[32] *Id.* at 419 .

[33] Barzoukas v. Found. Design, Ltd., 363 S.W.3d 829, 838 (Tex. App.—2012, pet. denied) (emphasis added).

[34] Chapman Custom Homes, Inc. v. Dallas Plumbing Co., 445 S.W.3d 716, 717 (Tex. 2014).

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] Chapman Custom Homes, Inc. v. Dallas Plumbing Co., 445 S.W.3d 716, 717 (Tex. 2014).

the common law in all construction contracts to perform work in a good and workmanlike manner: "[A] party states a tort claim when the duty allegedly breached is independent of the contractual undertaking and the harm suffered is *not merely the economic loss of a contractual benefit*."[39] The court recognized this exception to the economic loss doctrine just as it had in its prior holding in *Scharrenbeck*, involving a home destroyed by fire due to negligent performance of repairs to a water heater: "Accompanying every contract is a common-law duty to perform with care, skill, reasonable expedience[,] and faithfulness the thing agreed to be done, and a negligent failure to observe any of these conditions is a tort, as well as a breach of the contract."[40]

Just as in *Sharrenbeck*, the court in *Chapman* found the water damage to the new house extended "beyond the economic loss of any anticipated benefit under the plumbing contract."[41] Thus, the owner's loss was not purely economic. It involved physical damage that went beyond mere economic loss arising out of the failure of the homeowner's *contractual expectation of a benefit*.[42] This independent duty, with physical damage, propels the claim beyond that of purely economic loss.[43] The court noted:

> The economic loss rule generally precludes recovery in tort for economic losses resulting from a party's failure to perform under a contract when the harm consists *only of the economic loss of a contractual expectancy*...it does not bar all tort claims arising out of a contractual setting.[44]

The physical nature of the damage to the entire home clearly goes beyond purely economic loss of a contractual expectancy—but the decision does not reflect what the outcome would have been if the physical damage had occurred only to the plumbing system. What does it mean when the court speaks of "contractual benefit" and a loss of a "contractual expectancy?"[45] Can physical damage arising out of failure to fulfill a common law duty trump the economic loss doctrine even if the physical damage occurs only to the subject matter of the contractual expectation? In the case of a defectively manufactured product the answer is clearly no; however, as this question pertains to the construction industry it remains unresolved.[46]

The Houston Court of Appeals holding in *Barzoukas* reversed in favor of the homeowner because the evidence raised material fact issues, including an issue of "whether changing the pier depth caused *a loss unrelated to a subcontract* covering foundation plans and specifications."[47] While this issue might suggest that the physical damage must have been to "other" property, i.e. property other than that which the subcontractor was hired to build or install, it could also mean that any physical damage, even if only related to the foundation, was related to a negligent act and not the subcontract in a way that would support a

[39] *Id.* at 718 (emphasis added) (citing LAN/STV v. Martin K. Eby Constr. Co., 435 S.W.3d 234, 242–43 (Tex. 2014); *see also* Southwestern Bell Tel. Co. v. DeLanney, 809 S.W.2d 493, 494–95 (Tex. 1991)) (acknowledging limitations of duty and recovery).

[40] Montgomery Ward & Co. v. Scharrenbeck, 204 S.W.2d 508, 510 (Tex. 1947).

[41] *Chapman*, 445 S.W.3d at 719.

[42] *Id.* at 718.

[43] *Id.*

[44] *Id.* (emphasis added) (citations omitted).

[45] *See* Chapman Custom Homes, Inc. v. Dallas Plumbing Co., 445 S.W.3d 716, 718 (Tex. 2014) ("[A] party states a tort claim when the duty allegedly breached is independent of the contractual undertaking and the harm suffered is not merely the economic loss of a contractual benefit.").

[46] *See* Barzoukas v. Found. Design, Ltd., 363 S.W.3d 829, 837 (Tex. App.—Houston [14th Dist.] 2012, pet. denied) (explaining why the issue pertaining to construction remains unanswered). Construction contract cases are viewed differently from cases involving manufacture of a defective product, where damage to just the product itself precludes recovery in negligence:

> As this procedural history makes clear, *Pugh* applied existing economic loss rule principles governing negligence and strict liability claims by consumers against the remote manufacturer of a defective product. *Pugh* did not analyze the viability of claims asserted against a general contractor or a subcontractor. *Pugh* concluded that the economic loss rule foreclosed the homeowners' negligence and strict liability claims against product manufacturer General Terrazzo—even in the absence of privity between them—because "there was no personal injury or damage to other property that would have permitted the Pughs to assert a tort claim that would be excepted from the economic loss doctrine. In contrast to *Pugh*, Barzoukas does not aim his negligence and negligent misrepresentation claims at the remote manufacturer of an allegedly defective product. Barzoukas's claims involve Smith's asserted professional negligence in connection with approval of foundation piers that are shorter than the depth called for by the original plans and specifications. *Thus*, we must address a *different question that was left open* in *Sharyland* by addressing *whether*—in the particular home construction circumstances presented here—*the economic loss rule "precludes recovery completely between contractual strangers in a case not involving a defective product. . . ."* *Pugh* does not answer this question.

Id. at 836–37 (emphasis added) (citations omitted) (quoting Sharyland Water Supply Corp. v. City of Alton, 354 S.W.3d 407, 418 (Tex. 2011); Pugh v. Gen. Terrazzo Supplies, Inc., 243 S.W.3d 84, 94 (Tex. App.—Houston [1st Dist.] 2007, pet. denied)); *see* also Equistar Chems., LP v. Dresser Rand Co., 240 S.W.3d 864, 866, 868 (Tex. 2007) (noting the manufacturer failed to object to jury charge calling for damages to restore plan facility for failure to distinguish damages applicable to injury to product itself, which would be barred by economic loss doctrine).

[47] *Barzoukas*, 363 S.W.3d at 838 (emphasis added) (citing Sharyland Water Supply Corp. v. City of Alton, 354 S.W.3d 407, 420 (Tex. 2011); Goose Creek Consol. Indep. Sch. Dist. v. Jarrar's Plumbing, Inc., 74 S.W.3d 486, 495 (Tex. App.—Texarkana 2002, pet. denied); Thomson v. Espey Huston & Assocs., Inc., 899 S.W.2d 415, 421–22 (Tex. App.—Austin 1995, no writ)).

recovery in negligence that is not barred by the economic loss doctrine.

The Texarkana Court of Appeals reflected more directly on this issue in its holding in *Goose Creek Consolidated Independent School District v. Jarrar's Plumbing, Inc.*,[48] another plumbing case in which the owner was not barred by the economic loss doctrine from maintaining negligence claims against a subcontractor for damage due to sewage spilled in a school building:

> If the injury is only economic loss *to the subject matter of the contract itself*, the action will only sound in contract....'Economic loss has been defined as damages for inadequate value, costs of repair and replacement of the defective product, or consequent loss of profits—without any claim of personal injury or damage to *other* property.'
>
> ....
>
> The injury Goose Creek alleged was the invasion of sewage and sewer gas into the school buildings, which...constitutes an injury to property that was not the subject matter of the contract, that portion of the contract Goose Creek had with Lewis for which Lewis contracted with Jarrar's Plumbing, namely the plumbing. Therefore, the injury alleged did not constitute pure economic loss for which Goose Creek could recover only in contract.[49]

Does this mean Goose Creek Independent School District should not have recovered any damages caused to the subject of the plumbing subcontract itself? The Texarkana Court of Appeals touched on this question, but declined to answer it because the plumber did not raise the issue on appeal.

> Although the remedy Goose Creek sought for the alleged injury included the cost of repairing and replacing the plumbing, which may be pure economic loss not recoverable under tort, Jarrar's Plumbing does not raise on appeal the appropriateness of awarding such damages. We review only the issue that was raised regarding the denial of the Motion for Judgment Notwithstanding the Verdict, whether Jarrar's Plumbing owed a tort duty to Goose Creek for the alleged injury. Jarrar's Plumbing owed an independent tort duty to use reasonable care in the performance of the contract to install the plumbing so as not to injure persons or property, and Goose Creek alleged that such injury to property was caused by the failure to use such reasonable care. Therefore, Goose Creek properly maintained a tort action for negligence against Jarrar's Plumbing, and the trial court did not err in allowing such action to be maintained. This point of error is overruled.[50]

Neither the Texarkana Court of Appeals' holding in *Goose Creek*, the Houston Court of Appeals' holding in *Barzoukas*, nor the Texas Supreme Court's holding in *Chapman*, make it clear whether damage must have been to property other than that which the subcontractor worked upon. These cases, taken together, leave open the question of whether a subcontractor's negligence in causing physical injury only to the subcontractor's own work is pure economic loss, not recoverable under the economic loss doctrine, or a loss that is nevertheless recoverable because it arises out of the breach of an implied duty of good and workmanlike performance that is in and of itself entirely independent of the subcontract.

The Supreme Court of Texas's holding in *Jim Walter Homes, Inc. v. Reed* does not speak directly to this question of whether injury to a contractor's work alone is enough to overcome the economic loss doctrine.[51] In reversing an award of punitive damages to a home buyer whose claim was merely that the home purchased was not as represented by the seller, the court spoke to the fact there was no *independent* damage or injury. The court said:

> When the injury is only the economic loss to the subject of a contract itself, the action sounds in contract alone. The Reeds' injury was that the house they were promised and paid for was not the house they received. This can only be characterized as a breach of contract, and breach of contract cannot support recovery of exemplary damages.
>
> ....
>
> To support an award of exemplary damages in this case, the plaintiff must prove a distinct tortious

[48] Goose Creek Consol. Indep. Sch. Dist. v. Jarrar's Plumbing, Inc., 74 S.W.3d 486 (Tex. App.—Texarkana 2002, pet. denied).

[49] *Id.* at 494–95 (emphasis added) (quoting Bass v. City of Dallas, 34 S.W.3d 1, 9 (Tex. App.—Amarillo 2000, no pet.)) (internal quotation marks omitted).

[50] *Id.*

[51] Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617, 618 (Tex. 1986).

> injury with actual damages. The only issue on actual damages inquired as to the cost of repairing the home to the condition it was represented to be in at the time of sale.[52]

Query, if the Reeds' house had physically collapsed as a result of poor workmanship, rather than simply failed to conform to the contractual representations for its construction, would this have constituted a physical injury or damage for which damages could be sought in negligence? Perhaps.

On facts similar to those in *Barzoukas*, nearly twenty years earlier, the Austin Court of Appeals, in *Thomson v. Espey Huston & Associates, Inc.*, allowed the owner of an apartment complex to maintain negligence claims directly against a third party engineer for damages to the complex caused by the negligent design of a drainage system:

> Such damage is beyond the subject of the contract itself, distinguishing this case from Jim Walter Homes, wherein the defendant was contractually obligated to provide the entire house. . . . However, to the extent that the alleged inadequacies caused damage to parts of the property beyond Espey's contract, Thomson also has a tort claim.[53]

Clearly, where physical damage extends beyond the "subject of the contract" (whatever that phrase means), such circumstances support an independent negligence claim notwithstanding the existence of a contract because an independent duty exists not to negligently damage property.[54] However, an unanswered question remains: What if the owner's claim against a subcontractor is for physical injury or damage to only the subcontractor's work and not to "other" property? While one Texas appellate court has recognized the question, it has not been clearly answered, and remains open today.

Should the economic loss doctrine bar an owner's negligence claim against a subcontractor for physical injury to just the subcontractor's work? If a foundation is not quite as thick as it should have been, but it still holds up the house, and there is no damage, there is no claim outside of contract—it is merely not as represented. If a roof builder leaves off flashing needed to keep out the rain, but it is fixable without resulting damage to the roof decking itself, there is no claim outside of contract. If a plumber installs water lines but fails to insulate them against freezing, the cost to have the insulation properly installed is a cost to fulfill a mere contractual expectation that the lines be insulated, and there is no claim outside of contract.

However, if the foundation crumbles, or the roof collapses, or the water lines burst, then damages for the physical destruction of these elements of the structure, in addition to, and even in the absence of, any other resulting physical damage, could be recoverable by the owner in a negligence claim against the subcontractor in *addition* to, or regardless of, any other resulting damage to the rest of the structure. This is true because such damage may be said to arise out of the breach of a duty that is independent of contract. This duty to perform in a good and workmanlike manner, could support recovery in negligence because the physical damage to the work itself is a type of damage to the work that necessarily goes beyond the contractual expectations for its proper installation—it has resulted in the destruction of the work itself. It seems that such a conclusion would be entirely consistent with the Texas Supreme Court's holding in *Chapman*.

PRACTICAL ISSUES & IMPLICATIONS

Given the evolution of the economic loss doctrine under Texas common law, what should owners, design professionals, contractors, and subcontractors take into consideration in regard to the allocation of risk associated with economic losses that can be caused by the negligence of design professionals and subcontractors? How can they protect themselves? Fully answering this question would require an in-depth treatise on construction contract law, but the following general observations are offered as a starting point.

A. LIMITATIONS OF LIABILITY

Design professionals often seek to contractually limit their professional liability to their customers.[55] Now that a contractor can only assert a claim for purely economic losses from faulty design against the owner, a prudent contractor will want to know whether and to what extent the owner may have limited its right to seek recovery from

[52] *Id.* (internal citations omitted).

[53] Thomson v. Espey Huston & Assocs., Inc., 899 S.W.2d 415 (Tex. App.—Austin 1995, no writ) (internal citation omitted).

[54] *Id.*

[55] *See, e.g.*, CBI NA-CON, Inc. v. UOP Inc., 961 S.W.2d 336, 338 (Tex. App.—Houston [1st Dist.] 1997, writ denied) (quoting a design professional's contract with a customer that limits the design professional's liability).

its design professional.[56] Owners may be able to refuse to accept a contractual limitation of liability, or they may have to negotiate a limitation of the design professional's liability at a liquidated amount of damages reasonable to the risk. In recent years, the construction industry in Texas has seen significant design failures leading to major delays and economic losses on projects.[57]

If the owner and design professional do agree to set a monetary limit on the design professional's liability, the parties may consider establishing an exception to the limitation of liability. The liability limitation could be linked to the design professional's coverage under its professional liability insurance—or any project-specific excess professional liability insurance the owner may have required the design professional to procure. The liability limitation might exclude an obligation of the design professional to defend, indemnify and hold the owner harmless from and against any liability the owner incurs to a contractor as a result of the design professional's negligence.[58]

Design professionals, owners, and contractors should also be aware that waivers and limitations of liability may be on the verge of heightened judicial scrutiny in the wake of the recent holding of the Texas Supreme Court in the case of *Zachry v. Port Authority of Houston*.[59] In *Zachry*, the Texas Supreme Court held on grounds of public policy that a no-damages-for-delay clause would not be enforced to bar a contractor's damage claims for delay due to intentional interference by the owner of a construction project.[60] Waiver provisions, such as waivers of consequential damages, and even monetary limitations of liability, may come under attack on public policy grounds in situations where a party to the contract asserts the clause should shield it from liability caused even by its own intentional wrongdoing.[61] This is more likely a concern in the case of a damages waiver (i.e. an intentional relinquishment of the right to recover any damages of a certain type) as opposed to a *limitation* of liability to a liquidated amount for a category of damages otherwise recognized by the contract as recoverable. In the latter case, the public policy argument against enforcement of a limitation may yield to the counter-arguments that parties are free to contract and to become bound by their acceptance of harsh contractual terms, where the terms are clearly stated and the party sought to be bound is sophisticated.[62]

B. WARRANTY OF DESIGN

Courts may construe construction contracts to create a design warranty, expressly or impliedly, by either owner or contractor.[63] In the wake of *LAN/STV*, owners now have a greater interest in shifting responsibility for the sufficiency of design to their contractors to serve as a crosscheck on the work of their design professionals. Whether the construction contract is silent on the issue or expressly imposes warranty liability on the contractor for the sufficiency of the owner's design, the contractor may be wise to expressly limit or disclaim such liability altogether, or seek a limitation on liability for damages arising out of a failure to detect any deficiency in the designs of others. A limitation of design liability might be made to correspond to any limitation of the design professional's liability in the contract between the owner

[56] For a more extensive discussion of the considerations for drafting limitations of liability, see Richard L. Reed, *The Ultimate Survival Strategy: The Limitation of Liability Clause*, COATS ROSE, (Feb. 17–18, 2000), http://www.coatsrose.com/resources/learning-library/the-ultimate-survival-strategy-the-limitation-of-liability-clause/.

[57] *See 'Leaning Tower of South Padre' to Be Torn Down*, HOUS. CHRON., Dec. 10, 2009, http://www.chron.com/business/real-estate/article/Leaning-tower-of-South-Padre-to-be-torn-down-1532407.php (describing a failed condominium project whose foundation shifted in the sands of a Texas beach as the project neared completion, requiring implosion of the building and the halting of the condominium project after issues arose with the adequacy of the design, causing the public owner to cancel the project, pay termination damages to the contractor, and re-procure another contract for construction services after a new design was developed).

[58] Note, however, that such an obligation may not be covered as an assumption of contractual liability that falls within a contractual liability exclusion in the design professional's professional liability insurance policy, an issue discussed further infra in the context of commercial general liability insurance policies.

[59] Zachry Constr. Corp. v. Port of Hous. Auth., 449 S.W.3d 98 (Tex. 2014), *reh'g denied* (Dec. 19, 2014).

[60] *Id.* at 119; *see also* City of Houston v. R. F. Ball Constr. Co., 570 S.W.2d 75, 77 n.1 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ ref'd n.r.e) ("[One of the] . . . generally recognized exceptions [is] . . . [d]elay resulting from fraud, misrepresentation, or other bad faith on the part of one seeking the benefit of the provision.").

[61] *See Zachry*, 449 S.W.3d at 116 (citing Fairfield Ins. Co. v. Stephens Martin Paving, LP, 246 S.W.3d 653, 687 (Tex. 2008) (Hecht, J., concurring)).

[62] *See* BLACK'S LAW DICTIONARY 1717 (9th ed. 2009) ("The party alleged to have waived a right must have had both knowledge of the existing right and the intention of forgoing it."); *see, e.g.*, CBI NA CON, Inc. v. UOP Inc., 961 S.W.2d 336, 338 (Tex. App.—Houston [1st Dist.] 1997, writ denied) (providing a contract between sophisticated corporations that clearly stated the terms of the limitation).

[63] *See* United States v. Spearin, 248 U.S. 132, 137 (1918) (holding that the owner implied a warranty that if specifications were complied with, the sewer in question would have been adequate). The general contractor, Spearin, contracted with the U.S. Government to build a dry dock and in the process, relocate a sewer line. This new sewer line burst, causing substantial delays and the contractor was terminated. Since the contract supplied the dimensions and location for the new sewer line, the Court found that the U.S. Government had impliedly warranted that the new sewer design was sufficient and breached that warranty. *Id.* at 137.

The Texas Supreme Court initially addressed this issue, reaching a different conclusion, in *Lonergan v. San Antonio Loan & Trust Co.* In *Lonergan*, San Antonio Loan & Trust supplied the specs, and when construction was nearly complete, the structure collapsed. Lonergan v. San Antonio Loan & Trust Co., 101 Tex. 63, 104 S.W. 1061, 1064 (1907). The Court held that the owner did not impliedly warrant the sufficiency of the design specifications by submitting them to contractors for bidding or by entering into a contract for construction in accordance with those same plans and specifications unless such a guaranty was expressed in the language of the contract. *Id.* at 1065. In *Alamo Community College District v. Browning Construction Co.,* the court reinforced the holding in Lonergan. Alamo Cmty. Coll. Dist. v. Browning Constr. Co., 131 S.W.3d 146, 155 (Tex. App.—San Antonio 2004, pet. denied). The Fourth Court of Appeals overruled ACCD's argument that it had no duty under its contract with Browning to assume liability for design errors and found that the contract did unambiguously assume responsibility for design errors. *Id.*

and its design professional. Also, most subcontracts pass down a contractor's assumed risk to subcontractors, so they too may have a similar interest in disclaiming or limiting their own design liability. Additionally, a contractual warranty obligation to repair a defect appearing within a certain period of time, regardless of the proper performance of the work, gives rise to a form of liability assumed by contract that is beyond that imposed at common law.[64] Assumption of such a risk by contract may involve liability for which damages are excluded from insurance coverage as a form of contractual liability that otherwise would not have existed at common law.[65]

C. CONTRACTUAL STANDARDS OF CARE AND INSURANCE COVERAGE

As the Texas Supreme Court observed in *LAN/STV*, its holding will likely cause parties in the construction industry to focus on "who will buy business protection insurance."[66] The contractual duties and warranties assumed in contracts by contractors and design professionals give rise to significant insurance coverage implications. A prime example is a standard of care provision, often used in construction contracts (for construction services and professional design services) to impose a special, heightened standard of care to which the service provider will be held in fulfilling its responsibility under the contract. For example, assume a contractor or design professional agrees to perform under a standard of care equivalent to that practiced by firms with a national reputation, with revenues not less than $100 million annually, and who have successfully completed comparable projects valued at greater than $80 million. This is a heightened standard of care. At common law, a contractor's duty is to perform its work in a good and workmanlike manner,[67] and a design professional's duty is to perform the design services with that degree of skill and care exercised by a reasonable, prudent design professional rendering services of the same nature in the same locale on projects of comparable complexity.[68]

If a contractual standard of care provision sets a higher standard than the duty of ordinary or reasonable care imposed by common law, this may defeat insurance coverage under liability policies that contain a contractual liability exclusion. This issue has been addressed by the Supreme Court of Texas in recent cases, the most recent being *Ewing v. Amerisure*.[69] The court in *Ewing* first discussed the lack of any distinction between the contractor's contractual obligation and its common law duty[70] and, finding the contract imposed no higher duty, the Court found in favor of coverage for the contractor's liability for physical damage to its work:

64 *See* Ewing Constr. Co. v. Amerisure Ins. Co., 420 S.W.3d 30, 36–37 (Tex. 2014) (discussing this "assumption of liability" under an insured contract).

65 *See infra* Section IV. C.

66 LAN/STV v. Martin K. Eby Constr. Co., 435 S.W.3d 234, 248 (Tex. 2014). For example, consider the evolving usage of Building Information Modeling ("BIM"). *See generally* Howard W. Ashcraft, *Building Information Modeling: A Framework for Collaboration*, CONSTRUCTION LAW., Summer 2008, at 5 (giving an overview of BIM technology and its legal implications). It has many benefits to designers, contractors and owners alike, not the least of which is maximizing efficiency and minimizing costs, and it is becoming more and more commonplace on large civil and commercial projects involving collaborative contracting methodologies. Its use extends well beyond the design process to construction scheduling, ordering materials, operating and maintaining the facility after it is completed, and subsequent modifications and additions to the facility. Contractors participate in the design development phase by conducting "constructability reviews" of the design and often become involved in making contributions to the BIM model. Such contributions can constitute the practice of engineering, for which a license is required, and maintaining professional liability insurance for such activities is wise. Further, these constructability reviews may cause the contractor to assume some liability for warranting the sufficiency of the design contribution to the model.

67 This duty has been defined as "that quality of work performed by one who has the knowledge, training, or experience necessary for the successful practice of a trade or occupation and performed in a manner generally considered proficient by those capable of judging such work." Centex Homes & Centex Real Estate Corp. v. Buecher, 95 S.W.3d 266, 269 (Tex. 2002) (discussing the implied warranty of good workmanship found in *Humber v. Morton* (citing Humber v. Morton, 426 S.W.2d 554, 555 (Tex. 1968))); *see also* Comm. on Pattern Jury Charges, State Bar of Tex., *Texas Pattern Jury Charges: Business, Consumer, Insurance & Employment* PJC 102.12 (2012) ("A good and workmanlike manner is that quality of work performed by one who has the knowledge, training, or experience necessary for the successful practice of a trade or occupation and performed in a manner generally considered proficient by those capable of judging such work.").

68 This is articulated in Section 2.2 of the AIA's -B101 Standard Form of Agreement between the owner and the architect as follows:

> The Architect shall perform its services consistent with the professional skill and care ordinarily provided by architects practicing in the same or similar locality under the same or similar circumstances. The Architect shall perform its services as expeditiously as is consistent with such professional skill and care and the orderly progress of the Project.

AIA Document B101-2007, Standard Form of Agreement Between Owner and Architect, § 2.2.

69 Ewing Constr. Co. v. Amerisure Ins. Co., 420 S.W.3d 30 (Tex. 2014).

70 *Id.* at 37 ("TMISD's allegations that Ewing failed to perform in a good and workmanlike manner are substantively the same as its claims that Ewing negligently performed under the contract because they contain the same factual allegations and alleged misconduct. We have defined "good and workmanlike" as "that quality of work performed by one who has the knowledge, training, or experience necessary for the successful practice of a trade or occupation and performed in a manner generally considered proficient by those capable of judging such work." (quoting Melody Home Mfg. v. Barnes, 741 S.W.2d 349, 354 (Tex.1987))); *see* 20801, Inc. v. Parker, 249 S.W.3d 392, 398 (Tex.2008) (defining negligence as the failure to use ordinary care, that is, failing to do that which a reasonable person or "provider of the defendant's type" would "have done under the same or similar circumstances"). Based on these definitions, TMISD's claims that Ewing failed to perform in a good and workmanlike manner and its claims that Ewing negligently performed under the contract are substantively the same. *See* Coulson v. Lake L.B.J. Mun. Util. Dist., 734 S.W.2d 649, 651 (Tex.1987) ("We are unable to discern any real difference between the District's claim that Coulson's efforts were not good and workmanlike and did not meet the standards of reasonable engineering practice and its claim that Coulson was negligent in his performance of professional services."); *see also Ewing Constr. Co.*, 420 S.W.3d at 37 ("And as Ewing points out, it had a common law duty to perform its contract with skill and care.").

> [W]e conclude that a general contractor who agrees to perform its construction work in a good and workmanlike manner, without more, does not enlarge its duty to exercise ordinary care in fulfilling its contract, thus it does not "assume liability" for damages arising out of its defective work so as to trigger the Contractual Liability Exclusion.[71]

Ewing has since been followed by the Fifth Circuit Court of Appeals in *Crownover v.Mid-Continent Casualty Co*.[72] The federal appeals court withdrew its original decision that a contractual liability exclusion negated coverage for property damage since the contractor's obligation to "promptly correct work...failing to conform to the requirements of the Contract" went beyond an agreement to repair damage resulting from a failure to exercise reasonable care in performing the work or agreeing to perform the work in a good and workmanlike manner.[73] The court (after establishing a covered occurrence of property damage) declined to adopt the district court's reasoning that an express warranty of workmanship necessarily supersedes the contractor's implied warranty of good and workmanlike performance:

> [U]nder both *Ewing* and *Gilbert*, Mid[-] Continent must show that Arrow's express warranty to repair effected an assumption of liability *that was not already covered by general law*. The key question, therefore, becomes whether the source of adjudicated liability—the express duty to repair—*expanded* Arrow's obligations. We hold that it did not.[74]

In its opinion on rehearing, the Court held:

> Thus, there were three elements of paragraph 23.1 that could potentially have triggered the contractual-liability exclusion: (1) it constituted an *express* rather than implied warranty; (2) it was a duty to *repair* rather than construct; (3) it referred to performance in conformity with the *contract* documents rather than simple competent performance. None of these factors is dispositive and we conclude that not one of them (nor all of them together) extended Arrow's liability beyond its liability under general law.[75]

Owners, design professionals, and contractors alike should consider ways to preserve coverage that could be lost by expanding the level or standard of care of a design professional or contractor in regard to assuming liability for deficiencies in the construction documents prepared by the Owner's design professional. However, for coverage preservation purposes it may be possible to contract for a heightened standard of care with respect to damages for purely economic losses for which recovery against a stranger would be precluded by the economic loss doctrine anyway (e.g. increased cost of completing a project), but still retain a common law (lower) standard of care with respect to claims for damages that might otherwise be recoverable in negligence and insured at common law (e.g. damages for injury or physical property damage).[76]

D. CONTINGENT PAYMENT RIGHTS

Just as it is a matter of concern for contractors, subcontractors should be equally concerned whether an owner is able to pursue claims for faulty design against the owner's design professional. Since the contractor (and only the contractor) can only pursue claims against the owner (and only the owner) to pay for purely economic losses for failure of a contractual expectation that can be attributed to the negligence of the owner's design professional, contingent payment clauses found in most subcontracts become all the more risky for subcontractors. Contingent payment clauses are still enforceable under Texas law.[77] A subcontractor may be left without remedy if the subcontractor's right of recovery is against the contractor who cannot in turn collect from a defaulting owner.

[71] *Ewing Constr. Co.*, 420 S.W.3d at 38 (Tex. 2014).

[72] Crownover v. Mid-Continent Cas. Co., 772 F.3d 197 (5th Cir. 2014).

[73] *Id.* at 199.

[74] *Id.* at 207 (emphasis added).

[75] *Id.* at 207 (emphasis added).

[76] For example, a subcontract that imposes a high standard of care might further state:

> Notwithstanding any other provision in this Agreement, nothing herein shall be construed or deemed to alter or expand the Subcontractor's common law duty to the General Contractor or others with respect to liability for, or the duty to indemnify, defend or hold any party harmless under any other provision of this Agreement, with respect to any claim or liability for bodily injury or property damage, for which the Subcontractor's standard of care hereunder shall be deemed and construed to be no greater than that imposed upon the Subcontractor by common law.

[77] *See* Tex. Bus. & Com. Code § 35.521 (explaining that the statutory restrictions on contingent payment clauses do not apply to all construction contracts and only applies to specific enumerated categories of construction contracts); Rick Reed, *Following the Money: Managing The Risk Of Owner Non-Payment Under The New Texas Statutory Restrictions On Contingent Payment Clauses*, COATS/ROSE, http://www.coatsrose.com/resources/learning-library/following-the-money/ (last visited Dec. 19, 2014) (explaining that the contingent payment clauses are now governed by statute); see also Sheldon L. Pollack Corp. v. Falcon Indus. Inc., 794 S.W.2d 380, (Tex. App.—Corpus Christi 1990, writ denied) (enforcing a contingent payment clause, but only for "the timing of payment, not the liability of the general contractor to pay the subcontractor for money owed under the contract").

Where a subcontractor suffers a purely economic loss of its contractual expectation due to errors in the construction documents prepared by the owner's design professional, the subcontractor will want to make the contractor duty-bound to pursue the subcontractor's claims on its behalf, and be cognizant of strategies involving assignments of claim rights and pass-through claims.[78]

E. CONDITIONAL ASSIGNMENTS AND THIRD PARTY BENEFICIARY STATUS

Owners will want to consider obligating a contractor to provide for an optional, conditional right of the Owner to assume a subcontract by collateral assignment, or to assert claims on the subcontract, directly against the subcontractor upon the owner's election of third party beneficiary status. Upon taking an assignment of a subcontract, or being classified as a third party beneficiary to the subcontract, the owner may be subjected to subcontractor claims.[79] However, such contractual provisions can be made conditional, so that the owner's rights only become effective upon election by the owner to do so, usually upon the bankruptcy or default of the contractor.

F. DISPUTE RESOLUTION MECHANISMS

Since construction contracts are now likely to set the boundaries for resolution of claims for purely economic losses in the failure of contractual expectations, all project participants have a greater interest in ensuring efficient resolution of disputes. If different dispute resolution mechanisms apply to different contractual relationships, any participant may find it must simultaneously prosecute and defend claims in separate, parallel proceedings.[80] Avoiding this conundrum requires negotiation of consistent dispute resolution terms at all levels, which may not always be possible.[81]

CONCLUSION

Before accepting a contract to build in accordance with another's design on the expectation that the design will be correct and complete, one must be careful to allocate, limit, insure or otherwise transfer and manage its exposure to economic losses that may result from insufficiency of the design and the failure of its contractual expectation. The law in Texas is now clear that, absent narrow exceptions, each construction project participant must manage its risk and its right to recover for such losses within the four corners of its own contract and its own insurance policies. Any project participant would be wise to enter into a construction contract presuming that only under its own contract may there be a recovery of purely economic losses caused by another project participant who is a stranger to the contract.

[78] *See* Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 526 (2009) (explaining three areas of concern regarding the economic loss rule).

[79] *See id.* ("[T]he law of tort liability for purely economic loss is 'much less well settled and less uniform than one might wish it to be.'" (citing Herbert Bernstein, *Civil Liability for Pure Economic Loss Under American Tort Law*, 46 AM. J. COMP. L. 111, 125 (1998)).

[80] *See* In re Kellogg Brown & Root, Inc., 166 S.W.3d 732, 741–42 (Tex. 2005) (holding that under the doctrine of direct benefits estoppel, a non-signatory, second-tier subcontractor's claim based on quantum meruit, was not required to be arbitrated).

[81] For an example of a Joinder Agreement from a Bank of America contract *see Sample Business Contracts*, ONECLE, http://contracts.onecle.com/annies/bank-of-america-joinder-2013-11-22.shtml (last visited Dec. 27, 2014). In this Joinder Agreement, the Bank purports that it "is willing to allow the Additional Borrower to become a 'Borrower' pursuant to the terms of the Loan Agreement and . . . [if t]he Additional Borrower hereby acknowledges, agrees and confirms that, by its execution of this Agreement, effective the date hereof, the Additional Borrower will be deemed to be a party to the Loan Agreement and a 'Borrower' for all purposes of the Loan Agreement." *Sample Buisness Contracts*, ONECLE, http://contracts.onecle.com/annies/bank-of-america-joinder-2013-11-22.shtml (last visited Dec. 27, 2014).