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Commonwealth of Kentucky

Court of Appeals

NO. 2008-CA-002395-MR
AND
NO. 2009-CA-001123-MR

CINCINNATI INSURANCE COMPANIES — APPELLANT

v.

APPEAL FROM CAMPBELL CIRCUIT COURT
HONORABLE JULIE REINHARDT WARD, JUDGE
ACTION NO. 08-CI-1375 & 09-CI-00064

STAGGS & FISHER CONSULTING ENGINEERS, INC. AND OMNI ASSOCIATES, LTD. — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: DIXON, LAMBERT AND TAYLOR, JUDGES.

DIXON, JUDGE: Appellant, Cincinnati Insurance Companies, appeals from an order of the Campbell Circuit Court dismissing its action against Appellees, Staggs & Fisher Consulting Engineers, Inc. ("S & F") and Omni Associates, Ltd., for

failure to state a claim upon which relief can be granted. For the reasons set forth herein, we affirm.

This matter concerns a construction project in Nunn Hall on the campus of Northern Kentucky University. The Commonwealth of Kentucky contracted with Omni Associates to design the project who, in turn, subcontracted with S & F to also work on the project. The Commonwealth separately contracted with Messer Construction for the construction of the project. Messer Construction thereafter entered into a sub-contract with Banta for the electrical work on the project. In January 2007, Nunn Hall incurred damage that was attributed to Banta's electrical work. As a result, Banta's insurer, Cincinnati Insurance Companies, paid the Commonwealth $18,460.19 for the property damage.

In September 2008, Cincinnati filed the instant action in the Campbell Circuit Court against Omni and F & S, claiming that it was their negligent installation of a faulty transformer that caused the damage to Nunn Hall. Cincinnati sought to recover the amount it was required to pay on behalf of Banta. Rather than filing an answer, Omni and F & S filed a motion to dismiss for failure to state a claim under CR 12.02, arguing that the economic loss rule precluded the legal action. Following a hearing, the trial court granted the motion and dismissed Cincinnati's complaint. In so doing, the trial court held, "Kentucky adopted the economic loss doctrine in *Real Estate Market, Inc. v. Franz*, [885 S.W.2d 921 (Ky. 1994)]. Kentucky expressly joined the majority rule prohibiting tort recovery for economic losses absent contractual privity."

Cincinnati thereafter filed an appeal in this Court. On July 17, 2010, on this Court's own motion, the matter was held in abeyance pending the Kentucky Supreme Court's decision in *Giddings & Lewis, Inc. v. Industrial Risk Insurers*, 348 S.W.3d 729 (Ky. 2011). Such opinion became final in June 2011, and the matter herein was returned to the active docket.

On appeal, Cincinnati argues that the trial court erred in granting the motion to dismiss. As it did in the trial court, Cincinnati contends that Kentucky has not, in fact, adopted the economic loss rule. However, even if such rule has explicitly been adopted, Cincinnati maintains that it does not apply in this case because of the existence of a "damaging event." In light of the decision in *Industrial Risk Insurers*, we must find that Cincinnati's claims are without merit.

In ruling on a motion to dismiss under CR 12.02, "a court should not dismiss for failure to state a claim unless the pleading party appears not to be entitled to relief under any state of facts which could be proved in support of his claim." *Weller v. McCauley*, 383 S.W.2d 356, 357 (Ky. 1964). As noted by our Supreme Court in *Fox v. Grayson*, 317 S.W.3d 1, 7 (Ky. 2010),

> A motion to dismiss for failure to state a claim upon which relief may be granted admits as true the material facts of the complaint. So a court should not grant such a motion unless it appears the pleading party would not be entitled to relief under any set of facts which could be proved.... Accordingly, the pleadings should be liberally construed in the light most favorable to the plaintiff, all allegations being taken as true. This exacting standard of review eliminates any need by the trial court to make findings of fact; rather, the question is purely a matter of law. Stated another way, the court must ask if the facts

> alleged in the complaint can be proved, would the plaintiff be entitled to relief? Since a motion to dismiss for failure to state a claim upon which relief may be granted is a pure question of law, a reviewing court owes no deference to a trial court's determination; instead, an appellate court reviews the issue de novo. (Citations omitted).

The economic loss rule prevents a commercial purchaser of a product from suing in tort to recover for economic losses arising from the malfunction of the product itself, limiting the recovery of such damages, if at all, to contract law. In other words, the rule prohibits purchasers of products from recovering purely economic damages under most tort theories. Although the rule originally applied to products liability cases, it has spread into the realm of construction litigation. With respect to construction law,

> "[e]conomic loss," in its broadest sense, means pecuniary loss of bargained-for economic expectations resulting from the failure of a product or structure to function as expected. In the context of construction, "economic loss" includes the cost to repair or replace defective materials, damage to a structure, diminution in value of a damaged structure not repaired, loss of use or delay in utilizing property for its intended purposes, and related lost profits, lost revenue, and costs.
>
> Economic loss damages traditionally have been recoverable for contract breach because such damages lie at the heart of contractual expectations and reliance. Absent contractual rights and privity, however, recovery for economic loss under tort theories is legally justified only when economic loss is a consequence of a tortious invasion of (1) legally cognizable personal or property rights that causes personal injury or property damage to "other property" and results in economic loss, or (2) a legally protected "special relationship." Third parties lacking contractual rights have no legal basis for

> recovery of economic loss on theories of tortious conduct that cause neither personal injury nor damage to property "other" than the defective property itself.

6 *Bruner & O'Connor Construction Law* § 19:10 (2012).

In his concurring opinion in *Presnell Const. Managers, Inc. v. EH Const., LLC,* 134 S.W.3d 575 (Ky. 2004), Justice Keller engaged in an in-depth discussion of the rule:

> The "economic loss rule" is a judicially created doctrine that "marks the fundamental boundary between contract law, which is designed to enforce the expectancy interests of the parties, and tort law, which imposes a duty of reasonable care and thereby encourages citizens to avoid causing physical harm to others." "The crux of the doctrine is not privity but the premise that economic interests are protected, if at all, by contract principles, rather than tort principles." Although originally rooted primarily in product liability cases to protect manufacturers from tort liability for damage that is limited to the product itself, the economic loss rule "has evolved into a modern, general prohibition against tort recovery for economic loss." "In its broadest formulation, the economic loss rule prohibits tort recovery in negligence or products liability 'absent physical injury to a proprietary interest.'" "Under this sweeping rule, recovery of economic loss is foreclosed when a product or service falls short of an expected level of quality yet causes no personal injury or property damage."

Id. at 583-84 (Footnotes and citations omitted.). Significantly, Justice Keller pointed out that while no Kentucky appellate decision at that time had expressly articulated or adopted the economic loss rule in a published opinion, both courts had applied the rule's principles without identifying their source. *Falcon Coal Co. v. Clark Equipment Co.*, 802 S.W.2d 947 (Ky. App. 1990); *Real Estate Market,*

Inc. v. Franz, 885 S.W.2d 921 (Ky. 1994), *overruled in part by Industrial Risk Insurers*, 348 S.W.3d at 741; s*ee also* Thomas R. Yocum & Charles F. Hollis III, *The Economic Loss Rule in Kentucky: Will Contract Law Drown in a Sea of Tort?*, 28 N. KY. L. REV. 456, 467 (2001). Thus, while we agree with Cincinnati that the trial court erroneously stated that the rule was *explicitly* adopted in the *Franz* decision, the result is the same as it is clear that such has been consistently applied over the years.

Regardless, in *Giddings & Lewis, Inc. v. Industrial Risk Insurers*, 348 S.W.3d 729 (Ky. 2011), the Kentucky Supreme Court formally adopted the economic loss rule. In so doing, the Court held that

> This rule recognizes that economic losses, in essence, deprive the purchaser of the benefit of his bargain and that such losses are best addressed by the parties' contract and relevant provisions of Article 2 of the Uniform Commercial Code. *See* Kentucky Revised Statutes (KRS) 355.2–101 et seq. Like the United States Supreme Court, we believe the parties' allocation of risk by contract should control . . . . Thus, costs for repair or replacement of the product itself, lost profits and similar economic losses cannot be recovered pursuant to negligence or strict liability theories but are recoverable only under the parties' contract, including any express or implied warranties.

Id. at 738.

It is undisputed that the Commonwealth's contracts with Omni and S & F are entirely separate from its contracts with Messer and Banta. As such, there can be no contractual relationship or privity between Banta and either Omni or S & F. And while Omni and S & F owed certain contractual duties to the

Commonwealth, neither can be liable to Banta or Cincinnati under the facts herein. As the subrogee, Cincinnati stepped into the shoes of Banta. *Government Employees Ins. Co. v. Winsett*, 153 S.W.3d 862, 864 (Ky. App. 2004). Accordingly, since Banta would be prohibited by the economic loss rule from pursuing a negligence claim for economic damages against Omni or S & F, Cincinnati is similarly prohibited. *Wine v. Globe American Casualty Co*., 917 S.W.2d 558, 566 (Ky. 1996).

Cincinnati next argues that even if the economic loss rule has been adopted in Kentucky, such does not apply to the facts herein due to the existence of a "damaging event." Specifically, as it did in the trial court, Cincinnati relies upon an unpublished decision of this Court in *Hack v. Lone Oak Development, Inc.*, 2007-CA-001431-MR (June 13, 2008), wherein a homeowner sued a subdivision developer and contractor who installed a faulty drainpipe that subsequently resulted in damage to the homeowner's property. Although the parties did not dispute that there was no contractual privity, a panel of this Court concluded that the economic loss rule did not bar the negligence action. Relying upon language in *Franz*, the panel determined that tort recovery was contingent upon damage from a destructive occurrence as contrasted with economic loss related solely to diminution in value, even though, as to property damage, both may be measured by the cost of repair. In other words, damages were not limited to the property itself so long as there was the existence of a "damaging event." Cincinnati alleges that the failure of the transformer constituted a damaging event and thus, based on

Hack, its claim against Omni and S & F is not barred for lack of privity. We must disagree.

At the outset, we would note that the our Supreme Court denied discretionary review and ordered the *Hack* decision not to be published, thus calling into question its already limited persuasiveness. Furthermore, in the *Industrial Risk Insurers* case, the Court explicitly rejected any destructive or calamitous exception to the economic loss rule.

> [I]t appears that a majority of our sister courts do not recognize the exception, just as the U.S. Supreme Court declined to do in [*East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 870, 106 S.Ct. 2295, 90 L.Ed.2d 865 (1986)] . . . .
> . . .
>
> Having thoroughly considered the "calamitous event" rationale and its application in practice, we decline to adopt it as an exception to Kentucky's economic loss rule. To the extent *Franz's* alluded-to limitation of *Falcon Coal* can be read to suggest that a commercial purchaser can recover economic losses under a strict liability theory if a destructive event damages the product itself, *Franz* is hereby overruled.

Industrial Risk Insurers, 348 S.W.3d at 739-741*; see also East River*, 476 U.S. at 870, 106 S.Ct. at 2302 ("Even when the harm to the product itself occurs through an abrupt, accident-like event, the resulting loss due to repair costs, decreased value, and lost profits is essentially the failure of the purchaser to receive the benefit of its bargain—traditionally the core concern of contract law."). Therefore, Cincinnati's claim that the economic loss rule is not applicable must fail.

For the reasons set forth herein, the order of the Campbell Circuit Court dismissing Cincinnati's complaint is affirmed.

ALL CONCUR.

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