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Economic Loss Doctrine Gains Viability as Defense to Financial Claims

By Iram P. Valentin and Rina Bersohn

New Jersey federal courts actively utilize the "economic loss doctrine" to weed out tort claims where the legal obligations at issue are established by the parties' direct contractual relationship. See *SRC Construction Corp. of Monroe v. Atlantic City Hous. Auth.,* 935 F. Supp. 2d 796, 800-01 (D.N.J. 2013) (where the court predicted that the New Jersey Supreme Court would not apply the doctrine to a situation in which the parties did not have a direct contractual relationship).

Generally, the doctrine provides that where the scope of liability is defined by the obligations assumed in a contract, remedies in tort are not available, unless an independent duty is also owed. *Saltiel v. GSI Consult.,* 170 N.J. 297, 316 (2002). Unlike their federal counterparts, New Jersey state courts infrequently apply the doctrine. However, the recent application of the doctrine by New Jersey federal courts in financial services cases may breathe new life into the defense.

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Origin of the Economic Loss Doctrine

The doctrine is a species of products liability law. See "The Economic Loss Rule in NJ and the 'Integrated Product' Doctrine" (N.J.L.J., Dec. 10, 2014). The case often cited as establishing the doctrine is *Seely v. White*

Valentin is a partner with Kaufman Dolowich & Voluck in Hackensack. His practice focuses on professional liability defense, financial services litigation and complex civil litigation. Bersohn is an associate in the firm's New York City office, concentrating her practice in business and financial services litigation.

Motor Co., 45 Cal.2d 9 (1965), in which the court held that a manufacturer may be held liable on a negligence theory for physical injuries resulting from defects in his goods that do not meet a certain standard of care, but it cannot be held liable for the level of performance of its products in a consumer's business unless the manufacturer agrees in advance that the product is designed to meet the consumer's demands. Thus, in a negligence action, a manufacturer's liability would be limited to physical injuries caused by a defective product but would not include economic losses. Id. at 18.

New Jersey first adopted the doctrine in 1985 in *Spring Motors v. Ford Motor Co.,* 98 N.J. 555 (1985), where the New Jersey Supreme Court held that commercial buyers who sought damages for economic losses resulting from the purchase of defective goods could only recover from a seller and a remote supplier under a UCC breach of warranty theory but not under strict liability or negligence theories. The Supreme Court rationalized that a buyer's economic expectations are protected by the UCC and are not entitled to additional protection under negligence principles. Id. at 581. Since a party's duties in a commercial transaction are set forth in a contract, permitting the opposing party to also recover under a tort theory of liability results in a double recovery.

Slow Application by NJ State Courts

Since that time, New Jersey state courts have sparingly applied the doctrine, resulting in approximately 15 reported and unreported decisions. In *New Mea Constr. Corp. v. Harper,* 203 N.J. Super. 486 (1985), the Supreme Court held that a counterclaim for negligent supervision of the construction of a home due to use of materials that were not of the quality specified in the contract is a contract-based claim rather than a negligence claim. In *Saltiel v. GSI Consultants,* 170 N.J. 297 (2002), an architect filed an action against a turf-grass corporation for negligent design and negligent misrepresentation. The court held that these causes of action were not tort-based, as they arose out of the contract between the architect and the company regarding athletic field specifications. The Supreme Court held that a tort remedy does not arise from a contractual relationship unless the breaching party owes an independent duty that is imposed by New Jersey law. The Supreme Court further noted that physicians, attorneys and insurance brokers generally owe such independent duties of care. Consequently, New Jersey state and federal courts generally decline to apply the doctrine to bar claims against these classes of professionals, although the federal courts more broadly apply the doctrine.

Active Application by NJ Federal Courts

New Jersey federal courts have more actively applied the doctrine, resulting in approximately 155 decisions, 51 of which are reported. Further, the New Jersey District Court has been more willing to expand the application of the doctrine outside of the products liability context. For example, *LM Insurance v. All-Ply Roofing Co.,* 2015 WL 333469, involved a dispute between an insurer and a corporation over workers' compensation premiums. The district court granted a motion to dismiss the defendant's counterclaim for negligent misrepresentation, finding that the counterclaim did not assert the existence of an independent duty imposed by law separate and apart from the parties' contractual duties. In *Bracco Diagnostics v. Bergen Brunswig Drug Co.,* 226 F. Supp. 2d 557 (D. N.J. 2002), the district court held that the doctrine barred a manufacturer's claim against a distributor for common-law fraud.

Emerging Application in Cases Concerning Financial Services

Several recent New Jersey federal district court decisions have applied the doctrine to the financial services context. For example, in *Greenberger v. Varus Ventures et al.*, 2014 WL 6991993 (D.N.J.), the district court found that the plaintiffs' negligence claim was barred by the doctrine, as the claim arose out of a defendant's failure to perform in accordance with the parties' agreement. In *Greenberger*, the plaintiffs alleged that the defendants induced them to invest retirement funds in a sham financial vehicle. Specifically, the plaintiffs alleged that the defendant financial advisors represented that they were creating an investment fund that could be held in individual retirement accounts (IRAs) and that the investment fund would pay all administrative and custodial expenses associated with maintaining the IRAs. They also alleged that the financial advisors failed to invest their funds as promised, failed to properly form the investment fund, and failed to pay the administrative and custodial fees for their IRAs. One of the defendants filed a motion to dismiss, or,

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in the alternative, motion for a more definite statement, with respect to the contract and quasi-contract claims, tort claims and fraud claims.

The court found that an action for breach of contract was properly pleaded. However, the court dismissed with prejudice the negligence claim as being barred by the doctrine. The court noted that under New Jersey law, "the economic loss doctrine prohibits plaintiffs from recovering in tort economic losses to which they are entitled only by contract." Id. (citing *Arcand v. Brother Int'l Corp.*, 673 F. Supp. 2d 282, 308 (D.N.J. 2009); *Saltiel*, *supra*.). The district court found that the claims relating to mismanagement arose out of the moving defendant's failure to perform in accordance with the parties' contract.

The New Jersey district court also has applied the doctrine to corporate defendants. For example, in *American Fin. Resources v. Countrywide Home Loans*, 2013 WL 6816394 (D.N.J.), defendant Countrywide filed a motion to dismiss a first amended complaint. Plaintiff AFR originates mortgage loans, pools them, and then sells them to investors. It services some of its pooled loans and subcontracts the servicing of others. AFR subcontracted the servicing of some of its pooled loans to Countrywide pursuant to a written agreement. AFR commenced an action against Countrywide alleging breach of contract and gross negligence, among other claims. In considering the applicability of the doctrine to AFR's tort claims, the court quoted a New Jersey state court decision:

> [T[he purpose of a tort duty of care is to protect society's interest in freedom from harm, i.e., the duty arises from policy considerations formed without reference to any agreement between the parties [ ] whereas [a] contractual duty, by comparison, arises from society's interest in the performance of promises.

Spectraserv v. Middlesex Cnty. Util. Auth., 2013 WL 4764514 at *6 (N.J. Super. L.) (internal quotations omitted).

Thus, whether a negligence claim is barred by the doctrine depends on whether a duty exists separate and apart from any contractual duties. Since the contract at issue required Countrywide to comply with "the standard of care employed by prudent mortgage servicers" and to "compl[y] with all federal, state and local laws, ordinances, rules and regulations," the court found that the contract clearly delineated Countrywide's obligations and barred AFR's negligence claims. See also *Scherillo v. Dun & Bradstreet*, 2011 WL 2610134 (D.N.J.) (barring negligence and negligent misrepresentation claims against Dun & Bradstreet for allegedly failing to disclose that one of the companies' executives had been convicted of securities fraud).

Conclusion

The district court cases discussed above suggest that where allegations of financial misconduct are rooted in contract, New Jersey federal courts will not condone a plaintiff's attempt to "enhance the benefit of the bargain [it] contracted for with defendant…" by permitting the plaintiff to also seek damages in tort. *Saltiel*, 170 N.J. at 316. On the other hand, the doctrine will not bar claims against professionals who owe an independent duty of care separate from their contractual undertakings. This distinction raises an interesting substantive and, perhaps, mechanical, issue. "The question of whether a duty exists is a matter of law properly decided by the court, not the jury, and is largely a question of fairness or policy." *Wang v. Allstate Ins. Co.*, 592 A.2d 527, 534 (N.J. 1991) (citations omitted). Where the application of the doctrine is at issue, courts first should determine whether any independent duties exist outside the contract. If not, then the doctrine could apply. ■