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CONTRACT LAW

THE ECONOMIC LOSS RULE & UCC SECTION 36-2-719

In *Bishop Logging Co. v. John Deere Industrial Equipment Co.*[1] the South Carolina Court of Appeals held that John Deere's statements about the future performance of its equipment in Bishop's swamp logging operation were statements of opinion, not present fact, and thus, the statements were not actionable under either fraud or negligent misrepresentation theories.[2] Additionally, the court held that the "economic loss rule" operates in the commercial arena. That is, when sophisticated parties carry out a transaction governed by a contract, the rule will bar recovery in a subsequent action for negligent misrepresentation when the damage complained of is purely economic.[3] The court also held that when a seller fails to perform its obligation to "repair or replace" within a reasonable time according to an exclusive limited warranty provision, it thereby deprives the buyer of a substantial benefit of the bargain. As a result, the exclusive remedy fails of its essential purpose, and the buyer gains a right to resort to other remedies under the UCC.[4] Finally, the court held that a separate warranty provision excluding consequential damages will not be given independent effect when the parties contract under the premise of "certainty of repair." The rationale is that a seller's failure to repair or replace materially alters the balance of risks agreed upon by the parties.[5]

Bishop Logging Company purchased from John Deere Industrial Equipment Company several items of heavy equipment for use in a pioneering, swamp logging operation.[6] Despite having modified the equipment for use in a swamp environment, John Deere extended its standard "New Equipment Warranty" to the machinery. The warranty (1) disclaimed all other express and implied warranties, (2) limited the remedies available to Bishop Logging to repair or replacement of defective equipment, (3) explicitly excluded consequential damages, and (4) did not warranty the suitability of the equipment for any particular purpose.[7]

The equipment never proved satisfactory in the swamp logging operation. Mechanical problems arose frequently, and John Deere eventually made more

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1. ___ S.C. ___, 455 S.E.2d 183 (Ct. App. 1995).
2. *Id.* at ___, 455 S.E.2d at 188-89.
3. *Id.* at ___, 455 S.E.2d at 189.
4. *Id.* at ___, 455 S.E.2d at 191.
5. *Id.* at ___, 455 S.E.2d at 192-93.
6. *Id.* at ___, 455 S.E.2d at 185-86.
7. *Id.* at ___, 455 S.E.2d at 186, 190. The obvious implication was that the dealer had no authority to warranty the equipment's performance in a swamp environment.

than $110,000 in warranty repairs. John Deere was unable to effect any sort of permanent fix. Consequently, Bishop Logging was unable to meet production goals and sued John Deere. Bishop Logging alleged fraud, negligent misrepresentation, and breach of express warranty.[8] At trial, the jury found against John Deere on each claim. The South Carolina Court of Appeals reversed as to the fraud and negligent misrepresentation claims and affirmed as to liability for breach of warranty.[9]

The court determined that an action for fraud did not lie because John Deere made no representation of present fact. The statements made by John Deere and relied on by Bishop Logging related to the expected performance of the equipment in the swamp logging operation. Because the statements were not susceptible to exact knowledge when made, they were mere opinion. Therefore, the statements could not be the basis for a fraud cause of action.[10]

The court of appeals found that Bishop Logging improperly pleaded what was merely a breach of warranty claim as the tort of negligent misrepresentation in an attempt to circumvent the contractual exclusion of consequential damages. The court concluded that the tort was inapplicable to the facts of this case because (1) the "economic loss" rule bars its application and (2) the tort of negligent misrepresentation, like fraud, requires a representation of present fact.[11]

Despite the terms of John Deere's New Equipment Warranty, the court of appeals determined that Bishop Logging should receive lost profits and consequential damages for breach of an express warranty. The court concluded that there was ample evidence for the jury to find that John Deere had been unable to repair the equipment within a reasonable time, thereby denying Bishop Logging the value of the bargain. Therefore, the exclusive remedy established in the New Equipment Warranty "failed of its essential purpose"[12] under the UCC. The court then held that John Deere's inability to repair the equipment "materially altered the balance of risk set by the parties in the agreement."[13] Thus, the separate warranty term excluding consequential damages was properly disregarded by the lower court, and Bishop Logging could properly recover consequential damages.[14]

The economic loss rule provides that "there is no tort liability for a product defect if the damage suffered by the plaintiff is only to the product itself. In other words, tort liability only lies where the damage done is to other

8. *Id.* at ___, 455 S.E.2d at 185.
9. *Id.* at ___, 455 S.E.2d at 188-89, 193.
10. *Id.* at ___, 455 S.E.2d at 186-88.
11. *Id.* at ___, 455 S.E.2d at 187-88.
12. *Id.* at ___, 455 S.E.2d at 191.
13. *Id.* at ___, 455 S.E.2d at 193.
14. *Id.* at ___, 455 S.E.2d at 193.

property or is personal injury."[15] The rule "exists to assist in determining whether contract or tort theories are applicable to a given case."[16]

Application of the economic loss rule has been the subject of much discussion in South Carolina. The current trend is to limit its use. In *Kennedy v. Columbia Lumber & Manufacturing Co.*[17] the court discussed the tort liability of a builder for construction defects when the only damage to the purchaser was diminution in the value of the home. The court rejected application of the economic loss rule in the commercial home building context because it found the builder's breached duty was rooted in law.[18] The court stated: "If a builder performs construction in such a way that he violates a contractual duty *only*, then his liability is only contractual. If he acts in a way as to violate a legal duty, however, his liability is both in contract and in tort."[19] The court indicated that "[t]he 'economic loss' rule will still apply where duties are created *solely* by contract. In that situation, no cause of action in negligence will lie."[20]

In *Beachwalk Villas Condominium Ass'n v. Martin*[21] the court held that an architect could be held liable in tort for purely economic damage despite the economic loss rule because he "impliedly warrants [the design's] sufficiency for the purpose in view." The court considered this a "logical expansion" of the rule announced in *Kennedy*.[22]

In *Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc.*[23] the South Carolina Supreme Court found potential liability when a contractor sued a design engineer, in tort, for purely economic loss. The court determined that the engineer owed a legal duty to the contractor not to negligently design or supervise the project.[24] The court stated the test for applicability of the economic loss rule as follows:

> The question, thus, is not whether the damages are physical or economic. Rather the question of whether the plaintiff may maintain an action in tort for purely economic loss turns on the determination of the source of the duty plaintiff claims the defendant owed. A breach of a duty which arises under the provisions of a contract between the parties must be redressed

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15. Kennedy v. Columbia Lumber & Mfg. Co., 299 S.C. 335, 341, 384 S.E.2d 730, 734 (1989).

16. *Id.* at 345, 384 S.E.2d at 736.

17. *Id.* at 345-46, 384 S.E.2d at 737.

18. *Id.* at 347, 384 S.E.2d at 737.

19. *Id.* at 345-46, 384 S.E.2d at 737 (emphasis added).

20. *Id.* at 347, 384 S.E.2d at 737 (emphasis added).

21. 305 S.C. 144, 146, 406 S.E.2d 372, 374 (1991).

22. *Id.*

23. ___ S.C. ___, 463 S.E.2d 85 (1995).

24. *Id.* at ___, 463 S.E.2d at 89.

> under contract, and a tort action will not lie. A breach of a duty arising independently of any contract duties between the parties, however, may support a tort action.
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> In most instances, a negligence action will not lie when the parties are in privity of contract. When, however, there is a special relationship between the alleged tortfeasor and the injured party not arising in contract, the breach of that duty of care will support a tort action.[25]

Thus, South Carolina has adopted a clear test to determine when the economic loss rule will apply. The rule will operate to bar recovery for purely economic loss only when the duty breached arises solely from contract. In such a case, claimant's recovery will be limited by the contract. This seems to leave all areas of litigation involving a disappointing product open for application of tort principles so long as the plaintiff can allege the breach of some legal duty.

However, in *Kershaw County Board of Education v. United States Gypsum Co.*[26] the South Carolina Supreme Court stated that it had not yet decided if the economic loss rule should be rejected in all contexts, including the commercial arena. Thus, there seems to be room for application of the economic loss rule in particular contexts without examining the source of the duty owed to the plaintiff. *Bishop Logging* states such a rule. In cases when (1) a product liability complaint involving the failure of a product to live up to expectation and (2) commercial entities engaged in a transaction are governed by a contract, the economic loss rule should be used. In such situations, when there is only purely economic loss and no personal injury or damage to other property, the economic loss rule bars recovery based on a theory sounding in tort—negligent misrepresentation.[27]

This rule is in accord with several federal court pronouncements regarding application of the economic loss rule in the commercial arena. In *South Carolina Electric & Gas Co. v. Westinghouse Electric Corp.*[28] the district court concluded that in "a commercial transaction governed by a contract where the loss alleged is purely economic and the cause of action is for mere negligent misrepresentation—the economic loss rule bars recovery for losses that have occurred from the product's failure to live up to the purchaser's expectations."[29] Also, in *Myrtle Beach Pipeline Corp. v. Emerson Electric Co.*[30] the court held that a negligence action did not lie under the economic loss rule. The court observed a recurrent theme that when "sophisticated

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25. *Id.* at ___, 463 S.E.2d at 88 (citations omitted).

26. 302 S.C. 390, 396 S.E.2d 369 (1990).

27. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 189.

28. 826 F. Supp. 1549 (D.S.C. 1993).

29. *Id.* at 1557.

30. 843 F. Supp. 1027 (D.S.C. 1993), *aff'd*, 46 F.3d 1125 (4th Cir. 1995).

parties to a commercial transaction have negotiated a contract . . . and the product injures only itself and not other property belonging to the plaintiff . . . , contract law, specifically the Uniform Commercial Code, and not tort law, provides the exclusive rights and remedies of the parties."[31]

Has *Bishop Logging*, although in accord with federal authority, expanded application of the economic loss rule further than the South Carolina Supreme Court would allow?[32] Had *Bishop Logging* made an inquiry into the origin of the duty allegedly breached by John Deere (negligent misrepresentation),[33] it is possible that such an inquiry would have led to a finding that the duty was rooted in law.

In *Gilliland v. Elmwood Properties*[34] the supreme court stated that "[a] duty to exercise reasonable care in giving information exists when the defendant has a pecuniary interest in the transaction." The court in *Gilliland* allowed a negligent misrepresentation counterclaim for purely economic loss when Elmwood alleged that the representation induced it to enter the contract.[35] Furthermore, the court held that "neither the parol evidence rule nor the merger or integration clause in the parties' contract prevents Elmwood from proceeding on its negligent misrepresentation theory."[36] Thus, the South Carolina Supreme Court could hold that Bishop Logging's complaint of negligent misrepresentation alleges a breach of a legal duty and allows a plaintiff to puruse a tort action for purely economic harm. The court could so hold notwithstanding the existence of a contract containing warranties and any theory of merger or integration.[37]

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31. *Id.* at 1053.

32. Unlike the South Carolina Supreme Court cases discussed above, it does not seem that John Deere breached any legal duty arising independently from its contract with Bishop Logging—the absence of which opens the door to application of the economic loss rule under *Kennedy*, *Beachwalk Villas*, and *Griffin Plumbing*. Thus, it could be argued that nothing new was decided. However, the court clearly stated that the basis for its rejection of Bishop Logging's negligent misrepresentation claim rested on the economic loss rule's applicability to the facts of the case without regard to the court's holding on the alleged misrepresentations. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 189.

33. Breach of duty seemingly is required under *Kennedy*, *Beachwalk Villas*, and *Griffin Plumbing*.

34. 301 S.C. 295, 301, 391 S.E.2d 577, 580 (1990).

35. *Id.*

36. *Id.* at 302, 391 S.E.2d at 581.

37. In *Bishop Logging* it is true that the court found no actionable representations of present fact. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 189. Thus, the result is correct whether or not the economic loss rule is applied. It is future cases that make out a valid claim for negligent misrepresentation that concern us here.

In spite of this "seamless web of proper legal analysis"[38] the South Carolina Supreme Court could simply accept application of the economic loss rule in the commercial context of *Bishop Logging*. This possibility was left open in *Kershaw*.[39] Also, *Gilliland* involved a claim against a design professional,[40] a member of a class offering a product distinguishable from conventional goods,[41] as did *Griffin Plumbing*[42] and *Beachwalk Villas*.[43] Thus, although it is good law today, *Bishop Logging* may well be overruled tomorrow.

John Deere claimed that Bishop Logging could not recover consequential damages under its express warranty claim because Bishop Logging's exclusive remedy was limited to repair or replacement in accord with UCC section 36-2-719(1) (a). Further, John Deere agreed that it had separately excluded consequential damages in accord with UCC section 36-2-719(3).[44]

In response, the court in *Bishop Logging* made two distinct holdings. First, the court held that when there is an exclusive, limited remedy providing for repair or replacement and the seller fails to accomplish such repair or replacement, thereby causing the buyer to lose the benefit of the bargain, then the warranty fails of its essential purpose.[45] Therefore, because John Deere was unable to repair or replace the equipment within a reasonable time, Bishop Logging was entitled, under UCC section 36-2-719(2),[46] to pursue other remedies under the UCC, including consequential damages.

Second, the court considered the separate exclusion of consequential damages—pursuant to UCC section 32-2-719(3)—in the New Equipment Warranty and applied a test to determine whether this separate exclusion is entitled to independent effect.

Under UCC section 36-2-719(3) consequential damages are excludable unless such exclusion would be "unconscionable."[47] At issue is whether a warranty term limiting the remedy is to be considered failed under UCC

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38. Kennedy v. Columbia Lumber & Mfg. Co., 299 S.C. 335, 341, 384 S.E.2d 730, 734 (1989).

39. *See supra* note 27 and accompanying text. It is interesting to note that in *Griffin Plumbing* the court cited *Bishop Logging* for the proposition that "[p]urely 'economic losses' may be recoverable under a variety [of] tort theories." Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc., ___ S.C. ___, ___ n.2, 463 S.E.2d 85, 88 n.2 (1995). This is despite the fact that *Bishop Logging* rests liability on contract under the UCC.

40. *Gilliland*, 301 S.C. at 298, 391 S.E.2d at 578.

41. *Griffin Plumbing*, ___ S.C. at ___, 463 S.E.2d at 89.

42. *Id.* at ___, 463 S.E.2d at 89.

43. Beachwalk Villas Condominium Ass'n v. Martin, 305 S.C. 144, 145, 406 S.E.2d 372, 373 (1991).

44. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 190.

45. *Id.* at ___, 455 S.E.2d at 191.

46. S.C. CODE ANN. § 36-2-719(2) (Law. Co-op. 1976).

47. S.C. CODE ANN. § 36-2-719(3) (Law. Co-op. 1976).

section 36-2-719(2) or as standing on its own and entitled to independent significance, thereby excluding consequential damages notwithstanding a failure of the essential purpose of the exclusive remedy.[48] This issue is unresolved in the state courts of South Carolina.[49]

Professor Henry Mather has discussed five different approaches taken by courts in resolving this issue.[50] The approaches are: (1) that the buyer is entitled to pursue consequential damages notwithstanding the separate exclusion; (2) that consequential damages are excluded unless the separate exclusion is unconscionable; (3) that the buyer's recovery of consequential damages depends on the seller's misconduct; (4) that recovery depends on the intent of the parties, which is determined by the location of the separate exclusion clause in the contract; and (5) that the court should make a case-specific, facts-and-circumstances inquiry into the true intent of the parties.[51]

In *Bishop Logging* the court held, as a matter of contract interpretation, that the separate exclusion under UCC section 36-2-719(3) was inapplicable to damages resulting from John Deere's failure to repair or replace within a reasonable time.[52] The court's analysis is most consistent with the fifth approach discussed by Professor Mather.

This interpretation is also in accord with *Waters v. Massey-Ferguson, Inc.*[53] In *Waters* the Fourth Circuit Court of Appeals allowed the recovery of consequential damages but did not determine that the exclusion clause was part of a failed exclusive remedy or that it was unconscionable.[54] The court interpreted the exclusion as applicable only to damages resulting from the defect in the product and not to damages flowing from the seller's failure to repair or replace.[55] Further, the court examined the language used in the contract, made an inquiry into which party was responsible for drafting the provision, and looked at the commercial context surrounding the contract's execution.[56]

In *Bishop Logging* the court of appeals concluded that John Deere and Bishop Logging contracted under the assumption that any mechanical defect could be repaired or replaced.[57] John Deere's inability to repair the equipment "materially altered the balance of risk set by the parties in the agree-

48. *See* Waters v. Massey-Ferguson, Inc., 775 F.2d 587, 591 (4th Cir. 1985).

49. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 192.

50. Henry Mather, *Consequential Damages When Exclusive Repair Remedies Fail: Uniform Commercial Code Section 2-719*, 38 S.C. L. REV. 673 (1987).

51. *Id.* at 676-680.

52. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 192.

53. 775 F.2d 587 (4th Cir. 1985).

54. *Id.* at 591.

55. *Id.*

56. *Id.* at 591-92.

57. *Bishop Logging Co.*, ___ S.C. at ___, 455 S.E.2d at 192.

ment."[58] Thus, an exclusion clause applies only when the warrantor successfully performs its obligation to repair or replace, not when the obligation goes unfulfilled.[59]

Neither *Waters*[60] nor *Bishop Logging* directly addressed what some perceive as a conflict between subsections 2 and 3 of UCC section 36-2-719. However, by following the rational of *Waters*, *Bishop Logging* suggests that South Carolina courts will undertake a full analysis in all cases to determine the intent of the parties. Conceivably, South Carolina courts may always rule on the failure of the seller to repair or replace as it relates to the parties' intent.[61] *Bishop Logging* suggests that, given enough evidence that the parties' intended the buyer to bear the risk of the seller being unable to repair or replace, a separate exclusion under UCC section 36-2-719(3) would be given independent effect. However, if there is a direct conflict between a failed exclusive remedy under subsection 2 and a separate limitation under subsection 3, the law in South Carolina remains unclear.

Bishop Logging holds that the tort of negligent misrepresentation is not an available cause of action when sophisticated entities enter into a transaction governed by a contract that results in purely economic damage to one of the parties. Rather, such is the exclusive domain of contract law and the UCC. This position is arguably in tension with recent South Carolina Supreme Court decisions indicating that the economic loss rule is not to be applied when a duty breached by the defendant is rooted in law and not exclusively in contract.

The court in *Bishop Logging* held that when (1) a seller does not repair or replace defective goods within a reasonable time under an exclusive warranty providing for such and (2) thereby deprives the buyer of the substantial benefit of the bargain, the exclusive remedy has failed of its essential purpose, and the buyer may resort to other remedies available under the UCC. Additionally, the court made a facts-and-circumstances inquiry into the true intent of the parties to determine whether a separate warranty provision excluding consequential damages is to be given effect. When the failure of the exclusive remedy materially alters the balance of risk set by the parties, the independent exclusion does not apply to losses flowing from the failure of the remedy and is, therefore, not entitled to independent effect.

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58. *Id.* at ___, 455 S.E.2d at 193.

59. *Id.* at ___, 455 S.E.2d at 192.

60. In *Waters* the court expressly declined to address "the broader relationship between [section] 36-2-719(2) and [section] 36-2-719(3)]." 775 F.2d at 591.

61. Professor Mather contends that the intent of the parties is so difficult to determine that a rebuttable presumption is necessary to assist the courts. More precisely, Professor Mather would place the burden on the seller to draft a warranty that evidenced an intent to give the exclusion clause independent effect. Mather, *supra* note 52, at 691. Although the court adopted Professor Mather's preferred option, the court apparently did not adopt the rebuttable presumption.

These holdings are unprecedented in South Carolina state courts but are in accord with recent Fourth Circuit opinions interpreting South Carolina state law.

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