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Repository Citation

Ralph A. Anzivino, *The False Dilemma of the Economic Loss Doctrine*, 93 Marq. L. Rev. 1121 (2010).

Available at: <http://scholarship.law.marquette.edu/mulr/vol93/iss3/5>

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THE FALSE DILEMMA OF THE ECONOMIC LOSS DOCTRINE

RALPH A. ANZIVINO*

I. INTRODUCTION

A defective product causes various types of damages. The type of damage suffered generally determines whether contract or tort law will govern resolution of the parties' dispute. Contract law will control when the loss suffered is considered to be solely economic loss. For example, when a machine does not produce the number of parts per minute as warranted by the seller, the loss is solely an economic loss. On the other hand, when a defective product causes personal injury, tort law will be utilized to resolve the dispute. However, when the defective product causes "other property" damage (not economic loss or personal injury), both contract law and tort law claim application. The Uniform Commercial Code (U.C.C.) expressly provides for recovery of other property damage caused by a defective product. Coincidentally, the Restatement (Third) of Torts: Products Liability also expressly provides for recovery of other property damage caused by a defective product. The purpose of this Article is to offer a fresh approach to addressing other property damage disputes that emphasizes both contract and tort law rather than the current approach that requires a court to choose between contract or tort coverage.

II. THE OTHER PROPERTY EXCEPTION TO THE ECONOMIC LOSS DOCTRINE

Courts use the economic loss doctrine to determine whether liability resulting from a defective product should proceed as a tort or contract case.¹ The doctrine provides that when a defective product causes solely economic loss,² the buyer may pursue damages only through contract law.³ On the other hand, if the defective product causes personal injury or property damage, the buyer may pursue damages only through tort law.⁴ One of the main problems

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1. *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Ford Motor Co.*, 592 N.W.2d 201, 205 (Wis. 1999); *Sylla v. Massey-Ferguson, Inc.*, 660 F. Supp. 1044, 1046 (E.D. Mich. 1984).

2. For a discussion of the distinction between economic loss and noneconomic loss, see generally Ralph C. Anzivino, *The Economic Loss Doctrine: Distinguishing Economic Loss from Non-Economic Loss*, 91 MARQ. L. REV. 1081 (2008).

3. *Sunnyslope Grading, Inc. v. Miller, Bradford & Risberg, Inc.*, 437 N.W.2d 213, 217-18 (Wis. 1989).

4. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 1 (1998).

in applying the doctrine is determining when a defective product has caused the type of property damage that permits a buyer to use tort theories to recoup its loss. For example, a product that fails and damages only itself has caused property damage, but not the type of property damage that permits the use of tort theories.⁵ Damage to the product itself is tantamount to loss of product value and is not considered property damage.⁶ But what if the defective product causes damage beyond itself and damages the system of which it is a part? Here again, the general rule is that when a defective product causes damage to the system of which it is a part, such property damage is not sufficient to permit the injured party to pursue tort theories.⁷ This is known as the integrated system rule.⁸ Thus, a defective product that causes damage to itself or its integrated system has not caused sufficient property damage to engender tort remedies. Rather, the defective product must cause damage to property “other than” itself or its integrated system to trigger tort theories.⁹ This is known as the other property exception to the economic loss doctrine.¹⁰ In this Article the use of the term “other property” is intended to mean property damage that is damage to property other than the product or its integrated system.

III. CONTRACT LAW AND OTHER PROPERTY DAMAGE

Contract law’s approach to other property damage, as interpreted by the courts, can best be described as muddled. The primary factor motivating the economic loss doctrine is the availability of the U.C.C. to address conflicts over a product’s performance.¹¹ The U.C.C. contains a comprehensive system that balances the rights and obligations between buyers and sellers of products.¹² The parties, however, are generally permitted to change the rules established in the U.C.C.¹³ In the event a product proves defective, a number of U.C.C. sections aid the buyer, such as those covering express warranties,¹⁴ implied warranties,¹⁵ or both. For remedies, the buyer can seek to revoke his

5. *E. River S.S. Corp. v. Transamerica Delaval Inc.*, 476 U.S. 858, 871 (1986).

6. *See Trans States Airlines v. Pratt & Whitney Can., Inc.*, 682 N.E.2d 45, 52 (Ill. 1997).

7. *E. River S.S. Corp.*, 476 U.S. at 876; *Wausau Tile, Inc. v. County Concrete Corp.*, 593 N.W.2d 445, 452 (Wis. 1999).

8. *Wausau Tile*, 593 N.W.2d at 452.

9. *Saratoga Fishing Co. v. J.M. Martinac & Co.*, 520 U.S. 875, 877 (1997).

10. *Id.*

11. *Grams v. Milk Prods., Inc.*, 2005 WI 112, ¶ 15, 283 Wis. 2d 511, 699 N.W.2d 167; *Ins. Co. of N. Am. v. Cease Elec. Inc.*, 2004 WI 139, ¶¶ 28–29, 276 Wis. 2d 361, 688 N.W.2d 462.

12. *Alloway v. Gen. Marine Indus., L.P.*, 695 A.2d 264, 268–69 (N.J. 1997).

13. U.C.C. § 1-302 (2003); *accord* WIS. STAT. § 401.102(3) (2007–2008).

14. U.C.C. § 2-313; *accord* WIS. STAT. § 402.313.

15. U.C.C. §§ 2-314 to -315; *accord* WIS. STAT. §§ 402.314–.315.

acceptance¹⁶ and recover damages.¹⁷ Significantly, the buyer is permitted to recover consequential damages, which includes damage to other property that proximately results from any breach of warranty.¹⁸ In other words, the U.C.C. provides express coverage for other property damage caused by a defective product. Notably, with strict liability the U.C.C. provides parallel remedies, which also provide for damages when a defective product causes injury to other property.¹⁹

The U.C.C. also has provisions that aid the seller. In the event a product proves defective, the U.C.C. permits a seller to limit damages in a number of ways. Damages may be liquidated to a sum certain in the contract.²⁰ Also, a seller can exclude or modify the warranties that form the basis of a buyer's damage claim.²¹ For example, the U.C.C. permits a seller to sell a product "as is" or "with all faults."²² In addition, a seller may limit its exposure to damages by specifying in the sales contract that the buyer's remedy be limited to the return of the goods and repayment of the price, or to repair or replacement of the defective product.²³ Finally, the seller may limit or exclude consequential damages.²⁴ In particular, the U.C.C. provides that "[l]imitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but *limitation of damages where the loss is commercial is not.*"²⁵ In other words, limitation of consequential damages is appropriate under the U.C.C. when the loss is a commercial loss. But, the U.C.C. does not define the term "commercial loss." At least one court has concluded that the economic loss doctrine should be known as the "commercial loss doctrine."²⁶ Clearly, commercial loss would encompass economic loss as that term is understood.²⁷ But, would commercial loss also include damages to other property caused by a defective product? If so, a seller could successfully exclude other property damage caused by a defective product through the use of a clause in the contract

16. U.C.C. § 2-608; *accord* WIS. STAT. § 402.608.

17. U.C.C. §§ 2-712 to -715, 2-717; *accord* WIS. STAT. §§ 402.712–715, 402.717.

18. U.C.C. § 2-715(2)(b); *accord* WIS. STAT. § 402.715(2)(b).

19. *Kirkland v. Gen. Motors Corp.*, 521 P.2d 1353, 1362 (Okla. 1974) (quoting RESTATEMENT (SECOND) OF TORTS § 402A cmt. m (1965)); RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 1 (1998); RESTATEMENT (SECOND) OF TORTS § 402A cmt. a (1965).

20. U.C.C. § 2-718(1); *accord* WIS. STAT. § 402.718(1).

21. U.C.C. § 2-316; *accord* WIS. STAT. § 402.316.

22. U.C.C. § 2-316(3)(a); *accord* WIS. STAT. § 402.316(3)(a).

23. U.C.C. § 2-719(1)(a); *accord* WIS. STAT. § 402.719(1)(a).

24. U.C.C. § 2-719(3); *accord* WIS. STAT. § 402.719(3).

25. U.C.C. § 2-719(3) (emphasis added); *see also* WIS. STAT. § 402.719(3) (emphasis added).

26. *All-Tech Telecom, Inc. v. Amway Corp.*, 174 F.3d 862, 865 (7th Cir. 1999).

27. For a discussion of the distinction between economic loss and noneconomic loss, see generally Anzivino, *supra* note 2.

excluding consequential damages. The Restatement (Second) of Contracts clearly allows a seller to contractually exempt itself from tort liability for other property damage caused by its defective product.²⁸

Unfortunately, unlike the Restatement (Second) of Contracts, the U.C.C. approach is quite muddled. One approach taken by the courts is that, despite the consequential damage exclusion provision in the contract, the buyer is still permitted to bring a tort action.²⁹ These courts reason that a seller/manufacture should not be permitted to disclaim or limit its tort liability for other property damage.³⁰ Conversely, some courts indicate that a buyer cannot avoid any contractual limitation clauses by bringing a tort action for negligence or strict liability.³¹ Similarly, other courts reason that a buyer cannot avoid these various limitation clauses by suing for negligence when negligence is the basis of the claim for the breach of contract.³² Further, some courts place particular focus on the language used in the limitation-of-remedy clause. These courts indicate that, “[a]lthough the exclusion of consequential damages in a sales contract is ordinarily an exclusion of contract damages, the exclusion may be effective to exclude tort damages when the context indicates such broader exclusion.”³³ Finally, other courts are more exacting and require the exclusion of liability for negligence to be clearly expressed because the law does not favor such self-exculpation.³⁴

There are, of course, significant policy reasons to support the various approaches adopted by the courts. Those decisions that do not extend a consequential damage clause to cover damage to other property are premised on public safety. The policy is that manufacturers should be constantly encouraged to produce safer products, and that is accomplished through tort pressure.³⁵ On the other hand, those decisions that do extend a consequential damage clause to cover other property damage are premised on contractual bargaining.³⁶ The policy is that the parties are best able to assess their own exposures and risks inherent in the transaction and that should be a matter for their own bargaining. For example, a seller/manufacture who provides full warranties and no significant limitation of remedy should receive a much

28. RESTATEMENT (SECOND) OF CONTRACTS § 195(2) (1981).

29. 4B LARY LAWRENCE, LAWRENCE’S ANDERSON ON THE UNIFORM COMMERCIAL CODE § 2-719:9, at 10 (3d ed. 2001).

30. *Id.* § 2-719:62, at 51–52.

31. *Id.* § 2-719:9, at 11.

32. *Id.* § 2-719:62, at 51.

33. *Id.*

34. *Id.*

35. See McGraw-Edison Co. v. Ne. Rural Elec. Membership Corp., 678 N.E.2d 1120, 1125 (Ind. 1997); McCaskill v. Welch, 463 So. 2d 942, 947 (La. Ct. App. 1985).

36. 4B LAWRENCE, *supra* note 29, § 2-719:66, at 55–56.

higher price for its product than a seller/manufacturer who provides limited warranties and has excluded its liability for consequential damages in the event of a defective product.

Clearly, the U.C.C. provides a careful balance of protections for both sellers and buyers when confronted with a defective product. Further, the U.C.C. permits the parties to bargain for more or less protection than the U.C.C.'s starting point. Necessarily, whether a buyer receives more or less protection in the final negotiated contract will affect the final sales price.³⁷ The U.C.C. also expressly permits a buyer to recover other property damage or consequential damages incurred as a result of a defective product.³⁸ Significantly, the U.C.C. permits a seller to exclude consequential damages, which may include damage to other property.³⁹ However, to obtain such a beneficial clause, the U.C.C. anticipates that a seller should bargain for such protection. But, even if a seller/manufacturer bargains for and receives a consequential damage disclaimer in its contract, the ability of such a clause to protect the seller/manufacturer from tort liability for other property damage is uncertain, given the numerous approaches adopted by the courts. In sum, contract law's approach to other property damage is quite unsettled.

IV. TORT LAW AND OTHER PROPERTY DAMAGE

In 1965, the drafters of the Restatement (Second) of Torts created a special strict liability rule intended to apply to sellers of products.⁴⁰ The strict liability rule essentially provides that one who sells a defective product that is unreasonably dangerous to a user or his property is subject to liability for harm to his person or property.⁴¹ The justifications for this rule are that by placing a product in commerce, a seller "has undertaken . . . a special responsibility toward any member of the consuming public who may be injured by it"; that sellers will stand behind their products; "that public policy demands that the burden of accidental [damage] caused by products" be placed upon those who profit from it, and be treated as a cost of production and sale; and that the buyer of such a product is entitled to the maximum protection by the person who placed the product into commerce.⁴² Many states have adopted the strict liability rule since its promulgation.⁴³

37. *E. River S.S. Corp. v. Transamerica Delaval Inc.*, 476 U.S. 858, 873 (1986); *Ins. Co. of N. Am. v. Cease Elec. Inc.*, 2004 WI 139, ¶ 31, 276 Wis. 2d 361, 688 N.W.2d 462.

38. U.C.C. § 2-715(2)(b) (2003); *accord* WIS. STAT. § 402.715(2)(b) (2007–2008).

39. U.C.C. §§ 2-715, 2-719; *accord* WIS. STAT. §§ 402.715, 402.719.

40. *See* RESTATEMENT (SECOND) OF TORTS § 402A cmt. a (1965).

41. *Id.* § 402A.

42. *Id.* § 402A cmt. c.

43. *Markle v. Mulholland's Inc.*, 509 P.2d 529, 535 (Or. 1973).

In 1998, new strict liability rules were promulgated.⁴⁴ The modern rule provides that “[o]ne engaged in the business of selling or otherwise distributing . . . a defective product is subject to liability for harm to persons or property caused by the defect.”⁴⁵ A product is defective if it has a manufacturing defect,⁴⁶ a defect in design,⁴⁷ or inadequate instructions or warnings.⁴⁸ The objectives of the modern strict liability rule are to encourage greater investment in product safety, to “discourage[] the consumption of defective products by causing the purchase price of [such] products to [fully] reflect” all losses incurred, and to reduce the transaction costs in litigating product liability claims by eliminating fault determinations.⁴⁹ It is important to note that the modern strict liability rule eliminates the “unreasonably dangerous” standard for manufacturing defects,⁵⁰ but retains a “not reasonably safe” standard for design⁵¹ and warning or instruction⁵² defects. Manufacturing defects are more likely a greater cause of other property damage than design or warning or instruction defects. Thus, the substitution of a “manufacturing defect” for an unreasonably dangerous standard in the modern rule signals an intent to expand tort coverage for defective products that cause other property damage.

The leading case that addresses the use of tort law to recover for other property damage is the United States Supreme Court decision in *Saratoga Fishing Co. v. J.M. Martinac & Co.*⁵³ In *Saratoga Fishing*, the hydraulic system used in a fishing vessel caused a fire that led to the ship’s sinking.⁵⁴ The owner at the time of the loss was the second owner of the ship.⁵⁵ The initial owner of the ship added extra equipment to the ship after he purchased it,⁵⁶ but before he sold it to the second owner.⁵⁷ The issue before the Supreme Court was whether the added equipment constituted other property such that it would permit the second owner to pursue tort theories to recover its loss.⁵⁸

44. See RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. (1998).

45. *Id.* § 1.

46. *Id.* § 2(a).

47. *Id.* § 2(b).

48. *Id.* § 2(c).

49. *Id.* § 2 cmt. a.

50. *Id.* § 2(a).

51. *Id.* § 2(b).

52. *Id.* § 2(c).

53. 520 U.S. 875 (1997).

54. *Id.* at 877.

55. *Id.*

56. *Id.* (cataloging a skiff, a fishing net, and spare parts).

57. *Id.*

58. *Id.* at 879.

The Court held that the added equipment did constitute other property.⁵⁹ As a result, the Supreme Court affirmed the second owner's ability to pursue tort law for his recovery.⁶⁰ The Court expressly rejected the manufacturer's argument that permitting the owner to pursue its recovery under tort law would impose "too great a potential tort liability upon a manufacturer or distributor."⁶¹ The Court reasoned that "a host of other tort principles, such as foreseeability, proximate cause, and the 'economic loss' doctrine . . . would continue to[] limit liability in important ways."⁶² Subsequently, the Restatement (Third) of Torts expressly adopted the holding in *Saratoga Fishing* when it stated that "[t]he characterization of a claim as harm to other property may trigger liability not only for harm to physical property but also for incidental economic loss."⁶³ The Restatement (Third) of Torts also predicted that the strong majority of state courts that followed the Supreme Court's decision in *East River Steamship Corp. v. Trans America Delaval Inc.* would likely follow *Saratoga Fishing* as well.⁶⁴

The modern strict liability rule follows the damage to other property rule as developed by the courts.⁶⁵ A defective product that harms only itself is not governed by strict liability rules, but by the laws governing commercial transactions.⁶⁶ Also, when a defective product causes damage to its integrated system, such damage is considered to be damage to the product itself, and is not covered by the modern strict liability rule.⁶⁷ The Restatement (Third) of Torts offers two illustrations to highlight the difference between damage to other property and damage to the product or its integrated system. In the first illustration,⁶⁸ ABC Company sells a conveyor belt to XYZ Company for use in XYZ's engine assembly line.⁶⁹ The conveyor belt is defective and subsequently breaks, causing damage to XYZ's assembly line.⁷⁰ This is considered to be damage to only the defective product, and as such, does not fall within the ambit of the modern strict liability rule.⁷¹ The same result is reached via the integrated system exception to the other property rule.⁷² In the

59. *Id.* at 884.

60. *Id.* at 877.

61. *Id.* at 884.

62. *Id.*

63. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 21 cmt. e (1998).

64. *Id.* § 21 reporters' note.

65. *See supra* Part III.

66. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 21 cmt. d.

67. *Id.* § 21 cmt. e.

68. *Id.* § 21 cmt. d, illus. 3.

69. *Id.*

70. *Id.*

71. *Id.*

72. *See supra* Part II.

second illustration, the damage to the assembly line is caused by a defective steering mechanism in a forklift that causes the forklift to go out of control and collide with the assembly line.⁷³ In this illustration, the damage to the assembly line is considered damage to other property and subject to the modern strict liability rule.⁷⁴

Recovery for damage to other property is expressly subject to coverage by the Restatement (Third) of Torts.⁷⁵ The other property exception to the economic loss doctrine also provides that tort law, and not contract law, covers damage to other property.⁷⁶ Both the modern strict liability rule as expressed in the Restatement (Third) of Torts and the other property rule of the economic loss doctrine as developed by the courts are in total agreement on the treatment of other property damage. The U.C.C., however, is not in agreement and expressly covers cases of other property damage, not tort law.⁷⁷

V. A PROPOSAL TO RECONCILE THE CONTRACT AND TORT APPROACHES TO THE RECOVERY OF OTHER PROPERTY DAMAGE: THE CONTRACT-FIRST APPROACH

Both contract law⁷⁸ and tort law⁷⁹ claim to be the proper domain to remedy other property damage caused by a defective product.⁸⁰ The other property exception to the economic loss doctrine, as developed by the courts, generally provides that other property damage caused by a defective product is recoverable in tort, not contract.⁸¹ In other words, the case law simply ignores the express coverage of the U.C.C. This is contrary to the general rule, which requires courts to make every effort to enforce statutory enactments, rather than simply render them meaningless.⁸²

A few states have further compounded this area of the law by adopting the disappointed expectations test.⁸³ The disappointed expectations test provides that damage to other property that was reasonably foreseeable at the time of contracting cannot be pursued through tort law, only contract law.⁸⁴ In other

73. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 21 cmt. e, illus. 4.

74. *Id.*

75. *Id.* § 21 cmt. f.

76. *See supra* Part II.

77. U.C.C. § 2-715(2)(b) (2003); *accord* WIS. STAT. § 402.715(2)(b) (2007–2008).

78. *See, e.g.*, U.C.C. § 2-715(2)(b); WIS. STAT. § 402.715(2)(b).

79. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 1.

80. *See supra* Parts III and IV.

81. *Saratoga Fishing Co. v. J.M. Martinac & Co.*, 520 U.S. 875, 877 (1997).

82. *Holloway v. J.C. Penney Life Ins. Co.*, 190 F.3d 838, 843 (7th Cir. 1999).

83. *See* Ralph C. Anzivino, *The Disappointed Expectations Test and the Economic Loss Doctrine*, 92 MARQ. L. REV. 749, 752 n.24 (2009).

84. *See* *Grams v. Milk Prods., Inc.*, 2005 WI 112, ¶ 3, 283 Wis. 2d 511, 699 N.W.2d 167.

words, the disappointed expectations test shrinks the scope of the other property rule and expands the coverage of contract law. Thus, depending upon the outcome of the enigmatic disappointed expectations test, tort law may cover some other property damage, and contract law may cover some other property damage.⁸⁵ There is a simpler, fairer, and more user-friendly approach than navigating the maze of the other property rule and the disappointed expectations test.

The starting point is the parties' contract. The economic loss doctrine was created to provide greater deference to the U.C.C.⁸⁶ and to prevent contract law from drowning "in 'a sea of tort.'"⁸⁷ The underlying premise of the U.C.C. is that the parties are most apt to look after their own interests and contract accordingly.⁸⁸ Therefore, the parties' contract should be the starting point to determine their relative responsibilities. Courts should be careful not to permit a party to use tort law to circumvent limitations agreed upon in the parties' contract.⁸⁹ Courts should focus on the contract first.

There are many contractual limitations available to a seller/manufacture that wishes to decrease or eliminate its exposure to claims of other property damage that may result from a defective product.⁹⁰ Statutes define other property damage as consequential damages.⁹¹ The parties' contract may limit or exclude consequential damages.⁹² The contract may also limit a buyer's remedy to an exclusive remedy, such as repair or replacement.⁹³ Further, the parties' contract may provide for a waiver of tort liability.⁹⁴ All of these limitations can be negotiated and made part of the parties' contract. There are, however, significant safeguards that may preclude the enforceability of any or all of these contractual limitations.⁹⁵ Courts should review these safeguards in each case to determine the enforceability of the contractual limitations. If the contractual limitations were fairly negotiated and pass muster upon the court's review of the various safeguards, the court should enforce the parties' contract terms. Other property damage or consequential damages should not be recoverable in contract or tort if the contract prohibits

85. Anzivino, *supra* note 83, at 749.

86. *See* All-Tech Telecom, Inc. v. Amway Corp., 174 F.3d 862, 865–66 (7th Cir. 1999).

87. *Linden v. Cascade Stone Co.*, 2005 WI 113, ¶ 7, 283 Wis. 2d 606, 699 N.W.2d 189.

88. *See* Ins. Co. of N. Am. v. Cease Elec. Inc., 2004 WI 139, ¶¶ 28–31, 276 Wis. 2d 361, 688 N.W.2d 462.

89. *Sunnyslope Grading, Inc. v. Miller, Bradford & Risberg, Inc.*, 437 N.W.2d 213, 217–18 (Wis. 1989).

90. *See supra* Part III.

91. *See, e.g.*, U.C.C. § 2-715(2)(b) (2003); WIS. STAT. § 402.715(2)(b) (2007–2008).

92. *See, e.g.*, U.C.C. § 2-719(3); WIS. STAT. § 402.719(3).

93. *See, e.g.*, U.C.C. § 2-719(1); WIS. STAT. § 402.719(1).

94. RESTATEMENT (SECOND) OF CONTRACTS § 195 (1981).

95. *See infra* Part VI.

it. Courts should not permit a tort end run around the contract.

There are a number of cases that illustrate this Contract-First approach. In *Idaho Power Co. v. Westinghouse Electric Corp.*,⁹⁶ Idaho Power purchased a voltage regulator from Westinghouse.⁹⁷ The contract between the parties provided that, in the event the product proved defective, Westinghouse would not be liable for any consequential damages, whether in contract, tort, or otherwise.⁹⁸ The limitation of liability agreed to in the contract was that Westinghouse's liability would "not exceed the price of the product or part on which such liability [was] based."⁹⁹ Subsequently, the regulator proved defective and caused a fire.¹⁰⁰ The fire damaged the regulator and other property.¹⁰¹ Westinghouse repaired the regulator, but Idaho Power sought compensation for its other property damage.¹⁰² Idaho Power sued on breach of warranty, negligence, and strict tort liability claims.¹⁰³ The Ninth Circuit held that the contract limitations negotiated by the parties should control.¹⁰⁴ The court found that the parties were of relatively equal bargaining strength and that the parties discussed the contractual limitations.¹⁰⁵ Therefore, the court precluded Idaho Power from suing Westinghouse in either contract or tort.

A similar result was reached in *McDermott, Inc. v. Clyde Iron*,¹⁰⁶ where McDermott purchased a 5,000-ton crane to be used to move the deck of an offshore drilling platform.¹⁰⁷ The purchase contract provided McDermott with an exclusive repair or replacement remedy, and waived any other liability based on contract, tort, strict liability, or other theories.¹⁰⁸ Subsequently, McDermott was using the crane to load the deck onto a barge when the hook broke causing the deck to fall onto the barge.¹⁰⁹ The crane and the deck suffered serious damage.¹¹⁰ McDermott sued the manufacturer of the

96. 596 F.2d 924 (9th Cir. 1979).

97. *Id.* at 925.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.* at 928.

105. *Id.*

106. 979 F.2d 1068 (5th Cir. 1992), *rev'd on other grounds sub. nom.* *McDermott, Inc. v. AmClyde*, 511 U.S. 202 (1994).

107. *McDermott*, 979 F.2d at 1070.

108. *Id.*

109. *Id.*

110. *Id.*

crane based on contract and tort theories.¹¹¹ The court recognized that the damage to the crane was damage to the product itself, and damage to the deck was other property damage.¹¹² The manufacturer defended the contract claim on the basis of the exclusive remedy and defended the tort claims on the basis of the waiver of all tort liability.¹¹³ The court agreed with the manufacturer on both defenses.¹¹⁴ On the tort claims, the court held that contractual provisions that waive negligence and strict liability claims are enforceable if they pass close judicial scrutiny.¹¹⁵ The court noted that such clauses are common in commercial markets and should be enforced between sophisticated business entities.¹¹⁶ It was also important to the court that the contract clause specifically stated “tort” and “strict liability,” which are terms familiar to sophisticated business entities.¹¹⁷

Finally, in *Coach USA, Inc. v. Van Hool N.V.*,¹¹⁸ Coach USA leased a bus from a distributor of Van Hool-manufactured buses to use in Coach USA’s charter business.¹¹⁹ During a charter, the bus caught fire and caused substantial damage to the bus and the passengers’ personal property.¹²⁰ The contract between the parties provided that the distributor gave no warranties, and that any and all liability, whether in tort, contract, or otherwise, would be the sole responsibility of Coach USA.¹²¹ Despite the contract clause, Coach USA sued the distributor and manufacturer in tort to recoup its losses and for the damage caused to the passengers’ personal property.¹²² Coach USA’s theory was that the damage to the passengers’ property constituted other property damage, and that, pursuant to the other property rule, tort remedies were available.¹²³ The court agreed that the damage to the passengers’ personal property qualified as other property.¹²⁴ However, the court did not follow the other property tort rule, but instead upheld the contract terms. The court reasoned that the economic loss doctrine was created to “prevent[] ‘end runs’ around . . . contract[s] by prohibiting parties from reworking” contract claims into tort claims when the underlying complaint is the same—a

111. *Id.*

112. *Id.* at 1071.

113. *Id.*

114. *Id.* at 1071–72, 1075–76.

115. *Id.* at 1076.

116. *Id.*

117. *Id.*

118. No. 06-C-457-C, 2006 U.S. Dist. LEXIS 88783 (W.D. Wis. Dec. 5, 2006).

119. *Id.* at *3.

120. *Id.* at *5.

121. *Id.* at *4.

122. *Id.* at *5–7.

123. *Id.* at *11–12.

124. *Id.* at *13.

defective product.¹²⁵ Significantly, the court noted that the economic loss doctrine applies when the contract is silent with regard to tort claims, but is clear in its limit of contract claims.¹²⁶ The court further reasoned that the economic loss doctrine is not needed where the parties' contract expressly waives any tort claims.¹²⁷ The court indicated that when the parties signed the lease agreement, they anticipated the possibility of future tort claims.¹²⁸ In the contract, Coach USA "expressly [waived its] ability to bring such actions."¹²⁹ Thus, the court reasoned that "[i]n the absence of any suggestion by the parties that the lease agreement [was] unenforceable, [Coach USA was] not free to ignore the plain terms of [its] contract."¹³⁰ Finally, the court stated that to permit Coach USA to sue in tort "would be contrary to the parties' legitimate expectations at the time the lease agreement was signed and would violate the terms of their freely-negotiated agreement."¹³¹ Interestingly, after using the contract language to resolve the dispute, the court analyzed the case under the disappointed expectations test and reached the same result.¹³²

Once attorneys realize that the parties' contract will be the starting point in resolving disputes over contract and tort claims for consequential damages, there will be much greater use of and focus on bargaining for these protections. As a result, there are likely to be fewer cases where the parties have not bargained over these important matters. Nevertheless, there will be cases where either the parties' contract is silent on tort waivers or, after review of the enumerated safeguards,¹³³ the court decides not to enforce the limitations. In those circumstances, the courts should simply apply the other property tort rule and not utilize the flawed disappointed expectations test.¹³⁴ Simply applying the other property rule would mean that tort law would be available when the contract did not validly waive tort causes of action. The end result would be that both the U.C.C. and the Restatement (Third) of Torts are given meaning, and the determining factor would be the enforceability of the limitation clauses as negotiated by the parties and reviewed by the courts. The enigmatic disappointed expectations test simply would not be needed.¹³⁵

VI. MANDATORY SAFEGUARDS BEFORE UTILIZING THE

125. *Id.* at *9–10.

126. *Id.* at *10.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at *10–11.

132. *Id.* at *13–14.

133. *See infra* Part VI.

134. *See Anzivino, supra* note 83, at 777–78.

135. *Id.*

CONTRACT-FIRST APPROACH

There are many safeguards available to the courts when deciding whether contract clauses that limit liability, including tort liability, are enforceable. These safeguards are well-established and relatively routine issues where courts can rely on precedent to reach a decision. These safeguards should be understood to be conditions precedent that must be satisfied before a tort waiver or an exclusion of consequential damages is enforceable.

A. Unconscionability

Contracts may limit or exclude consequential damages unless the limitation or exclusion is unconscionable.¹³⁶ Limitation of consequential damages that result from injury to a person are prima facie unconscionable,¹³⁷ and are remedied under tort law.¹³⁸ However, contracts can exclude or limit consequential damages when there is a commercial loss, provided the limitation or exclusion is not unconscionable.¹³⁹ Clearly, other property damage qualifies as consequential damages,¹⁴⁰ and can be excluded unless the clause is unconscionable. Any clause waiving tort liability for other property damage should be subject to the same unconscionability limitation.¹⁴¹

Unconscionability is a defined concept under the U.C.C.¹⁴² Courts, however, have further refined the concept into two parts: substantive unconscionability and procedural unconscionability.¹⁴³ Procedural unconscionability focuses on the manner and circumstances leading up to the formation of the contract and concerns “whether there was a ‘real and voluntary meeting of the minds’ [between] the contracting parties.”¹⁴⁴ Courts consider factors such as “age, education, intelligence, business acumen and experience, relative bargaining power, who drafted the contract, whether the terms were explained to the weaker party,” whether the contract was an adhesion contract, and “whether there were alternative providers of the subject matter of the contract.”¹⁴⁵ “Substantive unconscionability addresses the fairness and reasonableness of the contract” terms.¹⁴⁶ Both elements must

136. U.C.C. § 2-719(3) (2003); *accord* Wis. STAT. § 402.719(3) (2007–2008).

137. U.C.C. § 2-719(3); *accord* Wis. STAT. § 402.719(3).

138. *See* RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 1 (1998).

139. U.C.C. § 2-719(3); *accord* Wis. STAT. § 402.719(3).

140. U.C.C. § 2-715(2)(b); *accord* Wis. STAT. § 402.715(2)(b); *see also supra* Part III.

141. *See* U.C.C. § 2-302; *accord* Wis. STAT. § 402.302.

142. U.C.C. § 2-302; *accord* Wis. STAT. § 402.302.

143. *Wis. Auto Title Loans, Inc. v. Jones*, 2006 WI 53, ¶ 33, 290 Wis. 2d 514, 714 N.W.2d 155.

144. *Id.*, ¶ 34 (citation omitted).

145. *Id.*

146. *Id.*, ¶ 35.

be proven, but unconscionability does not require equal amounts of each.¹⁴⁷ Any contract clause purporting to waive tort liability for other property damage must pass the unconscionability test.

In addition to the traditional notion of unconscionability, there is another circumstance where the courts make a finding of unconscionability. Where an exclusive remedy in the parties' contract fails to provide the buyer with a minimum adequate remedy when the product fails to perform, some courts will find the exclusive remedy clause to be unconscionable.¹⁴⁸ In *Phillips Petroleum Co. v. Bucyrus-Erie Co.*,¹⁴⁹ Phillips entered into a contract with Bucyrus-Erie requiring Bucyrus-Erie to manufacture and supply cranes to be used in Phillips's offshore drilling platforms in the North Sea.¹⁵⁰ The agreed exclusive remedy in the contract was repair or replacement at Bucyrus-Erie's plant, which was thousands of miles from the North Sea.¹⁵¹ Subsequently, the cranes proved defective.¹⁵² Phillips argued that it should not be bound to the exclusive remedy because it was simply unrealistic to bring the cranes back to the United States.¹⁵³ The court agreed and held that the remedy offered in the contract was unconscionably low.¹⁵⁴ The exclusive remedy failed to provide a "fair quantum of remedy."¹⁵⁵ Similarly, in *Trinkle v. Schumacher Co.*,¹⁵⁶ the buyer purchased fabric to be used in his drapery business.¹⁵⁷ After delivery of the fabric and during processing, it was discovered that the backing on the fabric was defective.¹⁵⁸ The parties' contract provided that no claims could be made against the supplier after the fabric was cut.¹⁵⁹ The court interpreted this clause as a consequential damage limitation.¹⁶⁰ The court, however, found that the defect was not discoverable until the fabric was cut.¹⁶¹ As a result, the court held that the no-cut clause was unconscionable because it failed to provide either a minimum or an adequate remedy to the buyer in the event of

147. *Id.*, ¶ 33.

148. *Phillips Petroleum Co. v. Bucyrus-Erie Co.*, 388 N.W.2d 584, 592 (Wis. 1986); *Trinkle v. Schumacher Co.*, 301 N.W.2d 255, 259 (Wis. Ct. App. 1980).

149. 388 N.W.2d 584.

150. *Id.* at 586.

151. *Id.* at 588.

152. *Id.* at 586.

153. *Id.* at 591.

154. *Id.* at 592.

155. *Id.*

156. 301 N.W.2d 255 (Wis. Ct. App. 1980).

157. *Id.* at 256.

158. *Id.*

159. *Id.*

160. *Id.* at 258.

161. *Id.* at 256.

breach.¹⁶² Therefore, the consequential damage limitation was not enforceable.¹⁶³ Courts should not give effect to any contract clause that purports to waive tort liability for other property damage and is found to be unconscionable.

B. Failure of Essential Purpose

The U.C.C. provides that “[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided [under the U.C.C.].”¹⁶⁴ A leading case that illustrates how a remedy fails of its essential purpose is *Murray v. Holiday Rambler, Inc.*¹⁶⁵ In *Murray*, the Murrays purchased a motor home.¹⁶⁶ The Murrays’ contract had a clause that excluded all consequential damages, and provided that the Murrays’ exclusive remedy in the event of a defect in the motor home was repair and replacement.¹⁶⁷ The motor home had a number of defects, and the defendant was unable to cure them after a reasonable opportunity to do so.¹⁶⁸ The court held that the contract’s limited remedy failed of its essential purpose¹⁶⁹ because it did not satisfy “[t]he purpose of an exclusive remedy of repair and replacement[, which] is to give [the buyer] goods which conform to the contract.”¹⁷⁰ As a result of the failure, the court concluded that the buyer was entitled to remedies under the U.C.C., including the right to recover consequential damages.¹⁷¹

Similarly, in *Wisconsin Plating Works of Racine, Inc. v. Beckart Environmental, Inc.*,¹⁷² Wisconsin Plating needed a system to treat the effluent produced by its electro plating plant prior to discharging it into the city sewer system.¹⁷³ Beckart contracted to design and install a satisfactory system.¹⁷⁴ The contract contained both an exclusive remedy of repair or replacement and a clause excluding consequential damages in the event the system failed.¹⁷⁵

162. *Id.* at 259.

163. *Id.*

164. U.C.C. § 2-719(2) (2003); accord WIS. STAT. § 402.719(2) (2007–2008).

165. 265 N.W.2d 513 (Wis. 1978).

166. *Id.* at 516.

167. *Id.* at 518–19.

168. *Id.* at 516–17.

169. *Id.* at 523.

170. *Id.* at 520.

171. *Id.* at 526. Some courts do not recognize failure of essential purpose as a limitation on a clause excluding consequential damages. Those courts only recognize unconscionability as a limitation by strictly adhering to the different language in § 2-719(2)–(3). See, e.g., *Chatlos Sys., Inc. v. Nat’l Cash Register Corp.*, 635 F.2d 1081, 1086 (3d Cir. 1980).

172. No. 96-1043, 1997 WL 134595 (Wis. Ct. App. Mar. 26, 1997).

173. *Id.* at *1.

174. *Id.*

175. *Id.* at *2.

The system proved defective, and Beckart was unable to repair the system within a reasonable time.¹⁷⁶ The court held that despite Beckart's best efforts to cure the defects, the exclusive remedy of repair or replacement failed of its essential purpose.¹⁷⁷ Thus, Wisconsin Plating was able to pursue full remedies under the U.C.C., including the recovery of consequential damages, despite the contract clause prohibiting such recovery.¹⁷⁸ Courts should not enforce any exclusive remedy in a contract that fails of its essential purpose, and should thereby permit the buyer to pursue its contract or tort remedies depending on the type of damages incurred.

C. Battle of the Forms

Another limitation on contract clauses limiting liability, including tort liability, is the battle of the forms. The phrase "battle of the forms" is used to identify the difficulty of ascertaining whether a contract has been formed and what the terms of the contract are when buyers and sellers transmit forms to each other that contain conflicting terms.¹⁷⁹ More specifically, if a seller transmits a form to a buyer that contains an exclusive remedy and a clause excluding consequential damages, are such terms part of the contract? The terms may or may not be part of the contract depending upon the battle of the forms determination.¹⁸⁰ In *Rich Products Corp. v. Kemutec, Inc.*,¹⁸¹ Rich Products Corp. was engaged in the manufacture of food products.¹⁸² Kemutec was a distributor of conveyor belts used in the manufacturing of food products.¹⁸³ Kemutec's standard terms and conditions of sale provided for the exclusive remedy of repair and replacement, excluded consequential damages, and waived the buyer's right to make any claim in negligence or strict liability.¹⁸⁴ During the formation of the contract, Kemutec was unable to establish that it ever transmitted its standard terms and conditions to Rich Products.¹⁸⁵ Subsequently, when it was discovered that the conveyor belt contaminated Rich Products' food products, Kemutec raised the various

176. *Id.* at *5.

177. *Id.* at *7.

178. *Id.*

179. BARKLEY CLARK & CHRISTOPHER SMITH, *THE LAW OF PRODUCT WARRANTIES* ¶ 8.03(8) (1984).

180. *Wis. Power & Light Co. v. Westinghouse Elec. Corp.*, 830 F.2d 1405, 1411 (7th Cir. 1987); *Twin Disc, Inc. v. Big Bud Tractor, Inc.*, 772 F.2d 1329, 1334 (7th Cir. 1985); *Rich Prods. Corp. v. Kemutec, Inc.*, 66 F. Supp. 2d 937, 955 (E.D. Wis. 1999).

181. 66 F. Supp. 2d. 937.

182. *Id.* at 944.

183. *Id.*

184. *Id.* at 946.

185. *Id.* at 951.

limitations, exclusions, and waivers as a defense.¹⁸⁶ The court, however, held that the limitations, exclusions, and waivers did not become part of the contract when the various forms were exchanged.¹⁸⁷

In *Wisconsin Power and Light Co. v. Westinghouse Electric Corp.*,¹⁸⁸ Westinghouse sold a transformer to Wisconsin Power.¹⁸⁹ Various proposals, purchase orders, and letters were transferred between the parties.¹⁹⁰ The transformers subsequently proved defective and caused extensive damage.¹⁹¹ Westinghouse's standard terms of sale provided an exclusive repair or replacement remedy, excluded consequential damages, and prohibited any claim in tort.¹⁹² Wisconsin Power sought to recoup its losses through negligence and strict liability claims.¹⁹³ Westinghouse asserted the various limitations in its defense.¹⁹⁴ The court reasoned that through the exchange of the various forms, the standard terms of Westinghouse became part of the contract.¹⁹⁵ As a result, Wisconsin Power contractually agreed to limit its remedies in contract and tort, and was not permitted to avoid its agreement.¹⁹⁶

D. Rigorous Standards Must Be Met Before a Tort Waiver Is Enforceable

As a general rule of contract law, a clause in a contract that exempts a party from tort liability for property damage caused by his own negligence is enforceable.¹⁹⁷ The Restatement (Third) of Torts provides that other property damage caused by a defective product falls within the coverage of product liability.¹⁹⁸ The Restatement (Third) of Torts further provides that “[a]lthough recovery for harm to property other than the defective product . . . is governed by this Restatement, the [American Law] Institute leaves to developing case law the questions of whether and under what circumstances contracting parties may disclaim or limit remedies for harm to other property.”¹⁹⁹ Most importantly, the Restatement states that contractual limitations on tort liability for harm to property, when fairly bargained for, may provide an effective way for the contracting parties to efficiently allocate risks of such harm between

186. *Id.* at 951–52, 955.

187. *Id.* at 955.

188. 830 F.2d 1405 (7th Cir. 1987).

189. *Id.* at 1406–08.

190. *Id.* at 1406–09.

191. *Id.* at 1409.

192. *Id.* at 1407–08.

193. *Id.* at 1409.

194. *Id.*

195. *Id.* at 1411.

196. *Id.* at 1411, 1413.

197. RESTATEMENT (SECOND) OF CONTRACTS § 195 (1981).

198. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 21 (1998).

199. *Id.* § 21 cmt. f.

themselves.²⁰⁰ It is significant to note that the Institute's comments are directed toward property damage, including other property damage, and not personal injury. Significantly, the Restatement permits contractual limitations on tort liability for harm to other property.

A number of state supreme courts have permitted parties to contractually allocate the risk of foreseeable property damage due to a defective product. In *Salt River Project Agricultural Improvement and Power District v. Westinghouse Electric Corp.*,²⁰¹ Salt River purchased a gas turbine generator from Westinghouse.²⁰² Subsequently, the generator proved defective and caused an explosion and fire.²⁰³ After resolving the battle of forms between the parties, the Arizona Supreme Court concluded that the parties' contract included an exclusive remedy, a limitation of liability, a tort waiver, and a clause excluding consequential damages.²⁰⁴ One issue before the court was whether parties could legally contract for a waiver of tort liability.²⁰⁵ The court held that tort remedies could be validly waived in a contract.²⁰⁶ The court reasoned that "[i]n a commercial setting there are often sound reasons" to bargain away remedies, including tort, should losses occur.²⁰⁷ For example, a lower price for the product may be the quid pro quo for the buyer assuming defects in the product.²⁰⁸ By bargaining over which party is to bear the risk of a defect in the product and setting the price accordingly, the parties achieve a more rational distribution of the risk than the law otherwise allows.²⁰⁹ This rationale, of course, presupposes that the contracting parties actually considered the ramifications of a defective product and have incorporated their conclusions into their contract.²¹⁰ Notably, the court identified four factors that must be satisfied to effectively waive potential tort liability.²¹¹ Those factors are as follows: (1) the parties must be dealing in a commercial setting; (2) their bargaining positions must be relatively equal; (3) they must bargain over the specifications of the product; and (4) they must actually bargain concerning the risk of loss from defects in the product.²¹² A tort

200. *Id.*

201. 694 P.2d 198 (Ariz. 1984).

202. *Id.* at 202.

203. *Id.* at 204.

204. *Id.*

205. *Id.* at 212.

206. *Id.* at 213.

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.* at 213–14.

212. *Id.*

waiver cannot be effectuated through a battle of the forms.²¹³ In other words, “[t]ort remedies may not be waived in an unknowing exchange of forms between shipping clerk and order clerk. An actual bargain must be made by those responsible for the transaction.”²¹⁴ When the four factors are satisfied, there is no public policy impediment to a tort waiver.²¹⁵ In *Phillips Petroleum Co. v. Bucyrus–Erie Co.*,²¹⁶ Bucyrus–Erie sold cranes to Phillips for use on their drilling platforms in the North Sea.²¹⁷ The contract between the parties contained a clause providing that Bucyrus–Erie’s warranty of repair and replacement was in lieu of all tort liability.²¹⁸ The Wisconsin Supreme Court indicated that as a matter of public policy, such tort waivers are not enforceable in the absence of specificity with respect to the tort disclaimed.²¹⁹ Further, the disclaimer must make it apparent that the parties struck an express bargain “to forego the possibility of tort recovery in exchange for negotiated alternate economic advantages, e.g., lower contract cost or express concessions on other terms.”²²⁰ In sum, it is clear that parties can provide for tort waiver in their contract, but they must satisfy the rigorous standards established by the *Salt River Project* and *Phillips Petroleum* courts.

E. Statutory Protection Other than the Uniform Commercial Code

In addition to those safeguards that derive directly from the U.C.C. and common law contracts, there are other statutory protections as well. The U.C.C. specifically provides that non-U.C.C. law shall supplement the Code.²²¹ The non-U.C.C. law includes both common law²²² and statutory law.²²³ The U.C.C. was drafted in the context of common law and equity, and relies on those bodies of law to supplement it.²²⁴ Although the U.C.C. specifically enumerates a list of supplemental law,²²⁵ the list is intended to be merely illustrative, not exclusive.²²⁶ Although the primary source of supplementation is common law and equity as interpreted by the courts,²²⁷

213. *Id.* at 215.

214. *Id.*

215. *Id.* at 213.

216. 388 N.W.2d 584 (Wis. 1986).

217. *Id.* at 586.

218. *Id.* at 587–88.

219. *Id.* at 589.

220. *Id.*

221. U.C.C. § 1-103(b) (2003); accord Wis. STAT. § 401.103 (2007–2008).

222. U.C.C. § 1-103 cmt. 2.

223. *Id.* § 1-103 cmt. 3.

224. *Id.* § 1-103 cmt. 2.

225. *Id.* § 1-103(b).

226. *Id.* § 1-103 cmt. 4.

227. *Id.* § 1-103 cmt. 3.

there are “a growing number of [federal and] state statutes addressing specific issues that come within the scope of the [U.C.C.]”²²⁸ In those cases where the statute provides some additional protection for a contracting party, those statutes will control over the U.C.C.²²⁹ Each state, of course, has its own unique statutory and regulatory protections. But, some examples of these types of statutes are the Wisconsin Consumer Act,²³⁰ the Wisconsin Lemon Law,²³¹ and the Magnuson–Moss Federal Warranty Act.²³² These are only a few of the significant statutory protections other than the U.C.C. available through federal and state statutes that supplement the specific U.C.C. safeguards.²³³

228. *Id.*

229. *See id.*

230. WIS. STAT. chs. 421–429 (2007–2008).

231. WIS. STAT. § 218.0171.

232. 15 U.S.C. §§ 2301–2312 (2006).

233. *Alloway v. Gen. Marine Indus., L.P.*, 695 A.2d 264, 274 (N.J. 1997).

F. Protection from Gross Negligence

A contract term that exempts a party from tort liability for damages caused by reckless conduct is unenforceable on public policy grounds.²³⁴ Gross negligence is defined as a “conscious, voluntary act or omission in reckless disregard of a legal duty and of the consequences to another.”²³⁵ Thus, a clause in a contract can exempt a party from negligent conduct,²³⁶ but not grossly negligent conduct.²³⁷ In *Lykes Bros. Steamship Co. v. Waukesha Bearings Corp.*,²³⁸ Lykes Brothers, who operated a large cargo ship, purchased a stern sealing system from Waukesha Bearings to keep seawater out of the ship where the propeller shaft passes through the hull.²³⁹ The contract between the parties provided for an exclusive remedy, a consequential damage disclaimer, and a tort waiver in the event the system was defective.²⁴⁰ Subsequently, the system failed due to a defective valve in the system.²⁴¹ The court noted that the limitation of liability clauses contained “in the Waukesha [Bearings] invoices . . . effectively limit[ed] Waukesha [Bearings’] liability for consequential damages under any theory of warranty, strict liability or negligence.”²⁴² However, the court stated that, for reasons of public policy, the protection afforded by the limitation of liability clauses only extended to ordinary negligence, not to gross negligence.²⁴³ Therefore, the court stated it had to address the difficult questions of whether Waukesha Bearings had a duty to test the valve and, if so, whether its failure to do so was negligence or gross negligence.²⁴⁴ The court reasoned that because Waukesha Bearings had recommended the use of that particular valve in the system, Waukesha Bearings had a duty to test the valve.²⁴⁵ Further, the court concluded that Waukesha Bearings’ failure to test the valve constituted gross negligence.²⁴⁶ The gross negligence finding was based on the magnitude of the foreseeable damages that would be incurred if the valve proved defective.²⁴⁷ The court identified the foreseeable damages that would result

234. RESTATEMENT (SECOND) OF CONTRACTS § 195(1) (1981).

235. BLACK’S LAW DICTIONARY 1062 (8th ed. 2004).

236. RESTATEMENT (SECOND) OF CONTRACTS § 195(2).

237. *Id.* § 195(1).

238. 502 F. Supp. 1163 (E.D. La. 1980).

239. *Id.* at 1166.

240. *Id.* at 1168–70.

241. *Id.* at 1170.

242. *Id.* at 1172.

243. *Id.*

244. *Id.* at 1173.

245. *Id.*

246. *Id.* at 1173–74.

247. *Id.*

from a defective valve to be: (1) loss of the ship's lubricating oil "with possible bearing damage and pollution law violation[s]"; (2) "removal of the vessel from service"; and (3) the expense of dry-docking the vessel, with the attendant expenses of finding and correcting the damage.²⁴⁸ As a result of Waukesha Bearings' gross negligence, the court did not enforce any of the contractual limitations of liability.²⁴⁹

VII. RATIONALES THAT SUPPORT THE CONTRACT-FIRST APPROACH TO OTHER PROPERTY DAMAGE

A. *The Contract-First Approach to Other Property Damage Enhances the Principles that Support the Economic Loss Doctrine*

The economic loss doctrine is based on three fundamental principles.²⁵⁰ Those principles are: "(1) to maintain the fundamental distinction between tort law and contract law; (2) to protect commercial parties' freedom to allocate economic risk by contract; and (3) to encourage the party best situated to assess the risk [of] economic loss, the commercial [buyer], to assume, allocate, or insure against that risk."²⁵¹ The Contract-First approach to resolving other property damage disputes enhances the principles that underlie the economic loss doctrine.

1. The Contract-First Approach to Other Property Damage Sharpens the Distinction Between Contract and Tort, and Promotes the Public Policies that Support both Contract Law and Tort Law

The first principle underlying the economic loss doctrine is to maintain the fundamental distinction between contract and tort law. Both contract and tort law lay claim to be the most appropriate means to afford recovery when a product proves defective and causes other property damage.²⁵² The contract claim is based on the U.C.C. and the fact that the parties' contract should resolve disputes over damages that were foreseeable at the time of contracting.²⁵³ The tort claim is based on the public safety notion that a manufacturer should be encouraged, through the threat of tort liability, to produce safe products.²⁵⁴ Because both contract and tort law claim to be the province for resolving disputes over damage to other property caused by a defective product, it is not surprising that the federal and state courts have not

248. *Id.*

249. *Id.* at 1175–76.

250. *Grams v. Milk Prods., Inc.*, 2005 WI 112, ¶ 13, 283 Wis. 2d 511, 699 N.W.2d 167; *Daanen & Janssen, Inc. v. Cedarapids, Inc.*, 573 N.W. 2d 842, 846 (Wis. 1998).

251. *Daanen & Janssen, Inc.*, 573 N.W.2d at 846.

252. *See supra* Parts III and IV.

253. *See supra* Part III.

254. *See supra* Part IV.

settled on a uniform approach.²⁵⁵ The reason for the discordant results is that the courts have been choosing between contract and tort law by analyzing numerous difficult issues²⁵⁶ when they can largely avoid those issues. The optimal solution would be one that utilizes both contract (bargaining) and tort (safety) rationales, and is fair in application. The Contract-First approach maximizes both contract and tort rationales, is simple to apply, and is more just than the current approach. The first step is for the court to simply determine if the parties' contract has allocated the risk of other property damage. For example, if the parties' contract provided that in the event the product proves defective and causes other property damage the buyer waives the right to sue in tort and agrees to other remedies, the court should enforce that clause, subject to satisfying the numerous safeguards described in the preceding section. The court should not permit the aggrieved party to do an end run around the contract. In other words, the first step in resolving an other property damage dispute would be to determine if the contract actually addresses the matter. Subject to compliance with the safeguards,²⁵⁷ the parties could resolve all their liability issues through their contract. There would be no need for the court to decide the difficult issues currently associated with an other property dispute that have led to conflicting decisions by the courts. It would be much easier for a court to distinguish a contract case from a tort case under the Contract-First approach.

However, in those cases where the contract did *not* resolve the issue, either because the safeguards were not satisfied, or the contract was silent on the matter, then tort principles should apply to the other property damage as provided in the Restatement (Third) of Torts. The effect of having tort principles apply in the event the contract did not resolve the other property damage claim is to provide a strong incentive for the seller/manufacture to introduce the matter into the negotiations. A Contract-First approach encourages seller/manufacturers and their counsel to introduce the other property damage issue into the negotiation process. It will also encourage the seller/manufacture to satisfy the required safeguards so that the damage limitations are enforceable. It is much more likely that the matter will be introduced into the negotiations if the seller/manufacture has an incentive to do it, unlike with the disappointed expectations' approach, which punishes the buyer for not having negotiated some protection. The Contract-First approach to handling other property damage claims satisfies the public policy of both

255. See *supra* notes 77–82 and accompanying text.

256. A few of the difficult issues would include (1) distinguishing economic loss from noneconomic loss, (2) applying the integrated systems rule, and (3) interpreting the disappointed expectations test.

257. See *supra* Part VI.

contract (bargaining) and tort (safety) law, and will encourage parties to resolve their disputes through contract negotiations, rather than litigation.

One could argue that the Contract-First approach is unfair to seller/manufacturers because in the event the parties fail to agree on a limitation, tort principles will apply. In other words, the buyer has little incentive to agree to a limitation of remedy clause. There are a number of responses to such an argument. First, the seller/manufacture can choose not to contract with that particular buyer, and avoid any tort exposure. Second, in many cases, seller/manufacturers are significant entities and have a strong enough bargaining position to overcome the perceived disadvantage. And finally, the disappointed expectations test creates a prejudice against the buyer in that, without any agreement, foreseeable other property damage is not recoverable in tort. Thus, the seller/manufacture receives tort immunity without any bargaining.²⁵⁸ On balance, the Contract-First approach is more likely to cause the parties to negotiate over prospective damages, reduce court battles, sharpen the distinction between contract and tort cases, and give due regard to both contract bargaining and public safety concerns.

2. The Contract-First Approach to Other Property Damage Maximizes the Contracting Parties' Ability to Allocate the Economic Risks of the Transaction

The second principle underlying the economic loss doctrine is to protect the parties' freedom to allocate their economic risk. The economic loss doctrine provides that when a defective product causes solely economic loss, the buyer's remedy is solely under contract law. The current approach to other property damage is that such damage is recoverable through tort theories if there is other property damage after applying the integrated system rule and, in some states, the disappointed expectations test. The parties' contract is not determinative or relevant, and the courts must apply the preceding, confusing doctrines.

The Contract-First approach to other property damage reverses the general rule for other property damage recovery. The Contract-First approach to other property damage focuses solely on the contract to determine if the parties have allocated the risk of other property damage in their contract. If so, the parties' contract should control the disposition of the other property damage claim, not tort law. Thus, under the Contract-First approach to other property damage, the economic loss doctrine would apply to solely economic loss and to other property damage, when covered by the contract and approved by the court. The net effect of the Contract-First approach is to give the contracting parties greater opportunity to allocate the economic risks of their transaction

258. See *supra* Part V.

and avoid application of the difficult integrated system rule and bewildering disappointed expectations test. The parties' contract would be permitted to allocate the risk of economic loss and other property damage, of course, subject to scrutiny by the courts with regard to the safeguards. The Contract-First approach obviously maximizes the ability of the parties to allocate the risks in the transaction by initially focusing on the parties' contract.

3. The Contract-First Approach to Other Property Damage Encourages the Parties to Assess the Economic Risk and Negotiate Concerning Its Allocation

The third principle underlying the economic loss doctrine places the burden on the buyer to assume, allocate, or insure against the risk that the product will prove defective. The assumption is that the buyer is best able to foresee the damages that a defective product might cause the buyer.²⁵⁹ It would seem equally reasonable to place this risk on the seller/manufacturer since the seller has the most experience with the kind of damage its defective product has actually caused. Nevertheless, the question should be which party is more likely to introduce the prospect of damages into the contract negotiations so that the parties can address contract damages before a loss, rather than litigate liability after the loss.

At least one court has seriously questioned whether the buyer is the best party on which to place the burden of negotiating for future damages. In *Foremost Farms USA Cooperative v. Performance Process, Inc.*,²⁶⁰ a buyer purchased a defoamer that subsequently proved defective and contaminated food products that the buyer produced.²⁶¹ In discussing whether the buyer generally is the best party to foresee future damages by a defective product, the court offered some rhetorical questions that challenge this assumption. When referencing a dispute between a farmer and its chemical supplier over a defective crop spray, the court asked, "do farmers . . . normally know that a chemical applied to crops for one purpose might cause harm in a manner unrelated to the expected function of the chemical? To what extent are . . . farmers expected to contemplate possible damage scenarios?"²⁶² The court noted that a careful buyer might anticipate the desirability of obtaining broad contractual protection against all damages caused by a defective product, but no manufacturer or distributor would agree to such far-reaching liability.²⁶³ Thus, the possibility of such buyer protection is primarily theoretical. And, as a result, it discourages the buyer from introducing the issue into the

259. *State Farm Mut. Auto. Ins. Co. v. Ford Motor Co.*, 592 N.W.2d 201, 212–13 (Wis. 1999).

260. 2006 WI App 246, 297 Wis. 2d 724, 726 N.W.2d 289.

261. *Id.*, ¶ 7.

262. *Id.*, ¶ 23.

263. *Id.*

negotiations. On the other hand, when using a Contract-First approach, the seller/manufacture has a strong incentive to seek limitations and protection from tort liability in the parties' contract. Thus, in nearly every negotiation, the seller/manufacture will be seeking contract protections. The net result is that, in most cases, the parties' contract will determine the risk allocation rather than the court, and for the seller's negotiated limitations the buyer will receive some quid pro quo rather than nothing, which is the current situation. Currently, with the integrated system rule and the disappointed expectations test, an other property damage case is virtually always a contract case.²⁶⁴ The bottom line is that the Contract-First approach gives the seller/manufacture a significant incentive to seek contractual limitations for its potential tort liability for other property damage. That incentive will ensure that the contract negotiations will include consideration of damage limitations. Thus, if an agreement is reached, the parties' contract will allocate the economic risks, assuming it passes judicial scrutiny on the safeguards. If the parties do not reach an agreement, the buyer can seek a more hospitable seller/manufacture. In either case, the commercial parties are controlling their business risks, not the court in hindsight.

B. Unlike the Current Approach, the Contract-First Approach to Other Property Damage Provides a Level Playing Field

The economic law doctrine rules, as currently applied, clearly favor seller/manufactures. If a seller/manufacture sells a defective product that causes solely economic loss, the buyer's remedy is in contract.²⁶⁵ On the other hand, if the defective product causes other property damage, the buyer's remedy is said to be in tort.²⁶⁶ However, once the other property claim passes through the prism of the integrated system rule and the reasonably foreseeable rule,²⁶⁷ there is virtually no tort claim remaining.²⁶⁸ In other words, the seller may not bargain for any tort immunity through the parties' contract, but nevertheless receives the immunity through the current approach. The Contract-First approach to other property damage does not favor either party. It simply permits the parties to negotiate their agreed treatment of other property damage should it occur. Further, by providing that, in the absence of contractual agreement on the treatment of other property damage, such damage is subject to tort liability, the seller/manufactures will be certain to

264. See Anzivino, *supra* note 83, at 757.

265. Sunnyslope Grading, Inc. v. Miller, Bradford & Risberg, Inc., 437 N.W.2d 213, 217-18 (Wis. 1989). For a discussion of the distinction between economic loss and noneconomic loss, see generally Anzivino, *supra* note 2.

266. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 1 (1998).

267. The reasonably foreseeable rule is also known as the disappointed expectations test.

268. See Anzivino, *supra* note 83, at 749, 777.

seek limitations in their contract negotiations. In sum, a Contract-First approach to other property damage is a more open, honest, and fair approach to handling other property damage disputes. It does not suffer the flaw in the current approach, which is to provide an un-bargained-for tort immunity, which clearly favors seller/manufacturers.

C. The Contract-First Approach Is Subject to Stringent Safeguards

One could argue that any approach that permits a seller/manufacture's contract to control its tort liability is a prescription for abuse. However, not all contracts between a seller/manufacture and a buyer will be allowed to control a seller/manufacture's exposure to tort liability when a defective product causes other property damage. Rather, there are a number of safeguards that parties must satisfy before their contract will control the disposition of the other property damage claim. The first is that the contract will not be enforced if the court finds it to be unconscionable.²⁶⁹ Second, if the seller/manufacture has contracted for an exclusive remedy that fails of its essential purpose, the court will not enforce any limitations in the parties' contract.²⁷⁰ Third, another impediment to a seller/manufacture enforcing its limitations on a buyer is the battle of forms analysis.²⁷¹ Simply because the seller/manufacture has limitation-of-liability clauses in its standard terms and conditions does not mean such limitations will become part of the parties' contract. Fourth, for a seller/manufacture to be able to waive tort liability for other property damage due to a defective product, the seller/manufacture must meet very specific and precise requirements.²⁷² Failure to satisfy any one of the requirements of specificity means the contract limitations are not enforceable. Fifth, the U.C.C. specifically provides that extra-U.C.C. law supplements the Code.²⁷³ In other words, courts should use any additional common law decisions or statutes to protect buyers. Some statutory examples are the Magnuson–Moss Federal Warranty Act,²⁷⁴ the Wisconsin Consumer Act,²⁷⁵ and the Wisconsin Lemon Law.²⁷⁶ There are many federal and state statutes similar to these that are designed to protect buyers from an overreaching seller/manufacture. Finally, a contract clause that exempts a seller/manufacture from tort liability for damages caused by the seller/manufacture's gross negligence is unenforceable on public policy

269. For a complete discussion, see *supra* Part VI.A.

270. See *supra* Part VI.B.

271. See *supra* Part VI.C.

272. See *supra* Part VI.D.

273. See *supra* Part VI.E.

274. 15 U.S.C. §§ 2301–2312 (2006).

275. WIS. STAT. chs. 421–429 (2007–2008).

276. WIS. STAT. § 218.0171.

grounds.²⁷⁷ Thus, if the other property damage is the result of the seller/manufacturer's grossly negligent conduct, the contract limitations will not be enforced.

All of these safeguards must be satisfied for a court to determine that a seller/manufacturer's contract limitations are fair and appropriate. After review, if the court determines the contractual limitations are enforceable, then no tort end run around the contract should be permitted. On the other hand, if the party does not comply with one of the safeguards, the court should not enforce the contract limitations. Rather, the other property damage should be recoverable in tort law as provided by the Restatement (Third) of Torts.²⁷⁸ The Restatement recognizes the integrated system rule, but not the disappointed expectations test. If seller/manufacturers understand that their failure to comply with safeguards makes tort recovery available, seller/manufacturers will have a strong incentive to comply with the various safeguards. Thus, the Contract-First approach to other property damage and the other property tort rule will actually complement each other.

D. The Contract-First Approach to Other Property Damage Focuses on the Actual Bargain Between the Parties, and Not on What Could Have Been Within the Scope of the Bargain as Required by the Disappointed Expectations Test (a.k.a. the Reasonably Foreseeable Rule)

The modern reasonably foreseeable rule provides that when a defective product causes other property damage and such damage was reasonably foreseeable by the buyer at the time of contracting, the buyer cannot recover other property damage in tort law.²⁷⁹ Despite the fact that the Restatement (Third) of Torts indicates that such other property damage is recoverable in tort and that the buyer did not contractually agree to waive tort recovery, the rule denies the buyer the right to sue in tort. This denial is based on the fact that the buyer could have foreseen the damages, and therefore, could have protected himself from such damages. Unquestionably, the modern reasonably foreseeable rule represents a significant loss of rights for the buyer. At the same time, the tort immunity gained by the seller/manufacturer is a significant benefit. This entire transfer of rights and benefits occurs by judicial fiat, not as a result of arm's-length bargaining between the parties. The Contract-First approach to other property damage avoids this judicial imposition on the buyer, and instead focuses on the actual bargain struck between the parties.

It is an established rule of law that courts generally strive to preserve the

277. See *supra* Part VI.F.

278. See RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. §1 (1998).

279. See *Grams v. Milk Prods., Inc.*, 2005 WI 112, ¶ 47, 283 Wis. 2d 877, 699 N.W.2d 167.

agreed allocation of risk between contracting parties.²⁸⁰ Contract law, including the U.C.C., was “designed to allow the parties to allocate the risk of product failure.”²⁸¹ The economic loss doctrine allows and protects both the manufacturer’s and buyer’s freedom to allocate economic risk by contract.²⁸² Seller/manufacturers may bargain for limitations of liability, including tort waivers, and in essence, buyers may pay a lower price.²⁸³ The economic loss doctrine seeks to hold parties to their bargain.²⁸⁴ Absent unusual circumstances,²⁸⁵ there is generally no reason to intrude into the parties’ allocation of risk of loss and to extricate the parties from their bargains. Unquestionably, the focus of the economic loss doctrine is on the actual bargain that was struck, not on what the scope of the bargain could have been. The Contract-First approach to other property damage is in complete harmony with the economic loss doctrine’s focus on the actual bargain that was struck.

E. Public Safety Will Not Be Sacrificed by Permitting the Parties’ Contract to Allocate the Risk of Other Property Damage

One could surmise that to allow a seller/manufacture to limit its tort exposure through its contract would essentially eliminate tort claims, and thereby undercut the seller/manufacture’s duty to produce safer products. That supposition, however, would not be accurate. The other property rule provides that when a defective product causes other property damage, the aggrieved party can sue in tort to recover its damages.²⁸⁶ However, after application of the integrated system rule²⁸⁷ and the reasonably foreseeable rule,²⁸⁸ there are very little other property damages available where tort remedies can be used.²⁸⁹ Thus, the public safety incentive that was the impetus for the other property tort rule has been steadily eroded to the point of near-extinction.

A seller/manufacture’s incentive to produce safer products is not diminished by having the parties’ contract address other property damage claims. Courts have indicated that, because a seller/manufacture “can[not]

280. See, e.g., *Brooks v. Hayes*, 395 N.W.2d 167, 175 (Wis. 1986).

281. *Sunnyslope Grading, Inc. v. Miller, Bradford & Risberg*, 437 N.W.2d 213, 217 (Wis. 1989).

282. *Daanen & Janssen, Inc. v. Cedarapids, Inc.*, 573 N.W.2d 842, 847 (Wis. 1998).

283. *Id.* at 848.

284. See *id.* at 849.

285. See *supra* Part V.

286. *Saratoga Fishing Co. v. J.M. Martinac & Co.*, 520 U.S. 875, 877 (1997); RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. §1 (1998).

287. *E. River S.S. Corp. v. Transamerica Delaval Inc.*, 476 U.S. 858, 867 (1986); *Wausau Tile, Inc. v. County Concrete Corp.*, 593 N.W.2d 445, 453 (Wis. 1999).

288. See *Anzivino*, *supra* note 83.

289. See *id.* at 777.

predict with any certainty that the damage [its] unsafe product causes will be confined to the product itself [or its system], tort liability . . . continue[s] to loom as a possibility.”²⁹⁰ Thus, the incentive to build safer products is not diminished by using a Contract-First approach to other property damage. Also, the Contract-First approach to other property damage is only applicable when the parties’ contract covers the allocation of risk and passes judicial review of the safeguards. Thus, the traditional tort rule should apply in those cases that do not pass judicial scrutiny or where the contract is silent on risk allocation. Therefore, the Contract-First approach to other property damage will actually increase tort coverage and thereby enhance public safety. Currently, there are few, if any, other property damage cases that survive the integrated system and reasonably foreseeable tests to qualify for tort coverage. But, under the Contract-First approach to other property damage, those contracts that fail the court’s safeguard review or are silent on risk allocation would qualify to be brought as tort claims. The net result would be an increase in tort cases and a boost to public safety.

F. The Bargaining Rationale that Is the Root of the Reasonably Foreseeable Rule Supports the Contract-First Approach to Other Property Damage

A number of rationales were offered to support the creation of the reasonably foreseeable rule of the disappointed expectations test. First, the reasonably foreseeable rule appears to be a logical extension of the integrated system rule. The integrated system rule stems from the United States Supreme Court’s decision in *East River Steamship Corp. v. Trans America Delaval Inc.*²⁹¹ In *East River*, turbines were installed as part of a propulsion system for supertankers.²⁹² Upon use, the turbines proved defective and damaged the propulsion systems in the supertankers.²⁹³ After incurring \$8 million in damages,²⁹⁴ the shipowners sued the shipbuilder arguing tort theories on the basis that the defective turbines caused other property damage by injuring the propulsion system.²⁹⁵ The Court noted that “[i]n the traditional [other] ‘property damage’ case[], the defective product damages other property.”²⁹⁶ But in this case, the Court held there was no other property damage.²⁹⁷ Rather, the Court reasoned that the turbines were part of an

290. *State Farm Mut. Auto. Ins. Co. v. Ford Motor Co.*, 592 N.W.2d 201, 210 n.4 (Wis. 1999) (quoting *Trans States Airlines v. Pratt & Whitney Can., Inc.*, 682 N.E.2d 45, 53 (Ill. 1997)).

291. 476 U.S. 858 (1986).

292. *Id.* at 859.

293. *Id.* at 860.

294. *Id.* at 861.

295. *Id.* at 867.

296. *Id.*

297. *Id.*

integrated system and, as such, when the defective turbines damaged the system of which it was a part, there was no other property damage.²⁹⁸ The Court reasoned that “all but the very simplest of machines have component parts, [and as such,] [a contrary] holding would require a finding of [other] ‘property damage’ in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability.”²⁹⁹ The effect of the integrated system rule is to expand the domain of contract law by shrinking the number of those cases that qualify as other property damage cases under tort law. The Restatement (Third) of Torts has accepted the reasoning of the integrated system rule.³⁰⁰ The premise of the rule is simple: it is reasonably foreseeable that a defective component part will likely damage the system of which it is a part, and as such, this damage should *not* be considered other property damage but damage within the contemplation of the sales contract. When a product is purchased, both parties should consider the possibility that the product may prove defective, and protect themselves accordingly. Obviously, when the product is a component part of a system, damage to the system is an eminently foreseeable event, and as such, the contract between the parties should address that possibility. Thus, the integrated system rule is based squarely on the foreseeability that a defective component will damage its system.³⁰¹ The reasonably foreseeable rule is a logical extension of the integrated system rule. It simply extends the damages that are foreseeable beyond the product’s integrated system to all those damages that were foreseeable at the time of contracting. The Contract-First approach encourages the parties to negotiate all foreseeable damages and incorporate the agreed result into their contract.

There is a second, and perhaps more compelling, rationale for the rule. Contract and product liability law serve different purposes. Product liability law governs the relationship between a consumer and a manufacturer where it is generally not possible for the parties to negotiate all the terms of sale. Product liability law, therefore, places a burden on the manufacturer to produce safe products. On the other hand, contract law applies to commercial transactions where the terms and conditions of the sale can be negotiated to each party’s satisfaction. Contract law operates on the assumption that commercial parties can allocate the costs and risks of the product’s non-performance through the bargaining process. When a defective product is purchased in a commercial setting and causes property damage, the

298. *Id.*

299. *Id.* (quoting *N. Power & Eng’g Corp. v. Caterpillar Tractor Co.*, 623 P.2d 324, 330 (Alaska 1981)).

300. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 21 cmt. e (1998).

301. *Grams v. Milk Prods., Inc.*, 2005 WI 112, ¶ 46, 283 Wis. 2d 511, 699 N.W.2d 167.

situation implicates both tort and contract law. When the court in *Grams v. Milk Products, Inc.* adopted the disappointed expectations test, the court clearly indicated that the bargaining rationale should control. The court reasoned that “[t]he ‘disappointed expectations’ concept is grounded in contract principles of bargaining and risk sharing, not on a redefinition of ‘other property.’”³⁰² The better question, however, is whether the focus should be on the potential bargain or the actual bargain.

Michigan was the first state to adopt the reasonably foreseeable rule of the disappointed expectations test.³⁰³ In *Neibarger v. Universal Cooperatives, Inc.*, a dairy farmer purchased a milking system to milk his cows.³⁰⁴ After the system was in operation for a period, the cows became ill and died, or had to be sold for beef.³⁰⁵ It was determined that the vacuum system on the milking equipment was defective.³⁰⁶ The farmers sued on contract and tort theories to recover their losses.³⁰⁷ The main issue before the court was whether the contract or tort statute of limitations should apply.³⁰⁸ At the time the farmers filed their case, the contract statute of limitations had expired, but the tort statute of limitations had not.³⁰⁹ In discussing the economic loss doctrine, the court explained that the doctrine turns “on a distinction between transactions involving the sale of goods for commercial purposes where economic expectations are protected by commercial and contract law, and those involving the sale of defective products to individual consumers who are injured in a manner . . . traditionally . . . remedied by resort to” tort law.³¹⁰ The court reasoned that the economic loss doctrine allows commercial parties “to predict with greater certainty their potential liability for product failure and to incorporate those predictions into the price or terms of the sale.”³¹¹ Moreover, the court noted that the parties “have the opportunity to negotiate the terms and specifications, including warranties, disclaimers, and limitations of remedies.”³¹²

Further, the court underscored the importance of applying the U.C.C. in resolving disputes between commercial parties that do not involve personal

302. *Id.*, ¶ 32.

303. *See* *Neibarger v. Universal Coops., Inc.*, 486 N.W.2d 612, 620–21 (Mich. 1992).

304. *Id.* at 613.

305. *Id.*

306. *Id.*

307. *Id.*

308. *Id.* at 615.

309. *Id.* at 614.

310. *Id.* at 615.

311. *Id.* at 619.

312. *Id.* at 616.

injury.³¹³ In *Neibarger*, the defective milking system damaged more than itself; it damaged the farmer's cows, which were other property. The court noted that in many cases, failure of a product to perform as expected might result in damage to other property.³¹⁴ However, the court held that where the failure of a product to perform as expected causes damage to other property, and such damage was within the contemplation of the parties at the time of contracting, the recovery for such damage should only be under the provisions of the U.C.C.³¹⁵ The court reasoned that property damage that is foreseeable at the time of contracting is considered consequential damages under the U.C.C.³¹⁶ In the court's opinion, contract principles are "more appropriate for [resolving] claims for consequential damage[s] that the parties have, or could have, addressed in their [contract]."³¹⁷ The court characterized the damage to the cows caused by the defective milking system as a "common problem for dairy farmers" and a "normal part of the dairy business."³¹⁸ As a result, the court held the damages were reasonably foreseeable other property damage at the time of contracting and only recoverable through the U.C.C., not tort law. Clearly, the *Neibarger* decision was also based on the bargaining rationale.

Another case that underscores the bargaining rationale as a primary factor in the adoption of the disappointed expectation test is *Detroit Edison Co. v. NABCO, Inc.*³¹⁹ In *Detroit Edison*, a utility company contracted with Dravo Corp. to supply pipe to be used in a power plant.³²⁰ The pipe was used to carry steam.³²¹ A number of years after installation, one of the pipes burst, injuring seventeen people and causing significant property damage.³²² Detroit Edison filed a product liability action to recoup its \$20 million in damages.³²³ Dravo defended on the basis that the economic loss doctrine barred the tort claims and that Detroit Edison's sole remedy was under the U.C.C.³²⁴ The Sixth Circuit applied the *Neibarger* analysis. The court reasoned that *Neibarger* requires a court to focus on the parties involved and the nature of the product's use.³²⁵ The court noted that both parties were "commercial

313. *Id.* at 619.

314. *Id.* at 620.

315. *Id.*

316. *Id.*

317. *Id.* at 615.

318. *Id.* at 620–21.

319. 35 F.3d 236 (6th Cir. 1994).

320. *Id.* at 238.

321. *Id.*

322. *Id.*

323. *Id.*

324. *Id.*

325. *Id.* at 242.

entities of equivalent bargaining power” and “were in a position to fully negotiate . . . the issue of potential liability” at the time of contracting.³²⁶ Further, with the U.C.C. warranties as a baseline, the parties could have considered the costs of bearing the risk of a defective pipe and allocated the costs of such risk with certainty.³²⁷ Finally, the court indicated that “[t]he parties could have then passed on their respective costs, as a cost of doing business, and [thereby] spread the burden over a broad commercial stream.”³²⁸ The court held that it was foreseeable that pipes that carry steam at high temperatures and pressures could explode upon failure.³²⁹ The court characterized the damages caused by the explosion as an inherent hazard.³³⁰ The court concluded that Detroit Edison could have foreseen and internalized in its costs of doing business the consequences of this inherent hazard.³³¹ The court did not permit Detroit Edison to “use tort law to shift onto Dravo the entire burden of the risk associated with the defective product.”³³² Rather, the court indicated that the dispute should be resolved under the U.C.C.³³³

It is clear that the disappointed expectations test is premised on the bargaining rationale. The rationale is that the buyer should address reasonably foreseeable other property damage in its contract; if not, the buyer is prohibited from pursuing any recovery through tort law. The Contract-First approach to recovery for other property damage is also premised on the bargaining rationale. But, the critical difference is that the Contract-First approach focuses on the actual bargain that was struck, and not on what the bargain could have been.

326. *Id.*

327. *Id.*

328. *Id.* (quoting *A.C. Hoyle Co. v. Sperry Rand Corp.*, 340 N.W.2d 326, 329 (Mich. Ct. App. 1983)).

329. *Detroit Edison*, 35 F.3d at 242.

330. *Id.*

331. *Id.*

332. *Id.*

333. *Id.*

G. The Contract-First Approach to Other Property Damage Is a Simpler and More User-Friendly Approach than the Current Approach

The majority of courts³³⁴ currently use an approach that involves difficult determinations for the contracting parties, practicing attorneys, and the courts. For example, the first step is to distinguish economic loss damage from other property damage.³³⁵ Courts have characterized this distinction as having “an appealing charm of simplicity” that “cannot stand the test of pragmatism or logic.”³³⁶ Further, the current approach is compounded by two judicially created rules that also must be considered. The first rule is the integrated system rule. The integrated system rule provides that when a product proves defective and damages itself and the system of which it is a component, no other property damage has occurred.³³⁷ It has often proved very difficult for a court to determine where a system ends and where other property begins.³³⁸ The second rule which some states³³⁹ have also adopted when determining if other property damage has occurred is the disappointed expectations test.³⁴⁰ Under the disappointed expectations test, damage to other property is not other property damage if the damage was foreseeable to the buyer at the time of contracting.³⁴¹ Again, this is a very challenging determination for a court.³⁴² The net effect of these rules is to virtually eliminate tort coverage for other property damage.³⁴³ In other words, after applying these difficult rules, the net result is that other property damage is almost always a contract matter. The Contract-First approach simply eliminates these difficult and contentious determinations and focuses the court’s attention on the contract between the parties to determine how the parties have allocated the risk of other property damage. Subject to judicial review of the current safeguards,³⁴⁴ the parties can agree in their contract whether contract or tort remedies are available. The safeguards are customary determinations that are familiar to the courts, unlike the determinations required under the current approach. The Contract-

334. See Ralph C. Anzivino, *The Fraud in the Inducement Exception to the Economic Loss Doctrine*, 90 MARQ. L. REV. 921, 924–26 n.22 (2007).

335. See Anzivino, *supra* note 2, at 1081.

336. Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp., 694 P.2d 198, 209 (Ariz. 1984) (quoting 3 RONALD A. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 2-314:50, at 156–57 (3d ed. 1983)).

337. E. River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 867 (1986); Wausau Tile, Inc. v. County Concrete Corp., 593 N.W.2d 445, 452 (Wis. 1999).

338. RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 21 cmt. e (1998).

339. See Anzivino, *supra* note 83, at 752–53 n.24.

340. Grams v. Milk Prods., Inc., 2005 WI 112, ¶ 32, 283 Wis. 2d 511, 699 N.W.2d 167.

341. *Id.*

342. See *id.*, ¶¶ 32–42.

343. See Anzivino, *supra* note 83, at 760.

344. See *supra* Part VI.

First approach is a very simple and easy means to resolve other property damage claims. In those cases where the parties' contract is silent on other property damage, or the contract limitations fail to satisfy the enumerated safeguards, the courts can resort to the other property rule as expressed in the Restatement (Third) of Torts.

VIII. CONCLUSION

When a defective product causes other property damage, the courts have been faced with a conundrum. Should the courts follow statutory law (the U.C.C.) and apply contract law, or the Restatement (Third) of Torts and apply tort law in resolving the dispute? Different courts have selected different paths. The courts have indicated that each path is mutually exclusive of the other. In other words, the current approach is for courts to choose between applying contract or tort law. The choice, however, is a false dilemma. There is a better approach to resolving an other property damage claim. The courts should first consult the parties' contract to determine if it addresses the recovery of other property damage. If it does, the court should enforce the contract, provided various safeguards were met in the contracting process. The various safeguards are well established in contract law and assure the court that the contractual provisions dealing with other property damage were actually and fairly negotiated. The Contract-First approach encourages the parties to assess and allocate the risks and rewards of the transaction in their contract, and enforces their agreement, subject to the safeguards. The approach does not permit an end run around the contract. If the safeguards are not met, the parties' contract should not control the other property damage dispute, tort law should. Under this approach, the free bargaining rationale of contract law and the public safety rationale of tort law are both in play. The fact that the contract's failure to satisfy the safeguards will cause tort law to be applicable, discouraging sellers from overreaching for fear that tort law will come into play. The net result is an approach that encourages the parties to address other property damage in the negotiation process and to reach a fair agreement over its treatment.