SUPREME COURT OF KENTUCKY
NO. 2009-SC-485-D

GIDDINGS & LEWIS, INC., ET AL. — APPELLANTS/ CROSS-APPELLEES

v.

ON APPEAL FROM THE COURT OF APPEALS
NO. 2007-CA-002163-MR

INDUSTRIAL RISK INSURERS, ET AL. — APPELLEES/ CROSS-APPELLANTS

BRIEF OF APPELLANTS, GIDDINGS & LEWIS, INC., ET AL.

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CERTIFICATE OF SERVICE

This certifies that a copy of appellants/cross-appellees' brief was served by first class mail on the 10th day of May, 2010, on:

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This further certifies that appellants/cross-appellees did not withdraw the record on appeal.

John L. Tate

INTRODUCTION

This case presents the Court, for the first time, a classic application of the Economic Loss Rule: two sophisticated commercial entities entered into a contract—including a warranty—for the sale of a complex industrial product, which failed after many years of use and the expiration of the warranty, damaging only itself. In reviewing the trial court's dismissal of all tort claims arising from the incident, the Court of Appeals recognized the existence of the Economic Loss Rule, but held that the Rule does not bar tort claims for negligent misrepresentation and fraud because those claims arise from "common law tort theories," and held that claims for damage to some components of the product also might not be barred; this Court should reverse.

STATEMENT CONCERNING ORAL ARGUMENT

Giddings & Lewis requests oral argument and believes it would assist the Court in reaching a full understanding of the underlying facts and the significant legal issues presented.

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STATEMENT OF THE CASE

I. Introduction

Ingersoll Rand purchased a Diffuser Cell System from Giddings & Lewis ("G&L"). As two sophisticated commercial entities, the parties negotiated a purchase contract—including a warranty. If the machine malfunctioned during the warranty period, G&L agreed to repair the machine at no cost to Ingersoll.

After the warranty expired, and after more than seven years of continuous operation, an accident occurred that damaged *only* the machine. With the warranty expired, G&L charged Ingersoll for the repairs to the machine and Ingersoll paid for those repairs. Ingersoll then submitted a claim to its insurance companies for the repair costs and the costs it incurred to replace lost production. The Insurance Companies, who along with Ingersoll are the Appellees in this appeal, paid the claim. The Insurance Companies then filed suit against G&L seeking to recover the amount they paid their insured.

Stepping into the shoes of the insured, the Insurance Companies now seek to recover in tort the damages Ingersoll negotiated away in its contract with G&L. Essentially, the Insurance Companies argue that the negotiated warranty provision in the contract between G&L and Ingersoll is void—that is, Ingersoll was entitled to negotiate a lower price for the machine in exchange for a limited warranty period AND that the limited warranty period should now be disregarded and G&L should be involuntarily subjected to an *unlimited* warranty period and *unlimited* damages.

This is a classic application of the Economic Loss Rule, which a clear majority of jurisdictions have adopted. A party cannot recover economic damages (i.e., damages that do not involve personal injury or damage to other property) that the party negotiated away in a contract by simply recasting those damages as "tort" damages. Without the

Economic Loss Rule, as the United States Supreme Court famously observed in an unanimous opinion, "contract law would drown in a sea of tort." *East River Steamship Corp. v. Transamerica Delaval*, 476 U.S. 858, 866 (1986).

The only relevant facts for purposes of this appeal are that the warranty expired before the accident and that there were no personal injuries or damage to property other than the Diffuser Cell. Because the parties do not dispute either of these facts, the Court is left only with a question of law: Does the Economic Loss Rule bar the Insurance Companies' claim?

II. Ingersoll issues specifications for the manufacture of a Diffuser Cell System.

The Diffuser Cell System consists of three integrated components: a Vertical Turning Lathe ("VTL"), two Vertical Machining Centers, and a Material Handling System. (R. 191-195.) The Diffuser Cell System cuts and shapes metal parts. In the first step of the process, the operator secures a block of raw metal onto a large pallet. The operator manually torques a large chuck—or clamp—that secures the metal block onto the pallet. The pallet and attached metal block are then automatically shuttled into the VTL via the Material Handling System. (R. 173-74; *Allen Depo.* at 55-61.)

The VTL spins the pallet and the attached metal block. Much like clay being transformed into a vase by a potter, computer controlled cutting tools move around the spinning block of metal to create a part shaped to precise dimensions. After the VTL completes its cuts, the part is then automatically shuttled into the Vertical Machining Center, where it undergoes further machining into its final form. (*Allen Depo.* at 14.)

All of the cutting and shaping by the VTL and the Vertical Machining Center are controlled by a computer program created by the customer—in this case, Ingersoll. (R. 173-74; *Allen Depo.* at 23.) Ingersoll's engineers also designed the clamping system to

keep the part secured to the pallet. This is so because the clamping and set up varies based on the design of the part and the particular cutting applications to which the part will be subjected. (*Allen Depo.* at 14-17.)

III. G&L manufactures the Diffuser Cell System according to Ingersoll's specifications.

Ingersoll is a large, sophisticated industrial conglomerate. Ingersoll employs more than 40,000 people and operates 80 manufacturing facilities around the world. (R. 197-98.)

Ingersoll issued an eight-page list of specifications for the Diffuser Cell System—including the VTL. (Attached hereto as Exhibit 5; R. 200-08.) The specifications dictated how G&L was to manufacture the Diffuser Cell System—including pallet size, travel times, minimum tolerances, performance standards, computer control systems, and—most importantly—RPM's.

G&L customarily manufactures the VTL to run at a maximum of 400 RPM. Ingersoll, however, specified that G&L manufacture a VTL to run at a maximum of 690 RPM. The higher speed permitted Ingersoll to produce parts faster. (R. 175.)

The Insurance Companies allege that the insured, Ingersoll, was unaware of the consequences of increasing the speed of the VTL and that G&L should have warned against it. (*See, e.g.,* R. 7.) In making this argument, the Insurance Companies ask the Court to treat Ingersoll like a naïve consumer purchasing a power tool for a weekend project. Ingersoll's engineers, however, who authored the specifications for the Diffuser Cell System were hardly naïve. Indeed, Ingersoll's engineer who created the program being run at the time of the accident, confirmed that the consequences of increasing the

RPM's would have been as obvious to Ingersoll's engineers as it would have been to any child on a playground:

> [A]ny kid that's been on the playground and been on the spinning turntable and tried to hang on gets a lesson right there that the faster that turntable turns, the more they're slung to the outside and that—that's how it works.

(*Quebe Depo.* at 73.)

G&L analyzed Ingersoll's request and redesigned the bearings, transmission, and the material of the pallet to accommodate Ingersoll's specifications. (R. 175; *Campshure Depo.* at 22.) With these changes, G&L manufactured the Diffuser Cell System according to Ingersoll's specifications. (R. 175.)

IV. The Diffuser Cell System remains in operation for seven years until the accident occurs.

The Diffuser Cell System went into service in June 1990. On June 7, 1997—after being in service for over seven years and being run "24/7"—the VTL threw off a spinning part—a large chunk of metal—as well as the chuck holding the part in place. (R. 8; Allen Depo. at 91-92.) The thrown part and chuck destroyed the Diffuser Cell System. Fortunately, there were no personal injuries. All the damages were purely economic losses. (*See, e.g.,* Amen. Compl. ¶¶ 3,4, R. 150; Pls.' Mem. of Law in Opp. to Defs.' Mot. for Summary Judgment at 11, included in the Record but not numbered.)

The evidence indicates that the accident occurred due to Ingersoll's deplorable operating and maintenance conditions. The machine operator, Charles Allen, testified that parts were thrown off the lathe about five times before the event at issue. (*Allen Depo.* at 53.) When Ingersoll investigated these previous incidents, they found the chuck was usually not clamping the part securely. (*Id.* at 62.) After these incidents, Ingersoll began occasionally testing the clamping power of the chuck. In 25% of those tests, the

chuck had insufficient clamping power. The greatest loss of clamping power was 50%. On average, the chuck showed a 20% loss of clamping power. (*Id.* at 47, 48.) Significantly, G&L did *not* manufacture or supply the chuck. (R. 109-113.)

According to Mr. Allen, the chuck operating manual required that the chuck be cleaned and greased every eight hours of operation. However, Ingersoll only cleaned and greased the chuck every three weeks of operation—or a 6300% deviation from the required maintenance schedule. (Allen Depo. at 48.) At the time of the accident, the machine had been operating 24 hours a day, seven days a week for an extended period of time. (*Id.* at 91-92.)

The machine operators were concerned (*Id.* at 64) and felt that Ingersoll's machine maintenance was "not adequate." (*Id.* at 66.) Nonetheless, the operators did not voice their concerns to management because management considered them to be "whiners." (*Id.* at 65.)

When the accident occurred, Ingersoll's engineers had just uploaded the program for the machining of this particular part. The program was "unproven" because this was the first use. (*Id.* at 23-24; 27-28; *Quebe Depo.* at 65, 72.) The operator noticed that when he was loading the part, the wrench was slipping. (*Allen Depo.* at 72-73.) From experience, the operator knew that this meant that the chuck was not clamping the part sufficiently. (*Id.* at 32, 51, 72.) Nonetheless, he hit the start button, and the part flew off minutes later.

V. Ingersoll pays G&L to repair the Diffuser Cell System.

After the accident, Ingersoll returned the Diffuser Cell System to G&L and requested that G&L rebuild it. Ingersoll paid G&L for the rebuild. (R. 144-66.) In total, the Insurance Companies paid Ingersoll $2,798,742 for its economic losses. (*Id.*)

VI. Trial court proceedings

The Insurance Companies filed suit seeking to recoup the money they paid on the claim by Ingersoll. (R. 8.) The Insurance Companies asserted claims for breach of an implied warranty, breach of a so-called "service contract," negligence, and strict liability. (R. 1-18.) When G&L moved for summary judgment on these claims, the Insurance Companies amended their complaint to include additional claims for negligent misrepresentation and fraud.[1] (R. 144-66.) G&L, therefore, amended its motion for summary judgment to include all claims. The trial court ultimately ruled as follows: (1) the statute of limitations barred the implied warranty claim; (2) the Economic Loss Rule applies in Kentucky; (3) the so-called "destructive occurrence" exception to the Economic Loss Rule does not apply; and (4) the Economic Loss Rule barred all remaining claims by the Insurance Companies because the Insurance Companies' only remedy (if any) was that available under the product warranty negotiated by Ingersoll when it purchased the machine. (Trial Court Orders attached as Exs. 1, 2.)

VII. The Court of Appeals decision

The Court of Appeals affirmed the trial court's recognition and application of the Economic Loss Rule, rejecting the so-called "exception" to the rule if a product fails as a result of a "destructive occurrence." (Court of Appeals' Opinion ("*Op.*") at 12-16

[1] The Insurance Companies also added a claim for breach of express warranty, but they voluntarily withdrew that claim when one of their witnesses admitted in deposition that the express warranty had expired by the time of the accident.

attached as Ex. 4.) Accordingly, the Court of Appeals affirmed the trial court's dismissal of the negligence, product liability, and breach of service contract claims. But the Court of Appeals *reversed* the trial court's other holdings, ruling that: (1) The Economic Loss Rule did not apply to the Insurance Companies' claims for negligent misrepresentation and fraud because those claims arose from "common law tort theories"; and, (2) A question of fact remained whether the various individual components of the Diffuser Cell System constituted "other property" to which the Economic Loss Rule did not apply.[2] (*Op.* at 16-18.)

ARGUMENT

The standard of review for summary judgments is "whether the trial court correctly determined that there were no genuine issues of material fact and that the moving party was entitled to judgment as a matter of law." *Lach v. Man O'War, LLC*, 256 S.W.3d 563, 567 (Ky. 2008), *citing Steelvest, Inc. v. Scansteel Serv. Ctr., Inc.*, 807 S.W.2d 476, 480 (Ky. 1991). That review is *de novo*. *Kegel v. Tillotson*, 297 S.W.3d 908, 910 (Ky. 2009).

I. The Economic Loss Rule.

A. The Economic Loss Rule preserves the boundary between tort and contract law.

The Economic Loss Rule recognizes that economic interests are protected by contract principles, not tort principles. Under the narrowest application of the Rule, a

[2] The Court of Appeals' Opinion contains conflicting language regarding the actual outcome. The Court first stated that it was affirming the trial court's dismissal of the "negligence and warranty claims" but reversing the trial court's dismissal of the "negligent misrepresentation and fraud claims." *Op.* at 17. Later, in the Conclusion, the Court stated that it was affirming the trial court's dismissal of the "contract" claims but reversing as to the misrepresentation and fraud claims. *Id.* at 21. Presumably, the Court's dismissal of the "negligence" claims included the strict liability claims and the dismissal of the "contract" claims included the breach of implied warranty and breach of service contract claims. To the extent this is a misunderstanding of the Court's decision, G&L appeals every aspect of the Court of Appeals decision that reversed the trial court.

commercial entity that contracts for the purchase of a product may not sue in tort to recover economic losses arising from the destruction of the product alone, but rather must sue under the terms of the contract to which the parties agreed. *East River Steamship Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 871 (1986); *Mt. Lebanon Personal Care Home, Inc. v. Hoover Universal, Inc.*, 276 F.3d 845, 848 (6th Cir. 2002). Tort suits for both direct and consequential economic losses are barred as long there were no personal injuries or damage to other property. *Mt. Lebanon Personal Care Home*, 276 F.3d at 848.

The Rule thus preserves an essential boundary between tort law, which is primarily concerned with safety, and contract law, which is primarily concerned with enforcing the terms of the parties' own agreement. *See East River Steamship Corp.*, 476 U.S. at 872-73; *Mt. Lebanon Personal Care Home*, 276 F.3d at 848. More specifically, three policy considerations support the Rule: (1) "it maintains the historical distinction between tort and contract law," (2) "it protects parties' freedom to allocate economic risk by contract," and (3) it encourages the party in the best position to assess the risk of the economic loss, typically the purchaser, "to assume, allocate, or insure against that risk." *Mt. Lebanon Personal Care Home*, 276 F.3d at 848.

1. The historical distinction between tort and contract law.

The historical distinction between "tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary." *East River Steamship Corp.*, 476 U.S. at 871. Products liability law developed out of a public policy judgment that contract law, and specifically warranty law, did not adequately protect consumers from dangerous products. *Id.* at 866. Thus, the "paradigmatic products-liability action" is one where a product "reasonably certain to place life and limb in peril ... causes bodily injury." *Id.*

Because of similar safety concerns, product-liability protection also applies when a product damages other property. *Id.* at 867. In the products-liability context, the manufacturer "is liable whether or not it is negligent because 'public policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market.'" *Id.* at 866 (citation omitted).

But when a product damages only itself the "tort concern with safety is reduced." *Id.* at 871. Such damage "means simply that the product has not met the customer's expectations, or, in other words that the customer has received 'insufficient product value.'" *Id.* at 872 (citation omitted). Ensuring product value and the expectations of the customer is "precisely the purpose" of contract law, and particularly warranties. *Id.*

2. There is no reason to disturb the parties' allocation of risk when a product damages only itself.

Thus, when a product damages only itself the "reasons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong." *Id.* at 871. There is simply no reason for society to presume that a customer whose product damages only itself "needs special protection." *Id.* at 872.

Rather, contract law is best suited to handle such controversies because it gives the parties the freedom to allocate the risk themselves. *Id.* at 873. For example, the manufacturer can "restrict its liability, within limits, by disclaiming warranties or limiting remedies." *Id.* In return, "the purchaser pays less for the product." *Id.* The purchaser can then insure against, or otherwise allocate, the risk it has assumed. *Id.* at 871. Thus, warranty law allows the purchaser to obtain "the full benefit of its bargain," whatever that bargain may be. *Id.* at 873.

In contrast, handling such controversies under products-liability law would significantly expand that law beyond its purpose. The increased cost "to the public that would result from holding a manufacturer liable in tort for injury to the product itself is not justified." *Id.* at 872; *Miller's Bottled Gas, Inc. v. Borg –Warner Corp.*, 955 F.2d 1043, 1050 (6th Cir. 1992) ("The public subsidizes the judicial system and thus stands to lose a great deal if all such parties suffering only economic injury may maintain negligence actions against manufacturers and suppliers of defective products."). The Economic Loss Rule encourages parties to allocate economic risks themselves and not flood the judicial system with these problems.

B. The history of the Economic Loss Rule in Kentucky.

This Court has not adopted the Economic Loss Rule by name, but a few Kentucky decisions address the doctrine. The most obvious expression and application of the Rule, although not by name, occurred in *Falcon Coal Co. v. Clark Equipment, Co.*, 802 S.W.2d 947, 948 (Ky. App. 1990). In *Falcon Coal*, plaintiff's front-end loader caught fire. Only the front-end loader was destroyed; no other property or person was damaged. *Id.* at 948.

The owner sued the manufacturer in tort. Relying on Section 402A of the Restatement (Second) of Torts, the court denied recovery because the damage was limited to the front-end loader itself. *Id.* Consistent with the Economic Loss Rule and citing the U.S. Supreme Court's seminal decision, the Court of Appeals held that recovery in a product liability action was only permitted when there was physical injury or damage to "other property." *Id.* (citing *East River*, 476 U.S. at 858).

A few years later, this Court briefly commented on the Court of Appeals' *Falcon Coal* opinion, although without discussing or mentioning the Economic Loss Rule, in a

case relating to defective home construction. *Real Estate Marketing v. Franz*, 885 S.W.2d 921, 926 (Ky. 1994). The issue in that case was whether the Franzes, homeowners who were *not* the original purchases and did not have a contract with the homebuilder, could "assert a viable claim against the homebuilder for structural defects." *Id.* at 922. The defects related to water leaking in the house, which caused a diminution in the value of the home but no injuries or damage other than to the house itself. *Id.* at 923. Because there was no contract, the Court upheld the dismissal of the Franzes' contract claims. The Court also upheld the dismissal of the negligence and negligence *per se* claims because "to recover in tort one cannot prove only that a defect exists; one must further prove a damaging event." *Id.* at 926. There was no damage to person or property other than the house itself, and the Court held that there could be no tort recovery for "economic loss related solely to diminution in value." *Id.* But the Court went on to note, in *dicta* and without any mention of the Economic Loss Rule, that: "We do not go so far as the Court of Appeals' opinion in *Falcon Coal Co. v. Clark Equipment Co.,* limiting recovery under a products liability theory to damage or destruction of property 'other' than the product itself." *Id.* (citation omitted.)

The fact that *Franz* did not mention the Economic Loss Rule is appropriate. Unlike the case at bar, the *Franz* case did not involve a contractual transaction at all, much less one between a sophisticated commercial buyer and a sophisticated commercial seller with equal bargaining power, which is the province of the Economic Loss Rule in its "classic definition." *See Louisville Gas & Elec. Co. v. Continental Field Sys.*, 420 F. Supp. 2d 764, 770 (W.D. Ky. 2005) (acknowledging that Kentucky, in the least, has adopted the Economic Loss Rule "in its classic definition"); *Gooch v. E.I. Du Pont de Nemours &*

Co., 40 F. Supp. 2d 863, 875 n.5 (W.D. Ky. 1999) (distinguishing *Franz* because the case did not involve a "transaction between a commercial buyer and seller"). Thus, as the Sixth Circuit recognized, *Franz* might imply that Kentucky law does not extend the Economic Loss Rule to consumer transactions, but it says nothing about the application of the classic form of the Rule in commercial situations. *Mt. Lebanon Personal Care Home*, 276 F.3d at 849.

The first mention of the Economic Loss Rule by name appears in a concurring opinion in *Presnell Construction v. EH Construction*, 134 S.W.3d 575 (Ky. 2004). As with *Franz*, *Presnell* did not involve a classic Economic Loss Rule presentation. The case arose after a building owner separately contracted with Presnell for construction management services and with EH Construction for general construction work. *Id.* at 576. Presnell and EH were not parties to any contract with each other. When EH suffered economic losses because of Presnell's failure to perform its construction management services, EH sued Presnell in tort for negligent supervision of the construction project and negligent misrepresentations. *Id.*

Thus, the case did not involve a classic Economic Loss Rule presentation because it involved the provision of services – construction supervision – rather than the sale of a product, and the parties did not have a contractual relationship. *See Louisville Gas & Electric*, 420 F. Supp. 2d at 768-69 (discussing why the "classic description of the economic loss rule" is limited to the sale of products). Appropriately, the majority *Presnell* opinion does not mention the Rule. Rather, the opinion merely formalizes, for the first time, recognition of the tort of negligent misrepresentation. *Presnell Construction,* 134 S.W.3d at 580, 582.

Two concurring Justices, however, stated their opinion that the Economic Loss Rule would bar the negligent supervision claims and that "this Court should expressly adopt the economic loss rule in order to encourage contracting parties to allocate such risks themselves." *Id.* at 583 (Keller, J., and Graves, J., concurring). After discussing the history and some of the parameters of the Rule, the concurring Justices also stated that the Rule would not bar a tort claim for negligent misrepresentation.[3] *Id.* at 590.

II. The Court of Appeals erred in holding that the Economic Loss Rule does not apply to the claims for negligent misrepresentation and fraud.

Interpreting the concurring opinion in *Presnell,* and applying it to the facts of this case, the Court of Appeals held that the Economic Loss Rule does not bar the Insurance Companies' claims for negligent misrepresentation and fraud. *Op.* at 16. According to the opinion, the Economic Loss Rule does not affect any claims that arise from "common law tort theories" independent of the parties' contract. *Id.* But that test is totally unworkable because, by definition, all tort claims putatively arise from "common law tort theories independent of contract." Indeed, the Court of Appeals dismissed the other tort claims—simple negligence and product liability—although those two causes of action also putatively arise from duties independent of the contract. *Id.*

A. The Economic Loss Rule bars all tort claims unless they are truly independent of the underlying contract.

Rather than merely look at the labels applied to a particular claim by a plaintiff, a court must look at the actual substance of the claim to determine if the claim simply "repackages" a product warranty claim and is thus barred by the Economic Loss Rule.

[3] The Kentucky Court of Appeals subsequently addressed the Economic Loss Rule in a construction defect case, which this Court later ordered depublished. *Hack v. Lone Oak Dev., Inc.*, 2008 Ky. App. LEXIS 188 (Ky. App. June 13, 2008). As with the other Kentucky cases addressing the Rule, the *Hack* case does not present the classic application because there was no contract between the parties.

Federal courts predicting and applying Kentucky law have squarely addressed this issue, and each has held that the Economic Loss Rule bars negligent misrepresentation and fraud claims if the claims are interwoven with the parties' barred warranty claims.[4] Such an interpretation, moreover, is consistent with the strong majority of other jurisdictions[5] and with the United States Supreme Court's analysis. *East River*, 476 U.S. at 874 (looking to the "nature of the injury" and the "resulting damages" in determining that "it is more natural to think of injury to a product itself in terms of warranty").

An illustrative case is *Strathmore Web Graphics v. Sanden Machine, Ltd.*, 2000 U.S. Dist. LEXIS 22618 (W.D. Ky. 2000). In *Strathmore*, the plaintiff purchased a press from defendant. Plaintiff alleged that the manufacturer misrepresented the capabilities of the press and that the misrepresentations induced plaintiff to purchase the press. The plaintiff sued for breach of contract *and* fraudulent misrepresentation. *Id.* at *2.

The court found that the fraudulent misrepresentation claims "relate solely to the quality or character of the press." *Id.* at *9. The court concluded that under Kentucky law "where there are no fraudulent representations alleged that are distinct from the breach of contract or warranty claims, but rather reference the quality or character of the

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[4] *See, e.g., Miller's Bottled Gas v. Borg-Warner Corp.*, 955 F.2d 1043, 1051 (6th Cir. 1992); *Westlake Vinyls v. Goodrich Corp.*, 518 F. Supp. 2d 955, 968-69 (W.D. Ky. 2007); *Ohio Cas. Ins. Co. v. Vermeer Manuf. Co.*, 298 F. Supp. 2d 575, 579 (W.D. Ky. 2004); *General Elec. Co. v. Latin Am. Imports*, 214 F. Supp. 2d 758, 762 (W.D. Ky. 2002); *Highland Stud Int'l v. Baffert*, 2002 U.S. Dist. LEXIS 27987, *15 & n. 7 (E.D. Ky. 2002) (holding that, under Kentucky law, the Economic Loss Rule barred plaintiff's fraud and negligent misrepresentation claims as impermissible "tort-based end-runs of contract law").

[5] *See, e.g., Duquesne Light Co. v. Westinghouse Elec. Corp.*, 66 F.3d 604, 620 (3rd. Cir. 1995) ("[C]ourts in jurisdictions which have adopted the economic loss doctrine routinely have declined to carve out an exception for claims of negligent misrepresentation."); *Werwinski v. Ford Motor Co.*, 286 F.3d 661, 676 (3rd Cir. 2002) (noting an "emerging trend" that permits fraud claims only where they arise independently of the underlying contract); *Waytec Elec. v. Rohm and Haas Elec. Mat.*, 459 F. Supp. 2d 480, 491 (W.D. Va. 2006) (Virginia law); *United Vaccines v. Diamond Animal Health*, 409 F. Supp. 2d 1083, 1094 (W.D. Wisc. 2006) (Wisconsin law).

goods sold, the fraud claim 'falls squarely within the ambit of the economic loss doctrine.'" *Id.* at **9-10 (quoting *Gooch*, 40 F. Supp. 2d at 876-77).[6]

B. The Insurance Companies' negligent misrepresentation and fraud claims relate solely to the character of the goods.

After G&L filed its original motion for summary judgment based on the Economic Loss Rule, the Insurance Companies amended their complaint and added two new tort causes of action: fraud by omission and negligent misrepresentation. Yet, these two new tort causes of action mirror the other tort claims and allege the same amount of damages as every other claim: $2,798,742. (R. 144-166).

The essence of the Insurance Companies' original claims is: "The product is defective." In comparison, the essence of the Insurance Companies' subsequent fraud and negligent misrepresentation claims is: "*You failed to tell us* the product is defective." The Insurance Companies' ploy is not unique; many other courts have correctly viewed such fraud and negligent misrepresentation claims as "interwoven into the contract" and, therefore, transparent attempts to avoid the Economic Loss Rule. *See Maynard Coop. v. Zeneca*, 143 F.3d 1099, 1102-03 (8th Cir. 1998) (for the purposes of the Economic Loss Rule, finding the distinction between negligent misrepresentation claim and product liability claim a "distinction without a difference.").

Here, as in *Strathmore*, the Insurance Companies assert that the alleged fraud and misrepresentation induced them to enter into the contract in the first place: "Ingersoll Rand would not have purchased the VTL if they had been told the turning speed of the VTL could create a loss of clamping pressure on the pallet and lead to the violent release

[6] *Compare Air Prods. & Chemicals v. Eaton Metal Prods.*, 256 F. Supp. 2d 329, 340 (E.D. Pa. 2003) (holding that the Economic Loss Rule did *not* bar misrepresentation claim because it did not reference the "character or quality" of the product but rather related to the manufacturer's representation that the product complied with an industrial code).

of the pallet, chuck and part during operation." (Amen. Compl., Count VI, ¶ 16; Count VII, ¶16; R. 144-166.) Also, as in *Strathmore*, the Insurance Companies' misrepresentation and fraud claims are not distinct from their abandoned warranty claims because all the claims reference only the "character and quality" of the Diffuser Cell System—specifically, the high RPM's.

The concurring opinion in the *Presnell* case, relied on in the Court of Appeals' opinion, actually does not dictate a contrary conclusion. As discussed above, although the concurring opinion broadly states that negligent misrepresentation claims are not barred by the Economic Loss Rule, the facts of the *Presnell* case, which did not involve the sale of a product or a contract between the parties, are readily distinguishable. *Presnell Construction*, 134 S.W.3d at 590 (citing *Town of Alma v. Azco Constr., Inc.*, 10 P.3d 1256 (Colo. 2000); *Keller v. A.O. Smith Harvestore Prods., Inc.*, 819 P.2d 69, 73 (Colo. 1991). Moreover, the two cases cited in the concurring *Presnell* opinion for the broad proposition that negligent misrepresentation claims are an exception to the Economic Loss Rule actually do not require that result here. *Town of Alma* did not involve negligent misrepresentation claims at all. *Town of Alma*, 10 P.3d at 1257-58. And *Keller* involved negligent misrepresentation claims, but the Economic Loss Rule was not implicated because the plaintiff alleged property damage beyond the product at issue. *Keller*, 819 P.2d at 71.

The Insurance Companies' negligent misrepresentation and fraud claims do not arise independently of the contract but instead are intertwined with the contract. As such, the Economic Loss Rule bars both claims.

III. The Court of Appeals erred in holding that a question of fact exists as to whether "other property" was damaged.

There is no disagreement that the Economic Loss Rule permits recovery of damages to "other property." The Court of Appeals ruled, however, that there was a dispute of material fact regarding what constituted the "product" for which the Economic Loss Rule barred recovery and whether "other property" was damaged. Specifically, the Court held that because certain components of the Diffuser Cell System could—in a different application—be used independently, a question of fact remained whether the components of the Diffuser Cell System that were damaged when another component failed should be considered "other property." (*Op.* at 18.)

The Court's analysis, again, turns the Economic Loss Rule on its head. The Court's analysis also—without any mention or discussion—rebukes the United States Supreme Court and *every* federal court that has interpreted the same issue under Kentucky law. If this ruling is left standing, only the simplest of machines—those with no separate components—will be covered by the Economic Loss Rule.

A. Ingersoll Rand purchased a "Diffuser Cell System," and the "Diffuser Cell System" constitutes the "product" for which damages are not recoverable.

The Diffuser Cell System consists of three integrated components: a Vertical Turning Lathe ("VTL"), two Vertical Machining Centers, and a Material Handling System. The Insurance Companies alleged that that in addition to the VTL—where it is undisputed the accident "began"—other components of the Diffuser Cell System were damaged. The Court of Appeals held that these other components of the Diffuser Cell System may constitute "other property" that would not be subject to the Economic Loss Rule. (*Op.* at 18.) Courts, however, have regularly rejected as unworkable such attempts

to parse a machine's component parts for the purposes of applying the Economic Loss Rule. Instead, courts focus on the final, as-delivered product bargained for.[7]

For example, in *Bowling Green Municipal Utilities v. Thomasson Lumber Co.*, 902 F. Supp. 134 (W.D. Ky. 1995), a utility purchased several hundred utility poles that were treated with a chemical preservative. The preservative proved to be defective and caused the poles to decay. *Id.* at 136. Plaintiff argued that the "product" was the defendant's preservative and that the poles were "other property" for which it could recover damages. *Id.* at 137.

The court rejected this argument, however, and held that the "product" was the poles and that "other property" was anything other than the poles themselves (as opposed to anything other than the defective preservative itself). The court thus denied recovery of the cost of the poles themselves. In so holding, the court discerned and then followed the "prevailing trend" among the jurisdictions and held that the defective "product" was the "finished product bargained for by the buyer, rather than its individual components." *Id.* at 139.[8]

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[7] *See East River Steamship Corp.*, 476 U.S. at 867 ("Since all but the very simplest of machines have component parts, [a contrary] holding would require a finding of 'property damage' in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability."); *Saratoga Fishing Co. v. J. M. Martinac & Co.*, 520 U.S. 875, 879 (U.S. 1997) ("When a Manufacturer places an item in the stream of commerce by selling it to an Initial User, that item is the 'product itself'" for purposes of the Economic Loss Rule); *Barton Brands v. O'Brien & Gere*, 550 F. Supp. 2d 681, 689 (W.D. Ky. 2008) (denying recovery for damage to supplies stored within the defective product because the supplies were not "other" property); *Gooch v. E.I. du Pont de Nemours & Co.*, 40 F. Supp. 2d 863, 875 (W.D. Ky. 1999) (denying recovery for damage to corn crop due to defective herbicide product because the corn crop was not "other property"); *In re General Motors Corp.*, 383 F. Supp. 2d 1340, 1343-44 (W.D. Okla. 2005) (holding that the relevant product is "the finished product into which the component is integrated."); *Waytec Elec. v. Rohm and Haas Elec. Mat.*, 459 F. Supp. 2d 480, 491 (W.D. Va. 2006) (denying recovery for damage to circuit boards caused by chemical solution applied to boards).

[8] *See also Barton Brands v. O'Brien & Gere*, 550 F. Supp. 2d 681, 689 (W.D. Ky. 2008) (denying recovery in tort for damage to supplies stored within the defective product because the supplies were not "other property"); *Gooch*, 40 F. Supp. 2d at 875 (denying recovery in tort for damage to corn crop due to defective herbicide product because the corn crop was not "other property").

In the case at bar, the "finished product bargained for" was a "Diffuser Cell System"—not merely a VTL. Most prominently, Ingersoll's initial specification and order to G&L was for a "Diffuser Cell System"—not merely a VTL. (Specifications, attached as Ex. 5 and R. 200-08.) Indeed, Ingersoll's specifications confirm that it was purchasing a system that integrated multiple machines:

> The **system** will consist of a vertical turning center, and (2) vertical machining centers tied or **integrated** into a machining system. This machining system will incorporate automated material handling in the form of a shuttle car with pallet transfer or the equivalent.

(Specifications at 1, attached as Ex. 5.)

It is clear that Ingersoll never considered the "product" to be merely a VTL, but rather, an entire *integrated system.* The VTL, standing alone, would not have met Ingersoll's needs. Therefore, the Diffuser Cell System—and not merely the VTL component of the Diffuser Cell System—is the "product" for the purposes of the Economic Loss Rule. Because the Insurance Companies allege only damage to the components of the Diffuser Cell System and not "other property," the Economic Loss Rule bars recovery. (*See, e.g.,* Pls.' Mem. of Law in Opp. to Defs.' Mot. for Summary Judgment at 11, included in the Record on Appeal but not numbered (acknowledging that only components of the Diffuser Cell System were damaged).)

B. Ingersoll Rand allocated and insured the risk of a defect in the Diffuser Cell System—not just the VTL.

The Economic Loss Rule applies when parties to a contract negotiate and allocate the risk of a defective product. The Economic Loss Rule preserves the benefit of the bargain by preventing the buyer from recovering damages that are barred by the contract. In determining how to define, for the purposes of the Economic Loss Rule, the relevant

"product" for which damages are not available, and "other property" for which damages *are* available, courts properly look back to the policies supporting the Economic Loss Rule in the first place.

Applying Kentucky law, the Sixth Circuit Court of Appeals adopted this approach. In *Mt. Lebanon Personal Care Home*, a nursing home operator alleged that the defendant manufactured defective fire retardant chemicals. These chemicals were applied to the wood trusses in the nursing home. The wood trusses failed as a result of the defective chemicals, and the entire nursing home had to be abandoned. 276 F.3d at 847.

The nursing home operator sought damages for the loss not only of the wood trusses—but of the entire nursing home itself. The nursing home operator argued that the "product" was the wood trusses and that the "other property" was the nursing home itself. If the court would have adopted the operator's position, the operator would have been able to recover the entire cost of the nursing home (less the cost of the wood trusses). *Id.* at 849. If, on the other hand, the "product" was the nursing home itself, then the Economic Loss Rule would bar the operator's claims "because the product—the nursing home—was the only thing damaged." *Id.* at 850.

Ultimately, the court concluded that under Kentucky law, the "product" was the nursing home itself—even though the defendant supplied only the chemically treated wood trusses and did not construct the nursing home:

> [I]f we were to hold that [the wood trusses are] the product for economic loss rule purposes, nearly any component part would be a product and we would, as a result, effectively eviscerate the distinction between contract and tort.

Id. at 850.

Generalizing its holding, the court stated that "the product for economic loss rule purposes includes the entire unit for which a party to a complex commercial transaction has the ability to *distribute risk by contract and insure against loss*. This rule ensures that the parties to complex commercial agreements—and not the courts—will be free to set the terms of their agreements." *Id.* at 851 (emphasis added). Because the nursing home operator had the ability to allocate the risk contractually with the builder or insure against loss with respect to the entire nursing home, the court was "unwilling now to restructure the terms of [the operator's] agreement without giving the builder or [the chemical manufacturer] an opportunity to negotiate for a higher price." *Id.*

So, to discern what constitutes the "product" and what constitutes the "other property," it is appropriate for this Court to look to (1) what Ingersoll considered to be the "product" in terms of allocating the risk of a defect; and (2) what "product" Ingersoll insured.

Ingersoll and G&L negotiated a warranty. "Form LD-190" contained the warranty Ingersoll contends applied to the purchase. (Attached hereto as Ex. 6, and R. 243-44). Form LD-190 in turn makes *no* reference to individual components of the Diffuser Cell System. Rather, the warranty applied generally and without any distinction among the components of the Diffuser Cell System. Therefore, for the purposes of allocating the risk, Ingersoll considered the "product" to be the entire Diffuser Cell System—not individual components comprising the system.

Consistent with the warranty it negotiated, Ingersoll secured insurance not just for the VTL but for the entire Diffuser Cell System. There can be no debate about the scope of the insurance coverage Ingersoll purchased because the Insurance Companies brought

this subrogation action seeking the money it paid to Ingersoll under *one* claim for damage to *all* of the components of the Diffuser Cell System—and not merely damage to the VTL.

Ingersoll both negotiated a warranty *and* procured insurance for the *entire* Diffuser Cell System. Thus, to preserve the benefit of the parties' bargain by recognizing that "parties to a complex commercial transaction have the ability to distribute risk by contract and insure against loss," the entire Diffuser Cell System must be the "product" for purposes of the Economic Loss Rule. Even though multiple components of the Diffuser Cell System were damaged in the accident, those other components cannot be considered to be "other property," and the Economic Loss Rule bars recovery of *all* damages.

CONCLUSION

G&L asks that the Court formally adopt the Economic Loss Rule and, based on that Rule, reinstate the trial court's order granting summary judgment to G&L and dismissing the Insurance Companies' claims in their entirety.

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