

The Evolution of a Legal Rule

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ABSTRACT

Efficient legal rules are central to efficient resource allocation in a market economy. But the question whether the common law actually converges to efficiency in commercial areas has remained empirically untested. We create a data set of 461 state court appellate decisions involving the economic loss rule in construction disputes and trace the evolution of this law from 1970 to 2005. We find that the law did not converge to any stable resting point and evolved differently in different states. Legal evolution is influenced by plaintiffs' choice of which legal claims to make, the relative economic power of the parties, and nonbinding federal precedent.

1. INTRODUCTION

We investigate the evolution of a particular common-law rule pertaining to the construction industry, as developed by state appellate courts in the United States over the last 3-and-a-half decades. The evolution and efficiency of legal rules governing commercial activity are central to understanding a market economy. As long as property rights are well defined and private parties whose behavior affects each other can freely contract over their conduct at low cost, they will agree to act efficiently (Coase 1960). Efficient behavior maximizes total surplus, which parties

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can agree to divide between themselves via contract. But when negotiating explicit contracts is costly, efficient resource allocation may require that the law create rules that give parties incentives to act efficiently—rules that steer parties to outcomes that mimic those that the market would produce if transaction costs were low. Hence, there is a need for efficient legal rules.

In a common-law system such as that of the United States, many legal rules are created by judges as a by-product of deciding appeals. Scholars in law and economics have sought to understand why common-law rules might be efficient. Posner (1973) recognized the importance of this question and argued that appellate judges have career or other personal incentives to maximize efficiency. Rubin (1977) and Priest (1977) argued that because inefficient legal rules lead to inefficient outcomes, they are more likely to be challenged in court. Such litigation is likely to drive them out in favor of efficient rules, even when judges do not consciously pursue efficiency (see also Cooter, Kornhauser, and Lane 1979).

These arguments do not come to grips with the legal realist criticism that judges have policy preferences other than social welfare or disagree about what serves social welfare. A considerable empirical literature concludes that judges often pursue political objectives (George and Epstein 1992; Brenner and Spaeth 1995; Songer and Lindquist 1996; Hansford and Spriggs 2006; Landes and Posner 2007), and when they do, the case for the efficiency of common law is harder to make. Nevertheless, one can still argue, in the spirit of Cardozo (1921), that the law evolves toward better rules through sequential decisions of judges with diverse preferences (see also Holmes 1897; Frank 1930; Llewellyn 1951; Stone 1985; Posner 2005).¹

Yet most of the discussion of the efficiency of legal rules remains theoretical, with few empirical studies of how the law evolves in commercial fields that particularly matter for the efficiency of resource allocation. That is the gap we try to fill. The doctrine we have chosen for our study is the economic loss rule (ELR), and the context is its application to a homogeneous universe of construction disputes. We ask whether the courts have adhered to the ELR (with some standard ex-

1. Gennaioli and Shleifer (2007) show that because appellate courts tend to distinguish prior cases from current ones on the basis of information generated by the latter, instead of overruling the prior cases and thus losing the knowledge generated by them, sequential decision making leads to the refinement of the law over time and thereby improves its efficiency on average even when full efficiency is not attained.

ceptions that might be necessary to make the rule efficient) in that industry and, if not, how the pattern of adherence and nonadherence has evolved.

Stated at its broadest, the ELR excludes tort liability for economic loss unless that loss is accompanied by personal injury or property damage. “Economic loss” means a loss that is not a personal injury or property damage. So if the builder of a house installs windows negligently, with the result that they do not keep out the rain, the owner cannot sue the builder in tort for the cost of reinstalling the windows carefully, because the loss is purely economic.² In contrast, if the water that seeps into the house because of the badly installed windows damages furniture (that is, causes damage to property other than what the builder sold), the owner can sue the builder in tort.

The antecedents of the ELR are old,³ but in the context of liability resulting from a product defect, the doctrine was first clearly articulated in the 1960s by the Supreme Court of California in *Seely v. White Motor Co.* (63 Cal. 2d 9 [1965]). The plaintiff had bought a truck with defective brakes. The truck overturned, but the plaintiff was not hurt, nor was there damage to any other property. He sued in both contract and tort to recover repair costs and lost profits. The court held that the plaintiff was limited to suing for breach of warranty, essentially a contractual remedy.⁴

The ELR was first applied to construction disputes in the 1970s; we have found no earlier precedents.⁵ Most construction activity is governed by contract, but there are two principal types of case in which tort claims,

2. The owner may of course be able to recover the cost of repairing or replacing the windows in a suit for breach of contract or warranty.

3. An early U.S. case is *Anthony v. Slaid* (52 Mass. 290 [1846]). An important early statement of the rule is Justice Oliver Wendell Holmes’s opinion for the Supreme Court in *Robins Dry Dock & Repair Co. v. Flint* (275 U.S. 303, 308–10 [1927]), an admiralty case. The most famous case announcing the fundamental principle is *Ultramares Corp. v. Touche* (255 N.Y. 170 [1931]), which held in an opinion by Chief Judge Benjamin Cardozo that an accountant owes no duty to third parties, such as lenders, to refrain from negligently causing economic injury as a result of a third party’s reliance on the accountant’s audit of a firm in which the third party invested or to which it made a loan. Feldthusen (2000) provides a detailed historical analysis of tort recovery for economic losses in various common-law countries. The arguments for limiting recovery in tort for economic loss are analyzed in Bishop (1982), Rabin (1985), Goldberg (1994), and Posner (2006).

4. Seely actually recovered for both the repair of the truck and lost profits under his warranty, but the case is important because it established the legal rule with respect to recovery for economic loss in tort. We discuss the role of contracts in the application of the economic loss rule (ELR) in Section 4.

5. See Barrett (1989) for a discussion of early ELR cases in the construction industry.

and therefore the ELR, become relevant. In the first, a property owner sues in tort for economic loss when he has no contract claim or when he wants to make additional claims, exploiting procedural or remedial advantages of tort over contract suits. In the second type of case, a builder sues other builders, architects, engineers, inspectors, or manufacturers for damages resulting from negligence. We investigate how state appellate courts have dealt with such cases.⁶ Our sample contains all of the 461 state appellate decisions between 1970 and 2005 that we could find: enough to reach some conclusions on how the law evolves but not so many as to make the project unmanageable.

We emphasize that our sample of cases—cases involving the application of the ELR to construction disputes in the United States—is homogeneous. Research in law and economics, including comparative work by Busani and Palmer (2003), Busani, Palmer, and Parisi (2003), Dari-Mattiacci and Schafer (2007), Gomez and Schafer (2007), and Parisi, Palmer, and Bussani (2007), confirms that the ELR covers diverse situations in which courts consider whether to allow recovery in tort for economic loss. Examples include a store owner who loses customers because of an accident in front of his store and a business that has to shut down because of accidental damage to electric lines resulting from construction activity several miles away (Posner 2006). Many of these are situations in which a contractual resolution is infeasible because of prohibitive transaction costs. We confine our study to one industry, and in all but 11 cases in our sample the plaintiff either is or could be in a contractual relationship with the defendant. In many ELR cases,⁷ the efficiency justification for the ELR is that it protects parties engaged in normal business conduct from unpredictable tort claims from strangers if an accident occurs. In construction disputes, the plaintiffs and the defendants are not strangers, so this argument does not apply. Our sample is focused on the product liability sphere of application of the ELR on the border of contract and tort emanating from *Seely*.

The theoretical case for the efficiency of the ELR in contractual settings rests on the feasibility of anticipating such disputes through explicit contracting. As Posner (1973) pointed out, courts prefer parties to govern their relationships through privately negotiated contracts rather than

6. Cases at the trial level are rarely decided in judicial opinions that explain the factual and legal issues fully. And opinions at the trial court level have very limited impact on the evolution of legal doctrine because they are not considered precedents—that is, authorities—binding courts in subsequent decisions.

7. Such as *Ultramares*. See note 3.

through tort suits whenever transaction costs are low enough because the parties know their business better than the judges can. He reiterated this logic as a judge in applying a bright-line ELR in *Miller v. United States Steel Corp.* (902 F.2d 573, 574 [7th Cir. 1990]): “[T]ort law is a superfluous and inapt tool for resolving purely commercial disputes. We have a body of law designed for such disputes. It is called contract law.” Because we are studying the ELR in cases in which parties do have an opportunity to contract, the refusal to allow the parties to bypass contract and thrust the allocative decision on the courts by invoking tort law is probably efficient.⁸ But this logic behind the ELR implies denial of monetary recovery to some persons harmed by wrongful acts, and that troubles some courts.⁹

Even in a homogeneous field, such as the application of the ELR to construction disputes, we need to specify what is an efficient ELR doctrine. One possibility is that efficiency requires applying the ELR with no exceptions at all (call this the strict view). On this view, if the law converges to efficiency, appellate courts should increasingly be refusing to allow any exceptions to the ELR. Another view is that efficiency admits several exceptions, specifically the ones that are generally recognized by most courts (call this the middle view). One such exception is fraud (the deliberate infliction of economic loss), and another is economic loss that accompanies a personal injury or physical damage; these situations are difficult to anticipate and make provision for by contract. The generally recognized exceptions essentially add standard default terms to private agreements and by doing so economize on transaction costs. Under the middle view, if the law converges to efficiency, over time courts should be refusing to make exceptions to the ELR other than the generally recognized ones. Thus, if we find that, over time, appellate courts not only fail to reduce the use of exceptions to the ELR but also fail to reduce the use of those exceptions that are not generally

8. Of course, this particular efficiency justification for the ELR does not extend to cases in which the parties are strangers and do not have the opportunity to contract. Other efficiency-based rationales for the ELR in these cases are presented in the comparative law and economics literature discussed above.

9. An example is the 1965 New Jersey case *Santor v. A & M Karagheusian, Inc.* (44 N.J. 52), in which a consumer recovered tort damages from a carpet manufacturer because the carpet had a defect. The dealer from whom he had bought the carpet had gone out of business before the consumer realized that the defect could not be fixed, so the dealer’s warranty was of no value to him, and there was no manufacturer’s warranty. We do not know whether the New Jersey court was moved by an alternative view of efficiency or by sympathy for the plaintiff, but it rejected the ELR.

recognized, we will have evidence against convergence to efficiency, according to the middle view.

A third view of efficiency is that courts have more information about cases than researchers do, and so the application of the ELR and its exceptions is contingent on specific facts of the case (call this the broad view) invisible to research based on aggregated data. Our data allow us to test both the strict and the middle view, but the broad view flexibly enough interpreted is untestable by the methods we use. Having said this, we will show in our empirical analysis just how elastic the broad view must be to be consistent with the data: different state appellate courts (or the same courts at different times) issue contradictory rulings in cases that appear to be nearly identical. We also present evidence of unusually high rates of dissent when courts adopt exceptions that courts in other states do not recognize.

In studying the evolution of the ELR in construction disputes, we first consider both the bright-line ELR (strict view) and the ELR with generally recognized exceptions (middle view) as candidates for the efficient rule and ask whether the law achieves or moves toward either of them. Then we ask more generally whether the law converges over time to any resting point. If it does not, in an environment that is basically stationary, it becomes harder to argue that the law tends toward efficiency.

We also look at the evolution of the law in different jurisdictions. Under the assumption that legal rules relating to construction should not efficiently vary across jurisdictions, large differences in the patterns of legal evolution across jurisdictions would argue against an inference of efficient judicial rulemaking under all three of our conceptions of efficiency.

To summarize the results, over our sample period the law did not converge to the bright-line (strict) ELR, to the ELR with generally recognized exceptions, or to any other resting point. While there is some tendency to convergence in the first 25 years of the sample, in the last decade courts increasingly have created idiosyncratic exceptions to the ELR—exceptions adopted in only a few jurisdictions and rejected in others. Moreover, while adherence to the ELR in some form has grown in some states, in others it has shrunk. These results are inconsistent with theories of efficient judicial lawmaking as well as with other theories that would predict that laws across states should converge. A tendency of judges to imitate decisions in other jurisdictions, for example, would bias against any finding of nonconvergence.

The ELR in construction deals with the important but fuzzy border between contract and tort, and legal scholars debate which field should cover particular situations in the border region (see Rubin 1993; Edlin and Schwartz 2000). For less controversial doctrines, courts would find it easier to agree on what would be efficient outcomes, and so there would be faster and more complete convergence. But no one doubts that efficiency has some domain in law; the interesting question is whether courts can converge to stable rules in the numerous areas of law in which there is room for disagreement about efficiency or equity. The ELR is one such area.

The next section describes the data. In Section 3, we present basic trends in the use of exceptions to the ELR by state appellate courts. Section 4 looks behind the trends to ask whether they reflect changes in plaintiffs' claims, the presence of explicit contracts, the economic power of the parties, or leadership by the U.S. Supreme Court. We also check how much variation there is across states.

2. DATA

2.1. Overview of the Database

We gathered data on state appellate decisions in all the construction cases involving the ELR that we were able to find, a total of 461 cases (see the Appendix for details). Even though appellate cases represent a tiny minority of all disputes, they contain the only authoritative statements of legal doctrine. There is no other body of data on which to base a study of the evolution of the rule.

A study like ours must immediately consider the effects of selection of disputes for appeal on our findings. To be specific, we must ask, is it possible that the law converges over time to efficient legal rules, but because of how cases are selected, our data reveal no convergence? We believe that the answer is no.

The selection of disputes could be a problem if we were trying to infer judicial support for the ELR from the frequency with which a plaintiff prevailed in a suit in which the ELR was invoked. For then we would have to consider the bearing of the Priest-Klein hypothesis that because uncertainty increases the likelihood that a case will be litigated to judgment and then appealed, rather than settled or abandoned, the win rates of appellants and appellees will tend to equality. We would also have to examine factors, such as asymmetric gains from litigation

or asymmetric information, that refute the Priest-Klein hypothesis in numerous areas of law (Priest and Klein 1984; see also Shavell 1996; Kessler, Meites, and Miller 1996; Eisenberg and Farber 1997). But the selection effect should not distort the accuracy with which appellate decisions state the legal rules that are applied to resolve a dispute. We determine legal doctrine directly instead of inferring it from the rate of plaintiff victories.

A more subtle selection effect is suggested by Parisi and Fon (2009), who argue that plaintiffs have some information about the political predispositions of judges, and therefore cases selected for litigation tend to reflect judges' political preferences. As a consequence, the law might evolve differently in different states, with the differences determined by the politics of state judiciaries rather than by efficiency. The implication for our analysis is that the number of suits, number of plaintiff wins, and number of idiosyncratic exceptions would all grow over time in liberal states relative to conservative ones. A finding that differences in the ELR across states in construction disputes were not explicable in efficiency terms would be consistent with the Parisi-Fon hypothesis but would not undermine the rejection of the null hypothesis that the law converges to efficiency.

We read the 461 cases in our sample and extracted our variables from the judicial opinion in each case. We coded the state in which each decision in our sample was rendered, the date of the decision, and the level of the court (whether the state's highest court or a lower appellate court). We did not include information about individual judges. We classified the parties as (1) property owner, (2) builder (such as a general contractor or subcontractor), (3) architect, engineer, or inspector, (4) manufacturer, and (5) other (real estate agent, insurance company, or bank). We noted whether the plaintiff and the defendant were parties to a contract and whether any contractual claims were made by the plaintiff (breach of contract, breach of express warranty, or breach of implied warranty), as well as the outcomes of such claims on trial and on appeal.

Our primary interest, however, is in the use of exceptions to the ELR by the court in tort claims. We use data about the specifics of such claims to investigate whether the appellate court applied an exception to the ELR to permit a tort claim to be made. That is a test for adherence to the strict view. The nature of the exceptions applied provides the test for the middle view.¹⁰

10. The fact that an exception is applied does not necessarily mean that the plaintiff

2.2. Coding the Reasons for Not Applying the Economic Loss Rule

The different types of exception are summarized here:

Generally recognized exceptions:

1. Independent torts
2. Other property
3. Generally recognized independent duties:
 - Statutory independent duties
 - Architects' independent duty to a general contractor under the *Restatement on Torts*

Idiosyncratic exceptions:

1. Idiosyncratic independent duties:
 - Builders' independent duty to property owners
 - Builders' independent duty to other builders
 - Architects' independent duty to property owners
 - Architects' independent duty to subcontractors
 - Manufacturers' independent duty to property owners
2. Other reasons:
 - The plaintiff does not have a contractual remedy.
 - The economic loss rule applies only to commercial plaintiffs.
 - The economic loss rule does not apply to negligence claims.
 - A sudden and calamitous event poses an unreasonable risk of injury.

We recorded only the primary exception to the ELR applied by the court. We distinguish between two categories of exceptions: generally recognized exceptions and idiosyncratic exceptions. The term “generally recognized exception” means that the exception is found in the vast majority of jurisdictions but does not necessarily mean that all cases from all jurisdictions have accepted it.¹¹ Under the middle view of efficiency,

can recover damages. The appellate court might return the case to a lower court to consider other defenses, assess damages, or resolve other issues essential to a final resolution of the litigation.

11. For example, we have coded fraudulent inducement as a generally recognized exception even though in two cases in our data set fraudulent inducement was held not to constitute an exception. One was overruled a year later; the other was based on a statutory exception. In *Woodson v. Martin* (663 So. 2d 1327 [Fla. 1995]), the Florida court held that any misrepresentations of the defects in the house caused only economic losses. This was overruled in *Wassall v. W. H. Payne* (682 So. 2d 678 [Fla. 1996]), and has been disapproved in a number of other Florida cases. In *Flagg Energy Development Corp. v. General Motors Corp.* (244 Conn. 126, 151–55 [1998]), the Connecticut court dismissed the claim for fraudulent misrepresentation, but while mentioning the ELR the court actually

courts should apply only generally recognized exceptions to defeat invocation of the ELR.

There are three kinds of generally recognized exception:

Independent Torts. Intentional wrongdoing is a generally recognized exception to the ELR. For example, when the defendant fraudulently induces the plaintiff to sign a contract, the ELR does not bar the plaintiff from suing the defendant in tort for fraud.

Other Property. The ELR precludes only recovery of economic loss unaccompanied by any other form of injury. Plaintiffs may be permitted to recover economic loss in tort if they also suffer personal injury or property damage. So if a defective product causes injury to the plaintiff or damage to his property, he can sue in tort for the damage to the defective product itself, invoking the other-property exception.¹²

Generally Recognized Independent Duties. Courts have recognized exceptions to the ELR when defendants owe a duty that is independent of any contract. Many of these exceptions are idiosyncratic, but two are generally recognized. First, as noted in section 552 of the *Restatement (Second) of Torts*, architects have an independent tort duty to avoid inflicting economic loss on a general contractor. This seems an efficient way of avoiding making architects contract separately with builders when both have already contracted with the owner. Second, several states have imposed statutory duties on these and other participants in construction, thus curtailing the common-law ELR. For example, Florida has imposed a number of statutory duties on builders, architects, and inspectors. Section 553.84 of Florida Statutes (1995) provides a cause of action for economic loss when a builder has caused a loss to a property owner by violating a building code or failing to obtain required permits. This duty is independent of any other available ground for a remedy.

Courts have carved out additional exceptions, which we call idiosyncratic, also summarized in the list above. These are exceptions peculiar to a few states or not uniformly recognized even within the same state. The label “idiosyncratic” does not refer to innovations as such (as in Gennaioli and Shleifer 2007); it merely denotes exceptions rejected by other courts. For each case that we classify as decided on the basis of an idiosyncratic exception, there is a factually similar case in which the ELR was applied.

based its decision on an interpretation of the Uniform Commercial Code. The case has not been overruled.

12. State courts vary in their application of this exception. For simplicity, we classify all applications of the other-property exception as generally recognized.

Most of the idiosyncratic exceptions are independent duties created by courts. A few courts subject builders or architects to a tort duty to property owners or subcontractors. For example, the courts in Colorado have consistently held that builders owe property owners a tort duty independent of the ELR. Most courts, however, have rejected this view, including courts in neighboring Utah.¹³ Likewise, Virginia does not impose duties on builders toward property owners, while neighboring West Virginia and Maryland do.¹⁴ Sometimes cases recognizing an idiosyncratic exception are inconsistent with other cases in the same state. In an early Illinois case (*Ferentchak v. Frankfort*, 121 Ill. App. 3d 599 [1984]), an architect was held to owe an independent duty to purchasers of residential property, but the ELR is applied in most such Illinois cases.¹⁵ Similarly, Florida imposed duties to property owners on architects, overturning cases that had held that no such duties existed.¹⁶

Some courts recognize an exception for cases in which the plaintiff has no contractual remedy, or confine the ELR to commercial but not residential property owners. These exceptions, which seem motivated by sympathy for harmed plaintiffs seemingly barred by the ELR, are rejected by other courts. It is difficult to reconcile idiosyncratic exceptions with the view that different legal rules are efficient in different states at the same time, or in the same state at different times, since construction is

13. See A.C. *Excavating v. Yacht Club II Homeowner's Ass'n* (114 P.3d 862 [Colo. 2005]) for an example of a Colorado court holding that a builder owes a duty in tort to a homeowner association, and *Snow Flower Homeowner's Ass'n v. Snow Flower* (2001 UT. App. 207), for a factually similar case from Utah holding that no such duty exists.

14. See, for example, *Sensenbrenner v. Rust, Orling & Neale, Architects, Inc.* (236 Va. 419 [1988]), which held that the defendant builder did not owe a duty to the plaintiff homeowners. Similar cases in West Virginia (see, for example, *Sewell v. Gregory*, 179 W.Va. 585 [1988]) and Maryland (see, for example, *Council of Co-Owners Atlantis Condominium, Inc. v. Whiting-Turner Contracting Co.*, 308 Md. 18 [1986]) carved out exceptions for defendant builders in certain circumstances.

15. Similar cases from Illinois that upheld the ELR are *Illinois Housing Development Authority v. M-Z Construction Corp.*, 110 Ill. App. 3d 129 (1982); *2314 Lincoln Park West Condominium Ass'n v. Mann, Gil, Ebel & Frazier, Ltd.*, 136 Ill. 2d 302 (1990); *Martusciello v. JDS Homes, Inc.*, 361 Ill. App. 3d 568 (2005).

16. In 1999, the Florida Supreme Court allowed a plaintiff home purchaser to make a claim in negligence against the defendant architect-engineer who had failed to discover structural defects (*Moransais v. Heathman*, 744 So.2d 973 [Fla. 1999]). This holding conflicted with earlier Florida case law, where these duties were not recognized (see, for example, *Sandarac Ass'n v. W.R. Frizzell Architects, Inc.*, 609 So.2d 1349 [Fla. 2d DCA 1992]; *Ocean Ritz of Daytona Condominium v. G.G.V. Assoc., Ltd.*, 710 So.2d 702 [Fla. 5th DCA 1998]).

Table 1. Incidence of Exceptions Used to Test Our Hypotheses

Candidate View of Efficient Rule	Exceptions Contradicting This View	Result of Convergence to the Candidate Efficient Rule
Strict view (bright-line ELR with no exceptions)	All exceptions	Use of all exceptions declines over time
Middle view (ELR with generally recognized exceptions)	Idiosyncratic exceptions	Use of idiosyncratic exceptions declines over time

Note. ELR = economic loss rule.

a stable industry, similar across states, with no significant technological change during the period covered by our sample.

Table 1 summarizes how we use the exceptions to test our hypotheses. Under the strict view of efficiency, decisions by appellate courts over time should eliminate exceptions. Under the middle view of efficiency, they should eliminate idiosyncratic exceptions but not generally recognized ones.¹⁷ Under the broad view of efficiency, as well as under the hypothesis that the law does not converge to efficiency over time, we should not expect to see systematic diminution in the employment of exceptions.

2.3. Brief Summary of the Data

Cases are not distributed uniformly across the years covered by the data set, 1970–2005. In some years we have no observations, while the maximum number of cases in one year is 28. Figure 1, which plots the number of cases each year, reveals a clear upward trend in appeals cases in which

17. We have considered alternative procedures for measuring convergence. For example, an alternative way of testing convergence to the middle view of efficiency would use state-by-year observations with a dummy dependent variable that measures the position of the law of each state in each year. The dependent variable would take a value of one if the state adopts the ELR with generally recognized exceptions and zero if the state uses idiosyncratic exceptions. Convergence to the middle view could be measured by testing whether the standard deviation across states converges to zero over time. However, this methodology presents problems. We have a number of different idiosyncratic exceptions, and, importantly, different states use different idiosyncratic exceptions. If a state uses just one of these idiosyncratic exceptions, this alternative methodology would suggest that we code the position of the law in that state as zero. This might lead to problems if a state judiciary generally adheres to the middle view of efficiency but in one outlying case uses an idiosyncratic exception. The dependent variable would fail to describe the law of the state accurately. The methodology that we use in this paper tracks each case as it occurs. It is a more direct method of addressing the issue of whether courts are increasing or decreasing their use of these different idiosyncratic exceptions.

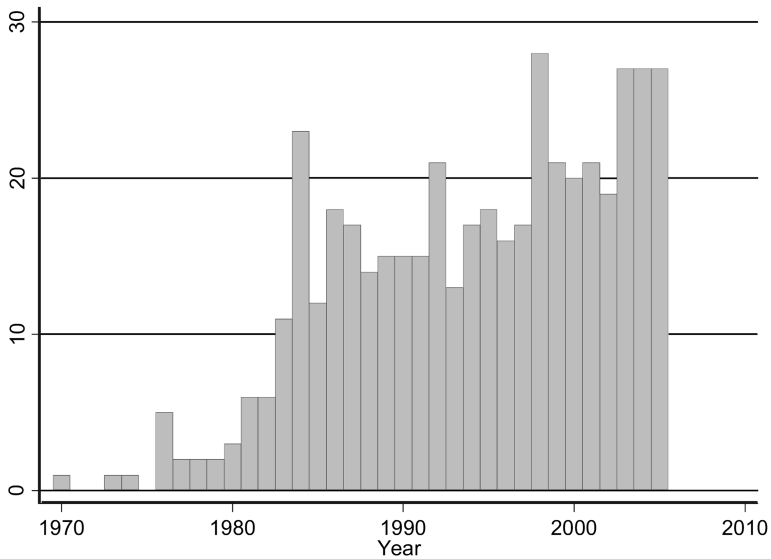


Figure 1. Number of cases in each year of our data set

the ELR is mentioned. The growth in the number of cases is affected by our search strategy in constructing the data set. Many construction cases from the 1970s and 1980s do not refer to the ELR explicitly and hence are not included in our sample. The result is to bias the plaintiffs' success rate downward in the early years, since a plaintiff is more likely to have recovered economic damages in a case in which the ELR was not mentioned than in one in which it was.

In the majority of cases, a plaintiff property owner is suing a builder, architect, engineer, inspector, or manufacturer. In 328 cases (71.15 percent), the plaintiff is a property owner. Builders are the only other significant plaintiff category (involved in 25.81 percent of the cases). The most frequent defendants are builders (involved in 34.71 percent of all cases), followed by manufacturers (27.33 percent), architects, engineers, and inspectors (21.04 percent), and property owners (14.32 percent). Table 2 summarizes these data.

Table 3 summarizes the application of exceptions to the ELR in our 461 cases. Exceptions were applied in 171 cases (37.09 percent). Courts applied generally recognized exceptions to the ELR in 114 of the 171 cases in which an exception was applied (66.67 percent) and idiosyncratic exceptions in the other 57 cases (33.33 percent). The most frequent

Table 2. Breakdown of the Parties to the 461 Disputes

Plaintiff	Defendant					Total
	Property Owner	Builder	Architect, Engineer, or Inspector	Manufacturer	Other	
Property owner	46	131	44	98	9	328 (71.15)
Builder	18	20	53	25	3	119 (25.81)
Architect, engineer, or inspector	1	7	0	1	0	9 (1.95)
Manufacturer	1	1	0	2	0	4 (.87)
Other	0	1	0	0	0	1 (.22)
Total	66 (14.32)	160 (34.71)	97 (21.04)	126 (27.33)	12 (2.60)	461

Note. Percentages are in parentheses.

Table 3. Outcomes of Cases and Frequency of Exceptions

Exceptions	Observations
Generally recognized:	
Other property	45
Independent torts	37
Generally recognized independent duties	32
Total	114
Idiosyncratic:	
Idiosyncratic independent duties	39
Other reasons	18
Total	57
Total cases with exceptions	171

types of exceptions are other property (26.31 percent of all cases in which an exception was applied by the court), idiosyncratic independent duties (22.81 percent), and independent torts (21.64 percent).

The data on means begin to tell the story of how the ELR has been applied. About 63 percent of the cases apply the ELR and thus bar the plaintiff's tort claims, while in nearly 25 percent a generally recognized exception is applied instead. In the other 12 percent of cases, an idiosyncratic exception is applied. On average, then, the ELR plus its generally recognized exceptions are widely but not universally accepted by state appellate courts. The question arises whether this acceptance has grown over time, which would suggest convergence. If it has grown, which exceptions have declined? If it has not grown, which exceptions are responsible? We address these questions next.

3. AGGREGATE OUTCOMES

3.1. Convergence to the Strict View

We measure convergence to the strict view by asking, are courts increasingly applying the ELR without exceptions? If the strict view represents the efficient rule and the law converges to efficiency, the application of exceptions should decline over time. Figure 2 presents the fraction of cases each year in which exceptions were applied. It reveals a U-shaped pattern: the resort to exceptions declines steadily over the first 20 years of the data but rises in the last decade. The frequency with which claims are rejected on the basis of the ELR rises in the 1970s and 1980s but falls after the mid-1990s.

There are various ways in which to establish the U shape more for-

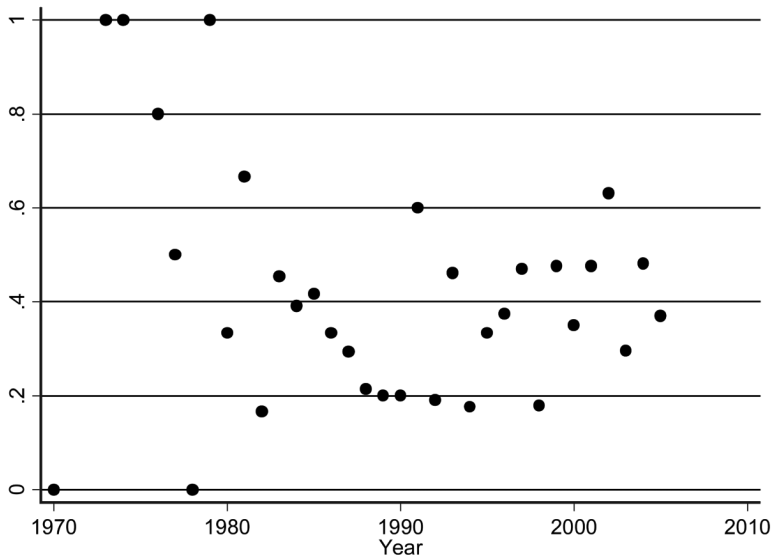


Figure 2. Fraction of cases that apply exceptions in each year

mally. A simple quadratic model fitting case outcomes with Time and Time² yields statistically significant results. The coefficient on Time is -3.9453 , with a t -statistic of -2.80 . The coefficient on Time² is $.0009$, with a t -statistic of 2.80 . Both are significant at the 1 percent level.

Figure 3 shows the trend over time of all 461 observations using locally weighted least squares (LOWESS) to fit the curve (solid line).¹⁸ The LOWESS curve suggests that outcomes indeed follow a U-shaped curve over time, with the minimum use of exceptions reached in the early 1990s. We also estimate linear regressions, dividing the sample at various points in the late 1980s and early 1990s. These specifications yield a negative and statistically significant trend in the use of exceptions in the earlier subsample and a positive and statistically significant trend

18. We fit the locally weighted least squares (LOWESS) curve over the 461 binary observations of cases applying exceptions. The trend curve is an amalgam of 461 linear regressions around each local point using a localized subset of the data. This smooths the data and generates a trend curve. The smoothing parameter (referred to as bandwidth) is the proportion of all observations that each regression uses. The smaller the bandwidth, the coarser the trend line appears, since individual regressions are more localized. The default bandwidth for LOWESS curves in Stata is $.8$ (meaning that each of the 461 regressions uses 369 observations), which we use throughout. The picture is similar with a bandwidth of $.25$.

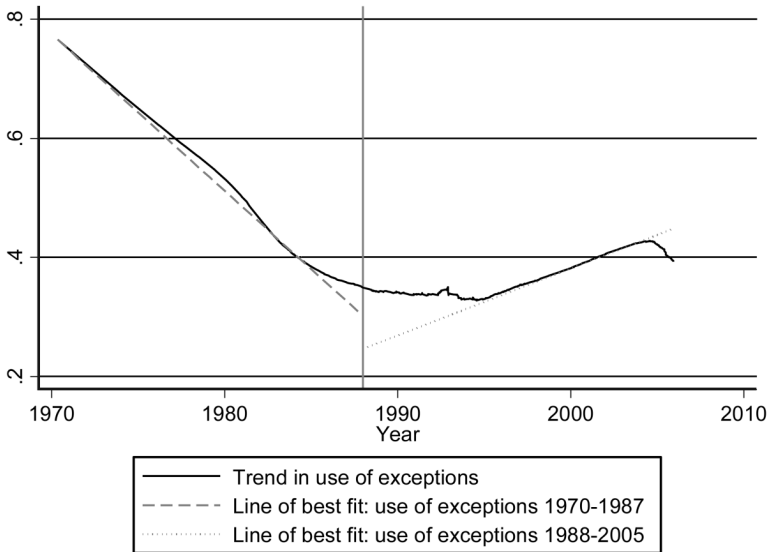


Figure 3. Downward trend in the use of exceptions, 1970–87 ($t = -1.97$), and upward trend, 1988–2005 ($t = 2.28$).

in the later one. These trends show that the law is not converging to the strict view of the ELR—the view that the law should always bar recovery of economic loss in tort. In Section 4, we show that the upward trend in the use of exceptions is partially explained by changes in plaintiffs’ claims.

3.2. Convergence to the Middle View

To examine convergence to the middle view, we ask whether courts are applying just exceptions to the ELR that are generally recognized or whether they are also applying idiosyncratic exceptions. Judges might experiment with many different exceptions to the rule in the early years of our sample. But under the middle view of efficiency, the application of inefficient idiosyncratic exceptions should decline over time as the efficient ones become generally recognized and the inefficient ones are discarded, as the law converges to the efficient rule.

As shown in Figure 4, the application of both generally recognized and idiosyncratic exceptions trends down in the 1970s and 1980s, except that the number of cases decided on the basis of generally recognized

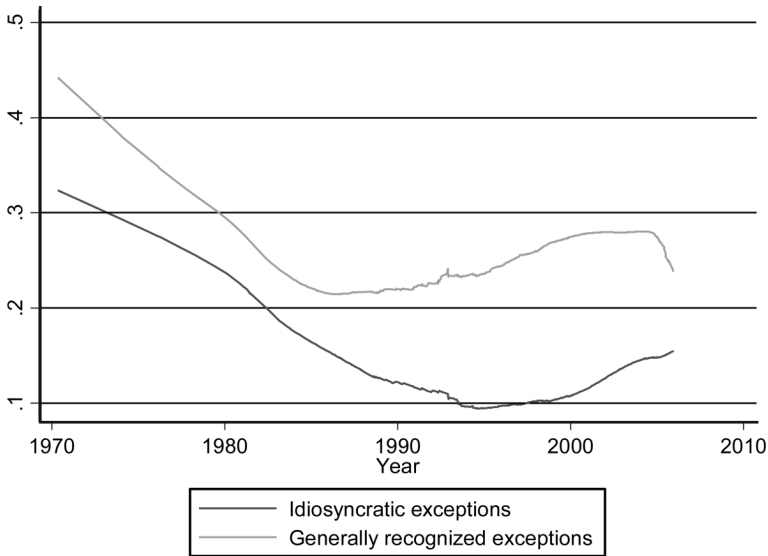


Figure 4. Fractions of cases applying generally recognized or idiosyncratic exceptions

exceptions bottoms out earlier, in the mid-1980s, at about 20 percent of all cases, and then begins rising gently (and not statistically significantly) in the mid-1990s, to about 30 percent of all cases, with a decline at the end of the sample period back to 20 percent. Idiosyncratic exceptions fall until the mid-1990s, to about 10 percent of all cases—a testament to apparent convergence to the ELR with generally recognized exceptions, except that they then rise toward the end of the sample period. Both the downward trend before the mid-1990s and the subsequent upward trend in idiosyncratic exceptions are significant.¹⁹

The real story told by these data is the growth of idiosyncratic exceptions both as a percentage of all cases and as a percentage of all exceptions in the last decade of the sample. We do not see convergence to the ELR with generally recognized exceptions, and we thus reject the middle view of the ELR's efficiency as well as the strict one. Yet had

19. Simple linear tests demonstrate that the downward trend in the use of idiosyncratic exceptions before the mid-1990s is significant ($t = -2.03$ for 1970–94) and the upward trend in these exceptions in the last 10 years of our sample is also significant ($t = 1.83$ for 1995–2005). Over the last 10 years of our sample, we see significant growth of idiosyncratic exceptions as a percentage of all exceptions.

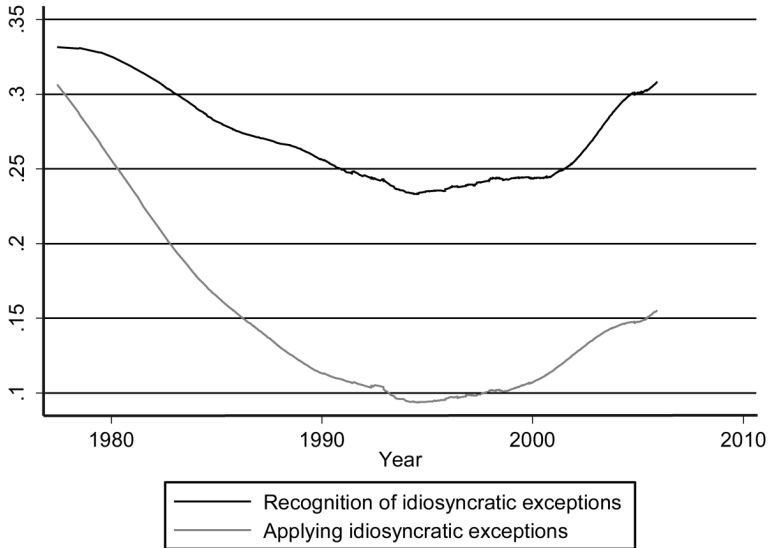


Figure 5. Fractions of cases in which idiosyncratic exceptions were applied or recognized but not applied.

this paper been written a decade ago, we would have concluded that the legal rule had converged to nearly universal acceptance of the ELR with generally recognized exceptions. The substantial and statistically significant growth in cases decided in plaintiffs' favor by application of idiosyncratic exceptions in the last decade of the sample precludes such a conclusion today.

We also track instances in which an idiosyncratic exception is recognized and approved by the court but nonetheless is not applied because the plaintiff failed to bring his claim within its scope. There are 61 such cases in our data set. Including the 57 cases in which idiosyncratic exceptions were applied to defeat the ELR (the same LOWESS curve as in Figure 4), we have 118 cases (25.60 percent of cases in our data set) in which idiosyncratic exceptions were recognized as valid. Figure 5 shows the trend in recognizing idiosyncratic exceptions, whether or not that exception applied in the case. We find a U-shaped curve in these data as well. The upward trend in recognition of idiosyncratic exceptions over the period 1995–2005 is significant at the 5 percent level ($t = 2.01$). This significant upward trend confirms our conclusion that we

have not seen convergence toward the middle view of efficiency. The downward trend in the recognition of idiosyncratic exceptions until the mid-1990s is no longer significant. These results are further evidence against convergence to efficiency.

Another way to look at the patterns is by focusing on dissents in judicial opinions: 55 of our 461 cases include at least one dissenting opinion. Overall, there is no difference between the frequency of dissents in cases in which the ELR is upheld and cases in which an exception is applied. But in cases in which the court relies on an idiosyncratic exception, the incidence of dissent is, as one would expect, significantly higher, as “idiosyncratic” implies that the law is unsettled. Only 10 of the 114 cases in which generally recognized exceptions were applied (8.77 percent) had a dissent, while 11 of the 57 cases in which idiosyncratic exceptions were applied (19.29 percent) had a dissent. This difference is significant at the 5 percent level ($t = 1.99$).

3.3. Summary of Aggregate Outcomes

The evolution of the law reveals some fascinating patterns. The first 20 years after the *Seely* decision—the case that set the law on its modern path—are best described as years of growing acceptance of the ELR, with declining application of either generally recognized or idiosyncratic exceptions. In the final decade of the sample, however, courts moved away from strict application of the doctrine by more frequently applying some of the generally recognized exceptions, such as the independent-tort and other-property exceptions, and some of the idiosyncratic exceptions as well. Courts also increasingly recognized idiosyncratic exceptions in cases in which they nevertheless concluded that the facts did not bring the plaintiff within the scope of one of them. The data reveal no convergence to any rule, let alone an efficient rule under either of our candidate definitions of efficiency.

As noted in the introduction, we cannot reject the hypothesis that judicial decisions are efficient if we adopt a sufficiently broad definition of efficiency, one that allows for the possibility that the law and the facts are more complicated than one can learn from reducing a judicial opinion to a handful of variables. At one level, therefore, what we call the broad view of efficiency eludes falsifiability. Suppose there are two cases in two different jurisdictions, and one case applies the ELR, explicitly rejecting an idiosyncratic exception, and the other case rejects it, explicitly endorsing and applying that very exception. Both cannot be efficient at the level of doctrine, although a more searching investigation of each

case might show that both outcomes were efficient because of factual differences that the opinions had not used to qualify the scope of the doctrine being applied. However, the fact that dissents are more frequent when idiosyncratic exceptions are applied casts doubt on the hypothesis that those decisions would be seen as efficient if only enough details were known about them.

So what is behind the time patterns we observe, both the convergence toward the ELR in the first 20 years of the sample and the movement away from it afterward? In the next section we address this question from different perspectives.

4. BEHIND THE PATTERNS

We try to deepen our understanding of the patterns uncovered in Section 3 by examining five aspects of the evolution of the ELR in the construction industry. First, we examine the claims that plaintiffs make and ask whether changes in those claims can explain the patterns of court decisions. We can expect plaintiffs to try new strategies when they encounter barriers to recovery with old ones. Perhaps the movement away from the ELR in later years reflects such adaptation, as plaintiffs discover or invent claims to which courts are more receptive. Second, we examine whether the application of the ELR is influenced by the presence of an explicit contract between the parties, implying that they considered the various risks of their relationship. Third, we investigate the relative economic power of plaintiff and defendant. Judges' sympathy for weaker parties may help explain deviations from the ELR in cases in which plaintiffs have less economic power than defendants. Fourth, we examine judicial leadership. In 1986 the U.S. Supreme Court issued a decision in an admiralty case, *East River S.S. Corp. v. Transamerica Delaval, Inc.* (476 U.S. 858 [1986]), that broadly endorsed the ELR. Although *East River* did not involve construction and was not binding on state courts applying state law, we can ask whether the decision influenced those courts. Fifth, we examine state variation in decisions. We ask whether the lack of convergence to the ELR is explained by the fact that in many states there are very few appellate cases involving ELR in construction. Perhaps it is those states that account for lack of convergence in the aggregate while the states with the highest caseloads exhibit a greater tendency to convergence.

4.1. Claims

Figure 6 graphs the evolution of tort theories advanced by plaintiffs. The proportion of cases in which the plaintiff alleges negligence has been falling (statistically significantly) since the mid-1980s. While claims of strict liability have also trended downward since the beginning of our sample, the trend is significant only in some periods. As the ELR becomes increasingly accepted, plaintiffs are using types of claims less likely to be barred by it. The increase in claims of fraud is marginally significant since the early 1980s, while the increase in claims of negligent misrepresentation over the same period is strongly significant.²⁰ The increase in claims for other torts is significant over the course of our entire sample.²¹ We get very similar trends if we look at the claims made in cases in which exceptions were applied instead of simply looking at all cases.

The change in tort theories can explain some of the increase in the use of generally recognized exceptions—for example, plaintiffs claim fraud and courts are receptive. But the changes do not explain the rise in idiosyncratic exceptions. It might seem that the increase in applications of idiosyncratic exceptions would stem from plaintiffs basing their claims on new, innovative theories that might persuade the courts to limit the scope of the ELR. This would imply, however, that new and different idiosyncratic exceptions would be applied by courts in the last 10 years of our sample. This is not what we observe. Rather, the increase in applications of idiosyncratic exceptions is due to courts embracing exceptions previously considered and rejected by other courts.

4.2. The Economic Loss Rule and the Contractual Relationship between Parties

We consider if judicial application of the ELR depends on whether the parties have an express written contract—thus excluding oral contracts, implied warranties, and contractual rights as a third-party beneficiary of someone else's contract. If the courts want to promote efficiency, they may be more willing to apply the ELR when the parties have defined

20. Over 1983–2005, the trend for fraud is positive and significant at the 10 percent level ($t = 1.92$). In the same period, the trend for negligent-misrepresentation claims is positive and significant at the 1 percent level ($t = 2.93$).

21. From 1970 to 2005, the trend for other torts is positive and significant at the 10 percent level ($t = 1.78$).

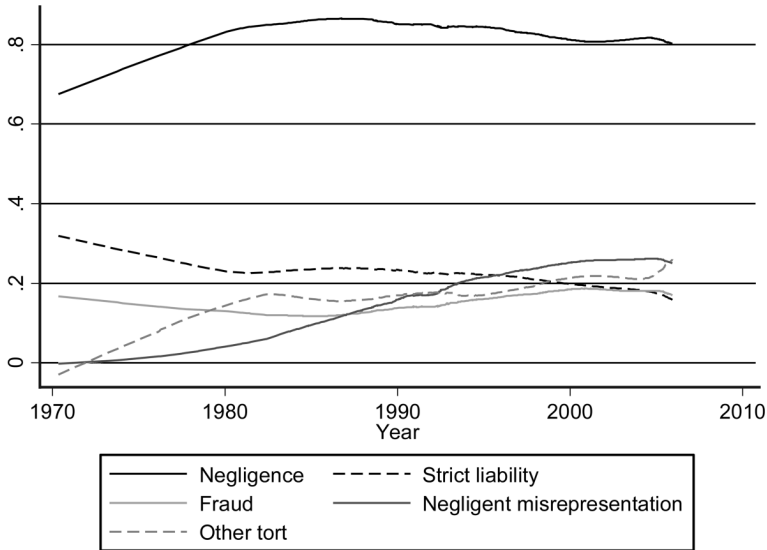


Figure 6. Trends in tort theories claimed by plaintiffs

their relationship in a contract, since the parties presumably have a better idea of the optimal terms of their relationship than a judge would have.

We see in Table 4 that the percentage of cases that apply exceptions is indeed greater when plaintiffs do not have an express written contract. But the difference is not significant ($t = 1.42$). Courts are, however, significantly more likely to apply idiosyncratic exceptions when the parties do not have a contract ($t = 1.87$). These courts in effect make a contract for the plaintiff instead of penalizing him for having failed to negotiate a contract that would have protected him from the loss that he is suing to recover. The reason that some courts are more likely to use idiosyncratic than generally recognized exceptions may be that those courts are not committed to the position that when transaction costs are low, parties should be forced to define their mutual duties in a contract instead of requiring the courts to do so in the name of tort law.

If courts are moving toward efficiency, the incidence of exceptions in those cases in which parties have an express written contract should fall over time. The data in Figure 7 do not support this hypothesis. Both the use of exceptions and the use of idiosyncratic exceptions rise significantly after 1997 when parties have an express contract.

Table 4. Percentages of Exceptions by Whether Parties Had an Express Written Contract

Contract	Cases	All Exceptions	Idiosyncratic Exceptions
No	288	39.27	14.58
Yes	173	33.53	8.67

4.3. Relative Economic Power of the Parties

We divide parties into two groups on the basis of rough proxies for economic power:

Weak parties:

- Individual property owners and tenants
- Associations of residents
- Subcontractors and small builders

Strong parties:

- Commercial property owners
- Public property owners
- Developers
- Architects and engineers
- Inspectors
- Manufacturers
- Suppliers
- Other parties (banks, insurance companies, and real estate agents)

Table 5 shows the rates of plaintiff recovery and application of idiosyncratic exceptions for the four types of combinations of plaintiff and defendant.

There is no statistically significant difference between the groups in the courts' use of exceptions overall. Courts, however, are more likely to apply an idiosyncratic exception when facing a weak plaintiff and strong defendant (17.64 percent of cases) than in cases in which both parties are strong (7.43 percent of cases). This difference is highly significant ($t = 2.97$). But the application of idiosyncratic exceptions is also more likely when courts face a strong plaintiff and a weak defendant (17.64 percent) than when both parties are strong ($t = 1.89$). No other differences are significant. This evidence mildly supports the hypothesis that sympathy moves courts to use idiosyncratic exceptions to help weak plaintiffs.

Multivariate regression analysis confirms the above results, controlling for state and time fixed effects. Table 6 illustrates that the relative

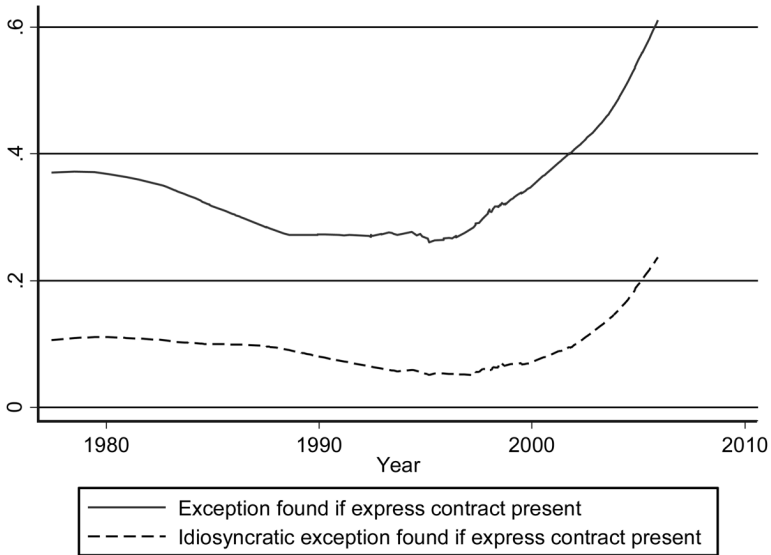


Figure 7. Use of exceptions and of idiosyncratic exceptions when parties have an express contract

strength of the parties does not significantly affect the application of exceptions overall (specifications [1]–[4]), but it does affect the application of idiosyncratic exceptions. Specifications (5)–(8) indicate that courts are more likely to introduce an idiosyncratic exception when parties do not have an express contract and when the plaintiff is weak.

4.4. The U.S. Supreme Court's Decision in *East River*

In *East River*, the Supreme Court strongly endorsed the ELR. A plaintiff shipbuilder had a contract with the defendant to design, manufacture, and install turbines for four supertankers. The ships malfunctioned and were damaged, and the plaintiff sought to recover the costs of repair, plus income lost while the ships were out of service. The plaintiff initially made claims in both contract and tort; the contract claims turned out to be barred by the statute of limitations. The negligence claims were rejected by the Supreme Court, which held that customer dissatisfaction with product quality is not a cognizable claim in admiralty tort law. Following the reasoning in *Seely*, the Court held that such claims can be brought only as claims for breach of warranty.

Although the *East River* decision was not binding on state courts,

Table 5. Incidence of Exceptions by Relative Economic Power of the Parties

	Cases		All Exceptions (%)	Idiosyncratic Exceptions (%)
	N	%		
Weak plaintiff and weak defendant	73	15.84	43.86	12.33
Weak plaintiff and strong defendant	152	32.97	38.15	17.64
Strong plaintiff and weak defendant	34	7.38	35.29	17.64
Strong plaintiff and strong defendant	202	43.82	33.66	7.43

we examine whether it had a significant influence on them in construction cases. Influence is difficult to ascertain here, since, as we showed in Section 3, the use of exceptions had been trending down for at least a decade before *East River* and bottomed out later, in the early 1990s. We find no effect of *East River* on the speed of convergence.

Another way to assess influence is by number of citations. Since *East River* denies recovery, we expect that state court decisions that cite *East River* are likely to deny liability. Indeed, 52 of the 68 cases (76.47 percent) in our sample that cite *East River* deny the plaintiff recovery, while only 196 of the 310 cases since *East River* that do not cite the case deny recovery (63.22 percent). This difference is significant ($t = 2.17$). Still, one needs to be cautious: cases that cite *East River* may do so as cover, trading on the prestige of the Supreme Court, whereas cases that do not cite *East River* can justify not citing it on the ground that an admiralty case is irrelevant to construction disputes. If this explanation is correct, the citation evidence yields some support for the legal realist hypothesis that state courts do what they want and use citations to provide rhetorical support for their conclusions.

While *East River* may have had some influence in consolidating support for the ELR, the proportion of cases citing the decision has fallen since the early 1990s. This trend is significant ($t = -2.24$ for 1990–2005). We cannot conclude from our data that the U.S. Supreme Court has had a major influence on the state courts' treatment of the ELR, at least in the construction industry.

4.5. Variation across States

There is tremendous variation in the application of exceptions across states. Kentucky has only cases that apply exceptions to the ELR, while Wyoming, Kansas, Virginia, and Maine have no cases that apply exceptions. We ask whether the use of exceptions can be explained by

Table 6. Effects of Contractual Relationships between the Parties and Their Relative Economic Power on the Incidence of Exceptions

Dependent Variable	All Exceptions				Idiosyncratic Exceptions			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Express contract	-.0621 (.0475)	-.0683 (.0490)	-.0625 (.0477)	-.0659 (.0492)	-.0542 ⁺ (.0322)	-.0660* (.0330)	-.0517 (.0323)	-.0601 ⁺ (.0330)
Strong plaintiff	-.0376 (.0465)	-.0509 (.0500)	-.0374 (.0466)	-.0511 (.0500)	-.0621* (.0316)	-.0788* (.0337)	-.0633* (.0316)	-.0794* (.0335)
Strong defendant	-.0711 (.0556)	-.0798 (.0563)	-.0708 (.0557)	-.0814 (.0564)	-.0172 (.0377)	-.0244 (.0379)	-.0194 (.0378)	-.0285 (.0378)
State controls	No	Yes	No	Yes	No	Yes	No	Yes
Time controls	No	No	Yes	Yes	No	No	Yes	Yes
R ²	.0096	.1392	.0096	.1400	.0178	.1587	.0201	.1682
F	1.477	1.456 ⁺	1.108	1.430 ⁺	2.755*	1.698**	2.340*	1.777**

Note. Values are the results of multivariate ordinary least squares regressions. Standard errors are in parentheses. N = 461.

⁺p < .10.

*p < .05.

**p < .01.

geographical or economic differences; the answer appears to be no.²² We ask whether the differences in the use of exceptions can be explained by the methods by which judges are selected and retained that different states employ, and again the answer is no.²³ Nor can the differences in the use of exceptions be explained by differences in political ideology among judges.²⁴

Might state courts that have the most experience with the ELR have greater respect for the doctrine? To examine this hypothesis, we focus on the five states with the highest ELR caseloads. The incidence of exceptions turns out to vary greatly in these states (see Table 7). New York is very strict on plaintiffs, applying exceptions to the ELR in a mere 15.91 percent of cases, while California is far more lenient (52.94 percent).²⁵

Not only do the averages differ greatly across the five busiest states; so do the trends among the five states (Figure 8). The incidence of application of exceptions in California is high on average but significantly decreasing over time ($t = -2.62$), while the application of exceptions in New York and Illinois is considerably less frequent but becoming more so. In Florida there has been a highly significant increase in the application of exceptions since the early 1980s ($t = 3.49$).

Across all states in our sample, the incidence of exceptions is not significantly correlated with the number of cases decided in a state. The proportion of cases that apply idiosyncratic exceptions is, however, cor-

22. Testing for differences in the use of exceptions across regions does not yield any notable patterns. Testing for differences based on levels of economic growth in each state from 1970 to 2005 generates insignificant results, as does testing for differences based on growth in the construction industry in each state from 1970 to 2005.

23. States differ in the methods by which judges are appointed and retained. We use the categories employed in Choi, Gulati, and Posner (2010) to divide states into four types of judicial selection method (appointment, merit selection, partisan election, and nonpartisan election). The methods by which judges are retained are highly correlated with the method of selection. The differences in the use of exceptions across states with different judicial selection methods are not significant.

24. Using a simple measure of party-adjusted surrogate judicial ideology (PAJID) from Brace, Langer, and Hall (2000), we test whether the ideology of the supreme court judges in a given state can help explain the variation in the use of exceptions across states. In the cases in which the court upheld the ELR to preclude recovery, the average PAJID score was 47.20. In those cases in which an exception was used, the average PAJID score was 47.46. The difference is not significant ($t = .1817$).

25. New York's position may reflect the prestige and continuing influence of Judge Cardozo, the author of the *Ultramares* opinion (see note 3), which continues in New York to block third-party suits against auditors, though a majority of other states have abandoned that application of the ELR.

Table 7. Incidence of Exceptions in States with the Highest Caseloads

State	Cases	All Exceptions		Idiosyncratic Exceptions	
		N	%	N	%
California	34	18	52.94	3	8.82
Florida	47	19	40.43	3	6.38
Ohio	32	12	37.50	2	6.25
Illinois	56	18	32.14	4	7.14
New York	44	7	15.91	2	4.55
Total	213	74	34.74	14	6.57

related with caseload. A simple linear regression indicates that states with higher caseloads use idiosyncratic exceptions less frequently ($t = -2.85$). This negative relationship is even stronger in the cases that recognize, without necessarily applying, idiosyncratic exceptions ($t = -3.41$). The implication is that idiosyncratic exceptions are more likely to be applied when courts have less experience with the ELR in construction cases. This hypothesis is further supported by a comparison of the first 10 decisions heard in each state with the subsequent decisions in those states (restricting the sample to those states that hear more than 10 cases). The early cases are significantly more likely than the later cases both to apply idiosyncratic exceptions ($t = 2.56$) and to recognize them ($t = 2.53$).

The punch line of this analysis is that light ELR caseloads in some states might explain why we have not seen stronger national convergence to the ELR, and more specifically why we have seen an increase in the application of idiosyncratic exceptions in the past decade. Although the ELR is widely accepted, the law has not come to a rest, and states continue experimenting, often in ways inconsistent with the ELR and its generally recognized exceptions. Experience slows this experimentation, but does not stop it.

The increase in the application of idiosyncratic exceptions is not limited to states with low caseloads. In fact, 76 percent of the cases that apply idiosyncratic exceptions since 1997 have come from states with 10 or more cases. Wisconsin (the state with the sixth highest caseload) has seen a sharp rise in cases decided by the application of idiosyncratic exceptions. Four of the five largest states have applied an idiosyncratic exception in the last 6 years of our sample. Thus, even in busy states

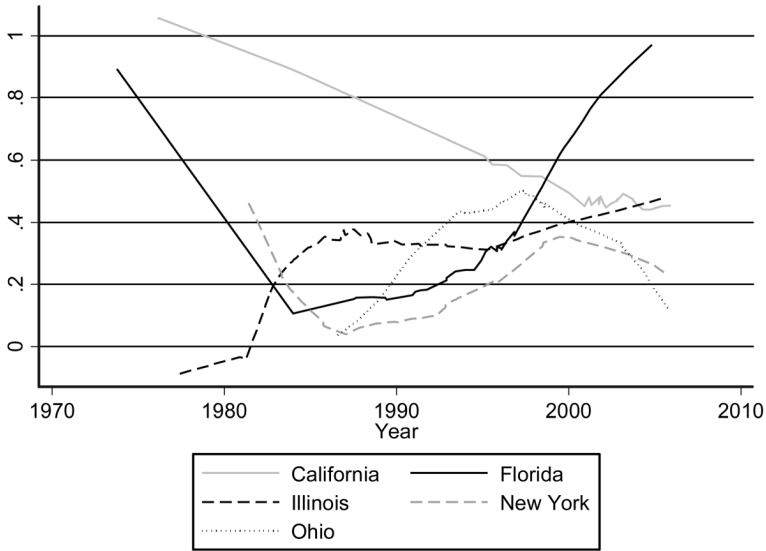


Figure 8. Use of exceptions in the states with the highest caseloads

we see an increasing tendency of courts to apply idiosyncratic exceptions to the ELR.

5. CONCLUSION

Over the 35 years covered by our study, the ELR has evolved in a way that cannot be easily described as convergence to efficiency. While over the first quarter century the law moved significantly toward adopting the ELR with generally recognized exceptions, over the last decade it has moved away from this equilibrium. Had we written this paper 10 years ago, we would have found the law converging to the ELR with generally recognized exceptions, but the law moved away from that rule afterward with no changes in the economic environment to explain the movement. Moreover, the law has evolved very differently in different states, which is inconsistent with efficiency in the absence of evidence of relevant economic differences in construction disputes across states.

The lack of convergence does not mean that judicial behavior is random or that the law is entirely unpredictable. The lack of nationwide convergence is consistent with settled law in individual states. And on

average in our sample, courts applied the ELR with generally recognized exceptions about 88 percent of the time, although in about 15 percent of these cases the courts accepted the validity of idiosyncratic exceptions but did not think the facts warranted their application. Overall, idiosyncratic exceptions were recognized by appellate courts in about 25 percent of cases. But many states are increasingly applying idiosyncratic exceptions to limit the ELR, and the amount of appellate litigation involving the ELR in construction disputes is growing. These are not signs of the law settling down.

Some additional evidence developed in this study sheds light on how legal evolution works. Plaintiffs' claims respond to what courts are receptive to, such as claims of fraud. But that is not the whole story. The key reason for nonconvergence is that courts distinguish earlier cases and create idiosyncratic exceptions to the prevailing legal doctrine that other courts reject. In the last decade covered by our study, courts increasingly applied such exceptions even when the parties had express contracts and so might have been thought unsympathetic tort claimants.

Idiosyncratic exceptions differ across states, with many states going in their own direction. State courts at first responded to a nonbinding 1986 U.S. Supreme Court ruling embracing the bright-line ELR in an admiralty case, but its influence declined over time. There is evidence that state courts with heavier caseloads in this area of litigation are more likely to converge to the adoption of the ELR with generally recognized exceptions, but even in those states there is residual uncertainty.

We conclude that appellate courts exercise a significant amount of discretion in deciding cases, leaving the law far from certain even after 3-and-a-half decades of evolution. The deviations from efficiency do not disappear over time. There may be evolutionary benefits of such legal flexibility, but the hypothesis that, in commercial fields, the common law is predictable and efficient, or at least is moving there, is not supported by our study. It would be illuminating, in this regard, to examine legal evolution in other areas of law; we would expect the pressures for efficiency outside purely economic environments such as construction to be weaker.

APPENDIX: CONSTRUCTION OF THE DATABASE

All data were obtained from the LexisNexis library of construction cases. To find the cases, we searched the library for state appeals court cases decided prior to December 31, 2005, that satisfy the following criteria:

(1) the phrase “economic loss” is found in either the overview or the core terms, and (2) “contract,” “agree,” or “warrant” is found in the overview or the core terms. (The overview is a summary of the case of approximately 150–200 words. The core terms are a list of 30–50 key terms that appear in the decision.) This search strategy captures all state appeals cases from the construction industry in which the ELR defense is raised by defense lawyers. No issue of different coverage periods for different states arises in our sample period.

This search yielded 1,171 cases. Of these, 209 were not appellate cases and so were dropped, and another four were not from state courts. Another 496 cases were excluded as irrelevant because the LexisNexis construction library turns out to include cases that do not pertain to construction. In 50 cases, more than one dispute is addressed on appeal. For example, a plaintiff may bring claims against the general contractor and subcontractors in one case. When the plaintiff brings different claims against the two defendants and both claims are being heard on appeal, we divide the case into two distinct observations. When the plaintiff brings claims against multiple defendants but the appeal addresses only one of them, it is counted as one observation. We have 46 cases that give rise to two observations and four cases that give rise to three observations; the other 412 cases involve single claims decided on appeal. Of the 516 individual disputes thus coded, 39 do not involve tort claims and another 16 involve tort claims that were not appealed. After removing these 55 disputes, we have our sample of 461 observations.

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