The Fourth Circuit Applies a Consequential Damages Exclusionary Clause and the Economic Loss Doctrine to Bar Claims by a Subrogating Insurer Seeking to Recover Over $19 Million in Damages

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In Severn Peanut Co., Inc. v. Industrial Fumigant Co., 807 F.3d 88 (4th Cir. (N.C.) 2015), the United States Court of Appeals for the Fourth Circuit ("Fourth Circuit"), applying North Carolina law, considered whether a consequential damages clause in a contract between the Severn Peanut Co., Inc. ("Severn") and Industrial Fumigant Co. ("IFC") barred Severn and its subrogating insurer, Travelers Property Casualty Company of America ("Travelers"), from recovering over $19 million in damages that Severn suffered as the result of a fire and explosion at its Severn, North Carolina plant. The Fourth Circuit, rejecting Severn's unconscionability and public policy arguments related to the consequential damages clause and finding that the economic loss doctrine barred Severn from pursuing negligence claims, affirmed the trial court's judgment granting summary judgment in IFC's favor.

As noted in the Severn decision, the facts showed that Severn and IFC signed a Pesticide Application Agreement ("PAA") requiring IFC to use phosphine, a pesticide, to fumigate Severn's peanut storage dome and to apply the pesticide "in a manner consistent with instructions . . . and precautions set forth in [its] labeling." With respect to damages, the PAA specified that IFC's charge for its services, $8,604 plus applicable sales tax, was "based solely upon the value of the services provided" and was not "related to the value of [Severn's] premises or the contents therein." In addition, the PAA specified that the $8,604 sum to which the parties agreed was not "sufficient to warrant IFC assuming any risk of incidental or consequential damages" to Severn's "property, product, equipment, downtime, or loss of business."

IFC used a phosphine called Fumitoxin and Fumitoxin's label, consistent with federal and state pesticide laws, required that the user avoid piling Fumitoxin tablets on top of each other when applying the pesticide. On April 4, 2009, IFC purportedly dumped approximately 49,000 tablets of Fumitoxin into Severn's peanut dome in a manner that caused the tablets to pile up on one another. Consequently, a fire and explosion occurred, causing the peanut dome to suffer extensive structural damage. After the incident, Travelers paid Severn over $19 million "to cover the loss of nearly 20,000,000 pounds of peanuts, lost business income, the damage to the peanut dome, and Severn's remediation and fire suppression costs."

After the fire and explosion, Severn filed suit against IFC, stating claims for negligence, negligence per se and breach of contract. The trial court, relying on the consequential damages clause in the PAA, granted summary judgment in IFC's favor with respect to Severn's breach of contract claim. The trial court also granted summary judgment in IFC's favor with respect to Severn's negligence claims. Severn appealed the trial court's rulings.

On appeal, Severn argued, among other things, that the PAA's consequential damages clause was unenforceable because it was unconscionable, exculpatory clauses are not favored, and the PAA violates North Carolina public policy. The Fourth Circuit rejected all of Severn's arguments. As noted by the Fourth Circuit, the PAA was a contract between sophisticated commercial entities who entered into an arm's length transaction and public policy accords contracting parties the freedom to bind themselves as they see fit. Moreover, companies faced with consequential damages limitations can protect themselves two ways: they can purchase insurance or attempt to bargain for greater protection against any breach from their contractual partner. In this case, Severn chose the former

method as it recovered money from its insurance company, "whose own business involves the contractual allocation of risk." Based on its findings, the Fourth Circuit upheld the trial court's decision granting summary judgment in IFC's favor on Severn's breach of contract claim.

With respect to Severn's negligence claims, the Fourth Circuit found that Severn's claims were barred by the economic loss doctrine, a doctrine that prohibits the recovery of purely economic loss in tort when a contract operates to allocate the risk of loss. On appeal, Severn argued that the doctrine did not apply because its peanuts and storage dome were "other property," outside of the contract and, thus, its damages were outside the scope of the doctrine. The Fourth Circuit disagreed, finding that "[t]he contract was for the treatment of 'commodities and/or space,' and it specified that this included Severn's '1,976,506 [c]ubic [f]eet' of peanuts and its . . . peanut dome." Moreover, the claimed tort remedy was for the breach of IFC's duty to apply Fumitoxin in accordance with its label, the same duty that supported Severn's breach of contract claim. Because the pesticide that caused the fire and destroyed the peanuts and dome were contractually and practically bound together, and Severn had the best opportunity to bargain for coverage for the risk of loss, the Fourth Circuit held that North Carolina's economic loss doctrine prevented Severn from transforming its breach of contract claim into a tort claim. Thus, the Fourth Circuit upheld the trial court's judgment with respect to Severn's negligence claim, leaving Severn's insurer with no cause of action to pursue.

The Severn decision serves a reminder that courts, generally, grant parties the freedom to contract and, particularly with respect to sophisticated commercial entities, will enforce consequential damages and other contractual limitations clauses. Thus, when faced with a loss that is, potentially, subject to an exculpatory or limitation of liability clause, subrogating insurers should secure a copy of the agreement containing the limiting clause and work with subrogation counsel to analyze the impact of the clause at the outset of the subrogation investigation. In addition, subrogating insurers and their counsel should analyze whether, based on the terms of the agreement, the economic loss doctrine will preclude negligence-based subrogation claims.

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