RECENT DEVELOPMENTS IN BUSINESS LITIGATION

Christine Spinella Davis, Joel W. Mohrman, Van Cates, Daniel Wilson, Karen Gunderman, Scott R. Wolf, Michael A. Sirignano, and Frank P. Tiscione

I. Civil RICO 116
II. Covenants Not to Compete 121
III. Breach of Contract 126
IV. Remedies 131
A. Vermont 132
B. Washington 133
C. Texas 135
V. Breach of Fiduciary Duty 137
VI. Fraud and Misrepresentation 140

This article highlights significant business litigation cases decided from October 1, 2011, through September 30, 2012, addressing (1) civil RICO, where federal courts for the most part continued to dismiss civil RICO claims that were not targeted at organized, long-term crime; (2) covenants not to compete, where one state appellate court during the past year developed a near exhaustive list of factors to consider in

Christine Spinella Davis and Karen Gunderman are with GEICO Claims Home Office/Legal in Chevy Chase, Maryland. Michael A. Sirignano is a partner and Frank P. Tiscione is an associate at Rivkin Radler LLP in Uniondale, New York. Joel W. Mohrman is a member in the Houston office at McGlinchey Stafford PLLC. Scott Wolf is a director/shareholder at Blanchard, Walker O'Quin & Roberts in Shreveport. Van A. Cates is assistant general counsel at Veolia Water North America in Tampa. Daniel Wilson is an associate with Johnson DeLuca Kurisky & Gould, P.C. in Houston. Ms. Davis and Messrs. Cates, Mohrman, and Wolf are vice-chairs of the TIPS Business Litigation Committee.

a reasonableness analysis; (3) breach of contract, notable for *Microsoft Corp. v. Motorola, Inc.*, which suggests that contract law is poised to become a key tool in patent litigation; (4) remedies, including continued expansion and contraction in various jurisdictions of the economic loss rule; (5) breach of fiduciary duty, where the Third Circuit found that a corporate director who sued the company had a fiduciary obligation to engage his opposing counsel; and (6) fraud and misrepresentation, in which courts across the country rendered decisions on both substantial and procedural issues.

I. CIVIL RICO

This past year federal courts, touching on a variety of pleading failures in their holdings, continued the trend of dismissing civil RICO claims that were not aimed at eradicating organized, long-term traditional criminal activity. However, plaintiffs in several federal court decisions did succeed in properly asserting RICO claims.

In *Walters v. McMahen*, the Fourth Circuit held that plaintiffs failed to state a cause of action for civil conspiracy because they did not sufficiently allege a violation of two RICO predicate acts.[1] Plaintiffs, a group of hourly wage employees at Perdue Farms, Inc., alleged that corporate managers and human resource staff conspired to violate 18 U.S.C. § 1962(c).[2] The conspiracy included violations of two different statutes that would qualify under RICO as predicate acts, specifically 8 U.S.C. § 1324 (harboring aliens) and 18 U.S.C. § 1546 (misuse of visas).[3] The court found that plaintiffs failed to allege sufficient facts to plead a § 1324 violation.[4] The court also held that the misuse of a visa violation cannot be a proximate cause of the plaintiff's injury because "there is no direct relationship between the injury asserted and the predicate act alleged."[5] Likewise, in *Maribel Delrio-Mocci v. Connolly Properties, Inc.*, the Third Circuit affirmed dismissal of a RICO claim because plaintiff, a tenant complaining that his property managers rented to illegal aliens, did not allege facts sufficient to constitute the predicate acts of harboring aliens.[6] In his concurring opinion, Chief Judge McKee characterized the complaint as a landlord-tenant dispute disguised as a federal RICO claim and urged Congress to restrict

1. 684 F.3d 435 (4th Cir. 2012); *see also* Sky Harbor Air Service, Inc. v. Reams, Nos. 11-8025, 11-8062, 2012 WL 2948180 (10th Cir. July 20, 2012).
2. *Walters*, 684 F.3d at 438.
3. *Id.*
4. *Id.* at 441.
5. *Id.* at 444.
6. 672 F.3d 241 (3d Cir. 2012), *cert. denied*, 133 S. Ct. 167 (Oct. 1, 2012).

the statute "to the ills Congress thought it was addressing when it enacted this far-reaching legislation."[7]

In *Crest Construction II, Inc. v. John Doe*, the Eighth Circuit affirmed the district court's decision dismissing a RICO claim arising from certain investment and business relationships among the parties.[8] Plaintiffs in *Crest* alleged in overly broad terms that defendants formed and operated an "association in fact" involving a web of interrelated, commonly owned and managed companies that engaged in mail and wire fraud, which ultimately induced plaintiffs to purchase third-party vehicle loan accounts.

The district court dismissed the RICO claim because plaintiffs failed to properly plead the RICO elements of an enterprise, i.e., a pattern of racketeering activity and at least two predicate acts committed by each defendant.[9] First, plaintiffs failed to allege a RICO enterprise because they only made conclusory allegations that did not establish how the defendants were associated with each other or the RICO enterprise.[10] Second, the complaint failed to state a pattern of racketeering by not satisfying the continuity element. The court deemed the alleged scheme to be legally insufficient to meet the closed-ended continuity requirement because it lasted less than seven months and legally insufficient to constitute open-ended continuity because the long-term threat was limited to plaintiffs, rather than affecting multiple victims over a significant period of time.[11] Finally, the Eighth Circuit held that plaintiffs failed to properly plead mail and wire fraud under the heightened pleading requirements of Rule 9(b).[12]

Likewise, the Fifth Circuit affirmed dismissal of a RICO claim in *ISystems v. Spark Networks, Limited*, again because plaintiffs did not adequately allege a proper RICO enterprise.[13] Plaintiff, which had at one time held the domain name "jdate.net," commenced an action against Sparks, Inc., the owner of "jdate.com," asserting claims under the Anticybersquatting Consumer Protection Act and RICO. Plaintiff attempted to connect Spark Inc., the alleged RICO person, to a distinct RICO enterprise. Plaintiff argued that Spark Ltd., the wholly owned subsidiary of Spark Inc., was a RICO enterprise, relying on the fact that the formal separate incorporation was sufficient distinction between the RICO enterprise and

---

7. *Id.* at 251. Judge McKee highlighted the fact that the treble damage provision of RICO spawns claims that are not at all related to the congressional purpose underlying the statute.
8. 660 F.3d 346, 350 (8th Cir. 2011).
9. *Id.* at 354.
10. *Id.* at 356–57.
11. *Id.* at 357–58.
12. *Id.* at 358.
13. No. 10-10905, 2012 WL 3101672 (5th Cir. Mar. 21, 2012).

the RICO person.[14] The Fifth Circuit held that plaintiff failed to show that the alleged RICO enterprise existed, because it did not allege that Spark Ltd. did anything beyond carrying out the regular business of Spark Inc.[15] Noting that the complaint in many instances failed to distinguish between the two entities, the court held that plaintiff's failure to plead any functional separation between Spark Inc. and Spark Ltd. "dooms its RICO claim."[16]

In *Heinrich v. Waiting Angels Adoption Services, Inc.*, the Sixth Circuit reversed the dismissal of civil RICO claims brought against an adoption service and its principals involving predicate acts that spanned less than two months.[17] Although plaintiffs pled only four predicate acts of racketeering activity, the district court found these were sufficient to establish a pattern of racketeering activity.[18] The four claims adequately alleged predicate acts of mail or wire fraud, specifically a scheme to defraud, use of the mail or wires in furtherance of the scheme, and a sufficient factual basis from which to infer scienter.[19] The predicate acts involved defendants making false representations to would-be adoptive couples with the goal of defrauding them.[20]

Significantly, the Sixth Circuit rejected defendant's argument that the scheme failed to meet the continuity prong to establish a pattern of racketeering. The court acknowledged that the predicate acts, spanning less than two months, did not meet the requirements for closed-ended continuity, but held that plaintiffs sufficiently alleged open-ended continuity.[21] Defendants argued that the adoption service was closed as part of a criminal prosecution, thereby eliminating any threat of continued criminal activity. The Sixth Circuit, however, held that subsequent events, such as criminal prosecution, are irrelevant to the continuity determination. In the context of open-ended racketeering, the threat of continuity must be viewed at the time the racketeering activity occurred.[22] As stated by the court, "[a]t the time the defendants committed the four predicate acts alleged here, there was no indication that their pattern of behavior would not continue indefinitely into the future."[23]

In the Seventh Circuit, a plaintiff was also successful in pleading a pattern of racketeering activity. In *Deguelle v. Camilli*, plaintiff alleged that he

14. *Id.* at * 5.
15. *Id.*
16. *Id.* at *4–5.
17. 668 F.3d 393, 411–12 (6th Cir. 2012).
18. *Id.* at 408–09.
19. *Id.*
20. *Id.* at 409.
21. *Id.* at 410.
22. *Id.*
23. *Id.* at 411.

was fired from S.C. Johnson & Son after reporting an alleged tax fraud scheme to company officials and law enforcement.[24] The district court dismissed plaintiff's RICO claim based on the failure to sufficiently plead a pattern of racketeering. Specifically, the court held that the predicate acts alleged, i.e., tax and mail fraud and illegal retaliation under Sarbanes-Oxley, were unrelated due to the presence of different actors, motives, and victims.[25] The Seventh Circuit reversed, noting that "[r]etaliatory acts are inherently connected to the underlying wrongdoing exposed by a whistleblower," although the facts in each case must still be examined.[26] After examining the alleged facts in *Deguelle*, the court held that the predicate acts were sufficiently related to establish a pattern of racketeering.[27]

To claim a violation of 18 U.S.C. § 1964(c), a plaintiff must allege that it was "injured in its business or property" by reason of a § 1962 (RICO) violation.[28] In *Santana v. Cook County Board of Review*, plaintiff alleged that the defendants' racketeering activity, including bribery, money laundering, and extortion, injured him "in business or property" and therefore violated § 1964(c).[29] The Seventh Circuit found that plaintiff had not plausibly demonstrated how he could have been injured in his business or property by defendants' conduct.[30] In *Davis-Lynch, Inc. v. Moreno*, the Fifth Circuit reversed the district court's decision granting summary judgment to plaintiff on its substantive RICO claims.[31] After plaintiff failed to show that it was injured from the investment or use of the alleged racketeering proceeds, the Fifth Circuit dismissed the § 1962(a) claim.[32]

In contrast, the Sixth Circuit held that plaintiffs properly pleaded an injury to property because they alleged the devaluation of either their expectancy of or claim for workers' compensation benefits.[33] In *Brown v. Cassens Transport Co.*, plaintiffs were allegedly injured while working for Cassens Transport Company but were denied worker's compensation benefits due to an alleged RICO conspiracy by Cassens, its claims adjudicator, and certain medical doctors.[34] The district court had dismissed plaintiffs' RICO claim, ruling that the claim could not be disentangled

24. 664 F.3d 192, 199–200 (7th Cir. 2011).
25. *Id.* at 200.
26. *Id.* at 201.
27. *Id.* at 203.
28. *See* Moss v. Morgan Stanley, Inc., 719 F.2d 5, 17 (2d Cir. 1983).
29. 679 F.3d 614, 618 (7th Cir. 2012).
30. *Id.* at 623. Further, the court found that plaintiff's alleged reputation injury was personal and therefore could not sustain a RICO claim.
31. 667 F.3d 539 (5th Cir. 2012).
32. *Id.* at 550–51.
33. Brown v. Cassens Transport Co., 675 F.3d 946, 956–57 (6th Cir. 2012).
34. *Id.*

from their underlying claim for workers' compensation benefits, which purports to be the employee's exclusive remedy against an employer.[35] The Sixth Circuit reversed, holding that a federal civil RICO claim and a state claim for workers' compensation are legally distinct, even though they share the same factual underpinnings.[36] The court further held that because a property interest in the form of entitlement to benefits is consistent with "property" as defined by RICO, plaintiffs properly stated a claim alleging injury to property when they alleged harm to their expectancy of statutory benefits under the workers' compensation act.[37]

Plaintiffs' RICO allegations failed in the Eighth and Ninth Circuits in cases involving standing issues. In *Gomez v. Wells Fargo Bank, N.A.*, the Eighth Circuit held that since plaintiffs did not allege plausibly a concrete financial loss caused by a RICO violation, the district court did not err in concluding plaintiffs lacked RICO standing.[38] Similarly, in *Ahn v. Hanil Development, Inc.*, the Ninth Circuit confirmed that plaintiff's individual § 1962(c) claims were properly dismissed because plaintiff lacked standing to pursue those claims.[39] Specifically, plaintiff lacked standing because his alleged injury was not unique to him but rather an injury to the corporation in which he was a shareholder.[40]

In *Rajput v. City Trading, LLC*, plaintiffs invested in Indian businesses promising extraordinarily high rates of return that not only failed to materialize but also left plaintiffs with less money than they had originally invested.[41] Plaintiffs alleged that the affiliate U.S. business defendant committed RICO violations as part of a scheme to launder funds obtained through the supposed Indian fraud.[42] Plaintiffs supported their claims by explaining a system of money laundering and offered specific allegations purporting to connect defendant City Trading to the alleged Indian fraud.[43] The Eleventh Circuit held that plaintiffs' pleadings sufficiently connected defendants to the alleged Indian fraud to qualify as factual content that allows the district court to draw the reasonable inference that defendants committed the alleged RICO violations and engaged in a RICO conspiracy.[44]

---

35. *Id.* at 952.
36. *Id.* at 953–54. The Sixth Circuit held that the Supremacy Clause prevents the Michigan legislature from preempting a RICO remedy by declaring its workers' compensation scheme to be exclusive of federal remedies.
37. *Id.* at 964–65.
38. 676 F.3d 655, 661–62 (8th Cir. 2012).
39. 471 Fed. App'x 615 (9th Cir. 2012).
40. *Id.*
41. 476 Fed. App'x 177 (11th Cir. 2012).
42. *Id.*
43. *Id.* at 179.
44. *Id.* at 180.

Finally, in *Cedeno v. Castillo*, the Second Circuit addressed arguments by plaintiffs regarding the purported extraterritorial reach of RICO.[45] Plaintiffs sought to recover from defendants under RICO based on predicate acts of money laundering (18 U.S.C. § 1956) and extortion (18 U.S.C. § 1951). The district court concluded these predicate acts were outside RICO's domestic reach. The Second Circuit agreed, finding that plaintiffs' complaint alleged conduct in the United States was insufficient to state a domestic RICO claim. The court reached this conclusion despite plaintiffs' argument that the predicate acts of money laundering and extortion applied extraterritorially. RICO does not extend outside the United States, even though statutes defining some of its predicate offenses may apply abroad.[46]

II. Covenants Not to Compete

Cases in the last year dealing with covenants not to compete focused on a number of issues, including tortious interference with contracts as it relates to such covenants. Because these covenants, often part of an employment agreement, are contracts, plaintiffs often also allege tortious interference with contract and with business relations. The following discussion examines how these two legal theories intertwine in such cases. Also, as we have stated in previous survey articles, courts often consider whether the covenants not to compete are reasonable. This reasonableness analysis can encompass many different factors. One of the cases discussed below has a near exhaustive list of the factors, including coercion, that courts may consider in determining whether a covenant not to compete is reasonable.

In *Charles T. Creech Inc. v. Brown*,[47] the former employer sued a departing employee (Brown) and his new employer (Standlee Hay) alleging breach of the noncompete agreement, fraud, and tortious interference with employment contracts. Brown worked two decades in the relevant industry before he came to Creech, where he was employed for eighteen years in many capacities. In 2006, Creech required Brown to execute a covenant that purported to prohibit leaving employees from working for any company that directly or indirectly competed with Creech for three years.

After Brown left Creech, his former employer executed a limited waiver of the noncompetition agreement, which permitted him to work for Standlee Hay as long as he did not directly or indirectly compete

45. 457 Fed App'x 35 (2d Cir. 2012).
46. *Id.* at 38.
47. No. 2011-CA-000629-MC, 2012 WL 3538351 (Ky. Ct. App. Aug. 17, 2012), *reh'g denied* (Sept. 26, 2012).

with Creech. Brown and Standlee Hay communicated to Creech that, in fact, Brown would be competing with his former company. Creech never responded to their notification and sometime later brought suit.

The trial court entered a temporary injunction against Brown and Standlee Hay. Defendants appealed the injunction and the court reversed the case, making statements that seemed to suggest that Creech's claims would "fail."[48] Upon remand the trial court, heeding the statements of the appellate court, entered summary judgment against Creech's claims. Creech appealed the decision.[49]

Addressing the case for the second time, the Kentucky Court of Appeals commented on the extremely factual nature of covenant not to compete cases, observing that:

> [i]t is tempting in disputes concerning non-competition agreements to turn to existing case law in search of a single guiding principal or perhaps a collection of hard-and-fast rules which determine the validity of any given covenant not to compete. In fact, very few bright-line rules govern the inquiry now before us.[50]

The court then enumerated the factors it believed should be considered when making the determination as to what is reasonable, including:

> (1) the nature of the industry; (2) the relevant characteristics of the employer; (3) the history of the employment relationship; (4) the interest the employer can reasonably expect to protect by execution of the non-competition agreement; (5) the degree of hardship the agreement imposes upon the employee, in particular, the extent to which it hampers the employee's ability to earn a living; and (6) the effect it has on the public.[51]

The court examined each of these characteristics in greater detail. As to the nature of the industry, the court considered the size of the market and the number of players as well as their market shares. Essentially, the court wanted to know how competitive the market was and whether obtaining proprietary information from former employees would allow a competitor to gain a significant advantage. Turning its attention to the interest that the employer seeks to protect, the court delved into whether the threat of competitors hiring away knowledgeable employees would hurt the former employer's incentive to innovate. The court also examined how signing a covenant not to compete would affect an employee's ability to earn a living. According to the court, any analysis of the rea-

---

48. *Id.* at *2.

49. The court discussed the effect of its prior ruling with Brown and Standlee Hay, agreeing with Brown that its finding had no precedential effect because it was an interlocutory order. *Id.* at *3.

50. *See id.* at *3.

51. *Id.* at *4.

sonableness of an agreement requires "case-specific flexibility" since industries, employers, and geography vary widely.

The court also examined the sufficiency of consideration. Brown did not receive any additional money at the time of signing the agreement. He was allowed to keep his job and worked for Creech some period of time thereafter. The court quoted *Dunn v. Gordon Food Service, Inc.*[52] for the proposition that: "The courts of Kentucky and those applying Kentucky law found that employer-employee agreements may be executed in exchange for merely retaining one's job."[53] The *Creech* court critiqued this position by citing a law review article that disparaged the position in *Dunn*, which stated that when covenants not to compete are signed, a new employment relationship arises that supersedes the prior relationship. In effect, the employee becomes a "new employee." The article notes that it must have been strange for the employee to be considered a new employee after he had already been employed for four years.[54]

> The court brushed aside the defendants' waiver argument by holding that whether Creech waived any of its rights was a fact issue, not something to be determined by summary judgment. The court reversed and remanded to the trial court for yet another go-round between the parties.[55]

In an interesting footnote, the court also introduced the possibility of coercion:

> To be clear, the proper focus in a reasonableness analysis is not whether the agreement was supported by consideration (the consideration often being continued employment), which requires a different and perhaps simpler inquiry, but about the fairness of requiring an employee to enter into such an agreement; if the employee appears to have been coerced, that there is a strong argument that it is unreasonable and unenforceable.[56]

In essence, the court added yet another factor to consider in deciding whether an agreement is reasonable. It would seem that the issue of coercion would be better decided under the principle of duress rather than as a part of a reasonableness analysis.

In *Lazer Spot, Inc. v. Hiring Partners, Inc.*,[57] the Texas Court of Appeals also visited the intersection of a covenant not to compete and tortious interference. Hiring Partners, which provided employees to companies

52. 780 F.Supp.2d 570, 574 (W.D. Ky. 2011).
53. *Creech*, 2012 WL 3538351, at *7.
54. *Id.* at *7 (citing Jordan Leidman & Richard Nathan, *The Enforceability of Post-Employment Non-Competition Agreements Formed After At-Will Employment Has Commenced: The Afterthought Agreement*, 60 S. Cal. L. Rev. 1465, 1533–34 (Sept. 1987)).
55. *Id.* at *8.
56. *See id.* at *5, n.6.
57. Lazer Spot, Inc. v. Hiring Partners, Inc., No. 06-12-00044-CV, 2012 WL 5266066 (Tex. App. Oct. 18, 2012).

on a contract basis, alleged that Lazer Spot, which advertises itself as a third-party management company, had tortiously interfered with contracts between Hiring Partners and some of its employees. Hiring Partners employees were required to sign a contract that specifically designated their positions as being at-will. It also contained a covenant not to compete clause that prohibited them from taking a job with any company for which they had worked as a Hiring Partners employee for ninety days after their employment with Hiring Partners was terminated.

The employees in question were gate clerks and dockhands for Arnold Transportation Co. at the Campbell's Soup Plant in Paris, Texas. After obtaining the Campbell's contract, Lazer Spot hired three at-will Hiring Partner employees who already were working at the plant. Hiring Partners sued Lazer Spot for tortious interference.

Lazer Spot argued that any tortious interference claim had to be based upon the covenant not to compete and alleged that the covenant was unenforceable because there was no legally enforceable consideration, the employees were engaged in a common calling, and the agreements were unreasonable. Lazer Spot also claimed the defenses of justification in the hiring of employees and estoppel with regard to the tortious interference claim.[58]

The parties filed competing motions for summary judgment, the trial court granted Hiring Partners' motion, and Lazer Spot appealed.

The Texas Court of Appeals conducted a thorough review of recent jurisprudence on covenants not to compete. After examining what constitutes proper consideration under this covenant, the court concluded that there was no consideration and then quickly eliminated the idea that trade secrets or confidential information were present.[59] Similarly, the court cast aside specialized training as consideration.[60] Hiring Partners had suggested to the court that protection of its goodwill conferred consideration upon the contract. However, the court contrasted the former employees of Hiring Partners, whom it characterized as blue collar workers who signed non-competition agreements in the absence of consideration,[61] with prior cases where managing directors who had stock in the company and had long-term relationships with critically important customers were found to have harmed the goodwill of their former employers.[62]

The court then cited case law for the proposition that "covenants not to compete which are unreasonable restraints of trade and unenforceable on grounds of public policy cannot form the basis of an action for tortious

58. *Id.* at *2.
59. *Id.* at *5.
60. *Id.*
61. *See id.* at *6.
62. Marsh USA, Inc. v. Cook, 354 S.W.3d 764, 773 (Tex. 2011).

interference."[63] Therefore, to the extent that Hiring Partners' claim of tortious interference was based upon the covenant, the court held that summary judgment should have been granted against Hiring Partners.

Hiring Partners also urged that a cause of action can exist for tortious interference with an at-will contract of employment regardless of whether a noncompete covenant is involved. Lazer Spot argued that the testimony of the Hiring Partners president that at-will employees "can go to anybody else but someplace we've introduced them to"[64] was an admission against interest that required summary judgment. After observing that the contract, excluding the covenant not to compete, was merely "the written memorialization of the common law at-will employment relationship,"[65] the court analyzed whether merely inducing an at-will employee to leave his job constitutes tortious interference.

The court distinguished between *Lazer Spot* and cases in which a third party allegedly interfered with the employment contract, e.g., by defaming the employee or inducing to commit a breach of the employment contract. Noting that Lazer Spot simply induced the employees to leave their jobs, which as at-will employees, they were absolutely free to do, the court held that this action did not induce breach of contract.[66] Finally, the court noted that if Hiring Partners' view of the law was upheld, tortious interference would occur every time a company hired a person who was already employed and "the economy in the state of Texas would soon grind to a halt."[67]

California is regarded as one of the most difficult states in which to enforce a covenant not to compete. One of the mechanisms that some companies use to attempt to render these covenants enforceable in California is to link them to the sale of an interest in the business. California does allow covenants that protect the goodwill in a business when it is purchased.[68] However, California courts are skeptical of arrangements that seek to emulate the sale of a business but actually deal with a more traditional employer-employee relationship.

In *Fillpoint LLC v. Maas*,[69] defendant Maas was employed by Star Video Games, which in turn was owned by Crave. Maas owned stock in Crave. When Handleman acquired Crave, Maas and several others signed

63. Juliette Fowler Homes, Inc. v. Welch Assoc., 793 S.W.2d 660, 665 (Tex. 1990).

64. *See Lazer Spot, Inc.*, 2012 WL 5266066, at *6–7.

65. *Id.* at *7.

66. The court noted that the Texas Supreme Court in *Walmart Stores, Inc. v. Sturges*, 52 S.W.3d 711, 713 (Tex. 2001) held that tortious interference requires proof that a defendant's conduct "was either independently tortious or unlawful." *Id.* at *7 n.21.

67. *Id.* at *8 n.23.

68. Cal. Bus. Prof. Code § 16601; *see also* Strategix Ltd v. Infocrossing West, Inc., 48 Cal. Rptr. 3d 614 (Ct. App. 2006).

69. Fillpoint LLC v. Maas, 146 Cal. Rptr. 3d 194 (2012).

agreements regarding the purchase. The purchase and sale agreement contained a covenant not to compete, which likely would have been enforceable under California law. By the time of the lawsuit, the three-year covenant not to compete had expired.

However, Maas also signed an employment agreement that contained a separate covenant. Fillpoint contended that the purchase agreement and the employment agreement must be read together. The noncompetition covenant under the employment agreement, which extended one year past Maas's termination, was a part of the acquisition and therefore enforceable. The court noted that the employment covenant was much broader and prohibited making sales contacts, working for any competitive business, or employing any Crave employees or consultants.[70]

Fillpoint argued that the two different covenants were designed to deal with different elements of damage that would result from Maas competing with Fillpoint after the acquisition. The court, however, found that the restrictions in the covenants "by their very nature" were different. The covenant under the purchase agreement focused on protecting goodwill for a limited time while the covenant under the employment agreement limited Maas's right to engage in his usual line of work. The court found the covenant to be unenforceable because it could not "be reconciled with California's strong public policy permitting employees the right to pursue a lawful occupation of their own choice."[71]

These cases illustrate attempts by plaintiffs to be very creative in enforcing covenants and pursuing related torts against departing employees. However, courts are still careful in applying such covenants using statutory scrutiny as well as general principles of reasonableness to ascertain the scope of such covenants.

III. BREACH OF CONTRACT

As with other areas of law, the explosion of patent litigation, which is likely to continue into the foreseeable future, has driven several recent developments in contact law. Spending on worldwide patent litigation, settlements, licenses, and purchases totaled as much as $20 billion in the past two years alone.[72] In 2012, both Apple and Google spent more on patent prosecution, litigation, and purchases worldwide than on research and development.[73]

70. *Id.* at 203–04.
71. *Id.* at 204.
72. Charles Duhigg & Steve Lohr, *The Patent, Used as a Sword*, N.Y. TIMES, Oct. 7, 2012, *available at* http://www.nytimes.com/2012/10/08/technology/patent-wars-among-tech-giants-can-stifle-competition.html.
73. *Id.*

As the result of a recent decision by the Ninth Circuit, contract law is poised to become a key tool in patent litigation. *Microsoft Corp. v. Motorola, Inc.* gives litigants in patent cases two new powerful cost-cutting tools: (1) under limited circumstances, a patent holder can be enjoined from enforcing its foreign patent rights through a breach of contract claim, and (2) worldwide patent disputes can be consolidated and streamlined using contract law, especially in cases involving patents that are part of universal standards.[74]

The dispute between Microsoft and Motorola began when Microsoft's hardware, including its popular Xbox 360 video game platform, allowed consumers to play digital video using the H.264 video coding standards. Motorola indisputably owns several patents related to the worldwide video coding standards that are regulated by international agencies.[75] However, a patent's adoption into a worldwide standard does not come without concessions. A patent holder must license an incorporated patent to anyone under "reasonable and nondiscriminatory" (RAND) terms.[76] When Motorola demanded a royalty of 2.25 percent for Microsoft's use of its patent, Microsoft sued Motorola for breaching its contract obligation to provide reasonable pricing, claiming third-party beneficiary status to the contract between Motorola and the entities propounding the worldwide standards.[77] The district court granted Microsoft's motion for summary judgment, agreeing that Microsoft was a third-party beneficiary to the agreements, and that Motorola had breached its RAND obligations.[78] On appeal, the Ninth Circuit agreed.

The lower court's ruling and the Ninth Circuit's opinion would not be legally or procedurally novel if it were not for one important fact: the courts forbade Motorola from enforcing an injunction issued in Germany under German law against Microsoft's German products being sold in Germany infringing Motorola's German patent.[79] Antisuit injunctions, even foreign antisuit injunctions, are not new.[80] However, *Microsoft v. Motorola* presented the Ninth Circuit with several novel issues. First, Microsoft did not merely succeed in preventing Motorola from filing a

74. Microsoft Corp. v. Motorola, Inc., 696 F.3d 872 (9th Cir. 2012).

75. *Id.* at 877–78.

76. *Id.* at 876. "Reasonable and nondiscriminatory" (RAND) pricing is sometimes referred to as "fair, reasonable, and nondiscriminatory" (FRAND) pricing. The terms are generally interchangeable. *See* Anne Layne-Farrar, A. Jorge Padilla & Richard Schmalensee, *Pricing Patents for Licensing in Standard-Setting Organizations: Making Sense of FRAND Commitments*, 74 ANTITRUST 671 (2007).

77. Microsoft v. Motorola, 696 F.3d at 878.

78. *Id.*

79. *Id.* at 889.

80. *Id.* at 881. *See* E. &. J. Gallo Winery v. Andina Licores S.A., 446 F.3d 984, 989 (9th Cir. 2006).

lawsuit overseas; it prevented Motorola from enforcing its remedies from a suit that it had already won.[81] Second, the U.S. injunction enforced Microsoft's third-party contract rights, which Microsoft does not have in Germany, in a country where third-party contract rights do not exist.[82]

The Ninth Circuit upheld the trial court's three bases justifying the injunction: (1) Motorola offered to license its foreign patents to Microsoft in America and its contracts to offer RAND licensing were on a worldwide basis, (2) the German litigation raised concerns about an inconsistent judgment and forum shopping, and (3) the impact of the injunction on comity would be tolerable.[83] To do so, the Ninth Circuit relied on the three-part test for a foreign antisuit injunction that was applied in *E. &. J. Gallo Winery v. Andina Licores S.A.*[84] The *Gallo* test states that a foreign antisuit injunction will only lie if the parties to the two actions are the same; the first action is dispositive of the second; at least one of the *Unterweser*[85] elements propounded by the Fifth Circuit applies; and the impact on comity is tolerable.[86]

The key to the court's ruling was the determination that Motorola's RAND licensing obligations were worldwide and Motorola's actions took place in America. The Ninth Circuit admitted that the trial court would have erred if it found that U.S. patent claims would dispose of a German patent suit, and that separate, independent foreign rights must be litigated overseas.[87] However, enjoining Motorola from enforcing its German rights forced the Ninth Circuit to delve into the underlying facts and depart from Microsoft's contract rights.[88] Conducting what it called a "ballpark, tentative assessment" of the German dispute, the trial court and the Ninth Circuit emphasized that Motorola offered its global patent rights in its letter to Microsoft and emphasized the concessions Motorola made to have its patents included in the international standards.[89]

81. Microsoft v. Motorola, 696 F.3d at 879–80.
82. *Id.* at 884–89.
83. *Id.* at 881.
84. *Id.* at 881 (citing *E. &. J. Gallo Winery*, 446 F.3d at 990–91).
85. *See* Unterweser Reederei GMBH, 428 F.2d 888, 896 (5th Cir.1970), *aff'd on reh'g*, 446 F.2d 907 (5th Cir. 1971) (en banc) (per curiam), *rev'd on other grounds sub nom*. M/S Bremen v. Zapata Off–Shore Co., 407 U.S. 1 (1972). The *Unterweser* elements are whether the foreign litigation would (1) frustrate a policy of the forum issuing the injunction, (2) be vexatious or oppressive, (3) threaten the issuing court's in rem or quasi in rem jurisdiction, or (4) where the proceedings prejudice other equitable considerations. *See Unterweser Reederei GMBH*, 428 F.2d at 896.
86. *Microsoft*, 696 F.3d at 881.
87. *Id.* at 883.
88. *Id.*
89. *Id.* at 884. Curiously, the Ninth Circuit stated that "Motorola does not dispute that its RAND commitments created a contract that Microsoft can enforce as a third-party beneficiary, even if it disagrees with Microsoft over how to interpret the terms of that contract."

To satisfy the second *Gallo* requirement, the court found Motorola's German infringement suit to be "vexatious," despite its success.[90] In doing so, the court relied on the dubious timing and posture of Motorola's infringement suit, and the interference with "equitable considerations" by forcing Microsoft to enter into a so-called holdup settlement before the completion of the U.S. suit.[91] Finally, the court found that the impact on comity to be "tolerable" partly through its interpretation of the dispute as a "private contractual dispute."[92] Motorola has already applied for a rehearing of the case en banc.

The implications of Microsoft and Motorola's dispute sweep beyond RAND licensing of patents. Technology worldwide is experiencing explosive innovation tempered by infringement suits as an increasingly important tool to stifle competition, despite an increasingly interconnected world economy. In this climate, companies and individuals must understand the potential global repercussions of their actions. In light of the apparent willingness of appellate courts to enter the arena, prudent lawyers would be well advised to evaluate and anticipate the potential for international litigation.

In another example of new technology driving changes to contract law, the First Circuit recently allowed consumers to pursue implied contract claims against a company that had suffered a computer security breach. In December 2007, sophisticated computer hackers gained access to the credit and debit card number system of Hannaford, a nationwide grocery chain, stealing as many as 4.2 million debit and credit card numbers over three months.[93] After the security breach, some banks declined to issue replacement cards at no charge to their customers,[94] some Hannaford customers purchased identity theft insurance,[95] and still others suffered fraudulent charges before their banks took corrective action.[96] Representatives of each group of customers brought collective actions against Hannaford, asserting, among other things, breach of implied contract.[97] A multidistrict litigation panel combined a variety of plaintiffs of all three types into the District of Maine.[98]

Id. at 884. Only five pages earlier, the Ninth Circuit acknowledged that Microsoft possessed no such rights in Germany.

90. *Id.* at 886.

91. *Id.*

92. *Id.* at 887 (citing Applied Med. Distrib. Corp. v. Surgical Co., 587 F.3d 909, 921 (9th Cir. 2009)).

93. Anderson v. Hannaford Bros., 659 F.3d 151 (1st Cir. 2011).

94. *Id.* at 155.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

Startlingly, despite the probable existence of written agreements governing the nature of the transactions and the relationship between the customers and Hannaford, the trial court found that the circumstances of the transactions implied that "an implicit agreement to safeguard the data is necessary."[99] Further muddying the waters, the trial court allowed plaintiffs' negligence claims to proceed.[100]

The court's willingness to construe what many would consider as a "duty" to be an "implied agreement" as well, especially in a climate of increased identity theft, must be troubling to multiple business sectors, especially those serving retail markets. In light of the opinion, groups of plaintiffs around the country have already attempted to exploit the benefits of a breach of contract action in response to identity theft, but with less success.

In *Holmes v. Countrywide Financial Corp.*, a group of consumers in Kentucky who also were the victims of identity theft, this time through their mortgage lender, brought a suit similar to the *Hannaford* litigation.[101] The *Holmes* plaintiffs emphasized the similarities between themselves and the *Hannaford* plaintiffs. The *Holmes* court was not convinced, but not because of a lack of implied contract.[102] Instead, the *Holmes* court distinguished plaintiffs' injuries, i.e., harm to credit and denied loan applications, from that of the *Hannaford* plaintiffs, finding that they had suffered "no direct financial burden."[103]

The Southern District of Texas more directly challenged *Hannaford*'s findings in *In re Heartland Payment Systems, Inc. Customer Data Security Breach Litigation*.[104] In *Heartland*, a variety of plaintiffs attempted to claim the same sort of benefits as the *Hannaford* plaintiffs, relying on *Hannaford* in their briefing.[105] The *Heartland* court distinguished *Hannaford* by emphasizing that the *Heartland* plaintiffs were not suing a party to their financial transactions but a bank that serviced the transactions.[106] *Heartland* ultimately found plaintiffs' claims to resemble more closely a New York case that denied a class action for lack of a direct contractual relationship.[107]

99. *Id.* at 159.
100. *Id.* at 155.
101. Holmes v. Countrywide Financial Corp., No. 5:08-CV-00205-R, 2012 WL 2873892 (W.D. Ky. July 12, 2012).
102. *Id.* at *9–10.
103. *Id.* at 10.
104. 834 F.Supp.2d 566 (S.D. Tex. 2011).
105. *Id.* at 581–82.
106. *Id.* at 582.
107. *Id.* (citing Hammond v. Bank of New York Mellon Corp., No. 08 Civ. 6060, 2010 WL 2643307 (S.D.N.Y. June 25, 2010)).

IV. REMEDIES

The last year has seen the continued expansion and contraction in various states of the economic loss rule, which was created by the California Supreme Court in *Seely v. White Motor Co.*[108] and adopted by the U.S. Supreme Court in *East River Steamship Corp. v. Transamerica Delaval, Inc.*[109]

The economic loss rule is a judicially created doctrine that seeks to

> (1) maintain the fundamental distinction between tort law and contract law; (2) protect commercial parties' freedom to allocate economic risk by contract; and (3) encourage the party best situated to assess the risk [of] economic loss, the commercial purchaser, to assume, allocate, or insure against that risk.[110]

The economic loss rule generally provides that a contracting party that suffers purely economic losses must seek a remedy in contract and not in tort.[111]

Economic loss includes both direct economic loss, which involves the loss of the product itself, and consequential economic loss, which is all other economic loss attributable to the product defect.[112] Although first developed in connection with product liability, the economic loss rule quickly expanded outside the parameters of product liability to bar other claims for economic loss where there is no underlying contract or privity between the claimant and the alleged tortfeasor.[113] However, the economic loss rule generally does not bar a tort claim that is based on a recognized independent duty of care that is outside the scope of the contract.[114]

---

108. 403 P.2d 145 (Cal. 1965).

109. 476 U.S. 858 (1986).

110. Van Lare v. Vogt, Inc., 683 N.W.2d 46, 51 (Wis. 2004).

111. Gen. Elec. Co. v. Lowe's Home Centers, 608 S.E.2d 636, 637 (Ga. 2005).

112. Daanen & Janssen, Inc. v. Cedarapids, Inc., 573 N.W.2d 842, 845 (Wis. 1998).

113. *See* BRW, Inc. v. Dufficy & Sons, Inc., 99 P.3d 66 (Colo. 2004) (steel subcontractor's claims for negligence and negligent misrepresentation against a design engineering firm and professional inspector for public-works project were barred by the economic loss rule despite lack of privity between the steel subcontractor, the design engineering firm, and the inspector). The economic loss rule encourages parties to a commercial contract to negotiate risk distribution and other legal protections into their contracts if they are concerned about economic damages flowing from the commercial transaction. *See* Berschauer/Phillips Const. Co. v. Seattle School Dist. No. 1, 881 P.2d 986, 992 (Wash. 1994). Three policies support the application of the economic loss rule to commercial transactions: (1) preserving the fundamental distinction between tort law and contract law; (2) protecting the parties' freedom to allocate economic risk by contract; and (3) encouraging the purchaser, which is the party best situated to assess the risk of economic loss, to assume, allocate, or insure against that risk. *See* Wausau Tile, Inc. v. County Concrete Corp., 593 N.W.2d 445, 451–52 (Wis. 1999).

114. Grynberg v. Agri Tech, Inc., 985 P.2d 59, 62 (Colo. Ct. App. 1999).

During the past year, the supreme courts of three states, Vermont, Washington, and Texas, addressed the application of the economic loss rule, providing a useful example of differences among the states.

A. *Vermont*

In *Long Trail House Condominium Association v. Engelberth Construction, Inc.*,[115] the Vermont Supreme Court applied the economic loss rule to affirm the trial court's summary judgment in favor of defendant Engleberth Construction. The Vermont decision cut off negligence claims for defective construction by a condominium association in a case with no privity between the plaintiff and the defendant.

Engleberth entered into a preconstruction agreement in 1997 and a construction agreement a year later with the developer, Stratton Corp., to build the condominium complex. Both agreements specifically excluded design, engineering, and professional services, a fact that the court found significant.[116] After its incorporation in 1999, the association immediately made claims against Stratton for construction defects that ultimately resulted in a settlement agreement for approximately $7 million. The repairs ultimately cost more than $8.5 million, at which point the association brought suit against Engleberth, alleging that the contractor was negligent in constructing the condominium project and breached express and implied warranties by failing to construct and repair the project in a good workmanlike manner free of defects.[117]

In granting the summary judgment in favor of Engleberth, the trial court concluded that the association's negligence claim was barred by the economic loss rule and that the absence of contractual privity was fatal to the warranty claims.[118] In affirming the trial court's summary judgment, the Vermont Supreme Court focused on the nature of the damages claimed by the association and characterized its damages as economic losses only, noting that "the remedy for purely economic losses resulting from 'the reduced value or costs of repairs of . . . construction defects sound[s] in contract rather than tort.'"[119] The court emphasized that once the damages are determined to be economic losses only, the economic loss rule applies, even if there is no privity between the parties.[120]

115. No. 2011–345, 2012 WL 4465561 (Vt. Sept. 28, 2012).
116. *Id.* ¶¶ 2–3.
117. *Id.* ¶ 6.
118. *Id.* ¶ 7.
119. *Id.* ¶ 11 (citing Heath v. Palmer, 915 A.2d 1290, 1296–97 (Vt. 2006)).
120. *Id.* ¶ 13 ("Privity, or lack thereof, is not the determining factor, nor are we persuaded that the [economic loss] rule's application turns on whether the parties had the opportunity to allocate risks, as the Association suggests. Instead, the focus is more appropriately on duty in cases such as this one.").

The court acknowledged that one exception to the economic loss rule involved a limited class of cases involving violation of a professional duty.[121] However, the court concluded, similar to its previous ruling in *EBWS, LLC v. Britly Corp.*,[122] that because the Engleberth contracts expressly excluded design, engineering, and professional services and the performance of construction services is not a professional service, this exception to the economic loss rule does not apply.[123] The court additionally rejected the association's assertion that the "threat of imminent harm" constituted an exception to the economic loss rule because actual injury, not simply risk of harm, is required before one can recover in negligence.[124]

B. *Washington*

The case of *Eastwood v. Horse Harbor Foundation, Inc.*[125] was reviewed in last year's survey as a major change in Washington case law regarding the economic loss rule.[126] While the Washington Supreme Court previously ruled in *Alejandre v. Bull*[127] that negligent misrepresentation claims under Restatement (Second) of Torts § 552 are not an exception to and are, in fact, excluded by the economic loss rule where the claims are between contracting parties and the parties "could or should have allocated the risk of loss, or had the opportunity to do so," the *Eastwood* court found to the contrary. It expressly held that the existence of a contract in which the parties "could or should have allocated the risk of loss, or had the opportunity to do so" will no longer lead to the application of the economic loss rule to preclude tort remedies.[128] In the process of rendering its decision, however, the *Eastwood* court rejected and changed the name of the "economic loss rule" to a new "independent duty doctrine."[129] It was opined at the time that the *Eastwood* decision obliterated the economic loss rule in Washington, which could result in contract law in Washington "[drowning] in a sea of tort."[130]

The recent case of *Elcon Construction, Inc. v. Eastern Washington University*[131] appears to confirm the worst fears arising from the *Eastwood* case.

121. *Id.* ¶ 13 (citing EBWS, LLC v. Britly Corp., 928 A.2d 497 (Vt. 2007)).
122. 928 A.2d 497 (Vt. 2007).
123. *Engleberth*, 2012 WL 4465561, ¶ 21.
124. *Id.* ¶ 25–26.
125. Eastwood v. Horse Harbor Found., Inc., 241 P.3d 1256 (Wash. 2010).
126. Christine Spinella Davis, et al., *Recent Developments in Business Litigation*, 47:1 Tort Trial & Ins. Prac. L.J. 95 (2012).
127. 153 P.3d 864 (Wash. 2007).
128. *Eastwood*, 241 P.3d 1256 at 1260–61.
129. *Id.* at 1266.
130. Christopher Scott D'Angelo, *The Economic Loss Doctrine: Saving Contract Warranty Law from Drowning in a Sea of Tort*, 26 U. Tol. L. Rev. 591, 599 (1995).
131. 273 P.3d 965 (Wash. 2012).

Elcon Construction entered into a written contract with Eastern Washington State University (EWSU) to drill two replacement water wells. Elcon and its subcontractor, Intermountain Drilling, did not conduct an independent investigation of the site, as arguably required by language in EWSU's request for proposal and the contract.[132] Elcon stopped drilling when an unforeseen layer of sand disrupted the work and sought additional compensation from EWSU. The university terminated the contract, and Elcon subsequently sued EWSU for contract and tort claims. The trial court submitted all contract claims to arbitration and stayed Elcon's tort claims pending completion of arbitration.[133] The arbitrator awarded Elcon $891,000 in addition to the $946,000 Eastern had previously paid for work performed. The court subsequently dismissed Elcon's tort claims for fraud and intentional interference claims by holding the intentional interference claim was factually insufficient and the fraud claims were barred by the economic loss rule.[134]

Although the supreme court ultimately reached the same result as the appellate court and affirmed the dismissal of Elcon's tort claims, it expressly held that the lower court misapplied the independent duty doctrine to bar the fraudulent inducement claim. The court stated: "We find no compelling reason, whether based on common sense, justice, policy, or precedent, to bar Elcon's fraud or tortious interference claim under the independent duty doctrine."[135] The concurring opinion in *Elcon* provides insight into the court's decision in the aftermath of *Eastwood* and explains the differences and competing priorities between the new independent duty doctrine and the now defunct economic loss rule:

> The economic loss rule is unlike the "independent duty rule" that has been described in recent opinions. *E.g.*, *Affiliated FM Ins. Co. v. LTK Consulting Servs., Inc.*, 170 Wash.2d 442, 243 P.3d 521 (2010) (plurality); *Eastwood v. Horse Harbor Found.*, Inc., 170 Wash.2d 380, 241 P.3d 1256 (2010) (plurality). The economic loss rule defaults to *contract* remedies where both are available. The "independent duty rule" defaults to tort remedies.[136]

The Washington Supreme Court barred Elcon's tort claims due to legal insufficiency to prove certain key elements. Absent these deficiencies, however, the court would have allowed Elcon to pursue and collect both contract damages and tort damages arising from the same commercial transaction. As predicted after *Eastwood*, the exceptions to the eco-

132. *Id.* at 967–68.
133. *Id.* at 968.
134. *Id.* at 969.
135. *Id.* at 970.
136. *Id.* at 973.

nomic loss rule in Washington have now subsumed the rule, and there is no economic loss rule in the State of Washington.

C. *Texas*

Texas courts have applied the economic loss rule to preclude tort claims between parties that are not in contractual privity.[137] For example, the purchaser of an airplane was barred by the economic loss rule from seeking claims against contractors that performed repairs on the plane prior to the purchase.[138] In another example, an oil and gas company engaged a geological contractor to help with choosing a drilling site and was subsequently barred from pursuing claims against a software developer that provided defective computer software to the geological contractor that resulted in the drilling of a dry well.[139]

Despite these cases, the Texas Supreme Court allowed a water supply corporation in *Sharyland Water Supply Corp. v. City of Alton*[140] to pursue tort claims against construction contractors based on allegedly improper construction of residential sewer lines under a contract with the City of Alton.[141] In reaching its ruling, the court described in great detail the history of the economic loss rule in Texas.[142] Of note, the court agreed with the scholarly proposition that because the economic loss rule applies to a diverse range of situations, there is not one economic loss rule, but several.[143] The court concluded its history lesson with the statement that "[a]lthough we applied this rule even to parties not in privity (e.g., a remote manufacturer and a consumer), we have never held that it precludes recovery completely between contractual strangers in a case not involving a defective product—as the court of appeals did here."[144] The court stated that the appellate court "overstate[d] and oversimplifie[d] the economic loss rule" by concluding that because there was no evidence that the sewer lines had contaminated the water supply, the water supply corporation, Sharyland, had not suffered property damage, and the economic loss rule precluded a damage award.[145]

137. *See* Sterling Chemicals, Inc. v. Texaco Inc., 259 S.W.3d 793, 797 (Tex. App. 2007).
138. Trans-Gulf Corp. v. Performance Aircraft Servs., Inc., 82 S.W.3d 691, 695 (Tex. App 2002) (A duty in tort does not lie when the only injury claimed is one for economic damages recoverable under a breach of contract claim).
139. Hou-Tex, Inc. v. Landmark Graphics, 26 S.W.3d 103, 106-07 (Tex. App. 2000).
140. 354 S.W.3d 407 (Tex. 2011).
141. *Id.* at 420.
142. *Id.* at 415–18.
143. *See* Jay M. Feinman, *The Economic Loss Rule and Private Ordering*, 48 ARIZ. L. REV. 813 (2006).
144. *Sharyland*, 354 S.W.3d at 418.
145. *Id.*

The court backed away from a bright line rule applying the economic loss rule to third-party tort claimants where damage is caused by the delivery of goods or the performance of services under a written contract:

> Moreover, the question is not whether the economic loss rule should apply where there is no privity of contract (we have already held that it can), but whether it should apply at all in a situation like this. Merely because the sewer was the subject of a contract does not mean that a contractual stranger is necessarily barred from suing a contracting party for breach of an independent duty. If that were the case, a party could avoid tort liability to the world simply by entering into a contract with one party. The economic loss rule does not swallow all claims between contractual and commercial strangers.[146]

Citing evidence that several sewer crossings had been illegally installed and at least one leaking sewer pipe was in close proximity to a water line, the court seemed to indicate that damage to property other than the sewer lines had likely occurred.[147] The court, therefore, held that the economic loss rule did not apply to Sharyland's tort claims against the sewer line contractors.[148] The court concluded by stating:

> While it is impossible to analyze all the situations in which an economic loss rule may apply, it does not govern here. The rule cannot apply to parties without even remote contractual privity, merely because one of those parties had a construction contract with a third party, and when the contracting party causes a loss unrelated to its contract.[149]

The *Sharyland* decision arguably represents a contraction of the bright line application of the economic loss doctrine in the State of Texas. Given the case-by-case approach espoused by the court in *Sharyland*, the determination in future cases of whether separate tort claims exist independent of the economic loss rule will likely not occur until the particular case is tried and all appeals are exhausted.

The above cases clearly demonstrate the conflict that arises when the economic loss rule is used to define the boundary between tort law and contract law. This conflict has led some judges and commentators to liken the economic loss rule to "the ever-expanding, all-consuming alien life form portrayed in the 1958 B-movie classic *The Blob*" and "a swelling globule on the legal landscape of [the] state."[150] At other times, the economic loss rule is simply described as "one of the most confusing doctrines

146. *Id.* at 419.
147. *Id.* at 420.
148. *Id.*
149. *Id.*
150. *See* Grams v. Milk Prods., Inc., 699 N.W.2d 167, 180 (Wis. 2005); 1325 North Van Buren, LLC v. T-3 Group, Ltd., 716 N.W.2d 822, 841 (Wis. 2006) (Bradley, J., dissenting).

in tort law."[151] As described above, the confusion surrounding the economic loss rule caused the Washington Supreme Court to kill the "globule" and reject the economic loss rule altogether.[152] In any event, this conflict will undoubtedly continue to be played out in cases across the country in the years to come.

V. BREACH OF FIDUCIARY DUTY

The past year was rather active in the area of litigation involving breach of a fiduciary duty. In *In re Lampe*, the Third Circuit found that a director of a corporation who filed a lawsuit against the corporation breached a fiduciary duty by failing to retain counsel to defend the corporation in that same lawsuit.[153] The director, Harold Lampe, filed a lawsuit in state court in Pennsylvania for debt that WEL Management, Inc. owed to him.[154] When WEL failed to answer the lawsuit, Lampe obtained a default judgment against it and then executed on the judgment by seizing corporate property.[155] Subsequently, Jestyn Payne, a custodian for a minor stockholder of the corporation, sued Lampe for breach of fiduciary duty.[156] Lampe filed for bankruptcy, beginning an adversary proceeding between Payne and Lampe.[157]

The bankruptcy court noted that Lampe owed the corporation the fiduciary duties of care and loyalty.[158] However, the court found that the test for liability for breach of fiduciary duty is whether a director was unjustly enriched by his actions.[159] Finding no proof of unjust enrichment, the court dismissed the proceeding.[160] The case was appealed to the Third Circuit.

The Third Circuit reversed, finding that Lampe had breached his duty of care and holding that the party charging the fiduciary with breach of duty need not always show that the fiduciary has been unjustly enriched by his conduct.[161] Applying Pennsylvania law, the court found that a

151. *See* R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789 (2000); Paul J. Schwiep, *The Economic Loss Rule Outbreak: The Monster That Ate Commercial Torts*, FLA. BUS. J., Nov. 1995 at 34 ("[I]t is clear that judges, lawyers, and commercial clients alike are all desperately struggling to define the parameters of the economic loss doctrine.").

152. Eastwood v. Horse Harbor Found., Inc., 241 P.3d 1256, 1266 (Wash. 2010).

153. 665 F.3d 506 (3d Cir. 2011).

154. *Id.* at 510–11.

155. *Id.* at 511.

156. *Id.* at 511–12.

157. *Id.* at 512.

158. *Id.* at 513.

159. *Id.*

160. *Id.*

161. *Id.* at 516.

director can breach his duty of care by mismanaging a corporation to its detriment even though he does not obtain any benefit from his actions.[162] Noting that it might seem odd that a director should have taken steps to defend a lawsuit he initiated, the court held that Lampe was required to do exactly that.[163] The court further held that Lampe breached his duty of loyalty to the corporation, finding that his failure to engage counsel for the corporation allowed him to gain personally at the expense of other shareholders.[164] The Third Circuit remanded the case to the bankruptcy court for further proceedings.

In another interesting case, the Sixth Circuit wrestled with a breach of fiduciary duty claim made by a borrower corporation against a holder of a promissory note in the case of *Petroleum Enhancer, LLC v. Woodward*.[165] The dispute arose because Richard Socia, a director of the borrower corporation, Polar Molecular Corporation (PMC), became embroiled into a dispute with the rest of the board and developed a plan to foreclose on the note through Petroleum Enhancer, LLC, which he had newly established.[166] Petroleum Enhancer acquired the promissory note, which by this time was in default.[167] The court applied Michigan law, holding that a fiduciary relationship arises from the reposing of faith, confidence, and trust and the reliance of one on the judgment and advice of another.[168] Further, when such a relationship exists, the fiduciary, i.e., the one who is entrusted to advise the other, "has a duty to act for the benefit of the principal regarding matters within the scope of the relationship."[169] Finally, fiduciaries must "subordinate [their] personal interests to that of the other person."[170]

After the dispute arose between Socia and the rest of the board, he was asked to resign. The court noted that Socia clearly had a fiduciary duty to PMC when he was elected to the board.[171] The question in this case was whether his fiduciary duty ended when he was asked to resign or four months later when he actually did resign.[172] Socia argued that when he was asked to resign he was effectively terminated because he was excluded from participating in all business decisions of the corporation as of that

162. *Id.*
163. *Id.* at 517.
164. *Id.* at 519–20.
165. 690 F.3d 757 (6th Cir. 2012).
166. *Id.* at 761–63.
167. *Id.*
168. *Id.* at 765.
169. *Id.* at 766.
170. *Id.*
171. *Id.*
172. *Id.*

day.[173] Thus, he owed no fiduciary duty to PMC after that day.[174] The district court agreed, finding that a fiduciary relationship ceased to exist.[175] PMC appealed that decision to the Sixth Circuit.

On appeal, PMC argued that a director's fiduciary duty continues until he either resigns or is removed by the shareholders.[176] PMC contended that the other directors could not remove a fellow director.[177] In addition, PMC asserted that Socia continued to act as a director and refused to submit his resignation until four months after he was asked to do so.[178]

In reversing the lower court, the Sixth Circuit agreed with PMC, finding that a director's fiduciary duty to a corporation continues until he either resigns or is removed from office by term or by vote.[179] The court found that this does not place an undue burden on a director, and that if a director is concerned about such a burden, the message to him is to resign.[180] Until he does so, he will continue to owe a fiduciary duty to the corporation.

The Second Circuit addressed the issue of fiduciary duty within the context of insider trading. In *Securities and Exchange Commission v. Obus*, the court dealt with an action filed by the Securities and Exchange Commission (SEC) against several individuals for the unlawful insider trading in securities based on material nonpublic information.[181] The classic theory of insider trading deals with the prohibition of a corporate insider (often referred to as a "tipper") who trades shares of a corporation based on nonpublic information in violation of the duty of trust and confidence owed to shareholders.[182] Another theory, grounded in misappropriation, targets a person, known as a "tippee," who is not a corporate insider but receives material nonpublic information in confidence and breaches a fiduciary duty to the source of the information to gain personal profit in the securities market.[183] Such conduct violates § 10(b) of the Securities and Exchange Act of 1934 because the misappropriator engages in deception by pretending loyalty to the principal while secretly converting the principal's information for personal gain.[184] One who has a fiduciary duty of trust and confidence to shareholders (classical theory) or to a

173. *Id.*
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.* at 769.
180. *Id.*
181. 693 F.3d 276 (2d Cir. 2012).
182. *Id.* at 284.
183. *Id.*
184. *Id.* at 284–85.

source of confidential information (misappropriation theory) and is in receipt of material nonpublic information has a duty to abstain from trading or to disclose the information publicly.[185] In *Obus*, the Second Circuit concluded that the SEC had demonstrated the existence of genuine questions of fact under a misappropriation theory.[186]

VI. FRAUD AND MISREPRESENTATION

Federal and state courts made several substantive and procedural decisions concerning fraud and misrepresentation, taking differing views on both procedural and substantive issues. In addition, an increasing number of courts throughout the country are overturning their own older established decisions. The following are but a few examples of these types of decisions found in the past year.

In *Peterson v. Allstate Indemnity Co*, the U.S. District Court for the Central District of California addressed whether a plaintiff's allegation of negligent misrepresentation must be pled with particularity as demanded by Federal Rule of Civil Procedure 9(b).[187] Overturning precedent, the court stated that negligent misrepresentation does not have the heightened pleading standard of Rule 9(b).[188]

Steven Peterson purchased an insurance policy from Allstate Indemnity Co. with medical coverage of $100,000.[189] After he was injured in an automobile accident in June 2008, he filed a claim, and Allstate paid $11,092 for medical treatment related to the accident. Sometime later, Peterson submitted additional claims for medical bills totaling $114,511, which Allstate denied on the basis that the treatment in question was not related to his 2008 injuries.[190]

In September 2011, Peterson filed a complaint against Allstate alleging nine different causes of action. After removing the case to federal court, Allstate brought a motion in February 2012 to dismiss three causes of action, specifically those dealing with fraud, negligent misrepresentation, and violations of the California Business & Professions Code § 17200.[191] Allstate made two arguments in support of its motion to dismiss: (1) the complaint's negligent misrepresentation claim failed to meet the height-

185. *Id.* at 285.
186. *Id.* at 289.
187. Peterson v. Allstate Indem. Co., 281 F.R.D. 413 (C.D. Cal. 2012).
188. *Id.* at 416.
189. *Id.* at 414.
190. *Id. at* 414–15.
191. *See id.* at 415. The motion to dismiss the cause of action under California Business & Professions Code § 17200, was unopposed, and that portion of Allstate's motion was granted. *Id.* at 422.

ened pleading standard of Rule 9(b), and (2) the fraud claim failed to allege facts showing defendant's intent not to perform.[192]

In support of its motion, Allstate relied upon two cases, *Glen Holly Entertainment, Inc. v. Tektronix, Inc.*[193] and *U.S. Concord, Inc. v. Harris Graphics Corp.*,[194] both of which held that claims of negligent misrepresentation must meet the heightened pleading of Rule 9(b).[195] After reviewing both cases, the court rejected the premise that negligent misrepresentation must comply with Rule 9(b).[196] *U.S. Concord* cited no authority for its one-line conclusion that negligent misrepresentation had to meet the heightened pleading standard, and *Glen Holly* cited a treatise that did not even mention negligent misrepresentation.[197]

The court also opined that express language of Rule 9(b) and recent case law did not support the premise that negligent misrepresentation had to meet heightened pleading standards.[198] The court noted that the rule's express language does not include negligent misrepresentation as one of the claims that must be pled with particularity.[199] The court next looked to recent case law, not only in its own jurisdiction but also across the country, construing Rule 9(b). Both the Fifth and Seventh Circuits, which the court described as "hardly champions of the plaintiffs bar," have held "that 'negligent misrepresentation' claims brought under Texas and Illinois law are not subject to Rule 9(b) because the express language of Rule 9(b) reserves that standard only for fraud or mistake."[200] Finally, the court looked to *Vess v. Ciba-Geigy Corp. U.S.A.*, in which the Ninth Circuit reversed the dismissal of a claim of negligent misrepresentation for failure to satisfy Rule 9(b) stating that "it was error to apply a heightened pleading standard to allegations that the defendant 'negligently' failed to disclose' information." Indeed, "[t]he

192. *Id.*

193. 100 F. Supp. 2d 1086, 1097–98 (C.D. Cal. 1999) (dismissing claim for "negligent misrepresentation" for failure to comply with Rule 9(b)).

194. 757 F. Supp. 1053, 1058 (N.D. Cal. 1991)).

195. *Id.* at 417.

196. *Id.* at 416–17.

197. *Id.* at 417. *See also U.S. Concord*, 757 F. Supp. at 1058 (merely observing that defendant's argument that the "negligent misrepresentation claim fails to satisfy Rule 9(b)'s particularity requirements" was "well taken"); *Glen Holly Entertainment*, 100 F.Supp.2d at 1093 ("[C]laims for fraud and *negligent misrepresentation* must meet the heightened pleading requirements of Rule 9(b)") (emphasis added); 5 Charles A. Wright & Arthur R. Miller, Federal Practice and Procedure § 1297, at 582 (1990) ("A pleading that simply avers the technical elements of *fraud* does not have sufficient informational content to satisfy Rule 9(b)'s requirements.") (emphasis added).

198. *Peterson*, 281 F.R.D. at 417.

199. *Id.* at 417.

200. *Id.* at 418 (citing GE Capital Corp. v. Posey, 415 F.3d 391, 394 n.2 (5th Cir. 2005); Tricontinental Indus. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 833 (7th Cir. 2007)).

Ninth Circuit concluded that such allegations of negligence 'are not based on fraud.' "[201]

The *Peterson* court further stated that even though the claim of negligent misrepresentation does not need to meet the heightened pleading standard, the allegations in plaintiffs' complaint did. Finally, the court addressed Allstate's last argument, holding that the claim did allege facts showing defendant's intent not to perform. Therefore, the court denied Allstate's motion to dismiss the claim of negligent mispresentation.[202]

In contrast, the Sixth Circuit in *Republic Bank & Trust Co. v. Bear Stearns & Co., Inc.*, held, in pertinent part, that a plaintiff's allegations of negligent misrepresentation must adhere to the heightened standard of pleading with particularity as required by Rule 9(b).[203] The Republic Bank & Trust Co. brought an action against Bear Stearns, Frederick Barney Jr., Bear Stearns Cos., and JP Morgan Chase & Co. (collectively referred to as Bear Stearns), alleging that Bear Stearns and one of its employees fraudulently induced the bank to buy and retain more than $51 million of residential mortgage backed-securities.[204] The value of Republic Bank's investments plummeted after the 2007 economic downturn.[205] The bank filed a complaint against Bear Stearns, alleging common law fraud, negligent misrepresentation, and violations of Kentucky's securities statutes, also known as the Blue Sky Law. The lower court dismissed the complaint with prejudice, and Republic Bank appealed.[206]

The Sixth Circuit relied on the firmly established rule that all claims based on fraud pose a "high risk of abusive litigation," and, therefore, the allegations in each complaint "must state with particularity the circumstances constituting fraud or mistake."[207] The court opined that the heightened pleading standard for fraud clearly applied to Republic Bank's fraud and deceit allegations and Blue Sky Law claims, but it was unclear whether Rule 9(b) applied to common law claims for negligent misrepresentation. Looking to other jurisdictions, the court found that other circuits were just as divided.[208]

---

201. *Id.* (quoting Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1106 (9th Cir. 2003)).
202. *Id.* at 418–22.
203. Republic Bank & Trust Co. v. Bear Stearns & Co., 683 F.3d 239 (6th Cir. 2102).
204. *Id.*
205. *Id.*
206. *Id.* at 244.
207. *Id.* at 247 (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 569 n.14 and Fed. R. Civ. P. 9(b)).
208. *Id. Compare* CNH Am. LLC v. Int'l Union, United Auto., Aerospace & Agric. Implement Workers of Am., 645 F.3d 785, 794 (6th Cir. 2011) (explaining that "[s]o long as the[] [plaintiff's] allegations are 'plausible,'" a negligent-misrepresentation claim governed by Wisconsin law could survive under "the modest notice-pleading requirements of Civil Rule 8(a)."), *and* Tricontinental Indus. v. PricewaterhouseCoopers, LLP, 475 F.3d 824, 833 (7th Cir. 2007) (holding that negligent misrepresentation claim was "*not* governed by

For guidance, the Sixth Circuit next turned to Kentucky state court decisions regarding pleading requirements for negligent misrepresentation, citing *Thomas v. Schneider* for the proposition that "[l]ike fraud, allegations of negligent misrepresentation must be pled with particularity."[209] The court further opined that at least one of the elements under Kentucky law must be facts pled indicating that the defendant "supplied false information for the guidance of others in a business transaction."[210] Holding that this element triggers the heightened pleading standard of Rule 9(b), the court found that all of the allegations in Republic Bank's complaint, including its allegation of negligent misrepresentation, should have been pled with particularity. Because the bank failed to do so, the court dismissed the complaint in its entirety.[211]

In *Titan Insurance Co. v. Hyten*, the Michigan Supreme Court addressed whether an insurance carrier may assert legal and equitable defenses of fraud and misrepresentation in the insurance application process to avoid liability under the policy, when the fraud was easily ascertainable and an injured third party was making a claim.[212]

This case concerned an automobile insurance policy issued by Titan Insurance Co. to McKinley Hyten, who signed an application on August 22, 2007, indicating that she had a valid driver's license although it had been suspended at the time. The policy took effect on August 24 but her license was not restored until September 20.[213] The following February, Hyten was in a car accident with Howard and Martha Holmes, who claimed injuries. While investigating the accident, Titan discovered that Hyten did not have a valid driver's license on the date the insurance policy was issued. Anticipating a lawsuit filed by the injured third parties, Titan filed a declaratory action seeking to have the automobile insurance contract reformed to reduce liability coverage limits to the statutory minimum because of the misrepresentation on Hyten's application.[214]

---

the heightened pleading standard of Rule 9(b)"), *with* Trooien v. Mansour, 608 F.3d 1020, 1028 (8th Cir. 2010) ("Under Minnesota law, any allegation of misrepresentation, whether labeled as a claim of fraudulent misrepresentation or negligent misrepresentation, is considered an allegation of fraud which must be pled with particularity."), *and* Lone Star Fund V (U.S.), L.P. v. Barclays Bank PLC, 594 F.3d 383, 387 (5th Cir. 2010) ("[A]s the claims sound in fraud and negligent misrepresentation, Appellants must plead the misrepresentations with particularity under Fed. Rule Civ. Proc. 9(b).").

209. *Republic Bank*, 683 F.3d 239, at 247–48 (quoting Thomas v. Schneider, No. 2009-CA-002132-MR, 2010 WL 3447662, at *1 n.2 (Ky. Ct. App. Sept. 3, 2010)).

210. *Republic Bank* at 248 (quoting Presnell Constr. Managers, Inc. v. EH Constr., LLC, 134 S.W.3d 575, 580 (Ky. 2004)).

211. *Id.*

212. 491 Mich. 547 (2012).

213. *Id.* at 551–52.

214. *Id.* at 552–53.

Both parties moved for summary disposition. The trial court granted summary disposition in favor of Hyten, finding that the insurance carrier could have easily ascertained whether her license was valid. The Michigan Court of Appeals affirmed, relying on *State Farm Mutual Automobile Insurance Co. v. Kurylowicz*.[215] However, following a growing trend of courts overturning long-standing precedent, the Michigan Supreme Court in June 2012 issued an opinion in *Hyten* that overruled the "easily ascertainable rule" formed by *Kurylowicz* and its progeny.[216] The rule established in *Kurylowicz* prohibited insurers from asserting the defense of fraud, once an insurable event occurred and there was an innocent, injured third party, when the fraud perpetrated by the insured was easily ascertainable by investigation.

Returning to basic contractual principles, the *Titan* court noted that an insurance policy is a contract and, therefore, unless prohibited by statute, common law defenses such as fraud may be invoked to avoid enforcement of an insurance policy.[217] The court next stated that a party asserting actionable fraud, innocent misrepresentation, or silent fraud is not required to prove that it investigated all assertions and representations made by the contracting partner as a prerequisite to establishing fraud. Therefore, unless the common law, legal, and equitable remedies are narrowed by statute, an insurer is not required to conduct an investigation.[218]

The *Titan* court next reviewed prior holdings of the Michigan Court of Appeals, which had held that the Michigan Financial Responsibility Act limits the ability of insurers to avoid liability on the grounds of fraud in the inception of a policy for all liability policies.[219] The prior holdings made a blanket ruling based on the language found in Michigan Compiled Laws § 257.520(f)(1), stating in relevant part:

> [t]he liability of the insurance carrier with respect to the insurance required by this chapter shall become absolute whenever injury or damage covered by said motor vehicle liability policy occurs; . . . [and] **no** fraud, misrepresentation, assumption of liability, or other act of the insured in obtaining or retaining such policy . . . shall constitute a defense as against such judgment creditor.[220]

215. *Id.* (quoting State Farm Mut. Auto. Ins. Co. v. Kurylowicz, 67 Mich. App. 568 (1976).

216. *Id.* at 550.

217. *Id.* at 554 (quoting Rory v. Continental Ins. Co., 473 Mich. 457, 461 (2005)).

218. *Id.*

219. *Id.* at 558 (construing State Farm Mut. Auto. Ins. Co. v. Sivey, 404 Mich. 51, 57 (Mich. 1978); Farmers Ins. Exch. v. Anderson, 206 Mich. App. 241 (Mich. Ct. App. 1994); and League Gen. Ins. Co. v. Budget Rent-A-Car of Detroit, 172 Mich. App. 802 (Mich. Ct. App. 1988)).

220. *Id* at 559.

The prior holdings applied only a small portion of one part of the Financial Responsibility Act to all liability policies. Opining that the earlier decisions did not closely analyze the statute, the *Titan* court took a closer look and found that § 257.520(f)(1) addressing "motor vehicle liability polic[ies]" applies only to owner or operator policies that are certified as proof of financial responsibility under §§ 257.518 or 257.519 and not to all liability policies. This holding overruled any cases that held to the contrary, specifically *State Farm Mutual Automobile Insurance Co. v. Sivey*, *Farmers Insurance Exchange v. Anderson* and *League General Insurance Co. v. Budget Rent-a-Car of Detroit*.[221]

Finally, the court held that the *Kurylowicz* court was wrong to ignore the law previously established in *Keys v. Pace*.[222] In *Keys*, the Michigan Supreme Court allowed an insurer to use fraud as a defense to avoid liability under an insurance policy even when the fraud may have been easily ascertainable and an innocent third party was involved.[223] Michigan case law has consistently defined the elements of fraud as not including an affirmative duty to investigate every representation made to the party asserting fraud. The court reaffirmed *Keys* as good law, even though the case had been decided before the No Fault Act was enacted. It was unclear from the record whether the trial court had found that all of the elements of actionable fraud were satisfied; therefore, the supreme court remanded this case to the trial court for further proceedings.[224]

221. *Id.* at 559–60 (citing *Sivey*, 404 Mich. at 57; *Anderson*, 206 Mich. App. at 241; and *League*, 172 Mich. App. at 802.

222. 358 Mich. 74 (1959).

223. *Titan*, 491 Mich. at 562 (2012).

224. *Id.* at 572.