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Part 21 of "The Restricting Covenant" Series: The Economic Loss Doctrine and Non-Competes

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In this article I discuss a lesser known judicially created doctrine that is equal parts *confusing in application* and *sweeping in scope* for litigants involved in restrictive covenant disputes – the Economic Loss Doctrine (ELD).

Origins of the ELD

The ELD is a judicially created rule of state law that originated in product liability and breach of warranty cases (*see, e.g.*, *Seely v. White Motor Co.* (Cal. 1965) and *East River S.S. Corp. v. Transamerica Delaval, Inc.* (U.S. Sup. Ct. 1986)), but subsequently has been applied in a variety of other cases involving allegations of fraud, negligence, malpractice, and tortious interference with business relationships. As one judge so endearingly described it: "Like the ever-expanding, all-consuming alien life form portrayed in the 1958 B-movie classic *The Blob*, the economic loss doctrine seems to be a swelling globule on the legal landscape of this state." *Grams v. Milk Products, Inc.* (Wis. 2005) (Abrahamson, J. dissenting).

A New Jersey appellate court explained the ELD's purpose as follows:

"The economic loss rule 'defines the boundary between the overlapping theories of tort law and contract law by barring the recovery of purely economic loss in tort, particularly in strict liability and negligence cases.'" "The purpose of the rule is to 'strike an equitable balance between countervailing public policies,' that exist in tort and contracts law.'" Generally, the economic loss doctrine prohibits plaintiffs from recovering in tort economic losses to which they are entitled only by contract. *Dean v. Barrett Homes, Inc.* (N.J. App. Div. 2009) (quotations and citations omitted).

Essentially, courts apply the ELD to preclude an aggrieved party from recovering unlimited "tort" damages that are inappropriate because the damages suffered actually are rooted in a breach of contract.

ELD in Non-Compete Cases

Although the ELD has its judicial roots in products liability law, the doctrine has found its way into business tort cases, including non-compete disputes in some states. Specifically, in addition to

breach of employment contract claims, employers in restrictive covenants cases often bring "tortious interference" with economic business relationships claims against former employees and their employers, usually in connection with solicitation of customers. *See* Part 11: Restatements of the Law and Restrictive Covenants.

The ELD has been invoked as a defense to tortious interference claims. In *ACS Partners, LLC v. Americon Group, Inc.* (W.D.N.C. 2010), for example, the employer (ACS) sued its former employee (Caputo) and his new employer (Americon) for breaching Caputo's non-compete and confidentiality agreement and tortiously interfering with its customer relationships. Caputo had agreed that he would not solicit, divert, or take away any current or prospective clients of ACS for two years. Caputo filed a motion to dismiss ACS's tortious interference claim, and argued that it was legally barred by the ELD under North Carolina law. The trial court agreed, finding that ACS's tort claim was not "distinct" from its primary breach of contract claim, explaining "[a]t most, Plaintiff may be able to prove that Caputo did not carry out his contractual obligations," and that "[t]he mere failure to carry out an obligation in contract, however, does not support an action for tortious interference with contract and prospective advantage."

Similarly, in *Trico Equipment v. Manor* (D.N.J. 2011), a federal trial court held that because the underlying conduct alleged to support the employer's breach of contract claim was identical to the conduct that supported the employer's tort-based claims, the ELD barred all claims except breach of contract. From a practical standpoint, however, it does not appear that the dismissal of these claims impacted the employer's ability to recover compensatory and other damages, including lost profits and attorneys' fees, related to the former employee's breach of the restrictive covenants in his employment agreement.

In contrast to the *ACS Partners* and *Trico* decisions, a federal trial court in the Northern District of Indiana (*Zimmer, Inc. v. Howmedica Osteonics Corp. d/b/a Stryker Orthopedics Corp.* (N.D. Ind. 2018)) allowed tort claims to proceed to trial in a breach of non-compete case. The judge held that because the plaintiff's claims were intentional torts (*e.g.*, breach of fiduciary duty), not negligence-based claims, the ELD was not applicable under Indiana law. Adding another layer of uncertainty and confusion to this evolving legal landscape is a New Jersey decision involving the same two corporate entities – Zimmer and Stryker – in which a federal judge held that New Jersey's economic loss rule barred tort claims against the individual defendant employees because the tort claims raised by Stryker against them arose from their employment contracts. *Howmedica Osteonics Corp. d/b/a Stryker Orthopedics Corp. v. Zimmer, Inc.* (D.N.J. 2012).

Defend Trade Secrets Act (DTSA) and the ELD

What happens when you mix the DTSA with the ELD, other than getting a bowl of alphabet soup? Recently, a federal trial court in Colorado held that theft of trade secret claims under the federal Defend Trade Secrets Act (DTSA) and state Colorado Uniform Trade Secrets Act were not barred by the ELD, but that common law tortious interference claims were barred by the ELD. In *Great American Opportunities, Inc. v. Kent* (D. Colo. 10/22/2018), the court, relying on Colorado law, held that the defendant's employment agreement imposed the same duty to not interfere with the plaintiff's current or prospective customers as the duty underlying the tort for interference with business contracts. However, because Congress expressly intended to provide extra-contractual remedies under the DTSA, the ELD did not preclude statutory claims under either the DTSA or the Colorado state analogue Uniform Trade Secrets Act.

Takeaways

The applicability of the ELD in non-compete cases is in a state of flux, with some courts declining to apply it and other courts embracing it as a defense to certain claims. The aggrieved party in non-compete cases would prefer to bring tort claims in addition to contract claims because tort claims generally offer a broader array of damages than contract claims, such as recovery of punitive damages and attorneys' fees. In addition, the type of claim – tort or contract – might affect whether an individual or company can be sued individually as a defendant or whether a particular claim is covered by insurance. As courts and legislatures around the country continue to scrutinize and challenge the viability of restrictive covenants, practitioners should be aware of the ELD and its potential impact on the viability of claims associated with violations of restrictive covenants.

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