NEGLIGENCE FOR MISPLACING CONFIDENTIAL DATA—WHEN THE ECONOMIC LOSS DOCTRINE MAY NOT APPLY

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Published: ICSC'S Shopping Legal Update, Volume 33 Issue 3
Fall/Winter 2013

Introduction

Before the age of the Internet and social media, there was something called "privacy." Most individuals kept their lives relatively secret; very little personal information was revealed to the outside world. But as time has passed and the web of social media has grown, people generally feel more and more comfortable disclosing every intimate detail about themselves to whomever is viewing their Facebook wall, Twitter feed or other social media outlet.

As part and parcel with this increased comfort with self-exposure, individuals have also become more comfortable with disclosing other private information formerly held as sacred. People everywhere now make online purchases by submitting credit card information, all without blinking an eye. They also provide their names, addresses, birthdates and even Social Security numbers online for a variety of reasons. While the vast majority of websites requesting such information provides secure portals, personal data cannot always be safeguarded with absolute certainty. A hacker might steal someone's credit card information, charge the card one or many times, and disappear with stolen goods never to be found. And acquiring such information no longer requires physically breaking into a building, safe or other protected location as it did before the Internet. Now, access to confidential information simply requires cyber hacking, which is much quicker, easier and less risky.

The monetary loss caused by such intrusions can be material. The SEC has issued regulations dictating the disclosure that is required by public companies as to the materiality of the risk to the companies from such an intrusion. Companies now have to evaluate the financial exposure that could result from a data breach.

In the past, many commercial liability and D&O (Directors and Officers) liability insurance policies (protects directors and officers at corporations against lawsuits by shareholders, employees or creditors) have afforded coverage for data breaches without the necessity of an express endorsement or additional premium. However, both with a growing threat and a significant loss history, many insurers are now excluding such coverage from traditional policies and requiring specialty policies that are being underwritten separately based on the insured's risk of loss.

When it comes to the types of loss, identity theft creates a laundry list of inconveniences for the individual(s) whose information was revealed—including their need to close and re-open bank accounts, monitor credit reports and have a constant concern of future recurrences. It has been the focus of much litigation, including consumer class actions. Moreover, the class of potential claimants has now been expanded.

Historically, liability for negligence was often limited to occasions in which an injured party suffers physical injury; however, the Fifth Circuit's recent decision in *Lone Star National Bank, N.A. v. Heartland Payments Systems, Inc.*1 shows that state courts have recognized exceptions to this rule and will likely continue to add exceptions. As more exceptions are added, businesses and individuals in possession of confidential information may face significant financial backlash if such information is negligently disclosed.

This article will first discuss the origin and rationale for the rule requiring physical injury for negligence, which is also known as the "economic loss doctrine." It will then list a few exceptions to that rule, which have been recognized by various states. It will analyze the 2013 *Lone Star National Bank, N.A.*, decision and its interpretation of New Jersey law's version of the economic loss doctrine. Finally, the article will discuss the potential impact of this ruling on future liability for entities that misplace confidential information.

Background on the Economic Loss Doctrine

The economic loss doctrine (the "doctrine") addresses the types of damages that can be recovered on negligence and other tort claims as compared to contract claims. In some cases, the doctrine prohibits any recovery of "pure economic loss" for negligence and other torts when those losses are the subject matter of a contract. (Pure economic loss includes only direct economic losses and/or consequential economic losses.)

In other words, if there is no personal injury or property damage, recovery may not be permitted under tort theories of recovery. Also, for losses that are the subject matter of a contract, the doctrine has been applied to preclude tort claims between parties who are not in privity.

Rationale Behind the Rule

The rationale behind the rule is that contract and tort causes of action should remain discrete. Tort claims generally provide a means for reimbursement for physical injury or damage to property. Contract claims are the appropriate venue for recouping financial injury. The rule attempts to maintain this bright-line distinction between tort and contract bases of recovery. The doctrine was developed through the court system and has been accepted in one form or another by most jurisdictions in the United States.

Exceptions to the Traditional Doctrine

Although there is a traditional Economic Loss Doctrine, not all states have identically conformed to it. While many states remain steadfast to the traditional rule, others (described below) have created exceptions, thus departing from the traditional rule.

J'Aire Corp. v. Gregory[2]

In 1979, in *J'Aire Corp. v. Gregory*, the Supreme Court of California was the first state court to deviate, substantially, from the customary Economic Loss Doctrine: The court allowed the existence of a negligence cause of action for pure economic loss where the plaintiff showed a special relationship between himself and the defendant. According to the *J'Aire Corp.* ruling, the existence of a special relationship depends on six factors:

1. Extent to which the transaction was intended to affect the plaintiff
2. Foreseeability of harm to the plaintiff
3. Degree of certainty that the plaintiff suffered injury
4. Proximity of connection between the conduct and the injury
5. Moral blame attached to the defendant's conduct and
6. Policy of preventing future similar harm

Additional states have recognized some version of this "special relationship" exception to the doctrine, including Idaho, New Hampshire and West Virginia.

Some other exceptions to the doctrine, which have been recognized by various states, include: exclusions for the specific tort committed (e.g., fraud, fraudulent inducement, professional negligence); situations in which tort duties arise separate and apart from contractual duties; sudden disastrous events; and lack of privity of contract with the tortfeasor.

Lone Star National Bank

When a person uses a bank-issued credit card or debit card, his or her personal information is transmitted through a chain of institutions. First, the information is provided to the merchant. Second, the merchant sends the customer's information to the merchant's bank ("Acquirer"). Third, the Acquirer Bank sends that information to a credit card processor. Fourth, the processor passes the information along to the bank that issued the card to the customer ("Issuer Bank"). Fifth, the Issuer Bank either approves or denies the use of the card and transmits this response back to the merchant using the same chain.

In *Lone Star National Bank, N.A.*, a credit card processor's data system was hacked and credit card information was stolen and used. Because of this breach, a number of issuer banks suffered significant losses, as they were obligated to reimburse their cardholders for unauthorized charges. The issuer banks had no contract with the credit card processor ("Heartland"), as credit card processors are selected by and contract with acquirer banks. The issuer banks asserted various claims against Heartland, including negligence and contract claims as third-party beneficiaries of Heartland's contracts with other entities.

The district court dismissed all of the issuer banks' claims against Heartland. Specifically, as to negligence, the court held that under either Texas law or New Jersey law (a disputed issue in the lawsuit), the economic loss doctrine would bar the issuer banks' claims.

On appeal, the Fifth Circuit agreed that if Texas law applies, the issuer banks' claims would be barred by the economic loss doctrine. However, the Fifth Circuit reversed, holding that if New Jersey law applies, the economic loss doctrine would not bar the issuer banks' negligence claim.

*People express Airlines, Inc.*3

Citing *People express Airlines, Inc.*, the court held that "under New Jersey law, the economic loss doctrine does not bar tort recovery where the defendant causes an identifiable class of plaintiffs to which it owes a duty of care to suffer economic loss that does not result in boundless liability."

Here, the issuer banks constitute an "identifiable class of plaintiffs," since Heartland could reasonably foresee that these entities would suffer economic losses if Heartland acted negligently. Also, Heartland would not be exposed to "boundless liability" since the number of injured entities is limited and their losses are reasonable. Finally, if the issuer banks cannot bring a claim for negligence against Heartland, they may be left with no remedy for recovery since it was unclear whether Heartland's contracts with other entities provided the issuer banks with any protection.

Conclusion and Advice

It goes without saying that any entity possessing confidential information must treat that information with the utmost care. Even with the more lax attitudes that individuals now have toward keeping their confidential information private, the repercussions are serious and, based on *Lone Star National Bank, N.A.*, may in fact grow. In the past, an entity that allowed such information to be leaked may have been liable to the person whose information was stolen. Now, if more state courts follow the Fifth Circuit's lead, an entity may also be liable for the subsequent actions of hackers or other individuals who illicitly acquire and use private data.

Accordingly, if private information must be possessed, all precautions must be taken to secure the confidential information. The added threat of financial exposure for the acts of an identity thief should show that the costs of protecting confidential information are minimal compared to the repercussions for negligent disclosure of such information.

[1] No. 12-20648, Sept. 3, 2013 (5th Cir.).
[2] *24 Cal.3d 799 (Cal. 1979).*
[3] *People express Airlines, Inc. v. Consolidated Rail Corp.*, 495 A.2d 107 (N.J. 1985).