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Texas Consumer & Commercial Law Update

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Welcome

In this edition of the ***Texas Consumer & Commercial Law Update***, we cast our net a bit wider as we look at current issues concerning trade secrets, covenants not to compete, and real estate. This eNewsletter presents a brief summary of the hot topics from our Texas attorneys who work in each of the respective areas.

This Edition

Protecting Trade Secrets Using Computer Fraud and Abuse Act

The Computer Fraud and Abuse Act is a federal statute that allows plaintiffs to recover damages arising out of unauthorized computer access. The statute applies to computers used in interstate or foreign commerce or communication and protects against the use of unauthorized access to intentionally transmit information. This act applies to lending institutions and other businesses.

Because modern business practice requires that virtually every computer is used in interstate commerce or communication, and because computers are ubiquitous in today's workplace, the Act has a remarkably broad scope. This broad scope has enabled the Act to become a useful tool in litigation.

Under its broadest provisions, the Computer Fraud and Abuse Act allows for a private lawsuit against a person who transmits information from a "protected computer" and causes "damage" and "loss" without

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authorization or in breach of his authorization.

A protected computer includes a computer “which is used in interstate or foreign commerce or communication.”

A damage is “any impairment to the integrity or availability of data, a program, a system, or information.”

A loss is “any reasonable cost to any victim, including the cost of responding to an offense, conducting a damage assessment, and restoring the data, program, system, or information to its condition prior to the offense, and any revenue lost, cost incurred, or other consequential damages incurred because of interruption of service.” The Act only applies to losses of at least $5,000.

Though Congress first passed the Act in 1984, the Act was only a criminal statute at the time. The Act did not allow for civil lawsuits until 1994. Since then, the Act’s dramatic rise in the area of trade secret litigation has reflected the rise of computers in business. Where a financial institution has reason to believe an employee or third party has violated the Act it may have civil remedies.

The case of *Shurgard Storage Centers, Inc. v. Safeguard Self Storage, Inc.* provides the prototypical example of the Act in a trade secret case.[1] Shurgard and Safeguard were competitors in the self-storage business. Shurguard alleged that it had trade secrets in its system of creating market plans, identifying appropriate development sites, and evaluating whether a site will provide a high return on investment. Safeguard engaged in a pattern of hiring Shurguard employees who were privy to Shurguard’s information. At least one of these Shurguard employees—while employed by Shurguard and without permission—sent e-mails to Safeguard containing Shurguard’s trade secrets. Shurguard alleged claims of trade secret misappropriation, conversion, unfair competition, tortious interference, and violation of the Act.

The court refused to dismiss Shurguard’s claim under the Act. First, although the employee had authorization to access the Shurguard information when he sent it, that authorization ended when he acquired adverse interests “or if he is otherwise guilty of a serious breach of loyalty to the principal.” Second, although the Shurguard information was not deleted or altered from Shurguard’s system, the information’s “integrity” was damaged when the employee compromised the information’s protected state.

The Act allows for recovery of economic damages. One court has read “economic damages” broadly and held that it includes loss of business and business goodwill. Regardless of the amount of economic or compensatory damages, there must be a threshold requirement of at least $5,000 in “loss.” Another court has concluded that the threshold

Debt Elimination Scams

Texas High Cost Home Loan Law

Next Edition

Update on Banking Law

Questions and Suggestions

"loss" does not include lost business opportunity unless it is attributable to an interruption in service.

Often, the most contested battleground in a trade secret misappropriation case is whether a trade secret exists. A trade secret that is not really secret can cause the misappropriation claim to fail and possibly drag other claims down with it. An appealing feature of a lawsuit under the Act is that it does not require that the transmitted information be a trade secret at all. There is no restriction as to the nature of the information transmitted, only that the transmission occurred without authorization. Because a claim under the Act is unburdened by the trade secret issue, it is a useful arrow in the plaintiff's quiver in a trade secret lawsuit.

Another feature some litigants may find attractive is that a claim under the Act provides a key to the federal courthouse. While opinions regarding the merits of state versus federal courts are as numerous as the lawyers offering them, those who prefer the federal courts may find the Act very helpful.

The Computer Fraud and Abuse Act's private remedies may not increase or decrease the total dollar amount recoverable in a case. However, a violation of the Act can be easier to prove and keep the door open to damages when other claims are hard to prove. Additionally, the Act can be used to bring a question of federal law into what would otherwise be a state law matter.

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[1] 119 F. Supp. 2d 1121 (W.D. Wash. 2000).p

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A Second Look at Non-Competes

Executive Summary

In a recent decision the Texas Supreme Court has made covenants not to compete much more enforceable. In Texas, employers no longer must provide valuable consideration to their employees at the very instant of signing the agreement. Rather, the Supreme Court has emphasized that covenants not to compete are enforceable as long as they are reasonable with regard to geography, time and scope. This represents a major shift in this area of the law.

Analysis

Texas law regarding covenants not to compete has significantly changed. Texas has long been thought to be one of the most difficult states in which to enforce covenants not to compete. The Texas

Supreme Court in *Alex Sheshunoff Mgmt. Servs., L.P. v. Kenneth Johnson and Strunk & Assocs., L.P.*, No. 03-1050, Slip. op. (Tex. Oct. 20, 2006) has altered this thinking by holding:

> Today we modify our holding in *Light*[1] and hold that an at-will employee's non-compete covenant becomes enforceable when the employer performs the promises it made in exchange for the covenant. In so holding, we disagree with language in *Light* stating that the Covenant Not To Compete Act[2] requires the agreement containing the covenant to be enforceable the instant the agreement is made.

Thus, the Texas Supreme Court has removed one of the greatest barriers to the enforcement of covenants not to compete - that consideration must be given to the employee the instant the agreement is signed.

Most businesses provide consideration to at-will employees over time. Whether it is training, access to trade secret information, or participation in developing good will, these things are not handed in bulk to employees at the moment of signing the agreement. Defendants inevitably seek to have a covenant declared unenforceable under *Light* because the exchange of this consideration by the employer in an at-will employee situation is not instantaneous. Employees' attorneys then argue that the employers' consideration' per *Light* is illusory. *Sheshunoff* eliminates this defense.

The benefits to employers of the *Sheshunoff* decision do not end with the holding that consideration may be provided over time. The *Sheshunoff* decision carefully goes through the legislative history of the Covenant Not To Compete Act and notes that, "the Act was passed to expand the enforceability of covenants not to compete."[3] The court states that, "the legislative history also indicates that one of the primary purposes of one of the amendments to the Covenant Not To Compete Act was to make clear that covenants not to compete were applicable to at-will employment situations and that the statute prevailed over contrary common law."[4] The court summarizes its review of the legislative history by stating:

- The 1989 and 1993 legislative initiatives sought to expand the enforceability of covenants not to compete.
- Covenants could be signed after the employment relationship began so long as there was new consideration.
- Covenants not to compete would apply in at-will employment situations.

One of the two concurring opinions in the case offer caution with regard to when the additional consideration must be supplied. In the first concurrence, the three justices who write the concurrence state

that the time within which this additional consideration must be supplied after signing the agreement must be "reasonable."[5] The majority did not agree.

This concurrence also provides additional help to employers by noting that good will is one of the business interests that may be protected.[6] The *Light* opinion seemed to suggest that the only acceptable form of consideration was trade secrets.[7] At page 12, the concurring justices also note that trade secrets may be continuously created by updating data to support a covenant given during the term of an employee's employment. Thus, customer lists may supply new consideration for existing employees as the trade secrets they embody change over time.

The second concurring opinion provides perhaps some of the best language for employers. This concurrence finds that the *Light* decision improperly added the two requirements that the confidentiality agreement "must give rise to the employer's interest in restraining the employee from competing," and the non-compete "must be designed to enforce the employee's consideration or return promise" not to disclose confidential information."[8] The second concurrence went on to note that this judge-made law was dicta since the *Light* decision did not deal with trade secrets. If the court were to actually adopt the reasoning of the second concurring opinion, this would also broaden enforcement of covenants not to compete.

Finally, the second concurrence wonders why an employer has to provide any consideration beyond initial employment or continued employment. It points out that employees, merely by virtue of their employment, have a fiduciary duty not to reveal an employer's trade secrets. The concurring opinion wonders why any additional consideration is needed to support a covenant not to compete. Once again, if the court actually adopts this position, employers will more easily enforce covenants.

The majority opinion focuses near the end on what it concludes is the real test. This test is not a technical dispute over whether a covenant "is ancillary to an otherwise enforceable agreement."[9] The majority opinion states that the real inquiry is whether or not the covenant is reasonable within the traditional standards of geography, scope and time. Such a rational and business sensitive approach will do much to improve business's ability to enforce existing covenants not to compete and to write new covenants not to compete that will protect their genuine interests.

Questions Businesses May Want to Consider

1. Do our covenants not to compete take full advantage of the ruling?
2. Can we detect situations where prospective employees may be

subject to restrictive agreements and make allowances for such restrictions?

3. Is any recent hiring by our competitors potentially subject to legal action based upon the standards set out in Sheshunoff?

View the majority opinion.

View the concurring opionions.

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[1] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642 (Tex. 1994).

[2] Tex. Bus. & Comm. Code Ann. §§ 15.50-15.52.

[3] Alex Sheshunoff Mgmt. Servs., L.P. v. Kenneth Johnson and Strunk & Assocs., L.P., No. 03-1050, Slip. op. at 13 (Tex. Oct. 20, 2006).

[4] *Id.* at 14.

[5] *Id.* at 1 & 8.

[6] *Id.* at 3 & 6.

[7] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 647 n.14 (Tex. 1994).

[8] Alex Sheshunoff Mgmt. Servs., L.P. v. Kenneth Johnson and Strunk & Assocs., L.P., No. 03-1050, Slip. op. at 2 (Tex. Oct. 20, 2006).

[9] *Id.* at 18.

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Mortgage Fraud: The New Crisis in Real Estate

Mortgage fraud is one of the fastest growing areas of criminal activity in the United States today and the FBI has turned its attention to enforcement. The typical perception of this issue is limited to a single instance of an individual who fudges information on a loan application in order to obtain a loan. The last several years, however, have seen a rising trend of fraud for profit that has serious implications for both the victimized lenders as well as the neighborhoods where the properties are located. For example, United States Attorney for the Northern District of Texas recently indicted several parties as a result of an elaborate mortgage fraud scheme that took place in the Dallas area.

Although the schemes vary in their nuances, the common thread is a conspiracy of several parties to pull off the scam. Virtually all of these scams involve inflated appraisals. The following is a brief description of a typical mortgage fraud scam:

Straw Purchaser. In this version the lead conspirator (many times a mortgage broker) finds an individual whose credit history allows the individual to qualify for a residential real estate loan . The participating individual certifies that he or she will reside in the property, although they have no intention of doing so. The lead conspirator informs the straw purchaser that the property is an investment opportunity and that: 1) the participant will make a handsome return without using their own money and 2) not to worry about the representations on the loan application, including the intent to reside. The straw borrower is informed that, after they purchase the property, a renter will be found who will cover the mortgage until the property is sold at a substantial profit. Next, an appraiser is found who agrees to substantially inflate the value of the property. Many times the employment and income information on the loan application is falsified and an accountant in on the scam verifies the income. Sometimes the escrow agent may be involved such that two HUD-1's are prepared with two different sales prices for the property. After closing no payments are made (or, at most, one or two) and the property ends up in foreclosure. The end result is that the lender extended a loan on a property that in reality is worth substantially less than the loan amount (usually there is a six figure deficiency) with the straw buyer deeply indebted on property they are unable to afford.

The danger of the straw purchase scams is that the lead conspirator replicates the process with a large number of purchasers, seemingly without end. So, instead of a single loss incurred by a one lender, which is containable, a number of lenders experience significant losses for which no or limited recovery is the only prospect. A future edition of the ***Texas Consumer & Commercial Law Update*** will address strategies for responding to and preventing this fast growing problem.

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News and Events

Webcast: Indemnification Clauses

On August 23, the State Bar of Texas produced a two-hour webcast titled "Negotiating and Drafting Indemnity Clauses." A total of 363 people registered for the program, making it the third highest rated webcast ever put on by the State Bar of Texas. David Smith of McGlinchey's Houston office was a presenter. Others on the panel included D. Hull Youngblood of Hughes Luce, LLP, Hon. G. Alan Waldrop of the Third Court of Appeals and Claude DuCloux. A representative from the Bar said, "It was an outstanding exchange of ideas and one of the best webcasts we've done."

The State Bar of Texas will offer a subsequent program covering

indemnity clauses early next year.

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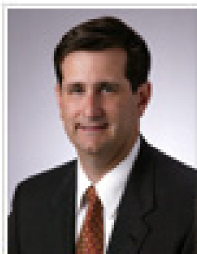
Ask the Editors



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