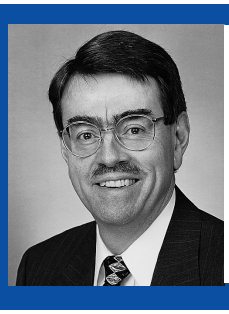
A Question of Ethics

Do Restrictive Covenants in Employment Agreements Present Ethical Issues?

"Have nothing to do with the fruitless deeds of darkness, but rather expose them."

—Eph. 5:11 (NIV)



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Restrictive covenants in employment are contractual provisions that limit some forms of competition, particularly after the affected employees or agents no longer work for the employers or principals with whom the covenants may have been negotiated. The courts generally do not favor their enforcement because public policy encourages open competition in the marketplace. But these covenants will be upheld if they are properly drawn up. In this column, we will examine some of the legal and ethical issues inherent in these provisions, and offer some generalized guidance as to how we should approach them.

Guideline G3.2 of the Code of Professional Ethics of the American Institute for CPCU (AICPCU) addresses this subject as follows:

> A CPCU should not, to the detriment of the insuring public, engage in any business practice or activity designed to restrict fair competition. However, this Guideline does not prohibit a CPCU's participation in a legally enforceable covenant not to compete . . .

Canon 3 of the same Code provides as follows:

> CPCUs should obey all laws and regulations, and should avoid any conduct or activity which would cause unjust harm to others.

Clearly, covenants not to compete may cause some harm to the parties bound by them. The question, for our purposes, is whether we can readily discern when that harm is unjust. As noted with respect to the previously quoted guideline, there is a suggestion that if the covenant not to compete is not legally enforceable, then there may be some room to argue that imposing the covenant on others may constitute an ethical violation. In particular, there may be a suggestion that if the covenant is imposed when it is known to be invalid, then its imposition may constitute a dishonest practice not supportive of fair competition. Rule R3.1 sets out as follows:

> In the conduct of business or professional activities, a CPCU shall not engage in any act or omission of a dishonest, deceitful, or fraudulent nature.

Consider that an unsophisticated worker may not appreciate whether a particular covenant is valid or not, and may simply be intimidated into accepting its limitations without question as a condition of employment. If that happens, then the party imposing it may be overreaching and, in essence, engaging in arguably dishonest conduct. A much closer question develops if there is merely some doubt as to the validity of the proposed covenant. For one thing, it may be more difficult to argue that the party imposing the covenant knew that doing so would not be legally binding. And only if the bound party takes exception to the overall arrangement will it likely be known whether the covenant in question would have been deemed valid or invalid.

An employer or principal has an interest in keeping its employees and agents employed in its behalf, and not having them work for a competitor. To be sure, terms of employment that bound the employees and agents not to work for competitors would likely not pass muster if challenged. But there are situations where the covenants are negotiated to protect trade secrets or established customer relationships or both. The most contentious setting, in my estimation, concerns covenants that protect customer data and relationships that the bound workers may have assigned to their principals or employers. Typically the departing employee or agent is prohibited from taking and using the customer information (which he or she may have helped to develop for the prior principal or employer) to solicit customers for a new principal or employer.

In other words, the fruits of the prior business effort may be deemed the property of the principal or employer, and not that of the agent or employee. The breach of these provisions may result in the forfeiture of commissions or other compensation held back by the former principal or employer. In addition, there is the prospect that the former principal or employer will seek to enjoin the former employee or agent from using the customer information previously entrusted to him or her to solicit those customers on behalf of the new principal or employer.

So what then are the ethical issues we might need to focus on? For our purposes, the predominant ethical considerations are the following:

1. Is it reasonably clear that the restrictive covenants in question were drawn to protect identifiable interests deemed worthy of protection? Preventing or dampening potential competition without more, as we have said, is not enough to justify the enforcement of these covenants.

2. Is it proper to submit an ethical complaint against a CPCU concerning the validity of a disputed covenant to which he or she may be a party? The underlying complaint may focus on the allegedly unfair competition that the covenant imposes on the bound party as a violation of Rule 3.1, previously discussed above, or Rule 4.1, which provides that a CPCU shall competently and consistently discharge his or her occupational duties. Interestingly, any boards of ethical inquiry appointed to examine these types of allegations, under the AICPCU's ethics policies, will likely refuse to consider these complaints. The following statement appears in a commentary on these ethical proscriptions:

   > [T]he Code of Ethics is not a remedy for employer-employee disputes, nor is it a remedy for other disputes that can better be settled through legal procedures and other remedies. [E. Wiening, Code of Professional Ethics of the American Institute for Chartered Property Casualty Underwriters with Commentary, p. 2.28 (7th Edition 2002)]

3. Are there circumstances where the AICPCU will want to examine allegations of unethical conduct in relation to one of these covenants? Wiening's commentary, cited above, alludes to the desirability of resolving the underlying dispute privately or through the courts if necessary as a possible precondition to the consideration of any violation of the Code. (Id. p. 2.29)

4. Why have other professions and professional groups disavowed or attempted to disavow the ethical propriety of restrictive covenants? For example, the codes of ethics that govern lawyers and the practice of law uniformly prohibit agreements that restrict a lawyer's right to practice law. With respect to CPCUs, and possibly other professional groups as well, the protection of established business relations and interests may indeed predominate over the public's freedom to choose the practitioners with whom they will deal.

5. Does the Society's Code of Ethics, as developed in the Society's ethics policy statement, address the subject of restrictive covenants? It does not, but it does invite us to think of how we might meet the potentially conflicting interests between an employer or principal and a client. If the member leaves the employment of his or her employer or principal while subject to a restrictive covenant, then what is the member to do if the client expresses a preference to deal with the member? Members need to be aware that they must respect the confidential relations they have with others as part of their business transactions. [Cf. CPCU Society Ethics Code Section 4(a)(3)]

Admittedly, it is rather challenging to grasp the essential nature of these restrictive covenants and the limits of their validity and enforcement. In practical terms, it is advisable to consult with competent attorneys when considering the negotiation or interpretation of these provisions.

My personal recommendations for CPCUs dealing with these covenants follow:

- Do seek to identify interests worthy of protection prior to the acceptance and negotiation of a restrictive covenant in an employment or other personal services agreement.
- Consider whether the restrictions being imposed are reasonably satisfactory in terms of their duration and geographical scope.
- Where you offer employment subject to a restrictive covenant, be sure to limit its application as narrowly as befits the interests you seek to protect.
- If your business interests allow, then consider conducting business without restrictive covenants anticipating that the public as a whole will best determine with whom it will deal.
- If you offer employment with restrictive covenants, then avoid terms so onerous or questionable as will likely serve to drive away your best prospects for service, in time create resentments that will harm productivity, or simply generate unproductive and costly disputes.

Editor's note: *The opinions expressed in this column are those of the author and do not necessarily reflect the views of the CPCU Society membership, the Society's Ethics Committee, or the author's employer. In upcoming issues of* CPCU News, *the authorship of the "Question of Ethics" column will rotate among members of the Ethics Committee. If you have suggestions for upcoming articles or comments about the "Question of Ethics" column, please contact* ***Steve G. Brown, CPCU, CLU,*** *Ethics Committee chairman, at steve.brown.bid2@statefarm.com.*