

Where Have All the Clients Gone?

With apologies to the original songwriter, the issue of who has rights over client lists has become a hot one for brokers and former employees.

BY STEVEN BORLAK

The demand for volume growth by brokers has been persistent in recent years. One popular method for brokers to achieve this growth is internally through the hiring of producers. This approach brings with it various legal risks. Among other things, as producers move from one broker to another, the broker's client list, or at least part of it, may move with the producer. But what determines the rights of the parties when the client list is under such an attack?

Consider these simple facts as an example. Peter Producer works for Bob the Broker. After Peter leaves to join Broker Charlie, Bob discovers significant attrition at policy renewal time and possibly even some mid-stream policy cancellations. Bob wants to stop the losses. Hopefully, for Bob, he had Peter sign an agreement at hiring that contained restrictions on sales activities following the termination of their relationship.

Does the agreement help Bob? Here is where we get into legal mumbo jumbo. Most such agreements will contain either a non-solicitation covenant or both a non-solicitation and a non-competition covenant. A non-competition covenant means that the producer agrees not to be involved in the general insurance industry for a specified period of time following termination and within a defined geographical



Borlak: Brokers beware.

area. A non-solicitation covenant means that the clients of a broker are off limits to the producer for a specified period of time. Both of these covenants are referred to as restrictive covenants and are considered to be covenants in restraint of trade.

The basic premise of the doctrine of restraint of trade is that all such covenants are prima facie illegal and therefore unenforceable. In most cases, parties who have reached an agreement with each other are able to enforce the terms of their agreement. However, restrictive covenants are unlike other contractual rights. Before Broker Bob can enforce such a covenant, he must first demonstrate

that the covenant is reasonably required to protect his property.

There is generally a distinction drawn in the cases between a restrictive covenant contained in an agreement for the sale of a business and one contained in a contract of employment. As a general rule, courts are more willing to enforce restrictive covenants against a seller than they are as against a former employee. This article will deal mainly with employment situations.

The remedies available to Bob will depend on a number of factual circumstances. The issues will also affect the exposure of Peter Producer and Broker Charlie. If Broker Bob commences an action against Peter to stop the plundering, a claim can also be made against Charlie to recover damages to the extent of any commission revenue from the original client list. Here are some of the circumstances to consider.

(1) Is it clear that the client list is owned by the broker and not the producer?

Bob should ensure that his ownership of the client list is clearly set out in the employment agreement at the time of hiring. Even in the absence of such a provision, the common law rule is that the "fruits" of an employee become the property of his master. However, the facts may dictate otherwise. For instance, Peter may have brought a portfolio of business prior to his hiring by Bob and this will

likely lead to an inference that Peter is the owner of all that he produces.

(2) Is there an agreement in place between the broker and the producer that contains non-competition or non-solicitation covenants and, if so, are the restrictions enforceable?

The 1978 Supreme Court of Canada decision *Elsley v. J.G. Collins* is probably the best precedent on this issue for the property and casualty industry. In that case, the Collins Company purchased the general insurance business of D.C. Elsley Limited. Elsley also became the manager of Collins Company's general insurance business in the greater Niagara Falls area. His management agreement was negotiated subsequent to the closing of the sale of business and Elsley managed the general insurance portfolio for 17 years to the almost total exclusion of Collins.

The management agreement contained a non-competition covenant that prevented Elsley, while employed by the company and for a further period of five years thereafter, from competing with Collins Company within the Niagara Falls area. Following termination of his employment with Collins Company, Elsley opened up his own general insurance business and took two insurance salesmen and a clerk from Collins. Many customers transferred their business to Elsley. It was unclear whether he actually solicited the former clients. Elsley's argument was that the covenant would have been valid if it had been drafted as one of non-solicitation to preclude him from soliciting clients of his former employer. Since the covenant was drafted in more sweeping terms as a non-competition covenant, Elsley argued that it was unenforceable.

On the facts in *Elsley*, the agreement was tested strictly on the basis of the employment relationship. The Supreme Court made it clear that, in exceptional cases, "the nature of the employment may justify a covenant prohibiting an employee not only from soliciting customers, but also from establishing his own business or working for others so as to be like-

ly to appropriate the employer's trade connection through his acquaintance with the employer's customers. This may indeed be the only effective covenant to protect the proprietary interest of the employer. A simple non-solicitation covenant would not suffice."

The evidence in the case demonstrated that a large number of clients switched their business to Elsley. On the basis of those facts, the Supreme Court was of the view that a non-solicitation covenant would not

"THE LARGEST GAP IN PROTECTION OCCURS WHEN THE PRODUCER LEAVES AND IS ABLE TO ESTABLISH THAT HE DID NOT SOLICIT CLIENTS."

have been sufficient to protect the property of Collins and the covenant against competition was therefore enforced. This case is very useful since it indicates that there may be situations where a court will uphold a non-competition covenant in an employment situation.

Ironically, nobody really won the case. Elsley died before the decision was rendered and while Collins was technically successful, it proved to be a pyrrhic victory when the award of damages was restricted to \$1,000 as a result of a poorly drafted liquidated damage clause.

Getting back to Broker Bob, a find-

ing that his covenant is unreasonable will probably result in the clause being struck down, in which case, Bob will receive no protection from the covenant at all. In many cases, the employment agreement includes a "blue pencil" clause. This is a technique developed by lawyers permitting a court to "read down" a restraint that is too broad, such as a lengthy non-solicitation period. It is extremely important for brokers to carefully draft these types of clauses and the party seeking protection must choose the minimum elements of protection (duration of time and geographical radius of application) required in order to survive judicial scrutiny.

(3) Have the contractual restrictions been drafted so that they specifically prohibit the activities the producer is engaged in?

The answer to this question involves a legal drafting exercise. For instance, a non-solicitation covenant should be drafted so that it prevents indirect solicitation as well as direct solicitation. In my experience, the largest gap in protection occurs when the producer leaves and is able to establish that he did not solicit clients, but in each case was approached by customers.

Here are some techniques that can be utilized by Bob to close this gap. (A) Perhaps Bob can include a non-competition covenant. Bob must then hope that when he enforces the covenant, the court will be willing to cast Peter in the same light as Elsley. Notwithstanding the *Elsley* decision, it is very rare that a court will enforce a non-competition covenant arising from an employment context. (B) If

continued on page 30

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continued from page 15

practical, Bob should structure a bonus scheme post-termination, which is only payable in the event

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that Peter complies with the restrictive covenants.

(4) In the absence of contractual restrictions, are there common law duties owed by the producer that the broker can raise to prevent the client list from being plundered?

At common law, once the employment relationship is terminated, Peter is free, in general terms, to compete with Bob. However, Peter is prohibited first from removing confidential information and then from using this information for a purpose not authorized by Bob. The difficulty with using this approach is the counter-argument that Peter may have developed the customer list, but he was not, strictly speaking, given any confidential information. It is my view that most decision makers will conclude that these lists are confidential.

There are also many conflicting cases that consider whether memorizing a client list is as culpable as removing a client list. The more commonly held view is that courts ought not to distinguish between actual removal and usage through memory.

Even if information is found to be non-confidential, its unauthorized use may still be prevented if Broker Bob can establish that Peter Producer owes a fiduciary duty to the brokerage. In the insurance context, a fiduciary must refrain from soliciting clients to break their attachment to the former employer. To fit the criteria, Bob will want to assert that Peter was part of "top management" and not a "mere employee." The fact that an employee has access to confidential information may elevate him or her to the status of fiduciary.

Consider the recent British Columbia Supreme Court case *Barton Insurance Brokers Ltd v. Irwin*. Irwin was a producer for Howat Insurance from 1980 to 1992. In 1992, Barton acquired the shares of Howat. After the takeover, Irwin's supervisory role was first removed, subsequently restored, and later removed again. In 1994, she began working for a competitor. When she left, Irwin had a portfolio worth about \$146,000 in commissions. At trial, the plaintiff alleged that it lost \$15,753.10 in commissions.

Irwin said she did not take any client lists but simply went systematically through the phone book, listed everyone she could remember as being a customer, then phoned them and solicited their business. The plaintiff argued that Irwin owed it either a fiduciary duty or common law duty of good faith not to use the confidential information. After a rigorous analysis, the court was of the view that the defendant was able to attract only a small proportion of her former clientele, with minimal impact on her former employer and that this was permissible.

This case demonstrates the painful fragile reality for the typical broker. Each case will be judged on its own facts and circumstances. It is therefore difficult to generalize as to what restrictions courts will find reasonable, whether contractual or at common law.

The final outcome may be based on the decision maker's assessment of fairness and equity. For example, what were the circumstances of termination? Was the producer/employee summarily terminated or did he plan his resignation over a number of months and cobble support from customers during his final period of employment? As the Supreme Court of Canada stated in the *Elsely* case: "The test of reasonableness can be applied, however, only in the peculiar circumstances of a particular case. Circumstances are of an infinite variety. Other cases may help in enunciating broad principles, but are otherwise of little assistance."

While I highly recommend that brokers insist on producers (and other employees who develop customer loyalty) signing restrictive covenants, it is impossible to guarantee 100 per cent success even with the contractual "protection." So the message of this article is "brokers beware." If you are achieving the volume growth demanded by your markets through the use of producers, be keenly aware of the risks when they depart. □

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