

## **Pirates of the Expirations Ownership, Trade Secrets and Other Perils**

A recent movie about Pirates is said to have broken all box office records for any pirate movie according to a report. There seems to be another record breaking event taking place in the insurance industry that relates to the actions and behavior of "Pirates". In the past 5 years, the authors of this article have been retained over 20 times by owners of Agencies to opine on the standards of care owed to an Agency in the protection of customer lists (expirations), when agency employees take the business and convert it to their personal benefit.

And it doesn't just begin with non-owner producers absconding with these valuable assets of the Agency. In recent times, we have seen the same pattern of conduct by Agency Officers and Partners. And lest we forget, it can be service personnel copying the trade secrets of the firm, and soliciting the very customers for whom they were entrusted to establish a rapport on behalf of their Agency employer. First a little history about these assets that belong to an Agency.

What are the trade secrets in your Agency? Whether they're in your database or in the traditional file cabinet, they're the confidential documents that profile the nature and characteristics of your clients — and they're valuable. Your work requires that you review them, change them, and keep them in order. They're *your* trade secrets, and you've developed them at great cost.

When you sell an Agency, its most valuable assets are the trade secrets contained in you files and records (i.e. your expiration rights). No, you don't display them on a Balance Sheet, unless of course you've acquired them in some other manner (and then only for purposes of a depreciable asset). You reflect their value in the Income Statement, and the persistency of the commissions they produce depends on your ability to place the client with an insurer that's acceptable and competitive. That's why it's important that you protect them. But just what constitutes the nature of these valuable trade secrets? Here's what one court said:

"A trade secret may consist of any formula, pattern, device or compilation of information that is used in one's business, and which gives one an opportunity to obtain an advantage over competitors who do not know how to use it. A trade secret may be a device or process which is patentable; but it need not be that. It may be a device which is clearly anticipated in the prior art or one which is merely a mechanical improvement that a good mechanic can make.

"When money and time are invested in the development of a procedure or device that is based on an idea which is not new to a particular industry, and when that certain procedure or device is not generally known, trade secret protection will exist. Further, when an effort is made to keep material important to a particular business from competitors, trade secret protection is warranted. *Items such as customer lists, pricing information, client information, customer preferences, buyer contacts, market strategies, blueprints, and drawings have been shown to be trade secrets.*" [italics added]

Some factors courts consider in determining whether information is one's trade secret are (1) the extent to which the information is known outside of his business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of measures take by him to guard the secrecy of the information; (4) the value of the information to him and his competitor; (5) the amount of effort or money expended by him in developing the information and (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. Restatement of Torts § 757.

Not all of these factors need exist in every case. Because each case must turn on its own facts, no standard formula for weighing the factors can be devised. The definition of "trade secret" depends on all of the equitable considerations in each case. Consequently, a more egregious

breach of confidence (or improper use of information) results in a lower burden on the plaintiff to show that the information constitutes trade secrets. *Metallurgical Industries, Inc. v. Fourtek, Inc.*, 790 F.2d 1195 (5<sup>th</sup> Cir. 1986, applying Texas law). The Court went on to state that confidentiality is only one factor in determining whether the information is a trade secret. "We conclude that a holder may divulge his information to a limited extent without destroying its status as a trade secret."

Of course, some degree of secrecy is required; but beyond that, there are no universal requirements, and the secrecy need not be absolute.

To further define trade secrets as they relate to the insurance industry, we turn to "Couch on Insurance," third edition, 57:59 Expirations. "Expirations" has acquired a definite and well-recognized meaning in insurance:

"'Expirations' or 'book of business' refers to a list of policies or copies of policies which show the name and address of the insured, a description of the article insured, expiration date of the policy, premium, and *all other information necessary to execute an insurance contract*. Such information is of vital assistance to the Agency in carrying on the insurance business and is recognized as a *valuable asset* in the nature of goodwill." [italics added]

This definition emphasizes the importance of customer files as assets. What are the confidential elements in the client's file? Think for a moment what you know about your insured that no one else knows, and analyze its importance. For example, you know the major players in the insured's business, and how they interact with the principal decision-maker. Owners delegate certain responsibilities to capable individuals. You know who has the delegated responsibility, and whether the owner relies on their judgment in making a renewal decision. It's important to know the dynamics of authority within the insured's firm and how you should relate to lines of authority, when and if they change.

Taking this one step further, who in the firm can provide the information you need to keep abreast of the operations of the company? Your rapport with the comptroller, fleet manager, human resources director, operations manager, marketing manager, and others is essential.

We've all heard about the need to learn who's who from top to bottom in our insureds company structure. The only change we'd make is that we need to know who is who from *bottom to top*. After all, the top is pretty easy to identify, but the players along the way can make you look good by providing information that's meaningful, confidential — and valuable. And your competition doesn't know any of what we've just discussed. That's not all they don't know.

The competition might be able to get the expiration date and maybe a copy of the policy (with the premiums erased). They might also determine ownership. But how about the insurance history (including the nature of claims), the challenges of loss control, the manner in which the insured wants to pay, the trail of audits, and the general financial condition of the firm over a period of time? Who are the clients? Who are the vendors? Do they have insurance certificates that meet risk management requirements? If they use independent contractors, do they tend to use the same ones? Do those contractors really qualify as independent contractors, or are they subject to the auditor's calculator?

And there are more questions, such as:

What's the financial condition of the firm? Do they require bonding? Have they weathered economic downturns and survived? What does the balance sheet look like and how do they spend their money as shown in the income statement? Who are the owners? Who is in control of the company today and who will be there tomorrow?

## TRADE SECRETS: WHO OWNS THE EXPIRATIONS?

We know that trade secrets have transferable value. Now we need to determine how to protect them from within the Agency. Agencies customarily define such issues in the contracts they form with their employees. Descriptions of trade secrets, sometimes referred to as "book of business" or "expirations," are also in these contracts. This is a typical producer agreement paragraph describing protected assets:

"The Producer during the term of this Agreement will have access to and become familiar with various trade secrets, consisting of insurance policies, lists or schedules of insureds or customers of the agency; forms, inter-office memos, correspondence and compilation of information, records and specifications, which are owned by the Agency, and which are regularly used in the operation of the business of the Agency."

Having represented Agencies suing former employees, we can attest to the conflict over the value of the customer list, and its accompanying myriad of information. Agencies seek remedy from the court in the form of temporary injunctions to forbid the former employee from calling on the Agency's customers. The pleadings protest "piracy" of that information. And courts have held that a reasonable agreement can prohibit the former employee from using this information to pirate the insureds away from the Agency. The key word is "reasonable," and in some cases courts have held that time and geography are too broad in nature. However, we see that the customer list is a valuable asset, in fact, a compilation of trade secrets.

And don't forget the IRS. When you sell or transfer ownership of an Agency, the IRS wants to know in order to assess taxes. Since we've already agreed that the greatest asset in almost every Agency is its customer list, the IRS predicates the tax assessment due on the transferable value of that asset. Is this taxable in the form of gain over basis, or strictly ordinary income after an initial corporate tax bite?

The issue of ownership of expirations and other trade secrets is ordinarily addressed in employment agreements between owners, as well as producers and personnel, in accordance with such distribution system configurations as independent agent or captive agent. These relationships include:

### A. INDEPENDENT AGENTS WITH THEIR INSURERS:

The Agency Agreement with your Insurance Companies state that the Agency owns the expirations. The only ownership exception concerns an agency that's in default in payment of premiums to the insurer. However, during our participation in one bankruptcy court case, the court ruled that the expirations were *not* the property of the insurer, but rather an asset belonging to the court.

### B. INDEPENDENT AGENCIES WITH THEIR PRODUCERS:

There are several types of ownership arrangement, including:

1. The Agency owns all business produced by the Producer in accordance with the Producer contract.
2. Producers own the business that they brought to the Agency in accordance with an Agreement.

- 3 Producers own a percentage of the business that they produce while at the Agency, with the Agency having right of first refusal to acquire the business in the event the Producer decides to leave the Agency (or a greater minority percentage).
4. Producers own a percentage of the business that they produce over a period of time, with the Agency having the first right of refusal in the event the Producer decides to leave. This is sometimes called the "vesting" method.

Note: Many of these rights of first refusal agreements stipulate that the Producer must submit any and all offers from other parties to the Agency in order for them to assess the third party offer.

A different ownership relationship exists for captive agents or direct writers, under which the company owns the expirations.

### C. CAPTIVE AGENT AGREEMENTS:

It's been our experience that Captive Agents don't have the ability to transfer the fair market value of their book of business in the same manner as Independent Agents. Stipulations in their contracts prohibit such transfers. We've been involved with several direct writers who receive business through Captive Agents. They're often described as independent contractors who have the right to operate their own business, but do *not* have ownership in the book of business. Sometimes a Captive Agent will claim ownership of expirations, even when they're specifically identified in the contract as trade secrets of the insurer. Once again, it's helpful to turn to "Couch on Insurance":

"An Agent cannot, by reason of custom or usage, claim and retain tabulated lists of policies compiled by him or her during his or her employment with an Agency, showing the facts regarding such policies, where the Agency contract provides that all records and other documents relating to the business of the company shall be and remain the property of the company." *Arrant v. Georgia Casualty Co.* 212 Ala. 309, 102 So. 447 (1924).

"Agency serving a direct writing company, as opposed to one functioning under the American Agency System, does not own the records in the hands of the Agent, and where the Agency contract with a direct writing company specifically provides that records shall be returned to the company upon demand, proof of the customs under the American Agency System that the Agency is the owner of records and expirations is of no avail to the Agency." *Hardin County Farm Bureau v. Farm Bureau Mutual Ins. Co.* 341 S.W. 2d 62 (KY. 1960).

A final case shows that agents in a contractual relationship who attempt to compete or interfere with the company and refuse to return records are entitled to no termination benefits:

"Where the Agency contract provided for payment of termination benefits provided that the Agent returned records and files, and agreed in writing not to service policyholders, or compete or interfere with insurer's business, agent who admittedly did not live up to such commitments was not entitled to termination benefits." *State Farm Mutual Auto Ins. Co. v. Anderson*, 70 NJ Super 520 176 A. 2d 23 (1961).

Whether you refer to them as trade secrets, books of business, or expirations, the major asset of an Insurance Agency is the information related to the renewal and retention of insureds. The persistency of the commission revenues derived from these trade secrets determine the ability of the Agency to retain competitive markets, employ trained and capable personnel, operate at a profit, and build transferable equity for retirement and perpetuation.

Remember: Case law in individual states governs the description and ownership entitlement of trade secrets. Seek counsel in making those determinations. Courts have recently refused to reform employment contracts that they decided were too broad in time and distance. They, long ago, decided that "covenants not to compete in the business" were far too restrictive to industry personnel who had a "common calling" in the business of insurance. Simply stated, it is not fair to take an individual out of the industry they know best, and can best earn a living.

So what is the answer to fair and equitable agreements between Agency owners and their Producers and/or service personnel? It has been our experience that the use of attorneys who specialize in drafting these agreements is the first line of defense in protecting the most valuable asset of the Agency. It has also been our experience that the simple duplication of old employment agreements is a potential pathway to disaster. Perhaps the best source for Agents who are looking for attorneys who have prepared fair and equitable...and acceptable agreements is your Agency Association. It continues to be the battle of control versus ownership. Many Agencies have taken steps to establish contractual parachutes in an attempt to clearly define ownership, but at the same time realize the important role of control of the relationship between Producer and the insured. Enforcing Non-Piracy promises is like the high seas, always full of peril.

**Thomas M. Braniff, JD, CPCU can be reached at**  
[Tomas@Braniff-law.com](mailto:Tomas@Braniff-law.com)

**Roy Phillips, CIC, CISR, AAI, CPIAL can be reached at**  
[Rphlconsult@kingphillips.com](mailto:Rphlconsult@kingphillips.com)