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Legal Beat

Who Owns A Customer'

By Michael Sean Quinn
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The American economic scene is characterized by at least three general trends. There may be more.

First, many large businesses are cutting back. Almost every day one reads in the paper that some huge, well-known corporation will soon have fewer employees, fewer offices and fewer plants than it did last year. Soon, not even your father will be able to buy an Oldsmobile.

Second, it is equally obvious that businesses that engage in mass marketing are trying to use direct sales more and more. One can buy almost any standardized product over the Internet. Progressive Insurance advertises toll-free telephone numbers on television and claims that if some other insurance company provides a lower rate, Progressive will identify the company and tell you their rate.

Third, there is a strong tendency in the law towards extending various legal protections to employees and distributors. There is, however, also strong resistance to this tendency. Nevertheless, over the last generation, a whole new branch of law has emerged. It is called employment law, and it is distinguished from labor law. Labor law is about union-management and union-worker relations. Employment law is about rights individuals have in dealing with their employers, near employers, quasi-employers, or what have you. In other words, employment law covers the rights of independent contractors, e.g., insurance agents, in dealing with their pseudo-employers, or insurance companies.

Making sense of the trends

When these three tendencies are put together, it is tempting to draw the inference that some large insurance companies want to reduce their dependence upon human persons as intermediaries between themselves and their policyholders. Recently, one insurance company even set up a program whereby it would answer policyholder questions and the agents wouldn't have to bother. The program was presented to the agents as convenience for them. One doesn't have to be very cynical to suspect that the program was in fact designed to push agents out of the way.

The company even tried to sell the agents on this arrangement by sharing profits from direct sales with agents. The company then described the arrangement as a "win/win" situation for both the insurer and the intermediaries. The idea was that customers would have more "points of access" to the insurer, so the insurer could sell more policies. It agreed to share some of the revenues from direct sales with the intermediaries, thereby encouraging the intermediaries to have others use direct access devices. What the company failed to mention was that as the customers get more and more use to direct access and direct sales, intermediaries will be marginalized.

Seed of discord

Of course, there has always been conflict between intermediaries (whether they are called agents, brokers, or more generically distributors) and insurers. Agents take the view that customers, or at least customer accounts, belong to them, and insurers tend to take the opposite view. Agents tend to speak loudly on this issue sometimes even hysterically. Insurers tend to address it quietly even surreptitiously. Of course, everyone really knows that customers don't belong to anybody. They are people, and we outlawed slavery in this country over 135 years ago. Customers have choices.

The real dispute is over who has a better right to maintain business relationships with the customer after the insurer and the intermediary part company. Insurers and agents deploy the usual panoply of legal theories designed to maintain control over customer accounts: contract rights and duties, the tort law of trade secrets, common law intellectual property rights, rules regarding confidential information, and so forth. These areas of the law tend to be mushy through-and-through. When applied to brokerage sector or the insurance industry, they constitute an outright morass. For example, it is extremely doubtful that one can, by contractual agreement, make something that is not a trade secret into a trade secret. That simple fact doesn't seem to deter everyone from trying, however. Similarly, the law of confidential information for data that is not quite a trade secret, is ephemeral, at best, and possibly non-existent.

The best way for an insurer to gain control over customer accounts is to subject the intermediary to a covenant not to compete. After all, the theme of sanctity of contracts is a strong one in our culture. Everyone teaches their children the importance of keeping promises. Exercising freedom is also a strong positive cultural value. Contracts are freely made, and hence sacred, sort of.

This is not the end of the story, however. Sometimes, big entities cram apparent choices down the throats of weaker entities. In those situations, the courts often create some protections. Often, the insurance intermediary is not an employee. When so, courts are often hesitant about enforcing such covenants. This observation is especially true when the intermediary has born substantial amount of the expense in developing the business.

Thus, at least in Texas, to be enforceable against an intermediary, a covenant not to compete must not only be reasonable, it must be really quite reasonable?perhaps even very reasonable. This is not the law found in law books. Nevertheless, it is the law every knowledgeable lawyer knows to be true. There is a difference between book-law and the law lawyers carry around in their heads.

Covenants not to compete against brokers that are only marginally reasonable at best are in general not enforceable. They are certainly not at all enforceable as written, although sometimes a court will take a pencil and reductively rewrite such a contract. Usually, it does this by limiting the length of time competition is proscribed, restricting the space in which it will operate, restricting it to customers only, and/or restricting the products to which it will apply.

Companies skirt the problem

Some insurance companies have gotten clever. Thus, some covenants not to compete are not formulated independent contractual provisions perhaps to be enforced through damage awards or injunction. Instead, they are written as negative conditions subsequent upon property interests. Thus, the insurer might operate some sort of deferred compensation fund for the intermediary. The agent's agreement specifies that the intermediary's right to payment from that account is extinguished if she violates what is, in reality, a covenant not to compete.

The power of this idea is lodged not only in its elegance but in the danger it presents. An insurer can?at least apparently?divest a breaching agent of substantial monetary rights without ever going to court. It simply refuses to pay, citing the contract and the breach. The agent then has to go to court to get her money. Usually, plaintiffs bear the burden of proof. This configuration of power is enough to make even the hearty gulp. Of course eliciting that reaction? or, perhaps, a full gasp?is exactly what the device is all about. Uncertainty is a powerful weapon the strong and continuing have against the weak and transitory.

Watch out!

Recently, one insurer came up with another twist on this idea. It went something like this, although not exactly.

The Colossus-Worldwide Insurance Company "made available" to its cadre of agents a computer system. Technically, the agent didn't have to buy the system at all, although if it did so it had a lot of other things to buy too: hardware, software, hookups, telephone line service, and so forth. What made buying the computer system somewhat less than optional was the fact that virtually all information the agents need is communicated quickly over the computer system and not quickly by any other means. As the coaches used to say, "If you want to play the game, you have to have the equipment."

Colossus charged each agent \$100 a month as a "service and support" fee for the use of the system, although the agents had to repair anything that went wrong with any implement not actually provided by Colossus. The System was a profit center, although the agents were not told this. Moreover, in order to get the system, the agents had to sign an agreement.

This agreement was entitled Automated Information System Service and Support Agreement for Colossus-Worldwide

Agents. It contained a most intriguing section smack-dab in the middle. Alas, it will have to be quoted at length:

At all times, the Colossus-Worldwide Computer System, is and will forever remain the property of Colossus. Each intermediary agrees not to copy, disclose, publish, release, transfer, or otherwise make available to any person any component of the system, any information about the system, any manuals for the operation of the system, or any information contained on the system, including but not restricted to any and all policyholder information. That information will not be maintained off the system in any form, and it will not be disclosed to any person in any form other than employees of the intermediary, employees of Colossus, and service personnel who work on the System. Each intermediary signing this agreement agrees that the System (hardware, software, manuals, policyholder information, and related documentation) are the property of and proprietary to Colossus.

And that's not all. The contract also contains an onerous indemnity clause:

Each intermediary agrees to protect and indemnify Colossus for any losses it sustains as a result of any unauthorized use or disclosure of any such material or information. Each intermediary also indemnifies Colossus for any act of any employee of the intermediary which would, if performed by the intermediary, constitute a breach of this section.

This contract is a scandal in a variety of ways. First, whatever lawyer drafted it ought to be disbarred for incompetence. It prohibits an agent from providing the policyholder information about himself. Furthermore, it prevents an intermediary from providing information to a third party at the policyholder's direction. This would include banks, finance companies, car dealerships, and the like, not to mention courts. It would also prohibit agents from assisting policyholders in providing information to other insurance companies. This section is utter madness in its generality.

The section is also sneaky. It is entitled Informational Security. Notice that the title says nothing about policyholder data. Also observe how the policyholder information restrictions are buried in the middle of routine propositions pertaining to software and manuals.

The section is also oppressive. It purports to make all information about every policyholder that is to any degree contained within the computer system "the property of and proprietary to" Colossus. An agreement does not explain what the difference between being the property of and being proprietary might be. Perhaps this is simply an inelegant redundancy. But property is a sort of thing that can be stolen, embezzled, converted, filched misappropriated, and made off with. When information is treated as someone's property, that fact suggest it is not easily accessible and that it is consequently secret. Classifying information as property is, therefore, the first step towards making information into a trade secret.

Perhaps the most shocking parts of this section are the indemnity agreements. Arguably, they require intermediaries to indemnify Colossus for its own negligence. If the use of information is not authorized and is the negligence of Colossus, by the literal terms of the agreement, the agent is still on the hook. Moreover, the agent has agreed to indemnify Colossus for the misconduct of her employees, even if she is not acting in cahoots with them.

These provisions are as crazy as they are unenforceable. Texas courts take a very dim view of brief and cryptic indemnity agreements buried in other agreements, whereby the indemnitor expressly or impliedly indemnifies someone else against his own negligence. Texas courts enforce such clauses only when they are clear, perspicuous and explicit.

Is this legal?

Speaking of enforceability, one wonders just how enforceable this new contract is when taken as a whole. Colossus issued it on a printed form, indicated that its intermediaries had two weeks in which to sign the contract or leave the company, and expressly ordained that no negotiations of any provision would be permitted under any circumstances. Contracts like this are often called "adhesion contracts" by poetically minded lawyers, because they stick to one. It is as though you are happening by on the sidewalk, and all of a sudden you find yourself in a contracted state?rather like having caught a communicable disease.

Modern courts don't much like contracts of adhesion when they involve complex, prolonged services and white collar workers. To borrow a phrase, they are likely void for vagueness. Nevertheless, contracts like this one are part of an overall strategy. The company may not intend actually to win a dispute brought under such a contract. What it is trying to do is deter lawsuits or to provide mechanisms for settling them along the way without having to adjudicate them.

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