LEGAL ASPECTS OF KNOWLEDGE MANAGEMENT

Business ethics, restrictions on employment and knowledge management

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Abstract

Purpose – The purpose of this paper is to address ethical and legal issues relating to employment contracts and the effect on knowledge transfer.

Design/methodology/approach – Relevant literature for business competition, learning and knowledge management and ethics were reviewed to prepare this paper.

Findings – This paper was an opportunity to express an opinion that employment contracts should reflect economic realities of both the employer and the employed to encourage high-ethical standards.

Practical implications – Employers and the employed may be encouraged to forthrightly discuss issues relating to ethics and competition in light of changing economic conditions.

Originality/value – This paper offers a self-help perspective for employees, making them more aware of employment contract terms and responsibilities. Employers may be encouraged to craft more progressive contracts to not only protect business proprietary information and maintain ethical integrity, but also assist employees in taking control of their futures.

Keywords Employment, Employment contracts, Business ethics, Information disclosure, Knowledge transfer, Social capital

Paper type Viewpoint

1. Introduction to the issue

Few businesses can ignore market’s influence on employee behavior, whether they are actively looking for new employment or holding fast while waiting for the next layoff. However, a business’s reliance on outmoded employee control mechanisms diminishes knowledge value. The US economy, in particular, depends on fluid knowledge transfer. Most companies acquire knowledge through asset purchases or by hiring experts in a particular industry. As I have discussed previously in other articles, the interests of companies, or knowledge acquirers (KA) and employees, or knowledge holders (KH) are often at odds[1]. This paper will address the balance of ethics and contracts to create a more robust knowledge economy. How successfully these interests are balanced will depend in large part on flexibility.

Many, if not all, employees with access to business proprietary information sign non-compete/non-disclosure agreements. In addition, professionals, such as engineers, architects and others, are bound to abide by a code of ethics promulgated by professional licensing organizations. Although violations of these codes are not actionable in court, licenses may be revoked by the granting organization if...
an individual does not adhere to the code. Professionals in many industries are, therefore, not only bound by the contracts they enter into, but also by professional responsibility guidelines.

I will first discuss the relationship between knowledge management (KM) and ethics.

2. KM and ethics
The link between KM and ethics is not intuitive. KM’s life blood is knowledge sharing. However, knowledge sharing in many situations may be unethical, if not illegal. If an employee has access to proprietary information, develops intellectual property (IP) for an employer, or signs a non-compete/non-disclosure agreement, sharing knowledge may be a breach of contract or breach of loyalty. In addition, employees may be restricted from sharing information because it would be unethical under professional responsibility guidelines. For government contracting activities, ethical guidelines are built-in and are part of the federal acquisition regulations or FAR. A useful example is embodied in a former Air Force Official, Darleen Druyun[2].

Since 2003, I have used the Darleen Druyun case as an example of what not to do while in the employ of either a government contractor or the government. Ms Druyun was a Key Administrator who used her position to negotiate a job for herself as well as her daughter and her daughter’s boyfriend (later son-in-law) at the Boeing Company, by granting lucrative contracts to the airplane manufacturer. In her effort to secure a new position after her retirement, she provided key proprietary information from Boeing’s competitors to Boeing which they, in turn, used in their bids. Her activities led to her own incarceration, that of her co-conspirator, as well as the resignation of Boeing’s President. The investigation of contracts granted to Boeing continues[3]. In fact, during the second quarter of 2006, Boeing reported a loss of $160 million which was due in large part to a $615 million settlement with the US Government over ethics charges.

She, more than anyone else on her team, knew the stringent rules of playing the government contracting game. Michael Sears, who also spent time in prison, is the private company example of what not to do when faced with hiring a person who not only brings knowledge and experience to an organization, but also substantial risk due to unethical behavior.

Druyun’s behavior was clearly unethical and illegal. She was not faced with the threat of losing her job due to downsizing, but rather, actively pursued an employment course of action leveraging her knowledge in order to pursue a new career. This activity resulted in incarceration as well as the loss of her hard fought for job. Whether an employee facing redundancy should be faced with the same consequences is the subject of the next few sections.

Knowledge-based businesses must have access to both tacit and implicit knowledge to remain competitive. In a competitive environment, companies are faced with making decisions that often border on illegal or unethical behavior. It is here, at the edge of ethics and contracts, where knowledge acquisition collides with the status of the KH. The KM architecture model pillar that may be most affected by ethics and contracts is learning.

Question:
• What can businesses do to ensure that knowledge acquired was not obtained via unethical means?
3. The learning pillar
The George Washington University has developed a KM architecture model which is represented graphically by four pillars supporting the knowledge enterprise. The four pillars represent leadership, organization, technology, and learning. For a business to benefit from knowledge, systems have to be put in place to facilitate the transfer of knowledge to others within the enterprise. Businesses are encouraged, if not mandated, to create learning environments.

Bixler (2002) explains the importance of organizational learning as follows:

Organizational learning must be addressed with approaches such as increasing internal communications, promoting cross-functional teams and creating a learning community. Learning is an integral part of knowledge management. In this context, learning can be described as the acquisition of knowledge or a skill through study, experience or instruction. Enterprises must recognize that people operate and communicate through learning that includes the social processes of collaborating, sharing knowledge and building on each other’s ideas. Managers must recognize that knowledge resides in people, and knowledge creation occurs in the process of social interaction and learning.

When businesses downsize, the remaining staff can do nothing but “muddle through.” Knowledge is lost despite a company’s best efforts to retain staff, but the market notices that lay-offs may indicate a deeper issue than merely cost cutting.

4. Current economy
The Bureau of Labor Statistics reported in February that employers took 1,672 mass layoff actions (Figures 1 and 2). Each of those actions involved at least 50 persons from a single employer. The February layoff events and related unemployment claimants were the highest since September 2005, which was after Hurricane Katrina.

![Figure 1.](http://www.bls.gov/news.release/pdf/mmls.pdf)
What these numbers to not reflect is the effect of layoffs on the knowledge transfer. Concentration solely on the bottom-line has a cost. According to Surowiecki (2007):

Downsizing may make companies temporarily more productive, but the gains quickly erode, in part because of the predictably negative effect on morale. And numerous studies suggest that, despite the lower payroll costs, layoffs do not make firms more profitable; Wayne Cascio, a management professor at the University of Colorado at Denver, looked at more than three hundred firms that downsized in the nineteen-eighties and found that three years after the layoffs the companies’ returns on assets, costs, and profit margins had not improved. It’s possible that these companies would have done even worse had they not downsized, but for the average company the effect of layoffs on the bottom line appears to be negligible.

Surowiecki concedes that costcutting, in and of itself is not necessarily bad. Even in a healthy economy, cutting costs is necessary and desirable, however:

The problem is that too many companies today define workers solely in terms of how much they cost, rather than how much value they create. This is understandable: after downsizing, it’s easier to measure a lower wage bill than it is to see the business the company isn’t getting because it has too few salesmen, or the new products it isn’t inventing because its R. & D. staff is too small. These lost opportunities may be hard to measure, but over time they can have a huge impact on corporate performance. Judging from its reaction to layoff announcements, the stock market understands this. It’s time executives did, too (Surowiecki, 2007).

Given this scenario, it is not surprising that employees devise ways to secure future employment. A wise job-seeker would do well to know employment terms as well as his or her own professional responsibility before pursuing employment with a current employer’s competitor.


Figure 2.
Mass layoff initial claims, seasonally adjusted, March 2003-February 2008
5. Non-competition and non-disclosure agreements

Securing the rights to knowledge via non-competition (non-compete) and non-disclosure agreements is commonplace. Not only do these agreements cover known IP that can be secured by government grant or use in commerce, but also any knowledge the firm considers “proprietary.” Most employees do not negotiate a fee for future unemployment as consideration for complying with non-compete and non-disclosure agreements.

Non-compete agreements prohibit an employee from working for a competitor and are looked upon with disfavor by courts in the USA because they affect trade by restricting an individual’s ability to find employment. Nevertheless, employees who acquire or have access to proprietary knowledge are frequently subjected to these agreements. By law, such a restriction is for a specific time period, within a certain geographic area, and is reasonably related to protecting the employer’s business interests.

Under employment-based non-disclosure agreements, an employee consents not to reveal any information learned during employment to anyone who may obtain a competitive advantage from such information.

Employers may seek an injunction or monetary damages when either agreement is breached. Absent a written agreement, and for “key personnel,” similar remedies may be sought under the legal theories of “breach of fiduciary duty/loyalty,” “misappropriation,” or fraud.

Non-compete/non-disclosure agreements are generally a “one size fits all” design. No matter how long an employee has worked with company, he or she is obligated to the contract terms, e.g. an employee who has been with a company for three months has the same non-compete/non-disclosure obligations as someone employed for over three years.

I recently shared some information with my students about the “duty of loyalty” and how employees are obligated to keep some information secret even when they are laid-off. To say they were outraged, would be an understatement. Why should they not be able to pursue positions with competitors if a company had laid them off? I explained that some enlightened companies may allow the terms to be modified, so a former employee can negotiate for a waiver to the contract terms. Otherwise, former employees are held to the terms of their bargain. Most employees do not look at their salary as not only pay for time worked, but also as consideration for promises made. In the example of non-compete/non-disclosure agreements, the employee’s salary is the consideration for keeping that promise as well as for work done.

Most employment agreements are “employment at will” where either the employer or employee can terminate the contract for any reason. This may seem unfair because employees do not have much negotiation power, especially when faced with a “take it, or leave it” proposition to sign a non-compete/non-disclosure agreement.

In a leading case, Advanced Marine Enterprise, Inc. v. PRC, Inc., 256 Va. 106; 501 S.E. 2d 148 (1998), PRC employees entered into non-compete and non-disclosure agreements. The employees were informed that PRC was going to sell the business and that some of its marine engineering employees should look for employment elsewhere. The marine engineering division was in touch with a competitor (prior to the announcement of a sale, but after being told to look for employment elsewhere) Advanced Marine (AME), to secure positions for the department. AME was aware of
the contracts entered into by PRC’s employees, but proceeded to make job offers. The marine engineering division and other managers resigned *en masse* on the same day resignations were tendered.

PRC filed a suit against AME, two AME executives, former PRC managers and other PRC employees for the following claims:

- breach of fiduciary duty;
- intentional interference with contractual relations;
- intentional interference with prospective business and contractual relations; and
- conspiracy to commit those acts[4].

PRC sought temporary restraining orders, which were granted, then later modified to exclude AME’s contracts with government entities. Ultimately, PRC won and was awarded treble damages as well as punitive damages.

How could the company on one hand tell employees to look for a job, and on the other, punish them for doing so?

As I have mentioned, the good will component of a company’s valuation includes the value of non-compete/non-disclosure agreements. Because PRC was in the process of selling its business, the departure of an entire division reduced the value of the company, even when that department, as indicated by the defense, only showed a profit of less than $50,000 in one year. The non-compete/non-disclosure agreements are, therefore, the personal property of the company.

The other component of this issue, though not litigated, was knowledge loss. When one person at a time leaves an organization, which PRC did not prohibit and, in fact encouraged, such an employee in such a specialized industry is likely to seek employment with a competitor. However, PRC did not intend to remain in the business after it experienced substantial losses, and, in fact sold the business. Who, then, are PRC’s competitors? The competitor’s of the future owners? Litton, PRC’s purchaser, was at one time a competitor.

In the case of professional engineers, their obligations go beyond an employment contract. The National Society of Professional Engineers promulgates a code of ethics to which PEs are required to adhere. Under the NSPE:

Engineers shall not reveal facts, data, or information without the prior consent of the client or employer except as authorized or required by law or this Code (NSPE Rules of Practice 1.c.).

And:

Engineers shall not disclose, without consent, confidential information concerning the business affairs or technical processes of any present or former client or employer, or public body on which they serve (NSPE Professional Obligations 4).

Under both sections, engineers are waived from adhering to the rules if prior consent is given. It is unlikely, however, that employees seek consent when faced with a company’s potential sale or lay-offs. A business’s behavior during a period of uncertainty can do much to assuage an employee’s fear, as well as increase its social capital to facilitate knowledge sharing whether or not an acquisition or layoff is pending. Offering employees an opportunity to negotiate the terms of a non-compete/non-disclosure at the outset or upon departure may eliminate
employees’ concerns about whether to approach an employer about a competitor’s offer.

Questions:

• How can an employee know who the competitors will be in advance of an acquisition or sale?

• What if the buyer does not go into the same business, and in fact, is really interested solely in other proprietary information, such as customer lists, and not the proprietary information about which a former employee has knowledge?

6. Social capital

Social capital represents the glue that binds networks together in order to realize a company’s potential. Whittaker et al. (2003) say that social capital enables knowledge transfer. How positive the relationship is amongst parties will determine the success of a knowledge transfer event:

If an individual believes another individual will act in their best interests […] they will feel motivated to exchange with them. They will feel that the exchange partner will not act opportunistically […] and they will reciprocate the favour […] If an individual has confidence in another’s ability to meet their obligations and perform a task […] they will anticipate the exchange will result in a positive and valuable outcome.

Subsequent to a mass layoff, social capital is inevitably lost, and may reduce any anticipated economic value. The:

[…] mere presence of firms, suppliers, and institutions in a location creates the potential for economic value, but it does not necessarily ensure the realization of that potential (emphasis added, Porter, 1998, p. 225).

When employment restrictions are inflexible, there is a loss to potential employers and employees.

7. Effects of restrictions on employment

Courts strive to balance the interests of businesses with employees. Restrictions on employment favor businesses because, the logic goes, employers would not be willing to invest in their employees or provide training or other benefits to them if employees could simply walk away and offer critical knowledge to a competitor. Arguably, such restrictions were devised when employees would stay with one company for an entire career. Employees today do not have that luxury.

From an ethical perspective, an employer may be faced with a Darleen Druyun situation where proprietary information was disclosed, resulting in losses in the millions, several hundred times over the salaries paid to the parties involved as well as any penalties paid by those who participated in criminal activities.

How the consequences to businesses and employees when there has been a breach of contract or ethical violation differ can be measured by the interest retained subsequent to a termination. Employers retain an interest in an employee beyond termination. If an employee is aware of a trade secret, has access to business proprietary information, or signs a non-compete/non-disclosure agreement, the employee can be bound to a former employer for years. An employee, however, holds no proprietary interest in a former company. So, for example, if a company does not
exploit a trade secret, other IP, or any other business advantage known by a former employee, not only is the knowledge held by the employee rendered useless, but also no other entity can benefit from the knowledge.

This is especially troublesome in industries where speed to market is critical and obsolescence beckons at the door. There is likely to be economic loss to an industry when employee knowledge:

- cannot be leveraged to the advantage of another business due to non-competition or non-disclosure agreements;
- is not exploited by an acquiring company and is, in fact suppressed; or
- and even more egregious, is unknown to the market.

Questions:

- Should employees refuse to sign non-compete/non-disclosure agreements? If so, should they refuse as a negotiating point for more pay, or refuse because they are not willing to hold their future hostage to the whims of a business organization?
- Should non-compete/non-disclosure agreements only be entered into with employees who would, due to the nature of their company position, have access to valuable business information?
- Should employees be told that the non-compete/non-disclosure agreements into which they have entered can be modified if that is indeed the company’s policy?
- Since non-compete/non-disclosure agreements are the personal property of a business, and represent value in either monetary or good will terms, should employees be compensated for that value if the company is sold?

8. Conclusion
At a time when corporate competitiveness depends on knowledge, businesses face the profound dilemma of knowledge loss, not due to employees “walking out the door,” but lay-offs and corporate restructuring. Entire divisions are wiped out, and like a complicated ecosystem, the effects may not be readily apparent. As businesses prepare for an impending lay-off, acquisition, or restructure, a KM system which contains a restrictive knowledge disclosure component cannot evolve with changing circumstances and may render such a system useless.

Businesses have a legitimate interest in keeping proprietary information close. Employees have a legitimate interest in remaining employable. Employment agreements which include non-compete/non-disclosure clauses should be more specifically tailored to economic realities of both parties.

How companies encourage employee participation in a KM system in advance, or in the wake of a corporate change is of increasing importance. Active employee participation in not only acquiring knowledge, but also passing that knowledge on to others in a supportive learning environment should be at the forefront of corporate restructuring. Permitting changes to non-compete/non-disclosure agreements may prove to be a fruitful negotiation tactic benefiting current employers, employees, future employers, and the economy.
Notes

1. Gayton (2006), “Legal issues for the knowledge economy in the twenty-first century”. A KA’s primary goal in the knowledge universe is to leverage intellectual capital to maintain a competitive advantage via licensing or upon acquisition or sale. A secondary goal is to keep knowledge from competitors. For the KH, the primary goal is to establish marketability as an employee or entrepreneur. The secondary goal is to sell or assign knowledge to the highest bidder.

2. See Statement of McNulty (2004), “Druyun was the Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management from 1993 until her retirement in November 2002. In that position she supervised, directed and oversaw the management of Air Force acquisition programs. This included negotiations in 2002 with the Boeing Company to lease 100 KC 767A tanker aircraft for the Air Force. The total value of this contract was projected to be in the range of $20 billion. From September 23, 2002 until November 5, 2002, Druyun participated personally and substantially as a government employee overseeing the negotiation of the lease from Boeing while she was at the same time negotiating prospective employment with a senior Executive of the Boeing Company. As a result of those negotiations, she accepted a position in January 2003 as Vice-President and Deputy General Manager of the Missile Defense Systems, a business unit of Boeing Integrated Defense Systems.”

3. The US Air Force decided to award a $25 billion refueling tanker contract to a partnership between EADS and Northrop Grumman. The Boeing Company decided to contest this decision which will likely delay the replacement of the US tanker fleet which was initially delayed due to the activities of Darleen Druyun (Weitzman and Sevastoplo, 2008).

4. “[a]ny two or more persons who combine, associate, agree, mutually undertake or concert together for the purpose of . . . willfully and maliciously injuring another in his reputation, trade, business or profession by any means whatever... shall be guilty of a Class 1 misdemeanor.” Section 18.2-500 provides a civil remedy for anyone who believes he or she has been “injured in his reputation, business or profession by reason of a violation of § 18.2-499.”

References


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