Spring 4-1997

Letter from RJM to Donald A. Daugherty, Jr. & Letter to RJM from Donald A. Daugherty, Jr.

Roger J. Miner

Donald A. Daugherty Jr.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

CHAMBERS OF
ROGER J. MINER
CIRCUIT JUDGE
UNITED STATES COURTHOUSE
445 BROADWAY, ROOM 414
ALBANY, NY 12207

April 28, 1997

PERSONAL AND UNOFFICIAL

Donald A. Daugherty, Jr., Esq.
Michael Best & Friedrich
100 East Wisconsin Ave.
Milwaukee, Wisconsin 53202-4108

Dear Don:

Many thanks for sending me a reprint of your article on physician covenants not to compete. I enjoyed reading it and think it will be helpful to all lawyers who practice in the rapidly growing area of Health Care Delivery Law. As you point out in the article, it formerly was a rare thing for a physician to sell his practice and then go to work for the purchasing entity. However, "the times they are a'changin'," and new law must be made to accommodate new situations.

As for the filling of the vacancy caused by my taking senior status, it seems that the President presently is facing a dilemma in regard to his appointments. According to news dispatches, the Republican senators want to change the emphasis in the advice and consent process, viz., they want to give more advice and less consent. Since they hold the majority, it will be interesting to see how the most current confrontation plays out. Meanwhile, the Second Circuit vacancies will remain unfilled.

Best regards to Jane.

Sincerely,

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April 10, 1997

The Honorable Roger J. Miner
One Merlin's Way
Camelot Heights
Hudson, New York 12534

Dear Judge Miner:

I enjoyed very much speaking with you last week, and I am glad to hear that you have rebounded from your heart troubles with great success. Although, it is unfortunate that Mr. Clinton will have an additional spot to fill on the Second Circuit, your senior status will give you a chance to relax and pursue your many interests.

I enclose a copy of an article I wrote that was recently published in the DePaul Journal of Health Care Law. I note that, as you will quickly see, the proofreading and general editing skills of the DePaul law students leave much to be desired. Nonetheless, I thought you might find the article to be of some interest, and, more importantly, I have a lot of extra copies. Happy reading and take care.

Very truly yours,

MICHAEL, BEST & FRIEDRICH

Donald A. Daugherty, Jr.

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Enclosure

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DE PAUL UNIVERSITY COLLEGE OF LAW
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ENFORCEMENT OF COVENANTS-NOT-TO-COMPETE AGAINST PHYSICIANS: BUYING THE PRACTICE AND EMPLOYING THE PHYSICIAN—WHAT RULES APPLY?

Donald A. Daugherty, Jr.

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ENFORCEMENT OF COVENANTS-NOT-TO-COMPETE AGAINST PHYSICIANS: BUYING THE PRACTICE AND EMPLOYING THE PHYSICIAN -- WHAT RULES APPLY?

Donald A. Daugherty, Jr.[*]

INTRODUCTION

One of the more significant legal issues implicated by the rise of integrated health care delivery systems relates to the use of covenants-not-to-compete. Because the value of a medical practice rests largely on the intangible talents of its physicians, noncompete clauses are an essential means of preserving the value of a medical practice as it transfers from seller to buyer. However, since noncompete clauses also have the effect of restraining a person from freely practicing her or her chosen trade, courts generally disfavor covenants-not-to-compete.[1] This is especially true when the covenantor is a physician because of the potential the covenant will interfere with patient relationships.

Nonetheless, most courts recognize and enforce covenants-not-to-compete in the context of the sale of a business (including a medical practice), as well as in employment agreements (including physicians' contracts). For the reasons discussed below, covenants included in contracts for in the sale of a business are enforced more liberally than those applying to an employment situation.

A recent problem regarding covenants, involves their use in a third "hybrid" situation: where a medical practice is sold and the selling physician then becomes an employee of the buyer. Given the disfavor with which courts view covenants-not-to-compete and the divergent treatment

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[1] Under common law, all contracts in restraint of trade were void as against public policy. Today, the doctrine has been relaxed, and a distinction between general and partial restraints of trade has been recognized by the courts. As discussed in greater detail in this article, while general restraints on trade are still void, contracts which constitute a partial and reasonable restraint are valid where supported by proper consideration. *See* Tarr v. Stearman, 264 Ill. 110 (1914); Pele v. Kulentis, 257 Ill. App. 213 (1930); Southwest Forest Indus., Inc. v. Sarfstein, 482 F.2d 915 (7th Cir. 1972); Field Surgical Assocs., Ltd. v. Shadab, 59 Ill. App.3d 991 (1978); Field, Lawter Intern, Inc. v. Carroll, 116 Ill. App.3d 717(1983); Cockerill v. Wilson, 51 Ill.3d 179 (1972); Firsch Corp. v. Ezzell, 25 Ill. App.2d 134 (1960); Match Corp. Of America v. Acme Match Corp., 285 S.E.2d 906 (W.Va. 1982).

A similar rationale has been relied on to justify the more liberal enforcement of noncompetition clauses in partnership agreements, where equal value is exchanged among the contracting parties since each partner not only commits herself or himself to the restrictions, but derives a benefit by exacting the same restrictions from every other partner.[10] For example, while the duration of a restrictive covenant in an employment agreement is generally unenforceable beyond two or three years,[11] restriction periods of five or more years in covenants that are ancillary to the sale of a business have been upheld.[12] This is especially significant as applied to the types of transactions discussed here, because the longer the period of restriction and the more secure the value of the acquired practice, the greater is the disincentive for the seller-physician to leave.[13]

Another example of the dissimilar treatment applied to covenants-not-to-compete depending on whether they are included in a contract involving the sale of a business, or an employment agreement, is the rule in certain jurisdictions that does not allow covenants included in employment contracts to be reformed by a court so as to render them enforceable. Reform is, however, permitted for covenants encompassed in a contract for the sale of a business.[14] Other examples of this disparity include Colorado and California statutes that both prohibit the use of noncompete covenants for certain employees except in the sale of business context,[15] and the courts of Louisiana and Alabama which exempt restrictive covenants contained in partnership agreements from statutes prohibiting covenants in connection with employment agreements.[16]

One of the most instructive decisions of how the courts treat the issue of non-compete covenants in the employment and sale of business context

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[10] Pittman v. Harbin Clinic Prof'l Ass'n, 437 S.E.2d 619 (Ga. Ct. App. 1993).

[11] Hammer Holding Group, Inc. v. Elmore, 613 N.E.2d 1190 (Ill. App. 1993).

[12] *Id., see, e.g.,* Sobers v. Shannon Optical Co., 473 A.2d 1035 (Pa. 1984); Betten Co. v. Brauman, 18 Wis. 203, 208 (1935); HBG Corp. v. Houbolt, 367 N.E.2d 414, 432 (N.C. App. Ct. 1977).

[13] MedX, Inc. of Fla. v. Ranger, 780 F. Supp. 398 (E.D. La 1991); Reddy v. Community Health Found., 298 S.E.2d 906 (W.Va. 1982).

[14] *See, e.g.,* White v. Fletcher/Mayo/Assocs., Inc., 303 S.E.2d 746, 749 (Ga. 1983).

[15] CAL. BUS. AND PROF. CODE § 16600 (1995); 1982 Colo. Sess. Laws, ch. 41 at 232.

[16] LA. REV. STAT. ANN. § 23:921 (West 1995); ALA. CODE § 8-1-1 (1995); *See* McCray v. Blackburn, 236 So. 2d 859 (La. 1970).

is the non-physician case of *White v. Fletcher\Mayo\Associates, Inc.*[17] In *White*, the plaintiff was the vice president and a 5 percent shareholder of an advertising agency.[18] When the agency was purchased by a company who then became his employer, White sought a judicial declaration voiding a noncompete covenant he had signed when first employed by the agency.[19] While the purchasing company sought to have the covenant construed as part of the sale of the business (in which transaction the plaintiff had sold his stock), the plaintiff sought to have it construed as part of his employment agreement.[20]

In analyzing the controversy, the *White* court stated, "[I]t is problematical whether his profit [on the sale of stock] constituted consideration for his covenant-not-to-compete, or whether the sole consideration flowing to [the plaintiff] in return for the covenant was his continued employment.[21] The court went on to hold that:

> where a trial judge is asked to determine the enforceability of a noncompetition covenant which the buyer of a business contends was given ancillary to the covenantor's relinquishment of his interest in the business to the buyer, and not given solely in return for the covenantor's continued employment, *the judge must determine the covenantor's status. If it appears that his bargaining capacity was not significantly greater than that of a mere employee, then the covenant should be treated like a covenant ancillary to an employment agreement . . . .*[22] (emphasis added).

In making this analysis, the *White* court found that White's bargaining power was no more than that of an ordinary employee and, thus, treated the noncompete clause as ancillary to White's employment contract.[23]

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[17] White, 303 S.E.2d at 749.
[18] *Id.* at 746.
[19] *Id.* at 747.
[20] White v. Fletcher/Mayo/Assocs., Inc., 303 S.E.2d 746, 747 (Ga. 1983).
[21] *Id.* at 750.
[22] *Id.* at 751.
[23] *Id.*

COVENANTS-NOT-TO-COMPLETE: EMERGENCE OF A HYBRID IN PHYSICIAN CASES

The rationale articulated in *White v Fletcher/Mayo Associates, Inc.*[24] has also been applied by the Georgia courts to cases involving the enforcement of noncompete clauses against physicians, most notably in *Pittman v. Harbin Clinical Profession Ass'n.*[25] In *Pittman*, a group of five neurologists and neurosurgeons sought a judicial declaration to render unenforceable the covenants-not-to-compete in their employment contracts with their former employer, a professional association clinic.[26] Two of the plaintiff-physicians had been shareholders in the clinic, while the other three physicians were strictly employees of the clinic and held no ownership interest.[27] The shareholder noncompete clauses prohibited the practice of medicine within thirty miles of the clinic for one year after leaving the clinic, but allowed the covenantor to buy out the restriction by paying a specified amount to the clinic.[28] The non-shareholder clauses were identical, except that the restricted area encompassed a fifty mile radius from the clinic, and required a lesser sum to buy out the covenant's restrictions.[29]

After examining the employment covenants, the *Pittman* court upheld the enforceability of the noncompete clauses against the shareholders; but the court found them unenforceable against the non shareholders.[30] The court found the terms of the covenants among the shareholders reasonable. In addition, the court found that although the agreements signed by the shareholders were denominated as "employment contracts," by executing the agreements, the shareholders not only agreed to restrict themselves to the covenants' terms, but obtained promises to do the same from the approximately thirty-five other physician-shareholders who executed identical contracts.[31] Thus, the court found the bargaining power

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[24] *Id.* at 746.

[25] Pittman v. Harbin Clinic Prof'l Ass'n, 437 S.E.2d 619 (Ga. Ct. App. 1993).

[26] *Id.*

[27] *Id.* at 621.

[28] *Id.*

[29] *Id.* at 623.

[30] *Id.* at 621-623.

[31] Pittman v. Harbin Clinical Prof'l Ass'n, 437 S.E.2d 619, 621-623 (Ga. Ct. App. 1993).

of the shareholder-plaintiffs was equal to that of those with whom they contracted, and the agreements were more analogous to medical partnership agreements than traditional employment contracts.[32]

With regard to the non shareholder employee physicians, the court examined the covenant's prohibitions, which included forbidding the physicians from practicing within fifty miles of the clinic. The court detemined that although the fifty mile radius was not *per se* unreasonable, because it was included only in the contracts of the non shareholder physicians whose bargaining position was significantly less than that of the clinic, stricter scrutiny of the covenant terms was required.[33]

Although the bargaining power factor set forth in *Pittman* has not yet been expressly adopted or applied to enforcement of physician noncompete clauses in other jurisdictions, several other courts have also considered the treatment of noncompete clauses agreed to by physicians who have then sold practices and become employees of the purchasing entity.[34]

For example, in *Boulder Medical Center v. Moore,* the plaintiff physician was part of a partnership which transferred its business to a corporation and then dissolved itself, at which time the purchasing corporation then employed the physician.[35] When the plaintiff chose to leave the corporation one year after the transaction, the corporation sought to enforce the covenant included in the physician's original employment contract.[36] The *Moore* court enforced the covenant upon finding that the physician not only owned an interest in the medical practice itself, but in the original partnership that still owned the equipment used in the practice, and in a corporation that owned the land upon which the clinic was located.[37] The court also examined the fact that upon the physician's

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[32] *Id.* at 621-622.

[33] *Id.*

[34] *See, e.g.,* Isuani, M.D. v. Manske-Sheffield Radiology Group, 798 S.W.2d 346 (Tex. Ct. App. 1990) (discussing the radiology partnership which brought suit seeking to enforce noncompete agreement against one of its partners); Jewett Orthopaedic Clinic, P.A. v. George M. White, M.D., 629 So.2d 922 (Fla. Dist. Ct. App. 1993); Rajiv Chandra, M.D., v. Gopal Dadodia, M.D., 610 So.2d 15 (Fla. Dist. Ct. App. 1992) (discussing a doctor and medical group which brought action seeking, *inter alia*, preliminary injunction to enforce noncompetition agreements contained in separated employment contracts with physicians).

[35] Boulder Medical Ctr. v. Moore, 651 P.2d 464, 465 (Colo. Ct. App. 1982) (predating state statute voiding injunctive relief under noncompete clauses in physician employment agreements).

[36] *Id.*

[37] *Id.*

departure, he was entitled to payment for his interests from all three entities, a circumstance which undermined the physician's assertion that he had not sold his business when he left.[38] Therefore, the *Moore* court held the covenant, which prohibited the physician from practicing medicine in Boulder County for five years after his departure, was enforceable since it fell within the sale of business exception to the state statute voiding certain covenants-not-to-compete.[39]

Similarly, in *Cardiology Assocs. of Southwestern Michigan, P.C. v. Zencka*, a group of cardiologists sought to enforce a noncompete covenant against the defendant cardiologist who was a shareholder in the plaintiff-professional corporation. The defendant had signed both an employment contract and a stock redemption agreement that included the covenant. The latter agreement was required under the stock ownership provision of the employment agreement.[40] Both agreements were executed by the defendant-cardiologist when he became a shareholder in the plaintiff-professional corporation.[41]

In *Zencka,* the court focused on the nature of the signed agreements and concluded that they constituted an employment contract with the sale of stock incident to the employment, rather than a sale of an interest in the cardiology practice with employment incident to the sale.[42] The *Zencka* court looked to the first employment contract signed by the defendant, requiring that if the defendant were to continue his employment beyond expiration of the contract, he would have to purchase stock in the corporation.[43] The court rejected the plaintiff's contentions, finding that the stock redemption did not effect a complete transfer of the corporation's business, equipment or patient list[44]; and, furthermore, the defendant was

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[38] *Id.*

[39] *Id.*

[40] Cardiology Assocs. of Southwestern Michigan, P.C. v. Zencka, M.D., 400 N.W.2d 606 (Mich. Ct. App. 1985).

[41] *Id.*

[42] *Id.*

[43] Echoing *Pittman*, the court noted additional supporting factors of the employer-employee relationship between the plaintiff and defendant, and the fact that the covenant-not-to-compete did not apply to the two other cardiologists in the group, who were senior to the defendant. *Id.* at 606-610.

[44] *Id.*

merely reselling that which he had initially purchased from the corporation rather than a separate business interest or goodwill.[45]

Finally, in *Bosley Medical Group v. Abramson*, a hair replacement clinic sued a former physician-employee, claiming he had breached a covenant-not-to-compete in a stock purchase agreement he had entered into with the clinic.[46] At the outset of his employment, the physician had been given a stock purchase agreement, along with an independent contractor's agreement.[47] He was advised that he would have to execute both in order to practice with the group.[48] The stock purchase agreement required that he buy nine shares of the clinic's stock, representing an interest in the corporation of nine percent, at a price of ten thousand dollars.[49] Seventy-three percent of the corporation's stock was held by a single individual who was the president and director.[50] The agreement required that the physician sell back the shares if he left the clinic[51] and contained an additional covenant under which the physician agreed not to engage in a similar practice within certain counties for three years after leaving the clinic.[52] When the physician left two years later and immediately opened his own hair transplant practice nearby, the clinic sought an injunction.[53]

The *Bosley* court held that the non-compete covenant was void and agreed with the physician that the stock purchase agreement he was required to sign upon his employment was a sham devised to fit within an exception of California law that prohibits agreements that restrict the practice of a business or profession.[54] Like the statute in *Moore*, the California exception permits covenants only when the sale of a shareholder's stock involves a substantial interest in the corporation such

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[45] *Id.* at 610.

[46] Bosley Med. Group v. Abramson, 161 Cal. App.3d 284, 287 (2d Dist. 1984).

[47] *Id.*

[48] *Id.* at 286.

[49] *Id.* at 287.

[50] *Id.*

[51] *Id.* at 287.

[52] Bosley Med. Group v. Abramson, 161 Cal. App.3d 284, 287 (2d Dist. 1984).

[53] *Id.*

[54] *Id.* (concluding that "the provision contained in the stock purchase agreement that Defendant will not compete ... is void and unenforceable").

that it constituted a transfer of goodwill.[55] The *Bosley* court concluded that the agreement signed by the physician that required his purchase of stock did not qualify under California law because it was not intended to benefit the physician, since the stock represented only a limited interest in the clinic from which he would not produce a reasonable return.[56]

The *Bosley* court was also convinced of the sham nature of the stock purchase simply because the agreement's stated purpose made little sense. The agreement purported to provide the physician with "additional incentive" to achieve a professional relationship between himself and the clinic.[57] The court dismissed this as pretextual since the clinic had told the physician that his annual salary would be at least $200,000; and, thus, it was questionable whether a mandatory purchase of $10,000 in stock would create any additional incentive.[58] Moreover, the "professional relationship" sought by the clinic was already assured by the independent contractor agreement that governed the parties' conduct.[59]

PRACTICAL CONSIDERATIONS FOR THE PRACTITIONER

In light of the above discussion, parties involved in the formation of integrated delivery systems, physician-hospital organizations and other health care entities that require the purchase of practices and employment of selling physicians, should be cautious in devising covenants-not-to-compete. A critical factor in enforcing covenants in these situations is the bargaining power of the covenantor, as shown in *Pittman* and the other cases analyzed in this article. An employer will have a more convincing argument that broad restrictions should be enforced against a partner or equity holder in the selling entity, while the argument will be less persuasive with regard to mere employees or associate physicians of the selling practice. Similarly, it may be argued that a shareholder-physician

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[55] *Bosley Med. Group*, 161 Cal. App. 3d at 287 (quoting CAL. BUS. AND PROF. CODE. § 16601 (West 1995)); Boulder Med. Ctr. v. Moore, 651 P.2d 464 (Colo. Ct. App. 1982)(citing COLO. REV. STAT. § 2 (1973)).

[56] *Bosley Med. Group*, 161 Cal. App. 3d at 290.

[57] *Id.* at 291.

[58] Bosley Med. Group v. Abramson, 161 Cal. App. 3d 284, 291 (2d Dist. 1984).

[59] *Id.*

in a large clinic has little bargaining power vis-a-vis the purchaser of a clinic, since he or she is merely one of numerous equity holders with a minor ownership interest. Physicians in such situations may be more successful in arguing that the covenants-not-to-compete as applied against them are enforceable only if they comply with requirements of employment covenants.

In addition, the law of the local jurisdiction must be consulted to be certain the restrictive terms (*e.g.*, time, geography) are reasonable.[60] Moreover, drafters should keep in mind that the stronger the argument that the covenant is part of the sale of assets, the more likely the purchaser will be able to enforce broader restrictions in the event physicians attempt to leave once the transaction has been consummated.

To ensure that a covenant is ancillary to the sale of the practice, the covenant should be included in the purchase documents. An additional covenant still may be required in the employment agreement in order to restrict physicians who leave once the covenant in the purchase documents has expired.[61] For example, in the formation of a physician-hospital organization through a hospital's acquisition of a clinic's assets, which clinic remains in existence solely to function as the asset-less employer of the physicians, broader covenants-not-to-compete could be included in the asset purchase agreement between the hospital and clinic; on the

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[60] The sale of a medical practice also must be structured so that it complies with the Federal Stark II, 42 U.S.C. §1395 (1996), and Anti-Kickback statutes, 42 U.S.C. §1320a-7b(b) (1996). Under these statutes, payment received for goodwill and other intangible assets (the value of which a covenant-not-to-compete serves to protect) could be characterized as illegal compensation or remuneration. To reduce the risk of violating these patient referral statutes, a buyer should obtain written opinions from qualified, independent appraisers that its acquisition is at fair market value and document its due diligence review of practice operations, earnings history and balance sheet assets. Similarly, a buyer should document any competing offers for the acquired practice.

[61] As with the purchase of the a medical practice, *see supra* note 60, employment of a physician must also be structured to comply with Stark II and Anti-kickback statutes. For example, the latter statute contains an exception to its prohibitions where a bona fide employment relationship exists, *see* 42 U.S.C.§1320a-7b(a)(3) (1996); the regulations defining the term "employee" as used in this exceoption relies on the meaning used by the IRS, *see* 42 C.F.R. §1001.952(i) (1996)(citing 26 U.S.C. §3121(d)(2) (1996)), and thus a W-2 employment relationship is required. Similarly, Stark II provides an exception for employment arrangements where (1) the emploment is for identifiable services; (2) The remuneration is consistent with fair market value for the services rendered and does not take into account the volume or value of referrals by the physician; (3) the agreement would be commercially reasonable even in the absence of any referrals to the employer; and (4) the employment meets the requirements of other applicable regulation. 42 U.S.C. §1395nn(e)(2) (1996).

otherhand, while the clinic could have narrower covenants in the employment contracts. A potential problem with this approach is that a court could conclude that the imposition of two different covenants against an individual is improper and overreaching. The law of the local jurisdiction should be reviewed to determine how to handle this issue.

Finally, in addition to covenants-not-to-compete, another method of promoting continued physician employment after consummation of a deal is through the use of a deferred purchase price or compensation arrangement. An asset purchase agreement can provide that, besides the purchase money paid at closing, a selling physician's interest in any deferred purchase price will vest incrementally over time after the deal closes. For example, the agreement could require that in order for a physician's share of the deferred purchase price to vest fully, the physician must remain employed by the new entity for a five year period.

CONCLUSION

At this point, a relatively small number of cases involving the hybrid situation exists in which a medical practice is sold and the selling physician becomes an employee of the buyer. However, from the cases reviewed above, it is clear that in integrating physicians and their practices into larger provider entities, parties must exercise caution in drafting covenants-not-to-compete physicians within whom they contract. An important consideration in determining the reasonableness of the covenant's terms will be the bargaining power of the covenantor-physicians, as well as the substance of the specific transaction in which the covenant is included.