PHYSICIAN COVENANTS NOT TO COMPETE

Many of my physician clients and I have discussed the trend seen in the courts and legislature disfavoring covenants against competition. Often, covenants are written in such a manner that the courts declare them an unreasonable restraint on trade. In the alternative, the courts look to the allocation of medical specialists in a specific geographic area and consider the needs of the community and voids a covenant against competition as a violation of public policy. Even if the covenant meets the legal criteria of the courts and is declared enforceable, the employing practice often finds that its legal remedy is inadequate. The practice must “prove” its damages. When the practice considers the difficulty in developing proof with the use of experts, the time the physicians must be away from the practice in depositions and court, the legal costs and attorneys’ fees, it hardly seems worthwhile pursuing an employee physician for violation of his covenant against competition.

Despite the problems with covenants against competition, a medical practice has a legitimate business interest in protecting itself from the financial hardship incurred when a new physician employee leaves the practice, particularly when he or she opens a new practice “down the street.” The addition of a new physician to your practice requires a tremendous use of practice resources, involving both financial and personal commitment from the practice, its professionals and staff. Often there are large outlays of cash or the practice acquires significant long-term indebtedness and lease obligations for additional facilities or equipment. Adding a new physician also requires the addition of new personnel, facilities and amendments of service contracts, each bearing actual and hidden costs. Thus, a prudent practice must consider some method of legitimately protecting its financial interest when recruiting and contracting with new physician employees. Fortunately, a recent case decided by the North Carolina Court of Appeals may provide your practice with a solution to this problem.

In *Eastern Carolina Internal Medicine, P.A. v. Faidas*[1]**,** the practice's primary area of service covered three counties. The practice's contract with the physician employee did not contain a traditional covenant against competition. Typically, a covenant *prevents* or *bars* a physician from practice in a specific geographic area for a specified period of time. In this case, upon her termination, the physician employee was allowed to practice in the three-county area, however, her contract provided that if she chose to do so, during the first year following her termination, she would pay "liquidated" damages. The physician employee argued that such a provision was an unreasonable restraint on trade and her ability to practice her profession and that the damages were an unreasonable penalty. The court disagreed. The physician was required to pay liquidated damages based upon a "Cost Sharing" analysis.

Liquidated damages are preset amounts of money that an individual is required to pay in the event that he fails to keep a contractual promise. The amount of damages are agreed upon at the time the parties enter the contract and must be based upon a reasonable attempt by the parties to determine in advance the amount of actual damages, even though such a determination is difficult. If the parties fail to make such an attempt to determine the actual damages, the court could view the damages as punitive and refuse to uphold damages designed to penalize the physician employee for practicing his profession.[2]

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[1] 149 N.C. App. 940, 564 S.E.2d 53 (2002), *aff'd* 356 N.C. 607, 572 S.E.2d 780 (2002).

[2]*Id.* at 8 (citing *City of Kinston v. Suddreth*, 266 N.C. 618, 620, 146 S.E.2d 660, 662 (1966)).

In *Eastern Carolina Internal Medicine, P.A.*, the practice's contract with the physician employee set out a formula for liquidated damages based upon the overhead incurred by the practice after employing the new physician. The physician signed the contract agreeing to pay an amount based on a pro rata share of the overhead for the fiscal year of the Practice immediately preceding the year in which she terminated her employment. The accepted this as a reasonable method of determining liquidated damages and did not view it as a penalty.[3]

When setting a formula to determined liquidated damages, there are other factors to consider as well as the practice overhead. You should also consider the initial costs incurred in the recruitment and hiring process. What will you pay in legal expenses? Will you use a recruiter? Will you expand your facilities and add additional equipment? Consider the hidden costs as well as your out of pocket expenses. For example, how many hours will it required your office manager to complete the paperwork for credentialing your new physician? How long will it take your staff to train new employees? These are expenses you will incur before your new physician sees his first patient. All these factors should be considered in developing a "Cost Sharing Analysis" for liquidated damages.

When your practice adds a new physician, I recommend you consider such a provision in your contract, rather than the traditional covenant against competition. The Practice will not be able to prevent the physician employee from leaving and practicing in the immediate area. However, such a provision will provide a strong disincentive for most physician employees when considering whether to open a practice in the restricted area. Furthermore, you are more likely to prevail in any legal action to recoup the practice's costs in bringing the physician to

[3] *Id*. at 5, 146 S.E.2d at 944.

your practice. One word of caution, if your practice currently has physician employees' under contract, you cannot change their employment contract without additional consideration. If the practice decides that it would like to amend the employment agreement to include a Cost Sharing Analysis for liquidated damages, the amendment needs to be tied to a bonus or salary increase or some other item of value.