

## Chapter 5

### **USING RESTRICTIVE COVENANTS FOR THE ASSOCIATE AND DEPARTING OWNER**

The primary value of any practice is its patient and/or referral base. In order to protect the patient and/or referral base, restrictive covenants are used as a tool to ensure that the parties to an associate employment relationship, sale and acquisition, associate buy-in or owner buy-out live up to their promises.

#### **Enforcement**

Enforcement of restrictive covenants vary from state to state. Irrespective of enforcement, restrictions between owners where consideration is paid for a practice or practice interest is more likely to be upheld than is a restriction relative to an employment relationship. The rationale is that restrictions for employment of a doctor are inconsistent with public policy in allowing the public to receive professional treatment. This, however, depends upon the particular state's statute and/or case law, the reasonableness of restriction(s), the facts of the case and the damage, if any, sustained by the practice.

Associate employment, sale and purchase, associate buy-in and owner buy-out restrictive covenant provisions share common prohibitions as to: (i) time; (ii) geographical radius; (iii) non-disclosure of confidential information, e.g., patient lists and/or referral sources; (iv) non-solicitation — of patients, referral sources or employees of the practice. Such restrictions may be in effect both during any employment term of the doctor and for some period of time thereafter.

#### **Associate Employment Relationships**

These restrictions are the toughest to enforce as the associate has no equity in the practice and the relationship between the practice owner and associate is one of employer/employee. If the associate doctor is classified as an independent contractor, it may be arguably more difficult to enforce a restrictive covenant than if the doctor/worker is classified as an employee.

It's advisable to have the associate employment agreement signed which contains restrictive covenants prior to the employment commencing. The reason for this is that all contracts have consideration on both sides. In exchange for the associate's compensation, the associate promises to perform professional services and not to compete with the practice, solicit patients, referral sources or employees and not to retain or disclose confidential information. In the event that the employment begins working and the associate is receiving compensation in exchange for services rendered, there is arguably no consideration for the associate's later promise not to compete after the employment term commences. If the associate started working without signing the employment agreement with the restrictive covenants, a way to resolve the problem is to provide a meaningful signing or annual non-competition bonus. This may provide consideration for the associate doctor's later promise to sign the restrictive covenant provisions. In the event that the associate may work at a second practice during the term of employment or if the employment is less than full-time, any ability to render professional services at another practice in or outside of the restricted area should be specified in the employment agreement. The

agreement may merely specify that the employer may, should the practice choose, grant or consent to such other employment in writing. In a full-time position, all revenues generated by the associate may be considered property of the practice if specified in the employment agreement.

One of the most difficult, but interesting restrictive covenant problems, is where the practice desires to protect itself from competition and dilution of value in the event the associate relationship does not workout, yet the associate grew up or resides in the same community where the practice is located. Protecting the practice, versus the ability of the associate to remain employed in the employee's hometown or place of residence, are competing goals. Usually, balance can be found with compromise, effort and all parties being reasonable. One way to effectively resolve this problem is to utilize a liquidated damage provision, whereby if the associate leaves the practice and works or sets up a practice within the restricted area, the associate would purchase his or her goodwill based on annualized production, e.g., 37% of one year's production. The liquidated damages provision would usually be a higher amount the longer the associate remains in the practice due to the associate's ability to attract patients and/or referral sources. This is one of the few instances where I recommend a liquidated damage provision and it would equal the goodwill produced by the associate.

Because courts typically look at the reasonableness of the restrictions to protect the legitimate interests of a business/practice, the court may consider the restrictions as overly broad. Certain states allow "blue pencilling", whereby the agreement containing the restrictions may contain language which allows the court to reform the restrictions to what it considers reasonable rather than to not enforce the restrictions as all or nothing. Courts usually enforce contracts only within "the four corners of the contract" and do not permit the parties to the contract to present outside or parole evidence, except in certain instances. This is especially true if the contract contains an "integration" provision which states that the entire agreement is contained within the written contract. Therefore, if the state allows blue pencilling, the employment agreement should provide specific language granting the court the power to reform the contract if the court determines the restrictions as overly broad.

Sometimes associate employment agreements contain "liquidated damages" as a deterrent to competition by the associate if the working relationship is unsuccessful. While a liquidated damage provision can relate to the value of the practice goodwill attributable to the associate, the court may not grant actual damages or an "injunction", which would prohibit the associate from competing if the liquidated damage provision is present. Too often, employment agreements contain extraordinarily high liquidated damage provisions, which are used as deterrents. These amounts have no bearing to the reality of the working relationship with the associate. It's questionable whether an extremely high liquidated damage amount would even be upheld. However, I would not recommend paying an attorney to find out.

The bottom line is don't sign what you don't agree to. I routinely get calls from unhappy associate doctors who question where the restrictive covenant provisions which they never meant to agree to, but signed, would be upheld. Since the agreement is already signed, the associate must live with what was agreed to.

The associate agreement should provide that the associate is not bound by any other employment agreement, particularly one which prohibits non-competition. If you are the hiring doctor, particularly if you have actual knowledge of a prior agreement, which restricts the associate from working in your practice, you and/or your practice could be liable to the other practice for intentional interference with contract.

Finally, the associate should not be overly intimidated by agreeing to reasonable restrictions to adequately protect the employer/practice. Without agreeing to such a protection for the practice, the associate probably won't get the job and the practice owner will be reluctant to introduce patients and/or referral sources. Further, assuming that the associate relationship is successful, the practice owner will later to be subject to similar restrictions in the event that the practice is acquired or the doctors become co-owners.

### **Sale and Acquisition**

Another component of any practice sale and acquisition is the agreement by the selling doctor not to compete, in any entity, with the purchaser's newly acquired practice.

The time and geographic boundaries are typically more stringent than in associate employment agreements due to the purchaser's payment of consideration, the purchase price, for the practice; e.g., time - five years versus two years, geographical radius 15-20 miles versus 2-10 miles.

The restrictive covenant should be drafted to restrict the selling doctor during the period of time such selling doctor renders professional services on behalf of the purchaser's practice. It should also run for the time period agreed to beginning on the date when the selling doctor ceases to render services on behalf of the purchaser's practice. For example, one doctor worked for the purchasing doctor's practice just over 5 years. The purchaser fired the selling doctor thinking that the restrictive covenant was in effect. In reality, the 5 year period commenced on the closing date for the sale and acquisition, not on the date when the seller's employment was terminated by the purchasing doctor's practice. The selling doctor who remained in good health, bought a small practice a short distance from the purchaser's practice, hired former staff members and ended up treating all former patients whom he desired to treat. This situation was not intended by the purchasing doctor who had just relocated the acquired practice to an expensive new facility. The covenant period should have commenced when the selling doctor ceased to render services on behalf of the purchasing doctor's practice.

Many selling doctors do not want to sell their practices without the ability to continue to work on a limited schedule. While this factor may impact the determination of the purchase price and when it is paid, a phased in retirement can greatly assist the purchasing doctor to retain patients and seems to be a reasonable request. If, however, the selling doctor's employment is inappropriately terminated by the purchasing doctor's practice, a provision may be contained in the selling doctor's employment or independent contractor agreement, as the case may be, may provide that upon inappropriate termination, the selling doctor's restrictive covenants would be null, void and without effect.

In the event that the seller finances all or a portion of the selling price, the sale and acquisition documents should contain a "reverse covenant" whereby upon an uncured default by the purchasing doctor in the payment of the purchase price, such purchaser would be excluded from practicing dentistry in competition with the acquired practice according to the terms and conditions on which the seller had agreed not to compete with the seller's former practice. In a purchase or default, the selling doctor's restrictive covenants would be null, void and without effect. Of course, the selling doctor would also need access to patient records, the right to enter the practice facility and the ability to take over the facility lease.

### **Associate Buy-Ins and Owner Buy-Outs**

In co-ownership arrangements, all doctors in the practice are typically prohibiting from competing. The rationale here is that a buy-sell agreement should be in place which would dispose of an owner's interest in the event of death, permanent disability, retirement or termination of employment for any reason. In death, the departing doctor cannot compete. In permanent disability, the disabled doctor could compete if the disability would no longer exist, e.g., hand problems. Retirement, as a defined term, often triggers a mandatory buy-out and the practice or purchasing doctor(s) would not desire for the retired doctor to compete. If a doctor elects to depart from practice and terminates employment, the other doctor(s) or practice may have the option to acquire the interest of the departing doctor. If the would not be exercised, the departing doctor would attempt to sell his or her interests to a third party candidate, with authorization of the remaining doctor(s). In such case, neither the third party incoming doctor nor the other doctor(s) in the practice would desire for the departing doctor to compete.

Upon an owner's retirement, the retiring owner's interest would typically be purchased by the remaining doctor(s), through an obligation, as opposed to an option. In any buy-out, the remaining doctor(s) would not desire for the retiring owner(s) to compete. Notwithstanding the necessity of strongly written restrictive covenant provisions, the remaining doctor(s) should consider making the retiring or departing doctor(s) payments for any practice interest contingent upon compliance with the non-competition provisions. Payments by the practice or remaining owner(s) to the retiring or departing doctor are usually paid over time. This is in contrast to cash in full at closing in a complete sale and acquisition of a solo practitioner.

Termination of employment for any reason, including dispute, may trigger a penalty buy-out provision, yet the restrictive covenants would remain in place for any buy-out of an owner.

Sometimes the doctor(s), owner(s) will agree not to practice together and will retain their respective patient and/or referral basis, split the tangible assets and retain their own practices. In such case, restrictive covenant provisions would not be in effect as no doctor is bought out.

There are several instances where restrictive covenant provisions can be used to protect the practice. While usually applicable to associates and owners, it is advisable to restrict staff members from disseminating confidential information. The patient base is both valuable and confidential and downloading confidential practice information is easier than ever today.