Board Action Item

Res-5-P- Non-compete or Liquidated Damages Clauses in Physician Employment Contracts

The Board approved the COL motion and the staff recommendation

The Council on Legislation voted unanimously to recommend to the BOD that CMS pursue legislation, time discretion with staff.

Staff Recommendation: The issue needs considerable work before legislation is filed. Staff prepared this document for COL as a "First Discussion". The questions posed, numbers 1-7 below, have not been adequately answered in our opinion. Staff recommends that the issue be referred to the Membership-Unity-Relevance (employed physician) work group for additional study and research, with a report to the board in July.

Background:

Res-5-P resolves CMS to task COL to pursue legislation that makes non-compete (liquidated damages) clauses unenforceable in instances when a physician is terminated from an employment contract using the without cause reason for termination." This resolution is the result of a health system's without cause termination of several physicians and enforcement of the non-compete clause. Res-5-P was referred to the Board of Directors for a decision. CMS staff asked COL in November to discuss Res-5-P so that staff can get a sense of how to proceed on this issue. Staff specifically asked for discussion on the following issues:

1. Is the current law physician exception to the general prohibition against covenants not to compete fair?
2. What are the pros and cons of termination without cause?
3. How prevalent are liquidated damages/non-compete clauses? Do you have one?
4. If you have a non-compete clause, what is the liquidated damages provision?
5. Were you able to negotiate the contract?
6. What is your perspective on non-compete provisions?
    a. From an individual physician perspective?
    b. From the perspective of an employer?
7. What additional information is needed to make a recommendation to the board on Res-5-P?

Background

COVENANTS NOT TO COMPETE

1. **WHAT IS A COVENANT NOT TO COMPETE**? Definition: Any agreement which prohibits someone from competing with another in some manner.

2. **WHEN ARE THEY TYPICALLY USED**? Covenants not to compete generally arise in the context of:

    a. **Employment**. A covenant not to compete in this context generally protects the employer from not only losing a specific employee upon termination, but also from losing business as a result of the employee taking actual or presumed business from the employer following the employee's termination.

    b. **The sale of business**. A covenant not to compete in this context protects the purchaser of a business from being faced with the seller simply opening up shop the next day and competing with the purchaser after presumably receiving value for the seller's assets, which typically include the seller's customer lists, good will, name, etc.

3. **COVENANTS NOT TO COMPETE ARE PRESUMED TO BE VOID IN COLORADO**. C.R.S. § 8-2-113(2), adopted by the Colorado legislature in 1973, presumes that covenants not to compete are void:

    "Any covenant not to compete which restricts the right of any person to receive compensation for performance of skilled or unskilled labor for any employer shall be void . . ."

    Thus, covenants not to compete in Colorado are VOID – not void*able*.

    a. **Statutory Exceptions**. There are statutory exceptions to Colorado's presumption that covenants not to compete are void; the exceptions specifically allow non-compete provisions in the following contexts:

        i. ***Purchase and sale of a business or the assets of a business***. C.R.S. § 8-2-113(2)(a). For the reason set forth above, this exception is enforced more liberally than those arising under the other exceptions. *Harrison v. Albright*, 577 P.2d 302 (Colo. App. 1977); *National Propane Corp. v. Miller*, 18 P.3d 782 (Colo. App. 2000).

        ii. ***To protect trade secrets***. C.R.S. § 8-2-113(2)(b). This exception is being used more and more often to try to enforce covenants not to compete. Employers will designate their business records, including, in the context of a medical practice, patient names, third party payors, health insurers, etc. as "confidential," and can enforce their non-compete provisions on the ground that it is necessary to protect their "trade secrets."

            1. To qualify as a trade secret, the information must actually meet the definition of "trade secret" found in C.R.S. § 7-74-102(4) and treated as such.

a. It can be "any scientific or technical information, design, process, procedure, formula, improvement, confidential business or financial information, listing of names, addresses, or telephone numbers, or other information." *Id.*

b. The confidentiality of the information must be maintained by, for example, keeping the information in a location that has limited access, limiting the number of employees who have access to the information, and shredding outdated information. *Id.*

2. Properly maintained patient information qualifies as a "trade secret" under Colorado law due to the confidentiality requirements set forth in various laws and regulations. *See, e.g.,* Health Insurance Portability and Accountability Act of 1996, 42 U.S.C. § 1320d-9; 45 C.F.R. Part 160; Part 164, Subparts A and E.

iii. ***To recover the expense of educating/training*** of an employee who has served any employer for less than two years. C.R.S. § 8-2-113(2)(c).

1. Must be contract/provision setting forth expense reimbursement requirements. *Dresser Industries, Inc. v. Sandvick*, 732 F.2d 783 (10th Cir. 1984).

2. Educating/training expense reimbursement requirement must be something more than company-wide, general employee training.

iv. Enforceable against employees who are "***executive and management personnel and officers and employees who constitute professional staff to executive and management personnel***." C.R.S. § 8-2-113(2)(d).

1. Fact issue decided on a case-by-case basis. *Management Recruiters of Boulder, Inc. v. Miller*, 762 P.2d 763 (Colo. App. 1988).

2. Includes owner, manager, "key person," someone "in charge of significant portion of business," and someone who is generally unsupervised or who supervises others. *Harrison v. Albright*, 577 P.2d 302.

3. Does not include employees who are not in charge of any significant portion of a business or who do not act in an unsupervised manner, regardless of title. *Atmel Corp. v. Vitesse Semiconductor Corp.*, 30 P.3d 789 (Colo. App.), *cert. denied* (2001).

b. **Physicians**. Non-compete provisions regarding physicians warranted their own exception:

"Any covenant not to compete provision of an employment, partnership, or corporate agreement between physicians which restricts the right of a physician to practice medicine . . . upon termination of such agreement, shall be void; except that all other provisions of such any agreement enforceable at law, including provisions which require the payment of damages in an amount that is reasonably related to the injury suffered by reason of termination of the agreement, shall be enforceable. Provisions which require the payment of damages upon termination of the agreement may include, but not be limited to, damages related to competition."

C.R.S. § 8-2-113(3).

i. ***Liquidated Damages Provisions are Acceptable.*** Agreements between physicians not to compete are void, but agreements that attach a dollar figure as liquidated damages for terminating an agreement or terminating and competing are acceptable. Bottom line: IT IS ACCEPTABLE TO REQUIRE A PHYSICIAN TO BUY THE PHYSICIAN'S WAY OUT OF A NON-COMPETE.[1]

ii. ***History.*** Physicians were originally included with the "professional staff to executive and management personnel" exception under C.R.S. § 8-2-113(2)(d). *Boulder Medical Center v. Moore*, 651 P.2d 464 (Colo. App. 1982).

1. In *Boulder Medical Center*, a covenant not to compete prohibited Dr. Moore, a pediatrician, from practicing medicine for 5 years in Boulder County when he left the Boulder Medical Center practice and provided for payment of liquidated damages if he violated that provision.
    a. Dr. Moore's employment contract provided for both injunctive relief (which prohibited him from practicing medicine in Boulder County) and liquidated damages (which required him to pay Boulder Medical Center a liquidated sum for lost business resulting from his competing practice).

    b. Employment contract's buy-sell agreement provided for re-purchase of Dr. Moore's stock by corporation.

2. The trial court entered an injunction against Dr. Moore, prohibiting him from practicing medicine in Boulder County and requiring

[1] Does anyone wonder why that is?

him to pay Boulder Medical Center liquidated damages. The Colorado Court of Appeals upheld the trial court's injunction and damages award under both the "professional staff" and the "sale of business" exceptions.

3. "Sixty Minutes" traveled to Boulder and interviewed Dr. Moore and several of his patients' parents for a segment of the show. The show's segment focused on the unfair effect the injunction had on Dr. Moore's child patients and their parents.

4. Presumably as a direct result of the "Sixty Minutes" segment, the Colorado legislature adopted an amendment to C.R.S. § 8-2-113, embodied in subsection (3). Adoption of subsection (3) meant that there could be no agreement precluding a physician from practicing where he/she deemed appropriate but that a reasonable liquidated damages provision would be enforced.[2]

iii. ***Post-Boulder Medical Center/Subsection (3).*** Following *Boulder Medical Center* and the enactment of C.R.S. § 8-2-113(3), the Colorado Court of Appeals addressed the liquidated damages provision in a physician's employment agreement in *Wojtowicz v. Greeley Anesthesia Services, Inc.*, 961 P.2d 520 (Colo. App. 1997).

1. In *Wojtowicz*, the employment agreement provided that Dr. Wojtowicz must pay Greeley Anesthesia liquidated damages if he practiced within a 25-mile radius of Greeley, Colorado, during a 2-year post termination period.

2. The trial court invalidated a $10,000 "loss of good will" liquidated damages provision because it did not approximate any damages allegedly suffered by Greeley Anesthesia but enforced a provision requiring Dr. Wojtowicz to pay Greeley Anesthesia 50% of all of his anesthesiologist fees for 2 years. The Colorado Court of Appeals invalidated both provisions on the ground that neither provision reasonably approximated the Greeley Anesthesia's actual damages and the 50% fee provision was "disproportionate to any possible loss incurred" by Greeley Anesthesia. *Id., citing Rohauer v. Little*, 736 P.2d 403 (Colo. 1987).

iv. ***Requirements of Liquidated Damages Provision.*** To be enforceable, a liquidated damages provision must meet a general three-prong test set out

[2] The new subsection (3) was noted by the Colorado Court of Appeals in the *Boulder Medical Center* case, which addressed the issue after subsection (3) was added, but did not apply it to Dr. Moore as it was not in effect when he terminated his employment agreement or by the time of trial.

by the Colorado Supreme Court in *Perino v. Jarvis*, 312 P.2d 108 (Colo. 1957):

1. The anticipated damages are uncertain in amount or difficult to be proved;

2. The parties must intend to liquidate their damages at the time of contracting;

3. The liquidated damages provision must be designed to provide a good faith, reasonable estimate of damages which is not greatly disproportionate to the probable or presumed loss.

v. ***Subsection (3) Only Applies to Physicians.*** Because subsection (3) is limited to "physicians" engaged in the "practice of medicine as defined in section 12-36-106, C.R.S.," the subsection does not apply to dentists, chiropractors, optometrists or podiatrists. These professions are specifically excluded from the definition of "practicing medicine" under C.R.S. §12-36-106.

4. **NON-COMPETE PROVISION MUST BE REASONABLE IN SCOPE, DURATION, AND GEOGRAPHIC AREA**. A liquidated damages provision pursuant to C.R.S. § 8-2-113(3) is enforceable only if the underlying covenant not to compete is reasonable as to "scope, duration, and geography." *National Graphics v. Dilley*, 681 P.2d 546 (Colo. App. 1984).

a. **Scope**. To be reasonable in scope, the limitation must not impose undue hardship and can be no wider than necessary to protect the legitimate business interests of the party in whose favor the covenant applies. *Whittenberg v. Williams*, 110 Colo. 418, 135 P.2d 228 (1943).

b. **Time**. There is no defined amount of time that is "reasonable" versus "unreasonable." Again, it must be reasonable and not impose an "undue hardship," given "all the facts and circumstances of each case." *Knoebel Merchantile Co. v. Siders*, 439 P.2d 355, 359 (Colo. 1968).

c. **Geographic Area**. Like the time limitation, there is no pre-defined geographic area that is "reasonable" versus "unreasonable." The nature of the business typically affects whether the geographic limitation is reasonable. For example, a statewide geographic limit has been enforced with respect to a statewide distribution company. *See Electrical Distributors, Inc. v. SFR, Inc*., 166 F.3d 1074 (10th Cir. 1999). Other cases have enforced much smaller geographic restrictions. *Compare Freudenthal v. Espey*, 102 P. 280 (Colo. 1909) (city-wide restriction regarding physician practice), *with Flower Haven Inc., v. Palmer*, 502 P.2d 424 (Colo. App. 1972) (county-wide restriction regarding florist business) and *Boulder Medical Center v. Moore*, 651 P.2d 464 (county-wide restriction

regarding physician practice). Generally, physician related non-compete provisions, depending on the practice location, are city-wide or mile limited (within X miles of original practice). Obviously, the more physician practices there are in a given area, the smaller the geographic limit is going to be in order to be "reasonable," as the more difficult it will be to prove that the a broader restriction is "necessary to protect the legitimate business interests" of a physician practice when there are numerous practices already competing in a given area.

5. **THE AMERICAN MEDICAL ASSOCIATION'S POSITION ON COVENANTS NOT TO COMPETE.**

   a. **The AMA Discourages Covenants Not to Compete**. The AMA takes a dim view of noncompetition agreements with doctors because:

      Covenants-not-to-compete restrict competition, disrupt continuity of care, and potentially deprive the public of medical services. The Counsel on Ethical and Judicial Affairs discourages any agreement between physicians which restricts the right of a physician to practice medicine for a specified period of time or in a specified area upon termination of employment, partnership, or corporate agreement. Restrictive covenants are unethical if they are excessive in geographic scope or duration in the circumstances presented, or if they fail to make reasonable accommodations of patients' choice of physicians.

      Opinions of the Council on Ethical and Judicial Affairs, American Medical Association, Section 9.2 (Revised 1998).

   b. **Potential Conflict with AMA Council on Ethical and Judicial Affairs, Opinions E-7.01 and 7.03**. These AMA Opinions provide that the interests of patients are paramount in the practice of medicine and no one should interfere with a patient's right (i) to be notified if their physician leaves a group; (ii) to obtain their physician's contact information from the practice group, or (iii) to have their records forwarded to the departing physician upon their request.

6. OTHER ISSUES.

   a. **Assignment**. Employment agreements can be assigned so long as they do not contain non-assignment provisions.

   b. **Waiver**. Although there are no reported Colorado cases regarding waiver of a non-compete provision, a party may, through its conduct, waive the right to enforce any particular provision in a contract. To be valid, a waiver must be knowing and intentional. *Duren, Inc. v. City of Lakewood*, 709 P.2d 74, 76 (Colo. App. 1985) ("waiver is a knowing and intentional relinquishment of a right").

c. **Business Termination**. A covenant not to compete cannot be enforced by a party who has ceased doing business. *Gibson v. Eberle*, 762 P.2d 777 (Colo. App. 1988). This includes the dissolution of a medical practice group.

d. **Each State is Different.** Each state varies with respect to how it views covenants not to compete. Some, like Colorado, hold that non-compete provisions are void *ab initio* (from inception). Others simply apply the "reasonable" test (discussed above) to non-compete provisions, requiring that their limitations be reasonable as to scope, time and geographic area, while still other states recognize them but prohibit them as against public policy in certain circumstances. *See In re UFG International, Inc.*, 225(B.R. 51 (S.D.N.Y. 1998) (public policy prohibits enforcement of covenant not to compete when an employee is laid off).

e. **FTC**: Below is the link to the FTC's pleadings and summary of its case in Reno, Nevada. There, the Renown Health System acquired more than a two-third market share (commonly associated with monopoly power), through a series of cardiology practice purchases . Renown's employment agreements with these cardiologists contained covenants not -to- compete that the FTC maintained prevented the emergence of competition in cardiology services in Reno and gave Renown market power in its dealing with health insurers for cardiology services. The FTC obtained a consent decree that is directed at the covenants not-to- compete and modifies them in ways described in the decree.

http://www.ftc.gov/opa/2012/08/renownhealth.shtm

Under antitrust law, covenants not to compete are certainly "contracts, combinations, or conspiracies". However, antitrust tribunals generally find them to be not in " unreasonable restraint of trade". The covenants are for example necessary to protect " trade secrets" (e.g. customer lists) and to encourage the formation of firms. Only in rare instances where they foreclose a large share of a market and prevent the entry of would -be - competitors (as in Renown Health) would they be unlawful. But given the market consolidations now taking place, we would expect challenges to covenants not to compete to become more prevalent.

f. **Model Physician-Hospital Employment Agreement:** Attached are copies of the AMA's model provisions for covenants not to compete during the term of the agreement and after termination. Physicians can negotiate a provision that will apply only if the physician terminates the agreement without cause or the employer terminates the physician with cause. Employers are reticent to make this exception, but in certain situations it is possible to make this work.

See Attachment B

See Attachment C