

The Basics of Restrictive Covenants

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INTRODUCTION

Perhaps no legal issue involving the “business” of medicine is as controversial as restrictive covenants. It seems that every physician has a different opinion about their enforceability and appropriateness, which usually is dependent on where in the spectrum from resident to equity owner of a group practice the physician falls. The purpose of this column is to summarize the legal principles involved in enforcing—or avoiding the enforcement of—restrictive covenants.

First, what are restrictive covenants? Restrictive covenants are contract provisions under which physicians limit their right to practice in certain ways or in certain areas for periods of time in exchange for the physicians being employed by or obtaining equity interest in practices.

Generally, there are 2 types of restrictive covenants: noncompetition covenants, which prevent physicians from practicing in certain geographic areas for finite periods of time, and nonsolicitation covenants, which only prohibit physicians from soliciting certain patients or employees for finite periods of time.

The \$64,000 question that every physician wants to know is, “Are they enforceable?” The simple answer is that although many people believe that physician-restrictive covenants are or should be illegal, only a handful of states prohibit their use. For example, California, Montana, North Dakota, and Oklahoma all have enacted statutes declaring noncompetition agreements void. Similarly, Colorado, Massachusetts, and Delaware have

enacted statutes that severely limit the enforceability of physician noncompetition clauses. There are also other states, such as Tennessee, where the courts, through case law, have substantially limited the enforceability of physician-restrictive covenants.

In the majority of states that generally permit the enforcement of physician-restrictive covenants, a party seeking to enforce such a covenant typically must establish that

- the covenant is drafted to protect a legitimate competitive interest;
- the covenant is reasonable in scope;
- the covenant, if enforced, would not unduly harm the physician against whom the covenant is sought to be enforced; and
- the covenant, if enforced, would not harm the public at large.

The remainder of this column discusses each of these elements. However, before reaching that discussion, it is important to emphasize that restrictive covenants are contained in contracts, and, accordingly, traditional contract defenses are at issue. Thus, for example, a practice seeking to enforce a restrictive covenant must show that there is a binding contract between the parties. The party seeking to enforce the restrictive covenant must also show that up to the date on which the physician breached the restrictive covenant, the practice materially performed all of its obligations under the contract. This contract defense, called the doctrine of prior material breach, is often hotly contested in restrictive covenant disputes. Its impact cannot be overstated; the practical ef-

fect of the defense is that even if a restrictive covenant, as drafted, is reasonable and clears all of the legal hurdles listed above, a physician can still avoid the strictures of the restrictive covenant if that physician can show that the practice itself failed in some material way to honor its obligations under the contract and that these failures were not caused by or waived by the physician.

LEGITIMATE COMPETITIVE INTEREST

Turning to the legal requirements that must be met before a restrictive covenant can be enforced, the first requirement is that the covenant must be designed to protect a legitimate competitive interest. This requirement is important because federal law, in our free-market economic system, does not tolerate attempts by entities to restrain or limit competition among providers of goods or services. Indeed, this principle is the fundamental theory underlying federal antitrust laws.

Accordingly, a restraint or limitation on competition generally will be allowed only if it serves some important purpose. Over the years, courts have recognized that a limitation on competition is acceptable if it protects a party from unfair competition. Physicians engage in unfair competition when they obtain confidential or competitively sensitive information about a practice or its patients while working for the practice and then use that information to compete against practice.

To prevent unfair competition, courts have allowed parties to enforce restrictive covenants provided that the covenants are narrowly tai-

lored to protect a party's legitimate competitive interest in preventing unfair competition. This means that to satisfy the legitimate competitive interest requirement, a practice must show that a departing physician had access to competitively sensitive information or such close contact with patients that there is a risk that the physician could use the information or access to compete with the practice.

For medical practices, the requirement of legitimate competitive interest is easy to meet. It is hard to imagine a physician who does not have access to competitively sensitive information or such close contact with patients that there is a risk that the physician could use the information after departure to compete against their former practice.

REASONABLE SCOPE

As discussed above, the second requirement for enforceability of a restrictive covenant is that it must be reasonable in scope, in duration, and in geographic area. The reasonableness requirement is derived from the principle that a restrictive covenant, as a restriction or limitation on competition, must be narrowly tailored to protect a practice's legitimate competitive interest in preventing unfair competition. The reasonableness requirement ensures that a covenant is narrowly tailored.

A practice satisfies the requirement for reasonable scope by ensuring that a covenant protects only the particular medical specialty or subspecialty that a physician practiced at the group. For example, if a physician is board certified in both internal medicine and radiology and provided only radiologic ser-

vices at a particular practice, then any restrictive covenant that applies to the physician reasonably can only prevent the physician from providing radiology, not internal medical services, after departure.

Turning to the requirement for reasonable duration, a restrictive covenant can last only as long as it needs to ensure that a physician is competing on the basis of their own skill and efforts, not on the basis of material to which they had access at a former practice. This requirement recognizes that even if a physician's initial practice is entirely dependent on the goodwill, access, and materials obtained while employed at a former practice, over time, the physician's ability to retain and enhance a patient base is dependent on their own skill and efforts. A general rule of thumb regarding the requirement for reasonable duration is that a covenant should last either the same amount of time as the term of the contract containing the restrictive covenant or 2 years, whichever is shorter.

With regard to reasonable geographic scope, a covenant should only prohibit a physician from practicing in the same geographic area from which a practice draws a majority of its patients. This means that a practice that provides a unique or advanced specialty, or a practice in a rural area, can have a larger geographic area restriction than an internal medicine practice or a practice in a large metropolitan area.

UNDUE BURDEN ON THE PHYSICIAN

After reasonableness, the next major requirement that must be met before a restrictive covenant is enforceable is that the covenant can-

not unduly harm or burden the physician against whom it is being sought. Of course, any restrictive covenant burdens the physician against whom it is enforced. The question is whether circumstances changed since the physician signed the restrictive covenant such that enforcing it would place a significant and extraordinary burden on the physician.

UNDUE BURDEN ON THE PUBLIC

The final requirement for the enforcement of a restrictive covenant is that the covenant not unduly harm the public. A covenant would harm the public, for example, if there were a shortage of the physician's specialty in the area where the physician practices. For example, if a physician is an interventional radiologist and there is no other interventional radiologist in or even near the restricted area covered by a restrictive covenant, enforcing the restrictive covenant most likely would be deemed to harm the general public because there would be no interventional radiologists to provide services.

CONCLUSION

As discussed above, in most states, as long as the requirements set forth above are met, courts will generally enforce restrictive covenants. The takeaway message, therefore, is that care should be taken in drafting and understanding a restrictive covenant before it is signed. And if a physician is thinking of leaving a practice, legal counsel should be consulted before any restrictive covenant is implicated.

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