Physician Employment Non-Compete Agreements

The Value Behind the Valuation

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The impact of restrictive covenants on competition and economic growth has long been a source of debate among economists, politicians, employers, workers, and state courts. The Workforce Mobility Act of 2021 introduced in the U.S. House of Representatives on February 25, 2021, aims to limit the use of non-compete agreements to certain circumstances, such as with the sale of a business or for senior executives. As one example, President Biden's Executive Order on Promoting Competition in the American Economy issued on July 9, 2021, states:

> *The American promise of a broad and sustained prosperity depends on an open and competitive economy. For workers, a competitive marketplace creates more high-quality jobs and the economic freedom to switch jobs or negotiate a higher wage…to address agreements that may unduly limit workers' ability to change jobs, the Chair of the FTC is encouraged to consider working with the rest of the Commission to exercise the FTC's statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility.*[1]

Regardless of the resulting overall impact of these recent efforts, restrictive covenants are currently ubiquitous in the American economy and should be reviewed thoroughly as employers and employees navigate the changing landscape.

Types of Restrictive Covenants

Restrictive covenants typically fall under three broad categories:

1. Non-Compete Agreements
   a. Limits competition by an individual after they cease employment with the employer by disallowing the individual to provide an identified service within a certain geographic region for a specific amount of time
2. Non-Solicitation Agreements
   a. Prohibits the solicitation of employees or customers of the subject business by the former employee
3. Non-Disclosure Agreements
   a. Protects against the use of proprietary information or trade secrets of the business after an employee has departed

While all types of restrictive covenants are worthy of consideration, the recent attention has been primarily on non-compete agreements, which will be the focus of the discussion presented herein.

Why and How Non-Compete Agreements Are Applied

According to a study by the Economic Policy Institute,[2] roughly half (49.9%) of American businesses in the private sector require at least some of their employees to enter into a non-compete agreement. This same study indicates that non-compete agreements are more commonly used when an employee has a college degree or higher education, such as with employed physicians.

1 EXECUTIVE ORDER ON PROMOTING COMPETITION IN THE AMERICAN ECONOMY. JULY 9, 2021. HTTPS://WWW.WHITEHOUSE.GOV/BRIEFING-ROOM/PRESIDENTIAL-ACTIONS/2021/07/09/EXECUTIVE-ORDER-ON-PROMOTING-COMPETITION-IN-THE-AMERICAN-ECONOMY/

2 "NONCOMPETE AGREEMENTS: UBIQUITOUS, HARMFUL TO WAGES AND TO COMPETITION, AND PART OF A GROWING TREND OF EMPLOYERS REQUIRING WORKERS TO SIGN AWAY THEIR RIGHTS." ALEXANDER J.S. COLVIN AND HEIDI SHIERHOLZ. ECONOMIC POLICY INSTITUTE.

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In the Journal of Human Resources, the Board of Regents of the University of Wisconsin System published an article[3] outlining observations regarding the use of non-compete agreements in primary care practices. The article highlights several correlations including:

- The use of non-compete agreements was more likely for physicians whose compensation arrangements included productivity incentives.
- Physicians subject to a non-compete agreement were found to have higher earnings growth than those not subject to non-compete agreements.
- Practices using non-compete agreements were found to have higher levels of intra-practice patient referrals.
- The use of non-compete agreements was found to be negatively correlated with higher Medicaid and charity care levels.

The deterrent effect of non-compete agreements was also observed. Physicians subject to a non-compete agreement had increased duration of employment as compared to physicians not subject to a non-compete agreement. Finally, for physicians without a non-compete agreement, higher enforceability of non-compete agreements in the state is correlated with shorter employment duration. The above findings suggest that employers seek to protect their investment of time and resources and that the application of non-compete agreements in contractual relationships can impact the behavior of physicians.

Non-Compete Enforcement

The enforceability of non-compete agreements varies from state to state. Some states largely ban non-compete agreements, while others impose limits on the scenarios under which they are permitted. When reviewing non-compete agreements, some courts rely on "Blue Pencil" enforcement (i.e., the unenforceable language is crossed out and leaves the rest of the non-compete agreement intact) while others rely on "Red Pencil" enforcement (i.e., if any part of the non-compete agreement is found to be unenforceable, the entire agreement is null and void). While the details are specific to each state, the enforceability of a non-compete agreement generally hinges on the reasonability of the scope of prohibited activities as related to a business's protectable interest, the duration of the non-compete agreement, and the geographic limitations imposed. In the case of non-compete agreements with physicians, some states have even found that the public interest in specialty care in a community was superior to the business interest of the physician's former employer. [4]

It should be noted that it is common for non-compete agreements connected to the transfer of a business to be viewed as reasonable and enforceable (assuming terms are not overburdensome), as the transaction price likely assumes a non-compete agreement is in place for the seller of the business. The proposed text of the Workforce Mobility Act specifically acknowledges the reasonability of a non-compete agreement in conjunction with the sale of a business.[5]

So, What is the Value?

The value of a non-compete agreement is useful for many purposes, including:

- The determination of a buyout provision at Fair Market Value
- Negotiation of value related to a potential transaction
- Enforcement or litigation of a breach related to a non-compete agreement

The valuation analyst will likely consider the three basic approaches in determining the fair market value of a physician non-compete agreement: the Market Approach, Cost Approach, and Income Approach. Generally, the three approaches to valuation are defined as:[6]

- The Market Approach is a general way of determining a value indication by using one or more methods that compare the subject to similar assets which have been involved in a transaction.
- The Cost Approach is a general way of determining a value indication by quantifying the amount of money required to replace the service capability of that asset.
- The Income Approach is a general way of determining a value using one or more methods that convert anticipated economic benefits into a present single amount.

In the context of the fair market valuation of a physician non-compete agreement, the Market Approach is not often applied as information related to transactions surrounding non-compete agreements is limited. Additionally, the value of a non-compete agreement is inherently contingent on a specific set of circumstances that makes a meaningful comparison to other agreements difficult.

The Cost Approach can be represented as the build-up of costs associated with replacing the employed physician, including (but certainly not limited to) the direct and indirect costs to recruit a similarly experienced physician and lost productivity related to training and ramp-up of the replacement physician.

The Income Approach is often derived using "With" and "Without" scenarios. That is, the value of the entity with the non-compete agreement in effect as compared to the value of the entity without the non-compete agreement in effect. The difference between the two scenarios, adjusted for risk, is the value of the noncompete agreement.

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3 THE IMPACTS OF RESTRICTING MOBILITY OF SKILLED SERVICE WORKERS: EVIDENCE FROM PHYSICIANS, THE JOURNAL OF HUMAN RESOURCES, FEBRUARY 7, 2019.

4 WELLSPAN HEALTH V. BAYLISS MD, 869 A.2D 990 (PA. SUPER. CT. 2005)

5 H.R. 1367, SEC. 3(B) HTTPS://WWW.CONGRESS.GOV/BILL/117TH-CONGRESS/HOUSE-BILL/1367/TEXT

6 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), STATEMENT ON STANDARDS FOR VALUATION SERVICES NO. 1, APPENDIX B: INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS.

The Income Approach is a commonly used methodology to determine the fair market value of a non-compete agreement. It allows for the valuation analyst to encapsulate the economic reality surrounding the agreement being analyzed. In developing the "With" and "Without" scenarios under the Income Approach, the valuation analyst should consider a number of factors including:

- The impact on revenue under each scenario:
    - Would the practice retain patient volume if the departed physician actively competed with the practice?
    - Would other physicians in the practice be able to absorb the volume currently handled by the departed physician?
    - Would the departed physician be able to obtain additional volume and/or revenue from the practice, in addition to their personal productivity?
    - Is any non-patient revenue linked to the departed physician or would it be retained by the practice?
- The impact on expenses under each scenario:
    - What variable costs could be reduced (e.g., medical supplies, variable staffing requirements)?
    - What fixed costs might be adjusted? Could the practice utilize a smaller space?
    - What are the direct and indirect costs of recruiting a replacement physician (e.g., travel, recruitment firm fees, interview costs)?
- The required working capital needs:
    - Would the practice require additional cash on hand to cover fixed expenses now born by fewer revenue-generating providers?
- An assessment regarding the duration, intensity, and timing of the competition:
    - What is the length of the non-compete agreement?
    - What is the anticipated timing of potential competition?
    - Will the impact of competition occur all at once or will it occur gradually?
    - What is the departed physician's financial and physical capacity? Will the departed physician be able to capture the business's interests?

Once the specifics of the "With" and "Without" scenarios are defined, it is important for the valuation analyst to consider the risks associated with each scenario in establishing the discount rates used to calculate the present value of the cash flows. Specifically, what is the likelihood that the departed physician will compete with the business? Does the physician have the desire to provide services covered under the non-compete agreement? What is the departed physician's ability to compete? Would the physician be required to obtain a Certificate of Need for a newly established competing business before offering services? The appropriateness of a valuation conclusion is dependent on an accurate assessment of these and other factors.

At the end of the day, it is important to remember that just because a non-compete agreement exists, does not mean that it is enforceable as written. States each have their own statutes and exemptions, and courts have different precedents related to the enforceability of restrictive covenants. It should also be noted that the law does not protect against ordinary competition. The non-compete agreement should specify the protectable business interest and the scope of services covered, the duration of the non-compete agreement, and the geographic limitations imposed.

Determining the value of a non-compete agreement depends on the purpose of the valuation and the valuation analyst's understanding of the nuances related to the valuation. It is beneficial for all parties involved to work with qualified legal counsel and certified valuation professional professionals, especially if it involves a healthcare entity. If litigation related to a non-compete agreement is anticipated, it is helpful that the parties rely upon the analysis and testimony of an experienced independent valuator who is well-versed in navigating and balancing the language of valuations, litigation, and the industry in question in conjunction with experienced legal counsel.