THE PHYSICIAN'S RIGHT IN § 15.50(B) TO BUY OUT A COVENANT NOT TO COMPETE IN TEXAS

Mike Kreager*

* Mike Kreager obtained a J.D. and L.L.M. (in taxation) from Southern Methodist University Law School. He is the founding shareholder of The Kreager Law Firm in San Antonio, Texas.

"Today, we view the idea of human capital—the sum of education, natural talent, training and experience that comprise the wellspring of future earnings flows—as fundamental to the understanding of major shifts in the global economy."[1]

I. PROLOGUES

Much uncertainty and frustration is experienced when drafting and interpreting covenants not to compete concerning physicians practicing medicine in Texas. In fact, these sentiments led to the writing of this Article.[2] Before discussing the specific topics listed in the table of contents, the following transcript of abbreviated, fictional telephone conversations between various physicians and their respective attorneys introduces the conflicting interests that can arise between the former employer and the departing physician, between a prospective employer and the newly recruited physician, and between the former employer and the prospective employer. These competing interests in the employment relationship underlie many of the difficult issues that evolve from physician covenants.

It is Monday morning, and your client, Dr. Jones, a surgeon with Surgical Associates, is on the telephone.

"Mike, I absolutely hate this practice. I've been here three years, I've worked hard, and I don't see any real opportunity to make money. It was

[1] PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 110 (John Wiley & Sons, Inc. 1996).

[2] This Article relies on several shorthand phrases, as follows. A "covenant not to compete," a "non-competition covenant," a "restrictive covenant," and similar contractual arrangements are called simply, a "covenant." The term "buyout clause" means the Texas Covenants Not to Compete Act's § 15.50(b)(2), discussed in Part II, that requires an enforceable covenant against a physician to contain a buyout of the covenant at a reasonable price. Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002). The phrase "buyout right" is the physician's right to buy out the covenant, as granted in section 15.50(b)(2). *Id.* The Act uses the term "promisor" to describe the person bound by the covenant. *See id.* § 15.51. In this Article, the promisor is the "physician" who is subject to restrictions in the covenant. Conversely, the term "promisee" used in the Act to describe the party entitled to enforce the covenant is designated the "employer" in this Article.

fine at first, when I met new doctors, but now I get plenty of referrals for surgeries. I've gotten to know the surgeons at Texas Thoracic. They practice good medicine and they make a lot more money than what I could ever hope to make here. I had dinner with their president Dr. Smith last night. He offered me $50,000 a year more than I make now!"

As Dr. Jones continues his story, Mike deftly accesses his digital copy of Dr. Jones' employment contract with Surgical Associates and finds the paragraph entitled "Covenant Not to Compete." Indeed, Dr. Jones agreed that he would not compete with Surgical Associates, and moving to Texas Thoracic would violate Dr. Jones' covenant with Surgical Associates. Reading a few more paragraphs, Mike spots a paragraph entitled "Buyout of Covenant." This paragraph gives Dr. Jones the right to cancel the competition restrictions against him by paying an amount equal to the salary Surgical Associates paid to him in the prior twelve months, $350,000.

With the satisfaction of a prompt solution, Mike interrupts Dr. Jones, "Well Dr. Jones, you remember that you signed a non-compete, but not to worry, you can get out of it. All you have to do is pay Surgical Associates $350,000."

"Oh my gosh! Mike, I don't have that kind of money, what with student loans and a new house. Can't you bust this thing?"

While Dr. Jones and Mike are conferring, Dr. Smith calls Texas Thoracic's attorney.

"Suzanne, we've hired Dr. Jones, a fine young surgeon, for $400,000 a year. Push the button on your computer and generate a new employment contract for Dr. Jones. We need to get him over here. He has a nice group of referring physicians and he can help us with call coverage."

"Dr. Smith, your group's standard employment agreement calls for a covenant not to compete. To be enforceable it has to give Dr. Jones a buyout right. Do you want to give Dr. Jones a price in the contract or let an arbitrator decide if it ever gets to that? Personally, I prefer arbitration. Why try to guess now what the right amount should be when the buyout may never come up?"

"Suzanne, we'll go with your recommendation, but how much might an arbitrator put on the covenant? Medicare keeps chopping our reimbursement rates, and I don't want any surprises."

Before Suzanne can answer, Dr. Smith exclaims, "Suzanne, if we're thinking about a non-compete for Dr. Jones, surely Surgical Associates already has one with him. You better take a look at his contract."

A few hours later, Surgical Associates' administrator, Wendy, calls her attorney.

"Hey Alex, I heard a rumor that Dr. Jones is considering jumping ship to go to work for Texas Thoracic. He has a non-compete with us. If he joins them, he has to pay us $350,000. Is that non-compete you wrote for him good? If he doesn't pay, I don't want him getting surgeries referred from our referral sources. We spent a lot of time introducing him to those referrers when he joined our group. And another thing, I don't like Texas Thoracic poaching one of our key doctors. Isn't there something you can do about that?"

Texas lawyers and their physician clients ask these questions daily. The questions pose not just general non-competition law issues that arise between employers and employees, but they call into play laws applicable only to physicians in Texas. Part II of this Article introduces the unique right to buyout a covenant possessed only by physician employees in Texas.[3] The conversation between Dr. Jones and his attorney, Mike, ends with a fundamental question: Is Dr. Jones' covenant enforceable if he cannot pay to buy it out? Parts III and IV of this Article will review the

[3] This Article focuses primarily on post-employment covenants. As will be seen in Part XII, covenants are also included in the sale of a physician's medical practice, which frequently occurs when a newly-trained physician purchases the practice of a retiring physician, when medical practices combine, and when a medical practice engages a management company to assume all non-medical operations of the medical practice. *See generally* Ferdinand S. Tinio, Annotation, *Validity and Construction of Contractual Restrictions On Right of Medical Practitioner to Practice, Incident to Sale of Practice*, 62 A.L.R.3d 918 (1975). Texas courts have frequently distinguished between the covenants not to compete that a buyer requires of a seller from a covenant not to compete that an employer requires of an employee. *See* Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 170 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002) (holding a covenant contained in a franchise agreement unenforceable as unreasonably restricting a franchisee's right to pursue a "common calling"); *see also* Justin Belt Co. v. Yost, 502 S.W.2d 681 (Tex. 1974); *Hill*, 725 S.W.2d at 170 ("Courts in Texas encounter two general varieties of covenants not to compete: covenants specifying that the seller of a business will not compete with the buyer, and covenants specifying that an employee, upon discharge, will not compete with the former employer.") (citing Daniel v. Goesl, 161 Tex. 490, 341 S.W.2d 892 (1960)). The Texas Covenants Not to Compete Act legislatively overrules *Hill's* blanket prohibition of covenants against employees engaged in a "common calling." *See* cases cited *infra* note 35. On many occasions a court reviewing an employment-related covenant will comment that the covenant must be reviewed more strictly than the review given to a covenant arising from the sale of a business. Emergicare Sys. Corp. v. Bourdon, 942 S.W.2d 201, 203, 205 (Tex. App.—Eastland 1997, no writ) (stating that an emergency room physician's covenant recited $50,000 as liquidated damages for its breach).

statutory ingredients required for an enforceable physician covenant in Texas.

The conversation between the recruiting physician, Dr. Smith, and his attorney, Suzanne, also highlights the uncertainty experienced in the employment process when deciding whether to include in the covenant a specific buyout price or to ignore the pricing issue and let an arbitrator decide it later. Inextricably tied to this choice are these questions: How much should the buyout price be? Can the buyout price be challenged? Parts V and VI discuss these issues.

The conversations over the buyout all assume that the buyout price represents a choice the employer and the physician must make in a covenant—between stating the amount in the covenant when entering into the employment agreement or deferring it to an arbitrator. Part VII of this Article argues that both buyout options must be written in the covenant for it to be enforceable. Part VIII extends the examination of the Act's buyout clause to inquire whether it violates the Texas Constitution's guarantee of open courts to resolve disputes or the constitution's prohibition against judicial delegation of factual determinations.

This Article gives practical answers supported by Texas legal principles from the applicable statutes and case law. In practice, physician covenants can vary infinitely in their limitations and conditions. Despite the lack of uniformity in physician covenants, this Article seeks to provide a uniform structure to write and judge them.

Creative attorneys will, in defense of physicians subject to covenants, often exploit the buyout right by suggesting alternate strategies that amount to defenses against the employer's enforcement of the covenant. These strategies center on the concept that a covenant may be partially performed in that they may be honored in part and bought out in part. The possibilities for partial performance are explored in Part XI.

In Part X, this Article will discuss substantive and procedural provisions that the contracting parties may add to a covenant beyond including the Act's minimum requirements for a buyout. This discussion gives a number of examples from covenants in physician employment agreements reviewed or drafted by this author. Part XII will briefly discuss the physician covenant in contexts other than employment.

The dialogue between Surgical Associates' administrator, Wendy, and her attorney, Alex, also hint that an employer may seek to hold another employer responsible for tortious interference with the covenant of a

departing physician. The tort of interference with a covenant is discussed in Part IX.

Finally, throughout the Article, questions will arise over physician covenants for which no certain answers exist. Where statutes and cases do not provide answers, Part XIII of this Article will suggest technical corrections to the Act to provide greater certainty in physician covenants.

II. INTRODUCTION TO THE PHYSICIAN'S § 15.50(B) RIGHT TO BUY OUT A COVENANT

A. The § 15.50(b) Buyout Right of Physicians

The Texas Covenants Not to Compete Act[4] (herein the "Act") allows an employer to restrict the ability of an employee to compete following the end of employment.[5] An employer of a physician may also restrict that physician's ability to practice medicine following the end of the employment relationship.[6] However, covenants restricting physicians must, in addition to all other requirements of the Act, include a buyout right. The buyout right, as the name suggests, allows a physician to purchase his or her freedom to compete with a former employer by paying a reasonable amount. As one can imagine, it offers a wonderful solution to the physician who seeks to leave an unhappy practice environment without having, in many instances, to move to a new and unfamiliar community to establish a new medical practice.

---

[4] Tex. Bus. & Com. Code Ann. §§ 15.50, 15.51.

[5] It is worth noting that while the Act does not specifically address a covenant not to compete between a law firm employer and an attorney employee, attorney covenants not to compete have been held void as against the public policy promoting a client's unrestricted access to legal representation by counsel of the client's choice. Tex. Disciplinary R. Prof'l Conduct 5.06, *reprinted in* Tex. Gov't Code Ann., tit. 2, subtit. G app. A (Vernon 2005) (Tex. State Bar R. art. X, § 9); *see* Dardas v. Fleming, Hovenkamp & Grayson, P.C., 194 S.W.3d 603, 618 (Tex. App.—Houston [14th Dist.] 2006, pet. denied); *see also* Whiteside v. Griffis & Griffis, P.C., 902 S.W.2d 739, 744 (Tex. App.—Austin 1995, writ denied) (court held restrictive stock agreement provision that reduced payment to departing attorney for his stock if the attorney competed with the law firm to be equivalent to a covenant, and although an indirect financial disincentive, held it violated state's public policy and disciplinary rules "against interfering with the client's freedom of choice").

[6] The American Medical Association discourages physician covenants and deems unethical covenants that are overly restrictive. Am. Med. Ass'n Council on Ethical & Judicial Affairs, Op. No. E-9.02 (1998), *available at* http://www.ama-assn.org/ad-com/polfind/Hlth-Ethics.pdf; *see* cases cited *infra* note 59 discussing public policy considerations of physician covenants.

The Act's buyout clause gives the employer and the physician two options in offering the buyout right to the physician.[7] In the first option, the employer and the physician may agree on the amount to be paid for the buyout and insert the specific amount in the physician's employment agreement. The covenant operates in a default mode by restricting the physician from practicing medicine after the end of employment. If the physician pays the stipulated amount to the employer, the physician may switch off the covenant releasing the restrictions of the covenant. This Article will refer to this type of buyout option as the "stipulated buyout covenant."

In the second option, the parties may postpone deciding the buyout amount to be paid until the end of the physician's employment. In this scenario, the parties may resort to an arbitrator to decide the buyout price that the physician must pay to the employer. This option is called an "arbitration buyout covenant" in this Article.

Before the buyout clause was added to the Act, a physician had very limited choices: perform the covenant (not practice medicine in competition with his or her former employer); violate the covenant; or sue to declare the covenant unenforceable.[8] If the physician broke the covenant and competed, the employer could sue the competing physician for an injunction to prohibit him or her from competing.[9] The injunction could be

[7] *See* discussion *infra* Part VII (evaluating an interpretation of the buyout clause that requires both options to be included in an enforceable covenant).

[8] Uniform Declaratory Judgment Act, Tex. Civ. Prac. & Rem. Code Ann. §§ 37.001–.011 (Vernon 2008).

[9] *See* Tex. Civ. Prac. & Rem. Code Ann. § 65.011(1)–(5) (Vernon 2008) (establishing five grounds for granting an injunction, one of which can be established when the applicant is entitled to the relief demanded and all or part of the relief requires the restraint of some act prejudicial to the applicant, and irreparable injury to real or personal property is threatened, irrespective of any remedy of law); DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 685–86 (Tex. 1990) (differentiating between two possible causes of action for wrongfully obtaining an injunction: (1) a cause of action upon an injunction bond; and (2) a cause of action for malicious prosecution); Lewis v. Kreuger, Hutchinson & Overton Clinic, 153 Tex. 363, 269 S.W.2d 798, 799 (1954) (approving reformation of covenant that restricted physician from practicing in Lubbock County, Texas, indefinitely after end of employment into a three year post-employment period); Cardinal Health Staffing Network, Inc. v. Bowen, 106 S.W.3d 230, 234 (Tex. App.—Houston [1st Dist.] 2003, no pet.) (holding that common law rules of equity and a requirement of the showing of irreparable entry for which no adequate remedy is available is not preempted by the Act where employer sought a temporary injunction to enforce covenant against former employee); Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787, 792 (Tex. App.—Houston [1st Dist.] 2001, no pet.) ("The enforceability of a covenant not to compete is a question of law for the

granted even if the covenant ultimately proved not to be enforceable, as the employer may seek a temporary restraining order or a temporary injunction to preserve the status quo pending final resolution of all issues over the covenant's enforceability.[10] Thus, the physician could be prevented from practicing medicine for some period of time even if the covenant was ultimately not enforceable.[11] Any prospective employer is similarly stymied from employing the restricted physician, leaving the employer no choice but to employ an unrestricted physician in lieu of the restricted physician.

While the buyout right offers a significant improvement over the uncertainties that the employer and the physician face when one of them ends the employment relationship, a great deal of uncertainty remains in a physician covenant containing a buyout right. The first question is the buyout amount itself. What is the right amount? Or, stated differently, how should the amount be determined—by the parties in a stipulated buyout covenant or by an arbitrator in an arbitration buyout covenant? Second, what recourse is available to the physician who believes the stipulated buyout price is unreasonable? Does a court have the power to reform the stipulated buyout amount to a reasonable amount? Third, what recourse does either party have if the arbitrated buyout price is objectionable? Fourth, how do the parties conduct a determination of the buyout price before an arbitrator? Fifth, may a physician choose not to pay the amount

court. We review questions of law de novo and without deference to the lower court's decision.") (citing Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 644 (Tex. 1994) (discussing employer seeking to enforce covenant against employee that court of appeals found to restrict too large a geographic area and encompass to many restricted activities)); CRC–Evans Pipeline Int'l, Inc. v. Myers, 927 S.W.2d 259, 263 (Tex. App.—Houston [1st Dist.] 1996, no writ); Precast Structures, Inc. v. City of Houston, 942 S.W.2d 632, 636 (Tex. App.—Houston [14th Dist.] 1996, no writ).

[10] Butnaru v. Ford Motor Co., 84 S.W.3d 198, 204 (Tex. 2002) (citing Walling v. Metcalfe, 863 S.W.2d 56, 57 (Tex. 1993) ("A temporary injunction's purpose is to preserve the status quo of the litigation's subject matter pending a trial on the merits. . . . To obtain a temporary injunction, the applicant must plead and prove three specific elements: (1) a cause of action against the defendant; (2) a probable right to the relief sought; and (3) a probable, imminent, and irreparable injury in the interim.")); Elec. Data Sys. Corp. v. Powell, 508 S.W.2d 137, 139 (Tex. Civ. App.—Dallas 1974, no writ); Sun Oil Co. v. Whitaker, 424 S.W.2d 216, 218 (Tex. 1968).

[11] Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787, 795 (Tex. App.—Houston [1st Dist.] 2001, no pet.) (citing Tex. Bus. & Com. Code Ann. §§ 15.50, 15.51(a) (Vernon 2008)) ("Thus, a showing by the promisee of an irreparable injury for which he has no adequate legal remedy is not a prerequisite for obtaining injunctive relief under the Covenants Not to Compete Act.").

set by the arbitrator if he or she is willing to perform the covenant, or is the physician bound by contract to pay the arbitrated amount? Sixth, does the arbitrator have the power to reform those restrictions in a covenant that he or she, as an arbitrator, finds unreasonable? Seventh, what avenue should the physician pursue if the physician believes that the covenant is unenforceable, without regard to the buyout right?

These questions exacerbate an already emotionally charged situation between the employer and the physician that exists both at the beginning of the employment relationship and at its end. The net effect of these uncertainties is that the employer and the physician are faced with the prospect of spending a substantial amount of money on attorneys and other advisors to pursue their respective options.[12] In some cases, at the outset of employment, the physician may simply agree to any proposed buyout arrangement, as the provision is not nearly as relevant at the beginning of employment as the stated salary and benefits. Conversely, the employer may simply choose some arbitrary amount, such as one year's salary, for the buyout in order to avoid the expense of pinpointing a reasonable amount. In some cases, at the end of employment the possible expenses and weight of uncertainty are so great that a physician chooses instead to relocate outside of the covenant's boundaries to avoid controversy.[13] On the other hand, the employer may choose to ignore its former physician employee's breach of a legitimate covenant similarly to avoid controversy.

The breadth of commentary on physician covenants easily supports the inference that employment agreements for physicians routinely include a covenant.[14] In 1971, the Wisconsin Supreme Court observed: "Often enough, such [an] employment agreement provides for some covenant on the part of the younger associate not to enter competitive practice in the

[12] Friedman, Clark & Shapiro, Inc. v. Greenberg, Grant & Richards, Inc., No. 14-99-01218-CV, 2001 WL 1136169, at *1–2 (Tex. App.—Houston [14th Dist.] Sept. 27, 2001, pet. denied) (not designated for publication) (discussing debt collection employer suing former employees for breach of covenants where jury awarded employer $122,825 in attorneys' fees).

[13] *See generally* M. Scott McDonald, *Noncompete Contracts: Understanding the Cost of Unpredictability*, 10 TEX. WESLEYAN L. REV. 137 (2003) (discussing the issues that parties face in context of covenant disputes).

[14] *See generally* Derek W. Loeser, *The Legal, Ethical, and Practical Implications of Noncompetition Clauses: What Physicians Should Know Before They Sign*, 31 J.L. MED. & ETHICS 283 (2003); James W. Lowry, *Covenants Not To Compete In Physician Contracts*, 24 J. LEGAL MED. 215 (2003); Arthur S. Di Dio, *The Legal Implications of Noncompetition Agreements In Physician Contracts*, 20 J. LEGAL MED. 457 (1999).

area served by the older doctor and for some reasonable period of time."[15] The anecdotal evidence also supports the conclusion that employers consistently include covenants in their physician employment agreements to protect the employer's medical practice.[16] Contrary to the ubiquitous legal opinions of physicians expressed in the proverbial doctors' lounge, a covenant preventing a physician from practicing medicine in competition with a former employer can be, and usually is, enforced.[17]

As of March 2008, approximately 45,000 physicians were licensed to practice medicine in Texas, substantially all of whom are in private practice.[18] This number is expected to grow significantly both because of

[15] Oudenhoven v. Nishioka, 190 N.W.2d 920, 923–24 (Wis. 1971) (holding that an employer could sustain a suit against an employee for violating a covenant not to compete).

[16] Coppa v. Lederman, No. 04 CV 0399ILG, 2004 WL 884258, at *1 (E.D.N.Y. 2004) (mem.) (noting in a case where a dermatologist sought to enjoin an employer from enforcing a covenant against her that "[r]estrictive covenants are fairly ubiquitous in employment agreements . . . ."); Lowry, *supra* note 14, at 232 ("Covenants not to compete in physician employment contracts have become a standard part of the employment relationship.").

[17] The assumption that covenants are not enforceable has been fostered by judicial references. *See* Trilogy Software, Inc. v. Callidus Software, Inc., 143 S.W.3d 452, 459 (Tex. App.—Austin 2004, pet. denied) ("A covenant not to compete is a disfavored contract in restraint of trade and is unenforceable unless it meets certain statutory requirements."); Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 658 (Tex. App.—Dallas 1992, no writ) (discussing employer seeking to enforce covenant against formerly employed chemist employed by a competitor) ("Courts generally disfavor noncompete covenants because of the public policy against restraints of trade and the hardships resulting from interference with a person's means of livelihood."); Stocks v. Banner Am. Corp., 599 S.W.2d 665, 667 (Tex. App.—Texarkana 1980, no writ) (discussing equal shareholder selling shares to remaining shareholder in consideration of cash payment and covenant) ("Covenants not to compete found in employment contracts are generally construed more strictly against the employer than those covenants made in connection with a sale of a business."); *see also* Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 127 (Idaho 2005) (discussing employer seeking to enforce covenant against ophthalmologist employee who agreed to pay $500,000 to employer to avoid restrictions in covenant) ("Covenants not to compete in employment contracts are 'disfavored' and 'strictly construed against the employer.'"); Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 898–900 (N.J. 2005) (holding that a non-profit hospital could enforce covenant against neurosurgeon subject to reformation of thirty five mile restriction and noting that the court's interpretation of the covenant will be more closely scrutinized if the employer terminated the physician's employment and less strictly scrutinized if the physician terminated his or her employment voluntarily).

[18] *See* Texas Medical Board, Physicians In and Out of State: March 2008 (Apr. 11, 2008), http://www.tmb.state.tx.us/agency/statistics/demo/docs/d2008/0308/inout.php (last visited Mar. 11, 2009). In comparison, 31,000 physicians were licensed by the State of Texas in May 1997. *See* Texas Medical Board, Physicians In and Out of State: May 1997, http://www.tmb.state.tx.us/agency/statistics/demo/docs/d1997/0597/inout.php (last visited Mar.

the growth in Texas' general population and because Texas voters approved tort reform measures several years ago that limit the damages recoverable against a Texas physician.[19] From a liability standpoint, these changes make Texas an attractive state in which to practice medicine.

Not surprisingly, no sources indicate the number of physicians who are subject to a covenant;[20] however, if one assumes that fifty percent of all licensed physicians are subject to covenant, the number of physician covenants subject to the Act's buyout right might be 22,500.[21] While this number does not seem significant, considering that Texas has 23.7 million residents as of 2007,[22] it is important to recognize the increased employment mobility of physicians between employers. Consequently, a physician may become subject to a covenant with each new employment opportunity. The author recognizes that the frequency of disputes over the buyout right will be statistically low because most covenants will not lead to disputes. The expected low frequency of disputes is inferentially supported by the fact that there are no appellate decisions directly

11, 2009). Interestingly, 70% of licensed physicians are between the ages of 35 and 60. Moreover, it has been widely reported that a significant shortage of physicians will exist nationally by the year 2025. *See, e.g.*, *Study Says U.S. Faces Shortage of General Physicians*, MEDICINE & HEALTH, May 2, 2008, at 1–2, *available at* http://find.galegroup.com/itx/publicationSearch.do (search Medicine & Health, enter year, select May 2) (last visited Mar. 11, 2009). One report predicts 200,000 fewer practicing physicians in the United States by 2020. Ann M. Hoppel, *Supply, Demand, and the Future of Health Care*, CLINICIAN REVIEWS, July 2008, at 1, 6–9, *available at* http://find.galegroup.com/itx/publicationSearch.do (search Clinician Reviews, enter year, select July) (last visited Mar. 11, 2009).

[19] *See* Ralph Blumenthal, *More Doctors in Texas After Malpractice Caps*, N.Y. TIMES, Oct. 4, 2007, at A21, *available at* http://www.nytimes.com/2007/10/05/us/05doctors.html; Tex. Civ. Prac. & Rem. Code Ann. §§ 74.301, 74.303 (Vernon 2005) (limiting noneconomic damages for healthcare claims and damages for healthcare claims for wrongful death).

[20] *See, e.g.*, Phyllis Korkki, *For Executives, Pay Is Good But Time Is Short*, N.Y. TIMES, Aug. 10, 2008, at B2, *available at* http://www.nytimes.com/2008/08/10/business/10count.html (stating that 65% of high ranking executives are subject to covenants in 2008, compared to 48% in 2007).

[21] Any prediction of the frequency with which a dispute with a physician will arise pales in comparison with the frequency of malpractice lawsuits. One source states that 60,000 malpractice suits are being tried on any given day, which represents about ten percent of the national number of physicians. Jeffrey Segal & Michael Sacopulos, *Do-It-Yourself Tort Reform*, WALL ST. J., Jul. 12, 2007, at A15, *available at* http://www.tortreform.com/node/426.

[22] Texas Department of State Health Services, *Population Data Estimates for Texas Counties, 2007*, Jan 12, 2009, http://www.dshs.state.tx.us/CHS/popdat/ST2007.shtm (last visited Mar. 11, 2009) (based on information compiled by the Texas State Data Center and Office of the State Demographer).

addressing the operation of the buyout right in physician covenants. However, notwithstanding the infrequency with which such a dispute occurs, its occurrence can be wrenching for the parties who previously trusted one another.

Articles on post-employment covenants abound, and numerous additional articles concentrate on physician covenants.[23] Yet no articles discuss the Act's buyout right in any detail, and the rare case mentioning the buyout right does not examine it, even though the Act has mandated the inclusion of a buyout right in physician covenants for nine years.[24] This

[23] S. Burleson & D. Clouston, *Light Dimmed by Johnson—The Enforceability of Covenants Not To Compete Under Texas Law*, 59 BAYLOR L. REV. 287 (2007); Daniel D. Quick, *Physician, Meet Thy Covenant*, MICH. BAR JOURNAL, MAY 2007, at 22, *available at* http://www.michbar.org/journal/pdf/pdf4article1139.pdf; Mike J. Wyatt, *Buy Out or Get Out: Why Covenants Not To Compete in Surgeon Employment Contracts Are Truly Bad Medicine*, 45 WASHBURN L.J. 715 (2006); Thomas B. Lewis & Amy Beth Dambeck, *Restrictive Covenants in a Physician's Employment Agreement: The New Jersey Example*, EMPLOYEE RELATIONS L.J., Winter 2005, at 12; T. Foss, *Texas, Covenants Not To Compete, and the Twenty-First Century: Can the Pieces Fit Together in a Dot.Com Business World?*, 3 HOUS. BUS. & TAX. L.J. 207 (2003); S. Borgman, *The New Covenant Not To Compete Statute*, 2 TEX. INTELL. PROP. L.J. 19 (1993); Comment, *The Story of Covenants Not To Compete in Texas Continues*, 33 HOUS. L. REV. 913 (1996); Comment, *Covenants Not To Compete: A Review of the Governing Standards of Enforceability After* DeSantis v. Wackenhut Corp. *and the Legislative Amendments to the Texas Business and Commerce Code*, 45 SW. L.J. 1009 (1991); Ferdinand S. Tinio, Annotation, *Validity and Construction of Contractual Restrictions on Right of Medical Practitioner To Practice, Incident to Employment Agreement*, 62 A.L.R.3d 1014 (1975); Tinio, *supra* note 3.

[24] Mahmood v. Fanasch, No. 09-05-134 CV, 2005 WL 3073786, at *3 (Tex. App.—Beaumont Nov. 17, 2005, no pet) (mem. op.) (holding that covenant was not enforceable against physician employee because his employment agreement did not prohibit physician from disclosing confidential information to be protected by the covenant); Laredo Med. Group v. Lightner, 153 S.W.3d 70, 73–74 (Tex. App.—San Antonio 2004, pet. denied) (remanding to trial court to determine reasonableness of covenant that employer obtained through purchase of the physician's practice and that employer sought to enforce against physician where covenant contained provision for payment of $200,000 to terminate two year and twenty five mile restrictions on post-employment practice); Gulf Coast Cardiology Group, P.A. v. Samman, No. 09-02-009CV, 2002 WL 1877175, at *1 (Tex. App.—Beaumont Aug. 15, 2002, no pet.) (mem. op.) (finding a physician's covenant not enforceable because it did not contain a buyout clause); Propath Servs., L.L.P. v. Ameripath, No. Civ.A.3:04-CV-1912-P, 2004 WL 2389214, at *2 (N.D. Tex. Oct. 21, 2004) (mem. op.) (discussing that employer could not enforce covenant against physician where the covenant omitted the requisite requirements of the buyout clause of the Act); Valley Diagnostic Clinic, P.A. v. Dougherty, 2009 WL 332252 at *5 (Tex. App.—Corpus Christi Feb. 12, 2009) (refusing to enforce a forfeiture of deferred compensation in a bylaw provision upon physician's subsequent competition with employer because forfeiture did not meet the "ancillary to" requirements of the Act).

Article fills that void and focuses solely on the buyout right in physician covenants.

B. Section 15.50(b) Is Unique Among State Laws on Covenants

Texas is somewhat unique among the states in regulating physician covenants.[25] No other state expressly grants a physician the right to buyout the covenant.

Seven states and the District of Columbia have statutes that prohibit physician covenants.[26] Other states have enacted laws that impose conditions on an enforceable physician covenant.[27] Only two states,

[25] *See* Katherine Benesch, *Covenants not to Compete and Healthcare: A Fifty State Survey*, 39 J. HEALTH L. 161 (2006).

[26] Alabama, California, the District of Columbia, Louisiana, Montana, North Dakota, and Massachusetts enacted laws prohibiting either covenants not to compete generally or covenants affecting professionals. *See* MASS. GEN. LAWS ch. 112, § 12X (2004); ALA. CODE § 8-1-1(a) (2002); CAL. BUS. & PROF. CODE § 16600 (West 2008); LA. REV. STAT. ANN. § 23:921 (1992); N.D. CENT. CODE § 9-08-006 (1987). Michigan prohibited physician covenants by statute until its repeal. *See* 1905 Mich. Pub. Acts 329 § 1 (codified at MICH. COMP. LAWS. § 445.761 (2006) (repealed 2006)); Burns Clinic Med. Ctr., P.C. v. Vorenkamp, 418 N.W.2d 393, 394 (Mich. App. 1988) (holding that physician covenant entered into when law declared such covenants void could not be enforced under subsequent repealing law permitting covenants). House Bill 851 was introduced in the Vermont Legislature that would add a statute to expressly prohibit physician covenants; the bill was referred to the Committee on Government Operations on February 5, 2008, but no further action has been taken as of this writing. *See* H.B. 851, 2007-2008 Leg. (Vt. 2008) (introduced), available at http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2008/bills/intro/H-851.HTM.

[27] The Florida statute requires that a person seeking to enforce a restrictive covenant prove a "legitimate business interest," for which the statute lists examples, including "patients." FLA. STAT. § 542.335(b)(4) (2007). A Florida appeals court has interpreted the statute not to include prospective patients within the term "legitimate business interests," thereby denying enforcement of a restrictive covenant that prohibited a former physician employee for competing for new patients. Fla. Hematology & Oncology v. Tummala, 927 So. 2d 135, 139 (Fla. Dist. Ct. App. 2006). Tennessee has very detailed statutory limitations on physician restrictive covenants. Beginning with a new law effective as of January 1, 2008, physician covenants are enforceable if the term is less than two years and the geographic restriction is less than ten miles or restricted to an identified facility. TENN. CODE ANN. § 63-1-148(a)(1) (Supp. 2008). However, a covenant is not enforceable against a physician who has been employed more than six years. *See id.* § 63-1-148(2). A second Tennessee statute regulates covenants applicable to physicians employed by hospitals or in faculty practice arrangements. *See id.* § 63-6-204. Prior to the adoption of § 63-1-148, the Tennessee Supreme Court held that covenants not to compete are not enforceable against physicians as a matter of public policy, except in the limited circumstances covered by section 63-6-204, as those arrangements fell within the Tennessee Legislature's police powers over hospital

Colorado and Delaware, come close to Texas' buyout requirement.[28] Those states prohibit the enforcement of a covenant against a physician following the end of employment, but allow the employer to contractually impose reasonable liquidated damages for its breach. The statutory statement of liquidated damages is analogous to Texas' stipulated buyout, which allows the parties to agree on the buyout amount.[29]

The Act differs from the Colorado and Delaware statutes in two important respects. First, the Act allows the enforcement of a covenant against a physician if the covenant satisfies the Act's conditions for an enforceable covenant.[30] In Delaware and Colorado, no physician covenant is enforceable. Second, the Act allows the parties to resort alternatively to arbitration at the end of employment in lieu of stipulating the buyout amount at the beginning of employment. The Colorado and Delaware statutes do not allow for an arbitrator to decide the liquidated damages

---

and faculty practice arrangements with physicians that are subject to the legislative restrictions described in section 63-6-204(f)(2)(A). Murfreesboro Med. Clinic, P.A. v. Udom, 166 S.W.3d 674, 683 (Tenn. 2005). *See also* discussion *infra* note 51.

[28] In *Hill*, decided more than twenty years ago, the Texas Supreme Court noted the states that had adopted statutes prohibiting or severely restricting covenants. *See* Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 170 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002).

[29] *See* COLO. REV. STAT. § 8-2-113(3) (2003); DEL. CODE ANN. tit. 6, § 2707 (2005). These states have a statute that does not permit injunctive enforcement of physician covenants but allows the employment agreement to contain contractual damages for violations. These statutes can be considered analogous to the Act's buyout clause:

> Any covenant not to compete provision of an employment . . . agreement between physicians which restricts the right of a physician to practice medicine . . . shall be void; except that all other provisions of such 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*.

Wojtowicz v. Greeley Anesthesia Servs., P.C., 961 P.2d 520, 522 (Colo. App. 1998) (emphasis added) (providing that employer of anesthesiologist could not support liquidated damages of 50% of physician's fees without showing damages based on future lost profits because net earnings of physician are not lost profits). In Tennessee, a covenant associated with a hospital's purchase of a physician's medical practice must give the physician the right to buy back the medical practice at its original purchase price, "[O]r, in the alternative, if the parties agree in writing, at a price not to exceed the fair market value of the practice at the time of the buy back, at which time such restriction on the practice shall be void." TENN. CODE ANN. § 63-6-204(f)(2)(A)(iii)(*a*) (2005).

[30] *See* discussion *infra* Part IV.

amount. Instead, the parties may state liquidated damages in the covenant, which is closely akin to the buyout clause's stipulated buyout covenant.

While Texas' statutory approach to the physician covenant is unique, the concept of a buyout is not altogether new. A number of reported cases have considered covenants that stated liquidated damages to be paid to the employer if the physician breached the covenant.[31] These cases would be akin to the Colorado and Delaware statutes, allowing the parties to include liquidated damages in the covenant if it is breached.[32] However, the difference is that Colorado and Delaware limit the remedies of the employer to liquidated damages, thereby preventing the employer's ability to enjoin the offending conduct.

[31] *See* Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 127 (Idaho 2005); Raymundo v. Hammond Clinic Ass'n, 449 N.E.2d 276, 278 (Ind. 1983) (discussing when an employer sued physician for liquidated damages for breach of two year, twenty five mile covenant); Wichita Clinic, P.A. v. Louis, 185 P.3d. 946, 952 (Kan. Ct. App. 2008) (providing that physician's covenant allowed physician to practice free of restrictions if physician paid 25% of all earnings collected during the three year post-employment competition subject to limitations of a lesser amount if employee was sixty-two years or older at time of termination of employment); Weber v. Tillman, 913 P.2d. 84, 87 (Kan. 1996) (providing that covenant permitted physician to practice without restrictions upon payment of an amount equal to six months' salary and bonus); Fields Found., Ltd. v. Christensen, 309 N.W.2d. 125, 130 (Wis. Ct. App. 1981) (providing that physician's covenant provided that physician was to pay liquidated damages to employer equal to $2000 each day physician violated the covenant's restrictions); Emergicare Sys. Corp. v. Bourdon, 942 S.W.2d 201, 205 (Tex. App.—Eastland 1997, no writ); Phillip H. Hunke, D.D.S., M.S.D., Inc. v. Wilcox, 815 S.W.2d 855, 856 (Tex. App.—Corpus Christi 1991, writ denied) (discussing where employer of pediatric dentist required dentist to sign a promissory note for $75,000 payable to employer if the dentist violated covenant); Mayhall v. Proskowetz, 537 S.W.2d 320, 321 (Tex. App.—Austin 1976, writ ref'd n.r.e.) (discussing employment agreement providing liquidated damages of $5000 if employee violated three year post-employment covenant with hearing aid distributor); Orenbaum Bros. v. Sowell Bros., 153 S.W. 905, 907 (Tex. App.—Dallas 1913, no writ) (holding that liquidated damages specified for breach of buyer's covenant was enforceable); Lehigh Valley Bone, Muscle & Joint Group, L.L.C. v. Puccio, 75 Pa. D. & C.4th 176 (Pa. Comm. Pl. 2005) (awarding liquidated damages to hospital as stated in covenant for physician's breach of the covenant); Oudenhoven v. Nishioka,190 N.W.2d 920, 921 (Wis. 1971) (discussing where physician agreed to pay employer $5000 within thirty days and another $20,000 in twelve months if he entered into a competitive practice to employer).

[32] John F. Reha, *The Law Of Trade Secrecy And Covenants Not To Compete in Colorado—Part II*, 30 COLO. LAW., May 2001, at 5, 8 ("Although no appellate decisions approving specific damages provisions in an agreement exist under subsection (3), some guidance is provided by cases determining the validity of liquidated damages provisions arising under competition restrictions involving persons other than physicians.").

The Texas cases on liquidated damages for breach of a covenant provide useful concepts for assessing a stipulated buyout covenant and are applied to it in Part VI. As will be seen when the legislative history to the buyout clause is discussed below, the physician's buyout right derives from the legislature's desire to promote the public's interest in unrestricted access to physician care.

C. Introduction to the Common Law Precedent for Evaluating the Buyout Price

The buyout right results in the payment of consideration to the employer as an alternative to the physician performing the covenant, to wit, not competing with the employer. If the physician violated the covenant without paying the buyout amount, the employer could sue the physician for the damages the employer suffered as a result. Logically, the buyout amount the physician should pay voluntarily pursuant to section 15.50(b)(2) should be equal to the amount the physician would have to pay if he or she violated the covenant. Thus, appellate decisions on the proper measurement of damages for breach of a contract will be useful tools to an arbitrator deciding the buyout price for an arbitration buyout covenant.

In a stipulated buyout covenant, the stipulated buyout price is equivalent to the parties stating liquidated damages to be paid if the physician violates the covenant.[33] The appellate cases mapping the boundaries of enforceable liquidated damages are a useful tool in evaluating stipulated buyout covenants.[34] As will be seen in Part VI, the cases, and consequently the evaluation of stipulated buyout amounts, are predicated on the proper measure of damages for the breach of the covenant.

Before considering how much the employer and the physician should insert in a stipulated buyout covenant, or how much an arbitrator should award as the buyout price for an arbitration buyout covenant, a review of the Act and significant Texas Supreme Court cases interpreting it is a necessary foundation. This discussion covers familiar territory in the law of enforceable covenants—a covenant's restrictions must be reasonable. The

[33] *See id.*; *Intermountain Eye & Laser Ctrs.*, 127 P.3d at 127 (observing that a covenant granting the physician the right to pay the employer a stated sum to terminate the covenant's restrictions was "somewhat analogous to a liquidated damages clause"); *Wojtowicz*, 961 P.2d at 521 (applying Colorado's law on physician covenants).

[34] *Raymundo*, 449 N.E.2d at 283 ("Indiana law clearly recognizes that contracts not to compete are especially adapted to liquidated damages provisions.").

review is still important, as the restrictions bear directly on the buyout price that a physician may choose to pay to eliminate the covenant.

III. OVERVIEW OF THE THREE SECTIONS OF THE TEXAS COVENANTS NOT TO COMPETE ACT

After several Texas Supreme Court decisions[35] virtually denuded covenants of their restrictive purposes, the Texas legislature passed the Act in 1989 and amended it in 1993 and 1999.[36] The most recent amendment added the provisions specific only to physician covenants, including the buyout right.[37]

The Act has three sections. The first section, section 15.50, identifies the obligatory items that must be included in an enforceable covenant.[38] The first obligatory item is an "otherwise enforceable agreement to which the covenant is ancillary" (herein "ancillary to" requirement).[39] Failure to meet the "ancillary to" obligatory item renders the covenant per se unenforceable.[40] For physician covenants, the right to buy out the covenant is a second obligatory ingredient.[41] A physician covenant that omits a buyout right is unenforceable.[42] Section 15.50 also includes other

[35] *See* Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 170 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002); DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 685–86 (Tex. 1990); Martin v. Credit Protection Ass'n, 793 S.W.2d 667, 670 (Tex. 1990). *But see* Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson and Strunk & Assocs., L.P., 209 S.W.3d 644, 654 (Tex. 2006) ("Cumulatively, this legislative history indicates that (1) in 1989 and 1993 the Legislature wanted to expand the enforceability of covenants not to compete beyond that which the courts had allowed . . . ."); Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 643 (Tex. 1994) ("In 1989, responding to decisions from this court, the Legislature passed the Covenants Not to Compete Act, a bill adding sections 15.50 and 15.51 to the *Texas Business and Commerce Code*."). *See generally* Michael Sean Quinn & Andrea Levin, *Post Employment Agreements Not To Compete: A Texas Odyssey*, 33 TEX. J. BUS. L. 7 (1996); Jeffrey W. Tayon, *Covenants Not To Compete in Texas: Shifting Sands from* Hill *to Light*, 3 TEX. INTELL. PROP. L.J. 143 (1995).

[36] Act of May 20, 1989, 71st Leg., R.S., ch. 1193, § 1, 1989 Tex. Gen. Laws 4852, *amended by* Act of May 29, 1993, 73d Leg., R.S., ch 965, § 1, 1993 Tex. Gen. Laws 4201.

[37] Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

[38] *See id.* § 15.50.

[39] *See id.* § 15.50(a).

[40] *Light*, 883 S.W.2d at 647.

[41] Tex. Bus. & Com. Code Ann. § 15.51(b)(2).

[42] Mahmood v. Fanasch, No. 09-05-134 CV, 2005 WL 3073786, at *2 (Tex. App.—Beaumont Nov. 17, 2005, no pet) (mem. op.) (finding a covenant not enforceable against

obligatory items for an enforceable covenant, which, if not entirely satisfied, can be changed by a court to rescue the covenant's enforceability. These items are the requirements that limit the covenant to reasonable restrictions on duration, geography, and activity (herein "boundaries").[43]

The Act's first section is a legislative affirmation that physician covenants do not offend Texas' public policies concerning physician employments.[44] As will be seen in the next part of this Article, the legislature included the buyout right to further the public policy of ensuring patient access to his or her physician.[45] On that basis, an attempt to obtain a court's decision that physician covenants are per se void as contrary to Texas' public policy might be considered futile.[46] Moreover, given Texas' regulation of the practice of medicine through licensure,[47] the imposition of the buyout right upon employers is well within the legislature's exercise of its police powers.

However, there may still be some room to reinsert public policy arguments into the equation in light of the Texas Supreme Court's

physician employee because his employment agreement did not prohibit physician from disclosing confidential information to be protected by the covenant); Gulf Coast Cardiology Group, P.A. v. Samman, No. 09-02-009CV, 2002 WL 1877175, at *1 (Tex. App.—Beaumont Aug. 15, 2002) (mem. op., not designated for publication) (holding that physician's covenant was not enforceable because it did not contain a buyout clause).

[43] Tex. Bus. & Com. Code Ann. § 15.50(a).

[44] *See* Hoddeson v. Conroe Ear, Nose & Throat Assocs., P.A., 751 S.W.2d 289, 290–91 (Tex. App.—Beaumont 1988, no writ) (holding that employer could not enforce covenant against the only ENT in the area encompassing the Woodlands near Houston); Tayon, *supra* note 35, at 165 (discussing *Hoddeson*); American Medical Association, *supra* note 6 (discussing the American Medical Association's adoption of the position that physician covenants should be discouraged); Berg, *supra* note 23, at 6–9 (discussing the history of the AMA's position).

[45] *See* discussion *infra* note 187.

[46] Yet considering the predictions of a shortage of physicians in the next ten to fifteen years, the public policy of access to physicians may take a much more important role in construing the enforceability of physician covenants and may well lead to further legislative action as has occurred in other states who have prohibited covenants against physicians. *See* Hoppel, *supra* note 18.

[47] *See* Tex. Occ. Code Ann. § 155.001 (Vernon 2004); *see also infra* note 177 (discussing the Texas Medical Board); *see generally* Cent. Ind. Podiatry, P.C. v. Krueger, 882 N.E.2d 723 (Ind. 2008); Mohanty v. St. John Heart Clinic, S.C., 866 N.E.2d 85 (Ill. 2007) (holding that any prohibition of physician covenants falls within the purview of the legislature in the exercise of its police powers to regulate professions); Raymundo v. Hammond Clinic Ass'n, 449 N.E.2d 276 (Ind. 1983).

discussion in *Juliette Fowler Homes*.[48] In that case, which is discussed in detail in Part IX, the court created a defense to tortious interference with a covenant based on public policy. The court held that although the unenforceability of a contract is not a defense to a claim of tortious interference, the unenforceability of a covenant is a defense to a claim of interference with the covenant.[49] The court based its exception to the general rule that unenforceability is not a defense to tortious interference on the theory that an unenforceable covenant is a restraint of trade and violates public policy.[50] In fact, the implementation of such public policy considerations in judicial decisions has been a growing trend across various jurisdictions.[51]

[48] 793 S.W.2d 660 (Tex. 1990); *see also* Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 833 (Tex. 1992) (citing *Juliette Fowler Homes*, 793 S.W.2d at 665) ("Covenants not to compete which are unreasonable restraints of trade and unenforceable on grounds of public policy cannot form the basis of an action for tortious interference."), *superseded by statute*, Act of Sept. 1, 1993, 73rd Leg., R.S., ch. 965, § 1, 1993 Tex. Gen. Laws 4201 (current version at Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2005) *as recognized in* Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644 (Tex. 2006).

[49] *Juliette Fowler Homes*, 793 S.W.2d at 667.

[50] *Id.*; *see also In re* Autonation, Inc., 228 S.W.3d 663, 668–69 (Tex. 2007) (discussing employer suing former employee in Florida for employee's violation of covenant that occurred in Texas and holding that a forum selection clause in the covenant was unenforceable on the basis of public policy considerations).

[51] Murfreesboro Med. Clinic, P.A. v. Udom, 166 S.W.3d 674, 682–84 (Tenn. 2005) ("In analyzing this issue, we see no practical difference between the practice of law and the practice of medicine. Both professions involve a public interest generally not present in commercial contexts. Both entail a duty on the part of practitioners to make their services available to the public. Also, both are marked by a relationship between the professional and the patient or client that goes well beyond merely providing goods or services."), *superseded by statute*, TENN. CODE ANN. § 63-1-148 (Supp. 2008); *see also* Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 895 (N.J. 2005); Cent. Ind. Podiatry, P.C. v. Krueger, 882 N.E.2d 723 (Ind. 2008) (stating that any policy decision to ban physician covenants should be left to the legislature); Pollack v. Calimag, 458 N.W.2d 591, 599 (Wis. Ct. App. 1990) (holding that employer could enforce 20 mile, two-year covenant against pain management physician) ("Finally, the agreement is not contrary to public policy. Agreements between physicians not to enter competitive practice within a reasonable time and distance are not disfavored in general."); Raymundo v. Hammond Clinic Ass'n, 449 N.E.2d 276, 281 (Ind. 1983) ("It appears that the enforceability of non-competition covenants has not been previously decided in this state, with respect to physicians. They have been upheld in other jurisdictions, however, and we see no reasons of public policy for holding them to be invalid per se."); Oudenhoven v. Nishioka, 190 N.W.2d 920, 922 (Wis. 1971) (noting that the physician subject to the covenant did not challenge the covenant as against statute). The New Jersey Supreme Court has also considered whether physician covenants violated New Jersey public policy. *See generally* Karlin v. Weinberg, 390 A.2d 1161 (N.J. 1978). In *Community Hospital*,

Further, it is interesting to note that the Beaumont Court of Appeals found a physician's covenant to be unenforceable on public policy grounds in a case decided in the decade preceding the enactment of the buyout clause.[52] The court held that the covenant was injurious to the public in denying the physician the right to practice medicine.[53] Before the Act, the judicial standards of review included considering the covenant's effect on the public, which to be enforceable must not be unreasonable.[54] The Act's section 15.50(b) is a legislative effort to strike a balance between the legislature's stated purpose of protecting patients' access to physicians and its statutory authorization of covenants against physicians.[55]

Moreover, section 15.50(a) requires a balancing of the restrictions contained in the covenant, including the scope of the activity restricted, so that the restrictions are not greater than necessary to protect the interests of the employer.[56] Although the Texas Supreme Court's previous creation of a

the court affirmed the continuing vitality of *Karlin*. *See Cmty. Hosp. Group, Inc.*, 869 A.2d at 895 ("We recognize the importance of patient choice in the initial selection and continuation of the relationship with a physician. Notwithstanding those considerations, on the record before us we find insufficient justification to overrule *Karlin* and adopt a *per se* rule invalidating restrictive covenants between physician or between a physician and a hospital."); *see also* Pierson v. Med. Health Ctrs., P.A., 869 A.2d 901, 904 (N.J. 2005) (serving as a companion case to *Community Hospital*, in which employer sought in a contractually agreed arbitration liquidated damages against a physician for violating a two year, twelve mile covenant and stating, "We continue to adhere to a case by case approach for determining a restrictive covenant in a post-employment contract is unreasonable and unenforceable. The trial court must determine whether the restrictive covenant protects the legitimate interests of the employer, imposes no undue hardship on the employee, and is not adverse to the public interest.").

[52] Hoddeson v. Conroe Ear, Nose & Throat Assocs., P.A., 751 S.W.2d 289, 290–91 (Tex. App.—Beaumont 1988, no writ) (holding that an employer could not enforce a covenant against the only ENT in the area encompassing the Woodlands near Houston), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002).

[53] *Hoddeson*, 751 S.W.2d at 290–91.

[54] Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 171 (Tex. 1987) *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002) ("Third, the covenant must not be injurious to the public, since courts are reluctant to enforce covenants which prevent competition and deprive the community of needed goods."), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002); Weatherford Oil Tool Co., v. Campbell, 161 Tex. 310, 340 S.W.2d 950, 951 (1960) ("Where the public interest is not directly involved, the test usually stated for determining the validity of the covenant as written is whether it imposes upon the employee any greater restraint than is reasonably necessary to protect the business and good will of the employer.").

[55] *See* Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

[56] *Id.* § 15.50(a).

"common calling" exception has been legislatively overruled by the Act, observations by the court's concurring opinion in *DeSantis* suggest that the Act's balancing requirement might also be a means to interject the effect on public policy as a defense against a covenant.[57] In his concurring opinion Justice Mauzy observed, "The 'scope of activity' language [in the Act], in my view, leaves adequate room for the continued vitality of the common calling doctrine."[58] It is not a far reach to extend Justice Mauzy's interpretation of the Act, requiring the court to consider the effect of a physician covenant on the public's right of access to physicians.

In the future, arguments to defeat a physician covenant based on its contravention of public policy, along the lines of the Arizona Supreme Court's admonishment that covenants be reviewed severely for reasonableness, can be expected.[59] Section 15.50(a) supplies the support for making the "public policy" argument for strict review of physician covenants in its requirement that the covenant "not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee."[60]

Section 15.51 of the Act allows an employer to seek remedies against a physician who breaches the covenant.[61] These remedies include compensatory damages, injunctive relief, or both.[62] This section also contains a "blue pencil" provision,[63] by which a court may change some, but not all, defects in a covenant so that it can be enforced.[64] In addition,

[57] *See Hill*, 725 S.W.2d at 172 (discussing the "common calling" exception).

[58] DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 690 (Tex. 1990) (Mauzy J., concurring).

[59] *See* Pizzini v. O'Neal, No. 09-05-102 CV, 2005 WL 2088369, at *4 (Tex. App.—Beaumont Aug. 31, 2005) (mem. op.) (discussing former chiropractor employee who attacked covenant as injurious to the public; however, the appellate court found that the injunction was based on the chiropractor's confidentiality agreement and not his covenant, but deferred the issue of public injury as a defense to a trial on the merits); Valley Med. Specialists v. Farber, 982 P.2d 1277, 1282 (Ariz. 1999) ("By restricting a physician's practice of medicine, this covenant involves strong public policy implications and must be closely scrutinized.").

[60] Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2002).

[61] *Id.* § 15.51(a).

[62] *Id.*

[63] Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 892 n.3 (N.J. 2005) ("'Blue Penciled' refers to a court's partial enforcement of a restrictive covenant. As the court reflected in *Karlin*, *supra*, courts 'may compress or reduce the geographical areas or temporal extent of their impact so as to render the covenants reasonable period.'").

[64] *See* Tex. Bus. & Com. Code Ann. § 15.51(c) (Vernon 2002); Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787, 794 (Tex. App.—Houston [1st Dist.] 2001, no pet) ("Furthermore,

this section articulates the employer's burden of proof and permits a court to award attorneys' fees to the physician subject to an unreasonable covenant that an employer knowingly imposes.[65]

The Act's third and last section, section 15.52, preempts the common law and other statutes as to the requisite content and the enforcement of covenants.[66] Its inclusion in the Act constrains a court's ability to judicially legislate in the field of covenants.[67] Nevertheless, decisions have limited the reach of the Act's preemption in cases not involving the final enforcement of the covenant.[68]

IV. THE ACT'S SPECIFIC REQUIREMENTS FOR AN ENFORCEABLE COVENANT

As introduced in Part III, section 15.50 specifies what a covenant must contain in order to be enforceable against a physician. The required contents are in the form of preconditions that can be grouped into three categories: (1) the "ancillary to" category; (2) the reasonable boundaries category; and (3) the physician-only category. This Part will discuss the attributes of an enforceable physician covenant in order to lay the groundwork for Parts V & VI, which then discuss the buyout of an enforceable covenant and the options of the parties if the covenant is believed to be either unreasonable or unenforceable.

The elements of an enforceable physician covenant are critical to the determination of a reasonable buyout price. To state the obvious, the Act's

Texas Business and Commerce Code section 15.51 imposes a statutory duty on a court to reform a covenant that it finds unreasonable as to time, geographical area, or scope of activity.") (citing Tex. Bus. & Com. Code Ann. § 15.51(c)).

[65] Tex. Bus. & Com. Code Ann. § 15.51(b)-(c).

[66] *Id.* § 15.52; Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 643 (Tex. 1994) ("[Section] 15.52 [of the Act] makes clear that the Legislature intended the [Act] to largely supplant the Texas common law relating to enforcement of covenants not to compete.").

[67] The *DeSantis* court made an interesting observation, as dicta, regarding the Act, which was adopted while the case was pending before the court. The court stated, "Accordingly, we leave for another day the issues of whether this recent legislation affects all covenants not to compete entered into before the effective date of the Act, and how it alters the common law principles governing such covenants." DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 685 (Tex. 1990).

[68] Perez v. Tex. Disposal Sys, Inc., 103 S.W.3d 591, 593 (Tex. App.—San Antonio 2003, pet. denied) (refusing to construe section 15.52 to entitle an employer to attorneys' fees in its suit to enforce a covenant that the trial court reformed, because the Act was silent on employer attorneys' fees after reformation and distinguishing *Gage Von Horn & Assocs., Inc. v. Tatom*, 26 S.W.3d 730, 733 (Tex. App.—Eastland 2000, pet. denied)).

buyout requirement only applies to an enforceable covenant; the unenforceable covenant does not merit a buyout. An understanding of an enforceable covenant is important not just for establishing a dividing line between enforceable and unenforceable covenants. It is also important for understanding the contours of the enforceable covenant, which will influence the amount that will apply to the buyout price of the covenant.

Part IV.A will discuss the "ancillary to" requirement. The underpinnings of this requirement are critical to an enforceable covenant. As will be seen in the discussion in Part IV.A, the "ancillary to" requirement defines the purposes for the covenant. In other words, the purposes of the covenant are not its barriers to the physician's competition. The purposes must justify the employer's reasons for imposing the barriers in the first place, even if the barriers are considered reasonable. These reasons protect those assets of the employer that give it a competitive advantage in its medical practice.

Part IV.B will discuss the familiar barriers to competition of the covenant itself, to which this Article refers as "boundaries" to emphasize the limits of the restrictions contained in the covenant. The discussion will focus on how the boundaries must relate to the interests of the employer that may be protected under the "ancillary to" standards. While the boundaries of the covenant have the greatest impact on the physician's future ability to practice medicine, the buyout price for the covenant must, as will be seen, relate both to the employer's interests to be protected and the means by which the covenant protects them.

It is not enough to value the consequences of the covenant's barrier to competition, namely, the exclusion of a physician from practicing a defined specialty of medicine in a defined territory for a defined period of time. The true value of the covenant must also take into account the business interests of the employer that the Act permits the covenant to protect. As an example, if the purpose of the covenant is to protect the employer's patient base by protecting its existing lists of patient contact information, the value of the covenant will relate to the value of that patient base, with additional adjustment factors that are suggested in Part V.B. If the covenant's purpose is to protect the employer's demonstrable goodwill in attracting new patients, the covenant's value should take into account the probability of a future stream of patients to the employer.

A. The "Ancillary To" Requirement

At the outset, the Act requires all covenants to be ancillary to an otherwise enforceable agreement at the time the employer and the physician make covenant.[69] The "ancillary to" requirement is obligatory; without it, the covenant fails on its face.[70] The Texas Supreme Court interprets an "otherwise enforceable agreement" to be more than an elementary contract.[71]

Even though an employment agreement between the employer and the physician is an ancillary contract, it does not satisfy the court's interpretation of the "ancillary to" requirement of the Act for an enforceable covenant.[72] Instead, the ancillary contract must address "an interest worthy of protection."[73] In those decisions, the court identified goodwill and confidential or proprietary information as examples of legitimate business interests that could be protected in the ancillary agreement.[74] Hence,

[69] Tex. Bus. & Com. Code Ann. § 15.50(a).

[70] *Light*, 883 S.W.2d at 647 (stating two requirements for an otherwise enforceable agreement to which the covenant must be ancillary: "(1) the consideration given by the employer in the otherwise enforceable agreement must give rise to the employer's interest in restraining the employee from competing; and (2) the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement").

[71] Even in pre-Act cases, the common law required the covenant to meet the "ancillary to" requirement. *See* Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 170 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002); Justin Belt Co. v. Yost, 502 S.W.2d 681, 683–84 (Tex. 1974) (deciding that a settlement agreement with former employees containing a covenant could satisfy the "ancillary to" requirement of the common law) ("Texas courts have stated the rule that contracts which are in reasonable restraint of trade must be ancillary to and in support of another contract."); Weatherford Oil Tool Co., v. Campbell, 161 Tex. 310, 340 S.W.2d 950, 951 (1960); *DeSantis*, 793 S.W.2d at 681–82 ("First, the agreement not to compete must be ancillary to an otherwise valid transaction or relationship.") (citing RESTATEMENT (SECOND) OF CONTRACTS § 187 (1981)).

[72] *See Light*, 883 S.W.2d at 647.

[73] *See id.*; Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 658 (Tex. 2006) (Wallace, C.J., concurring) ("The transaction or relationship had to create a legitimate interest worthy of protection, such as 'business goodwill, trade secrets, and other confidential or proprietary information.'") (quoting DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 681–82 (Tex. 1990)); *see generally* Mahmood v. Fanasch, No. 09-05-134 CV, 2005 WL 3073786 (Tex. App.—Beaumont Nov. 17, 2005, no pet.).

[74] *See Light*, 883 S.W.2d at 647 (citing DeSantis v. Wackenhut Corp., 793 S.W.2d 670 (Tex. 1990)); *DeSantis*, 793 S.W.2d at 682 (noting that business goodwill, trade secrets, and other confidential or proprietary information are examples of interests protectable by a covenant) (citing RESTATEMENT (SECOND) OF CONTRACTS § 188 (1981)). It is worth noting that as of this writing

ancillary contracts that address ordinary employment issues, such as those requiring a minimum number of days of notice to be given to terminate employment, will not support a covenant.[75] In order to justify a covenant, the physician's employment agreement must address a business interest of the employer.[76]

On the other hand, if the covenant is not ancillary to an agreement protecting the employer's business interests, a court is powerless to enforce the covenant and may not step in to reform the covenant.[77] Thus, it is

no cases have been reported approving ancillary agreements protecting the employer's business interests other than goodwill, trade secrets, and confidential information. *See, e.g.*, O'Brien v. Rattikin Title Co., No. 2-05-238-CV, 2006 WL 417237 at *4 (Tex. App.—Ft. Worth 2006) (mem. op.) (enforcing covenant against title company closer who was provided confidential information and breached covenant by working for another title company during the restricted period) ("Examples of legitimate, protectable business interests include business goodwill, trade secrets, and other confidential and proprietary information.").

[75] Texas is an employee "at will" state, meaning that employers generally may terminate an employee's employment with no prior notice. Montgomery County Hosp. Dist. v. Brown, 965 S.W.2d 501, 502 (Tex. 1998) (discussing employee who sought to modify at-will status based on employer's oral statements of continued employment subject to employee's satisfactory performance) ("For well over a century, the general rule in this State, as in most American jurisdictions, has been absent a specific agreement to the contrary, employment may be terminated by the employer or the employee at will, for good cause, bad cause, or no cause at all."). However, physician employment contracts typically give both the employer and the physician the option to terminate the agreement without being obligated to show a reason, that is, "without cause," on some minimum notice to the other party, which usually ranges from thirty to ninety days. The obligation to give at least the minimum notice constitutes a contract; however, that obligation, in the words of the Texas Supreme Court, is "illusory." *See Light*, 883 S.W.2d at 646 n.10 (discussing a contract that required employer to give employee fourteen days notice of termination of employment) ("We need not, and do not, decide the question of whether such a notice provision precludes the employment relationship from being at-will, for even if that provision created an employment contract for a term of two weeks, the covenant at issue would not be ancillary to such an agreement."); Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 832–33 (Tex. 1992) (discussing employer that sought to enforce covenant against former employee who joined parents competing travel agency and sought damages against competing travel agency for tortious interference with employer's covenant) ("An 'employment-at-will' relationship is not binding upon either the employee or the employer. Either may terminate the relationship at any time. Thus, an employment-at will relationship, although valid, is not an otherwise enforceable agreement.").

[76] *Light*, 883 S.W.2d at 647; DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 682 (Tex. 1990).

[77] *Light*, 883 S.W.2d at 647; Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2002). A court is only permitted to "blue pencil" a covenant's restrictions if the covenant is ancillary to an otherwise enforceable agreement. *See* Tex. Bus. & Com. Code Ann. § 15.51(c); Mann Frankfort

important to examine the agreement to which the physician covenant is ancillary. If the ancillary agreement does not contain provisions affecting the employer's business interests, specifically an employer's confidential information, trade secrets, or goodwill, any concern over the buyout right is irrelevant as the covenant is not enforceable *ab initio*.[78]

A footnote in *Light* caused Texas courts to strike covenants as unenforceable for a number of years because the otherwise enforceable agreement to which the covenant had to be ancillary was not entered into at the same time that the parties agreed to the contract, even when the covenant was included in the other agreement, to wit, an employment agreement.[79] If the employer promised to deliver confidential information during employment, *Light's* Footnote 6 stated that the employer's promise was an "illusory," unilateral contract because the employer could terminate the employee's employment without ever delivering the confidential information to the employee.[80] A number of courts after *Light*, and before *Sheshunoff*, struggled with the incipient issue of a contemporaneous

Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 (Texas April 17, 2009) ("Unless both elements of the [ancillary to] test are satisfied, the covenant is a naked restraint of trade and unenforceable.") (quoting *Light*, 883 S.W.2d at 647).

[78] Valley Diagnostic Clinic, P.A. v. Dougherty, 2009 WL 332252 at *5 (Tex. App.—Corpus Christi Feb. 12, 2009) (refusing to enforce a forfeiture of deferred compensation in a bylaw provision upon physician's subsequent competition with employer because forfeiture did not meet the "ancillary to" requirement of the Act).

[79] *See Light*, 883 S.W.2d at 645 n.6. Footnote 6 in *Light* was actually dicta because the employment contract under the court's review did not contain an affirmative obligation of the employee not to disclose confidential information, and therefore, there was no ancillary agreement binding on the employee. The failure of the employer's consideration was not needed to strike the covenant. Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 651 (Tex. 2006) ("At the outset, [Footnote 6] in *Light* was not essential to the holding in that case . . . as explained above, the fatal defect in the agreement in *Light* was not that it was unenforceable when made, but that there was no 'ancillary' promise by the employee, such as a promise not disclose confidential information, that the covenant not to compete was designed to enforce."); *see also* Vanegas v. Am. Energy Servs., 224 S.W.3d 544, 551–53 (Tex. App.—Eastland 2007, no pet.) (discussing at-will employees that sued employer for percentage of proceeds from sale of company and discussing *Light's* analysis of at will employment and illusory promises insufficient to support a covenant); Morse Wholesale Paper Co. v. Talley, No. 14-05-01180-CV, 2006 WL 995262 at *2 (Tex. App.—Houston [14th Dist.] 2006) (mem. op.) (enforcing covenant because there was contradictory evidence over whether the employer furnished the employee with confidential or proprietary information or training at the time the covenant was entered).

[80] *See Light*, 883 S.W.2d at 645 n.6 ("If only one promise is illusory, a unilateral contract can still be formed; the non-illusory promise can serve as an offer, which the promisor who made the illusory promise can accept by performance.").

exchange of confidential information when evaluating the enforceability covenants.[81]

The *Light* court considered this promise insufficient to constitute consideration to create an enforceable "other" agreement.[82] While the confidentiality obligations satisfied the legitimate business interests test of the "ancillary to" requirement, the obligations were not supported by consideration at the time they were entered into.[83] Since the employer may or may not supply the missing consideration during the term of employment, the consideration failed, and there was not another enforceable agreement at the time the parties entered into the covenant.[84]

However, twelve years later in *Sheshunoff*, the Texas Supreme Court reconsidered the far-reaching implications *Light's* Footnote 6 had on covenants.[85] While the court approved the central decision of *Light* (providing that a covenant must relate to another agreement between the employer and the employee that serves to protect the legitimate business interests of the employer), it likewise resolved the uncertainty created by *Light's* Footnote 6 when it held that the employer's consideration for the other agreement could be an offer to make a unilateral contract under which the employer's subsequent performance may serve as acceptance.[86] Thus, the physician employment agreement may recite that the employer will disclose confidential information to the employee during the course of employment as consideration for the physician's promise not to disclose the information after the physician's employment ends.

The *Sheshunoff* court concluded that the non-disclosure obligations constituted a unilateral contract that could become binding when the

[81] *See, e.g.*, Wright v. Sport Supply Group, Inc., 137 S.W.3d 289, 296–97 (Tex. App.—Beaumont 2004, no pet.) (providing that when employer showed it gave employee confidential information and training before and after entering into covenant the appellate court reviewed the reported decisions of other appellate courts that did and did not require confidential information to be delivered to the employee at the time the employer and the employee signed the covenant); *Morse Wholesale Paper Co.*, 2006 WL 995262, at *2 ("There must be a contemporaneous exchange of consideration between the parties at the time the otherwise enforceable agreement is executed for the promise not to be illusory.").

[82] *See Light*, 883 S.W.2d at 645.

[83] *Id.*

[84] *Id.*

[85] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 655 (Tex. 2006).

[86] *Id.* at 648–49, 651 ("There is no sound reason why a unilateral contract made enforceable by performance should fail under the Act.").

employer actually revealed the confidential information to the employee.[87] Once the non-disclosure obligations become binding on both the employer and the employee, an otherwise enforceable agreement is established that satisfies the obligatory "ancillary to" requirement.[88] Because of *Sheshunoff*, the timing of the delivery of confidential information to the employee is less relevant than the employer's ability to demonstrate that confidential information was revealed during employment.[89]

The Texas Supreme Court recently addressed the "ancillary to" requirement in a covenant by a certified public accountant when the employer made no express commitment to give the accountant confidential information. [90] The court in *Mann Frankfort* concluded that the employer's obligation to provide confidential information could be implied from the employment relationship in that the accountant would need access to confidential information in order to do his job. [91]

The *Mann Frankfort* case nicely summarizes the supreme court's analysis of the "ancillary to" requirement of the Act. The analysis

---

[87] *Id.*

[88] Chief Justice Jefferson expressed serious reservations regarding an employer's ability to provide confidential information to an "at will" employee immediately prior to termination, and thus create an enforceable agreement by manipulating the court's holding in *Sheshunoff*. *Id.* at 662 ("After today, an employer may easily refrain from sharing trade secrets or other specialized technical knowledge with an employee for a substantial period of time after the covenant is signed, only to quickly perform once an employee indicates an intention to leave his current job for the employer's competitor.").

[89] One physician employment agreement reviewed by the author contained an appendix to be signed at the time the employment agreement was signed, wherein the physician acknowledged receipt of confidential information from the employer and generally described the disclosed confidential information. Presumably the employer's attorney was concerned about satisfying *Light's* requirement, in footnote 6, that the other agreement be enforceable at the time of the covenant. *See* Powerhouse Prods., Inc. v. Scott, 260 S.W.3d 693, 697 (Tex. App.—Dallas 2008, no pet.) (holding that employer could not enforce covenant against long time employee when employer could not show the disclosure of confidential information or training or otherwise show adequate consideration for the covenant).

[90] Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 (Tex. Apr. 17, 2009) (covenant in the form of a contractual obligation in the accountant's employment contract that required a payment to the employer to purchase the business of any client of the employer for whom the accountant performed services during the year following the end of the accountant's employment).

[91] *Id.* at *6–7 ("In order for Fielding to perform his duties, Mann Frankfort gave him access to its client database, which contains clients' names, billing information, and pertinent tax and financial information.").

undertakes two inquiries: "(1) is there an 'otherwise enforceable agreement,' and (2) was the covenant not to compete 'ancillary to or part of" that agreement . . ."[92] The court found that there was an otherwise enforceable agreement because the contract expressly required the accountant to maintain the confidentiality of confidential information provided by the employer and the employer had an implied obligation to reveal that information to the accountant. When the employer revealed confidential information to the accountant, the unilateral contract of the accountant became binding on both parties.[93]

The supreme court also stated *Mann Frankfort* that the second inquiry above must satisfy two requirements in order to satisfy the "ancillary to" requirement of the Act.[94] "First the consideration given by the employer in the otherwise enforceable agreement must give rise to the employer's interest in retraining the employee from competing.[95] Second, the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement."[96] In applying its tests, the supreme court concluded that the accountant's covenant, which in the case was a purchase obligation, was designed to protect the employer's interest in the confidential information it revealed to the accountant. The confidential information revealed by the employer to the accountant constituted the employer's consideration in the otherwise enforceable agreement between them—the employer would reveal to the accountant its confidential information and the accountant would not reveal it.[97]

In the typical physician employment agreement, the parties agree to reciprocal obligations whereby the employer promises to reveal confidential information to the physician during employment in exchange for the physician's promise to keep the disclosed information confidential after the end of employment.[98] The confidential information constitutes the

[92] *Id.* at *4.

[93] *Id.*

[94] *Id.*

[95] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 648–49 (Tex. 2006); Light v. Centel Cellular Co. of Tex., 883 S.W.3d 642, 647 (Tex. 1994).

[96] *Id.*

[97] *Id.* at *7.

[98] The confidentiality paragraph from a commonly used form of physician employment agreement reads as follows. The confidentiality obligations of the employer and the physician are italicized for reference:

employer's business interests to be protected by the covenant. The employer's promise to disclose and the physician's promise not to reveal the confidential information constitute an otherwise enforceable agreement under the Act. Therefore, both prongs of the "ancillary to" requirement are met, assuming of course that the employer reveals confidential information to the physician that is worthy of protection.

The legitimate business interests that a covenant may protect, and which as a pre-condition must be present, fall within two categories: confidential information and goodwill.[99] The former category has received the most attention in employment-related covenants. The latter category arises from a long history of cases holding that goodwill is a protected property right acquired by the business purchaser and is a legitimate interest to be

(a) Physician acknowledges that prior to entering into this Agreement, Physician has not had access to patient lists and information about the internal operation of the Employer.

(b) During the course of Physician's relationship with Employer, *the Employer will impart Confidential Information to Physician.* "Confidential Information" means any proprietary or financial information, confidential technology, marketing and pricing information, internal publications and memoranda, patient lists, medical records, fee schedules, payor or managed care contracts, referring physician lists or contact information, or trade secrets of the Employer or its other contracting physicians or any matter or information ascertained by Physician through Physician's relationship with the Employer which the Employer does not specifically identify in writing to not be Confidential Information. *While employed and perpetually after this Agreement terminates, Physician shall not disclose any Confidential Information of the Employer except as expressly required in writing by the Employer or by law.*

(c) During the term of this Agreement and for two years after this Agreement terminates, Physician shall keep confidential and not disclose, to any person or other legal entity, the terms of this Agreement, except that Physician may disclose the terms of this Agreement to Physician's attorney; provided that Physician's attorney has assumed like obligations of confidentiality.

(d) If this Agreement terminates, Physician will deliver promptly to the Employer all Confidential Information that Physician may then possess or have under Physician's control.

[99] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 647 (Tex. 1994); DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 682 (Tex. 1990) ("[E]xamples of legitimate protectable interests include business goodwill, trade secrets, and other confidential or proprietary information.") (citing RESTATEMENT (SECOND) OF CONTRACTS § 188 (1981)).

protected by a covenant.[100] Moreover, the Act specifically mentions goodwill as part of its "ancillary to" requirement.[101] Although goodwill arises predominantly in covenants associated with the sale of a business, an employer may also have goodwill, as discussed below.[102]

The confidential information[103] that the employer seeks to protect can include any of the following categories of information pertinent to the employer's medical practice: patient names and contact information;[104] contracts with payors; patient medical records;[105] names and contact

[100] Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 171 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002) ("In the case of covenants not to compete incident to the sale of the business, the seller's promise not to compete with the buyer increases the value of the business to the buyer. Without such a covenant the value of the business would be reduced, lessening the likelihood that the businesses would be purchased."); RESTATEMENT (SECOND) OF CONTRACTS § 188 cmt. f (1981) ("A promise to refrain from competition made in connection with the sale of a business may be reasonable in the light of the buyer's need to protect the value of the good will that he has acquired."); RESTATEMENT (FIRST) OF CONTRACTS (1932) § 516 ("The following bargains do not impose unreasonable restraint of trade … (a) A bargain by the transferor of property or of a business not to compete with the buyer in such a way as to injure the value of the property or business sold."); *see also supra* note 3 regarding the inclination of courts not to review covenants arising from the sale of business as strictly as covenants associated with employment.

[101] Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2002).

[102] Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 170 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002).

[103] Hyde Corp. v. Huffines, 158 Tex. 566, 314 S.W.2d 763, 776 (1958) (listing the types of information that can constitute an employer's trade secrets if the employer uses adequate safeguards to maintain confidentiality) (citing RESTATEMENT (FIRST) OF TORTS § 757 (1939)).

[104] Arguably, patient names and contact information are equivalent to a business' customer list. The courts have upheld confidentiality for customer lists. Guy Carpenter & Co. v. Provenzale, 334 F.3d 459, 467 (5th Cir. 2003) (discussing where employer sought to enforce non-disclosure covenant in employee's contract when employee solicited a customer list of insurance clients on behalf of a competitor) ("Texas courts consistently consider three factors when determining whether a customer list is a trade secret: (1) what steps, if any, an employer has taken to maintain the confidentiality of a customer list; (2) whether a departing employee acknowledges that the customer list is confidential; and (3) whether the content of the list is readily ascertainable.").

[105] 22 Tex. Admin. Code § 165.1(a) (2009) ("Each licensed physician of the board shall maintain an adequate medical record for each patient that is complete, contemporaneous and legible."). The patients' rights to privacy in the disclosure of their medical records is protected in federal statutes. 42 U.S.C. § 1320d [Health Insurance Portability and Accountability Act of 1996 ("HIPAA")]; 45 C.F.R. Parts 160 and 164.

information of referring physicians;[106] fee schedules; marketing information; protocols and practice procedures; and internal business information. All of the foregoing types of information are used by the employer in the conduct of its medical practice and are kept confidential in order to preserve a competitive advantage. While these types of information, in the suitable context, can meet the supreme court's requirement of a legitimate business interest, counsel for employers are well advised to resist the temptation to include every conceivable type of business information. Counsel should first consider whether the information is actually used by the employer in its medical practice, is kept confidential in its medical practice, and is material to its medical practice.

Physician employers who are interested in covenants are motivated more by the anticompetitive benefits than the protection of confidential information. Consequently, the employer is likely to request its counsel to draft the covenant with restrictions that extend as far as possible, excluding the physician from the employer's marketplace, first and foremost. However, this behavior is deemed illegal under Texas' antitrust law: "Every contract, combination, or conspiracy in restraint of trade or commerce is unlawful."[107] When discussed later in this Article, only the business concerns of the employer entitled to protection under the "ancillary to" requirement should be taken into account when arriving at a buyout price to be paid by the physician. These concerns are discussed in the ensuing paragraphs and are intended to be useful examples, not a comprehensive list.

First, an employer will seek to protect patient names of the employer's medical practice.[108] Names will include current and former patients, and in

[106] Wellspan Health v. Bayliss, 869 A.2d 990, 1000 (Pa. Super. Ct. 2005) (holding hospital entitled to injunction against perinatologist physician to prevent physician from soliciting referring physicians because employer's relationship with referring physicians is worthy of protection).

[107] Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2002).

[108] Ordinarily customer lists (which I am arguing includes patient lists) are considered an employer's trade secret. *Hyde*, 314 S.W.2d at 776. However, the Texas Medical Board Rules require a physician leaving employment to notify by letter all of the patients the physician treated in the previous two years. 22 Tex. Admin. Code § 165.5(C) (2009). Moreover, the employer is to place a sign in the employer's offices notifying patients of the physician's departure at least thirty days before the physician's last day of service. *Id.* § 165.1. Interestingly, the Act only requires a covenant to grant the physician access to patients the physician has seen or treated within one year prior to the end of employment. Tex. Bus. & Com. Code Ann. § 15.50(b)(1)(A) (Vernon 2002).

some specialty practices, the names of prospective patients.[109] Names from the entire medical practice, not just the patients that the physician treated while employed, are at issue. Simply put, the employer does not want the physician soliciting the employer's patients if the physician no longer works for the employer.[110]

The identities of the patients are not a secret;[111] however, it would take substantial resources to assemble the patient list without the assistance of the employer's list. This fact is frequently confirmed by the actions of departing physicians immediately prior to separation from the employer. The departing physician will covertly copy the patient list from the employer's records intending to use it after leaving the employer's medical practice.[112] Obviously, notwithstanding applicable law on covenants, those activities constitute a breach of the physician's duty of loyalty to the employer.[113]

While the employer legitimately desires to keep patient lists confidential, several legal impediments exist against that goal, which arise

[109] As an example, a plastic surgeon may conduct public seminars on cosmetic procedures that generate leads to be followed for future procedures. *Cf.* Wright v. Sport Supply Group, Inc., 137 S.W.3d 289, 298 (Tex. App.—Beaumont 2004, no pet.) (refusing to enforce a covenant that restricted a sales representative for sporting goods from contacting prospective customers with whom he had no prior dealings).

[110] Wichita Clinic, P.A. v. Louis, 185 P.3d. 946, 956 (Kan. Ct. App. 2008) (discussing the employer's argument that the family practice physician could easily take existing patients from employer if permitted to continue practicing in the restricted county).

[111] Apart from claiming the confidentiality of patient lists as a justification for the physician's covenant, both the employer and the physician are subject to strict privacy requirements under federal and state laws. *See supra* note 96 and *infra* note 124. In addition, the Federal Rules of Evidence and the Texas Rules of Evidence clearly privilege "doctor-patient" communications for introduction as evidence, except for a very few exceptions that would not apply to a physician's employment.

[112] Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 889 (N.J. 2005) ("Between the date of his notice of resignation and his separation date, Dr. More removed documents from the Institute identifying patients' names and addresses, as well as the identity and location of the Institute's referral sources."); Fields Found., Ltd. v. Christensen, 309 N.W.2d 125, 129 (Wis. Ct. App. 1981) ("The trial court found that Christensen was nevertheless most interested in obtaining possession of the Center's referral list. He photocopied the list in 1979 to provide himself with a 'base' from which to compete with the Center and made some contacts with referral agencies and physicians with respect to opening his own clinic.").

[113] Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193, 202 (Tex. 2002) (holding that attorney employee owed duty of loyalty to law firm employer and cannot solicit firm clients for new firm prior to announcing to employer his intentions to terminate employment).

out of the state's public policy regarding patient access to physicians.[114] The first impediment is contained in the Act itself. Section 15.50(b)(1)(A) provides that the covenant may "not deny the physician access to a list of his patients whom he had seen or treated within one year of the termination."[115] The Act requires the employer to provide that information to the physician.[116] It is not contingent on the physician buying out the covenant; it is an obligatory condition to having an enforceable covenant—without it, the covenant is unenforceable. The legislature's instruction to employers, while growing out of its public policy concerns, draws into question whether, as between the employer and the physician, the patient list is a protectable business interest of the employer.

The second impediment to the employer maintaining the confidentiality of its patient list grows from the Texas Medical Board Rule 165.5, which has no relation to physician covenants.[117] The rule requires any physician whose employment with a medical practice has ended to send a notice to all patients the physician has seen in the prior two years.[118] The physician is responsible for notifying his or her patients,[119] and the employer must cooperate with the physician in complying with the rule.[120] As a result, the employer must furnish the patient contact information to the physician.

The rule specifies the contents of the notice, which is designed to inform the patient how to obtain, or transfer to another physician, a copy of the patient's medical records.[121] The rule also requires a sign to be placed in the employer's offices for thirty days notifying the patients of the physician's departure, the publication of the same notice in the newspaper, and notice to the Texas Medical Board confirming that the physician complied with the rule.[122] The net effect of the rule is to give the physician

[114] The State's policy regarding patient access to physicians is discussed in Part IV.C.

[115] Tex. Bus. & Com. Code Ann. § 15.50(b)(1)(A) (Vernon 2002); *see infra* Part IV.C (detailing the legislative history to § 15.50(b) and the public policy underlying its addition to the Act).

[116] Tex. Bus. & Com. Code Ann. § 15.50(b)(1)(A).

[117] 22 Tex. Admin. Code § 165.5 (2009).

[118] *Id.* § 165.5(b)(2)(C).

[119] *Id.* § 165.5(a)(3).

[120] *Id.* § 165.5(c).

[121] *Id.* § 165.5(a).

[122] *Id.* § 165.5(b)(2).

access to the information and to inform both the physician's patients and the public at large of the physician's separation from the practice.[123]

If both the Act and the Texas Medical Board Rule require the employer to furnish its patient list information to the departing physician, to the extent it pertains, then one might question if the employer has a protectable interest in the physician's patient list. No Texas appellate case seems to have addressed whether a legitimate business interest in a "customer base" can be protected by a covenant when the employer is compelled by law to disclose the list, thereby impairing its confidentiality.[124]

An employer's counsel might well argue in support of the covenant's protection that the requirement to provide the information to the physician does not mean that the physician has the right to use the list competitively. The physician, post-employment, is contractually obligated by the confidentiality paragraphs of the employment agreement to keep the list confidential and to not reveal it to anyone else. For example, the physician, upon separation from the employer, will be provided with the information that satisfies both section 15.50(b)(1)(A) and Texas Medical Board Rule 165.5, but mere possession of that confidential information does authorize the physician to disclose it to his or her subsequent employer.

Perhaps a close second in priority of information is that an employer will want to prevent a departing physician from using its information pertaining to referral sources.[125] Referral sources to medical practices can vary, but common examples are physicians in other medical specialties who refer patients to the employer, and to the physician while employed, for treatment.[126]

---

[123] In practice, counsel for some employer's have tried to control a departing physician's access to the patient list by including provisions in the physician's employment agreement in which the physician delegates the responsibility for complying with Texas Medical Board Rule 165.5.

[124] Ctr. for Econ. Justice v. Am. Ins. Assoc., 39 S.W.3d 337, 346 (Tex. App.—Austin 2001, no pet.) (affirming trade secret status of a quasi-customer list that insurance companies are required to submit to a Texas regulatory agency).

[125] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 128 (Idaho Ct. App. 2005) ("And medical services firms, particularly those providing specialized care, generally have protectable interests in referral sources.").

[126] Cardiovascular Surgical Specialists, Corp. v. Mammana, 61 P.3d 210, 212 (Okla. 2003) (discussing a covenant in physician's employment contract restricted physician from soliciting other physicians who referred patients to the employer) ("As with any practice of cardiovascular and thoracic surgery, Drs. Cholmia and Mammana were, and are, particularly dependent on referrals from other physicians in the medical community. Patients normally seek treatment from

The information pertaining to the referral network is highly valuable to the employer, as the network constitutes the wellspring for the continuing flow of new patients to the employer's practice.[127] The employer cultivates referring physicians through various marketing efforts and by leading seminars to educate referring physicians about the employer's medical practice.[128] Once cultivated, the employer will maintain strong ties with the members of the referring network to facilitate on-going referrals.[129]

Unlike patient lists, no statutory or regulatory mandates are imposed on the employer to furnish the list of referral sources to the departing physician. As the physician has access to the referral database during employment, protecting against the disclosure and subsequent use of this database falls squarely within the type of business interests that the Texas Supreme Court considers worthy of protection by a covenant.[130] Moreover,

a less specialized medical practitioner who then refers the patients for possible surgery."). Other referral examples include: OB/GYN doctors are an excellent referring source of patients to pediatricians, as expectant mothers ask their OB/GYN doctor for a recommendation of a pediatrician to care for the baby after birth; pediatricians are an excellent referral source to surgeons specializing in pediatric surgery; and orthopedic surgeons refer patients to radiologists for imaging.

[127] Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 897 (N.J. 2005) (recognizing that an employer possessed a protectable interest in patient and patient referral bases.)

[128] *See, e.g.*, Detko v. Comm'r, 53 T.C.M. (CCH) 186 (1987) (discussing that anesthesiologist sought to increase referrals by entertaining referral physicians on physician's fishing boat, but IRS disallowed business deductions related to fishing boat expenses) ("In a competitive market such as that faced by Dr. Detko, the maintenance of positive relationships with doctors who were referring patients already was as important as gaining the confidence of doctors who had no prior history of referrals.").

[129] *More*, 869 A.2d at 897 ("Further, Dr. More admitted he removed patient and patient referral lists from [employer] between the time of his resignation and his eventual departure from [employer]. It was also undisputed that many of the patients Dr. More treated after joining NAPA in Somerset were once patients of [employer] or were referred to Dr. More from one of [employer's] referral sources."); Pizzini v. O'Neal, No. 09-05-102 CV, 2005 WL 2088369, at *2 (Tex. App.—Beaumont, Aug. 31, 2005, no pet.) (discussing enforcement of employer's covenant against chiropractor) ("Anitra Williams [the administrator of O'Neal's Port Arthur facility] testified Pizzini downloaded O'Neal's patient files onto a disk, and the disk was missing after Pizzini left. O'Neal introduced into evidence a computer back-up report showing that someone logged in as Pizzini and retrieved the patient list from O'Neal's hard drive.").

[130] DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 682 (Tex. 1990) (noting the legitimate business interests that could be protected, but finding the employer did not provide sufficient proof of its interests to sustain the covenant). *Contra*, *Cardiovascular Surgical Specialists, Corp.*, 61 P.3d at 214 ("One surgeon has no legitimate business interest in another surgeon's referral base regardless of a past employer-employee relationship."). *Cf.* Guy Carpenter & Co. v. Provenzale,

employers will introduce the new specialist physician to its referral sources in order for the new specialist physician to gain acceptance in the medical community.[131] Prudent employers will establish uniform office and employment practices to safeguard its database on referral sources.[132] These practices include practice-wide confidentiality agreements with all employees, including administrative and support staff, and restricting access to employees who have a need to know the information.[133]

Marketing plans and business procedures are good examples of other confidential information that an employer may seek to protect by a covenant. If specific types of information that enhance an employer's competitive position exist, the employer should include a description of the specific information in the confidentiality portion of the covenant. Many medical groups develop sophisticated procedures in marketing their services and competing for medical business, and this information should be described in the covenant in sufficient detail to show its importance to the employer. For example, if the employer has developed a system for following patients that is not used by other medical practices, the system should be generally described as post-encounter follow-up procedures.

Fee schedules used by the employer can contain information that gives it a competitive advantage. This advantage is particularly prominent in large practice settings where the employer's size in the relevant market

334 F.3d 459, 468 (5th Cir. 2003) (noting that under Texas trade secret law, whether a customer list is a trade secret is a question of law to be determined by the court). If the nature of the physician's practice is dependent on physicians in certain specialties, the physician may question whether the list of referral sources is not protectable, as the physician can determine the identities of the specialists from readily available directories.

[131] Graham v. Cirocco, 69 P.3d 194, 199 (Kan. Ct. App. 2003) ("Instead, he came to an entirely new area of the country, became board-certified while working for Graham, and, for six years, took advantage of Graham's established contacts in the community to make a name for himself.").

[132] Pizzini v. O'Neal, No. 09-05-102 CV, 2005 WL 2088369, at *3 (Tex. App.—Beaumont Aug. 31, 2005, no pet.) ("Darlene testified that the employees at O'Neal's practice had separate computer passwords which were kept secret."); *Guy Carpenter & Co.*, 334 F.3d at 467.

[133] Tom James of Dallas, Inc. v. Cobb, 109 S.W.3d 877, 888 (Tex. App.—Dallas 2003, no pet.) ("A non-disclosure agreement may be enforceable even if a covenant not to compete is not."); Bandit Messenger of Austin, Inc. v. Contreras, No. 03-00-00359-CV, 2000 WL 1587664 (Tex. App.—Austin Oct. 26, 2000, no pet.) (holding that a former driver subject to confidentiality agreement showed that his employer delivery company did not take steps to maintain the secrecy of its customer base) ("As noted above, he had never before taken steps to ascertain whether such information might be being used by other former Bandit employees and drivers.").

gives it bargaining leverage with the payors, like insurance companies, in negotiating reimbursement levels for patient claims. This information, however, applies to private, as opposed to government-sponsored, payment plans. The private payors are predominantly insurance companies offering a variety of health care insurance products. When compared to all sources of payment of health care claims, a very small percentage of patients pay for their health care without government or insurance company assistance.[134]

The fee schedules of government-sponsored health care plans are not a secret. Medicare pays physicians' claims for services to patients according to a preset fee schedule adopted annually by the Center for Medicare and Medicaid Services (CMS) of the U.S. Department of Health and Human Services.[135] Private payors, such as insurance companies offering general indemnity, PPO, and HMO coverage, often base their reimbursements on Medicare's fee schedule or a multiplier of it. Knowledge of the reimbursement rates that the private payors contracted with the employer could give the physician a competitive advantage if the physician chooses to compete with the employer.

The point of this discussion is to question the utility of blanket descriptions that include the proverbial kitchen sink. Attorneys drafting covenants tend to believe that listing as many types of information as possible will enhance the enforceability of the covenant in the future without regard to whether the information is actually used by the employer. However, over-inclusion of non-essential types of information may lead a court to consider the covenant unreasonable, as its protections are not tied to business interests specific to the employer. To date, no court has focused on the enforceability of a covenant in an employment agreement with a long

[134] In 2003, individual out-of-pocket health care expenditures accounted for 14% of the $1.7 trillion spend in the United States for health care. Private health insurance accounted for 36% and the public sector accounted for the rest, including 17% from the Medicare program and 16% from the Medicaid and SCHIP programs. *Effects of Health Care Spending on the U.S. Economy*, http://aspe.hhs.gov/health/costgrowth/. Total health care expenditures in the United States in 2006 were $2.1 trillion, with the Medicare and Medicaid programs accounting for 34.1% of the total. http://www.cms.hhs.gov/NationalHealthExpendData/02_NationalHealthAccountsHistorical.asp#TopOfPage.

[135] The Centers for Medicare and Medicaid Services are expected to fund $800 billion of the United States' healthcare costs, which were $2.2 trillion in 2007. Alex Berenson & Reed Abelson, *Weighing the Costs of a Look Inside the Heart*, N.Y. TIMES, June 29, 2008, at A1, 18-19.

list of protected business interests, many of which are interests in the abstract but not in fact.

As previously mentioned, often the typical physician employment agreement will include a laundry list of items that the employer contends are confidential by their inclusion, such as training, patents, trademarks, copyrights, designs, methods, and processes. Some of these items may not even exist. And if they do exist, the covenant is not truly needed if the intellectual property is protected through federal and state patent, trademark, and copyright laws giving the owner the right to enjoin an infringer,[136] and state secrecy laws, which make disclosure illegal.

Training can be deceptive. Physicians undergo extensive clinical training after completing medical school through approved residency programs, and often a physician will undergo even further training in a fellowship program. Residency training is also a prerequisite to a physician joining a hospital's medical staff and to obtaining privileges to admit patients to the hospital. Moreover, it is the physician's particular skill, developed independently by the physician during his or her residency training, which attracts patients to the physician.[137]

Without question, physicians who become employed directly from residency training or from active duty service in the armed forces will benefit from the private practice experience of the employer and its other physician employees. However, this process of adapting to private practice fails to rise to the level of a legitimate business interest.[138] More likely, the inclusion of training in the laundry list of protected information is a holdover from the Texas Supreme Court cases that led to the legislature's

[136] 35 U.S.C. § 281 *et seq.* (patents); 17 U.S.S. § 101 *et seq.* (copyrights); 15 U.S.C. § 1051 *et seq.* (trademarks); *see also* Tex. Pen. Code Ann. § 31.05 (Vernon 2003) (theft of trade secrets); Hyde Corp. v. Huffines, 158 Tex. 566, 314 S.W.2d 763, 771–72 (1958) (discussing trade secret treatment of an invention that was also the subject of a patent application).

[137] Hoddeson v. Conroe Ear, Nose & Throat Assocs., P.A., 751 S.W.2d 289, 290 (Tex. App.—Beaumont 1988, no writ) ("The record shows that referring physicians are governed by the skills and qualifications of the receiving physician, rather than his associations. [The employer] did not impart trade secrets, specialized training or confidential information to [the physician.]").

[138] Hosp. Consultants, Inc. v. Potyka, 531 S.W.2d 657, 662 (Tex. Civ. App.—San Antonio 1975, no writ) (discussing in a pre-Act case decided before *Hill* that employer's general training did not justify an interest to be protected by a three year, fifty mile covenant against emergency room physician) ("We're unwilling to hold that general knowledge, skill or facility acquired through training or experience while working for an employer become the 'property' of the employer. Such knowledge and skill appertain exclusively to the employee, even though they were acquired by on-the-job training which was expensive and costly.").

passage of the Act. Specifically, those cases held that training associated with a common calling did not justify the enforcement of a covenant.[139] On the other hand, under those decisions, specialized, technical training by an employer would support a covenant.[140]

The mere listing of training in the employment agreement no longer justifies the protection of a covenant under the Act. *Light* made it clear that the legitimate business interests to be protected by a covenant were confidential information and goodwill. If an employer instructs a physician in skills not possessed when the physician became employed, such as techniques not generally known in the medical specialty, the instruction constitutes confidential information worthy of protection. The employer in that situation should describe the information that will be imparted to the physician, such as advanced plastic surgery techniques.[141]

The foregoing examples are not given merely to encourage more precise drafting, but also to illustrate the effect that poorly-described employer interests might have on the buyout price. To the extent that the information of the employer included in the employment agreement which the covenant is to protect is vague, all encompassing, or non-existent, the arbitrator determining the buyout price of that covenant should disregard the information as having no monetary value.

---

[139] *Hill*, 725 S.W.2d at 172 (noting that the restricted franchisee was already skilled in the business covered by the franchise agreement) ("Finally, the covenant is oppressive to the promissor, Hill. Not only has he lost his franchise and investment therein, he is now prevented from using his previously acquired skills and talent to support him and his family in the county of their residence. We recognize that a man's talents are his own. Absent clear and convincing proof to the contrary, there must be a presumption that he is not bargained away the future use of those talents."); Cujakti v. Burkett, 772 S.W.2d 215, 217 (Tex. App.—Dallas 1989, no writ) (refusing to enforce employer's covenant against former veterinarian employee) ("The [Texas Supreme] Court has suggested that a common calling consists of activities that do not require extensive, highly sophisticated training in a complex field.").

[140] *Hill*, 725 S.W.2d at 171 ("In employee covenants, the special training or knowledge acquired by the employee through his employer is valuable consideration and often enhances the value of the employee to other firms. To allow employees to use or sell this valuable training or knowledge upon leaving a firm would create a disincentive for employers to train or educate employees."); DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 681 n.6 (Tex. 1990).

[141] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 129 (Idaho 2005) (discussing the split among state courts and holding rather experienced and skilled gained by the physician while employed justifies a covenant); *see also* Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L, REV. 625, 652 (1960).

In addition to protecting confidential information, an employer may also use a covenant to protect the employer's goodwill. Goodwill is considered intangible, as it is the additional value a business has above its physical assets, cash, and accounts receivable.[142]

An employer can demonstrate goodwill in its medical practice. Its records can demonstrate the flow of new patients to the practice prior to the employment of the physician. This historical flow of patients will provide quantifiable evidence that the medical practice has goodwill that is worthy of protection. While the new patient flow is circumstantial evidence of goodwill, the employer will want to identify the reasons its medical practice is able to attract new patients. One of these reasons may be marketing efforts to "brand" the employer's medical practice in the community it serves. Another reason for an employer's ability to attract patients might be its employment of another "star" physician to whom the patients, and persons referring them, desire to entrust their care. In these instances, an employer has goodwill that deserves protection by a covenant.[143]

Goodwill of the employer must be distinguished from the goodwill of the physician. A physician can develop a professional reputation while employed by the employer that demonstrates his or her ability to attract patients to the employer's medical practice. The personal goodwill of the physician should not be subject to protection by a covenant, as it is personal to the physician, and not to the employer.[144] This conclusion is derived

---

[142] Peat Marwick Main & Co. v. Haass, 818 S.W.2d. 381, 389 (Tex. 1991) (Cornyn, J., dissenting); Swinnea v. ERI Consulting Eng'rs, Inc., 236 S.W.3d 825, 837 (Tex. App.—Tyler 2007, no pet.) ("Goodwill is generally understood to mean advantages that accrue to a business on account of its name, location, reputation and success.").

[143] One physician employment contract defined the goodwill of the employer to be protected by the covenant as follows:

> Goodwill. Physician acknowledges and agrees that the Employer provides the opportunities and the resources for each party to initiate, establish and/or develop contacts and relationships within the Employer's referral sources. All goodwill and other benefits (collectively, the "Goodwill") derived from such efforts described in this paragraph shall inure solely to the Employer. Physician recognizes that the Goodwill is a valuable asset of the Employer. Physician agrees to refrain from using the Goodwill for the benefit of any other person or entity other than for the benefit of the Employer and in furtherance of the duties and services required hereunder.

[144] Nail v. Nail, 486 S.W.2d 761, 764 (Tex. 1972) (holding that the goodwill of the husband's ophthalmology practice was not property of the marital estate that could be equitably divided between the spouses in divorce).

from cases in which a physician's goodwill is held personal to the individual physician and not goodwill of the medical practice in which the spouse of the physician may own a community property interest.[145]

Instead, the goodwill that a covenant may protect is the corporate goodwill of the employer. That goodwill is the ability of the employer to attract patients, who presumably will be treated by the physician.[146] The employer's ability to attract patients is dependent on its business operations, such as efficient procedures to maintain the flow of patients, as opposed to the individual reputation of the physician subject to the covenant. In the latter instance, patients come to the practice because of the physician's skill and reputation.[147] The arbitrator should distinguish between the value of the employer's goodwill that the covenant can protect and the personal goodwill that the covenant cannot protect when deciding what amount is a reasonable buyout price for the covenant.[148]

B. Reasonable Boundaries Requirement

Section 15.50(a) also contains a second category of content required for enforceable covenants, consisting of three general limitations: duration,

---

[145] *Id.* ("[The goodwill] did not possess value or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in event of the sale of the practice or the loss of his patients, whatever the cause."); R.V.K. v. L.L.K., 103 S.W.3d 612, 617 (Tex. App.—San Antonio, 2003, no pet.) (holding that valuation of physician's interest in medical practice should distinguish individual goodwill from corporate goodwill); *see also* Kim v. Choe, No. 182158, 2004 WL 1879195 (Va. Cir. Ct. Aug. 11, 2004) (discussing a martial property dispute over the value of a spouse's medical practice) ("Virginia courts recognized a distinction between personal goodwill and industrial goodwill. The distinction is significant because the former is deemed separate property while the later [sic] is deemed marital property.") (citations omitted).

[146] Fields Found., Ltd. v. Christensen, 309 N.W.2d 125, 130 (Wis. Ct. App. 1981) ("Despite his limited patient contacts, Christensen's identification with the Center's considerable goodwill by those referring business to it provides him with significant advantages of other competitors. Having the referral list enables Christensen that part of the community most responsive to such goodwill.").

[147] Hoddeson v. Conroe Ear, Nose & Throat Assocs., P.A., 751 S.W.2d 289, 290 (Tex. App.—Beaumont 1988, no writ).

[148] *Nail*, 486 S.W.2d at 764 ("It is to be understood that in resolving the question at hand, we are not concerned with good will as an asset incident to the sale of a professional practice, or that may exist in a professional partnership or corporation apart from the person of an individual member, or that may be an element of damage by reason of tortious conduct.").

geography, and activity.[149] These limitations establish the boundaries of the covenant's restrictions. Each boundary must be reasonable and may not impose a greater restraint than is necessary to protect the business interests of the employer.[150] However, if the covenant meets the "ancillary to" requirement, a court may adjust a covenant's boundaries, if necessary to make them reasonable.[151]

The Act requires that all covenants, including physician covenants, include only boundaries that are designed to protect the business interests of the employer for which the Act permits protection.[152] As seen in the prior subpart, the Act's "ancillary to" requirement is selective among the interests that an employer may protect as confidential information and goodwill. Even amongst the interests that justify protection, those particular interests must be evaluated to best determine whether the covenant's boundaries are appropriate and not excessive.

Typically, a physician's covenant will restrict the physician from practicing the physician's medical specialty for one to two years within a set number of miles from the employer's place of business after the end of their employment.[153] Disputes over boundaries comprise the bulk of the litigation over the enforceability of covenants.[154] Moreover, the Texas

[149] Tex. Bus. & Com. Code. Ann. § 15.50(a) (Vernon 2002).

[150] *Id.*; Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 655 (Tex. 2006); Weatherford Oil Tool Co. v. Campbell, 161 Tex. 310, 340 S.W.2d 950, 951 (1960) (holding that covenant prohibiting salesman from selling competing products must not be more restrictive than necessary to protect employer's interests).

[151] Tex. Bus. & Com. Code Ann. § 15.51(c) (Vernon 2002).

[152] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 644 (Tex. 1994).

[153] *See, e.g.*, Parker v. Slayter, 238 S.W.2d 814, 816 (Tex. Civ. App.—Galveston 1951, writ ref'd n.r.e.) (considering a covenant not to compete for a one year term, restricted within a particular county). As a rule of thumb, primary care medical practices, *e.g.*, family practice, internal medicine, and OB/GYN, have a more restricted geographic scope and time duration, frequently expressed as a five mile radius and one year duration. Medical specialties that require additional training, such as various subspecialties of surgery, will also require a greater geographic range for patients, and will thus have larger geographic restrictions, such as a ten mile radius and longer durations, such as two years. In this author's experience, the covenants in physician employment agreements will apply to the physician even if the employer terminates the physician's employment without cause.

[154] *See* Wolff v. Hirschfeld, 57 S.W. 572, 573 (Tex. Civ. App.—San Antonio 1900, no writ) (approving the ten year, ten mile restriction contracted for in the sale of a medical practice); Lewis v. Krueger, Hutchinson & Overton Clinic, 153 Tex. 363, 269 S.W.2d 798, 800 (1954) (approving three year post-employment restraint on physician whose covenant was not limited as to duration). *Cf.* Toch v. Eric Schuster Corp., 490 S.W.2d 618, 620–21 (Tex. Civ. App.—Dallas

Supreme Court indicated in *Alex Sheshunoff Management Services L.P. v. Johnson* that courts in the future should concentrate on the covenant's boundaries in evaluating the interests of the employer to be protected.[155]

The court's instruction is relevant to physician covenants and the boundaries of the covenant's restrictions upon the physician. Under *Sheshunoff*, a court must evaluate whether the boundaries of the covenant protect the interests of the employer in a reasonable manner.[156] As discussed above, the employer seeks to protect the physician from using confidential information and goodwill to compete with the employer.[157] If the confidential information and goodwill are legitimate employer interests as discussed in the preceding subpart, the relevant inquiry becomes whether the covenant's restrictions are reasonable to protect those interests.[158] As will be seen in Part V.B., the arbitrator will consider the restrictions in determining what the physician should reasonably pay to the employer for release of the covenant. Parts V and VI deal with situations in which the physician may escape the covenant's restrictions without any obligation to pay because the covenant was not reasonable.

For purposes of discussing the Act's requirements for reasonable boundaries, assume that the most important information the employer desires to protect is the relationships it enjoys with physicians who refer surgery patients to its practice. Prior to employment with the employer, the physician has no prior presence in the community.[159] Generally, the physicians who refer patients to the employer, *i.e.*, the referral sources, do not know the new physician. As a condition to employment the employer requires the physician not to solicit the referring physicians after leaving

1972, writ ref'd n.r.e.) ("The question of the validity of covenants voluntarily entered into between employer and employee not to engage in competition following termination of the employment contract has been the subject of much litigation in Texas in recent years.").

[155] 209 S.W.3d 644, 655–56 (Tex. 2006) ("Concerns that have driven disputes over whether a covenant is ancillary to an otherwise enforceable agreement—such as the amount of information an employee has received, its importance, its true degree of confidentiality, and the time period over which it is received—are better addressed in determining whether and to what extent a restraint on competition is justified.").

[156] *Id.* at 655.

[157] *See* discussion *supra* Part IV.A.

[158] *See* Tex. Bus. & Com. Code § 15.50(a) (Vernon 2002).

[159] *See, e.g.*, Raymundo v. Hammond Clinic Ass'n, 449 N.E.2d 276, 278 (Ind. 1983) ("Dr. Raymundo came to the Clinic, as an employee in late 1971, after having completed his advanced training in the State of Michigan. He had no prior experience in Indiana and was not acquainted in the medical community of the area.").

employment in exchange for the employer's promise to introduce him or her to them.

Thus, an ancillary agreement exists as to the employer's legitimate business interests in maintaining the confidentiality of its referral sources after they are disclosed to the physician. In order to prevent the physician from infringing on those interests by using the information, the physician's employment agreement also contains a covenant excluding the physician from practicing surgery within five miles of the employer's offices for two years after the physician's employment ends, which is written as follows. The covenant's boundaries on duration, geography, and activity are italicized:

> Covenant Not-To-Compete.
>
> (a) Physician expressly acknowledges and agrees that:
>
> (i) Important and essential assets of Employer include its established surgery practice, its Confidential Information, its list of the names and addresses of its patients, its knowledge of the needs of those patients, the goodwill that it enjoys with its patients, and its referral relationship with referring physicians.
>
> (ii) Employer has expended substantial time, money and effort in acquiring and building its practice and its patients, accumulating its Confidential Information, learning each patient's needs, and developing the goodwill which it enjoys with its patients.
>
> (iii) Employer's practice requires special skill and knowledge in order that the patients receive the desired treatment and services, and the knowledge and skill with respect to the processes and procedures involved in the practice are Confidential Information and valuable assets of Employer.
>
> (iv) Physician will receive specialized knowledge and skill by reason of Physician's relationship with Employer; gain valuable knowledge regarding the names, addresses, and needs of Employer's patients, and Employer's referral relationships; receive continuing experience in the practice of surgery; gain valuable knowledge and skill regarding the

> processes and procedures involved in respect of the practice and Employer's other activities; and have access to Employer's Confidential Information.
>
> (v) The training, knowledge, access to Confidential Information, education and experience that will be acquired by Physician is a material inducement for entering into this Agreement and the training, Confidential Information, education, knowledge, and experience that will be acquired constitutes valuable consideration which will enhance the value of Physician to other physicians or entities through which medicine is practiced. Physician recognizes and acknowledges that Physician engaging in a competitive practice would be a significant detriment to Employer's medical practice.
>
> (b) In recognition of the facts noted in paragraph (a) above, other consideration as provided herein, and as a means of enforcing confidentiality provisions in this Agreement, Physician expressly agrees that during the term of this Agreement and *for a period of two (2) years after the date this Agreement terminates* (regardless of the time or manner of termination, and regardless of whether the Agreement was terminated, with or without cause, by Employer or Physician), Physician shall not either directly or indirectly, individually or on behalf of or in conjunction with any person or entity, other than Employer: *(i) provide surgical medical services within a five (5) mile radius of any office of Employer at which Physician provided services at any time during the term of this Agreement;* (ii) contact any patient of Employer for the purpose of soliciting the patient away from Employer; or (iii) hire or solicit the employment of any employee of Employer or former employee of Employer whose employment with Employer ended less than one year prior to such hiring or solicitation.

The covenant contained in paragraph (b) is intended to protect the employer's business interest in preserving the relationship it enjoys with the referral sources, as expressed as confidential information described in

paragraph (a) of the covenant.[160] As the covenant relates to the employer's interests in protecting its confidential information regarding referral relationships, and, therefore, meets the "ancillary to" requirement of the Act, the next inquiry of the covenant's enforceability is to examine its restrictions for reasonableness and extent of restraint. More specifically, do the covenant's boundaries relate to the interest protected and, if there is a relationship, are the boundaries sufficiently delimited for the interest protected? The answers to those questions are very specific to each employer's medical practice and will affect the buyout price.

While this example is useful to illustrate the interplay of the "ancillary to" requirement and the reasonable boundaries requirement, the application to specific employment arrangements will result in any number of other factors to be considered in addition to those discussed below. The Act permits the covenant if the boundaries on its duration, geographic coverage and proscribed activity—the covenant's restrictions—are reasonable for the employer's interest to be protected, which in this discussion are the referral sources.

The covenant's temporal boundary is the period of time that the employer reasonably needs to recruit a replacement physician and to introduce him or her to the referring physicians.[161] The employer understandably wants the exclusionary period of the covenant to last as long as possible. However, the employer's interest, as determined under the "ancillary to" test, is in protecting its database relating to referring physicians.[162] The temporal restriction must relate to protecting that interest, and that relation in this example translates into a reasonable period of time to find a replacement physician and to introduce the physician to the referral sources.[163]

---

[160] The quoted covenant comes from an actual agreement on file with the author. It is easy to spot several instances where the scrivener resorted to the laundry list approach to identifying the employer's various business interests to be protected, and therefore the covenant contains the faults described in the immediately preceding subpart of this Article.

[161] Wichita Clinic, P.A. v. Louis, 185 P.3d. 946, 944 (Kan. Ct. App. 2008); Valley Med. Specialists v. Farber, 982 P.2d 1277, 1284 (Ariz. 1999) ("The idea is to give the employer a reasonable amount of time to overcome the former employee's loss, usually by hiring a replacement and giving that replacement time to establish a working relationship.").

[162] *See* Pratt v. Gruenwald, No. 14160, 1994 WL 313050 at *2 (Ohio Ct. App. June 29, 1994).

[163] *See id.* ("Two years is a sufficient hiatus to provide [the employer] a reasonable opportunity to establish a new relationship with a referring physician whose primary loyalty may have been to the former physician employee rather than [the employer].").

The time necessary to find a replacement will depend on the supply of physicians in the appropriate specialty that can be recruited to the employer's medical practice.[164] The duration of the covenant should be inverse to the supply; that is, the greater the availability of physicians who can be recruited, the shorter duration of the covenant.[165] The time required can only be a reasoned guess at the beginning of the physician's employment. When the employment ends, and the employer must look for a replacement, the marketplace for replacements may have changed dramatically. Both the employer and the physician must suffer the consequence of the change in supply and demand for possible replacement physicians, which is completely beyond their control.[166]

If the supply of physicians is abundant when the covenant is written, but has substantially diminished by the end of employment, the duration of the covenant may now be too short. The employer suffers the consequence of perhaps having too little time to recruit a replacement physician. To arrive at the appropriate time boundary to insert in the covenant, the employer can rely on its experience in recruiting the physician, other physicians in the practice and generally available information from consultants.[167] In addition, the covenant should account for the notice period required to end the physician's employment. If the parties promise in the employment agreement to give at least ninety days notice before ending employment, a carefully-crafted covenant would credit the ninety days against its temporal restriction.[168] This conclusion is justified because the employer can then begin recruiting as soon as the notice is given.

Thus, it is not necessary to use a rule of thumb, that is, one or two years, in describing the covenant's temporal boundary.[169] Instead, the employer

[164] Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 898 (N.J. 2005) (evaluating a covenant with a two year restriction and concluding that two years was a reasonable amount of time for the employer to replace and train a neurosurgeon).

[165] *See id.*

[166] *See supra* note 18.

[167] For example, large metropolitan hospital systems usually have administrative staff dedicated to the recruitment of physicians to the community. These persons will have readily available experience to guide the employer on the expected time period it will take it to employ a replacement for the departed physician.

[168] *See supra* note 75.

[169] *Cf.* Stone v. Griffin Commc'ns & Sec. Sys., Inc., 53 S.W.3d 687, 696 (Tex. App.—Tyler 2001, no pet.) ("[T]wo to five years has repeatedly been held a reasonable time restriction in a non-competition covenant."), *overruled on other grounds by* Am. Fracmaster, Ltd. v. Richardson,

should tie the covenant's duration to objective, third-party information on the time it takes to recruit a replacement physician. As will be seen in following parts, the employer is motivated to use care in selecting the duration of the covenant. That is not to deny that the process of defining the appropriate time period is frustrating, because the employer uses historical experiences from reliable sources on the time needed to recruit physicians and then applies those experiences to its current employment relationship with the physician, which could end the next day or in ten years.

The geographic boundary determined to protect the employer's referral sources should be analyzed based on the population density of referring physicians.[170] Assume that 80% of the referring physicians have offices located within three miles of the employer's offices, and that 90% of the referring physicians have offices located within seven miles of the employer's offices.[171] There is a reasonable basis for the covenant to use a five mile geographic boundary instead of a seven mile boundary. The employer desires the additional two mile radius, as it provides a greater protective zone around the locations of the offices associated with 80% of the referring physicians. Thus, a five mile radius has a direct connection to substantially all of the employer's referral sources that it seeks to protect.[172] If, however, the employer sought to extend the geographic boundary of the

71 S.W.3d 381 (Tex. App.—Tyler 2001, pet. granted, judgm't vacated w.r.m.); Prof'l Beauty Prods., Inc. v. Derington, 513 S.W.2d 236, 238 (Tex. Civ. App.—El Paso 1974, writ ref'd n.r.e.) ("Many cases have held that a one-year term in a covenant not to compete is reasonable.").

[170] *See* Raymundo v. Hammond Clinic Ass'n, 449 N.E.2d 276, 281 (Ind. 1983) (reviewing the employer's list of names and addresses of its 50,000 patients in evaluating the covenant's geographic twenty-five mile restriction); Lewis v. Krueger, Hutchinson & Overton Clinic, 153 Tex. 363, 269 S.W.2d 798, 799 (1954) (noting that unlike the clinic in Parker, the employer drew patients from "all over Lubbock County and the contiguous area"); Parker v. Slayter, 238 S.W.2d 814, 816 (Tex. Civ. App.—Galveston 1951, writ ref'd n.r.e.) (concluding that the geographic restriction of the covenant, which included all of Harris County, was overbroad based on the portion of the county from which the employer chiropractic clinic drew its patients).

[171] Cmty Hosp. Group, Inc. v. More, 869 A.2d 884, 890 (N.J. 2005) (noting that 17% of the employer's patients resided outside the thirty mile radius when evaluating a geographic restriction of a thirty mile radius).

[172] Fields Found., Ltd. v. Christensen, 309 N.W.2d. 125, 132 (Wis. Ct. App. 1981) ("The fifty-mile restriction covers an area from which sixty-two percent of the Center's business originated. The restriction bears a reasonable relation to the Center's business and is not overbroad. The restriction not only leaves thirty-eight percent of the Center's business open to competition, but allows Christensen to divert part of the protected business by establishing a clinic outside the area and treating patients who reside in it.").

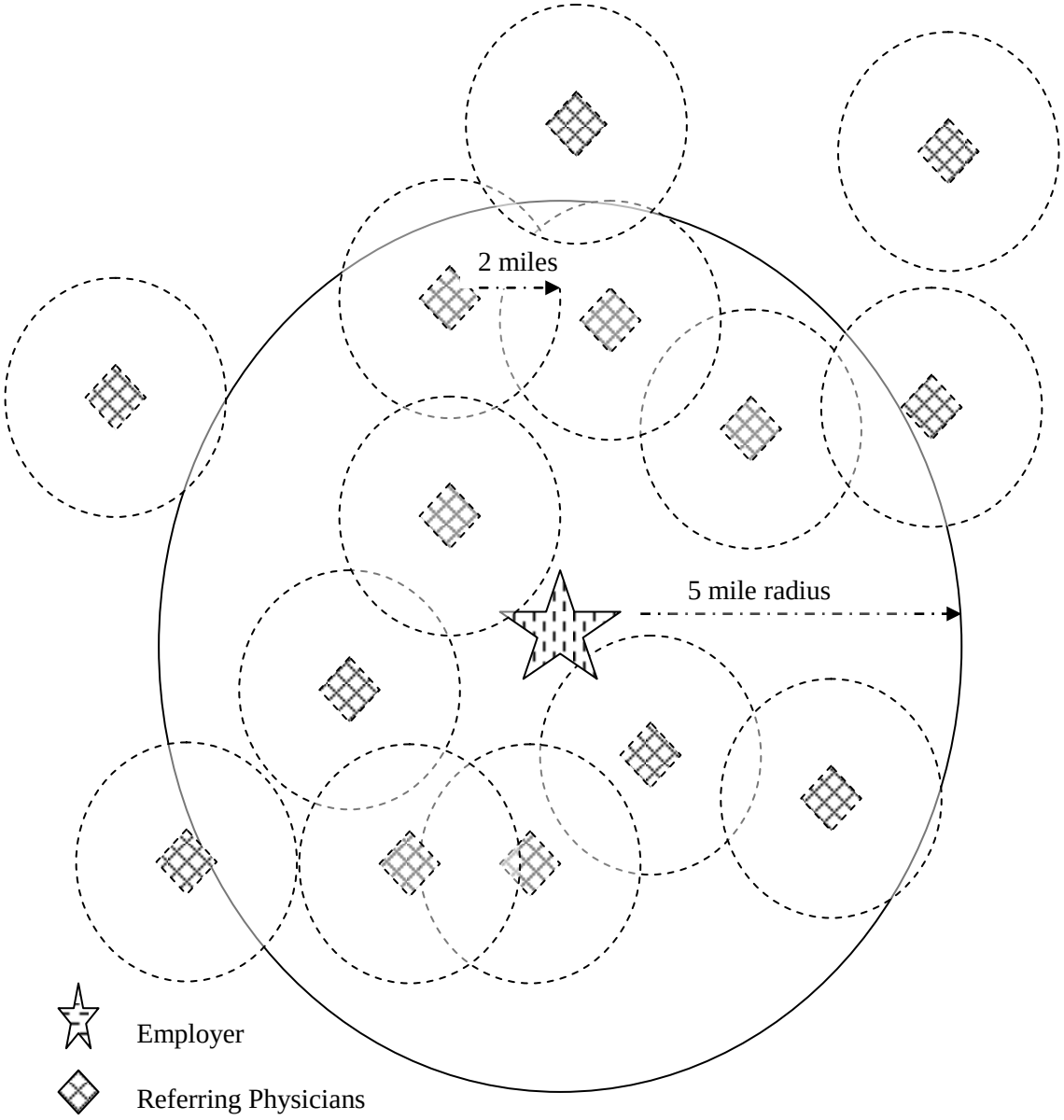
covenant to seven miles, a court might easily find that the additional seventy-five square miles of protection, in which the physician is barred from locating, does not warrant securing an additional 10% of the referral sources.[173]

The above example relies on an assumed distribution of the locations of the referring physicians in order to pick a reasonable geographic boundary. In practice, the employer must use the data available in order to select a boundary that is reasonable in protecting its business interests. In the case of protecting referral sources, an analysis of the locations of the employer's referral sources is necessary. As a starting point, the employer could list its referral sources and, for each source, list its location and its contribution to the employer's revenue. Using that data, an employer would be able to map the referring physician's locations. The map would show the distribution of the employer's referral sources. Analyzing the distribution of the referral sources on the map, the employer can plot varying radii that generate circumferences around increasing percentages of them. Thus the employer can arrive at the geographic boundary using a method that is sensitive to the relationship between the distance and the percentage of referral of sources that are protected by the chosen distance.[174]

The permissible extent of the geographic boundary protecting an employer's referral sources highlights the importance of the covenant's relationship to the employer's protected interests, in this case, the referral sources. To protect the referral sources, the geographic boundary should be measured from the point of origin—that is, each significant referral source. In application, the employer would identify the referral sources as described above that are important to the employer and measure a protective distance from each source. The resulting geographic boundary would encompass the subsets of geography around each referral source. The diagram on the next page illustrates the technique of using subsets of geographic protection to arrive at the geographic boundary of the covenant.

[173] Applying the formula for determining the area covered by a radius, *pi* times the distance of the radius squared, shows the very substantial difference in the square miles covered by a five mile radius, 78.5, and a seven mile radius, 153.9, or roughly twice the size.

[174] *Cf.* Stone v. Griffin Commc'n & Sec. Sys., Inc., 53 S.W.3d 687, 695–96 (Tex. App.—Tyler 2001, pet. denied), *overruled on other grounds by* Am. Fracmaster, Ltd. v. Richardson, 71 S.W.3d 381 (Tex. App.—Tyler 2001, pet. granted, judgm't vacated w.r.m.); Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 660–61 (Tex. App.—Dallas 1992, no writ).



The identification of the referring sources could be measured several ways. One way would be to include all referral sources that referred at least five percent of the employer's patients in the previous year. Another option would focus on the repetitive aspect of referring concentrating on any

referral source that sent more than a minimum threshold of patients in a year. The guiding factor should be the rational relationship between the referral sources and the employer.

Certainly, great variation exists in the way covenants choose to state their geographic restriction. Some examples are an entire county of the state,[175] an area bounded by named streets or highways, or a distance from a hospital. Most often the geographic restriction is expressed as the distance of a radius from the employer's offices.[176]

As discussed above, the distance should be measured from the referral source's office. Because the referral sources will likely change over time, there is no reason why the covenant's geographic restriction could not be written as the area encompassed by a radius of a specified distance from any physician's office that meets stated qualifications justifying it as a referral source. For example, the pediatric surgeon agrees not to practice pediatric surgery within three miles of any pediatrician who has referred two or more pediatric surgery cases to the employer in the eighteen months immediately preceding the termination of the physician's employment.

This Article's discussion of an employer's use of a geographic boundary to protect its referral sources highlights how an employer who desires to protect its existing patient list or goodwill will likely use a different analysis to support its selection of a geographic boundary. The employer protecting an established patient base will express the boundary in the traditional way, as a distance measured from its office location.[177] That employer will want to analyze its patient distribution to arrive at a database supporting the distance that its covenant will reach. For example, if 75% of an employer's patients live within a certain distance of the employer's offices, then that

[175] Lewis v. Krueger, Hutchinson & Overton Clinic, 153 Tex. 363, 269 S.W.2d 798, 799 (1954) (distinguishing *Parker* and stating Lubbock County, Texas to be the reasonably restricted area of the covenant); Parker v. Slayter, 238 S.W.2d 814, 816 (Tex. Civ. App.—Galveston 1951, writ ref'd n.r.e.) (stating Harris County, Texas to be the restricted area of the covenant).

[176] Harris v. Univ. Hosp. of Cleveland, Nos. 76724, 76785, 2002 WL 363593, at *6 (Ohio Ct. App. Mar. 7, 2002) (discussing where employer sought to enforce five mile covenant against physician who relocated 4.6 miles from employer and physician sought to avoid enforcement because driving on the roads between the two locations was more than five miles. The court rejected this argument, stating, "Case law has been historically uniform in rejecting this theory and in holding that the correct way to measure the distance between locations is as the crow flies, or the straight-line approach used by a surveyor.").

[177] *Cf.* Stocks v. Banner Am. Corp., 599 S.W.2d 665, 668 (Tex. Civ. App.—Texarkana 1980, no writ) ("The use of a customer list as an alternative to setting a specific geographical limit is a reasonable means of enforcing a covenant not to compete.").

distance would be reasonable. Similarly, the same analysis could be conducted to identify the postal zip codes in which 75% of the employer's patients live. The foregoing comment that a covenant geographically encircling 75% of the employer's patients is reasonable cannot be a conclusion of law. Rather, reasonableness is determined in large part by contrasting against a continuum of restraint that becomes demonstrably unreasonable.

If the employer has more than one office where it treats patients, it should evaluate whether the physician has worked predominantly in one office or a specific group of offices. If the physician's responsibilities have been predominantly at only one office, the covenant should be restricted so that the geographic boundary applies only to that office. Some covenants describe the point from which the radius is measured as the office where the physician practiced more than fifty percent of their time.

There is little direction in the case law on how to measure a covenant's geographic and temporal boundaries for reasonableness.[178] Yet an employer will want to make these factual inquiries about its medical practice because they provide a way of measuring its protectable business interests in lieu of using an attorney's rule of thumb.[179] Armed with underlying data, the employer will be in a position to justify its selection of each of the covenant's boundaries.

No employer wants to leave any opening for a departing physician to compete, and the natural business motivation is to extend the covenant in time and direction as far as possible. Several reasons will dictate against that motivation. If a court finds that the covenant's boundaries are unreasonable, the court may not award the employer damages for the

[178] Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787, 793 (Tex. App.—Houston [1st Dist.] 2001, no pet) ("The breadth of enforcement of territorial restraint in covenants not to compete depends upon the nature and extent of the employer's business and the degree of the employee's involvement. The covenant must bear some relationship to the activities of the employee; if it is overbroad, the court may reform its terms to make them reasonable. Generally, a reasonable area for purposes of a covenant not to compete is considered to be the territory in which the employee worked while in the employment of his employer.") (citations omitted); Fields Found., Ltd. v. Christensen, 309 N.W.2d. 125, 132 (Wis. Ct. App. 1981) ("Reasonableness does not require that a covenant not to compete be precise in appearance but unworkable and illusory in fact. Flat rules of reasonableness do not exist for restrictive covenants . . . .").

[179] Recall the admonition in *Alex Sheshunoff Mgmt., L.P. v. Johnson*, 209 S.W.3d 644, 655–56 (Tex. 2006) that the covenant is to be evaluated with respect to the interest protected and the reasonableness of the restraint for that protection.

physician's breach prior to the court acting to reform the boundaries.[180] Moreover, if the physician shows that the employer knew the covenant's boundaries were unreasonable when they were entered into, the court may award the physician his or her attorneys' fees.[181] If the employer cannot show that it conducted an analysis of its medical practice to arrive at the boundaries, the physician has an evidentiary advantage in proving that the employer knew that the boundaries were unreasonable or that the employer ignored any duty to determine a reasonable boundary. To date, no case has considered the proof required in satisfying the burden of proof to support the award of attorneys' fees to a physician or had occasion to comment on the analysis the employer should conduct when crafting its covenant.

The covenant's boundary on professional activity is less difficult to examine. Medicine has not become just specialized, it has become sub-specialized.[182] In a reasonable covenant, an employer will identify the physician's sub-specialties in which the physician is restricted from practicing—the sub-specialties for which the referral sources are sending patients.[183] In that situation, a covenant would be reasonable if it precluded the physician from practicing in those specialties.[184] For example, an orthopedic surgeon would not need to be restricted from practicing ophthalmology. A covenant that prohibited the physician from practicing medicine altogether would be a greater restraint than the employer needs to protect its referral sources.

---

[180] Tex. Bus. & Com. Code Ann. § 15.51(c) (Vernon 2002) ("If the covenant is found to be ancillary to or part of an otherwise enforceable agreement but contains limitations as to time, geographical area, or scope of activity to be restrained that are not reasonable and impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee the court shall reform the covenant to the extent necessary to cause the limitations contained in the covenant as to time, geographical area, and scope of activity to be restrained to be reasonable and to impose a restraint that is not greater than necessary to protect the goodwill or other business interest of the promisee and enforce the covenant as reformed, except the court may not award the promisee damages for a breach of the covenant before its reformation and the relief granted to the promise shall be limited to injunctive relief.").

[181] *Id.*

[182] There are twenty-four separate medical specialty boards of certification. Am. Bd. of Med. Specialties, *What Board Certification Means*, (2008), http://www.abms.org/About_Board_Certification/means.aspx.

[183] Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884, 898 (N.J. 2005) (finding the covenant restricting the physician from practicing neurosurgery was sufficiently narrow for enforcement).

[184] *Id.*

Some interesting conundrums can arise in specialized medical practices that make it especially important to restrict as little activity as reasonably possible.[185] The employer may have recruited the physician to provide care in a specialty related to, but not the same as, the services already provided by the employer. For example, an employer with an established general ophthalmology practice may employ a retina specialist for its patients while prior to employing the specialist, the employer had to refer its patients to a retina specialist outside of the practice. If the retina specialist leaves the employer's practice, the employer will no longer provide the specialty care provided by the physician.[186] Nevertheless, the employer is justified in protecting the referral sources even though it cannot provide the service, because it should have a reasonable opportunity to recruit a replacement physician in that specialty.

Another interesting dilemma arises in hospital-based practices, such as pathology, where the hospital entered into an exclusive professional services agreement with the employer to provide all the pathology services at that hospital. If the hospital terminates the exclusive arrangement with the employer and enters into an exclusive arrangement with a competitor, the physician is subject to a covenant that offers no protection to the employer. The employer does not have the hospital's business, and it makes no difference to the employer's loss of the business if the physician goes to work for the competing group that has garnered exclusively the hospital's pathology work.

C. The Requirement of a Buyout

The Act's third category of limitations applies only to physician[187] covenants and lists four requirements in addition to the buyout right.[188] The

[185] Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787, 794 (Tex. App.—Houston [1st Dist.] 2001, no pet.) ("Restraints are 'easier to justify if . . . limited to one field of activity among many that are available to the employee.'") (quoting RESTATEMENT (SECOND) OF CONTRACTS § 188 cmt. g (1979)).

[186] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 131 (Idaho 2005) (involving an ophthalmology practice which recruited a physician as a cornea specialist who left the practice post-employment covenant; however, after departure, the practice group continued to refer cornea patients they could not treat to that physician).

[187] The Act more specifically states, "[A] person licensed as a physician by the Texas Board of Medical of Medical Examiners . . . ." Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002). The Texas Board of Medical Examiners, which is now the Texas Medical Board, has the "police power" to regulate medicine in Texas. Tex. Occ. Code Ann. § 152.001 (Vernon 2004).

contracting parties can quote the four additional limitations verbatim in the covenant and thereby assure enforceability.[189] However, the buyout clause requires the contracting parties to specifically address the buyout price by setting a dollar figure in the agreement or by providing that an arbitrator will decide the buyout amount.[190]

The legislative history to the buyout clause is abbreviated.[191] Representative Leticia Van de Putte introduced House Bill 3285 on March 25, 1999.[192] The House Committee on Public Health conducted a very brief committee hearing on April 21, 1999. At the hearing Representative Uresti substituted a complete replacement bill to the original bill initially presented at the hearing.[193] Representative Van de Putte made a brief

Interestingly, an employer has argued while trying to enforce a covenant against its pathologist employee that the Act does not apply to pathologists. Propath Serv., L.L.P. v. Ameripath Inc., No. Civ.A.3:04-CV-1912-P, 2004 WL 2389214, at *2 (N.D. Tex. Oct. 21, 2004).

[188]The four additional limitations are: (1) the covenant must not deny the physician access to a list of the physician's patients whom the physician has treated in the year preceding the end of employment; (2) the covenant must provide access to the physician's patient records upon due authorization and copies of them for a reasonable fee; (3) the covenant must provide that the patient list and the patient medical records need not be in a form different than the form maintained by the employer; and, (4) the covenant must not prohibit a physician from providing continuing care or treatment to acutely ill patients after the end of employment. Tex. Bus. & Com. Code Ann. §§ 15.50(b)(1)(A)–(C), 15.50(b)(3) (Vernon 2002).

[189]Complying with some of the mandates can be problematic at the end of the physician's employment. For example, the employer may satisfy the Act by giving the departing physician a list of patient names, but not addresses. A patient list without addresses would not comply with the spirit of the Act, which encourages a physician's accessibility to patients, and probably violates Texas Medical Board Rule 165.1, which prohibits the employer from interfering with the Rule's notice requirements. See *supra* note 121.

[190]Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[191]The author is mindful of the Texas Supreme Court's statement in *Sheshunoff* on relying on legislative history to interpret the Act versus relying on the plain meaning of the words used in therein. Sheshunoff v. Johnson, 209 S.W.3d 644, 652 n.4 (Tex. 2006) ("Wherever possible, we construe statutes as written, but where enacted language is nebulous, we may cautiously consult legislative history to help divine legislative intent.").

[192]The original version of HB 3285 added a different version of the physician conditions to the Act that, interestingly, voided the covenant "if the contract or employment of the physician has been terminated without cause or in bad faith." Tex. H.B. 3285, 76th Leg., R.S. (1999) (introduced). The substituted version of HB 3285 omitted the language that voided a covenant if the physician's employment was terminated without cause or in bad faith. Tex. H.B. 3285, 76th Leg., R.S. (1999) (House Committee Report).

[193]The original version of HB 3285, like the substituted bill, contained a requirement that an enforceable covenant not to compete must contain a buyout at a reasonable price. Tex. H.B. 3285,

statement that consisted of reading the "Background and Purpose" section of the Office of House Bill Analysis on HB 3285 as follows:[194]

> In today's medical practice environment, many physicians have grouped together to form multi-specialty clinics, leaving fewer solo practitioners. When a physician leaves a group to enter his or her own practice or another group practice, the ability of the departing physician to treat his or her patients may be hindered due to a covenant not to compete, a contractual clause in the physician's work contract. This clause may make it difficult for the patients to have his or her records transferred to the departing physician's new office and to receive continuing care from that physician. H.B. 3285 provides a "buy-out" clause in a covenant not to compete, as well as other provisions designed to allow a departing physician to provide his or her patients with continued care.[195]

The foregoing Background and Purpose and the statements of Representative Van de Putte at the hearing on H.B. 3285 indicate a clear concern of the legislature that the departing physician have the opportunity to continue to care for existing patients. On the other hand, prospective patient encounters, which are also usually restricted in physician covenants, do not seem to have been a concern of the legislators. The Background and Purpose makes it clear that the legislature wanted to ensure that existing patients had access to their regular physician.

As seen in the prior discussion on the "ancillary to" requirement, employers may have goodwill, separate from that of the departing physician, whereby the employer's medical practice will attract patients. The employer's goodwill that allows it to attract new patients to its practice should be entitled to protection by a covenant through the wording of the

76th Leg., R.S. (1999) (introduced). The original bill required the covenant to contain a provision that allowed a buyout of covenant "at a reasonable price as determined by a mutually agreed arbitrator." *Id.* The substituted bill changed the original bill to provide for a buyout at a reasonable price or at the option of either party by a mutually agreed arbitrator. Tex. H.B. 3285, 76th Leg., R.S. (1999) (House Committee Report). The substituted bill also added that if the parties could not agree on an arbitrator, a court could select an arbitrator. *Id.*

[194] *Background and Purpose Section: Office of House Bill Analysis*, on H.B. 3285, 76th Leg. (Tex. 1999).

[195] House Comm. on Public Health, Bill Analysis, Tex. H.B. 3285, 76th Leg., R.S. (1999).

Act.[196] The prospect of attracting future patients will figure prominently as an important issue in the next part discussing how to price a buyout right.

The public policy in protecting the continuity of healthcare of citizens consists of two parts. First, the policy protects the citizen's right to continue care with their physician. The legislative history to the buyout clause reflects this policy. Specifically, an enforceable physician covenant may not prohibit the physician from providing continuing care to a patient during the course of acute illness after the end of the physician's employment.[197] Second, the policy protects the citizen's right to seek care from any physician of the citizen's choice. This broader policy is enunciated in the state supreme court cases of Arizona, Pennsylvania, New Jersey, and Idaho.[198] However, the Act promotes this policy only from the perspective of the physician. Only if the physician exercises his or her buyout right will the physician's patients have the right to continue medical care with that physician. The power of continuing care rests only in the hands of the restricted physician.

As described above, the Act might be interpreted to allow only covenants that restrict the physician's treatment of patients that the physician treated while employed by the employer. That interpretation derives from the above quoted legislative history and the Act's specific provisions dealing with access to patient information,[199] transfer of charts,[200] and continuity of care.[201] All of these provisions address actual patients of the physician, not prospective patients of either the physician or the employer. However, such an interpretation is far too restrictive. In

[196] Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2002); Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 171 (Tex. 1987), *superseded by statute*, Tex. Bus. & Com. Code Ann. §§ 15.50–15.51 (Vernon 2002), *as recognized in* DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 682–83 (Tex. 1990).

[197] Tex. Bus. & Com. Code Ann. § 15.50(b)(3) (Vernon 2002).

[198] *See* Valley Med. Specialists v. Farber, 982 P.2d 1277, 1285 (Ariz. 1999); Intermountain Eye & Laser Ctr., P.L.L.C. v. Miller, 127 P.3d 121 (Idaho 2005); Cmty. Hosp. Group, Inc. v. More, 869 A.2d 884 (N.J. 2005); Wellspan Health v. Bayliss, 869 A.2d 990 (Pa. Super. Ct. 2005).

[199] Tex. Bus. & Com. Code § 15.50(b)(1)(A) (Vernon 2002) (stating the covenant must "not deny the physician access to a list of his patients whom he had seen or treated within one year of termination of the contract or employment").

[200] *Id.* § 15.50(b)(1)(B) (stating the covenant must "provide access to medical records of the physician's patients upon authorization of the patient").

[201] *Id.* § 15.50(b)(3) ("[T]he physician will not be prohibited from providing continuing care and treatment to a specific patient or patients during the course of an acute illness even after the contract or employment has been terminated.").

particular, the interpretation fails to take into account the interests of the employer in protecting its goodwill, as permitted generally by the statute.[202]

No Texas case has focused on a covenant that restricts a physician from prospective patients. This restriction is found almost universally in physician covenants that restrict the physician from a specific territory.[203] In other words it would be the rare covenant that only prohibited the physician from treating former patients. Moreover, a number of supreme courts of other states have expressly recognized that an employer has the right to protect its referral sources, the protection of which, by definition, would include prospective patients.[204] However, as seen in the following paragraphs, these courts apply a balancing requirement in the employer's protection of its existing patient base.

Several Texas Supreme Court covenant decisions involved restrictions concerning the employer's customer base. In *Haass*, the court held that the partnership agreement was unreasonably too broad in requiring a departing partner to pay as liquidated damages an amount based on any client of the firm, whether or not the client was serviced by the partner, including clients the partnership added during the post-partnership restricted period.[205] The court was particularly attuned to the clients serviced by the employee in *DeSantis*, but from a standpoint of whether the clients were brought to the employer by the employee or were attracted to the employer through its general goodwill in the community.[206] In *Henshaw*, the court enforced liquidated damages against an employee who violated a covenant that was defined to protect clients of the employer as of the date that the employee's

[202] *Id.* § 15.50(a).

[203] *See More*, 869 A.2d at 899 (reasoning that a boundary restriction in a neurosurgeon's covenant could prevent emergency room patients from receiving necessary neurological treatment, without reference to whether these patients were already patients of the employer).

[204] *Id.* at 897; Valley Med. Specialists v. Farber, 982 P.2d 1277, 1284 (Ariz. 1999) (stating agreement with the plaintiff employer that had protectable interest in its referral sources); Weber v. Tillman, 913 P.2d. 84, 91 (Kan. 1996); Fields Found., Ltd. v. Christensen, 309 N.W.2d. 125, 130 (Wis. Ct. App. 1981). *Contra*, Cardiovascular Surgical Specialists, Corp. v. Mammana, 61 P.3d 210, 214 (Okla. 2002).

[205] Peat Marwick Main & Co. v. Haass, 818 S.W.2d. 381, 386–87 (Tex. 1991). In *Alex Sheshunoff Mgmt. Servs. v. Johnson*, 209 S.W.3d 644, 647 (Tex. 2006), the employee was restricted from consulting services to any client for whom he had provided more than forty hours of service in the last year of employment or to any identified prospective client. The court found the restriction reasonable and remanded to the trial court the determination of the employer's damages resulting from the employee's breach of the covenant. *Id.*

[206] DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 683 (Tex. 1990).

employment ended and twelve months prior to that date.[207] These cases are not likely predictive of the court's view of the enforceability of a physician covenant that extends to prospective patients of the restricted physician, as opposed to patients of the physician while employed.

In *Valley Medical Specialists*, the employer sought to enjoin a pulmonologist from practicing within a five mile territory surrounding three separate offices, totaling 235 miles.[208] The court noted that the employer had a protectable interest in its patients, but that such interest was outweighed by the patient's interest in seeking care from a physician chosen by the patient.[209] "In the medical context, however, the personal relationship between doctor and patient, as well as the patient's freedom to see a particular doctor, affects the extent of the employer's interest."[210] The court concluded that the employer had not trained the physician and therefore the employer could not restrict the physician from treating patients he formerly treated while employed.[211] The court was persuaded by the fact that the territorial boundary of the covenant applicable to Dr. Farber included 235 miles, which had the practical effect of preventing former patients from reaching him for treatment should he move outside of a reasonably proscribed territory.[212]

In *Intermountain Eye*, the employer sought to enforce a covenant against an ophthalmologist employee who agreed in his employment agreement to pay $500,000 to the employer to avoid restrictions in his covenant.[213] Interestingly, as previously suggested, the balancing of protections required by section 15.50(a), and as suggested in Justice Mauzy's concurrence in *DeSantis*, could be the impetus for analyzing the scope of activity restriction in a physician covenant for its impact on the physician's ability to provide medical service and the community's need for the physician's services.[214] The Idaho Supreme Court expressly followed the Arizona and New Jersey Supreme Courts' decisions to balance the protectable interests of the employer in its patient base against the interests

[207] Henshaw v. Kroenecke, 656 S.W.2d 416, 419 (Tex. 1983).

[208] Valley Med. Specalists v. Farber, 982 P.2d 1277, 1280 (Ariz. 1999) (en banc).

[209] *Id.* at 1285.

[210] *Id.*

[211] *Id.* at 1284. In contrast, the Arizona Supreme Court held that the employer had a protectable interest in its referral sources. *Id.*

[212] *Id.* at 1285.

[213] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 123 (Idaho 2005).

[214] DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 690 (Tex. 1990) (Mauzy, J., concurring).

of the patients in seeking care from the restricted physician.[215] The court held that the reasonableness of the covenant had to be evaluated taking into account its effect on patients continuing care with the restricted physician and seeking care from a physician of their choice.[216]

Restatement section 188, addressing ancillary restraints on competition, supports this extension.[217] Specifically, the Restatement uses a physician covenant as an illustration of the balancing of restraints on the physician with the protection of the employer's interests.[218] In the illustration, it is assumed that there is a shortage of physicians, and the physician covenant would be unenforceable on public policy grounds for unreasonably restraining the public's access to physicians.[219] Comment (c) observes that even when the restraint is no greater than is needed to protect the employer's interest, the employer's interest may be outweighed by the injury to the public.[220] The Reporter's Note to Comment (h) concludes in saying, "[I]t would seem self-evident that the public interest is greater when access to serving professionals, especially physicians, is restricted, than it is when a purely business transaction is involved."[221]

Representative Van de Putte indicated during the hearing on the 1999 amendment of the Act concerning physician covenants that the substituted bill added the possibility of a court-appointed arbitrator to determine the buyout price of a covenant. In the prior version of the bill, the parties simply mutually agreed on the arbitrator and the bill was silent on the possibility that the parties may not agree on the arbitrator to be selected.[222] The Committee's hearing on H.B. 3285 lasted only a few minutes.[223] No witnesses were questioned, though the Committee noted that the Texas Medical Association and The Texas Academy for Family Physicians supported the amended bill.[224] H.B. 3285 became law effective on

[215] *Intermountain Eye & Laser Ctrs., P.L.L.C.*, 127 P.3d at 132.

[216] *Id.*

[217] RESTATEMENT (SECOND) OF CONTRACTS § 188(1) (1981).

[218] *Id.* § 188, cmt. h., illus. 14.

[219] *Id.*

[220] *Id.*, § 188, cmt. c.

[221] *Id.* Reporter's Note, cmt. h.

[222] Tex. H.B. 3285, 76th Leg., R.S. (1999) (introduced).

[223] Texas House of Representatives, 76th Legislature, House Committee on Public Health, Audio Recordings of Hearings held on April 21, 1999.

[224] *Id.*

September 1, 1999 and applies to covenants entered on or after that date with respect to physicians.[225]

V. ARBITRATION OF THE BUYOUT AMOUNT

Thanks to the legislature's addition of the buyout clause to the Act, physicians have the unique opportunity to buy out their covenants that is not available to any other employee subject to a covenant.[226] As previously explained, the employer and the physician can satisfy the Act's requirement for a buyout in one of two ways: stating the buyout amount in the covenant (a stipulated buyout covenant); or, stating that an arbitrator will determine the buyout amount (an arbitration buyout covenant).[227] In either type of covenant, the buyout clause requires the buyout price to be a reasonable amount.

The Act's buyout clause uses the phrase at a "reasonable price."[228] The phrase "reasonable price" is both ubiquitous and ephemeral in the Texas common law. Easily four hundred reported Texas appellate opinions have used the phrase, and yet there is no definition of it to use when construing a buyout clause.[229] Many of the cases address pricing by utilities or other regulated industries, such as the oil and gas industry. Other cases use the phrase in the commercial sales context,[230] such as determining whether a secured party properly exercised its rights in conducting a commercially reasonable sale of the secured property.[231] In that context, a reasonable sales price is an indication that the sale was commercially reasonable.

---

[225] Act of May 26, 1999, 76th Leg., R.S. ch. 1574 §§ 2–3, 1999 Tex. Gen. Laws 5408, 5409 (amended 2001) (current version at Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002)).

[226] The buyout clause does not apply to health care professionals, who, though not licensed to practice medicine as required by the Act, are highly trained and licensed by state agencies other than the Texas Medical Board such as podiatrists, dentists, psychologists, certified registered nurse anesthetists, medical assistants, and nurse practitioners.

[227] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002). No source collects information on the decisions of arbitrators on the buyout amount. Moreover, no reported cases discuss a stipulated buyout amount covenant for the reasonableness of the buyout amount.

[228] *Id.*

[229] "Reasonable, adj. 1. Fair, proper, or moderate under the circumstances." BLACK'S LAW DICTIONARY 1293 (8th ed. 2004).

[230] Tex. Bus. & Com. Code Ann. § 2.305(a) (Vernon 2002) (stating that a reasonable price at the time of delivery is the price to be paid if contract for sale fails to state the price).

[231] Wilson v. Gen. Motors Acceptance Corp., 897 S.W.2d 818, 822 (Tex. App.—Houston [1st Dist.] 1994, no writ) (discussing where a deficiency claim enforced against claim because

Finally, the courts often refer to a reasonable price when construing an incomplete contract. For example, as a principle of contract law, a contract will be enforced between parties even though it does not state a price, as the courts will insert a reasonable price.[232] In the context of the sale of goods or the provision of services, a reasonable price can be determined from comparisons to the marketplace.[233]

The word "reasonable" necessarily invokes uncertainty as to its meaning. The case law is not very instructive in how to arrive at a reasonable price in the above situations, other than to indicate that evidence of the value of the good or service is the best indication of a reasonable price. In *Bendalin*, the Texas Supreme Court extended the rule that a reasonable price will be implied in contracts involving the sale of goods or services to a contract before it involving the purchase and sale of an intangible asset, specifically stock.[234] The court rejected the defendant's argument that a greater degree of specificity was required in a specific performance action.[235] In its analysis, the court held that a reasonable price in actions at law for damages resulting from the breach of contract was equally applicable to a specific performance action lying in equity.[236] The court's analysis is instructive to ascertaining a "reasonable price" for a covenant.[237] Specifically, the determination of a reasonable price has at its inception the computation of the damages that a party sustains because of the breach of the covenant.

---

reasonable sales price obtained by secured party in disposing of the collateral demonstrated a disposition in a commercially reasonable manner); Tex. Bus. & Com. Code Ann. § 9.610(b) (requiring the disposition of collateral by a secured party to be conducted in a commercially reasonable manner).

[232] Bendalin v. Delgado, 406 S.W.2d 897, 900 (Tex. 1966) ("Where the parties have done everything else necessary to make a binding agreement for the sale of goods and services, their failure to specify the price does not leave the contract so incomplete that it cannot be enforced. In such a case it will be presumed that a reasonable price was intended.").

[233] Elec. Wire & Cable Co. v. Ray, 456 S.W.2d 260, 263 (Tex. Civ. App.—Houston [14th Dist.] 1970, writ ref'd n.r.e.) (finding that testimony by servicing mechanic on the value of his labor and materials was sufficient evidence of a fair and reasonable price).

[234] *Bendalin*, 406 S.W.2d at 900.

[235] *Id.*

[236] *Id.*

[237] Patterson v. A.L. Poss & Sons, Inc., 705 S.W.2d 301, 303 (Tex. App.—San Antonio 1986, no writ) (holding that claimant in suit for damages for breach of a contract for hauling equipment that did not state a price need not prove damages with precision but within a reasonable range).

As will be seen in the following subpart, a reasonable price is one that justly compensates the employer for losing the protection of an enforceable covenant. Even though the Act lists arbitration in the buyout clause as the second of two alternate solutions, the proper buyout price for an enforceable covenant can be best explained in the context of the arbitration buyout covenant.[238] Part VI will discuss the buyout price for a stipulated buyout covenant.

A. The Legal Principles To Determine the Buyout Amount

In the arbitration buyout covenant, the determination of the reasonable buyout price will be made at the end of the physician's employment, when the covenant's restrictions will apply to his or her practice of medicine in competition with the employer. If, at that time, either party asks an arbitrator to decide the buyout amount, how should the arbitrator arrive at a reasonable amount that the physician must pay the employer to buy out the covenant?[239] The common law's measure of the damages to be paid to a

[238] Part VII of this Article discusses the possibility that a court might interpret the buyout clause as requiring both solutions to be available.

[239] This Article argues that the proper calculation of the buyout price for a covenant is the employer's lost profits resulting from its breach. It is worth noting that covenants are valued in contexts other than a buyout. Financial Accounting Standards Board Statement 142, *Goodwill and Intangibles*, requires the valuation of intangible assets, including covenants. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 142: GOODWILL AND OTHER INTANGIBLE ASSETS 10 (June 2001). Moreover, the final "Phase III Rule" containing safe-harbor regulations to the *Stark Law* pertaining to hospital recruitment of a physician to an employer permits the hospital to impose reasonable liquidated damages if the physician leaves the service areas. 42 C.F.R. § 411.357(e) ("We note that we may consider a liquidated damages clause requiring a significant or unreasonable payment to the physician leaving the physician practice to have a substantial effect on the recruited physician's ability to remain in the recruiting hospital's geographic service area."). Stark Law, Phase III, 72 Fed. Reg. 51012, 51054 (Sept. 5, 2007) (response to comment on proposed rule, now codified at 42 C.F.R. § 411.357(e)). Although the effect is to retain the physician in the community serviced by the hospital, the valuation should be the same as set forth in this Article. Lastly, prior to the enactment of Internal Revenue Code § 197 in 1993, purchasers and sellers often battled over the amount of the purchase price to be allocated to a seller's covenant. The seller sought to increase the allocation because it could amortize the cost over the duration of the covenant. As a result, numerous cases arose over the valuation of a covenant for purposes of federal income taxation. Section 197 requires a buyer who allocates a portion of the purchase price to a seller's covenant to amortize the value of the covenant over fifteen years. I.R.C. § 197 (LexisNexis 2008). Issues arise in the division of marital property over spousal goodwill and existing covenants. Robert J. Alberts, Terrence M. Clauretie & Joseph P. Matoney, *Small Business Valuation: Goodwill and*

non-breaching party for the other party's breach of their contract answers the question.[240]

A covenant is a contract between the employer and the physician.[241] If the physician violates the covenant by competing with the employer inside the boundaries of the covenant, the physician breaches the contract. Consequently, a reasonable price required from the physician in the buyout clause is the amount of damages that the employer could prove in a lawsuit if the physician breached the covenant. Therefore, the arbitrator must award a buyout amount based on a measure of the employer's damages for the physician's breach of the covenant. As will be seen shortly, the appropriate measure of damages is the employer's lost profits.

A cause of action for breach of contract has four requisite elements, the last of which is the measure of damages: (1) the existence of a valid contract; (2) performance by the non-breaching party[242]; (3) breach by the other contracting party; and (4) damages resulting from the breach.[243] For purposes of this discussion, we assume that the employer can prove the first three elements of the cause of action. What remains is the calculation of the

Covenant-Not-To-Compete in Community Property Divorce Actions, 13 J. FORENSIC ECON. 217, 217–18 (2000); *cf.* ASWATH DAMODARAN, DAMODARAN ON VALUATION: SECURITY ANALYSIS FOR INVESTMENT AND CORPORATE FINANCE, 422 (2d ed. 2006) ("Goodwill is not an asset but a plug variable.").

[240]This Article relies on the common law measure of damages for breach of contract to interpret the Act's requirement for a reasonable buyout amount. Interestingly, relying on the common law could be construed as conflicting with the Act's preemption of the common law. Tex. Bus. & Com. Code Ann. § 15.52 (Vernon 2002).

[241]Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 651 (Tex. 2006) ("[A]n agreement not to compete, like any other contract, must be supported by consideration.") (quoting DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 681 n.6 (Tex. 1990)); *see also* Farmer v. Holley, 237 S.W.3d 758, 760 (Tex. App.—Waco 2007, pet. denied) ("A covenant is a formal agreement or promise which is usually in a contract."); Tom James of Dallas, Inc. v. Cobb, 109 S.W.3d 877, 885 (Tex. App.—Dallas 2003, no pet.) ("A covenant not to compete is a contract . . . ."); Juliette Fowler Homes, Inc. v. Welch Assocs., Inc., 793 S.W.2d 660, 664 (Tex. 1990).

[242]Most physician covenants will also include a provision that the covenant may be enforced notwithstanding any default of the employer under the terms of the balance of the agreement. *See* discussion *infra* Part X discussing the equitable doctrine of "unclean hands."

[243]City of Houston v. Swinerton Builders, Inc., 233 S.W.3d 4, 10 n.7 (Tex. App.—Houston [1st Dist.] 2007, no pet.) (discussing where a statute waiving city's immunity against a contract claim did not apply to contractor's *quantum meruit* claim); Aquila Sw. Pipeline, Inc. v. Harmony Exploration, Inc., 48 S.W.3d 225, 235 (Tex. App.—San Antonio 2001, pet. denied) (discussing where gas producer sued gas gatherer for breach of contract).

employer's resulting damages attributable to the physician's breach of the covenant.

The Texas common law follows section 347 of the Restatement (Second) of Contracts:

> [T]he injured party has a right to damages based on his expectation interest as measured by (a) the loss in the value to him of the other party's performance caused by its failure or deficiency, plus (b) any other loss, including incidental or consequential loss, caused by the breach, less (c) any costs or other loss that he has avoided by not having to perform.[244]

The comments to section 347 indicate that damages should give the injured party the benefit of his bargain.[245]

Thus, the damages replace the non-breaching party's expectation of a fulfilled contract. In other words, the employer is entitled to enjoy the physician's observance of the boundary limits of the covenant, less any savings from no longer employing the physician,[246] plus any incidental or consequential damages. That amount, as anticipated in the comments to the Restatement, almost always translates into a measurement of the employer's lost profits.[247]

---

[244] RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981); Qaddura v. Indo-European Foods, Inc., 141 S.W.3d 882, 888 (Tex. App.—Dallas 2004, pet. denied) ("The universal rule for measuring damages for the breach of a contract is just compensation for the loss or damage sustained. Damages for breach of contract protect three interests: a restitution interest, a reliance interest, and an expectation interest.").

[245] RESTATEMENT (SECOND) OF CONTRACTS § 347, cmt. a (1981) ("Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed.").

[246] RESTATEMENT (SECOND) OF CONTRACTS § 350(1) (1981) ("[D]amages are not recoverable for loss that the injured party could have avoided without undue risk or humiliation.").

[247] RESTATEMENT (SECOND) OF CONTRACTS § 347, cmt. b (1981) ("Where the injured party's expected advantage consists largely or exclusively of the realization of profit, it may be possible to express this loss in value in terms of money with some assurance. In other situations, however, this is not possible and compensation for lost value may be precluded by the limitation of certainty."); Orchid Software, Inc. v. Prentice Hall, Inc., 804 S.W.2d 208, 210 (Tex. App.—Austin 1991, writ denied) (finding that newly created software development corporation could sue for lost profits when publisher cancelled contract) ("[A]n injured party may recover damages for lost profits by showing that the loss is a natural and probable result of the act or omission

Recently the Utah Supreme Court specifically addressed the measure of damages for a breach of a covenant in response the certification of the question by the United States District Court for the District of Utah.[248] The In considering the question, the court noted it to be one of first impression and reviewed the supreme court authority of other jurisdictions. The Utah Supreme Court adopted lost profits as the proper measure of damages for an employee's breach of a covenant.[249] Moreover, the court specifically held that restitution or unjust enrichment are not the appropriate measure of damages, assigning those measures as proper for quantum meruit actions.[250]

Other state courts considering the measure of damages for a physician's breach of a covenant similarly conclude that lost profits is the appropriate measure.[251]

In a recently decided case, a surgeon violated his two-year, twenty-mile covenant.[252] Initially, the employer sought to enforce the covenant, but the duration of the covenant had expired and the trial court refused to permit the employer to seek damages for the breach of the covenant. The New Jersey appeals court reversed the trial court's decision, finding that the employer could pursue damages.[253] Subsequently, in the trial upon remand, the employer sought damages based on its investment losses, which it showed included the fee paid to a placement agency in recruiting the physician, malpractice premiums paid for the benefit of the physician, advertising expenses, and reimbursements paid to the physician associated with business expenses.[254] The employer did not submit evidence in support of any lost profits resulting from the breach. The trial court granted the physician's summary judgment motion that the foregoing expenses were

complained of and that the amount of profits that the party would have earned is reasonably certain.").

[248] Trugreen Cos., L.L.C. v. Mower Bros., Inc., 199 P.3d 929, 930 (Utah 2008).

[249] *Id*. at 932.

[250] *Id*. at 933.

[251] Moses H. Cone Mem'l Health Servs. Corp. v. Triplett, 605 S.E.2d 492, 497 (N.C. Ct. App. 2004) (finding employer entitled to lost profits as damages resulting from physician's breach of covenant); Prairie Eye Ctr., Ltd. v. Butler, 768 N.E.2d 414, 422 (Ill. App. Ct. 2002) (finding ophthalmologist who breached covenant responsible for lost profits suffered by employer).

[252] Salartash Surgical Associates, L.L.C. v. Del Rosario, No. A-0434-07 2008 WL 5083135 at *1, *3 (N.J. Super. A.D. December 4, 2008) (lost profits are the correct compensatory damages for breach of covenant and not employer's "investment losses).

[253] *Id*. at *1.

[254] *Id*.

not compensable damages for a breach of a covenant.[255] The Pennsylvania appeals court affirmed the trial court's decision, stating: "Lost profits and diminution in the value of the practice are other ways to measure damages."[256] The appeals court rejected the employer's theory that it was entitled to damages based on its investment in the physician.[257]

As pointed out previously, Colorado and Delaware have statutes that, although prohibiting physician covenants, permit the inclusion of liquidated damages, which are akin to the Texas buyout right.[258] The only reported case interpreting either statute is a Colorado appeals court case.[259] In that case, the court found that the appropriate measure by which to judge the liquidated damages specified in the physician covenant under its consideration was the employer's lost profits.[260]

Lost profits are generally stated to be the non-breaching party's revenues less the expenses incurred.[261] Lost profits are not just the non-breaching party's "top line" revenue or income. They are the net amount lost after taking into account the costs of producing the revenue. And while the definition of lost profits is simple, the actual measurement of the employer's lost profits is anything but simple.[262]

---

[255] *Id*. at *2, analyzing the court's suggestion in *Cmy. Hosp., Inc. v. More* that the employer's claim for damages included but was not limited to the loss of patients, see n. 170, supra.

[256] *Id*.

[257] *Id*.

[258] *See supra* note 29.

[259] *See* Wojtowicz v. Greeley Anesthesia Servs., P.C., 961 P.2d 520, 522–23 (Colo. Ct. App. 1998).

[260] *See id.* at 522–23; Reha, *supra* note 32.

[261] Mood v. Kronos Prods., Inc., 245 S.W.3d 8, 12 (Tex. App.—Dallas 2007, no pet.) (finding supplier's economic model of damages from termination of supply contract failed to support claim for direct and consequential damages of lost profits); Atlas Copco Tools, Inc. v. Air Power Tool & Hoist, Inc., 131 S.W.3d 203, 209 (Tex. App.—Fort Worth 2004, pet. denied) (discussing where tool distributor sued manufacturer for anticompetitive practices) ("'Net profits' are defined as 'what remains in the conduct of business after deducting from its total receipts all of the expenses incurred in carrying on the business.'"); Aiken Indus., Inc. v. Estate of Wilson, 383 A.2d 808, 812 (Pa. 1978) ("Lost profits are the 'net pecuniary gain from a transaction, the gross pecuniary gain diminished by the cost of obtaining them.'") (citing RESTATEMENT (SECOND) OF CONTRACTS § 331, cmt. b (1981)).

[262] Aquila Sw. Pipeline, Inc. v. Harmony Exploration, Inc., 48 S.W.3d 225, 246 (Tex. App.—San Antonio 2001, pet. denied) (finding that expert's lost profit calculation followed the appropriate methodology, but was flawed because the expert based his calculations on a well test done years before the breach of contract occurred and did not use "objective facts, figures, and data from historical profitability").

Consequently, the Texas Supreme Court has repeatedly held that the injured party need only show a loss with reasonable certainty, but not necessarily with mathematical exactitude. In other words, estimates of loss are permitted.[263] However, the court requires any estimate of loss to be supported with "objective facts, figures or data from which lost profits can be ascertained."[264] The court nevertheless recognizes that an aggrieved party may prove its lost profits by any number of methods using objective supporting information.[265] A party seeking damages for lost profits may use samples as proof of the loss if the samples are uniform.[266] In the context of a medical practice, sampling will be a useful tool for the arbitrator to arrive at the buyout amount, as will be seen below.

A reasonable buyout amount will correlate with the employer's expected lost profits from the physician's breach of the covenant. An estimate is compelled by virtue of the operation of the buyout clause. The buyout right is intended to be a means for the physician to practice without the covenant's restrictions and to continue his or her professional relationship with the physician's patients.[267] In consideration of the employer losing the protection afforded by the Act, the buyout clause is

[263] *See* Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex. 1992) (discussing where bulldozer owner sued repair company for lost profits for failure to honor warranty); Szczepanik v. First S. Trust Co., 883 S.W.2d 648, 649 (Tex. 1994) (per curiam); Tex. Instruments, Inc. v. Teletron Energy Mgmt., Inc., 877 S.W.2d 276, 280 (Tex. 1994) (finding that inventor without established business for product could not sustain proof of lost profits against manufacturer for breach of prototype production agreement, not because there were no sales of an established product, but because the claims were not supported by evidence of a reasonable certainty); Sw. Battery Corp. v. Owen, 131 Tex. 423, 115 S.W.2d 1097, 1098 (1938) (claim for lost profits as a result of breach of battery supply contract must be shown by "competent evidence with reasonable certainty"); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981).

[264] *Holt Atherton Indus., Inc.*, 835 S.W.2d at 84.

[265] *Id.* at 85 ("We do not sanction any one method of determining lost profits.").

[266] Hindman v. Tex. Lime Co., 157 Tex. 592, 305 S.W.2d 947, 953 (1957) ("Without a showing of some uniformity of damage that could be applied to a substantial portion of the automobiles involved, the 'example' or 'sampling' method here employed provides nothing more than a basis for a guess or surmise on the part of the jury . . . ."); *see also* Humana Med. Plan, Inc. v. Jacobson, 614 So. 2d 520 (Fla. Dist. Ct. App. 1992) (discussing where insurance company's agreement with physician to provide care to insurance company's enrollees contained a liquidated damage clause providing that physician would pay to insurance company $700 per patient treated by physician under a competing insurance plan).

[267] *See* discussion *supra* Part III.C.

also intended to give the employer fair compensation, that is, the buyout price, for the loss of the protections of the covenant.[268]

Those statutory purposes suggest that the buyout amount will be paid to the employer when the physician begins to compete. Since the actual lost profits will not be known at the time, they must be estimated. As a practical matter, in the arbitration of a buyout covenant, the amount to be paid cannot be known until the arbitrator makes his or her decision, so there will be some gap in time between the end of employment, when the buyout clause contemplates payment of the buyout price, and the time when the amount to be paid is known to the parties.

Therefore, the amount will be a forward-looking estimate[269] of the loss that the employer will suffer after taking into account the specifics of the employer's medical practice, the nature of the physician's specialty, the relevant medical market, and the specific effects of the covenant's boundaries. Each of these variables has an impact on the employer's profits from the physician's services while employed. For example, if the time boundary of the covenant is one year, the employer's lost profits are limited to one year, not longer.

Given all of the factors that the arbitrator should take into account, the court's observation in *Szczepanik v. First South Trust Co.* could not be more applicable to the determination of the buyout amount: "What constitutes reasonably certain evidence of lost profits is a fact intensive determination."[270] In the following paragraphs the specifics of the foregoing variables will be discussed in application of the lost profits formula, *i.e.*, revenue less expense, to the physician's covenant.

Employers have brought countless suits against employees for breach of a covenant. While the employer almost always seeks both the remedies of injunction and damages, few reported cases discuss how to measure the

[268] *See* discussion *supra* Part III.C.

[269] One might argue that the parties could simply wait until the covenant expires and determine the employer's lost profits at that time. The buyout clause does not place a deadline on either party to request an arbitrator to decide the buyout amount. The applicable limitations period to a breach of a covenant is four years. Tex. Civ. Prac. & Rem. Code Ann. § 16.004 (Vernon 2007). Thus, it is feasible that the parties could wait for the covenant's expiration, but this is impractical. First if the parties wait, the employer loses all right to seek an injunction. The employer then incurs the risk that the physician cannot pay the amount. Moreover, the employer experiences lost opportunity costs in delaying the payment of the buyout amount.

[270] Szczepanik v. First S. Trust Co., 883 S.W.2d 648, 649 (Tex. 1994).

employer's damages.[271] In those isolated cases, the courts decided that lost profits are the appropriate measure of damages for the breach of a covenant.[272] Some of these cases attempted to measure the employer's lost profits.[273] Courts in other states likewise concluded that the measure of

[271] *See, e.g.*, Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 831 (Tex. 1991) (employer sought injunctive relief and damages against former employee for violating covenant); Gill v. Guy Chipman Co., 681 S.W.2d 264, 266 (Tex. App.—San Antonio 1984, no writ) (real estate brokerage firm imposed an $8000 buyout for a covenant against a broker, which the court enforced when the employer offered evidence that its business declined after the employee opened a competing office); Hogg v. Prof'l Pathology Assocs., P.A., 598 S.W.2d 328, 329 (Tex. Civ. App.—Houston [14th Dist.] 1980, writ dism'd) (employer sought an injunction and damages against a pathologist who violated a covenant).

[272] Clay v. Richardson, 38 S.W.2d 849, 851 (Tex. Civ. App.—Amarillo 1931, no writ) (discussing a breach of covenant not to compete in contract for sale of moving picture business) ("If one who has entered into a valid contract not to engage in a certain business breaks such contract and competes with the promisee, the only available measure of damages is the amount of profits which the promisee has lost by reason of such breach . . . ."); *see, e.g.*, Isuani v. Manske-Sheffield Radiology Group, P.A., 805 S.W.2d 602, 608–09 (Tex. App.—Beaumont 1991, writ denied) (Burgess, J., dissenting) (finding a trial court determination of $500,000 supersedeas bond to be made by radiologist violating one year, fifteen mile covenant reasonable) ("If after [the radiologist] left the group, [the radiologist] diverted some of those contracts or referrals, then that lost income is capable of being calculated and [the radiologist] could face a suit for damages."); *cf.* Arabesque Studios, Inc. v. Acad. of Fine Arts Int'l, Inc., 529 S.W.2d 564, 566 (Tex. Civ. App.—Dallas 1975, no writ) (decided before the Act) (finding that in instances of employee breach, "[I]t is proper for the jury to consider profits made by the subsequent employer of the defendant inasmuch as these profits may have, in some part, accrued to plaintiff in the absence of the breach").

[273] Chandler v. Mastercraft Dental Corp. of Tex. Inc., 739 S.W.2d 460, 466 (Tex. App.—Fort Worth 1987, writ denied) (noting that the jury could determine lost profits suffered by seller of assets against buyer for breach of covenant given as part of the sale to determine damages); *Arabesque Studios, Inc.*, 529 S.W.2d at 569 ("In this case Arabesque presented evidence that possibly thirty-eight, and admittedly thirty-two, of its former students left the Richardson studio at the time Harris left its employment and went with her to the Academy studio. Harris admitted that she violated the contract of employment by teaching these former students of Arabesque at Academy. The jury was certainly entitled to take into consideration the amount of fees that Arabesque would have made had these students remained. The jury could infer that had Harris remained at Arabesque the students would not have attended Academy. In addition, the jury was entitled to consider the divergent profits which occurred between Preston Royal and Richardson studios. While the evidence of damages was not subject to mathematical exactness, we think that it was adequate to enable the jury to make a fair and reasonable approximation of damages.").

damages for the breach of a covenant is the lost profits of the non-breaching party.[274]

B. Calculating a Reasonable Price for the Buyout Based on Lost Profits

At the end of the employment relationship, if the physician desires to slip the bondage of the covenant, he or she must ask an arbitrator to determine the price to be paid.[275] The appropriate and reasonable price will be the profit that the employer will lose because of the physician working for another employer or simply for himself or herself. Three possible sources of information can inform an estimate of loss. The first and most reliable source is the historical accounting information that the employer has within its accounting records regarding the physician's performance prior to the physician's departure. A second source is the employer's diminished profit after the physician's departure measured against the employer's profit prior to the departure. A third source is the new employer's accounting information regarding the physician's performance in competition with the employer.

As reasoned above, the buyout payment should be made soon after the physician leaves the employer's medical practice and begins competing. At that point in time, the employer's pre-departure accounting information will offer the most complete set of accounting information from which to

[274] *See* Moses H. Cone Mem'l Health Servs. Corp. v. Triplett, 605 S.E.2d 492, 497 (N.C. Ct. App. 2004); Prairie Eye Ctr., Ltd. v. Butler, 768 N.E.2d 414, 423 (Ill. App. Ct. 2002); Hopper v. All Pet Animal Clinic, Inc., 861 P.2d 531, 547–48 (Wyo. 1993) (finding lost profits a proper element of recovery for breach of a covenant not to compete); Quad-States, Inc. v. Vande Mheen, 368 N.W. 2d 795, 798 (Neb. 1985) (finding that buyer could recover lost profits from seller as a result of seller's breach of covenant if supported by financial data estimating loss); Am. Air Filter Co. v. McNichol, 527 F.2d 1297, 1299 (3d Cir. 1975) (stating that the measure of damages for salesman's breach of the covenant not to compete is the profits that the former employer would have made on the sales it could reasonably have expected to secure had the salesman not breached the agreement).

[275] The buyout clause states that either the employer or the physician has the option to request the arbitrator to decide the buyout price. However, in practice, only the physician will request the buyout amount. The employer has the benefit of the covenant and expects the physician to honor its boundaries. If the physician competes with the employer without requesting the arbitrator to decide the buyout price, the statute does allow the employer, in lieu of seeking equitable remedies of an injunction, to request the arbitration. Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2007). In that instance, the employer would argue that the physician's competition is an affirmative election to buy out the covenant.

extrapolate its lost profits.[276] The information from the second and third sources might be unreliable and incomplete if the information is requested soon after the physician's departure. In the short period following the physician's departure, the total effect of the physician's competition during the transition process of leaving one employer and joining another employer may not be fully experienced as some patients may be deciding whether to stay with the former employer or to follow the physician.

If the process of arbitration is delayed significantly after the physician's departure, the passage of time could elevate the new employer's accounting information to an important source of information regarding the consequences of the physician's competition.[277] Similarly, the employer's accounting information post-departure could show whether it experienced a decline in profitability that it previously enjoyed while the physician was employed by it.[278] Regardless of the source of the accounting information, the determination of lost profits requires a determination of the revenue and expense associated with the physician's services to the employer's patients because of the competition.

The arbitrator should follow a multi-step process to determine the employer's lost profits resulting from the physician's competition. In the first step, the arbitrator must determine whether the employer had net profits from the physician's services. This determination will involve

[276] Gen. Devices, Inc. v. Bacon, 888 S.W.2d 497, 502–03 (Tex. App.—Dallas 1994, writ denied) (quoting D/FW Commercial Roofing Co. v. Mehra, 854 S.W.2d 182 (Tex. App.—Dallas 1993, no writ)) ("A party must show either a history of profitability or the actual existence of future contracts from which lost profits can be calculated with reasonable certainty. Texas cases permit recovery for lost profits in reliance upon routinely kept business records so long as the evaluation of the business's decreased profitability is based upon objective facts, figures, and data."); Adkins Adjustment Serv., Inc. v. Blumhoff, No. CIV.A.3:98-CV-2789-H, 2001 WL 484436 at *1 (N.D. Tex. May 2, 2001) (mem op.) (discussing where employer sued employee for lost profits resulting from breach of covenant); Butler v. Arrow Mirror & Glass, Inc., 51 S.W.3d 787, 791 (Tex. App.—Houston [1st Dist.] 2001, no pet.) (finding that employer did not adequately prove its lost profits and the trial court denied its claims for damages for breach of the covenant).

[277] George P. Roach, *Correcting Uncertain Prophecies: An Analysis of Business Consequential Damages*, 22 REV. LITIG. 1, 16 (2003) ("In addition, sometimes the defendant's actual profits are considered a rational proxy for plaintiff's lost profits.").

[278] RESTATEMENT (SECOND) OF CONTRACTS § 352 cmt. b (1981) ("Evidence of past performance will form the basis for a reasonable prediction as to the future."). *But see* Custom Drapery Co., Inc. v. Hardwick, 531 S.W.2d 160, 164–65 (Tex. Civ. App.—Houston [1st Dist.] 1975, no writ) (discussing where employer introduced testimony that it suffered a decline in the volume of sales as a result of former salesman going to work for a competitor).

ascertaining the employer's revenue or income from the physician's services and likewise the employer's costs from the physician's production of the revenue. The arbitrator will subtract the employer's costs from the employer's revenue to arrive at the net profit attributable to the physician.

In the next step, the arbitrator will apply the covenant's restrictions to the net profit to eliminate profit that is not protected by the covenant and to multiply the net profit for the covenant's duration. In the final steps, the arbitrator will adjust the net profit of the covenant by the following factors to the extent they are applicable to the subject covenant: (i) the attrition of patients; (ii) the "stickiness" of patients; (iii) anticipated trends; and (iv) the unique attributes of the employer's medical practice. Following these steps, the arbitrator will have the proper price to be paid by the physician to buy out the covenant.

The arbitrator will undertake the foregoing multi-step calculations using the accounting information available, which as concluded above, will most likely be the employer's historical accounting information.[279] If the employer employed the physician for many years, the arbitrator may choose to use an average of the three most recent years' accounting results, which would tend to eliminate aberrations in revenues and costs from year to year. Although the following description of the multi-step process is based on information that the arbitrator should take into account, each contestant—the employer and the physician—will supply a version of the information that best supports the contestant's position. Each contestant's expert witness in the arbitration, such as certified public accountants and business valuation experts, may further interpret this information.[280]

[279] A very common way to value an enterprise, or a specific asset, is to use a discounted cash flow methodology. This methodology estimates free cash flow (earnings before interest and taxes) and applies a discount rate that accounts for the attendant risks to the estimated cash flow. Free cash flow is arrived at by multiplying operating income times one minus the tax rate and subtracting capital expenditures less depreciation and subtracting the change in non-cash working capital. DAMODARAN, *supra* note 229, at 10–11, 79–80, 117. Given that a covenant has a short duration, usually less than two years, it is not necessary to apply a discount rate to the expected estimated cash flow. This author has relied on lost profits as a substitute for cash flow, and while there may be differences in the methodology, essentially the same result is achieved through the multistep process described in this Article. This author prefers to use the term "lost profits" instead of cash flow or net income, so that the term directly relates to the common law determination of damages.

[280] "Perhaps in the future the courts may accept the testimony of an expert as to the value of a covenant-not-to-compete." Alberts, et al., *supra* note 239 at 226.

1. Determine the Physician's Net Profit to the Employer

As previously indicated, the first valuation step is to determine the employer's net profit attributable to the physician.[281] The net profit will be the difference between the revenue and the cost of producing that revenue.[282] Applied to a medical practice, revenue is the employer's cash received for the physician's services.[283] For tax reasons, virtually all physician groups use the cash method of accounting.

A medical practice's revenue can easily include more than payments for the professional services to patients personally performed by the physician. In addition to payments for the physician's personally performed professional services, the employer's revenue can also include payments for additional, ancillary services,[284] from diagnostic tests or laboratory work such as magnetic resonance imaging (MRI) or nuclear cardiac stress tests. Other ancillary sources of revenue include procedures that can be performed in an ambulatory surgery center (ASC), such as colonoscopies performed by gastroenterologists, for which the employer is compensated

[281] RESTATEMENT (SECOND) OF CONTRACTS (1981) § 352, cmt. b ("Evidence of past performance will form the basis for a reasonable predication as to the future.").

[282] Lost profits are determined from an income statement for the entire entity. Under financial accounting standards, net income (before taxes) is determined by aggregating all revenue from continuing operations and subtracting the costs of goods sold to arrive at gross margin. Net income is the gross margin less all operating expenses. STEVEN M. BRAGG, ACCOUNTING REFERENCE DESKTOP, 596 (John Wiley & Sons, Inc. 2002).

[283] *Id.* In private practice, principally due to cash flow considerations and to a lesser degree income tax considerations, employers will frequently compensate physician employees based on the employer's collections during a fixed time, yearly, quarterly, or monthly. It is important to point out one of the unique aspects of the healthcare business: Physicians will bill at their respective fee schedules, but due to contractual arrangements with insurance companies, they will be paid a substantially discounted amount. This discount is referred to as "contractual adjustments" in the industry. Anyone looking at an explanation of benefits (EOB) from an insurance company is surprised by the small proportion of the physician or hospital's charges that are paid after the application of the contractual discount. Thus, billings and accounts receivable have no relevance to a physician's revenue.

[284] An entire specialty of health care law has grown in dealing with Congress' and states' efforts to curb perceived fraud and abuse in claims submitted to government sponsored health coverage resulting from a physician's referral of a patient to his or her practice's facilities for diagnostic tests, such as laboratory reference work and imaging. 42 U.S.C.A. § 1395nn (West Supp. 2008); 42 C.F.R. § 411.350 (2008); 42 U.S.C.A. § 1320a-7b(b) (West Supp. 2008); Tex. Occ. Code Ann. § 102 (Vernon 2007); 1 Tex. Admin. Code § 371.1721 (2008) (Tex. Health and Human Srvcs. Comm'n, Violations).

for the use of the facility.[285] In addition to revenue for ancillary services, an employer may receive revenue in the form of hospital stipend payments to provide emergency call coverage, particularly for specialties where there is a significant shortage of physicians due to supply or risk, such as neurosurgery.

From the income information, the arbitrator must count only income attributable to the physician's services. Therefore, in addition to the fees earned by the physician's personally performed professional services, there will need to be an allocation of income from the ancillary services described above if present in the employer's medical practice. This allocation can be on a per-patient basis. For example, the employer may charge a technical fee for each nuclear stress test the cardiology physician orders. The revenue would be equal to the employer's collections for those ancillary services for the subject physician's patients. As pointed out above, the measure of lost profits is not equal to the employer's lost revenue.[286] The complete calculation must subtract the employer's cost in generating that income.[287]

The employer's costs in connection with the physician's services fall within two categories: direct expenses of the physician and overhead.[288] Direct expenses of the physician's employment are very easily determined. They consist of salary, benefits,[289] the employer's portion[290] of employment

[285] In practice, the revenue attributable to the use of equipment or facilities associated with the professional services is referred to as the "technical fee."

[286] Gen. Devices, Inc. v. Bacon, 888 S.W.2d 497, 501 (Tex. App.—Dallas 1994, writ denied) ("Evidence of lost income, standing alone, is no evidence of lost profits.").

[287] Adkins Adjustment Serv., Inc. v. Blumhoff, No. CIV.A.3:98-CV-2789-H, 2001 WL 484436 at *1 (N.D. Tex. May 2, 2001) (mem. op.) (rejecting expert witness report on lost profits analysis for failing to disclose what costs he took into account in arriving at lost profits); Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex. 1992) ("[L]ost income is not the correct measure of damages.").

[288] *See, e.g.*, Wichita Clinic, P.A. v. Louis, 185 P.3d. 946, 957–58 (Kan. Ct. App. 2008) ("He further testified that revenue from a family practitioner like Dr. Louis was generally divided equally between the physician and the Clinic for overhead expenses. Overhead included the direct expenses of the physician, that is, the physician's staff, personnel, medical supplies, equipment depreciation, rent, maintenance, and receptionist or support staff salaries; and the indirect expenses, such as billing, support staff, maintenance, computer technicians, computer equipment, and telephone service.").

[289] A physician's benefits, also sometimes referred to as fringe benefits or perquisites, most often include group medical, disability and life insurance, vacation leave, and qualified retirement contributions such as 401(k) profit sharing plans. The arbitrator could review the expenses quite

taxes of the physician and the staff (nurses and schedulers) whom the physician uses exclusively, continuing medical education costs (CME),[291] dues the employer pays to medical societies and national associations,[292] license renewal fees,[293] permit fees from the Drug Enforcement Agency and the Texas Department of Public Safety,[294] reimbursement for meals and entertainment, and malpractice insurance premiums for the physician's individual professional liability policy.[295] Another category of direct expenses includes vaccines and infusion drugs that are given on the physician's orders. For example, a pediatrician will give regularly scheduled vaccines to pediatric patients. As another example, the rheumatologist will order periodic intravenous infusions of drugs be given in the employer's offices to an arthritis patient.

easily, as the employer likely made premium payments or contributions and recorded the amounts in its accounting and tax records. While vacation leave is a benefit, it should be excluded from the employer's costs, even though the employer may have employed a *locum tenens* to cover the vacationing physician, if the associated revenue produced by the *locum tenens* physician is also excluded. Some care should be used in connection with the accounting for *locum tenens* physician revenue, as the Medicare rules require the *locum tenens*' claims be submitted to CMS under the vacationing physician's national provider identifier (NPI) number.

[290] The employer is responsible for paying employment taxes, Social Security, and Medicare on the physician's wages. The employer must remit to the United States Treasury 6.2% of the physician's wages up to an annual wage limit of $102,000 in 2008 for Social Security and 1.45% of the physician's wages with no annual limit for Medicare. Federal Insurance Contributions Act, 26 U.S.C.A § 3101 (West Supp. 2008); Social Security Act, 42 U.S.C.A. § 430 (West 2003 & Supp. 2008). The state of Texas also requires the payment of unemployment taxes based on the physician's wages up to annual limit of $9000. Tex. Lab. Code Ann. § 201.082 (Vernon 2006).

[291] To qualify for the renewal of a Texas medical license, a Texas physician must complete twenty-four hours of continuing medical education annually, twelve of which must be in formal courses. 22 Tex. Admin. Code § 166.2 (2008) (Tex. Med. Bd., Continuing Medical Education).

[292] *See, e.g.*, American Board of Medical Specialties, a non-profit organization providing board certification to physicians in twenty-four medical practice specialties, http://www.abms.org/.

[293] Texas requires licensed physicians to renew their medical license every two years. The Texas Medical Board charges a renewal fee of $752 as of 2008. 22 Tex. Admin. Code § 175.2 (2008) (Tex. Med. Bd., Registration and Renewal Fees).

[294] Physicians who prescribe certain classes of pharmaceuticals must possess a certificate issued by both the United States Drug Enforcement Administration and the Texas Department of Public Safety. 37 Tex. Admin. Code § 13.21 (2008) (Tex. Dep't of Public Safety, Registration).

[295] The employer may also incur variable expenses in connection with the physician's employment, such as supplies or drug inventory. These variable expenses should also be a deduction in arriving at lost profits.

The employer's overhead consists of expenses associated with operating the practice in support of the physician's services that do not relate to expenses directly associated with the physician.[296] The employer's overhead includes: office rent; commercial general liability; worker's compensation and casualty insurance premiums; advertising and promotional expenses; salaries and benefits of staff not dedicated solely to supporting the physician's services, such as staff to schedule patients and to code, bill, and collect for services rendered on behalf of the employer; the employer's professional expenses to attorneys and accountants; state taxes imposed on the employer as a taxable entity;[297] federal income taxes imposed on the employer as a taxable entity; state property taxes imposed on the employer's real and personal property; and equipment costs, among others, but should exclude direct expenses associated with other employed physicians, such the other physicians' salaries, benefits, CME, and malpractice premiums.

The employer's overhead must be allocated to the physician on a proportionate basis, such as dividing the total overhead by the number of full time physicians employed by the employer.[298] Many employers use a sophisticated accounting formula to compensate their physician employees. These formulas are tied to the physician's production of income and subtract the physician's direct expenses and an allocated amount of overhead costs.

If the employer uses these types of "eat what you bill" formulas, the accounting information supporting the calculations used to pay the

[296] Adkins Adjustment Servs., Inc. v. Neal, No. 05-00-01419-CV, 2001 WL 1231685 at *1 (Tex. App.—Dallas Oct. 17, 2001, no pet.) (not designated for publication) (discussing that where employer sued employee for breach of covenant and for tortious interference with contract, and the employer provided no evidence of lost net profits, the expert's testimony did not deduct "nonallocable expenses such as rent, officer salaries, general clerical salaries, general insurance payments, or utility charges"). In *Atlas Copco Tools, Inc. v. Air Power Tool & Hoist, Inc.*, 131 S.W.3d 203, 208–09 (Tex. App.—Fort Worth 2004, pet denied), the appellate court severely criticized the plaintiff's damages expert's testimony. In particular, the court noted that the expert only took into account the incremental costs in selling and not the total expenses in carrying on the plaintiff's business.

[297] Tex. Tax Code Ann. § 171.001 (Vernon 2007) (imposing a franchise tax on the "margin" of virtually all entities, including professional entities employing physicians, payable to the Texas Comptroller of Public Accounts).

[298] Methodist Hosps. of Dallas v. Corporate Communicators, Inc., No. 05-92-01922-CV, 1993 WL 189894 (Tex. App.—Dallas May 28, 1993, writ denied) (not designated for publication) (stating that fixed overhead is recoverable as an element of lost profits for breach of a contract).

physician monthly or quarterly will be very helpful to the arbitrator. In those compensation formulas, the employer allocates revenue and expenses to the physician to determine the net profit payable to the physician as compensation. As the employer and the physician will have negotiated the terms of the compensation, there is a strong likelihood that the allocations are fairly stated between the parties. For salaried physicians, the allocations may be more difficult for the arbitrator, as the parties will not have internally allocated the revenue and expenses in the compensation formula, though it is common for even salaried physicians to be able to earn bonuses based on their production.

Again, the specifics of the employer's medical practice must be considered. If the employer has multiple locations and the physician works predominantly at one location, it might not be fair to allocate to the physician the costs associated with the other locations, as they may be cheaper or more expensive to operate. In multi-specialty practices, the overhead costs may need to be allocated according to the physician's medical specialty. If the physician is a primary-care specialist in a multi-specialty practice, the physician's allocable overhead should be higher than that of, say, a surgeon in the practice. The primary-care physician requires much more support from staff to generate collections for the employer than the surgeon who performs much of his or her work in the hospital's operating rooms, where the hospital furnishes the supporting personnel at its cost.

In multi-specialty medical practices that provide substantial ancillary diagnostic services, the primary-care physician should be allocated more of the overhead associated with the operation of the ancillary services than the surgeon because the primary care physician will refer more patients for diagnostic tests than the surgeon, although the surgeon could be a heavy user of radiologic (MRI) diagnostic services. In some medical practices, it might be important to allocate overhead using a weighting system. The more patients seen by a physician, the more overhead services of support staff will be needed to schedule patients and to bill and collect for services the physician performs. In those situations, the arbitrator could weigh the allocation of those types of costs based on the physician's collections as a percentage of the total collections of the employer.

The employer's financial records will reveal the specifics of the employer's collections for physician's services and for related ancillary diagnostic services and the overhead costs of operating the practice. With the aid of those records, the arbitrator can determine whether the physician

was profitable during his or employment.[299] Of course, as mentioned above, the information may also come from possibly two other sources pertaining to the period following the physician's separation of service: the new employer's accounting records [300] or the former employer's accounting records.

2. Apply the Covenant's Restrictions to the Physician's Net Profit

At the conclusion of Step One, the arbitrator will have determined the net profit that the employer earned from the physician who is restricted by a covenant. In Step Two, the arbitrator must adjust the employer's net profit by the particular restraints of the covenant, as described in the succeeding paragraphs.

The first restraint of a covenant to consider is its duration. If the covenant lasts longer than one year, the arbitrator will need to adjust the net profit to match the period that the covenant would otherwise have lasted. Thus, if the employer's annual net profit from the physician was $100,000 and the covenant lasts two years, then the arbitrator should multiply the covenant by two. Similarly, if the covenant lasts only six months, the arbitrator would divide the annual net profit by two.

On the other hand, the arbitrator may choose to weight the duration of the covenant. The length of the covenant permits the employer to replace the physician restricted by the covenant with another physician who will treat the employer's patients. If it is expected that the employer can replace the physician in the first year of the covenant, the physician's effect on the employer's lost profit might be reduced as the physician has less opportunity to influence referring physicians to refer patients to him or her instead of the employer's replacement. Consequently, in a two-year covenant, the arbitrator may choose to weigh the second year less than the first year, as the prospect of competition will be less due to the employer finding a replacement physician. Continuing with the prior example, the arbitrator will give full credit to one year's net profit of $100,000, but only 50% credit to the second year's net profit, for a total of $150,000.

---

[299] Chandler v. Mastercraft Dental Corp. of Tex. Inc., 739 S.W.2d 460, 466 (Tex. App.—Fort Worth 1987, writ denied).

[300] A party may use the records of the employer to show lost profits. *Id.* at 466; Arabesque Studios, Inc. v. Acad. of Fine Arts Int'l, Inc., 529 S.W.2d 564, 569 (Tex. Civ. App.—Dallas 1975, no writ).

The geographic boundaries of the covenant also need to be applied to the physician's net profit. Specifically, the physician should only be obligated to pay to his or her employer that portion of the physician's net profit that would be affected by the physician's competition. To illustrate the adjustment, consider a covenant that prohibits the physician from competing anywhere within a five mile radius of the employer's office.

The arbitrator should eliminate from the employer's net profit any profit attributable to the physician's services to patients who originated from outside the restricted area. The physician would be able to treat those patients as long as the physician locates outside the five mile barrier, and it would be a windfall to compensate the employer for profits that it would not receive when the physician complies with the covenant. When implementing this rationale, the arbitrator will most likely allocate the employer's profit equally among patients treated by the physician and multiply that per patient profit times the number of patients that originate from outside the protected territory.

The last restriction of a covenant is the specific activity that cannot be conducted by the physician. An adjustment based on this restriction would only be required if the physician performed services on behalf of the employer that are not covered by the restricted activity. As a practical matter, it is not likely that the employer will impose a covenant that does not cover the medical specialties that the physician will practice for the employer.

One setting in which this possibility might occur is an employer who practices in a very limited subspecialty, the training for which qualifies the physician to perform broader specialties. As an example, bariatric surgeons, physicians who specialize in the surgical treatment of obese patients, are also trained and qualified to perform general surgery. If the employer is a bariatric specialty practice, its covenant may restrict the physician from practicing bariatric surgery. If the physician performed general surgery cases, then the arbitrator should exclude the net profit earned by the employer from those cases.

3. Adjust the Net Profit for Patient Attrition

In a primary-care medical practice, such as internal medicine, family practice, pediatrics, and OB/GYN, the patients typically repeat their visits to the physician with regularity for annual physicals, vaccinations, or well-baby checkups. Nonetheless, a patient, no matter how loyal, may be forced to leave his or her physician's care because the patient relocates to another

state. In other words, the medical practice will suffer a natural loss of patients due to attrition. As attrition occurs in a given time period, the employer will lose any profit associated with these patients, regardless of the covenant's protection. Consequently, the arbitrator should adjust the physician's profit to exclude the profit associated with patients who would leave the employer's medical practice while the covenant is in effect.

Using historical information, the arbitrator can account for the attrition of patients by extrapolation.[301] The employer's practice will have information that will show how many patients requested a transfer of their medical charts and how many did not return for follow-visits. This number can be divided by the physician's total number of patients to arrive at a percentage of patients lost to attrition. The arbitrator should reduce the employer's lost profit by the percentage attributable to attrition to properly account for the fact that the employer would not have received a profit from these patients even if the physician had observed the covenant.

4. Adjust the Profit by a Patient "Stickiness" Factor

The arbitrator must determine the stickiness of the physician's patients, or stated another way, how likely is it that the physician's patients will leave the employer's practice to follow the physician for care?[302] The answer to the stickiness question will depend on the nature of the employer's medical practice.

The arbitrator can ascertain how many of the employer's patients will follow the physician by inference. For example, a pediatrician might show that 85% of his or her patients live within two miles of the pediatrician's office. One could infer that the parents of those patients choose the pediatrician out of the convenience of the employer's location. In a different example, the employer may have contracts with managed care insurance companies with insurance plans, which allow the employer's physicians to be listed as preferred providers of the plan, but not physicians

[301] Scruggs Mgmt. Servs., Inc. v. Hanson, No. 2–05–413–CV, 2006 WL 3438243, at *7 (Tex. App.—Fort Worth Jan. 13, 2006, pet. denied) (noting how an employer must show that employee took clients or business away from employer).

[302] Wichita Clinic, P.A. v. Louis, 185 P.3d. 946, 956 (Kan. Ct. App. 2008) ("The Clinic argues that the liquidated damages were related to the expected loss it would incur if Dr. Louis breached the noncompetition provision . . . . The Clinic maintains that it could not predict with absolute certainty Dr. Louis' actual collections or how many Clinic patients or referrals would follow Dr. Louis upon termination.").

of other employers. The patients who are the plan's beneficiaries may desire to follow the physician but financially cannot because the physician is no longer a preferred provider whose claims for treating the patient will be covered by the patient's insurance.

Physicians practicing surgery and related subspecialties typically do not have repeat business from a patient; therefore, the patient's stickiness is not as significant an issue as it is in a primary-care practice. An orthopedic surgeon only needs to replace a patient's diseased hip once. Nevertheless, the arbitrator may make factually-based assumptions regarding the future stream of patients that will follow the surgeon and not remain with the employer's practice. For example, the arbitrator may ascertain that the employer referred 25% of the physician's surgery patients to him or her in each year of practice, due perhaps to its other physicians having backlogs of patients. The remaining patients came to the surgeon from his or her own referral sources. Upon departure, the physician will not have access to the patients that the employer referred to him or her.

Lastly, the stickiness of patients is also influenced by length of employment of the physician. If the physician has only been employed a short while, say less than six months, there is not much opportunity for the employer's patients to attach to the physician. On the other hand, if the physician works with an employer for a long time, there is a much greater opportunity for the patients to follow the physician after departure—presuming, of course, that the physician enjoys a suitable reputation with the patients.

5. Adjust for Foreseeable Trends

If the arbitrator determines that the employer did not earn a profit on the physician, the inquiry need not end there. There may be information that supports an expectation of a profit during the term of the covenant. This expectation would flow naturally from an arrangement where the physician stayed with the employer only as long as it took the physician to establish his or her medical practice. The arbitrator could extrapolate an accounting trend of this arrangement to forecast that if the physician stayed with the employer past that point, the employer would have earned a profit.

If the arbitrator determined that the physician was profitable in the final three months before the end of his or her employment, the arbitrator could assume that the physician had surpassed break-even status and would continue to be profitable into the future. Future profitability would be supported by trends in the volumes of the physician's patients. If an

upward trend exists in the number of patients in each succeeding month of the physician's employment with the employer, the trend would be expected to continue until a full schedule was reached if the physician were still employed with the employer. The arbitrator could project the profitability based on the physician's profit in the final months of employment on a prospective basis, but using the same formula for lost profits described above.

In addition, to accurately forecast the profit the employer will lose, the arbitrator should take into account economic trends that may affect in the future the historical profit determined in Step One. These trends would be expected to occur because of external factors that neither the physician nor the employer could influence. For example, Congress is currently struggling with containing the costs of providing the Medicare program. In producing the annual fee schedule, CMS must take into account its costs. Until Congress intervened,[303] the physician fee schedule was to be reduced by approximately 10% effective July 1, 2008. In this example, had Congress not intervened, an arbitrator should take into account the prospective reduction in revenue for the employer.

Concomitant with changes in revenue, trends in the employer's costs may also need to be taken into account. The Bureau of Labor Statistics, an independent agency of the U.S. Department of Labor, publishes monthly an inflation index for medical care services based on a U.S. city average.[304] Based on the index, the cost of medical care services increased 4.6% from June 2007 to June 2008. The arbitrator may need to take the effect of inflation into account in adjusting the historical profit the employer earned from the physician. If the arbitrator determines that inflation is occurring, the costs in Step One should be increased, reducing the employer's projected profit over the duration of the covenant if revenue is expected to remain constant.

[303] Medicare Improvements for Patients and Providers Act, Pub. L. No. 110-275, 122 Stat. 2494.

[304] Measuring Price Change for Medical Care in the CPI, http://www.bls.gov/cpi/cpifact4.htm (describing how the Bureau of Labor Statistics calculates the price change for medical care in the consumer price index).

6. Adjust for the Employer's Unique Attributes of the Employer's Medical Practice

The arbitrator may have to take into account other considerations when faced with a covenant of a subspecialist physician. Several medical subspecialties are tied to relationships with healthcare providers other than the employer. For example, pathology, emergency room, radiology, and anesthesiology medical groups will enter into exclusive arrangements with a hospital or a system of multiple hospitals. If the physician leaves the group, the physician is contractually excluded from the patients who use those hospitals.[305]

In another setting, external factors may need to be taken into account by the arbitrator. If the employer loses an important professional services contract, such as an exclusive agreement to provide a hospital with all anesthesia services, the employer will have lost profits, but not as a result of the breach of the covenant. If the physician did not influence the hospital to terminate the exclusive services agreement with the employer, the loss is independent of the physician's activities. Thus, if the physician becomes employed by a competing anesthesia group who succeeds the employer as the exclusive provider of anesthesia in the hospital, the employer's lost profits are virtually zero.

7. The Valuation Formula

The employer's lost profits associated with a physician's covenant can be based on a mathematical formula, as follows: Employer's Lost Profits = Per Patient Profit x the Covenant Adjustment x the Attrition Adjustment x the Stickiness Adjustment x Foreseeable Trends Adjustment x Practice Attributes Adjustment.

To find the Per Patient Profit, the arbitrator will divide the physician's average annual profit to the employer by the total number of the physician's

[305] Note that the employment agreement for a hospital-based physician, such as a pathologist, radiologist, emergency room physician, hospitalist, or anesthesiologist, who is employed by an employer with an exclusive provider arrangement with a hospital, will often obligate the physician to resign the physician's privileges to practice at the hospital in connection with the end of the physician's employment. A typical contract reads: "Upon termination of this Agreement for any reason, Physician will immediately resign staff and similar privileges at medical facility for which the Employer has rendered services at any time during the two year period prior to the termination of this Agreement."

patients that accounted for the profit.[306] The Covenant Adjustment will be the multiplier for the duration of the covenant and for the percentage of patients to whom the physician could render services without violating the covenant. The Attrition and the Stickiness Adjustments will decrease the Per Patient Profit by the percentage of patients the arbitrator finds will leave the employer's practice during the covenant due to reasons unrelated to the physician's competition and by the percentage of patients that will remain with the employer's practice despite the physician's competition. The Trends Adjustment will adjust the Per Patient Profit for predicted changes in the employer's revenue or expenses to more closely approximate the profit for the duration of the covenant. Lastly, the Unique Practice Attributes Adjustment will further adjust the Per Patient Profit due to reasons that are unique in the employer's medical practice. The resulting computation of Employer Lost Profits will equal the reasonable price the physician should pay to the employer to compete without restriction by the covenant.

The foregoing formula satisfies the Texas Supreme Court's mandate in determining lost profits. The calculation is only an estimation of the loss because the arbitrator will necessarily make assumptions, such as the number of patients lost due to attrition or stickiness. However, the calculation is based on the actual revenue and costs of the employer associated with the physician's employment and the adjustments are derived from the employer's patient encounter and financial records. This foundation of accounting information satisfies the court's requirement of reasonability, though it is not necessarily mathematically exact.[307]

Before exploring the possibility that the employer has no net profit from the physician, it is worth briefly exploring market comparisons as an alternate valuation methodology. A market comparison postulates that the value of the covenant can be derived by comparing the compensation that

[306] *See, e.g.*, Humana Med. Plan, Inc. v. Jacobson, 614 So. 2d 520, 521–22 (Fla. Dist. Ct. App. 1992) (deeming $700 per patient liquidated damages provision between physician and insurance company for soliciting patients to another insurance plan to be against public policy encouraging interaction between doctors and patients, and an unreasonable amount, as insurance company had extensive resources to determine revenues and expenses per patient).

[307] Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex. 1992) ("As a minimum, opinions or estimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits can be ascertained."); Sw. Battery Corp. v. Owen, 131 Tex. 423, 115 S.W.2d 1097, 1098–99 (1938) (distinguishing between certainty as to fault, which is fatal to recovery, and certainty as to amount, which will not necessarily bar recovery).

an employer is willing to pay a physician for his or her services without a covenant and the compensation an employer is willing to pay the physician with a covenant. The difference in compensation should equal the value of the covenant. While in theory the market comparison could form the basis of valuing the covenant, it is impractical to use and is likely based on faulty assumptions.

The impracticality arises from the fact that information on covenants from which to draw the comparison is not readily available. Certain management group organizations conduct surveys of compensation by specialty and region, but these are not exact comparisons focusing on the salaries paid to physicians with a covenant with physicians without a covenant. The comparison methodology also contains faulty assumptions. It assumes that the employer consciously makes a distinction based on the covenant, when in actuality the employer may not care whether the physician is subject to a covenant.

The comparison methodology also assumes other employment conditions are the same. In reality, employment conditions are rarely the same. Benefits, such as vacation, insurance, and reimbursed business expenses, vary widely among employers. Likewise, work conditions, such as call coverage, vary widely. And perhaps most importantly, the methodology assumes that the covenants are the same in the market comparison. In reality, the boundaries of the covenants vary widely. Lastly, the market comparison suffers from isolated sample sizes and do not contain sufficient numbers of examples from which to draw a normal distribution for statistical purposes.

In the case of a physician who did not earn a profit for his or her employer and whose patient growth rate is not positive, the arbitrator may still find that the employer has suffered consequential damages in the form of costs that the employer incurred specifically for the physician's employment.[308] These costs could include, for example, the payment of a fee to a recruiting organization (headhunter) that introduced the physician to the practice, which might be up to one-third of the physician's annual

[308] RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981) ("As an alternative to the measure of damages stated in section 347, the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed.").

salary.[309] The employer may have paid the physician's relocation expenses as part of the physician's employment and may have paid a sign up bonus to induce the physician to commit to join the employer's medical practice.

The employer may have incurred additional overhead costs to purchase specific equipment or lease additional office space to accommodate the physician. While the employer has the opportunity to mitigate these costs by recruiting a replacement physician to use the equipment or the offices for which the expense was incurred, the employer nevertheless must bear the cost of underutilized offices, staff, and equipment until the replacement physician begins working for the employer.

Although various costs described in the preceding paragraph do not measure lost profits, they do represent a loss suffered by the employer because of the physician's termination of employment.[310] The case law on lost-profits damages uniformly holds that the non-breaching party may be awarded nominal damages if it cannot prove lost profits.[311] Nevertheless, the employer should be entitled to recover consequential damages even if it cannot prove lost profits. As such, the arbitrator will be forced to evaluate whether the expenses incurred by the employer represent consequential

[309] *See* Contingency Recruiting Contract of Clarian Health Physician Recruitment, http://www.clarian.org/physicianrecruitment/includes/Contingency_Recruiting_Contract.pdf ("Recruiting Fee. Recruiter's total fee for the recruitment of a qualified physician of any/all specialties shall be $15,000. Fifty percent ($7,500) will be paid when both Clarian and the qualified physician sign an employment agreement. In the event the candidate physician fails to complete 30 days of employment, as agreed under the terms of the employment contract, Recruiter must refund all fees previously paid to Recruiter by Clarian for that candidate. The remaining fifty percent of the fee ($7,500) will be paid to Recruiter upon candidates' successful completion of thirty (30) days of employment.").

[310] RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981) ("As an alternative to the measure of damages stated in section 347, the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed."); Aiken Industries, Inc. v. Wilson, 383 A.2d 808, 813 (Pa. 1978) (stating that damages for breach of covenant also included the employer's costs in training replacement personnel).

[311] Hyatt v. Tate, 505 S.W.2d 373, 375 (Tex. Civ. App—Houston [1st Dist.] 1974, no writ) (discussing where plaintiff sued to recover cost of repairs to automobile as a result of collision); RESTATEMENT (SECOND) OF CONTRACTS § 346 cmt. b (1981) ("There are also instances in which losses caused but recovery for that loss is precluded because it cannot be proved with reasonable certainty or because of one of the other limitations stated in this Chapter. *See* §§ 350–53. In all these instances the injured party will nevertheless get judgment for nominal damages, a small sum usually fixed by judicial practice in the jurisdiction in which the action is brought.").

damages because of the physician's competition and are tied to the employer's business interests that the covenant was intended to protect. The physician will contend that the employer's loss occurs only because of the end of the physician's employment. If the termination of the physician's employment contract did not constitute a breach of its terms, then the loss would occur even if the physician observed the conditions of the covenant.

The foregoing discussion underscores the importance of the specific attributes of the medical practice in which the covenant arises. If the arbitrator is to find a truly reasonable price for the buyout of the covenant, the arbitrator must measure the consequences in terms of lost profits that the employer will suffer. Without a doubt, the arbitrator must draw conclusions from trends and other circumstantial evidence presented by the parties in order to quantify the lost profits. The arbitrator's conclusions can only be a reasonable estimate, but it is not merely a guess. It is predicated on objective, quantifiable information supplied by the parties. At the end of the day, when the arbitrator is asked to make his or her decision, at least one thing is certain: The parties will have spent substantial sums on accountants, valuation experts, and attorneys to justify their respective positions to the arbitrator.

C. Resort to the Procedures of the Texas General Arbitration Act

Part IV.B. set forth the multi-step valuation process that the arbitrator should use, beginning with the accounting data from the employer's medical practice, and adjusting that data for five additional factors relevant to the that practice and the boundaries of the covenant.[312] The valuation steps produce a reasonable buyout price to be paid by the physician. Using the lost profits methodology, the arbitrator is able to determine the buyout price as required by the buyout clause.

Unfortunately, the buyout clause poses challenges to the employer and the physician when the time comes for the determination of the buyout price, which will likely be the time in their professional relationship when harmony and collegiality are at a low ebb. Except for the single instruction that the buyout price is to be determined by an arbitrator, the buyout clause is virtually bereft of guidance on conduct of the arbitration by the appointed arbitrator.

---

[312] *See supra* Part IV.B.

The first challenge faced by the parties during arbitration is the selection of the arbitrator. This person will be critical to the fair evaluation of the covenant for purposes of applying the lost profits measure of damages, hopefully using the previously described formula to arrive at the buyout price. This person should have an adequate background in law to understand the proper measure of damages as well as the capability to evaluate the accounting proof to be presented by the parties in support of lost profits.

The buyout clause provides that the parties may agree on the arbitrator.[313] If the covenant is silent, no process exists for the parties to submit to one another the names of persons acceptable to the party as an arbitrator.[314] The buyout clause assumes in its informal approach to dispute resolution that the parties will talk to one another, which is highly unlikely in the emotional context of the end of employment and the looming restrictions of the covenant.[315]

The legislators took some pride in revising the bill prior to enactment to give the parties an avenue to resolve such an inability to agree.[316] However, no indication exists of what effort, if any, the parties must make in selecting a mutually-acceptable arbitrator.[317] The state's public policy is to conserve judicial resources and prefer the private resolution of disputes by giving the parties the opportunity to attempt to agree on an arbitrator as a condition to requesting the court to select one for them.[318] One interpretation of the clause is that the parties are to try to agree on the selection of the arbitrator when a party elects to have the buyout price determined by the arbitrator. Part X of this Article discusses supplementing the covenant with contractual provisions setting forth the method the parties will follow in mutually selecting the arbitrator.[319] These contractual provisions could entirely circumvent the need to resort to court appointment of the arbitrator.

If the parties are unable to agree on an arbitrator, the buyout clause provides that "the court whose decision shall be binding on the parties" will

[313] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[314] *See id.*

[315] *See generally id.*

[316] *See supra* note 187–195 and accompanying text (discussing the House Committee's addition of the court-appointed arbitrator to the buyout clause).

[317] *See supra* note 187–195 and accompanying text.

[318] *See supra* note 187–195 and accompanying text.

[319] *See infra* Part X.

appoint the arbitrator.[320] With that short phrase, the parties encounter the next challenge of determining the court to which one or the other party should apply for the appointment of the arbitrator. Presumably, the buyout clause is referring to the court that has jurisdiction over the employer and the physician. Therefore, the district court and the county court may each have original jurisdiction to appoint the arbitrator.[321] As a result, jurisdictional issues could arise at the initial application for the appointment of an arbitrator. If a party believes the buyout amount should be less than $100,000, the party may elect to file in the county court because of advantages that may be present in that level over the district courts, such as availability. However, if the other party, i.e., the employer, believes that the buyout is more than $100,000, it will file pleadings to remove the physician's application to the district court. Even before the arbitrator is selected, the parties will be expending legal fees in pursuit of the proper court to appoint the arbitrator.

Chapter 15 of the Texas Civil Practice and Remedies Code will determine the county of the court in which the application for appointment should be filed.[322] In most situations, the physician and the employer will reside in the same county, but in large metropolitan practices that span more than one county, the possibility exists that they will not. In the situations involving more than one county, the parties may have reasons to engage in forum shopping. One such reason may be to choose a county where the courts may be friendlier to a party's predicament that could translate into the selection of an arbitrator who could give an award more acceptable to the resident party.

In stark contrast to the buyout clause's brevity, the Texas General Arbitration Act (the "Arbitration Act")[323] contains detailed provisions

[320] Tex. Bus. & Com. Code Ann. § 15.50(b)(2).

[321] The Texas constitution establishes the jurisdiction of the district courts, which is original jurisdiction over all actions, proceedings, and remedies, except to the extent conferred on another court. TEX. CONST. art. V, § 8. The Texas Government Code reiterates that the district court's jurisdiction is set forth in the Texas constitution. Tex. Gov't Code Ann. § 24.007 (Vernon 2004). Texas statutory county courts have jurisdiction over all actions, proceedings, and remedies prescribed for statutory courts. *Id.* § 25.0003(a). The statutory county court's jurisdiction is concurrent with the district court in matters involving amounts in excess of $500 but not exceeding $100,000, excluding interest and attorneys' fees. *Id.* § 25.003(c)(1).

[322] Tex. Civ. Prac. & Rem. Code Ann. § 171.096(a) (Vernon 2005) (stating the application for arbitration is to be filed in the county where the adverse party resides or has a place of business).

[323] *Id.* §§ 171.001–.098.

regarding the conduct of an arbitration. Amazingly, the buyout clause does not refer to or incorporate the provisions of the Arbitration Act.[324] By failing to incorporate the Arbitration Act expressly, the legislature missed an opportunity to avoid much of the uncertainty over the arbitration that the buyout clause dictates to be conducted. Nevertheless, even in the absence of specifically referencing the Arbitration Act, there are compelling reasons, described below, for the Arbitration Act to control both the application for the arbitrator and the arbitration to be conducted by that arbitrator. But before examining those reasons, it will be useful to review other Texas statutes that contain dispute resolution provisions.

Interestingly, a number of Texas statutes authorize resolution of particular disputes by arbitration. These statutes vary widely in their implementation of the arbitration process. Two statutes are multistate compacts that allow each state, or the state's administrator, to appoint an arbitrator and provide that the chosen arbitrators are to choose an arbitrator to decide the matter.[325] These compacts do not set forth procedures for conducting the arbitration. Another statute[326] addressing issues of campus peace officers provides for the appointment of an impartial hearing examiner in the absence of agreement from a list of names provided from the American Arbitration Association (AAA)[327] or the Federal Mediation and Conciliation Services. That statute further provides the means to select from the names supplied and some procedures to be followed in conducting the hearing.[328] At least one statute provides that the arbitration is to be conducted pursuant to the AAA's procedures.[329] Another statute in the Agriculture Code provides that the State Seed and Plant Board is to act as

[324] *See id.*

[325] Tex. Occ. Code Ann. § 304.001(11)(c) (providing for arbitration of disputes under the Nurse Licensure Compact); Tex. Water Code Ann. § 44.010(8)(j) (Vernon 2008) (providing for arbitration of disputes between Texas and Louisiana under the Sabine River Compact in the case of a tie vote on any of the Administration's determinations).

[326] Tex. Educ. Code Ann. § 51.2126(d) (Vernon Supp. 2008) (providing for resolution of disciplinary and promotional issues for peace officers in providing services to multiple schools under mutual assistance agreements).

[327] The American Arbitration Association is a non-profit corporation that offers mediation and arbitration services to parties assenting to them by contract. *See generally* American Arbitration Association, http://adr.org/about (last visited Mar. 29, 2009).

[328] Tex. Educ. Code Ann. § 51.2126(e)–(j).

[329] Tex. Bus. & Com. Code § 20.08 (Vernon 2002) (pertaining to the resolution of consumer reporting agency issues if the parties agree to arbitrate, to use the AAA rules).

an arbitration board[330] to determine issues pertaining to seeds and sets forth specific arbitration procedures it is to follow.[331]

The Beer Industry Fair Dealing Law (the "Beer Law") specifically requires arbitration to be conducted under the Arbitration Act.[332] The Beer Law shares some similarity with the Act. The Beer Law compels a manufacturer who terminates a distributor's alcoholic beverage distribution agreement without cause to pay the distributor reasonable compensation equal to the fair market value of the distributor's business affected by the distributed brands.[333]

The Beer Law first allows the parties to attempt to agree on the amount of compensation to be paid by the manufacturer.[334] If the parties cannot agree on the amount, either party may request arbitration to decide the amount, which is similar to the buyout clause's resolution of the buyout amount.[335] However, unlike the Act, the Beer Law sets forth the specific procedure by which the parties are to select the arbitrator. In the Beer Law, each party is to appoint an arbitrator, and the two appointed arbitrators are to appoint a third arbitrator.[336] The Beer Law's method of the parties' representatives selecting a third arbitrator is arguably preferable to the Act informally asking the parties to try to agree on the arbitrator. In the Beer Law, if the third arbitrator is not selected within ten days by the parties' representatives, a district court judge is to select the arbitrator.[337]

The Texas Property Code establishes a non-binding arbitration process to resolve disputes between homeowners and builders over defects in residential construction.[338] The residential property arbitration statute incorporates the provisions of the Arbitration Act and the Federal

[330] Tex. Agric. Code Ann. § 64.005 (Vernon 2004).

[331] *Id.* § 64.006.

[332] Tex. Alco. Bev. Code Ann. § 102.77(b) (Vernon 2007) (providing for arbitration under the Arbitration Act to resolve disputes over reasonable compensation to be paid to terminated distributors); Tex. Gov't Code Ann. § 2258.053(a) (Vernon 2008) (providing for resolution of disputes over prevailing wage).

[333] Tex. Alco. Bev. Code Ann. § 102.77(a).

[334] *Id.* § 102.77(b).

[335] *Id.*

[336] *Id.*

[337] *Id.*

[338] Tex. Prop. Code Ann. §§ 436.001–438.001 (Vernon 2007).

Arbitration Act.[339] The Residential Construction Arbitration Act is interesting in two respects. First, it supplements the Arbitration Act and the Federal Arbitration Act with specific provisions, the most significant of which is the requirement that the arbitration take place in the county where the home is located.[340] Second, it provides that when awards are filed in a court, the filing must include specific listed information about the parties, their attorneys, the dispute, the arbitrator's fee, the prevailing party, and the amount of the award.[341]

The Arbitration Act has an important jurisdictional prerequisite: It applies only to arbitrations to be conducted pursuant to an agreement to arbitrate.[342] Fortunately for employers and physicians, the buyout clause actually solves the necessity of an agreement between the parties to arbitrate, and the parties may avail themselves of the additional procedures contained in the Arbitration Act. As described, in order to have an enforceable physician covenant, the covenant must provide for a buyout of the covenant at a reasonable price.[343] In satisfying the Act's buyout requirement, the parties can stipulate the price in the covenant or allow it to be determined by the arbitrator.[344] The parties must state that choice in the covenant itself. Consequently, to satisfy the Act and to be an enforceable covenant, the parties will have by necessity agreed in writing to arbitration.[345]

This conclusion is further supported by the different treatment the courts have afforded the Beer Law's provisions providing for the arbitration of the value of a terminated distributorship. Section 102.77 of the Beer Law closely resembles the buyout clause of the Act.[346] That section authorizes

[339] *Id.* § 436.002; Tex. Civ. Prac. & Rem. Code Ann. §§ 71.001–.098 (Vernon 2007); Federal Arbitration Act, 9 U.S.C. §§ 1–16 (2008).

[340] Tex. Prop. Code Ann. § 436.003(a) (Vernon 2007).

[341] *Id.* § 437.001(a)(1–8).

[342] Tex. Civ. Prac. & Rem. Code Ann. § 171.021(b) (Vernon 2005).

[343] *See supra* Part V.

[344] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[345] It should also be noted that physician employment agreements are often written to provide for binding arbitration of all disputes between the employer and the physician. These provisions usually are written to invoke the AAA Commercial Arbitration Rules or the American Health Lawyers Association Dispute Resolution Rules. *See infra* text accompanying note 662. Clearly, covenants contained in employment agreements with global, mandatory arbitration would be subject to the Arbitration Act.

[346] Tex. Alco. Bev. Code Ann. § 102.77 (Vernon 2007).

either the manufacturer or the distributor to seek arbitration pursuant to the Arbitration Act to determine two issues: whether good cause existed to justify the termination of the distributor's rights, and the compensation to be paid to the distributor for termination not based on good cause.[347] Section 102.77 of the Beer Law, in contrast to the buyout clause, does not require the section's arbitration provision to be incorporated in the agreement between the manufacturer and the distributor.[348]

Two courts have concluded that if the distributorship agreement omits the arbitration provision of the Beer Law, a court may not compel arbitration pursuant to the Arbitration Act, as no agreement to arbitrate exists between the parties.[349] In those cases, the courts refused to incorporate by reference a statutory arbitration right in the written agreement between the parties.[350] The courts justified the decision not to incorporate the Beer Law's arbitration section based on an additional section in the Beer Law that allows the parties to file a lawsuit over the same issues that can be arbitrated.[351] The Act avoids these impediments to arbitrating a physician buyout amount under the Arbitration Act by requiring the parties to include the arbitrated buyout option in the covenant.[352]

As noted above, other statutes incorporate the procedures of the AAA. The Arbitration Act should, however, be given priority, as it is the legislature's statement of the conduct of arbitrations. Arbitrations administered by the AAA are conducted pursuant to AAA's Commercial Arbitration Rules to the extent the agreement of the parties does not vary them.[353] Those Texas statutes incorporating the AAA's procedures address consumer complaints and not valuation issues.[354] The statutes involving

[347] *Id.* § 102.77(a).

[348] *See id.*

[349] Glazer's Wholesale Distribs., Inc. v. Heineken USA, Inc., 95 S.W.3d 286, 297 (Tex. App.—Dallas 2001, pet. granted, judgm't vacated w.r.m.); Cerveceria Cuauhtemoc Moctezuma S.A. de C.V. v. Mont. Beverage Co., 330 F.3d 284, 286–87 (5th Cir. 2003) (holding a district court's refusal to compel arbitration is a non-appealable interlocutory order when the parties did not clearly demonstrate an intent to submit their disputes to binding arbitration).

[350] *See Glazer's*, 95 S.W.3d at 289; *see also Cerveceria*, 330 F.3d at 287.

[351] *Glazer's*, 95 S.W.3d at 297; *Cerveceria*, 330 F.3d at 287.

[352] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[353] American Arbitration Association–Commercial Arbitration, http://www.adr.org/commercial_arbitration (last visited Apr. 6, 2009).

[354] *See supra* text accompanying note 329.

valuation that refer to the AAA do so for the purpose of identifying eligible arbitrators, but the statutes contain detailed provisions on the conduct of the valuation hearing.[355] Since it is clear that any covenant satisfying the prerequisites of an enforceable physician covenant will necessarily satisfy the Arbitration Act's prerequisite of an agreement requiring arbitration, there is no reason to employ the rules of an alternate arbitration service like AAA, the Federal Mediation and Conciliation Service, or the AHLA unless the covenant specifies the use of those rules.[356]

As the legislature has acted many times to provide procedural guidance in statutes enacted with arbitration provisions involving valuation, it is unfortunate that the legislature omitted this guidance from the Act.[357] Part XIV below offers suggested language to remedy that omission.[358] Nevertheless, when the buyout price must be decided under the Act, the parties and the arbitrator should follow the procedures contained in the Arbitration Act if the covenant in question does not otherwise provide more specific procedural and evidentiary criteria to be used in the arbitration.[359]

D. The Arbitration Process

The Arbitration Act sets forth a clear procedure to obtain the court's appointment of the arbitrator.[360] To commence the arbitration process, either party files the application for the appointment of an arbitrator with the clerk of the court and pays the filing fees required for a civil action.[361] The application must state a minimum amount of information: the

[355] Tex. Health & Safety Code Ann. § 775.0221(a) (Vernon 2003 & Supp. 2008) (providing for arbitration to resolve the compensation to an emergency services district for removed territory); *id.* § 776.0521(a) (providing similar provisions for emergency services in rural counties); Tex. Loc. Gov't Code Ann. § 43.0564(a) (Vernon 2008) (providing similar procedures for negotiating services provided by municipalities to territory not annexed).

[356] Tex. Civ. Prac. & Rem. Code Ann. §§ 171.041–.055 (demonstrating that some procedures in the Arbitration Act can be varied by the arbitration agreement of the parties).

[357] The legislature also did not specify arbitration procedures in Tex. Occ. Code Ann. § 2502.203 (Vernon 2007), *repealed by* Act of June 18, 2005, 79th Leg., R.S., ch. 1143, § 1, 2005 Tex. Occ. Code § 2505.201, and neither do the two interstate compacts cited in note 306, *supra*.

[358] *See infra* Part XIV.

[359] *See infra* Part XIV.

[360] *See generally* Donald R. Philbin, Jr. & Audrey Lynn Maness, *Litigating Arbitration: A 2007 Texas Arbitration Review*, 60 BAYLOR L. REV. 613 (2008) (providing a helpful discussion of arbitration).

[361] Tex. Civ. Prac. & Rem. Code Ann. § 171.082 (Vernon 2007).

jurisdiction of the court; a copy of the agreement to arbitrate; the issues subject to arbitration; the status of the arbitration (which may be none if no arbitration has commenced); and the need for an order from the court.[362]

The court clerk issues process for service on each adverse party with a copy of the application.[363] The court is to "hear the application in the manner and with the notice required by law or court rule for making and hearing a motion filed in a pending civil action in a district court."[364] Rule 21 of the Texas Rules of Civil Procedure requires a party to give a minimum of three days notice of the hearing.[365] If the service of the application on the adverse party is to be performed in the same manner as the service of a civil action, presumably the adverse party has until 10 a.m. on the Monday next following twenty days after service of process to answer the application.[366]

Ordinarily, there should be no controversy over the issue of the appointment of an arbitrator to determine the buyout price of the subject covenant. If a hearing is held, the moving party may submit proof by affidavit showing that there is an employment contract between the parties that contains a covenant, in which the parties agree that an arbitrator will determine the buyout price.[367] The Texas Supreme Court has stated that the hearing on the motion to compel arbitration should be an expedited hearing:[368]

> Because the main benefits of arbitration lie in expedited and less expensive disposition of a dispute, and the legislature has mandated that a motion to compel arbitration be decided summarily, we think it unlikely that

[362] *Id.* § 171.085(a).

[363] *Id.* § 171.094(a).

[364] *Id.* § 171.093.

[365] Tex. R. Civ. P. 21.

[366] Tex. Civ. Prac. & Rem. Code Ann. § 171.094 (Vernon 2007) (providing that the process and service and return of service must be in the form and include the substance required for process and service on a defendant in a civil action in a district court); Tex. R. Civ. P. 15.

[367] Tex. Civ. Prac. & Rem. Code Ann. § 171.041(b) (Vernon 2005).

[368] *In re* Poly-America, L.P., 262 S.W.3d. 337, 354 (Tex. 2008) (involving an employment contract that contained an arbitration agreement that, among other restrictions, limited discovery in subsequent resolution of disputes between employer and employee, including retaliatory discharge claims).

> the legislature intended the issue to be resolved following a full evidentiary hearing in all cases.[369]

It is possible that the party responding to a motion to compel arbitration may seek to oppose the appointment of an arbitrator. In view of the supreme court's mandate that the decision to compel arbitration should be made by the district court as quickly as possible, the court in *In re Poly-America* set forth additional guidance.[370] If the respondent is able to show that facts exist demonstrating arbitration should not be granted, such as a poorly-written employment agreement that may be subject to multiple interpretations, the district court is to hold an evidentiary hearing to determine the disputed material facts.[371]

Should the district court deny the motion to appoint an arbitrator, the movant may appeal the decision; however, the law that governs the arbitration agreement dictates the appellate route the appellant must take. If the arbitration agreement is to be governed by the Federal Arbitration Act, the decision of the district court may only be challenged by mandamus and not by an interlocutory appeal.[372] If the Arbitration Act governs the arbitration, an interlocutory appeal is the proper method to obtain relief from an order denying a motion to compel arbitration.[373] If the district court orders the arbitration to proceed, the respondent must await the end of the arbitration before seeking an appeal.[374]

The public policy encouraging arbitration severely limits the disappointed party's ability to obtain an appellate review by the district court's decision. Section 16 of the Federal Arbitration Act prohibits an appeal of the district court's order compelling arbitration.[375] It is also possible that competing actions may be taking place in different forums. One party to the employment agreement may seek a declaratory judgment

---

[369] *Id.* (quoting Jack B. Anglin Co. v. Tipps, 842 S.W.2d 266, 269 (Tex. 1992)).

[370] *Id.*

[371] *Id.*

[372] Wee Tots Pediatrics, P.A. v. Morohunfola, 268 S.W.3d. 784, 789 (Tex. App.—Fort Worth 2008, no pet.) (involving a physician employment agreement containing a general arbitration clause covering disputes other than those involving the physician's covenant).

[373] *Id.* ("If the arbitration agreement is governed by the Texas General Arbitration Act . . . interlocutory appeal is the proper method for seeking relief from an order denying a motion to compel arbitration.").

[374] Philbin & Maness, *supra* note 360, at 640.

[375] Perry Homes v. Cull, 258 S.W.3d 580, 586 (Tex. 2008) (discussing an arbitration provision in homeowner's warranty contract due to party's pursuit of litigation up to eve of trial).

action in district court regarding the enforceability of the covenant. The other party may be seeking to compel arbitration. Under Texas law, the district court is to stay the declaratory judgment action and permit the arbitration to proceed first.[376]

Although the Arbitration Act allows a party to an arbitration agreement to request the court to appoint one or more arbitrators,[377] the buyout clause is quite specific that only one arbitrator is to be appointed.[378] As such, the application to the court should request the appointment of only one arbitrator. Unless the parties agree on specific qualifications of the arbitrator in the employment agreement, the court may appoint any person to be the arbitrator if the person is neutral.[379] The arbitrator need not have any particular qualification to serve as arbitrator.[380] The buyout clause contains no requirements on the qualifications for the arbitrator to be appointed, and presumably the legislature leaves to the court the responsibility for determining the appropriate arbitrator.

The Arbitration Act does not specify how the arbitrator's fees are to be determined.[381] Presumably, the arbitrator applies to the court for approval of his or her fees. The Arbitration Act does provide that, in the absence of an agreement, the arbitrator's expenses and fees are to be paid as provided in the arbitrator's award.[382] In view of the foregoing, the Act's lack of direction could permit the employer and employee to agree in the employment agreement on which of them is responsible for paying the arbitrator's fee regardless of the outcome. If the agreement provides that the physician is to pay the arbitrator's fees, one might question the reasonableness of the arrangement.

The buyout clause gives the arbitrator a single task—to determine a reasonable buyout price—but it does not explain anything else about how the arbitrator is to conduct that task.[383] Under the Arbitration Act, the

[376] Tex. Civ. Prac. & Rem. Code Ann. § 171.025(a) (Vernon 2005).

[377] *Id.* § 171.041(b).

[378] *But see infra* Part X, in which it is posited that the parties might agree to arbitration by more than one arbitrator.

[379] Tex. Civ. Prac. & Rem. Code Ann. § 171.041(b).

[380] *See id.* § 171.041.

[381] *Id.* § 171.055.

[382] *Id.*

[383] Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

arbitrator, in the absence of direction in the arbitration agreement, is to conduct a hearing to decide the amount.[384]

The arbitrator is to set the time, date, and place of the hearing if those details are not in the arbitration agreement, and, regardless of the agreement's terms to the contrary, the arbitrator must give at least five days notice of the hearing either personally or by certified mail, return receipt requested.[385] If the arbitrator does not schedule a prompt hearing, a party may request the court to direct the arbitrator to proceed promptly with holding a hearing and deciding the issue.[386] The arbitration statute confirms that a party may appear at the hearing represented by counsel, present evidence, and cross-examine witnesses.[387]

In conducting the arbitration process under the Arbitration Act, the arbitrator may administer oaths to testifying witnesses,[388] authorize depositions, and issue subpoenas in the same manner applicable to civil actions in a district court.[389] Upon completing the hearing, the arbitrator is to sign a written award stating the decision of the arbitrator and deliver it to each party personally or by certified mail, return receipt requested.[390] The award is to be made within the time specified in the arbitration agreement

[384] Tex. Civ. Prac. & Rem. Code Ann. § 171.043(a).

[385] *Id.* § 171.044(a)–(b).

[386] *Id.* § 171.044(c).

[387] *Id.* §§ 171.047, 171.048. As the arbitrator necessarily will need to hear opinion testimony of experts, such as accountants, these experts will need to satisfy the requirements of *Daubert* and *Robinson*. *Cf.* Republic Parking Sys. of Tex., Inc. v. Med. Towers, Ltd., No. 14-02-01141-CV, 2004 WL 2358315, at *3 (Tex. App.—Houston [14th Dist.] Oct. 21, 2004, pet. ref'd) (unreported mem. op.) (stating expert's testimony on lost profits suffered by parking garage owner due to management company's breach of contract and breach of fiduciary duty was competent evidence with reasonable certainty (citing Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579, 589–90 (1993); E.I. du Pont de Nemours & Co. v. Robinson, 923 S.W.2d 549, 558 (Tex. 1995)); *see also* Adkins Adjustment Serv., Inc. v. Blumhoff, No. CIV.A.3:98-CV-2789-H, 2001 WL 484436, at *1 (N.D. Tex. May 2, 2001); Adkins Adjustment Servs., Inc. v. Neal, No. 05-00-01419-CV, 2001 WL 1231685, at *1 (Tex. App.—Dallas Oct. 17, 2001, no pet.) (not designated for publication), both of which involved the court's review of the expert witnesses report on the calculation of the employer's lost profits resulting from the employee's breach of the covenant.

[388] The parties should consider engaging the services of a certified court reporter to transcribe the testimony of the witnesses and the statements of the arbitrator and respective counsel for the possibility of filing an appeal to review the arbitrator's award, even though those services will add significant expense to the cost of the arbitration.

[389] Tex. Civ. Prac. & Rem. Code Ann. §§ 171.049–.057.

[390] *Id.* § 171.053(a)–(b).

or within the time specified by the court upon application by a party.[391] Thus a party seeking an award is well advised to request a schedule from the court in its application for the appointment of an arbitrator.

The Arbitration Act also allows the parties to contractually agree on the manner in which the arbitration is to be conducted.[392] The parties may set forth limitations on the hearing, such as a limit on the number of witnesses,[393] or they may specify that no hearing is to be held and require the arbitrator to decide the question based on position papers and documentary support.[394] The parties also may require the decision to take place within a specified time, such as thirty days after the arbitrator is appointed.[395]

The Arbitration Act allows the parties to seek judicial enforcement of the arbitrator's decision.[396] If a party is unsatisfied, the party may apply to the court to vacate or modify the arbitrator's decision, but only if the complaining party asserts statutory, common law, or public policy grounds.[397] The reviewing court should otherwise defer to the arbitrator's decision and order its enforcement.[398] The court's review should be limited and expeditious.[399] However, the physician may choose to appeal the award on public policy grounds, invoking the requirement of the Act that the covenant must be reasonable in its application.[400] The appellate court possesses the power to make that determination de novo, as a matter of law.[401] As a result, the parties will want to introduce evidence during the arbitration hearing that supports or negates the reasonableness of the covenant.

---

[391] *Id.* § 171.053(c).

[392] *Id.* § 171.001.

[393] *See id.* § 171.047.

[394] *See id.* § 171.044(a).

[395] *Id.* § 171.053(c)(1).

[396] *Id.* § 171.092.

[397] *See id.* §§ 171.088, 171.091.

[398] *See id.* §§ 171.088(c), 171.091.

[399] Crossmark, Inc. v. Hazar, 124 S.W.3d 422, 429 (Tex. App.—Dallas 2004, pet. denied) (stating standards of review of arbitrators' findings in dispute in sale of business assets and payments to be made under covenant to seller).

[400] *See* Tex. Civ. Prac. & Rem. Code Ann § 171.098; *see also* Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

[401] GJR Mgmt. Holdings, L.P. v. Jack Raus, Ltd., 126 S.W.3d 257, 262 (Tex. App.—San Antonio 2003, pet. denied).

E. Limits to the Arbitration Process

The buyout clause limits the question that the arbitrator is to decide as to the buyout price and does not extend beyond that inquiry. The arbitrator must decide the buyout amount for the covenant's restrictions as written in the employment agreement, hopefully applying the Texas common law applicable to measuring damages and using the formula described in subpart V.B.[402] The arbitrator may base his or her decision on evidence presented by the parties in support of their position of the buyout price.[403]

The buyout clause is silent on the timing of the payment of the buyout price.[404] Once the arbitrator decides the amount, no deadline stated in the buyout clause for payment to the employer exists.[405] Nevertheless, within the general application of the Arbitration Act, the arbitrator should have the ancillary authority to make an award that specifies the implementation of the arbitrator's decision.[406] Specifically, the arbitrator may award the buyout amount with an instruction that the physician pay the amount to the employer within a specified period. Whether the arbitrator can vary the terms further is debatable. The simplicity of the buyout clause suggests a onetime payment, but other possibilities are present; the arbitrator conceivably has the authority under the Arbitration Act to customize the timing of the physician's payments.[407]

Notwithstanding implied ancillary authority to implement the arbitrator's award to the employer, that is, the buyout price, the buyout clause severely restricts the arbitrator's authority. Under the clearly stated terms of the buyout clause, the arbitrator's authority does not extend beyond determining the buyout price.[408] Accordingly, the arbitrator has no authority to determine whether the covenant complies with the Act or is otherwise enforceable.[409] Most importantly, the arbitrator does not possess

[402] *See supra* Part V.B.

[403] *See supra* Part V.B.

[404] *See* Tex. Bus. & Com. Code Ann. § 15.50(b).

[405] *See id.*

[406] *See* Tex. Civ. Prac. & Rem. Code Ann. §§ 171.001–.096.

[407] *See* Tex. Bus. & Com. Code Ann. § 15.50(b); *see also* Tex. Civ. Prac. & Rem. Code Ann. §§ 171.001–.096.

[408] *See* Tex. Bus. & Com. Code Ann. § 15.50(b).

[409] *See generally id.*

the power under section 15.51(c) of the Act to blue pencil the covenant's restrictions.[410]

Subsumed in the arbitration process pursuant to the buyout clause is the critical assumption that the buyout price being determined is for a covenant that is enforceable under the Act. As discussed in Part IV, any number of reasons may exist as to why the covenant does not satisfy the various requirements to be enforceable under the Act.[411] Moreover, the subject covenant might be enforceable only if one or more of its boundaries were reformed to make them reasonable; however, the arbitrator is powerless to make such reformations.[412]

If a question exists as to the enforceability of the covenant, the physician will be the party to raise it. As the arbitrator has no power to rule on the issues of enforceability,[413] the physician is forced to bring a declaratory judgment action in court to determine if the covenant is enforceable. Conjoined with the declaratory judgment action, the physician also will request the court to stay the arbitration proceeding until the court rules on the covenant.[414] If an appeal of the arbitration award occurs, the duration of the covenant may expire during the appeals process. If the court finds the covenant enforceable but has to reform one or more of its boundaries, then the arbitrator should determine the buyout price of the covenant as reformed by the court. As will be seen in Part VI, the possibility of a buyout of a reformed covenant is not legally possible when the buyout stipulates the buyout price in lieu of referring it to an arbitrator.[415]

The Act's legislative deficiencies with respect to physician covenants become starkly evident when the physician is faced with contesting the covenant. If the physician does not seek a declaratory judgment action on

[410] *See id.* § 15.51(c).

[411] *See supra* Part IV.

[412] *See* Tex. Bus. & Com. Code Ann. § 15.51(c) ("[T]he court shall reform the covenant to the extent necessary . . . .").

[413] *See* Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 644 (Tex. 1994) ("The enforceability of a covenant not to compete, including the question of whether a covenant not to compete is a reasonable restraint of trade, is a question of law for the court."); Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 832 (Tex. 1992) ("[W]hether a covenant not to compete is a reasonable restraint of trade is a question of law for the court.").

[414] *In re* Pediatrix Med. Servs., Inc., No. 05-05-00986, 2005 WL 17776039, at *1 (Tex. App.—Dallas July 28, 2005, no pet.) (mem. op.).

[415] *See infra* Part VI.

the covenant's enforceability, the physician risks an election of remedies (assuming the physician does not appeal the arbitrator's award). The buyout clause states that the decision of the arbitrator "shall be binding on the parties."[416] The statutory use of "binding" could simply mean that the arbitrator's decision is effective *sua sponte*, and no opportunity to bring a separate lawsuit exists for the court to determine the buyout price de novo. This conclusion is supported by the preemption section of the Act, section 15.52, which provides that section 15.50 controls the sole criteria for the enforceability of the covenant.[417]

The legislature's failure to place the arbitration of the buyout amount in the remedies section of the Act, i.e., section 15.50(b), creates a great deal of uncertainty over the arbitration process. As a starting point, the preemption section states that the determination of enforceability of a covenant under section 15.50 preempts all other criteria, whether at common law or in other statutes.[418] The preemption continues in saying that section 15.51 preempts all other procedures and remedies in an action to enforce a covenant.[419] Yet using the phrase "binding on the parties" certainly indicates that the legislature considers the arbitrator's decision a remedy and not a condition to enforceability. As a result, legislative drafting error exists in failing to incorporate the arbitration process the procedures and remedies of section 15.51.

Section 15.51 presents additional confusion for the parties when the physician contests the enforceability of the covenant. The Texas Supreme Court has been steadfastly consistent in both pre and post-Act cases in holding that the question of whether a covenant is enforceable is a matter of law to be decided by the court.[420] As pointed out above, section 15.50(b)

---

[416] Tex. Bus. & Com. Code Ann. § 15.50(b).

[417] *Id.* § 15.52.

[418] *Id.*

[419] *Id. But see* Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 at *8 (Tex. Apr. 17, 2009) ("We do not reach the issues of whether the Act preempts the agreement in regard to entitlement to attorney's fees or whether the client purchase was severable from the remainder of the agreement."); Perez v. Tex. Disposal Sys., Inc., 103 S.W.3d 591, 593–94 (Tex. App.—San Antonio 2003, pet denied).

[420] Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 at *4 (Tex. Apr. 17, 2009) ("The enforceability of a covenant not to compete is a question of law."); Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson & Strunk & Assocs., L.P., 209 S.W.3d 644, 657 (Tex. 2006); Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 644 (Tex. 1994); Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 832 (Tex. 1992); DeSantis v. Wackenhut Corp., 793

tasks the arbitrator with determining only the buyout price.[421] To give the arbitrator additional authority would contravene the long-standing precedent that the enforceability of the covenant is to be decided by a court.[422] Moreover, section 15.51(b) places the burden of proof on the employer to show that the physician's covenant is enforceable under section 15.50.[423] However, section 15.51(b) also states that for the employer to sustain its burden of proof, it must prevail with a preponderance of evidence.[424]

Specifically, the employer must persuade the triers of fact that the "existence of the fact is more probable than its nonexistence."[425] In the absence of the arbitration provision in section 15.50(b)(2), the triers of fact falls into two categories: juries and the courts. This division would be consistent with the supreme court's precedent on enforceability.[426] The court, as opposed to a jury, would decide the issue of the covenant meeting the requirements for enforceability in section 15.50 enforceability.[427] If requested by a party, a jury would decide the issue of damages, one of the forms of relief provided by the Act.[428] The well-organized bifurcation of the triers of fact between juries and courts breaks down with the introduction of the arbitrator in section 15.50(b)(2). As a result, a difference of opinion could exist over whether the arbitrator qualifies as a trier of fact on the covenant's enforceability or whether that issue is still reserved to the court to decide. To date, no Texas state court cases that have interpreted the procedural provisions of the Act's section 15.51(b)

S.W.2d 670, 682 (Tex. 1990); Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 170 (Tex. 1987) ("Whether a covenant not to compete is reasonable is a question of law for the court.").

[421] *See* Tex. Bus. & Com. Code Ann. § 15.50(b).

[422] *Alex Sheshunoff*, 209 S.W.3d at 657; *Light*, 883 S.W.2d at 644; *Travel Masters*, 827 S.W.2d at 832; *DeSantis*, 793 S.W.2d at 682; *Hill*, 725 S.W.2d at 170.

[423] Tex. Bus. & Com. Code Ann. § 15.51(b) (Vernon 2002) (placing the burden of proof of enforceability on the employer if the covenant is ancillary to a personal services contract).

[424] *Id.*

[425] *Id.*

[426] *See Alex Sheshunoff*, 209 S.W.3d at 657; *Light*, 883 S.W.2d at 644; *Travel Masters*, 827 S.W.2d at 832; *DeSantis*, 793 S.W.2d at 681; *Hill*, 725 S.W.2d at 170.

[427] Prof'l Beauty Prods., Inc. v. Derington, 513 S.W.2d 236, 238 (Tex. Civ. App.—El Paso 1974, writ ref'd n.r.e.) (discussing an employer's right to enforce liquidated damages of $3000 for formerly employed sales persons' breach of their respective covenants and stating, "The question as to whether the covenant not to compete is reasonable is a law question for the Court and not a fact issue for the jury").

[428] Tex. Bus. & Com. Code Ann. § 15.51(a).

appear to exist. One federal trial court opinion decided soon after the enactment of the Act concluded that notwithstanding the inclusion of triers of fact in the Act, a court, not a jury, is to determine whether a covenant is reasonable.[429]

Some decisions support the concept that while the determination of the enforceability of a covenant is a question of law to be decided by the court, the reasonableness of the restrictions and the factual underpinnings supporting their reasonableness, are questions to be decided by the jury. In *DeSantis*, the jury found that the employee had violated the covenant but did not find that the employer would be irreparably harmed if the employee's continued violation was not enjoined.[430] The court posited that only a court could make a determination of irreparable injury, but the jury could determine the factual issues to be considered by the court in making that determination.[431] In assessing the reasonableness of restrictions contained in physician covenants, the supreme courts of Arizona[432] and Idaho[433] each have concluded that the jury as a trier of fact must make the determination of reasonableness, even though the court makes the ultimate determination that the covenant is enforceable.

Pending clarification of the statutory authority of the arbitrator to determine a covenant's enforceability, the physician is forced to bring the declaratory judgment action described above and to request a stay of the arbitration to avoid waiving his or her objection to the covenant. As a result, the process of appointing an arbitrator, determining the enforceability of the covenant, conducting an arbitration hearing, and publishing an award that decides the buyout amount could take many

[429] Wabash Life Ins. Co. v. Garner, 732 F. Supp. 692, 694–95 (N.D. Tex. 1989) (holding that due to enactment of the Act, reconsideration of order granting summary judgment denying tortious interference with contract claims as covenant was unenforceable and stating, "Plaintiffs assert that the Statute's use of the term 'triers of fact' in this context unmistakably shifts the reasonableness determination into the sole province of the jury").

[430] *DeSantis*, 793 S.W.2d at 676.

[431] *Id.* at 676 n.1 (addressing the issue of irreparable harm as opposed to the reasonableness of a covenant).

[432] Valley Med. Specialists v. Farber, 982 P.2d 1277, 1280–81 (Ariz. 1999) ("It is true that the ultimate question of reasonableness is a question of law. But reasonableness is a fact-intensive inquiry that depends on weighing the totality of the circumstances.").

[433] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 132 (Idaho 2005) (holding "[t]he extent of that business interest [prospective patients of the employer], and whether the practice fee [liquidated damages] is no more restrictive than necessary to protect it, must be determined by the trier of fact").

months, assuming that no party seeks to appeal the court's determination of the covenant's enforceability. As the duration of physician covenants are typically one or two years,[434] the time taken in arriving at the buyout price is significant.

The affected physician undoubtedly will ask the arbitrator to take into account the value of the period that the physician cannot compete in reaching the final decision of the buyout amount if during that interval the physician is observing the terms of the covenant. If the duration of the covenant is one year, the arbitration takes three months, and during the three months, the physician cannot compete, the buyout of the one year compete should be less because the period is really only nine months. Moreover, the physician may argue that the value of the covenant should be "front end" weighted as the interruption of the physician's patient flow and the ensuing uncertainty among the physician's patients over the physician's availability results in a continuing loss for the physician in his or her new practice.[435]

As previously discussed, the buyout's arbitration is subject to the Arbitration Act.[436] If either party is dissatisfied with the arbitrator's award of the buyout price, the Arbitration Act allows the party to apply to the district court to vacate[437] the decision (referred to as the "award" in the Arbitration Act) or to modify or correct the decision.[438] Section 171.088 of the Arbitration Act states the grounds for a court to vacate an arbitrator's decision.[439] These grounds center on the arbitrator's lack of impartiality or inherent unfairness in the conduct of the arbitration.[440]

---

[434] Paula Berg, *Judicial Enforcement of Covenants Not to Compete Between Physicians: Protecting Doctors' Interests at Patients' Expense*, 45 RUTGERS L. REV. 1, 2526 n.113 (1992).

[435] Krueger, Hutchinson & Overton Clinic v. Lewis, 266 S.W.2d 885, 891 (Tex. Civ. App.—Amarillo 1954), *aff'd*, Lewis v. Kreuger, Hutchinson & Overton Clinic,153 Tex. 363, 269 S.W.2d 798 (1954) (reforming a covenant that lasted for the life of a surgeon because the restricted territory was described as Lubbock County, Texas). The court in *Krueger* made an interesting observation: "A restriction of professional men not to practice for two or three years probably has the same effect as one for ten years or for a lifetime." *Id.*

[436] *See supra* Part V.C.

[437] Tex. Civ. Prac. & Rem. Code Ann. § 171.088 (Vernon 2005).

[438] *Id.* § 171.091.

[439] *Id.* § 171.088

[440] *Id.*

Section 171.091 of the Arbitration Act allows the court to modify or correct the arbitrator's decision.[441] Several of the grounds for correction or modification have a direct impact on the arbitrator's decision of a buyout price. This section allows the court to correct the award if an evident miscalculation of numbers exists.[442] This authority suggests that the court could reform the buyout price. That authority might be a basis to supplement the court's blue pencil powers in section 15.51(b). In other words, the court could exercise its powers under the Arbitration Act in reviewing the arbitrator's decision, which would fall outside of the strict parameters of the enforcement of the Act and circumvent the preemption provisions of section 15.52 with respect to an enforceable covenant.

Section 171.091 also allows the court to modify or correct the arbitrator's decision if the arbitrator made his or her decision based on matters not submitted to the arbitrator, and the decision may be corrected without affecting the merits of the decision made with respect to issues that were submitted.[443] This subpart V began with the statement that the buyout clause limits the arbitrator's authority to a single issue of deciding the buyout price.[444] This Article contends that the buyout price must relate to financial issues that bear upon the employer's estimated lost profit resulting from the physician's competition. Inherent in the decision-making process of the arbitrator, the parties must submit information to the arbitrator and, in addition, present arguments that the limitations of the subject covenant are or are not reasonable, the answer of which bears on the buyout price.

The process of reviewing the arbitrator's award is expedited under the Arbitration Act. If a party seeks the court to vacate or modify the arbitrator's decision, the party must submit its application to the court within ninety days of the date of the delivery of the arbitrator's decision to the applicant.[445] If the court should vacate the arbitrator's decision, the court may order a rehearing before a new arbitrator.[446] If the court agrees with the arbitrator's decision, or if the court modifies or corrects the decision, the court is to grant an order that confirms the decision.[447] The

[441] *Id.* § 171.091.

[442] *Id.* § 171.091(a)(1)(A).

[443] *Id.* § 171.091(a)(2).

[444] *See* Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

[445] Tex. Civ. Prac. & Rem. Code Ann. §§ 171.088(b), 171.091(b).

[446] *Id.* § 171.089(a).

[447] *Id.* § 171.092.

order of confirmation permits the entry of a judgment or decree confirming the decision as rendered by the arbitrator or as modified or corrected by the court.[448] An unhappy party still may appeal the court's judgment or decree, which is to be pursued in the same manner as appeals of judgments in civil actions.[449]

If an appellate court reviews the trial court's action, including a court's confirmation of the arbitrator's award, the review is extremely narrow.[450] The court of appeals in *Affiliated Pathologists* succinctly stated the appellate court's scope of review:

> An arbitration award has the same effect as the judgment of a court of last resort, and a reviewing court may not substitute its judgment for that of the arbitrators merely because it would have reached a different result. Because arbitration is favored as a means of dispute resolution, every reasonable presumption must be indulged to uphold the arbitrators' decision, and none is indulged against it.[451] Review is so limited that a court may not vacate an arbitration award even if it is based upon a mistake of fact or law.[452] Although our review is de novo, we must give strong deference to the arbitrator and are not free to correct the arbitration award.[453]

F. Election of Remedies

As seen repeatedly, the buyout clause requires the inclusion of a buyout right in the covenant, but it is sorely silent on the manner in which the physician is to exercise the buyout right.[454] Presumably the physician simply notifies the employer that he or she will buy out the covenant. Is the

---

[448] *Id.*

[449] *Id.* § 171.098.

[450] Affiliated Pathologists, P.A. v. McKee, 261 S.W.3d 874, 877, 879 (Tex. App.—Dallas 2008, no pet.) (pursuant to physician's employment agreement that predated the Act and contained covenant to arbitrate all employment disputes, an arbitrator awarded $500,000 to employer for breach of covenant).

[451] *Id.* at 879 (citing Universal Computer Sys. v. Dealer Solutions, 183 S.W.3d 741, 752 (Tex. App.—Houston [1st Dist.] 2005, pet. denied)).

[452] *Id.*

[453] *Id.*

[454] *See* Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

physician who takes the first step in the buyout process pursuant to an arbitration buyout covenant irrevocably bound to complete the buyout? The answer is supplied by the application of the election of remedies doctrine.

The Texas Supreme Court has set forth a four part test for the imposition of the equitable defense of an election of remedies: "(1) one successfully exercises an informed choice (2) between two or more remedies, rights or states of facts (3) which are so inconsistent as to (4) constitute manifest injustice."[455] Although frequently referred to as an affirmative defense,[456] the supreme court noted in *Bocanegra* that the doctrine of election exists in many branches of the law: "The situations in which an election might arise are so variable that an all-inclusive definition has been elusive, and discussions of the doctrine often borrow terms that may also appropriately relate to other affirmative defenses."[457]

The court's discussion in *Bocanegra* was in the context of an insurance company's attempt to bar a suit by an injured employee, but the concept of electing between opposite remedies is equally applicable to the buyout clause's offer of opposite remedies to the physician concerning a covenant.[458] Thus, the application of the election of remedies doctrine determines whether the physician must buy out the covenant—be compelled to buy out the covenant, after telling the employer that he or she desires to buy out the covenant.

The four tests of *Bocanegra* can be applied to the arbitration buyout covenant. The second and third tests are met easily. Two rights or remedies are present in the covenant: The physician may either honor the covenant or buy it.[459] Those two rights are completely opposite from one

[455] Bocanegra v. Aetna Life Ins. Co., 605 S.W.2d 848, 851 (Tex. 1980) (holding the medical insurance company could not bar employee's claims for hospital and medical expenses for back surgery even though employee previously received settlement of workplace injury claim from worker's compensation insurance company).

[456] Sharp v. Smith, No. 12-7-00219-CV, 2008 WL 257237, at *3 (Tex. App.—Tyler Jan. 31, 2008, no pet.) (mem. op.) (discussing a buyer of land on contract for deed who did not elect between remedy of damages and rescission of the contract and stating that "[e]lection of remedies is an affirmative defense").

[457] *Bocanegra*, 605 S.W.2d at 850 (citing as examples judicial estoppel, equitable estoppel, ratification, waiver, or satisfaction).

[458] *See generally id.*

[459] *See supra* Part V.F.

another. That leaves the first and fourth tests, for which the results are not entirely clear.

The first test is whether the physician exercises an informed choice when notifying the employer of his or her desire to buy out the covenant.[460] In notifying the employer of the desire to buy out the covenant, the physician chooses between honoring the covenant and buying it. The physician knows the consequences of the decision; however, one important piece of information is not known—the price of the buyout. The physician may not be able to pay the amount determined by the arbitrator. Thus, the physician is not making a fully informed decision.[461]

The fourth test involves the fundamental equitable concern of the fairness of binding a party to its decision.[462] When applied to the arbitration buyout covenant, the legislature's public policy concern in enacting the buyout clause is an important consideration. The legislature intended the physician to have an option, not an obligation. If the arbitrator's award places the ability to buy out the covenant beyond the physician's reach, the physician still can perform the covenant by adhering to its limitations. The employer suffers no adverse consequences as a result of the physician performing the covenant and probably prefers that result. Considering that the physician cannot know the buyout amount prior to giving notice of intent to buy the covenant to the employer, requiring the physician to complete the buyout once the amount is known would be manifestly unjust. Merely asking for the determination of the buyout amount is equivalent to seeking inconsistent remedies without committing to one or the other.[463]

If no election of remedies exists, the question remains as to whether, under principles of contract law, the physician creates a contract with the employer to buy out the covenant when he or she exercises the buyout option. This analysis follows the supreme court's review of unilateral

[460] *Bocandegra*, 605 S.W.3d at 851.

[461] *Sharp*, 2008 WL 257237, at *3 ("Moreover, a party does not lose a remedy by electing to pursue another unless it appears that he acted voluntarily, intentionally, and with the knowledge essential to the exercise of an intelligent choice.").

[462] *See Bocanegra*, 605 S.W.2d at 851.

[463] Hanks v. GAB Bus. Servs., Inc., 626 S.W.2d 564, 566 (Tex. App.—Amarillo 1981), *rev'd on other grounds*, 644 S.W.2d 707 (Tex. 1981) (holding a buyer's suit to enforce covenant against seller and to void remaining payments due to seller was not an election of remedies and stating, "We cannot agree that the mere filing of the suit was sufficient to meet the *Bocanegra* test"); *Sharp*, 2008 WL 257237, at *3 (holding that "pursuing inconsistent remedies, without more, is not enough to invoke the application of the doctrine of election").

contracts in *Light*[464] and *Sheshunoff*.[465] The Act requires the employer to include the buyout right in the covenant in order to create an enforceable covenant at the outset.[466] The inclusion of the buyout right is tantamount to a continuing offer to the physician to buy out the covenant for a specified, but as of then, unknown payment.[467] If the physician notifies the employer that he or she will buy the covenant, the physician accepts the employer's offer and a binding contract to buy the covenant is formed.[468]

The determination of the buyout price by the arbitrator is a condition subsequent that does not affect the formation of the contract but renders it performable. Once the buyout price is known, the physician has no choice other than to pay it to the employer. Failure to pay the amount constitutes a breach of the contract, and the employer may sue for payment. If this interpretation prevails, then in those situations that the physician believes the covenant to be unreasonable or unenforceable, the physician must contest the enforceability of the covenant through a declaratory judgment action prior to notifying the employer of the physician's intent to buy out the covenant, or risk waiving that remedy.

An alternate interpretation to the creation of a binding contract by exercising the buyout right also exists. The wording of the buyout clause, as it applies to an arbitration buyout covenant allows either party to request an arbitrator to decide the reasonable buyout price.[469] If either party may request the arbitrator to make the determination, an equally plausible interpretation is that no contract is formed until the physician accepts the arbitrator's selected buyout price. If the physician does not accept the buyout price decided by the arbitrator, then the physician is not obligated to pay it and may choose at that time to honor the covenant. This interpretation is consistent with the legislature's stated policy to give

[464] Light v. Centel Cellular Co., 883 S.W.2d 642, 645 n.6 (Tex. 1994) ("If, however, the employer accepts the employee's offer by performing, in other words by providing the training, a unilateral contract is created in which the employee is now bound by the employee's promise.").

[465] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 656–57 (Tex. 2006) (construing the covenant to be enforceable).

[466] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[467] Montgomery County Hosp. Dist. v. Brown, 965 S.W.2d 501, 502 (Tex. 1998) ("A promise, acceptance of which will form a contract, 'is a manifestation of intention to act or refrain from acting in a specified way, so made as to justify a promisee in understanding that a commitment has been made.'" (quoting RESTATEMENT (SECOND) OF CONTRACTS § 2(1) (1981))

[468] *See* Tex. Bus. & Com. Code Ann. § 15.50(b) (Vernon 2002).

[469] *Id.* § 15.50(b)(2) ("[O]r, at the option of either party . . . ."); *see also infra* Part VII.

physicians the right to buy out the covenant. The legislature intended to give the parties flexibility in the operation of the buyout with the inclusion of the possibility of arbitrating the buyout price. An interpretation that holds the exercise of the buyout right prior to knowing its price to be a binding contract would frustrate the legislature's purpose in adding the buyout clause to the Act.

Under this alternate interpretation, once the arbitrator decides the buyout amount, the physician is not obligated to pay the buyout price to the employer. The physician still possesses the freedom to elect to pay the arbitrated price and freely compete; or, if the price is too high, the physician could choose not pay it and comply with the terms of the covenant. Since the right to request an arbitrated buyout amount is a decision that can be made by either party,[470] the initiation of the process does not create an enforceable obligation to pay the buyout amount. Instead, the physician may decide to pay or to comply with the contracted restrictions.

If the physician competes before paying the buyout amount, the employer is not precluded from enforcing the covenant against the physician until the physician actually pays the buyout amount. If the physician competes, the physician has taken additional steps that could result in a binding election of remedies under the *Bocanegra* test. Specifically, allowing the physician to compete while the arbitration is taking place, and then, when the price is unacceptably high, choosing to observe the covenant would be manifestly unjust. In that instance, the employer has a much stronger basis for arguing for a binding buyout contract once the price is known.

Perhaps the employer's right to seek a temporary injunction is another reason that *Bocanegra's* fourth test is still not met. Until the parties know the arbitrator's decision on the buyout amount and know whether the physician is going to pay it, the employer may seek a temporary injunction to maintain the status quo of the covenant.[471] This protection is equivalent

[470] The employer likely would never exercise its right under the buyout clause to arbitrate the buyout price. If the physician exercises the buyout right in an arbitration buyout covenant, the physician will be forced to request the arbitration of the price, otherwise the physician is subject to the covenant and the employer retains the right to enforce its limitations by injunction if the physician breaches them.

[471] Tex. Bus. & Com. Code Ann. § 15.51(a) (stating that the employer's remedies include damages, injunctive relief or both); Dallas Anesthesiology Assocs., P.A. v. Tex. Anesthesia Group, P.A., 190 S.W.3d 891, 897 (Tex. App.—Dallas 2006, no pet.) (granting a temporary

to the physician seeking a stay of the arbitration proceeding pending a determination by a court that the covenant is unenforceable or requires reformation. The employer should not be able to sue the physician for damages until after the buyout amount is known and the physician chooses not to pay it.

The period between the end of the physician's employment and the arbitrator's decision on the buyout price presents an interesting tension between the parties. The buyout clause is clear that payment of the buyout amount frees the physician of the covenant's restrictions.[472] A physician willing to pay the buyout amount is disadvantaged if he or she is precluded from practicing medicine while the arbitrator decides the buyout amount. On the other hand, the employer will certainly argue that the physician should not be able to compete during the arbitration as the physician is not bound by the arbitrator's decision.[473]

G. Equitable Extension of a Covenant

"Equitable extension" is a judicial remedy that an employer may seek against the employee who violates his or her covenant. Under the remedy, the court judicially extends the term of the covenant by the period of time that the employee violated the covenant.[474] Texas courts have addressed the equitable extension remedy on a few occasions, but have not thoroughly developed the remedy.[475] In *RenewData Corp. v. Strickler*, the Austin Court of Appeals recognized that equitable extension can be granted as an equitable remedy for an employer against an employee who has violated the employee's covenant.[476] However, as an equitable remedy, the Austin court

injunction to an employer against competing physicians to preserve the status quo pending the suit on the merits of claims of breaches of fiduciary duties owed by physicians to employer).

[472] *See* Tex. Bus. & Com. Code Ann. § 15.50(b).

[473] NMTC Corp. v. Conarroe, 99 S.W.3d 865, 868 (Tex. App.—Beaumont 2003, no pet.) (explaining that a trial court may balance the probable harm that the enjoined party may suffer as a result of an erroneously granted temporary injunction notwithstanding the Act's preemption section).

[474] *See* Guy Carpenter & Co. v. Provenzale, 334 F.3d 459, 464 (5th Cir. 2003).

[475] *See* Farmer v. Holley, 237 S.W.3d 758, 761 (Tex. App.—Waco 2007, pet. denied) ("[W]e do not hold that a covenant not to compete cannot be equitably extended, but hold that the record does not support Holley's argument that the violations of the covenant, if any, were continuous and persistent."); RenewData Corp. v. Strickler, No. 03-05-00273-CV, 2006 WL 504998, at *5 (Tex. App.—Austin Mar. 3, 2006 no pet.) (not designated for publication).

[476] 2006 WL 504998, at *5.

considered the actions of the employer, which delayed seeking enforcement of the covenant, and found that the employer's delay did not constitute equity. Consequently, the court denied the employer's request for an equitable extension of the covenant's restrictions.[477] The Fifth Circuit similarly has recognized the remedy of equitable extension of covenants.[478]

The legislature intended to maximize the access patients have to their physicians by giving the physician the right to buy out the covenant.[479] The legislature's reliance on an arbitrator to decide the buyout price when the parties entered into an arbitration buyout covenant shows an intent that the buyout right be implemented without delay. This inference is supported by the legislature stating that an enforceable covenant will permit the physician to treat his or her acutely ill patients after the end of employment.[480] Despite the legislature's efforts to give patients prompt and continuing access to their physicians, the many deficiencies and unanswered questions over the arbitration buyout clause lead to the conclusion that the process in practice will not achieve that worthy goal.

H. Observations on the Arbitration Buyout

An arbitration buyout covenant is disarming in its neutrality on the buyout price. When the employer and the physician agree to an arbitration buyout covenant, they postpone the determination of the buyout price until the need for it arises. They avoid the discomfort of negotiating a buyout price to be inserted in the covenant. As a result, the parties may prefer the arbitration buyout covenant over the stipulated buyout covenant. The former allows them to concentrate on the economic provisions that bear

[477] *Id.* ("We find that Renew did not diligently pursue its remedies under the covenant not to compete and that the district court, in the exercise of its equitable jurisdiction, did not abuse its discretion in denying Renew's motion for equitable extension of the covenant not to compete.").

[478] *See Guy Carpenter & Co.*, 334 F.3d at 469 (granting equitable extension of injunction beyond the expiration of the non-solicitation covenant because of litigation delay); Premier Indus. Corp. v. Tex. Indus. Fastener Co., 450 F.2d, 444, 448 (5th Cir. 1971) (granting equitable extension due to the expiration of relief within a few months).

[479] *See* discussion *supra* Part IV.C. (quoting the legislature's purpose in adding the buyout clause to the Act).

[480] Tex. Bus. & Com. Code Ann. § 15.50(b)(3) (Vernon 2002) ("[T]he covenant must provide that the physician will not be prohibited from providing continuing care and treatment to a specific patient or patients during the course of an acute illness even after the contract or employment has been terminated.").

directly on the employment of the physician and his or her productivity on behalf of the employer.

However, the neutrality of the arbitration buyout covenant results in oppressive uncertainty for the physician if he or she wants to exercise the buyout option. The physician will want to buy out the covenant in two circumstances: (1) Either the physician wants to start his or her own medical practice in competition with the employer; or (2) the physician wants to become employed with a medical practice that competes with the employer. In either instance, neither the employer nor the physician knows what the buyout price will be, as it must be determined by the arbitrator.

The oppressive nature of the arbitration buyout covenant arises from the inherent delay in the determination of the buyout price by the arbitrator. If the physician moves forward with his or her plans, the physician is bound to complete the buyout or be responsible for damages for failing to do so. To avoid the possibility that the physician cannot pay the arbitrated price, the physician has no choice but to remain inactive until the arbitration is completed. During the arbitration, the physician has no income and bears legal expenses. In the meantime, the value of the covenant will decrease. The physician cannot finalize plans to start his or her own practice, nor can the physician begin employment with a competing practice. The employer, on the other hand, is equally uncertain about the price, but suffers no significant adverse consequences of the arbitration. The employer will either get the benefit of the physician's performance of the covenant or the payment of the buyout price once the arbitrator determines it. Consequently, the physician is the one who will likely be frustrated during the arbitration and adversely affected by it.

VI. STIPULATION OF THE BUYOUT AMOUNT IN THE EMPLOYMENT AGREEMENT

This Part explores the alternate buyout covenant permitted by the buyout clause—the stipulated buyout covenant. In this type of buyout covenant, the parties choose to insert the buyout price in the covenant when they enter into the employment agreement. As mentioned in Part II, prior to enactment of the Act, covenants on occasion stated a price to be paid if the employee violated a covenant. Thus, the concept of a payment for being

excused from the covenant's limitations is not entirely new.[481] What is new in the Act is that the covenant gives the physician an opportunity to be excused from the covenant by a payment to the employer as opposed to a volitional agreement on the penalty (liquidated damages) to be paid if the covenant is violated.[482]

In practice, when the parties include a stipulated buyout right in the employment agreement, they usually tie the buyout amount to the most recent annual compensation or base starting salary of the physician. For example, a physician must pay the employer $150,000, his annual salary. Other covenants contain a punitive amount intended to deter the departure of an employed physician, such as $750,000, even though the physician only makes $150,000 annually. These benchmarks for a buyout price are convenient, but they have no bearing on the legal damages that the employer will suffer.[483] As will be seen in this Part, employers who choose to use a buyout amount that is tied to compensation will do so at the risk of forfeiting receipt of the buyout price and the protection of the covenant.

A version of the stipulated buyout covenant that appears frequently in a physician employment agreement reads as follows, with the wording of the buyout right and the buyout print italicized:

> After this Agreement terminates, Physician shall have the right and option (the "Buy-Out Option") to buy out and terminate the non-competition covenants set forth in this Section under the following procedures:
>
> (i) If Physician wishes to exercise the Buy-Out Option, Physician shall, within 30 days after this Agreement terminates, give the Employer written notice of Physician's intent (the "Buy-Out Notice"). If Physician does not exercise the Buy-Out Option within this 30 days, the Buy-

[481] UT Med. Group, Inc. v. Vogt, 235 S.W.3d 110, 113–14 (Tenn. 2007) (noting physician's covenant contained liquidated damages provision upon breach equal to two-thirds of physician's revenue to employer, which the parties described as a buyout right); Michael R. Sullivan, *Covenants Not to Compete and Liquidated Damages Clauses: Diagnosis and Treatment for Physicians*, 46 S.C. L. REV. 505, 521 (1995).

[482] Tex. Bus. & Com. Code Ann. § 15.50(b).

[483] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981) ("The parties to a contract may effectively provide in advance the damages that are to be payable in the event of breach as long as the provision does not disregard the principles of compensation.").

> Out Option will expire and Physician shall have no further right to buy-out the non-competition covenant.
>
> (ii) If Physician exercises the Buy-Out Option, *Physician shall pay Employer an amount equal to twelve (12) times Physician's gross monthly salary at the time of the termination of the Agreement (the "Buy-Out Price") as consideration for the Employer's agreement to release Physician from the non-competition provisions of this Section*. The Buy-Out Price shall be due and payable in full by Physician to Employer no later than five (5) business days following the date of the Buy-Out Notice. Physician hereby expressly agrees and acknowledges that the Buy-Out Price is a fair and reasonable price for the Employer's agreement to release Physician from the non-competition provisions of this Section and has been determined in a manner that fairly and reasonably compensates the Employer for the lost revenues and other damages to the Employer's business that would occur if Physician were allowed to compete with the Employer in the restricted areas. Physician shall not be released from the non-competition covenant of this Section until the Buy-Out Price has been paid in full to the Employer.

As will be seen in the next subpart, the calculation of the buyout price will follow the principles discussed in the preceding subpart on an arbitration buyout covenant, but the stipulated buyout covenant will present the parties with its own challenges.[484] By its nature, the stipulated buyout price is determined a priori, before the physician begins working for the employer. In contrast, the arbitrated buyout price is determined *a posteriori*, after the physician has worked for the employer, at which time the arbitrator can determine retrospectively whether the employer earned any profits on the physician's services.

A. Calculating the Stipulated Buyout Amount

If the parties choose to state a buyout price in the covenant in lieu of deferring its determination to an arbitrator, they should follow the same legal principles that the arbitrator must follow in deciding a reasonable

[484] *See supra* Part V.H.

buyout price. Specifically, the employer and the physician should seek to estimate the profit the employer will lose if the physician does not observe the covenant's restrictions.[485]

The arbitrator has the luxury of reviewing the employer's accounting records to ascertain if the employer earned a profit on the physician's services, but that retrospective analysis is not available when the parties enter into the employment agreement. Yet, the absence of a "look back" does not excuse the parties from looking forward in estimating prospective profits.[486] The parties may use reliable assumptions regarding the physician's services to estimate the employer's revenue and costs associated with employing the physician to calculate the employer's net profit. Moreover, basing the estimate on an assumption that the physician will remain employed for at least the minimum duration of the minimum term of employment under the employment agreement if such a period, e.g., one year, is stated, or for a reasonable period if no period is stated, would be reasonable. Otherwise, a stipulated buyout price would always be subject to attack should the physician decide to terminate his or her employment after only a brief period of service.[487]

Several useful sources of information upon which parties may rely to forecast the employer's future revenue from the physician's services exist: (1) historical accounting information of the employer pertaining to other physicians it employs; (2) the employer may engage an accounting firm who represents medical practices; and (3) surveys performed by trade associations, such as the Medical Group Managers Association.

Additionally, the parties could arrive at an estimate based on the assumption that, a physician working full-time will treat a projected number

[485] H.B. Chermside, Jr., Annotation, *Employer's Damages For Breach of Employment Contract by Employee's Terminating Employment*, 61 A.L.R.2d 1008, 1018 (1958) ("[T]he loss of patronage which might follow the withdrawal of the salesman from the business, the need of the old establishment for his services, the peculiar value of his services arising therefrom, and the harm that he could do by entering the employ of a rival concern, these were all elements which should be considered.").

[486] Healix Infusion Therapy, Inc. v. Bellos, No. 11-02-00346-CV, 2003 WL 22411873, at *1 (Tex. App.—Eastland Oct. 23, 2003, no pet.) (mem. op., not designated for publication) ("Courts will enforce liquidated damages provisions in contracts when the court finds that the harm resulting from a breach of the contract is incapable or difficult to estimate and when it also finds that the amount provided as liquidated damages is a reasonable forecast of just compensation.").

[487] *See* Step Four *supra* Part V.B. (adjusting the employer's net profit by a "stickiness" factor).

of patients per day. These patients can be assigned a revenue amount based on the subspecialty of the physician and a projected range of illnesses to be treated. The employer will have historical experience on the average number of those patients the physician will encounter and the average reimbursement for treating them. If the employer does not have that information, the parties may resort to outside survey information regarding the average reimbursement for the types of treatments the physician will render, including the annual physician fee schedule published by CMS for Medicare patients. To the extent the physician's patients will produce ancillary revenue, that revenue should be estimated and included for purposes of the profit computation.

To arrive at the employer's expected net profit, the parties also may estimate the costs of the employer by predicting both the physician's direct expenses and the physician's share of the employer's overhead.[488] This determination will be based on the employer's costs of operation in effect at the time of signing the covenant. The annualized projected net profit from the physician's services will be the physician's estimated revenue minus the sum of the physician's direct costs and share of the employer's overhead.

As was the case for the arbitrator's determination of the buyout price, the estimated net profit should be adjusted by the factors described in Part V.B.[489] These adjustments accounted for the attributes of the covenant's boundaries, the attrition of patients after the end of the physician's employment, the stickiness of patients in remaining with the employer in spite of competition, anticipated trends, and unique aspects of the employer's medical practice.[490] The application of adjustments will be more challenging because of the a priori nature of the estimate, but the parties should apply those adjustments that appear reliable.[491]

---

[488] *See, e.g.*, Wichita Clinic, P.A. v. Louis, 185 P.3d. 946, 956 (Kan. Ct. App. 2008) ("The Clinic asserts that the liquidated damages provision was not an unenforceable penalty and argues that the trial court incorrectly relied on two hypothetical situations to determine the reasonableness of the restrictive covenant. The Clinic asserts that the evidence showed that Dr. Louis' net production the first 17 months after leaving the Clinic was similar to her production at the Clinic. Moreover, the Clinic alleges that 25% of Dr. Louis' net production would not cover the amount of overhead lost when Dr. Louis quit. In other words, the Clinic maintains that its actual damages are greater than the liquidated damages and, therefore, the covenant cannot be considered a penalty.").

[489] *See supra* Part V.B.

[490] *See supra* Part V.B. (outlining the use of the factors).

[491] The following sentence from a United States Supreme Court case regarding a reasonable price, quoted repeatedly in price-fixing antitrust cases, should be noted with respect to arriving at

The parties should attempt to substantiate their estimate of the employer's expected profits from the physician's services. Unfortunately, a trend has developed since the passage of the buyout clause to use the physician's annual salary, or some variable of it, in the stipulated buyout covenant. However, as seen in the discussion in Part V.B., the reliance on the physician's compensation for the buyout price does not comport with the appropriate measure of damages that instead should be followed.[492] In the former, the parties are basing the buyout price only on a cost component of net profits, i.e., the employer's cost is the physician's salary, which is just as defective as basing it only on the revenue component.[493]

The prudent employer will consult with an accountant or a valuation expert who will produce a written record of the assumptions made in arriving at the physician's estimated net profit. These assumptions will rely on the various sources described above for the employer's revenue and costs. Ideally, an independent accountant not regularly associated with the employer, will undertake the valuation methodology. The physician likely will not have the resources to engage an accountant to undertake the detailed evaluation necessary to support the stipulated buyout price.[494] To extent possible, the parties' bases for the stipulated buyout price will be included in the employment agreement, thereby providing a court with a point of reference in evaluating the price.

B. Contesting the Stipulated Buyout Amount

When the employment relationship between the employer and the physician ends, the physician may desire to compete with the employer. If the physician believes that the stipulated amount is fair, he or she will pay it and compete. However, assuming that the covenant meets all of the Act's mandatory conditions for an enforceable covenant, three possibilities may

a buyout price in a stipulated buyout covenant: "The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow." United States v. Trenton Potteries Co., 273 U.S. 392, 397 (1927).

[492] *See supra* Part V.B.

[493] *See* discussion *supra* Part V.A.

[494] Wichita Clinic, P.A. v. Louis, 185 P.3d 946, 957 (Kan. Ct. App. 2008) ("The court determined that Dr. Louis did not have the ability to negotiate for a different liquidated damages formula because she was just beginning her first year of practice when she signed with the Clinic.").

emerge in which the physician will object to paying the stipulated buyout price.

First, the stipulated price may not be reasonable for an otherwise enforceable covenant. In other words, the price may exceed what the valuation methodology shows should be the price. Second, the covenant may contain unreasonable restraints on duration, geographic area or activity, but may state a reasonable buyout price for the covenant once its restraints are reformed. Third, in a combination of the prior two possibilities, both the covenant's stipulated buyout price and its restraints may be unreasonable. These possibilities are discussed in their order in the balance of this subpart B.

1. Reasonable Restraints, but Unreasonable Buyout Price

If the stated price is an unreasonable amount to be paid for the covenant, the physician may pursue two alternate, but familiar, procedural avenues to protect his or her interests.[495] Traversing the first avenue, the physician

[495] Most physician covenants also include a section on remedies the employer may pursue against the physician if the physician violates the covenant. The following is an example:

> Remedies.
>
> (a) The parties agree that a breach by Physician of any of the provisions of the confidentiality and non-competition sections of this Agreement would cause irreparable damage to the Employer. Therefore, the Employer shall be entitled, in addition to all other rights available under applicable law, to preliminary and permanent injunction restraining Physician from breaching or continuing any breach of any of the provisions of the confidentiality or non-competition sections, and any other equitable relief. Accordingly, if the Employer seeks an injunction, the Employer need not show proof of actual damage and the parties hereto waive any requirement that the Employer post bond. The existence of any claim or cause of action on the part of Physician against the Employer, whether arising from this Agreement or otherwise, shall not constitute a defense to the granting or enforcement of this injunctive relief.
>
> (b) The remedies available to the Employer under this Section are cumulative, are in addition to any remedies given by law or in equity, and may be enforced successively or concurrently. The Employer may, at its sole discretion, elect to pursue all or any of the remedies.
>
> (c) Physician acknowledges that Physician has carefully read and considered the confidentiality, non-competition and enforcement provisions of this Agreement and agrees that these provisions are fair and reasonably required for the protection of the Employer.

may take the initiative and sue the employer for a declaratory judgment[496] that the buyout amount is unreasonable pursuant to the Texas Uniform Declaratory Judgment Act (Declaratory Judgment Act),[497] which empowers a court to declare the rights of a party to a contract.[498] The Declaratory Judgment Act offers the physician the flexibility of requesting the court's determination in the negative, i.e., that the covenant is unenforceable.[499]

Or, taking the second avenue, the physician could compete with the employer, and, if the employer seeks to enforce the covenant against the physician for his or her breach of it,[500] the physician could defend against the injunction on grounds that the covenant is not enforceable because it fails to state a reasonable buyout amount as required by section 15.50(b)(2).[501] Either procedural avenue ultimately leads to the

---

(d) The confidentiality, non-competition and enforcement provisions of this Agreement survive the termination of this Agreement.

(e) If the Employer is required to enforce any of its rights under any part of this Agreement, Employer shall be entitled to recover from Physician all attorney's fees, court costs and other expenses incurred by the Employer in connection with the enforcement of those rights.

[496] *See* Justin Belt Co., v. Yost, 502 S.W.2d 681, 683 (Tex. 1974) (former employees sought declaratory judgment that covenant in settlement agreement was unenforceable); *see also* Bird v. Kornman, 152 S.W.3d 154, 157 (Tex. App.—Dallas 2004, pet. denied) (employee sued employer for declaratory judgment that covenant was invalid and unenforceable and sought an injunction against enforcement of the covenant).

[497] Tex. Civ. Prac. & Rem. Code Ann. § 37.002 (Vernon 2008) ("This chapter is remedial; its purpose is to settle and to afford relief from uncertainty and insecurity with respect to rights, status, and other legal relations; and it is to be liberally construed and administered."); *id.* § 37.002(b); *see also* Hardy v. Mann Frankfort Stein & Lipp Advisors, Inc., 263 S.W.3d 232, 253 (Tex. App.—Houston [1st Dist.] 2007, pet. granted.) (former employees sued former employer for declaratory judgment that covenant was unenforceable), *reversed*, Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 (Tex. Apr. 17, 2009).

[498] Tex. Civ. Prac. & Rem. Code Ann. § 37.003.

[499] *Id.* § 37.003(b); *see also id.* § 37.004(b).

[500] *Id.* §§ 65.001–.045; *see also* Tex. Bus. & Com. Code Ann. § 15.51(a) (Vernon 2002) (including injunctive relief as an available remedy).

[501] As uncertain as the final buyout amount will be, the uncertainty of the final amount is really a small consideration that a physician and his or her future employer must consider, as the former employer may resort to a claim of tortious interference with the covenant by the new employer. This prospect of very serious damages has a considerable chilling effect on the mobility of a physician among various employers within the community. Tortious interference is discussed in Part IX.

determination of the merits of the physician's claim that all or part of the covenant is unreasonable. The merits should be analyzed as follows.

The central issue of the first possibility is whether the stipulated buyout price is reasonable as required by section 15.50(b)(2).[502] If the price is not reasonable, then the covenant does not satisfy an obligatory condition for an enforceable covenant and is void.[503] Section 15.51(b) imposes on the employer the burden of proving, by a preponderance of the evidence, that the covenant meets all of the criteria of section 15.50 for an enforceable covenant.[504] Among these criteria is section 15.50(b)(2)'s requirement that the buyout price is reasonable.[505]

The covenant is part of the physician's employment contract, which is a personal services agreement. Consequently, section 15.51(b) saddles the employer with proving the covenant is enforceable.[506] This section globally refers to the triers of fact as the person to determine whether the employer has sustained or failed its burden of proof.[507] For the reasons set forth in Part V.D., the court hearing the controversy is the only logical choice to act as the trier of fact on the enforceability of the covenant.[508]

This interpretation is supported by the Act and by a long line of Texas Supreme Court precedent.[509] Section 15.51(c), which gives the court the ability to blue-pencil a covenant, predicates that ability on a determination that the covenant meets the "ancillary to" requirement.[510] Asking the jury to make a two-tiered inquiry of the covenant would be very inefficient. First, does the covenant meet the obligatory ancillary to and buyout

[502] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[503] *See id.* § 15.50(b)(2).

[504] *Id.* § 15.51(b).

[505] *Id.* § 15.51(b)(2); *see also* Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 at *9 (Tex. Apr. 17, 2009) (Hecht, J., concurring).

[506] Tex. Bus. & Com. Code Ann. § 15.51(b).

[507] *Id.*

[508] *See infra* Part V.D.

[509] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 649 (Tex. 2006) (stating "We do not disturb the holding in *Light*."); Light v. Centel Cellular Co. of Texas, 883 S.W.2d 642, 644 (Tex. 1994) ("The enforceability of a covenant not to compete, including the question of whether a covenant not to compete is a reasonable restraint of trade, is a question of law for the court."); Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 832 (Tex. 1992) ("Whether a covenant not to compete is a reasonable restraint of trade is a question of law for the court."); Henshaw v. Kroenecke, 656 S.W.2d 416, 418 (Tex. 1983) ("The question of whether a covenant not to compete is reasonable is a legal question for the court.").

[510] Tex. Bus. & Com. Code Ann. § 15.52(c).

requirements? If the jury answers in the affirmative, the jury then decides if the covenant's limitations are reasonable. If that second inquiry is answered in the negative, the Act clearly tasks the court with reforming the covenant so that it imposes reasonable restrictions.[511] As mentioned previously, the Texas Supreme Court has consistently held that the enforceability of a covenant is a question of law and not one for a jury.[512] This discussion underscores the need for the legislature to clarify the Act so that there is no confusion over who is to determine the facts of reasonableness and apply the law: the court, the jury, or an arbitrator.[513]

a. Liquidated Damages Law Applies to the Buyout Price

The court hearing the controversy should review the stipulated buyout price using the same multi-step valuation methodology that the arbitrator must follow in the buyout price in an arbitration buyout covenant.[514] The employer has the obligation under the Act to prove to the trial court that the stated buyout price meets the requirements of section 15.50: that it is reasonable.[515] Thus, the employer must demonstrate to the court all of the factors that it considered in arriving at the stated buyout price in the covenant.

Once the court makes its assessment of the stipulated buyout price, it must then evaluate whether the amount was a reasonable forecast of the employer's damages suffered if the physician chose not to perform the covenant.[516] In essence, the court will determine if the buyout price is reasonable when compared to its estimate of the employer's forecasted lost profit if the physician violated the covenant.[517] This determination is

[511] *Id.*

[512] *Alex Sheshunoff*, 209 S.W.3d at 657 (reviewing the subject covenant for reasonableness as a matter of law); *Light*, 883 S.W.2d at 644; *Travel Masters*, 827 S.W.2d at 832; Trilogy Software, Inc. v. Callidus Software, Inc., 143 S.W.3d 452, 459 (Tex. App.—Austin 2004, pet. denied); Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 660 (Tex. App.—Dallas 1992, no writ); Custom Drapery Co., Inc. v. Hardwick, 531 S.W.2d 160, 164 (Tex. Civ. App.—Houston [1st Dist.] 1975, no writ); Prof'l Beauty Prods., Inc. v. Derington, 513 S.W.2d 236, 238 (Tex. Civ. App.—El Paso 1974, writ ref'd n.r.e.).

[513] *See* discussion on the trier of fact *supra* Part V.E.

[514] *See supra* Part V.B.

[515] Tex. Bus. & Com. Code Ann. § 15.51(b).

[516] *Id.* § 15.51(c).

[517] To allow the logic of the discussion to progress more quickly, the discussion speaks of the court undertaking the valuation analysis. In a hearing each party would present expert testimony

exactly analogous to the determination that a court must make in deciding whether the stipulated price contained in the parties' contract is liquidated damages or an unenforceable penalty.

The Idaho Supreme Court recently reviewed a physician covenant that allowed the physician to buy out the post-employment restrictions for $500,000.[518] While the court did not decide the issue of the reasonableness of the amount but instead raised an interesting reformation idea that is discussed below, the court did consider the buyout price to be equivalent to liquidated damages:

> The non-compete provision in this case is a hybrid of sorts. The provision does not place an absolute prohibition on Dr. Miller's ability to practice. Rather, it allows him to practice, provided that he pays a practice fee. To the extent it allows Dr. Miller to buy back into the market should he decide to practice in the designated areas within the designated time period, the non-compete provision *is somewhat analogous to a liquidated damages clause*. Parties to a contract may agree in advance to the amount of damages in case of a breach.[519]

The Texas common law has been settled for some time on stipulated damages. The common law allows parties to a contract to stipulate an amount to be paid if a party breaches the contract if the amount is a reasonable approximation of the damages the non-breaching party will suffer as a result.[520] The amount must be directly related to the damages that would flow to the injured party for the breach.[521]

---

in support of its position, each following the multi-step valuation methodology recommended in Part IV.

[518] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121, 123 (Idaho 2005).

[519] *Id.* at 127 (emphasis added).

[520] *See* Stewart v. Basey, 150 Tex. 666, 245 S.W.2d 484, 485–86 (1952) (discussing the availability of liquidated damages clauses).

[521] *Id.* ("The universal rule for measuring damages for the breach of a contract is just compensation for the loss or damage sustained. By operation of that rule a party generally should be awarded neither less nor more than his actual damages. . . . In those cases in which courts enforce stipulations of the parties as a measure of damages for the breach of covenants, the principle of just compensation is not abandoned and another principle substituted therefore. What courts really do in those cases is to permit the parties to estimate in advance the amount of damages, provided they adhere to the principle of just compensation."); Flores v. Millennium Interests, Ltd., 185 S.W.3d 427, 431 (Tex. 2006) ("The term 'liquidated damages' ordinarily

Thus, the buyout price to escape the covenant must be a reasonable forecast of the compensation required to reinstate the position of the contracting parties. Amounts that are not a reasonable forecast of damages are penalties.[522] Consequently, the parties must use some reliable methodology to forecast the employer's damages from a breach of the covenant.[523] As explained earlier, the most appropriate methodology will

refers to an acceptable measure of damages that parties stipulate in advance will be assessed in the event of a contract breach.").

[522] The Texas Supreme Court explained the reasonableness requirement:

> A contractual provision like the one here by which one party agrees to pay the other some multiple of actual damages for breach of the agreement does not meet either part of the legal test for an enforceable liquidated damages provision. It cannot meet the first prong of the test because the harm caused by the breach of the contract is not incapable or difficult of estimation. The provision assumes actual damages can and will be determined, indeed must be determined, before the prescribed multiplier can be applied. The provision cannot meet the second prong of the test because, instead of attempting to forecast actual damages, it calls for them to be determined and then multiplied.

Phillips v. Phillips, 820 S.W.2d 785, 789 (Tex. 1991) (holding provision in partnership agreement an unenforceable penalty based on the rule in *Stewart*, where agreement required damages owed by breaching party to be multiplied); *see also* Annotation, *Stipulation as to Amount Recoverable for Breach of Contract Against Entering Certain Business or Employment as a Provision for Liquidated Damages or for a Penalty*, 59 A.L.R. 1135, 1136 (1929). The Sixth Circuit explained when liquidated damages are treated as a penalty:

> Under Texas law, a "liquidated damages" term is treated as a penalty, unenforceable for reasons of public policy, except when all three of the following conditions are met: (1) the anticipated damages for a breach must be difficult or impossible to estimate, (2) the amount of liquidated damages must be a reasonable forecast of the amount necessary to render just compensation; and (3) liquidated damages must not be disproportionate to actual damages, as measured at the time of the breach.

In re Dow Corning Corp., 419 F.3d 543, 549 (6th Cir. 2005) (citing Thanksgiving Tower Partners v. Anros Thanksgiving Partners, 64 F.3d 227, 232 (5th Cir. 1995). *Contra* Gregory Scott Crespi, *Measuring 'Actual Harm' for the Purpose of Determining the Enforceability of Liquidated Damages Clauses*, 41 HOUS. L. REV. 1579, 1579–81 (2005) (arguing that a party may satisfy either *Dow Corning*'s condition (2) or (3) but that a party need not satisfy both items).

[523] Jones v. Chester, 363 S.W.2d 150, 157 (Tex. Civ. App.—Austin 1962, writ ref'd n.r.e.) (physician's accounts receivable were not a reasonable estimate of medical practice's damages as result of the termination of physician's association with the medical practice); Reha, *supra* note 32, at 8 ("Because subsection (3) [of the Colorado non-competition statute permitting liquidated damages] clearly assumes that the provision will need to be predictive as to damages, it is likely

rely on accounting data that supports a formula calculation of the net profit the employer might expect to lose if the physician later competes.

b. The Stipulated Buyout Price May Not Be Reformed

If, after reviewing each party's supporting information on the employer's projected lost profits, the court determines that the covenant's stipulated buyout price exceeds a reasonable price, the court must summarily rule the covenant to be unenforceable.[524] For example, if the covenant requires the physician to pay the employer $750,000 to buy out the covenant but the estimated profit that the employer would lose if the physician violated the covenant is not more than $200,000, the covenant's $750,000 amount would be unreasonable. Moreover, the physician cannot be compelled to pay $200,000 to the employer. This unlikely result follows due to the strict rules of the Act, which does not allow a court to reform the buyout price by reducing it to a reasonable amount pursuant to its blue pencil powers in section 15.51(c).[525]

Pursuant to section 15.51(c), a court may reform a covenant if it at least meets the ancillary to requirement of enforceability.[526] An employer may resort to this section to obtain blue-pencil relief to change a covenant's boundaries to levels that are reasonable for the protection of the employer's goodwill and other business interests.[527] For example, if the physician's covenant was reasonable in all other respects, except that it prohibited the

---

that a workable method of providing for anticipated net profits will be found and approved if it is tied to some real measure of net profit losses.").

[524] *See* Tex. Bus. & Com. Code Ann. § 15.50 (Vernon 2002).

[525] Reformation of an overly broad restriction in a covenant is often referred to as applying a blue pencil. Peat Marwick Main & Co. v. Haass, 818 S.W.2d. 381, 390 (Tex. 1991) (Cornyn, J., dissenting) (partnership agreement imposing contractual amount to be paid by departing accountant for clients transferring business equivalent to a covenant).

[526] Tex. Bus. & Com. Code Ann. § 15.51(c).

[527] Employers frequently add blue-pencil provisions to the covenant. An example might read as follows:

> If any provisions of this Section are declared by a court of competent jurisdiction or an arbitrator to not comply with the requirements of Section 15.50(b) of the Texas Business & Commerce Code, the parties agree that the nonconforming provision shall be reformed in a manner that the court or arbitrator deems reasonable and enforceable under Section 15.50(b) of the Texas Business & Commerce Code and that the non-competition covenant set forth in this Section, as reformed, shall continue in full force and effect.

physician from practicing in any location within a ten-mile radius of the employer's medical offices, a court, upon finding that ten miles was unreasonable for the protective purposes of the covenant, could reduce the radius to five miles. Once changed, the employer could enforce the covenant against the physician up to the five-mile radius. In fact, the Act imposes a mandatory obligation on the court to reform unreasonable restraints of an otherwise enforceable covenant.[528]

However, the court's blue-pencil power under the Act does not extend to reforming the buyout price. The blue pencil section is quite specific in its mandate. It directs the court to "reform the covenant to the extent necessary to cause the limitations contained in the covenant as to time, geographical area, and scope of activity to be restrained to be reasonable . . . ."[529] The buyout price is not listed specifically as a limitation that the court may reform.[530] If the Act does not contain a remedy concerning a covenant, its preemption section, section 15.52, precludes any other relief to the parties.[531]

Section 15.52 dictates that "the procedures and remedies in an action to enforce a covenant not to compete provided by section 15.51 of this code are exclusive and preempt any other . . . procedures and remedies in an action to enforce a covenant not to compete under common law or otherwise."[532] As no other remedy is available to the employer, the court must refuse to enforce the covenant, and, as a result, the physician has no obligation to pay any amount for the covenant to the employer. This result is also interesting because the preempted effect of section 15.52 overrides the common law power of the court to blue-pencil an unreasonable covenant.[533]

2. Reasonable Buyout Price Stated for Reformed Restraints

In a second possibility, the physician may believe that the covenant is unreasonable in its restraints, although the buyout price itself may be

[528] Tex. Bus. & Com. Code Ann. § 15.51(c) ("[T]he court shall reform the covenant.").

[529] *Id.*

[530] *See id.*

[531] *Id.* § 15.52 ("[T]he procedures and remedies in an action to enforce a covenant . . . are exclusive.").

[532] *Id.*

[533] Weatherford Oil Tool Co., v. Campbell, 161 Tex. 310, 340 S.W.2d 950, 952 (1960); Lewis v. Krueger, Hutchinson & Overton Clinic, 153 Tex. 363, 269 S.W.2d 798, 799–800 (1954).

reasonable. This possibility offers the employer the tantalizing opportunity to seek the reformation of the covenant's unreasonable restraint. Referring to the covenant described in a preceding paragraph that had an unreasonable ten-mile radius, that covenant's unreasonable geographic limitation could be reformed, to wit, reduced to a five-mile radius, rendering it enforceable against the physician.

Unfortunately, the opportunity of reformation of the covenant's unreasonable limitation is an ill-fated remedy. If the court finds that the stated buyout price is unreasonable, it has no choice but to declare the entire covenant void and unenforceable.[534] This result occurs even if the stipulated buyout price is a reasonable amount when applied to the covenant as revised. Again, the employer will be disappointed that it has no protection and no payment; however, Texas Supreme Court cases support this conclusion.

In *Weatherford Oil Tool Co. v. A.G. Campbell*, perhaps one of the most frequently cited cases on covenants, the Texas Supreme Court reviewed a covenant that stated liquidated damages in the case of breach.[535] The court found the covenant's geographic boundary unreasonable and conceded that a court could reform the boundary to a reasonable restriction.[536] Nonetheless, the court would not enforce the liquidated damages portion of the covenant even after it was reformed.[537] The court held that the liquidated damages had to be reviewed on the basis of the original agreement and, as the original terms of covenant were not enforceable, measuring the damages resulting from its breach would be impossible.[538]

More recently, the Texas Supreme Court in *Peat Marwick Main & Co. v. Haass* denied an employer liquidated damages for breach of a covenant

[534] *See* Tex. Bus. & Com. Code Ann. § 15.50.

[535] 340 S.W.2d at 950.

[536] *Id.*

[537] *Id.* at 952–53.

[538] *Id.* at 953. The Texas Supreme Court consistently has followed *Weatherford*. *See* Frankiewicz v. Nat'l Comp Assocs., 633 S.W.2d 505, 507 (Tex. 1982) ("For purposes of monetary damages, a restrictive covenant must stand or fall as written. We refused to redraft the contract to render it reasonable and enforceable."); Henshaw v. Kroenecke, 656 S.W.2d 416, 418 (Tex. 1983) (partner in a consulting partnership containing a covenant obligated to pay liquidated damages as stated in partnership agreement because damages determined reasonable); Juliette Fowler Homes, Inc. v. Welch Assocs., Inc., 793 S.W.2d 660, 663 (Tex. 1990).

even though the covenant's terms could be reformed.[539] Although the breach of the covenant preceded the Act's effective date, the court took note of the Act's blue-pencil section but held that liquidated damages could not be awarded to an employer for breach of a covenant containing unreasonable boundaries.[540] Its conclusion relied on the common law espoused in *Weatherford* and succeeding cases and on the text of the Act's blue-pencil section.[541] Specifically, section 15.51(c) denies damages to the employer for the period of a breach prior to the court's reformation of an unreasonable covenant.[542]

The legislature essentially codified the rules of *Weatherford* in section 15.51(c). That paragraph grants a court the power to change with a judicial blue pencil the boundaries of a covenant that are unreasonable to new boundaries that are reasonable.[543] However, the paragraph expressly denudes the court from awarding damages for the employee's breach of the covenant prior to the court's correction of the covenant.[544]

The employer may have some hope in at least getting relief in this second possibility of a reasonable buyout price that applies to a reformed covenant. This hope stems from the Act's instruction to the court in enforcing a reformed buyout. In that instruction, the court may not award damages for the physician's competition prior to the breach, but it may grant the employer injunctive relief.[545] The actual wording of the Act is: "The relief granted to the promisee shall be limited to injunctive relief."[546]

In this situation the physician will be unhappy, as the court may choose to enforce the covenant by injunction unless the physician pays the buyout

---

[539] 818 S.W.2d 381, 388 (Tex. 1991) (holding a merger of accounting partnership included covenant against partners of merging firm that applied to all possible clients of the merged firms).

[540] *Id.* ("Even if we gave the act the sweeping retroactive effect MH seeks, the reformation argument is invalid because both the legislative intent and a literal application of the statute would not allow MH to collect damages.").

[541] *Id.* ("Texas common law prior to *Hill* clearly provided that when the suit was at law for damages, the restrictive provision had to stand or fall as written and could not be reformed to make it reasonable."); Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 644 (Tex. 1994).

[542] Tex. Bus. & Com. Code Ann. §15.51(c) (Vernon 2002); Perez v. Tex. Disposal Sys, Inc., 103 S.W.3d 591, 593 (Tex. App.—San Antonio 2003, pet. denied) (no award of attorneys' fees in the absence of specific direction from the Act).

[543] Tex. Bus. & Com. Code Ann. § 15.51(c).

[544] *Id.* § 15.51(c) ("[E]xcept that the court may not award the promisee damages for a breach of the covenant before its reformation.").

[545] *Id.* § 15.51(c).

[546] *Id.*

amount to the employer. As the buyout price is reasonable for the reformed restraints imposed by the covenant, the covenant meets the pre-condition to enforceability by including a buyout at a reasonable price.[547] Moreover, the court's hands are tied in adjusting the buyout price downward to account for the passage of time while a decision was made on reformation, assuming that the physician did not choose to compete during that period. However, if the physician chose to compete after the end of employment, equity would dictate that the physician pay what has been determined to be a reasonable buyout price for the reformed covenant, even though a portion of the payment is the equivalent to damages for the period prior to the court's reformation and would otherwise not be owed by the physician under section 15.51(c).[548] On the other hand, the physician may argue, in effect for a reformation of the buyout price in order to reduce it for the pre-reformation period damages applicable to the breach of the covenant.

3. Unreasonable Buyout Price Stated for Reformed Restraints

The third possibility is that the covenant contains one or more unreasonable restraints on the physician and the stipulated buyout price is unreasonable for the covenant even after the court reforms it. A covenant arising under these circumstances may not be enforced. Although it can be reformed to correct its unreasonable restraints, the buyout price cannot be reformed. In this situation, the court may not enforce the covenant using its injunctive powers under section 15.51(c), because the covenant does not meet all the requirements of an enforceable covenant. The most important requirement for physician covenants is the physician's right to buy out the covenant for a reasonable price.[549] The pre-condition to enforceability is not met and therefore the covenant may not be enforced.[550]

These three possibilities of defective physician covenants underscore the difficulty of integrating the physician's right to buy out the covenant under section 15.50(b)(2) into the procedures and remedies in section 15.51. The primary disconnect between the two sections lies in the failure of the legislature to address in section 15.51 the buyout right and the reasonable price it requires. The court has no power to reform an unreasonable buyout price under section 15.51 because it is not included in the three specific

[547] *Id.* § 15.50(b)(2).
[548] *Id.* § 15.51(c).
[549] *Id.* § 15.50(b)(2).
[550] *See id.* § 15.50(a).

limitations, which, if unreasonable, the court may reform. Section 15.52, which preempts other final remedies, prevents the court from resorting to other relief, which it would likely have the power to grant under the common law by invoking its equitable powers to reform an unreasonable price. Lastly, if by happenstance the covenant is unreasonable as to its restraints, but contains a reasonable buyout price for those restraints when corrected by the court, the Act does not state whether the physician must either perform the covenant or pay the buyout price.

In response to the foregoing interpretations of the Act and its treatment of an unreasonable buyout, an employer may choose to provide a remedy in the employment agreement. Specifically, the employer may anticipate the court's inability to reform an unreasonable price and contractually empower the court to do so in the employment agreement. In the employment agreement, the physician would acknowledge the difficulty in predicting a reasonable buyout price and agree that if for any reason the court found the price to be unreasonable, authorize the court to reform the price. The employment agreement would attempt to correct the legislature's oversight in fully incorporating and expanding the Act's remedies section into the stipulated buyout covenant. In practice, employment agreements include reformation language routinely, so it would not be a stretch for the customary reformation language to be enlarged to include the parties' agreement that the court may also reform the stated buyout price to a reasonable price if it finds the stated price to be unreasonable.

As creative as this solution to the deficiency of the Act might be, an employment agreement contractually empowering the court to reform the buyout price must fail, and its covenant must be declared unenforceable. The Act makes the buyout right at a reasonable price an obligatory condition to an enforceable covenant. The parties may not alter the requirements of the Act by agreement because that alteration is founded on the physician's waiver of a fundamental requirement of the Act. That waiver would be equally as unenforceable as if the agreement waived the "ancillary to" requirement of the Act.[551]

The lesson that employers should take to heart from the foregoing three possibilities is that great care should be used in stating the buyout price in the covenant. As suggested in the prior subpart, the prudent employer will

[551] *Contra* Wright v. Sport Supply Group, Inc., 137 S.W.3d 289, 294 (Tex. App.—Beaumont 2004, no pet.) ("Absent a statute or fundamental public policy precluding waiver, one generally may contractually waive even constitutional or statutory rights, whether present or future.").

use the services of an accountant or valuation expert to develop an accounting model forecasting the expected profit of the physician to be employed that is then adjusted for the various factors described in Part V.D., e.g., boundaries, attrition, stickiness, trends, and uniqueness. The net result will be a reasonable estimate of the loss that the employer might suffer if the physician competed with the employer. That loss amount will be a reasonable buyout price. If the employer takes a shortcut that substitutes some multiple of the physician's compensation for the buyout price, as appears to occur routinely in practice, the employer runs a serious risk that the price will be unreasonable. In that event, the covenant is not enforceable and cannot be reformed to be enforceable, and the physician competes free of charge.

This Article concludes that the physician cannot be forced to pay a stipulated buyout price if the price is unreasonable, even though the restrictions in the covenant are reasonable, or if the covenant contains unreasonable restrictions, even though the stipulated buyout price is reasonable. This conclusion derived from the interplay between section 15.51(c) which describes the instances when the court may reform a covenant, i.e., duration, geography and activity, and section 15.52, which makes the terms contained in section 15.50 and 15.51 controlling as to covenants to the exclusion of other applicable laws and principles.

Before leaving this subject, however, it is worth noting again the Idaho Supreme Court's treatment of a $500,000 buyout price in a physician covenant.[552] In *Intermountain Eye*, the court recognized that the buyout price was analogous to a liquidated damages provision.[553] The court noted the legal requirement that the stipulated damages must be reasonable with regard to the damages incurred.[554] The court then observed that at oral argument, counsel for the employer answered the court's question whether the buyout price was a liquidated damages clause, to which the attorney replied "No."[555] The court did not undertake a liquidated damages analysis of the buyout price in that covenant. Instead, the court treated the buyout price as a limitation on the covenant, no different than a limitation on duration, geography or activity:

[552] Intermountain Eye & Laser Ctrs., P.L.L.C. v. Miller, 127 P.3d 121 (Idaho 2005).

[553] *Id.* at 127.

[554] *Id.*

[555] *Id.*

> Whether [the buyout price] is properly characterized as reimbursement or something else, we need not decide; it is, in substance, a component of the non-compete provision. It just happens to be a restriction in the form of money, rather than duration or scope. As with other restrictions, under non-compete rules, this amount must be no more restrictive than necessary to protect Intermountain Eye's business interest. Assuming that recouping its investment in Dr. Miller is a protectable business interest, the amount must be no more restrictive than necessary to protect such interest.[556]

The Idaho Supreme Court could not determine whether the buyout price was reasonable because there were insufficient facts in the record.[557] Consequently, the court remanded the issue to the trial court for a determination of whether the buyout price stated in the covenant was unreasonable as a matter of law, a decision which was to be made by the trial court upon further factual inquiry and not summary judgment.[558] In a footnote, the Idaho Supreme Court suggested that the buyout price, as a component of the covenant, could be blue penciled to a reasonable amount.[559]

C. Attorneys' Fees

As indicated at the beginning of this Part, the physician may choose one of two alternate routes in contesting a covenant that in the physician's opinion states an unreasonable buyout price or states unreasonable boundary limitations, or both. When the controversy being heard in either route comes to a conclusion, the prevailing party will want the other party to pay its legal fees.

The Act authorizes a court to give a physician his or her attorneys' fees if he or she proves that the employer knew the buyout amount was unreasonable at the time it was stated in a stipulated buyout amount.[560] The Declaratory Judgment Act authorizes a court to award "reasonable and

[556] *Id.* at 127–28.

[557] *Id.* at 128.

[558] *Id.* at 128, 133.

[559] *Id.* at 128 n.2.

[560] Tex. Bus. & Com. Code Ann. § 15.51(c) (Vernon 2007).

necessary attorneys' fees as are equitable and just."[561] The parties may also provide in their employment agreement that in subsequent litigation the prevailing party is entitled to reasonable attorneys' fees. Unfortunately the Texas Supreme Court in *Mann Frankfort* did not take the opportunity to address the possibility of preemption of the Act over contractual attorney's fees.[562] Even in the absence of that statement, a prevailing party may recover attorneys' fees in a claim for a contract.[563] Several cases over covenants have raised questions over a party's right to also obtain attorneys' fees. These cases have the effect of crystallizing the reach of the Act's preemption of remedies in the enforcement of covenants. The majority of these cases hold that the prevailing party in a declaratory judgment action may seek attorneys' fees and that right to fees is not affected by the Act's preemption.[564] As noted above, the Texas Supreme Court left undecided the issue of attorney's fees in the *Mann Frankfort* case.

D. Election of Remedies

Part V.F., discussing the arbitration buyout covenant, questioned whether the physician elected a remedy when notifying the employer of the desire to buy the covenant. That discussion concluded that the physician had not elected a remedy because the first and fourth tests of *Bocanegra* are not met.[565] Specifically, the physician cannot make an informed choice to buy out the covenant unless he or she knows how much it will cost—the first *Bocanegra* test.[566] And the decision to buy out the covenant does not

[561] Tex. Civ. Prac. & Rem. Code Ann. § 37.009 (Vernon 2007).

[562] Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 at *8 (Tex. Apr. 17, 2009). See also Justice Hecht's concurring opinion on preemption of attorney's fees that might be awarded in a suit for declaratory judgment. *Id*. at *8–9.

[563] Tex. Civ. Prac. & Rem. Code Ann. § 38.001(6) (pertaining to oral or written contracts).

[564] Hardy v. Mann Frankfort Stein & Lipp Advisors, Inc., 263 S.W.3d 232, 254–56 (Tex. App.—Houston [1st Dist.] 2007, pet. granted) (analyzing *Perez v. Tex. Disposal Sys, Inc.*, 103 S.W.3d 591 (Tex. App.—San Antonio 2003, pet denied), *Gage Von Horn & Assocs. v. Tatom*, 26 S.W.3d 730 (Tex. App.—Eastland 2000, pet. denied), and *Contemporary Contractors, Inc. v. Strauser*, No. 05-04-00478-CV, 2005 WL 1774983 (Tex. App.—Dallas July 28, 2005, no pet.) (mem. op., not designated for publication) and concluding that the Act's preemption only extends to cases brought to enforce a covenant), *rev'd*, Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 2009 WL 1028051 (Tex. Apr. 17, 2009).

[565] Bocanegra v. Aetna Life Ins. Co., 605 S.W.2d 848, 851 (Tex. 1980).

[566] *Id.*

rise to the level of manifest injustice for the employer because the employer may still enforce the covenant against the physician if the physician does not buy it—the fourth *Bocanegra* test.[567]

The conclusion on the election of remedies changes upon applying the *Bocanegra* tests to a physician who chooses to buy out a stipulated buyout covenant. In a stipulated buyout covenant, the physician knows the amount and voluntarily chooses to buy out the covenant instead of performing it. Thus, the first *Bocanegra* test is satisfied. As for the fourth *Bocanegra* test, it is not fair to allow the physician to decide later not to pay the amount due to the employer, particularly if the physician has begun competing. The employer should be entitled to sue the physician for the stated buyout price. One might argue that the employer is still not prejudiced as the employer may sue for damages for the period of competition and seek to enjoin the physician from violating the covenant after that period of time. [568]

E. Observations on the Stipulated Buyout Covenant

It was observed at the end of the discussion in Part V on the arbitration buyout covenant that it offered a disarming avenue of neutrality to the parties when entering into a covenant. However, that neutrality in reality offered a serious disadvantage to the restricted physician who wanted to exercise his or her right to buy out the covenant to pursue competition with the employer. The stipulated buyout covenant requires the parties to negotiate a buyout price at the time they enter into the covenant, or, if a fixed price is not used, to negotiate a formula that will yield a fixed price at the time the buyout option is exercised.

In practice, the employer and the physician rarely negotiate the buyout price. The employer usually inserts the price as part of the covenant and it is generally a take it or leave it proposition. The physician understandably is much more interested in the employment prospects and any negotiation

---

[567] *Id.*

[568] Hanks v. GAB Bus. Servs., Inc., 626 S.W.2d 564, 567 (Tex. App.—Amarillo 1982), *rev'd on other grounds*, 644 S.W.2d 707 (Tex. 1982) ("It is a fundamental proposition of contract law that when one party breaches its contract, the other party is put to an election of continuing or ceasing performance, any action indicating an intention to continue will operate as a conclusive choice, not depriving the injured party of his cause of action for the breach which has already taken place, depriving him only of any excuse for ceasing performance on his own part."). For an interesting discussion of anticipatory repudiation of a physician covenant containing a liquidated damage provision that the parties treated as a buyout right, see *UT Medical Group, Inc. v. Vogt*, 235 S.W.3d 110, 120 (Tenn. 2007) (applying Tennessee law).

concentrates on salary, bonus, vacation and other benefits. Moreover, the physician is most likely to be unable to resort to the professional services of an accountant or valuation expert to analyze or compute the buyout price, and the employer is unlikely to cooperate in furnishing the necessary underlying information to test the stated price. However, the physician has the certainty of the minimum amount he or she must pay to the employer to compete. Consequently, the employer bears the risk that setting too high a buyout price may render the covenant unenforceable, as a court cannot reform the buyout price, and therefore the physician cannot be held responsible for damages for the breach of the covenant's restrictions. If the buyout price is unreasonable, then the covenant itself does not meet the Act's requirements for an enforceable buyout.

The arbitrator deciding the buyout price for an arbitration buyout covenant has the luxury of reviewing supporting information from both the employer and the physician. The arbitrator has the time, and the parties have the resources, to undertake an analysis of the buyout price, taking into account the factors discussed in Part V. However, in recruiting a new physician to the medical practice, the employer is not likely to undertake any substantive analysis of the proper buyout price, much less attempt to apply the various factors discussed in Part V.B. The proper analysis requires too much information, time and professional support. The employer, and its attorney, will abandon the required analysis in writing the physician's covenant and take a shortcut based on the physician's salary or compensation. Even if the employer's attorney does not subscribe to the conclusions in this Article that the proper buyout requires the multi-step process outlined in Part V.B., the employer should, at a minimum, attempt to base the buyout amount on its projected loss of profit on the physician it seeks to employ. Any lesser analytic effort marks an unreasonable covenant at the outset.

The physician who contests the buyout amount and wins has the satisfaction that he or she will not be liable for damages during the period of competition, but while the dispute is being heard by the court, the employer may successfully enjoin the physician for violating the covenant until the court's judgment is entered.[569] If the employer proves the buyout price to be reasonable, the court may enjoin the physician for the remainder of the covenant, or possibly equitably extend the duration of the covenant if

[569] *See supra* note 9 for a discussion on temporary injunctions that preserve the status quo without deciding the merits of the dispute.

it expired during the court's determination of the reasonableness of the buyout price. As in the case of the arbitration buyout covenant, the physician is again idled on the sidelines, postponing his or her professional plans.

VII. CONSTRUING THE BUYOUT CLAUSE: CONJUNCTIVE OR DISJUNCTIVE

The pertinent portion of the buyout clause reads as follows: "the covenant must provide for a buy out . . . at a reasonable price or, at the option of either party, as determined by a mutually agreed upon arbitrator . . . ."[570] If the covenant fails to afford the physician the right to buy out the covenant, it is not enforceable.[571]

So the question is whether the covenant is enforceable if (a) it only states a buyout price, but does not include a right to arbitration or conversely (b) if it provides for arbitration, but does not state a buyout amount. In other words, does the buyout clause give two alternate pricing options: (a) a stated price; or (b) an arbitrated price; or does the clause require that both pricing options must be included in the covenant? If the question is answered that both pricing options be included in an enforceable covenant, the practical implications could be enormous as numbers of covenants offer only one pricing option.

The buyout clause is worded disjunctively, as noted in the quoted language above.[572] Parts V and VI of this Article discussed the buyout right assuming that the buyout clause is disjunctive in application. The buyout amount can be an amount the employer and physician state in the employment agreement (stipulated pricing) or an amount that an arbitrator

[570] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

[571] If the buyout right is absent from the covenant, it is unenforceable. Propath Servs., L.L.P. v. Ameripath, Inc., No. Civ.A.3:04-CV-1912-P, 2004 WL 2389214, at *4 (N.D. Tex. Oct. 21, 2004); Gulf Coast Cardiology Group, P.A. v. Samman, No. 09-02-009CV, 2002 WL 1877175, at *1 (Tex. App.—Beaumont Aug. 15, 2002, pet. denied) (mem. op., not designated for publication).

[572] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 651–52 (Tex. 2006) ("Ordinarily, the truest manifestation of what legislators intended is what lawmakers enacted, the literal text they voted on. This enacted language is what constitutes the law, and when a statute's words are unambiguous and yield a single inescapable interpretation, the judge's inquiry is at an end."); Cardinal Health Staffing Network, Inc. v. Bowen, 106 S.W.3d 230, 238 (Tex. App.—Houston [1st Dist.] 2003, no pet.) (holding that the Act only governs final remedies, not temporary injunctions) ("In ascertaining legislative intent, we do not confine our review to isolated statutory words, phrases, or clauses, but we instead examine the entire act.").

determines, presumably at the end of the physician's employment (arbitrated pricing). Although worded in the disjunctive, the buyout clause could be interpreted to require the inclusion of both options in the physician's employment agreement in order to satisfy the requirements of an enforceable covenant.

Occasionally, Texas courts have interpreted the word "or" in statutes. In those decisions, they universally invoke the principle of statutory construction that the plain meaning of the words used in the statute should be used in construing the statute.[573] The Texas Supreme Court has interpreted the word "or" to be disjunctive in one case and conjunctive in another.[574] The court will endeavor to treat the word "or" in the disjunctive unless the legislative purpose of the statute would be clearly frustrated.[575]

The very essence of the Act is to carve, albeit widely, an exception to the state's prohibition against agreements restraining trade[576] that is based on reasonable, purpose-driven restrictions. In addition, the legislature gave the physician the right to buy out the covenant by paying the employer a reasonable amount. The buyout clause appears worded to offer the parties when entering into the covenant the choice of selecting either the stated price option or the arbitrated price option. While the parties may have set the amount in the employment agreement at the outset of their relationship, the protective purpose of the buyout clause could be reasonably interpreted to give either party a "second look" at the reasonableness of the amount. This interpretation results from the phrase "or at the option of either party," which immediately precedes the wording used for the arbitrated buyout price.

When the employer and the physician enter into an employment agreement containing the covenant, they can agree on a stated option price or an arbitrated option price. If they agree on the arbitrated option price, the language "or at the option of either party" is superfluous. In order for the covenant to be enforceable they must exercise the buyout clause's option at

[573] Bd. of Ins. Comm'rs. of Tex. v. Guardian Life Ins. Co. of Tex., 142 Tex. 630, 180 S.W.2d 906, 909 (1944) ("Where the language of a statute is unambiguous, and its meaning is clear, the statute must be given effect according to its terms, and 'we are not at liberty to speculate upon the intention of the Legislature in its enactment.'").

[574] *Id.*; Ross v. Terrell, 99 Tex. 502, 90 S.W. 1093, 1095 (1906) (interpreting the word "or" in statute allowing purchase of additional sections of public lands to mean "and").

[575] *Bd. of Ins. Comm'rs of Tex.*, 180 S.W.2d at 908.

[576] Texas Free Enterprise and Antitrust Act of 1983, Tex. Bus. & Com. Code Ann. § 15.05 (Vernon 2002).

the time they enter into the employment agreement, rendering the "or at the option of either party" surplus language in a very sparsely written statute. Surely, the legislature did not intend for the parties to write a covenant at the beginning of the employment relationship that gives either party the right to elect the arbitration of the buyout price. That result is nonsensical.

The buyout clause gives the physician the right to buy out the covenant. If the arbitrated pricing option were in the covenant, only the physician would elect to exercise the option, as only the physician will decide whether to buy out the covenant. The buyout clause does not give the employer the right to require the physician to buy out the covenant; only the physician holds that option. The pricing options are merely ways to determine the reasonable buyout price to be paid by the physician. Thus, the employer could not ever exercise the arbitrated pricing option, and the wording "or at the option of either party" is a misstatement. Assuming that the legislature did not intend the phrase to be surplus language and that it is not a misstatement, an alternate interpretation of the buyout clause is that the buyout clause is conjunctive notwithstanding the use of the placement of the word "or" between the stated pricing option language and the arbitrated pricing option language.

The Beer Law,[577] previously discussed in Part V.D., analyzed whether the Arbitration Act applied to the conduct of the arbitration of the buyout price pursuant to section 15.50(b)(2). As will be recalled, the Beer Law contains the following clause in requiring the manufacturer to pay a distributor, whose distribution agreement has been terminated, the fair market value of the business relating to the terminated brands: "the matter [the value of the distributorship], may, at the option of either the distributor or manufacturer, be submitted to three arbitrators."[578] The wording used in the Beer Law is very similar to the buyout clause.

The Beer Law allows the parties an opportunity to agree upon the value of the terminated distribution agreement.[579] If the parties cannot agree, either party may submit the valuation issued to three arbitrators.[580] The option of agreeing on the value is similar to the buyout clause's option to stipulate the buyout amount at the beginning of the employment arrangement, although the two statutes are different in that the buyout

[577] Tex. Alco. Bev. Code Ann. § 102.77 (Vernon 2002).

[578] *Id.* § 102.77(b).

[579] *Id.* § 102.77(a).

[580] *Id.* § 102.77(b).

clause occurs when the parties initially agree and the Beer Law gives the parties the ability to agree at the end of the agreement.[581] Two cases have held that this statutory requirement does not compel arbitration, as was discussed in Part V.D.[582] Instead, those cases found that arbitration could only be compelled when the parties agree to it in their distribution agreement.[583] These conclusions were based on the use of the word "may" in the quoted phrase at the end of the last paragraph.[584]

In addition, the courts found that the Beer Law contains a statutory right of action for the parties if they cannot agree on the value of the terminated distributorship and do not submit the issue to arbitration.[585] Under this statutory right of action, the aggrieved party may bring suit against the other party in a court of competent jurisdiction.[586] Thus, the Beer Law is easily distinguished from the buyout clause because the right to arbitration in the Beer Law is merely discretionary and is not binding on the parties unless they contractually agree to it.[587] The buyout clause has a similar arbitration option, but the Act contains no explicit statutory right to sue as is present in the Beer Law.[588]

Often, particularly for the physician entering the work force directly from residency training, the employer has the stronger bargaining position.[589] At that time it is nearly impossible for the physician to negotiate with the employer a reasonable buyout price, or, for that matter, have enough experience or resources to evaluate the price. Moreover, the

---

[581] *Id.* § 102.77(a).

[582] Cerveceria Cuauhtemoc Moctezuma S.A. de C.V. v. Mont. Beverage Co., 330 F.3d 284, 287 (5th Cir. 2003); Glazer's Wholesale Distribs., Inc. v. Heineken USA, Inc., 95 S.W.3d 286, 297 (Tex. App.—Dallas 2001, pet. granted, judgm't vacated w.r.m.).

[583] *See, e.g., Glazer's Wholesale Distribs., Inc.*, 95 S.W.3d at 297.

[584] *Id.*

[585] *Id.*

[586] Tex. Alco. Bev. Code Ann. § 102.79(a) (Vernon 2007).

[587] *Id.*

[588] *Id.*

[589] Quinn & Levin, *supra* note 35, at 74 ("Employers do not, of course, negotiate the provisions of their covenants not to compete. Covenants not to compete are adhesionary."); *cf.* DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 682 (Tex. 1990) ("[The covenant] must not also take unfair advantage of the disparity of bargaining power between [the employer and the employee]."); RESTATEMENT (SECOND) OF CONTRACTS § 188, cmt. g (1981) ("Post-employment restraints are scrutinized with particular care because they are often the product of unequal bargaining power and because the employee is likely to give scant attention to the hardship he may later suffer through loss of his livelihood.").

parties are motivated to reach agreement on the employment terms that will be the most important to them during employment, to wit, the physician's salary, benefits and bonus. At the end of the employment relationship the physician may level the playing field by invoking arbitration. Conversely, the employer may at the same time invoke arbitration if the employer believes the amount is insufficient to protect its interests. As to the latter possibility, in actuality, it seems remote.

The buyout clause requires the parties to address the physician's buyout right in the employer agreement. The right cannot be omitted or waived. It is reasonable that the legislature desired that the parties agree on a stated buyout amount at the outset. If at the end of employment the physician desires to compete, the physician can pay the agreed amount to the employer and terminate the covenant. However, if at the end of the physician's employment either party does not agree with the initially stated price, either party may request arbitration. Therefore, under that construction, a covenant that includes the right to arbitrate the amount but fails to state a specific amount would not be enforceable.

Ascribing to the conjunctive interpretation of the buyout clause is not without problems.[590] First, as alluded to above, the "at the option of either party" does not fit entirely logically in the conjunctive interpretation. If the parties agree on a buyout price and also add that the final price can be determined by arbitration requested at the option of either party, the initial setting of the price seems unnecessary. It can only be justified under the rationale that the legislature desired agreement if possible, in which case a competing physician would pay the stated price, and if there was disagreement over the price, then either party could resort to arbitration. Second, assuming the legislature intended a "second bite" at pricing the buyout, there is no procedural guidance of any kind. As written, either party has an indefinite period of time to request arbitration of the buyout price. Third, as mentioned above, why would the employer request arbitration if there is a stated price and the physician is willing to pay it? It is possible that the employer's circumstances may have changed, but given the legislature's overriding goal of giving the buyout right, it does not seem that the legislature was overly concerned about protecting the employer against buyout price inflation.

[590] This interpretation could render unenforceable covenants written after 1999 that did not include both a buyout amount and an arbitration right.

Naturally, the legislature could have avoided the disjunctive–conjunctive issue if it added a paragraph to section 15.51 (the procedures and remedies section of the Act) that allowed the parties to arbitrate the buyout amount. In lieu of that alternative, one can infer that the legislature wanted the employer and the physician, if they could agree upon the buyout price, to state it in the employment agreement. If they could not agree, or if they choose not to address the amount prior to employment, the Act allows the parties to defer to arbitration, but only if the right to arbitration is expressly included in the employment agreement. Rather than designating the arbitration right in the Act as a remedy, the legislature insisted that right be written in the employment agreement, presumably because the parties would be more likely to look at their written agreement than the Act.

This author believes the inclusion of either means of quantifying the buyout satisfies the Act. If the parties could resort to arbitration of a contractually-stated amount, then the requirement of a stated amount would be superfluous.

VIII. DOES THE ARBITRATION CLAUSE VIOLATE THE OPEN COURTS DOCTRINE?

The Texas Constitution assures the citizens of Texas the right to obtain the resolution of common law claims in the courts.[591] The Texas Supreme Court has adopted the "open courts doctrine" to evaluate whether legislation impermissibly encroaches upon the citizens' rights to the judicial system by requiring litigants to resolve common law disputes in forums other than the courts.[592]

[591] TEX. CONST. art. I, § 13 ("All courts shall be open, and every person for an injury done to him, in his lands, goods, person or reputation, shall have remedy by due course of law."); Glazer's Wholesale Distribs., Inc. v. Heineken USA, Inc., 95 S.W.3d 286, 298–99 (Tex. App.—Dallas 2001 pet. granted, judgm't vacated w.r.m.) ("This clause acts as an additional due process guarantee granted in the Texas Constitution. It prohibits legislative bodies from arbitrarily withdrawing all legal remedies from anyone having a well-defined cause of action under the common law.").

[592] Shah v. Moss, 67 S.W.3d 836, 841, 45 (Tex. 2001) ("The Texas Constitution guarantees that persons bringing common-law claims will not unreasonably or arbitrarily be denied access to the courts."); Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 227 (Tex. 2002) (holding that the state's police power over regulating automobile dealerships justified requiring a dealership to exhaust administrative remedies before pursing breach of oral contract claims); Butnaru v. Ford Motor Co., 84 S.W.3d 198, 204 (Tex. 2002) (holding Texas Motor Vehicle Commission Code's grant of original jurisdiction to the Texas Motor Vehicle

The court has developed a two-prong test in evaluating whether a statute violates the open courts doctrine. The first prong requires the contestant to show a "cognizable, common law claim."[593] To satisfy the second prong, the contestant must show that the statute's restriction is "unreasonable or arbitrary when balanced against the statute's purpose and basis."[594]

The Act's buyout clause adds the buyout right as a condition to an enforceable physician covenant. Prior to 1989, physicians did not possess this statutory remedy. However, the employer did possess certain common law remedies to the violation of a covenant. The employer was entitled under common law to seek damages for the physician's breach of the covenant.[595] Even when the Act was originally adopted, section 15.51(a) preserved the employer's right to seek damages against a competing physician.[596] The addition of the buyout clause in effect limits the employer's right to seek damages, as the clause allows the physician to buy out the covenant. This Article argues that the buyout price to be paid should be an amount equal to the damages that the employer would be entitled to receive in a suit to recover damages for a breach of the covenant and is in effect a substitution for damages.

Under the buyout clause, the parties may agree to ascertain the buyout price for the covenant in arbitration. The issue then becomes whether the employer's right to statutory damages—payment of the buyout price—is truncated by the buyout clause's arbitration option. The answer is no, principally because the second prong of *Shah's* two-prong is not met. However, it is not entirely clear whether the first prong is met.

A party arguing that the buyout clause does not violate the open court's doctrine would attack the first prong of the test: There must be a common law claim. In support of the argument, the party could persuasively show

---

Commission to resolve automobile dealership disputes did not violate the open courts doctrine because the Commission did not have authority to resolve exclusively common law claims of dealerships).

[593] *Shah*, 67 S.W.3d at 842; Jennings v. Burgess, 917 S.W.2d 790, 793 (Tex. 1996); *see Butnaru*, 84 S.W.3d at 204.

[594] *Shah*, 67 S.W.3d at 842; *Jennings*, 917 S.W.2d at 793; *see Subaru of Am., Inc.*, 84 S.W.3d at 227.

[595] *See* Juliette Fowler Homes, Inc. v. Welch Assocs., Inc., 793 S.W.2d 660, 662–63 (Tex. 1990); Toch v. Eric Schuster Corp., 490 S.W.2d 618, 624 (Tex. Civ. App.—Dallas 1972, writ ref'd n.r.e.).

[596] Tex. Bus. & Com. Code Ann. § 15.51(a) (Vernon 2002) ("[A] court may award the promisee under a covenant not to compete damages . . . .").

that the buyout clause created a new right in the hands of physicians subject to covenants. The right is a statutory creation and did not exist at common law. Prior to 1989, the physician could not buy out the covenant. As the buyout right is a creature of statute, the arbitration option in the buyout clause does not violate the open courts doctrine. This conclusion is similar the Texas Supreme Court's holding in *Subaru of America, Inc.* that a dealership's claims for deceptive trade practices arose from the Texas Deceptive Trade Practices Act and were not common law claims.[597]

The *Glazer's Wholesale Distributors* court reached a different conclusion over whether the Beer Law's arbitration provision created a new statutory right.[598] As will be recalled, the Beer Law allows the parties to a distributorship agreement to resort to arbitration to determine the fair market value the manufacturer must pay to the distributor when the agreement is terminated.[599] In examining the Beer Law's arbitration provision, the court in *Glazer's Wholesale Distributors* found it to be essentially equivalent to a breach of contract action.[600] The court concluded that the statutory right was no different than the common law right the parties possessed prior to the law for breach of termination of the distributorship agreement without cause.[601] In the context of a physician covenant, the buyout right is simply equal to the common law right to seek damages for the breach of the covenant, as suggested, a statutory substitution.

Notwithstanding the opposing arguments as to whether the buyout clause is a statutory right or a substitution for an existing common law claim, the public policy and the state's police power ultimately precludes a party from succeeding on an open courts doctrine challenge of the buyout clause. *Shah's* second prong requires the contestant to show that the statute is unreasonable or arbitrary.[602] In *Shah*, the court held that the two-year limitations provision in the Medical Liability and Insurance Improvement Act while affecting the patient's common law claim for negligence was not

[597] *Subaru of Am., Inc.*, 84 S.W.3d at 227.

[598] Glazer's Wholesale Distribs., Inc. v. Heineken USA, Inc., 95 S.W.3d 286, 300 (Tex. App.—Dallas 2001 pet. granted, judgm't vacated w.r.m.).

[599] *Id.*

[600] *Id.*

[601] *Id.*

[602] Shah v. Moss, 67 S.W.3d 836, 842 (Tex. 2002).

unreasonable.[603] The court stated that the two-year period offered the injured patient a reasonable opportunity to discover the negligence and sue for it.[604]

In *Subaru of America, Inc.*, the court noted the legislature's exercise of its police powers over automobile dealerships in the Texas Motor Vehicle Code, which requires dealerships to obtain a license in order to conduct business.[605] The court noted that the Motor Vehicle Commission Code expressly states that its provisions govern all aspects of the sale and distribution of vehicles.[606] Based on the statute's public policy purpose, the court required the claimant to exhaust its administrative remedies before the Motor Vehicle Commission. Similarly, the Dallas Court of Appeals, in *Glazer's Wholesale Distributors*, concluded that the legislature's police power relating to the regulation of alcoholic beverages was a sufficient basis for restricting the distributor's right to sue in court.[607]

Before leaving the subject of the constitutionality of the buyout clause under the open courts doctrine, it is worth noting the *Glazer's Wholesale Distributors* opinion considered another constitutionality concern over the Beer Law. In that case, the distributor argued that the statute unconstitutionally delegated the state's judicial power to the arbitrator. The Dallas court of appeals agreed and held that the statute violated Article V, Section 1 of the Texas Constitution.[608] The court found that the Beer Law's arbitration provision required "the trial court at the option of either party and without contractual agreement, to delegate to nonjudicial entities [arbitrators] its nondelegable authority and duty to determine the judicial

---

[603] *Id.* at 846–47.

[604] *Id.* at 847.

[605] Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 227 (Tex. 2002).

[606] *Id.* (citing § 3.01(b) of the Texas Motor Vehicle Commission Code).

[607] Glazer's Wholesale Distribs., Inc. v. Heineken USA, Inc., 95 S.W.3d 286, 298–304 (Tex. App.—Dallas 2001 pet. granted, judgm't vacated w.r.m.) ("The abrogation of the common-law breach of contract cause of action and its replacement with the statutory cause of action is not an abuse of police power in this case because it provides the identical relief sought by Glazer's in its common-law breach of contract cause of action.").

[608] *Id.* at 304–05. Article V, section 1 of the Texas Constitution states: "The judicial power of this State shall be vested in one Supreme Court, in one Court of Criminal Appeals, in Courts of Appeals, in the District Courts, in Courts of Justices of the Peace, and in such other courts as may be provided by law." *See also* Tabor v. Hogan, 955 S.W.2d 894, 897 (Tex. App.—Amarillo 1997, no pet.) (holding a trial court's decision to allow a county official to determine the location of a public road resulting from an implied dedication was an impermissible delegation of the court's power to determine the facts of the case).

issues in the case."[609] While the decision in *Glazer's Wholesale Distributors* does not represent binding authority due to the subsequent vacation of its judgment, the distributor's arguments may well be asserted with respect to the buyout clause of the Act. It should be noted that the *Glazer's Wholesale Distributors* decision in part rested on the absence of a contract of the parties to delegate the issue to arbitration. The buyout clause requires the arbitration buyout option to be contained in the parties' contract, which could easily distinguish the buyout clause from the Beer Law.

IX. TORTIOUS INTERFERENCE WITH THE COVENANT BY THE PROSPECTIVE EMPLOYER

The patient reader will recall the last conversation between the attorney and the office manager at the start of this Article. The office manager of the departing physician's employer asks her attorney if her practice can sue the new employer. The attorney's answer would almost immediately be "yes, of course"—tortious interference with a contract. The physician's covenant against competing with his or her former employer is a contract entitled to protection from intentional interference by outside parties.[610]

When a dispute between an employer and a departing employee arises, there is frequently a conjoined dispute with the employee's new employer over interference. Tortious interference with a contract has been a recognized cause of action in Texas for a very long time,[611] and the Texas Supreme Court has consistently set forth the requisite four elements to establish a claim for interference.[612] The possibility of a tortious

[609] *Glazer's Wholesale Distribs., Inc.*, 95 S.W.3d at 305.

[610] *See* Juliette Fowler Homes, Inc. v. Welch Assocs., Inc., 793 S.W.2d 660, 664–65 (Tex. 1990) (creating a defense to tortious interference with a covenant if the covenant was unenforceable, but the negative implication is that a cause of action of interference will lie in tort if another employer interferes with a physician's covenant).

[611] Holloway v. Skinner, 898 S.W.2d 793, 794–95 (Tex. 1995) ("Texas jurisprudence has long recognized that a party to a contract has a cause of action for tortious interference against any third person (a stranger to the contract) who wrongly induces another contracting party to breach the contract.").

[612] *Id.* at 795–96 ("The elements of a cause of action for tortious interference with a contract are: (1) the existence of a contract subject to interference, (2) the occurrence of an act of interference that was willful and intentional, (3) the act was a proximate cause of the plaintiff's damage, and (4) actual damage or loss occurred."); Butnaru v. Ford Motor Co., 84 S.W.3d 198, 207 (Tex. 2002); Tex. Beef Cattle Co. v. Green, 921 S.W.2d 203, 210 (Tex. 1996) (clarifying

interference claim creates substantial concern for the accused party because of the possibility of the assessment of punitive damages, as were famously awarded to Pennzoil against Texaco for $3 billion in 1985.[613]

The Texas Supreme Court addressed tortious interference with a covenant in *Juliette Fowler Homes*.[614] In that case, Juliette Fowler Homes, Inc., a church-related non-profit entity, contracted with Welch Associates, Inc. to raise funds for it.[615] Welch in turn contracted with John W. Butler Companies, Inc. to assist Welch to perform its fund raising contract.[616] The contract between Welch and Butler Companies contained a covenant that prohibited Butler Companies from entering into a service contract with any of Welch's clients for two years after the end of the Welch-Butler Companies' contract.[617] When the various contracts between Fowler, Welch, and Butler Companies ended unhappily, an affiliate of Fowler hired the owner of Butler Companies to complete Fowler's capital campaign for which Welch was originally engaged.[618] Welch sued Fowler for interfering with its covenant with Butler Companies by inducing Butler to accept employment with Fowler's affiliate.[619]

The court outlined the elements of tortious interference as follows:

> In Texas, the elements of a cause of action for tortious interference with contractual relations are (1) there was a contract subject to interference, (2) the act of the interference was willful and intentional, (3) such intentional act was a proximate cause of plaintiff's damage, and (4) actual damage or loss occurred.[620]

justification as an affirmative defense to a tortious interference with a contract claim requiring proof of the defendant's exercise of the defendant's own legal rights or a good-faith claim to a colorable legal right, even though the claim is later proven to be mistaken).

[613] Texaco, Inc. v. Pennzoil, Co., 729 S.W.2d 768, 865–66 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.) (Pennzoil sued Texaco for interfering with its contract, applying New York law, to purchase stock of Getty Oil; the $3 billion of punitive damages were reduced on appeal to $1 billion).

[614] *Juliette Fowler Homes, Inc.*, 793 S.W.2d at 664–65.

[615] *Id.* at 661.

[616] *Id.*

[617] *Id.*

[618] *Id.*

[619] *Id.*

[620] *Id.* at 664.

The court reviewed the covenant restricting the Butler Companies and found that the covenant's restrictions on Butler Companies were unreasonable because they contained no limitation on the geographic scope.[621] As a result, Welch was not entitled to damages for its breach, but was entitled to an injunction.[622] The court reached this conclusion based on the Texas Supreme Court's rationale in *Weatherford* and *Frankiewicz*, which has been discussed in Part VI.B.2 of this Article.[623] The court chose to measure the enforceability of the covenant against the common law standards existing prior to the enactment of the Act.[624] Nevertheless, the court took judicial notice of the Act, which became law after the case had been argued.[625] The court concluded it did not need to decide if the Act covered covenants written before its enactment because its holding after applying the common law equaled the effect of the Act.[626] In particular, the court noted that the Act does not allow an employer to recover damages from an employee who breaches a covenant, the restrictions of which are not reasonable.[627]

Although the covenant was not enforceable, the court considered whether Welch could obtain damages from Fowler for interference with the covenant.[628] The court held that the covenant was a contract that satisfied the first element of the interference cause of action.[629] Moreover, the court observed that a tortious interference action can exist even if the contract is unenforceable, as long as the contract is not void.[630] The unenforceability of the contract is not a defense to a tortious interference action.[631] However, the court carved out an exception to the interference rules for unenforceable covenants. Specifically, the court reasoned that an unenforceable covenant amounts to a violation of the state's public policy to eliminate restraints on trade.[632] Therefore, a third party accused of

[621] *Id.* at 663.
[622] *Id.*
[623] *Id.*
[624] *Id.*
[625] *Id.* at n.6.
[626] *Id.*
[627] *Id.*
[628] *Id.* at 664–65.
[629] *Id.* at 664.
[630] *Id.*
[631] *Id.*
[632] *Id.* at 665.

interfering with the contract may assert as a matter of law the defense that the covenant is not enforceable.

The court's judicially-created defense of unenforceability has been repeated many times.[633] A district judge for the Southern District of Texas has given a fine explanation of the *Juliette Fowler Homes*' defense to a claim of tortious interference: "The court then created an exception to the general rule and held that a tortious interference claim may not be grounded on a contract that was 'void or illegal,' or where there is 'any public policy opposing its performance.'"[634]

Unfortunately, the *Juliette Fowler Homes* court did not explore all of the ramifications of the defense, particularly with respect to the Act's blue pencil provisions. The court reached its decision relying upon the common law precedent of *Weatherford* and its progeny of cases denying an employer damages for an employee's breach of an unenforceable covenant.[635] The common law, as discussed in Part VI.B.2. above, was incorporated into section 15.51(b) of the Act. However, the court did not address the blue pencil provisions of that section of the Act. It ceased its analysis when it held, consistent with *Weatherford*, that an overly broad covenant will not support a damages claim, as the contract must be viewed as written, not as reformed.[636]

The covenant in *Juliette Fowler Homes* was found to be unreasonably broad.[637] The parties had not requested reformation of the covenant's restrictive scope to reasonable limits.[638] The court simply stated that the employer's only relief was injunctive, not damages.[639] No case since *Juliette Fowler Homes* has discussed the possibility of reformation.

---

[633] Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830, 833 (Tex. 1992), *superseded by statute*, Act of Sept. 1, 1993, 73rd Leg., R.S., ch. 965, § 1, 1993 Tex. Gen. Laws 4201 (current version at Tex. Bus. & Com. Code Ann. § 15.50(a) (Vernon 2005) *as recognized in* Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644 (Tex. 2006); Emergicare Sys. Corp. v. Bourdon, 942 S.W.2d 201, 205 (Tex. App.—Eastland 1997, no writ); Sorbus, Inc, v. UHW Corp., 855 S.W.2d 771, 775 (Tex. App.—El Paso 1993, writ denied).

[634] York Group, Inc. v. Horizon Casket Group, Inc., No. H-06-0262, 2007 WL 2120419, at *3 (S.D. Tex. Jul. 10, 2007) (manufacturer sued a corporation formed by the manufacturer's distributors for tortious interference with manufacturer's distribution agreements).

[635] *See* Juliette Fowler Homes, Inc. v. Welch Assocs., Inc., 793 S.W.2d 660, 663 (Tex. 1990).

[636] *Id.*

[637] *Id.*

[638] *Id.*

[639] *Id.*

Consequently, a gap in the authorities exists on the following issue: may a former employer still bring a tortious interference claim against the new employer for interference after an unreasonable covenant is reformed? The court's opinion in *Juliette Fowler Homes* suggests that the former employer may obtain an injunction against the physician from continuing in the employment of the new employer based on a reformed covenant.[640]

If the former employer seeks the injunction, the issue of interference will only arise if the new employer persists in employing the physician, which is not a likely course of events in the milieu of litigation between the former employer and the physician. The court's reasoning in denying damages for breach of the unreformed covenant correspondingly deny damages against a third party accused of interfering with the unreformed covenant:

> It is one thing for the court to do this [reform] as an incident to the granting of injunctive relief which operates prospectively and an entirely different matter to reform the contract for the purpose of giving the employer a cause of action for damages. In the latter situation the defendant would be required to respond in damages for what he had done at a time when there was no way of determining, except possibly by an action for declaratory judgment, where or for how long he was legally obligated to refrain from competing.[641]

Advising the new employer who wants to employ a physician subject to a covenant presents a serious challenge to the new employer's attorney. The attorney must evaluate the covenant. Is it enforceable? If it is enforceable, are the restrictions unreasonable for the protection of the former employer's legitimate interests? As one can well imagine, there are no precise boundary limits for covenants. An incorrect evaluation of the enforceability of the covenant could result in the new employer facing a lawsuit from the former employer for interference with the physician's covenant.[642] The costs of defending a claim, and the risk of exposure to liability, almost always compel the new employer not to offer employment

---

[640] *Id.*

[641] *Id.* (quoting Weatherford Oil Tool Co. v. Campbell, 161 Tex. 310, 314 S.W.2d 950, 952 (1960)).

[642] *See generally* McDonald, *supra* note 13.

to the physician. It should be noted that many physician employment contracts require the physician to represent to the employer that he or she is not subject to any agreement that limits the physician's ability to work for the employer.

The *Juliette Fowler Homes* decision gives some comfort to prospective employers. As noted above, a critical element to the tortious interference with a contract claim is the act by the new employer that constitutes the interference.[643] The interference element requires the act to be willful and intentional.[644] The *Juliette Fowler Homes* court reviewed the facts leading up to Fowler's affiliate hiring Butler.[645] The court drew a distinction that gives employers of a physician subject to a covenant some comfort: "Even if John Butler had induced Fowler to terminate the Fowler-Welch contract, merely inducing one of the parties to exercise his right to terminate contractual relations after giving the required notice does not *necessarily* constitute tortious interference with contract under Texas law."[646] Thus, a prospective employer who discusses employment with a physician employed under a covenant may encourage the physician to take the steps necessary, such as giving notice, to end employment. A conservative prospective employer will not enter into an employment contract with the physician until after the physician gives the former employer notice of termination of the employment agreement.

If the prospective employer employs the physician, the former employer is free to seek an injunction against the physician to prevent him or her from working for the new employer and may seek damages from the physician for breach of contract, but the new employer should not be subject to tortious interference claims. The buyout clause adds new dimensions to the prospective employer's defense, and possible limitation of damages, for tortiously interfering with a physician's covenant. If a prospective employer acts in a manner that constitutes tortious interference, as would be the case if the prospective employer encouraged the physician to disclose the former employer's confidential information, the prospective employer, while liable, may successfully limit the damages owed to the former employer.

---

[643] *See* McDonald, *supra* note 13, at 240.

[644] McDonald, *supra* note 13, at 240.

[645] *Juliette Fowler Homes, Inc.*, 793 S.W.2d at 666.

[646] *Id.* at 666–67.

The proper measure of the former employer's damages from the interference is its lost profits.[647] In theory, the physician who enters into new employment in violation of his or her covenant could have lawfully done so if he or she had paid the amount equal to the foregoing damages. Similarly, the same measure of damages applies to the prospective employer who tortiously interferes with the former employer's covenant with the physician. However, one substantial risk still exists for the prospective employer—punitive damages.

If the prospective employer's interference is particularly egregious, the former employer may seek punitive (also known as exemplary) damages against the new employer. Section 41.003 of the Texas Civil Practice & Remedies Code authorizes the award of punitive damages if the former employer proves by clear and convincing evidence that interference resulted from fraud, malice or gross negligence.[648] Although Chapter 41 of the Civil Practice & Remedies Code contains a number of limitations on punitive damages and imposes substantial hurdles for the former employer to overcome,[649] the very risk of punitive damages deters the prospective employer from being accused of interference, chiefly because it avoids employing the physician.

The same measure of damages was discussed in Part V.B. as the amount that the physician should pay to buy out the covenant. Nonetheless, an important distinction can be made concerning interference with a physician

---

[647] Adkins Adjustment Servs., Inc. v. Neal, No. 05-00-01419-CV, 2001 WL 1231685, at *1 (Tex. App.—Dallas Oct. 17, 2001, no pet.) ("The proper measure of damages in a breach of contract or tortious interference with contract case for loss of profits is *net* profits.") (not designated for publication); Edmunds v. Sanders, 2 S.W.3d 697, 705 (Tex. App.—El Paso 1999, pet. denied); *see also* Trugreen Cos., L.L.C. v. Mower Bros., Inc., 199 P.3d 929, 935 (Utah 2008) (rejecting unjust enrichment damages for tortious interference with contract and adopting lost profits as the proper measure of damages).

[648] Tex. Civ. Prac. & Rem. Code Ann. § 41.003(a) (Vernon 2008); *see id.* §§ 41.001(6), (7), (11) (defining the terms "fraud," "malice," and "gross negligence," respectively); Tex. Beef Cattle Co. v. Green, 921 S.W.2d 203, 210 (Tex. 1996) (noting that actual malice need not be shown to support a claim for tortious interference, but must be shown to support punitive damages).

[649] *See, e.g.*, Tex. Civ. Prac. & Rem. Code Ann. § 41.003(d) (requiring jury award to be unanimous among the jurors); *id.* § 41.004(a) (disallowing punitive damages if only nominal damages were awarded by the jury for the underlying injury); *id.* § 41.008(b) (limiting punitive damages to the greater of $200,000 or two times the economic damages (plus noneconomic damages, which are not likely in a covenant case)); *id.* § 41.009 (allowing a separate trial to determine the punitive damages).

covenant versus any other covenant. The physician covenant is only enforceable if it is accompanied by a buyout right. The buyout right must be a reasonable amount. This Article argues that a buyout price is only reasonable if it correlates to the reasonable, enforceable boundaries of the covenant. That correlation must take into account the multi-step pricing process outlined in Part V.B. One of those steps takes into account the duration of the covenant. The buyout price cannot compensate the former employer for more than the duration of the covenant. In contrast, interference claims for other contracts are not subject to definitive cut-off in duration.

If the physician may purchase his or her freedom from a covenant by paying an amount, determined as set forth above, the prospective employer, even if responsible for tortious interference, should be responsible to the former employer for no more than that buyout price. That reasoning may not, however, exempt the prospective employer from punitive damages. The prospective employer's acts regarding the covenant may have constituted reprehensible conduct entitling the former employer to punitive damages.[650] To illustrate, the employer and the prospective employer may compete in the same market, but the physician's particular relationships with a hospital administration permits the employer to provide medical services that the prospective employer is not able to provide. The prospective employer, unable to recruit and market a physician who directly competes, solicits the physician's employment with added incentives. The prospective employer not only seizes the market, but effectively excludes the employer from the market.

The punitive damages relate to the prospective employer's conduct. On the other hand, if the prospective employer's conduct is confined to the covenant by virtue of contracting the employment of the physician and does not constitute other conduct, such as violating the former employer's rights to confidentiality, the prospective employer may still have a defense to punitive damages. This defense stems from the simple fact that the physician has the freedom to sever the covenant by a payment. Any act of the prospective employer facilitating the physician's termination of employment should not result in any harsher treatment than paying the amount due to the former employer. This conclusion is based on the statements of the court in *Juliette Fowler Homes* that exonerated the

[650] *See id.* § 41.011(a) (listing evidence to be considered in awarding punitive damages, such as the character of the conduct involved and the defendant's net worth).

prospective employer who encouraged the employee to end his employment.[651]

X. SUPPLEMENTING THE COVENANT BEYOND THE ACT'S REQUIREMENTS

As the language of the buyout clause is short on detail, drafters of covenants often supplement the buyout right with additional contractual provisions. The legislature added the buyout right to protect the public's access to physicians.[652] It is totally consistent with this purpose that the employer and the physician can agree on additional contractual provisions to facilitate the buyout right.

It is very daunting to the parties to a physician employment agreement to resolve the buyout of the covenant if the employment only quotes the language of the Act. For example, one physician employment agreement reads simply as follows:

> Physician is entitled to buy-out these Non-Competition and Non-Solicitation provisions at a reasonable price as agreed to by Physician and the Employer, or, at the option of either party as determined by a mutually agreed upon arbitrator, or, in the case of an inability to agree, an arbitrator of the court whose decision shall be binding on all parties.

The foregoing gives the parties no guidance on how to try to agree upon the buyout price and for how long they will attempt to agree upon the price. In fact, the quoted buyout right suggests that the physician and employer are going to try to agree in the future on the buyout price. The buyout clause of the Act actually contemplates in the stipulated buyout option that the parties agree on the price in the covenant.[653]

Additions to a physician covenant can be procedural, substantive or surplus, but regardless of categorization, they must always be examined in light of the policy underlying the buyout right. The covenant may add a provision that the parties are choosing one of the two forms of the buyout

---

[651] *See* Juliette Fowler Homes, Inc. v. Welch Assocs., Inc., 793 S.W.2d 660, 666–67 (Tex. 1990).

[652] House Comm. on Public Health, Bill Analysis, Tex. H.B. 3285, 76th Leg., R.S. (1999) (enrolled), *available at* http://www.legis.state.tx.us/.

[653] Tex. Bus. & Com. Code Ann. § 15.50(b)(2) (Vernon 2002).

under the Act: arbitration or stated amount, and waive the other.[654] The parties thereby affirmatively circumvent the possible conjunctive interpretation of the buyout clause as discussed in part seven.

The buyout clause's paucity of information compels the parties to write the covenant in a manner to guide them on the buyout process. Without direction in the covenant, the employer does not know when to expect the physician to exercise his or her buyout right. Moreover, if the physician exercises the buyout right, the physician does know when to pay the buyout amount to the employer. By supplementing the covenant the parties can avoid much uncertainty at the end of the employment relationship.

As a start, the parties may insert a deadline for the physician to exercise the buyout right. For example, an employment agreement will require the physician to exercise the buyout right within five or ten days of the end of employment.[655] In the absence of that deadline, the physician could exercise the buyout right at any time before the covenant's duration expired. With a deadline, the parties know the physician's choice and the consequences of that choice: conforming to the covenant's restrictions, or buying it out. The deadline for the physician's exercise of the option is most often stated in the covenant as a number of days after the termination of employment.

The covenant should also specify the form and content of the notice of exercise of the buyout option to avoid a dispute over whether the option was timely given. Most covenants require the physician to give a written notice upon affirmatively exercising the option.[656] Many covenants provide that if the physician does not affirmatively notify the employer that the physician intends to buy out the covenant by a certain deadline, then the

[654] One employment agreement recently reviewed by the author provided that the physician waived the right to have the buyout amount determined by arbitration. The drafter of the agreement undoubtedly wanted to avoid, as much as possible, a conjunctive construction of the buyout options.

[655] A recently reviewed physician employment agreement reads as follows: "Physician shall have the right and option to buy out the non-competition covenant by providing the Employer with written notice of the Physician's exercise of the buy out option with ten (10) days following the effective date of the termination of this Agreement."

[656] One of the common boilerplate provisions at the end of an employment agreement is a notice paragraph. This paragraph will require that all notices given by the parties pursuant to the employment agreement must be given in writing and delivered either in person from one party to another or delivered by registered or certified mail, return receipt requested, by overnight delivery courier or by facsimile (fax).

physician irrevocably waives the buyout right.[657] Thus, if the deadline expires, the physician contractually may not exercise the statutorily given buyout right.[658]

In either the stipulated buyout option or arbitrated buyout option form of the covenant, the parties will want to state a deadline for payment of the buyout amount to the employer. The typical paragraph of a stipulated buyout option will specify the number of days after the physician gives notice of exercise of the option to pay the stipulated amount to the employer, almost always in a lump sum. In the arbitrated buyout option, the paragraph will state the number of days after the arbitrator notifies the parties of the arbitrated amount within which the physician must pay the buyout amount to the employer. Many employment agreements state that the physician must observe the covenant's restrictions until the buyout amount is paid.[659]

One interesting possibility for an employer is to require a deposit of an estimated buyout amount pending the arbitration. This possibility would have to be used with care. First, the amount would need to be pegged to some definable formula, such as six months' salary. If too high an amount is stated, the covenant could be unreasonable. Second, the deposit would necessarily be refundable, because the physician may choose not to pay the amount set by the arbitrator. Part V.F. concluded that the arbitration option was not an election of remedies by the physician.

Contractual deadlines to exercise the buyout right and to pay the buyout amount must be reasonable in order to be consistent with Act's intent that the covenant's restrictions not be greater than necessary to protect the interests of the employer.[660] Along these lines, a covenant requiring

[657] "If Physician does not exercise the Buy-Out Option within 30 days of the termination of employment, the Buy-Out Option will expire, and Physician shall have no further right to buy out the non-competition covenant."

[658] Compare with the buy back option statutorily granted to a physician employed by a hospital that purchased the physician's practice: "Not require that the physician give more than thirty-day's notice to exercise the repurchase option . . . ." TENN. CODE ANN. § 63-6-204(f)(2)(A)(iii)(*b*) (Supp. 2008).

[659] An example reads: "The Physician further agrees that the Physician shall not be released from the non-competition covenant until the Buy-Out Price has been paid in full to the Employer."

[660] O'Brien v. Rattikin Title Co., No. 2-05-238-CV, 2006 WL 417237, at *5–6 (Tex. App.—Fort Worth 2006, pet. dism'd w.o.j.) (mem. op., not designated for publication) ("An injunction is an equitable remedy, and the trial court must weigh the respective conveniences and hardships of the parties and balance the equities.").

payment of the buyout amount within five days after the end of the physician's employment is quite arguably unreasonable, particularly in the case of a covenant that applies to a physician whose employment the employer terminated without cause.[661] In that event, five days is not sufficient time for a physician to arrange for payment. Whether the physician pays the buyout amount to the employer in five days or thirty days does not prejudice the employer's right to compensation for lost profits for the duration the covenant was otherwise going to last. Consequently, an employer who insists on unreasonable procedures to be followed by the physician to the exercise the buyout right runs the risk that a court may deny enforcement of the covenant as being unreasonable. Moreover, as previously discussed, this author does not believe a court has a reformation power over unreasonable buyout clauses in a physician covenant.

A covenant that relies on an arbitrator to determine the buyout amount is ripe for added contractual procedures. The buyout clause uses the phrase "as determined by a mutually agreed upon arbitrator." The parties may set forth in the covenant the manner by which they will select an arbitrator in order to avoid inevitably resorting to a court appointed arbitrator due to one party refusing to agree to any person suggested by the other party. For example, the employment agreement may state that, at the end of the physician's employment, each party may suggest an accountant located in the city where the physician works, having more than ten years of public accounting experience, and the two designated accountants will select a third accountant meeting the same qualifications who will act as the arbitrator to decide the buyout amount. Additional contractual provisions would spell out the timing and related details to the selection of the arbitrator. These details would place deadlines on informing the other party of the accountant chosen by a party and deadlines for the two accountant

[661] Most physician employment agreements will allow either party to terminate the physician's employment upon merely giving a minimum amount of notice, for example, "without cause." Agreements vary, but most often the notice period is ninety days or less. The short notice could be very disadvantageous to a physician subject to a covenant. If the employer terminates the physician's employment, the physician may have very limited options. If the covenant contains deadlines on exercising the buyout, the deadline very well may pass before the physician can even become employed with a competing practice or establish his or her own competing practice. *See, e.g.*, Trilogy Software, Inc. v. Callidus Software, Inc., 143 S.W.3d 452, 456–57 (Tex. App.—Austin 2004, pet. denied) (employer sought enforcement of covenant and damages against employee when employer laid-off employee due to lack of work).

representatives of the parties to select the arbitrator. Although the covenant uses arbitrator in the singular, an employment agreement that establishes a panel of arbitrators to decide the buyout amount does not offend the statute.

The covenant may require the parties to use the services of a dispute resolution organization, such as the American Arbitration Association (AAA) or the American Health Lawyer's Association's (AHLA) Alternative Dispute Resolution Service. These organizations provide, for a fee, the services of individuals who are trained as mediators and arbitrators. In addition to the arbitration service's fee, the parties must also pay the fee of the mutually-selected arbitrator. The covenant may specify that the arbitration service be used only for the selection of the arbitrator and specify other guidelines for the conduct of the arbitration, as discussed below. The AHLA provides a service known as a hearing officer selection process. Or, the covenant may make the entire arbitration process totally subject to the arbitration service's rules.[662]

The freedom to supplement the covenant is not unlimited. A covenant that selects as the arbitrator a person employed or controlled by the employer is not enforceable.[663] The employer might be tempted to use the employer's accountant to calculate the buyout amount. This arrangement does not contain any safeguard for the physician if the accountant's loyalty and continued engagement is dependent on the continued favor of the employer.

If an arbitration covenant does not contain provisions resulting in the selection of an arbitrator by the parties, the covenant may nevertheless control the court's appointment of an arbitrator. For example, the covenant may specify that the court must choose an arbitrator who is an independent certified public accountant or a qualified valuation expert having ten years of experience in the field of valuations as an arbitrator.

Subsequent to the selection of the arbitrator, the buyout clause is flexible enough to permit the parties to agree on procedures the arbitrator should follow in the deciding the buyout amount. These procedures might specify when the arbitration should take place and the deadline for the

[662] *See* AAA's Commercial Arbitration Rules, http://www.adr.org/commercial_arbitration (last visited Mar. 21, 2009); AHLA's Alternative Dispute Resolution Service, http://www.healthlawyers.org/adr (last visited Mar. 21, 2009).

[663] BDO Seidman v. Miller, 949 S.W.2d 858, 861 (Tex. App.—Austin 1997, writ dism'd w.o.j.) (accounting firm could not enforce covenant governed by New York law that appointed five of the firm's directors as arbitrators to determine the monetary damages a former employee must pay for violating the covenant).

arbitrator to announce a decision. The possibilities for describing the arbitration process are limited only by the imagination of the parties. If the process supports the efficient administration of the buyout clause, the additional provisions should be enforceable against the parties.[664]

The Texas Supreme Court in *In re Poly-America, L.P.* reviewed an arbitration clause that severely limited an employee's conduct of discovery in the arbitration.[665] The court made the following observation:

> Although an issue of first impression in this Court, several courts around the country have analyzed the enforceability of similar arbitration provisions limiting parties' access to various forms of discovery. Applying a rule functionally equivalent to that used to analyze fee-splitting provisions, these courts refused to enforce such limitations when adequate evidence is presented that a plaintiff's ability to present his or her claims in an arbitral forum is thereby hindered.[666]

The court, in reviewing the discovery limitations in the subject employment agreement, held that the enforceability of discovery limitations is best left to the arbitrator to decide during the conduct of the arbitration proceeding.[667]

As an example, the covenant might specify the following additional procedures to be followed by the arbitrator and the parties in arriving at the buyout amount. Each party will submit a position statement to the arbitrator and the other party within thirty days after the arbitrator is selected. Each party's position statement must state the party's buyout price for the covenant and be accompanied with supporting documentary evidence. Following receipt of the initial position statement each party may respond in a responding position statement to the other party and the arbitrator within ten days. The arbitrator will have ten days to make an award that states the buyout price to be paid.

---

[664] *In re* Fleetwood Homes of Tex., L.P., 257 S.W.3d. 692, 695 (Tex. 2008) (per curiam) (holding that the arbitration provisions under consideration were not unconscionable because they limited discovery, as "limited discovery is one of arbitration's 'most distinctive features'"); Perry Homes v. Cull, 258 S.W.3d 580, 599 (Tex. 2008), *cert. denied*, 77 U.S.L.W. 3396 (U.S. Jan. 12, 2009) (No. 08-707).

[665] 262 S.W.3d 337, 344 (Tex. 2008).

[666] *Id.* at 357.

[667] *Id.* at 358.

The foregoing example tries to adopt an accelerated decision-making process, and in doing so, permits its flaws to surface. First and foremost, the physician has no access to critical information the employer possesses. This information regarding profitability and patients would be useful for both parties and the arbitrator to consider, but the employer controls the arbitrator's and the physician's access to the information.

An arbitration covenant may also choose to instruct the arbitrator on what factors the arbitrator should consider in arriving at a buyout amount. The covenant may require the arbitrator to assume that the covenant's boundaries are all reasonable and enforceable and prohibit him or her from considering whether they exceed what is reasonable. A covenant may inform the arbitrator that he or she should ignore the circumstances of the physician's separation from the employer, e.g., where the employer terminated the physician's employment without cause.[668]

Alternatively, the parties may choose to empower the arbitrator to exercise a blue pencil in arriving at a reasonable buyout amount. Under this scenario the arbitrator could decide that a reformed covenant would support a stated buyout price. However, as discussed in Part V.D., the Act does not authorize the arbitrator to reform the covenant in addition to determining the buyout price. Nevertheless, if the employment agreement contains a far-reaching arbitration agreement—one that requires all issues pertaining to employment, not just the determination of the buyout amount, the arbitrator presumably would be empowered to blue pencil the covenant before deciding the buyout amount. This power would be consistent with the Act's authorization of a court to blue pencil and would also fill the gap concerning the arbitrator's powers now existing in the Act. However, as pointed out in Part V.E., the arbitrator is limited to reforming the covenant by using blue pencil powers, but may not determine the buyout amount for the covenant, whether reformed or not. As reformed, the arbitrator may grant injunctive relief if the agreement empowers the arbitrator to do so, but the arbitrator may not set a buyout price. The precedent that does not permit the award of liquidated damages for an unreasonable covenant dictates this limitation on the arbitrator's power.

The covenant may state that the arbitrator may consider the employer's expenses; however, a covenant advising the arbitrator to consider the physician's compensation would not be enforceable as it is unreasonable. For example, if the employer paid a substantial recruiting fee to locate the

[668] *See supra* note 75 (discussing termination of employment without cause).

physician, the covenant may advise the arbitrator to include that amount.[669] The covenant may encourage the arbitrator to take into account post-termination facts such as the physician's violation of the covenant and the number of the patients that the physician has treated after the end of his or her employment.

In addition to procedural matters, the parties may add substantive provisions to the covenant.[670] The Texas Supreme Court has noted the state's policy of encouraging agreements between the employers and the employees to resolve disputes by arbitration.[671] Thus, the provisions relating to a covenant in a physician employment agreement could include any number of substantive provisions bearing upon the determination of the buyout amount, in addition to the procedural provisions, as long as the substantive provisions do not override the purpose of the Act and are not unconscionable. The Texas Supreme Court has noted a variety of factors to be considered in determining whether an arbitration provision contains unconscionable provisions, including "oppression and unfair surprise."[672]

A physician agreement may provide that all issues pertaining to the covenant, not just the buyout amount, are to be determined through arbitration. The foregoing paragraphs describe procedural supplements that may be added contractually to arbitration of the buyout of the covenant. The parties may go further contractually and require that all interpretation and enforcement of the covenant be decided by an arbitrator.

The Oklahoma Supreme Court reviewed an employment contract containing a broad arbitration provision.[673] In that case, an established cardiovascular surgeon recruited an associate and employed him pursuant to an employment agreement that contained a covenant restricting the associate physician from competing with the employing physician for two years following the termination of employment anywhere within twenty

[669] RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981) (noting that damages can include expenditures made in performance).

[670] *See In re Poly-America*, 262 S.W.3d at 349 ("An arbitration agreement covering statutory claims is valid so long as the arbitration agreement does not waive the substantive rights and remedies the statute affords and the arbitration procedures are fair, such that the employee may 'effectively vindicate his statutory rights.'"); *see also* Tex. Civ. Prac. & Rem. Code Ann. § 171.022 (Vernon 2005) (stripping a court of any authority to enforce an agreement to arbitrate that was unconscionable at the time it was made).

[671] *In re Poly-America*, 262 S.W.3d at 348.

[672] *Id.*

[673] Cardiovascular Surgical Specialists, Corp. v. Mammana, 61 P.3d 210 (Okla. 2002).

miles of the employer's offices. The employment agreement also provided that all disputes were to be decided by arbitration. The physician departed the practice after two years and promptly competed with his employer.

When the employer's claim for the breach of the covenant and request for injunction were ultimately referred to the arbitration panel, the arbitrators found the covenant to be enforceable and the employer entitled to injunctive relief. The employer sought to confirm the award in district court as a predicate to obtaining an injunction. The district court confirmed the award and enjoined the physician. The physician appealed, and the Oklahoma Supreme Court evaluated whether the covenant was enforceable under Oklahoma law.

The Oklahoma Supreme Court found that the covenant did not comply with Oklahoma law on two grounds: first, the restrictions were more extensive than needed to protect the employer's interest; and second, the restrictions prevented the physician from accepting referrals.[674] The Oklahoma Supreme Court held that the employer and the physician could not by agreement authorize an arbitration panel to determine whether the covenant was enforceable under Oklahoma law.[675] Thus, in Oklahoma, according to this precedent, the parties are not able to submit all issues concerning the covenant to arbitration. No Texas court has determined whether an employer and a physician may contractually agree that the issue of the enforceability of the covenant may be decided by arbitration. However, in view of the Texas Supreme Court's strong endorsement of the arbitration of employment disputes, the referral of such issues to an arbitrator does not seem inconsistent with the Texas Supreme Court's statements that the enforceability of a covenant is a matter of law.[676] Moreover, the Texas Legislature has at least indicated its approval of arbitration of the buyout amount, so its tacit approval of total arbitration can be inferred.

On the one hand, the Texas courts have held that an arbitration panel's decision is essentially a final judgment, indicating that the arbitration panel may make determinations of fact and law.[677] On the other hand, the Texas Supreme Court has been consistent in stating that the arbitration panel is not

[674] *Id.* at 214.

[675] *Id.* at 213.

[676] *In re Poly-America*, 262 S.W.3d at 349.

[677] Affiliated Pathologists, P.A. v. McKee, 261 S.W.3d 874, 879 (Tex. App.—Dallas 2008, no pet.).

in a position to determine certain defensive issues one party may assert in the arbitration.[678] In *Perry Homes*, the Texas Supreme Court ruled that the determination of whether the parties had waived contractual arbitration provisions by pursuing litigation was a matter of law that only the courts could decide and could not be decided by the arbitration panel.[679]

In *In re Poly-America*, the Texas Supreme Court similarly decided that issues over the scope of the arbitration of employment matters which involved unconscionability or a reduction in statutory rights are to be decided as a matter of law by courts and not by the arbitration panel.[680] By analogy, the arbitrators in evaluating whether a particular physician covenant is enforceable must make determinations of law under the Act. As the Act is the statement of the state's public policy that restraints on competition will be tolerated only in limited circumstances, one might conclude that an employment agreement's provisions that delegate to an arbitration panel the exclusive right to decide the enforceability of a covenant would be held on appeal as an impermissible delegation.

A very important substantive provision that may be added to physician covenants is one that apportions the cost of the arbitration. The buyout clause only authorizes the arbitrator to determine the buyout amount. A covenant could provide that if the physician desires to arbitrate the buyout amount, then the physician must pay the arbitrator's fee. If the covenant is silent on the subject, as discussed in Part V.C., the court that appointed the arbitrator will determine which party pays the arbitrator's fee.[681] In addition, the covenant may provide that the costs of the arbitration are to be split between the employer and the physician. The Texas Supreme Court reviewed a "fee-splitting" provision in an employment contract containing arbitration provisions to resolve all employment disputes. The court found that the arbitrator could arbitrate a retaliatory discharge claim by the employee for having made a worker's compensation claim.[682] The court took the opportunity to adopt the universal opinion of other courts that

[678] *In re Poly America*, 262 S.W.3d at 348; Perry Homes v. Cull, 258 S.W.3d 580, 587 (Tex. 2008).

[679] *Perry Homes*, 258 S.W.3d at 587.

[680] *In re Poly-America*, 262 S.W.3d at 349 ("Whether a contract is contrary to public policy or unconscionable at the time it is formed is a question of law.").

[681] *Id.* at 355–56 (refusing to hold an arbitration provision allowing the award of attorneys' fees to the prevailing party as unconscionable, because the provision was consistent with Texas law on the award of attorneys' fees under the Civil Practice and Remedies Code).

[682] *Id.* at 352.

provisions in arbitration agreements are unenforceable as unconscionable if they prevent the employee from pursuing statutory rights.[683]

The physician's statutory right is to buy out the covenant at a reasonable price. The arbitration will result in the determination of a reasonable buyout amount. The requirement that the physician split the costs of the arbitration, which would include the arbitrator's fee, the filing fee to commence the arbitration, court costs in obtaining the appointment of an arbitrator and similar charges, does not impair the physician's right to pursue the determination of the buyout amount. In *In re Poly-America*, the court reached its unconscionability holding because the court was troubled that the employee would be unduly burdened and deterred from pursuing arbitration of his retaliatory discharge claim if the costs of the arbitration were significant when compared to the employee's salary.

An aggressive counsel for an employer might be tempted to obtain the physician's written waiver of the buyout right altogether. As the right to the buyout is a statutory right of the physician and a statutory prerequisite to the enforceability of the covenant, an omnibus waiver by the physicians, even if contained in an enforceable agreement, should be held to be against the public policy of the Act. The enforceability of covenants has been removed from the common law and is governed exclusively by the Act, although the Texas Supreme Court in *Haass* concluded that the Act codified the common law on covenants.[684] The Act is explicit in stating that an enforceable covenant against a physician must contain a buyout right. A waiver of that statutory right would be unconscionable and unenforceable, as it would violate public policy. This state's public policy is to outlaw restrictions on competition unless the restriction meets the strict requirements of the Act.

The Texas courts have reviewed waivers of arbitration provisions in the context of the parties pursuing traditional lawsuits in state courts.[685] In *In*

[683] *Id.* at 356.

[684] Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 388 (Tex. 1991) ("MH correctly argues that the purpose of the act was to return Texas' law generally to the common-law as it existed prior to *Hill v. Mobile Auto Trim*.").

[685] *See* Perry Homes v. Cull, 258 S.W.3d 580, 593 (Tex. 2008) (holding that a home purchaser asserting claims against insurer for warranty claims subject to contractual arbitration did not invoke the litigation process substantially enough to result in the waiver of the arbitration provisions); *see also In re* Fleetwood Homes of Tex., L.P., 257 S.W.3d. 692 (Tex. 2008) (per curiam) (holding that a mobile home dealer did not waive right to arbitration in mobile home dealership agreement with manufacturer).

re Fleetwood Homes, the court addressed whether emails from counsel for a mobile home dealer constituted either an express or an implied waiver of the binding arbitration provisions contained in the dealership agreement. Although the court found no waiver to exist from the communications, the court observed:

> Waiver is a legal question for the court based on the totality of the circumstances, and asks whether a party has substantially invoked the judicial process to an opponent's detriment, the latter term meaning inherent unfairness caused by "a party's attempt to have it both ways by switching between litigation and arbitration to its own advantage."[686]

While the court's decision in *In re Fleetwood Homes* does not specifically control the issue of waiver of the buyout right, the court's analysis in the case strongly suggests that a waiver will not be enforced because the physician is precluded from pursuing the statutory buyout right. On the other hand, should the physician not pursue his or her right to seek arbitration, the physician may be deemed to have waived the right. In this latter instance, the physician is not precluded from pursuing the right, but is estopped from pursuing the right because of material prejudice to the employer.[687] This argument would apply to the physician who briefly abides by the covenant after the termination of employment, and then six months later chooses to exercise the buyout right. While the employer has had the protection of the covenant during the six months of the physician's compliance, it seems hardly fair to require the employer to go through the expense, in the case of an arbitration buyout option, to arbitrate the price. In the stipulated buyout option, the physician surely would not be remiss in pointing out that the employer receives what it bargained for in the covenant, to wit, payment.

Some covenants go beyond procedural and substantive provisions on the buyout and include statements that the physician acknowledges that the

---

[686] *In re Fleetwood Homes*, 257 S.W.3d.at 694.

[687] *Perry Homes*, 258 S.W.3d at 593 (contrasting waiver and estoppel by finding that waiver is a unilateral act not requiring action on the part of the other party to complete it and estoppel requires a prejudicial effect as a result of the Act) ("Like any other contract right, arbitration can be waived if the parties agree instead to resolve a dispute in court. Such waiver can be implied from a party's conduct, although that conduct must be unequivocal. And in close cases, the 'strong presumption against waiver' should govern.").

covenant's terms are reasonable.[688] These covenants frequently recite provisions in which the physician agrees that the employer's business interests being protected by the covenant, such as additional specialized training to be received during employment.[689] These interests were discussed in detail in Part IV.A., which reviewed the "ancillary to" requirement of the Act for an enforceable covenant. In a stipulated buyout option, the physician would affirm that the stated amount is reasonable.[690] While some courts have taken note of a party's affirmations of reasonableness of a covenant,[691] a court should ignore self-serving affirmations when reviewing a covenant. Instead, the court or the arbitrator should examine the buyout amount using the standards discussed in this Article. In practice, the reality of the physician employment agreement is that the employer's attorney writes it on behalf of the employer. The employer's attorney includes these provisions to buttress the covenant when

[688] From a physician employment agreement, "Physician acknowledges and agrees that the duration, scope and area covered by the non-competition covenant are reasonable and necessary to protect the Employer's legitimate business interests." *See* Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 657 (Tex. 2006) ("Johnson testified that his covenant with Strunk was reasonable, just as he admitted in his employment agreement that his covenant with ASM was reasonable.").

[689] An example from a reviewed physician employment agreement:

> Physician acknowledges that Physician will receive specialized knowledge and skill by reason of Physician's employment by the Employer. Physician further acknowledges that such training, knowledge, education and experience have been material inducement for entering into this Agreement and that such special training, knowledge, education and experience acquired by Physician constitutes valuable consideration which will enhance the value of Physician to other physicians or entities through which medicine is practiced.

[690] From another physician employment agreement:

> Physician hereby expressly agrees and acknowledges that the Buy-Out Price is a fair and reasonable price for the Employer's agreement to release Physician from the non-competition provisions of this Agreement and has been determined in a manner that fairly and reasonably compensates the Employer for the lost revenues and other damages to the Employer's business that would occur if Physician competed with the Employer.

[691] Bird v. Kornman, 152 S.W.3d 154, 156 (Tex. App.—Dallas 2004, pet. denied) (noting that the employment agreement was fifty-two single-spaced pages, and the employment agreement recited that the employee was given the opportunity to review it and to consult with an attorney of his own choosing before signing it); Hoddeson v. Conroe Ear, Nose & Throat Assocs., P.A., 751 S.W.2d 289, 291 (Tex. App.—Beaumont 1988, no writ) (Brookshire, J., dissenting).

the time comes for enforcement against the physician. The physician, being highly desirous of employment, does not have a real opportunity to negotiate the removal of these self-serving provisions from the agreement. This unequal bargaining position is cited as the reason for the stricter scrutiny of post employment covenants than covenants arising in other situations.[692]

On the other hand, if the parties choose to include substantive statements that support their determination of the buyout amount, the court or the arbitrator should give deference to the parties' agreement.[693] These statements might suggest a formula for determining the amount. As an example, the covenant could provide that the buyout amount will be equal to the profit the employer received from the physician's services as follows:

The buyout amount shall be determined by the following formula:

> The employer's accounting firm shall determine the gross revenue of the physician for the twelve (12) months immediately preceding the termination of the physician's employment and subtract from such amount the employer's direct expenses and shared overhead allocable to the physician for the same period of time. The difference shall be the buyout amount.

Gross revenue shall be an amount equal to the employer's billings for the physician's services during the twelve (12) month period less a reasonable reserve for contractual discounts[694] and doubtful accounts. [As

[692] RESTATEMENT (SECOND) OF CONTRACTS § 188, cmt. g (1981) ("Post-employment restraints are scrutinized with particular care because they are often the product of unequal bargaining power and because the employee is likely to give scant attention to the hardship he may later suffer through the loss of his livelihood.").

[693] There are several important differences between relying upon a court or an arbitrator to decide the enforceability of the covenant. These differences include the absence of procedural and evidentiary rules in an arbitration, unless explicitly included in the employment agreement. These differences are precisely why some commentators conclude that the arbitration is expeditious, though noting its shortcomings. *See* Glazer's Wholesale Distribs., Inc. v. Heineken USA, Inc., 95 S.W.3d 286, 295 (Tex. App.—Dallas 2001, pet. granted, judgm't vacated w.r.m.*)* ("Arbitration is a streamlined decision-making process. The Texas General Arbitration Act permits only limited discovery. . . . [T]he rules of evidence do not apply.").

[694] Typically physicians will adopt a specific fee schedule for patient services; however, the insurance companies enter into contracts with the physicians for reimbursement for a lesser amount. The contractual discount is the difference between the physician's bill based on his or

an alternate measure of revenue, the agreement could substitute the employer's actual collections for the physician's services, which as a metric is precise and is not subject to assumed reductions for contractual discounts.] Direct expenses shall include all expenses for the benefit of the physician, such as salary, employment taxes, health insurance premiums, malpractice insurance premiums, continuing education, dues and license fees. Shared overhead shall mean all expenses of the employer that are not the direct expenses of any of its physician employees, divided by all physician employees of the employer.

Pre-Act and post-Act covenants often contain other statements that can be self-serving in favor of the employer. In these covenants, the physician acknowledges that he or she can support himself or herself even if forced to observe the covenant's restrictions.[695] The inclusion of this statement presumably supports a conclusion that the covenant's restrictions are reasonable because the physician is able to earn a living abiding by them. In other words, the physician does not mind relocating outside the geographic boundary of the covenant.

In *Wee Tots Pediatrics*, the physician signed a pre-Act agreement that provided for the arbitration of all employment disputes others than the covenant not to compete. The court enforced the division of the disputes arising out of the employment relationship between the arbitration and judicial forums even though some claims were subject to arbitration and other claims were subject to judicial resolution. In response to the physician's objection to the division of forums, the court observed that the agreement was clear on which forum would resolve a particular dispute. In support of its finding, the court cited the general rule that a party to a contract is held to know the provisions of the contract the parties signed and comprehended the consequences of those provisions.[696]

In another contractual statement added to physician covenants, the physician may waive the statutory requirement that the employer post a

her fee schedule and the amount the insurance company will reimburse the physician for that service.

[695] From a reviewed agreement: "Physician acknowledges and agrees that Physician can comply with the foregoing non-competition and non-solicitation provisions without interfering with Physician's ability to pursue a livelihood."

[696] Wee Tots Pediatrics, P.A. v. Morohunfola, 268 S.W.3d 784, 792 (Tex. App.—Fort Worth 2008, no pet.) (quoting Tamez v. Sw. Motor Transp., Inc., 155 S.W.3d 564, 570 (Tex. App.—San Antonio 2004, no pet.)).

bond[697] in connection with obtaining a temporary restraining order or a temporary injunction against the physician for violating the covenant.[698] The covenant may also add as a conclusory fact that violating the covenant will result in irreparable injury.[699] This statement is included so that the employer may demonstrate to a court the right to obtain an injunction.[700] While these additions are not strictly relevant to the subject of the physician's buyout right, a court or arbitrator should nevertheless ignore them.

In addition to the types of one-sided additions an employer may include in a physician covenant to facilitate its subsequent enforcement through injunction, most physician covenants provide that the covenant is independent of the other agreements of the employer and the physician in the employment agreement.[701] The provision isolates a breach by the employer of one of its other agreements from the physician's covenant.[702]

The inclusion of the foregoing provision arises from a long line of Texas cases that apply the equitable principle of "unclean hands." In summary, an

[697] Tex. R. Civ. P. 684.

[698] "If the Employer seeks an injunction against Physician, the Employer need not show proof of actual damage and Physician waives any requirement that the Employer post bond."

[699] From a physician employment agreement: "The parties agree that a breach by Physician of this non-competition covenant would cause irreparable damage to the Employer." *See* Pizzini v. O'Neal, No. 09-05-102 CV, 2005 WL 2088369, at *3 n.3 (Tex. App.—Beaumont Aug. 31, 2005, no pet.) (mem. op., not designated for publication) ("The contract also contains a clause stating Pizzini recognizes that any breach of the non-competition and confidentiality provisions of the contract would cause O'Neal irreparable injury for which money damages would not be an adequate reedy [sic], and agreeing O'Neal would be entitled to an injunction restraining Pizzini from violating the agreement."); Wood v. Reserve First Partners, Ltd., No. 09-06-217 CV, 2007 WL 2199901, at *4 (Tex. App.—Beaumont Aug. 2, 2007, no pet.) (mem. op., not designated for publication) ("Wood stipulated to the reasonableness of the limitations when he signed the amended agreement that included the covenant not to compete . . . .").

[700] *See supra* note 9 (discussing the necessity to show irreparable injury in order to justify an injunction); Tex. Civ. Prac. & Rem. Code Ann. § 65.001 (Vernon 2007) ("The principles governing courts of equity govern injunction proceedings if not in conflict with this chapter or other law.").

[701] "The existence of any claim or cause of action on the part of Physician against the Employer, whether arising from this Agreement or otherwise, shall not constitute a defense to the granting or enforcement of injunctive relief against Physician."

[702] While not determinative of its holding, the *DeSantis* court tangentially observed, "Also, performance of a covenant not to compete, like performance of other contractual obligations, may, in certain circumstances at least, be excused by the promisee's own breach." DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 681, n.6 (Tex. 1990).

employer's enforcement of a covenant against an employee requires a court to exercise its equitable powers of injunction. In exercising those equitable powers, the court must also apply the doctrine of "unclean hands." An employee may defeat an employer's enforcement of a covenant if the employer has breached a material term of the employment agreement with the employee.[703] The equitable doctrine has been further refined to say that the breach by the employer must be significant and not merely immaterial.[704] As a result of these cases involving employees seeking to deny the enforcement of the covenant by showing a breach of the employment agreement by the employer, employers regularly include in the covenant an independent statement to the effect described above. Courts have enforced these statements of independence.[705] By including an independence clause, an employer can isolate from a dispute over the covenant any collateral issues involving the employer's performance of the employment agreement.[706]

---

[703] *Id.* ("And enforcement of an agreement not to compete may not be by injunction if the party seeking enforcement is not entitled to such equitable relief, as, for as example, when that party has himself engaged in inequitable conduct.") (citations omitted); Nat'l Chemsearch Corp. v. Frazier, 488 S.W.2d 545, 548 (Tex. Civ. App.—Waco 1972, no writ) ("Under the 'clean hands' doctrine, an employer may be denied enforcement by injunction of an agreement by an employee not to engage in post-employment competition where the employer has been guilty of a breach of the contract, or other inequitable conduct, that was injurious to the employee."); Carpenter v. S. Prop., Inc., 299 S.W. 440, 444 (Tex. Civ. App.—Dallas 1927, writ ref'd) ("It is a recognized fundamental principal of equity that he who seeks equity must do equity, and he who comes into a court of equity must come with clean hands.").

[704] Gillen v. Diadrill, Inc., 624 S.W.2d 259, 263 (Tex. App.—Corpus Christi 1981, writ dism'd) (holding that an employer could obtain injunction to enforce covenant against the employee even though employee alleged that certain fees and terminate pay or earned vacation had not been paid to employee.); Norris of Houston, Inc. v. Gafas, 562 S.W.2d 894, 897 (Tex. Civ. App.—Houston [1st Dist.] 1978, writ ref'd n.r.e.) ("The clean hand maxim should not be applied when the defendant has not been seriously harmed and the wrong complained of can be corrected.").

[705] French v. Cmty. Broad. of Coastal Bend, Inc, 766 S.W.2d 330, 334 (Tex. App.—Corpus Christi 1989, writ dism'd w.o.j.) (holding that an employee could not rely on the equitable defense of "unclean hands," due to employer's failure to pay severance pay, because the employment contract stated that it "shall be construed as an agreement independent of any of the provision").

[706] Sometimes, for any number of reasons, an employer may choose not to enforce a covenant against a departed physician. A subsequently departing physician may argue that the employer may not enforce the covenant against him or her. The independence clause should not preclude the argument, as it is not predicated on any breach by the employer. Instead the physician's argument is that the employer should be estopped from seeking to enforce the covenant. In essence the argument is that the employer did not need to protect its legitimate business interests,

XI. PARTIAL BUYOUT OF THE COVENANT

This Part will discuss whether a physician may alter a properly-constructed buyout right. The author has heard anecdotally of physician attorneys proposing a partial buyout of the covenant when the physician's employment has ended and the physician wants to practice within the geographic boundary of the covenant.

For example, if the covenant's restriction is delimited by a five-mile radius and the buyout is $100,000, the physician may propose to "buy" the outer two miles of the radius for $40,000, thereby being able to compete three miles closer. In another example, if the restriction lasts two years, perhaps paying one-half the stated buyout amount could shorten the restriction to one year. In yet another example, a physician might pay a portion of the stated price to release a particular medical specialty, such as a subspecialty, from the scope of the covenant. The possibilities are almost limitless. While the foregoing examples address a stipulated buyout, they apply equally to an arbitrated buyout if posed to the arbitrator in finding a reasonable buyout price.

No recent Texas cases were found supporting the possibility that a physician could partially perform the covenant; that is, observe the covenant in part and violate it in part. In an early case, the Texas Supreme Court declined to consider partial performance in a case involving stipulated damages if the employee's performance did not continue for one year.[707] The court posited that there might be an argument that a lesser amount than the stipulated amount should apply, but it did not answer the

presumably the same confidential information that has been disclosed to both physicians, when the first physician departed and therefore the protection is not needed as to the second, departing physician. As a result of this possible line of argument, employers will want to treat departing physicians consistently with respect to their covenants.

[707] Lone Star Salt Co. v. Tex. Short Line Ry. Co., 99 Tex. 434, 90 S.W. 863, 866 (1906) ("The reason why it is urged that the sum named should be held a penalty, and not stipulated damages, although the parties show their intention to make it such, is that it is in terms payable for the smallest breach of, as well as for a total failure to perform, the contract in any one year. Whether or not this fact itself shows the stipulation to be a penalty, or whether the provision makes the named sum payable as liquidated damages only for an entire failure to perform for one year, making a partial failure a possibility, are also questions we deem it improper to prejudge, as they may arise in other cases in which the plaintiff may be entitled to relief in damages.").

question.[708] This argument was made successfully in *Stewart*, discussed in Part VI.B.1. of this Article. In that case, a fixed penalty in a lease applied against the tenant regardless of the severity of the breach of the lease's terms. Consequently, the Texas Supreme Court held the fixed penalty amount unenforceable.[709]

The idea of a partial buyout presupposes that the Act contemplates that paying a portion of the buyout price can alter the covenant's express restrictions. And, assuming that a court approves a partial buyout under the Act, a presumption still exist that the stated price correlates to the dimensions of the covenant's boundaries: time, geography, or activity. While it may be tempting to argue that any boundary can be reduced by a partial payment, the business reality is that the metrics of the covenant are not directly correlated with the buyout price. If a covenant covers a five mile radius, the value of the covenant to the new practice is not equal to the buyout price divided by five miles. The value depends on the percentage of the physician's patients or referral sources who are covered by the territorial restriction, who may not be evenly distributed through the restricted area.[710]

While the courts have enforced liquidated damages where the stated amount for a breach is a reasonable approximation of the damages suffered, the courts have also declined to enforce liquidated damages, though reasonable for a breach, if the stated amount applies to a variety of breaches.[711] If the stated amount will apply for breaches that are only minor infractions, the court will not enforce the provision even though the amount might be reasonable when applied to another, more substantive breach. Thus, as was the case in *Stewart*, a lease stating a fixed monthly amount for any breach of a lease is not enforceable if it applies to any breach, whether of minor or major nature.[712]

Pursuing this line of reasoning would permit an argument that there are degrees to which a covenant may not be performed. A physician subject to a five-mile covenant may open a medical practice 4.9 miles away from the

[708] Orenbaum Bros. v. Sowell Bros., 153 S.W. 905, 906 (Tex. Civ. App.—Dallas 1913, writ ref'd) (noting that the Texas Supreme Court in *Lone Star Salt Co.* did not answer the question of partial performance).

[709] Stewart v. Basey, 150 Tex. 666, 245 S.W.2d 484, 485–86 (1952).

[710] As was observed *supra* note 173, the restricted area of a covenant increases by the square of the radius.

[711] *Stewart*, 245 S.W.2d at 487.

[712] *Id.* at 486.

employer.[713] The physician has partially performed the covenant by relocating 4.9 miles away and has failed to perform by not locating an additional 0.1 miles away. The physician would argue that, in the instance of a stipulated buyout covenant, it would be unreasonable to pay the full buyout price to be excused from 0.1 miles of the covenant. Under *Stewart's* analysis, the stipulated amount begins to resemble a penalty for violating, in such a minor way, the covenant.[714] Moreover, the buyout clause clearly states that the legislature believed that the parties, or an arbitrator, could value covenants with varying boundaries. All covenants have elasticity because the boundary can be set at varying points until, at some final point, it becomes unreasonable. This observation applies to any of the three boundaries that are applicable to a covenant. As an example, a covenant might be reasonable anywhere from zero to five miles, but beyond ten miles it is considered clearly unreasonable. The distance between five miles and ten miles becomes increasingly unreasonable as it approaches ten miles.

The foregoing conclusion could render havoc on physician covenants. At the outset of employment, the parties agree to the boundaries of the covenant. At the end of employment, the employer expects full performance with the covenant or full payment of a reasonable buyout price to excuse performance.[715] In the stipulated buyout, the physician would be altering the covenant unilaterally. The employer's response would be to seek enforcement of the covenant.[716]

---

[713] *See, e.g.*, Harris v. Univ. Hosps. of Cleveland, Nos. 76724, 76785, 2002 WL 363593, at *6 (Ohio Ct. App. Mar. 7, 2002) (not designated for publication) (holding that a physician practiced 4.6 miles from former employer in breach of five mile covenant).

[714] In *Harris*, the physician sought to avoid enforcement of a five-mile covenant by the employer when he was located 4.6 miles away from the employer. *Id.* at *6 ("No cases dealing with the breach of a restrictive covenant have held that a defendant's technical, though minor, breach of a geographical restriction can affect the enforceability of the provision.").

[715] Raymundo v. Hammond Clinic Ass'n, 449 N.E.2d 276, 282 (Ind. 1983) ("However, we aware of no authority indicating that in order for a covenant to be reasonable, the covenantee must show that it had rendered its service or sold its product in every nook and cranny of the protected area. Were it otherwise, no such covenant could ever stand.").

[716] *But see* WSP, Inc. v. Wyo. Steel Fabricators & Erectors, Inc., 158 P.3d 651, 655 (Wyo. 2007) (reviewing a trial court's determination of the buyer's damages for the seller's partial performance of a covenant arising from the sale of a business, in which the court allocated the damages based on the number of months the seller violated the covenant divided by the duration of the covenant.

XII. COVENANTS ASSOCIATED WITH THE SALE OF A MEDICAL PRACTICE

The focus of this Article has been on the buyout of covenants associated with the employment of a physician, as this arrangement is the most prevalent physician arrangement that is governed by the Act. Nonetheless, the employment arrangement is not the only arrangement in which a physician may be subject to a covenant. The Act is not limited only to employment arrangements.

Physicians often sell their medical practices. These sales may be as simple as a physician retiring from the practice of medicine and selling his or her patient charts to another, perhaps newly trained, physician. In that sale, the buying physician will want to obtain a covenant from the selling physician to preserve the value of the charts purchased. The sale may also be more complicated, such as when a medical practice sells its assets to a management company. The management company will pay the medical practice for its assets and the ability to provide ongoing management services for a fee over a guaranteed period of time. Similarly, in that sale, the management company will obtain a covenant from the selling physician to protect the value of its management arrangement. As has been observed earlier in this Article, the courts are much more likely to enforce a covenant against a selling physician, and the reasons are compelling.[717] The buyer has given the selling physician substantial consideration for the purchased assets. Moreover, the nature of the purchased assets contain a strong element of "goodwill," in that the buyer is purchasing the assets on the assumption that the assets will have continuing "going concern" value after the sale is completed.

In addition to the sale of a practice, most physicians who practice in an entity setting, such as a professional association[718] or a professional limited liability company,[719] enter into stock transfer restriction agreements or buy-sell agreements. Under these agreements, the entity and its physician owners agree that if certain events occur as to any owner, the entity and the other owners may, or, in some arrangements must, buy the affected

[717] *See* Stocks v. Banner Am. Corp., 599 S.W.2d 665, 667 (Tex. Civ. App.—Texarkana 1980, no writ) ("Covenants not to compete found in employment contracts are generally construed more strictly against the employer than those covenants made in connection with the sale of a business.").

[718] *See* Tex. Bus. Orgs. Code Ann. §§ 302.001–.013 (Vernon 2008).

[719] *See id.* § 304.001.

shareholder's ownership interests. Triggering events for the buy-sell agreement include, among others, the death or disability of the physician, retirement, or cessation of employment. It is not uncommon for a buy-sell agreement to include a covenant restricting the physician whose ownership interests are being purchased from competing with the entity. Obviously, the covenant would not have much meaning in the events of death and disability, but the covenant becomes vitally important in the event of the separation of the physician from the practice.

Covenants may be contractually imposed on physicians in non-employment arrangements. In order to generate additional income from investment opportunities related to their medical practices, physicians will purchase shares or membership interests in specialty hospitals or ambulatory surgical centers in which they treat patients. These arrangements are subject to a variety of fraud and abuse laws previously noted in this Article. In order to prevent a physician from competing with the medical facility, the ownership arrangements pertaining to the physician's investment in the facility will require the physician to abide by a covenant after the physician divests his or her ownership interests. The covenant will restrict the physician from owning an interest in a competing facility. An example from an ambulatory surgery partnership is:

> The partners agree that during the period that a partner is a partner and for two (2) years after the date such person is not a partner, the partner shall not directly or indirectly have an ownership interest in or operate an ambulatory surgery center within ten (10) miles of the partnership's ambulatory surgery center.

All of the above arrangements falls within the purview of the Act's buyout clause. Strictly speaking, any covenant associated with the arrangement should contain a buyout option or it will not be enforced. The legislature likely did not even consider the possibility of these arrangements when it passed the buyout clause. The legislative history strongly indicates that the buyout clause had only one purpose: to safeguard the right of a patient to continue treatment with a physician, although the physician is the only person who can safeguard the right by buying out the covenant. In the context of the sale of a medical practice from one physician to another, the patients of the practice will have the opportunity to continue care with the purchasing physician, and the purchasing physician will want the assurance

that the selling physician will not reenter the market and undermine the value of the practice that was purchased.

Nevertheless, covenants in these arrangements must comply with the buyout clause and offer the restricted physician the right to buyout the covenant. The valuation of the buyout price should still follow the lost profits formula discussed in Part V.B. Those various factors will apply equally to a covenant arising in connection with these other arrangements not tied specifically to employment. In each of these other arrangements the central issue to the buyout price is the lost profits that the promisee of the covenant will suffer if the covenant is not honored. However, the buyer of the medical practice, as opposed to the employer, will be in a position to show that the buyout price should be based on a longer period of time than what an employer would require to hire a successor physician and introduce him or her to patients and referral sources. The buyer should be entitled to a longer period of protection in order to recoup the investment in the practice, which would particularly be the case if the purchase price was based on some multiple of earnings.[720]

XIII. SUGGESTED LEGISLATIVE CLARIFICATIONS

The buyout clause was conceived as a very narrow legislative remedy to promote the state's public policy of unrestricted patient access to physicians. Unfortunately, as pointed out in prior parts of this Article, there are troubling substantive and procedural deficiencies in the Act. The first substantive deficiency is whether the buyout clause is conjunctive or disjunctive in its requirements for the inclusion of a stipulated buyout option or an arbitrated buyout option. The second substantive deficiency is the omission of the power to reform the stated price in the stipulated buy out covenant. The most significant procedural deficiency is the absence of guidance on how the arbitrator should conduct the arbitration and the scope of the arbitrator's adjudicative powers over a covenant.

The following revised Act is proffered to correct the foregoing deficiencies:

[720] RESTATEMENT (SECOND) OF CONTRACTS § 188, cmt. f, illus. 4 (1981).

§ 15.50. Criteria For Enforceability Of Covenants Not To Compete.

(a) Notwithstanding Section 15.05 of this code, and subject to any applicable provision of Subsection (b), a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.

(b) A covenant not to compete is enforceable against a person licensed as a physician by the Texas State Board of Medical Examiners if such covenant complies with the following requirements:

(1) the covenant must:

(A) ~~not deny~~ allow the physician to request and receive ~~access to~~ a list of the patients, and their contact information, whom ~~he~~ the physician had seen or treated within ~~one year~~ two years of termination of the contract or employment;

(B) provide access to medical records of the physician's patients upon authorization of the patient and any copies of medical records for a reasonable fee as established by the Texas State Board of Medical Examiners under Section 159.008, Occupations Code; and

(C) provide that ~~any access to a~~ the list of patients, and their contact information, or ~~to~~ the patients' medical records, ~~after termination of the contract or employment shall not require such list or records to~~ may be provided in the same format ~~different that that~~ in which the records are maintained ~~except by mutual consent of the parties to the contract~~;

(2) the covenant must provide for a buy out of the covenant by the physician at a reasonable price by one of the following means, which may not be waived prior to the

termination of the contract or employment: ~~or, at the option of either party, as determined by a mutual agreed upon arbitrator or, in the case of an inability to agree, an arbitrator of the court whose decision shall be binding on the parties~~; and

(i) the covenant may state a reasonable buy out price or the means of calculating a reasonable buy out price; or,

(ii) the covenant may allow either party to request an arbitrator to determine a reasonable buy out price promptly after the termination of the contract or employment; and

(3) the covenant may contain additional reasonable provisions to promote or effect the buy out if the provisions are not contrary to the purposes of this Act; and,

(4) the covenant must not prohibit ~~provide that~~ the physician ~~will not be prohibited~~ from providing continuing care and treatment to a specific patient or patients during the course of an acute illness even after the contract or employment has been terminated.

§ 15.51. Procedures And Remedies In Actions To Enforce Covenants Not To Compete.

(a) Except as provided in Subsection (c) of this section, a court may award the promisee under a covenant not to compete damages, injunctive relief, or both damages and injunctive relief for a breach by the promisor of the covenant.

(b) If the primary purpose of the agreement to which the covenant is ancillary is to obligate the promisor to render personal services, for a term or at will, the promisee has the burden of establishing that the covenant meets the criteria specified by Section 15.50 of this code. If the agreement has a different primary purpose, the promisor has the burden of establishing that the covenant does not meet those criteria. For the purposes of this subsection, the "burden of establishing" a fact means the burden of persuading the ~~triers of fact~~ the trier of fact that the existence of the fact is more probable than its nonexistence.

The trier of fact is the court, or if properly requested the jury, except the arbitrator is the tier of fact under Subsection (d) of this section.

(c) If the court finds the covenant based on the determination of the trier of fact ~~is found~~ to be ancillary to or part of an otherwise enforceable agreement but contains limitations as to time, geographical area, or scope of activity to be restrained that are not reasonable and impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee, the court shall reform the covenant to the extent necessary to cause the limitations contained in the covenant as to time, geographical area, and scope of activity to be restrained to be reasonable and to impose a restraint that is not greater than necessary to protect the goodwill or other business interest of the promisee and enforce the covenant as reformed, except that the court may not award the promisee damages for a breach of the covenant before its reformation and the relief granted to the promisee shall be limited to injunctive relief. If the primary purpose of the agreement to which the covenant is ancillary is to obligate the promisor to render personal services, the promisor establishes that the promisee knew at the time of the execution of the agreement that the covenant did not contain limitations as to time, geographical area, and scope of activity to be restrained that were reasonable and the limitations imposed a greater restraint than necessary to protect the goodwill or other business interest of the promisee, and the promisee sought to enforce the covenant to a greater extent than was necessary to protect the goodwill or other business interest of the promisee, the court may award the promisor the costs, including reasonable attorney's fees, actually and reasonably incurred by the promisor in defending the action to enforce the covenant.

(d)(i) If a covenant contains a buy out pursuant to Section 15.50(b)(2)(i) of this Code, the court shall also determine the issue of a reasonable buy out price and if the court finds

the price to be unreasonable, the court shall reduce the price to a reasonable amount.

(ii) If a covenant contains a buy out pursuant to Section 15.50(b)(2)(ii) of this Code, the arbitrator shall decide all issues pertaining to the covenant and exercise the powers of the court described in this Section 15.51. The arbitration shall be conducted pursuant to the Texas General Arbitration Act, Civil Practice and Remedies Code Chapter 171. The parties by agreement may agree to use a dispute resolution organization defined in Section 154.001(2) of the Civil Practice and Remedies Code as to any portion of the arbitration proceeding. The parties may select the arbitrator by mutual agreement and if they cannot agree, either party may apply to the court for the appointment of an arbitrator.

(iii) The Texas State Medical Board shall adopt procedures for reporting results of arbitrations pursuant to Section 15.50(b)(2)(ii).

§ 15.52. Preemption Of Other Law.

The criteria for enforceability of a covenant not to compete provided by Section 15.50 of this code and the procedures and remedies in an action to enforce a covenant not to compete provided by Section 15.51 of this code are exclusive and preempt any other criteria for enforceability of a covenant not to compete or procedures and remedies in an action to enforce a covenant not to compete under common law or otherwise and include preliminary determinations made prior to final enforcement of a covenant.

CONCLUSION

In the world of covenants, physicians enjoy a unique advantage over all other employed persons, save for attorneys. This advantage resides in the buyout clause of the Act. As a result of the buyout clause, a physician holds the power to control his or her professional destiny by choosing to exercise or not exercise the buyout right. As was seen, the buyout right stems from the Texas Legislature's concern that patients would not be able

to continue treatment with a physician subject to a covenant. The legislature did not necessarily consider physician covenants to be enforceable as against Texas public policy, but it sought a means to assure patients continued care during acute illnesses and empower physicians with the ability to continue care with previously established patients, and new patients, if the physician bought out the covenant. This Article points out, however, the effect of the covenant on patient choice, and access to any physician may still need to be considered by a court when evaluating whether the covenant's restraints are reasonable.

On its face, the buyout clause of the Act requires the application of a reasonable price for the buyout of the covenant. Unfortunately, the term "reasonable price" in isolation gives no direction, and, too often, covenants state some arbitrary figure. This Article began as the author's attempt to better understand the legal basis for determining a "reasonable price." The price that a stipulated buyout covenant should state, or the price at which the arbitrator should arrive, is a price that bears a direct correlation to the employer's anticipated lost profits and possibly other expenses that the employer will suffer. This theory is simple in the abstract, but the circumstances of the medical practice that are unique to each physician and each employer must be taken into account. The parties can forecast the consequences, perhaps not with exact measurement, and arrive at a reasonable estimate using the employer's financial information. While the principles of valuation discussed in this Article are soundly grounded in law, the application of these principles, and in particular the multi-step valuation process discussed in Part V, will greatly annoy employers. Nevertheless, applying these principles to the greatest practical degree possible will result in a physician covenant that a court is more likely to enforce.

Too often in practice an employer simply inserts the physician's annual salary in the covenant as the buyout amount. This amount has no rational relationship with the damages that the employer might actually suffer. When the employer uses this "rule of thumb," the employer risks in a subsequent dispute with the physician the outcome that a court will refuse to enforce the covenant.