A NEW PRESCRIPTION FOR PHYSICIAN RESTRICTIVE COVENANTS IN ILLINOIS

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For years, Illinois courts generally upheld the validity of restrictive covenants in physician employment and shareholder agreements. But recently, courts have issued decisions that will provide physicians and the attorneys that represent them with a greater ability to challenge the enforceability of restrictive covenants.

I. Background

These developments come as the healthcare landscape is undergoing rapid and systemic change. The Affordable Care Act (ACA) mandates the use of costly information technology systems to comply with quality of care metrics in order to obtain more favorable reimbursement rates from Medicare and other government healthcare reimbursement programs. These ACA mandates compound the existing problems and pressures of malpractice insurance and diminishing reimbursement rates from private third-party payors. As a result, many physicians are deciding that they do not want the administrative, financial and legal burdens of owning and operating their own independent medical practice.

In turn, hospitals and health systems view direct employment of experienced and established physicians as a critical element to securing market share in the communities they serve. This dynamic has created mobility in the profession as physicians move from independent practice to employment by large multi-specialty groups, hospitals and health systems.

As this seismic shift is occurring, physician practices and hospitals that are seeing physicians leave are confronted with the challenge how to enforce restrictive covenants. Historically, restrictive covenants, or non-competition provisions, have been widely used in the medical profession. The justification has been that they allow an established medical practice or hospital practice to recruit, hire, and train young physicians with some comfort that if the physician ever leaves the practice, they will not go into direct competition with the practice for a reasonable period of time.

This area of the law was once guided by well-settled rules and tests, but now the enforceability of those restrictive covenants will turn on a variety of fact specific issues that will likely add to the time and expense of litigating such cases.

II. The Basic Rules: A Legitimate Protectable Business Interest

As a threshold matter, for a restrictive covenant to be enforceable, it must be reasonable in

duration and geographic scope and supported by consideration exchanged by the parties. Once this threshold test has been met, the court will inquire into the reasonableness of the restrictions using the following factors:

- The restrictions are no greater than is required to protect *a legitimate business interest* of the employer;
- It does not impose *undue hardship* on the employee; and
- It is *not injurious to the public*.

This three prong analysis has come to be known as the "*rule of reason*" test that is used by lawyers and judges determining the enforceability of restrictive covenants.

Over time, Illinois courts also came to give great weight to others factors such as:

- whether competition from the former employee would threaten "permanent or near permanent" customer relationships;
- whether there is a risk that the employer's confidential business information might be used by the departing employee for his or her own benefit.

Dating back almost 60 years, Illinois case law has held that physician practices have a legitimate business interest in limiting competition from a former member of the group and that a restrictive covenant to that effect does not pose a risk of harm to the public. As recently as 2006, the Illinois Supreme Court specifically reaffirmed that restrictive covenants are permissible in physician employment arrangements, so long as they are reasonable and serve a legitimate business interest.

III. The *Reliable Fire* Case: A Facts & Circumstances Test

In 2011, in an effort to clarify the appropriate standard for what constitutes a "legitimate business interest," the Illinois Supreme Court issued a decision that was both praised and criticized at the time.

The ***Reliable Fire*** case (so named for the company that brought the appeal of a lower court's refusal to enforce a restrictive covenant) holds that the process of determining what constitutes an employer's legitimate business interest is not a strict, rule-based analysis using only the "rule of reason" test. The court stated that permanency of the relationship with a client/patient or the misappropriation of confidential business information by a competing former employee would no longer be regarded as the exclusive tests to enforce a restrictive covenant.

Rather, the court held the "rule of reason" test and these other factors are merely "inconclusive aids" and that a balancing test, with a careful analysis of the totality of the circumstances of the particular set of facts surrounding each individual case, is required to determine if a legitimate business interest exists to enforce a restrictive covenant.

Moreover, the court ruled that in determining whether a legitimate protectable business interest exists, no one factor carries any more weight than any other factor. The importance of any factor used in the analysis is dependent on the specific facts and circumstances of each individual case. The court was careful to note that it was not expressly overturning previous cases that it had decided using the strict, rules-based formula for reviewing the validity of restrictive covenants. But those cases are now of limited precedential value and will have to be carefully analyzed to determine if they provide support to an employer's efforts to enforce a non-compete provision of a contract.

The court also ruled that the parties must be given a full opportunity to develop the necessary evidentiary record before the trial court can rule on whether a restrictive covenant should be enforced.

IV. The Facts & Circumstances Test Applied To Physician Practice Agreements

In 2013, the First District Appellate Court, an intermediate level appeals court in Chicago, used the standards set forth in *Reliable Fire* to analyze the totality of the facts and circumstances of a restrictive covenant contained in a physician employment agreement and determined it was unenforceable.

A gastroenterologist in the northern suburbs who had been with a practice for 10 years left his group to join NorthShore University HealthSystems Medical Group. The former group sued to enforce a restrictive covenant against the departing physician. After considering all of the evidence using the standards dictated by the Illinois Supreme Court in the *Reliable Fire* case, the trial court ruled in favor of the physician and found the group had no legitimate business interest in need of protection that would mandate enforcement of the restrictive covenant.

In upholding the trial court, the Appeals Court reviewed several factors, including the group's business operations and inbound referral streams, and determined that the relationship between the group and the patients was not a near permanent one. The evidentiary record developed in the case showed that although the physician was a member of the group, his patient referral stream, marketing and billing systems, and compensation were all independent of the members of the group. The physician even maintained a separate office location and phone number from the group. In light of these factors, the court ruled that the relationship existed between the departing physician and his patients. Therefore, the group had no legitimate business interest in need of protection from competition by the departing physician.

A short time later, the Appellate Court followed up with another decision holding that no legitimate business interest existed in enforcing a restrictive covenant that did not contain a specific limitation on the time a physician was restricted from competing with his practice.

V. Conclusion

So what does all this new case law mean to physicians and their employers?

For starters, employers who may believe they have an open and shut case to enforce a restrictive covenant will likely be frustrated and surprised to find out that Illinois courts will now give much greater latitude to a former employee to put forth evidence to establish: 1) their current employment does not actually compete with the employer; and 2) there is no a legitimate business interest on the part of the employer for the court to protect. Courts will be much less inclined to grant the employer a temporary restraining order (TRO) or other initial injunctive that in the past could leave departing physician professionally paralyzed while the merits of the case are litigated. Before ***Reliable Fire***, the prospect that a judge might issue a TRO would serve as a strong deterrent against the physician leaving in the first place.

The discovery phase of litigation to enforce restrictive covenants will likely become more time consuming and expensive as the parties attempt to develop the law and facts together in such a way that the court will find in their favor on the issue of whether a legitimate protectable business interest exists.

Certain types of single specialty physician groups, such as primary care or oncology, that have near permanent relationships with patients may have greater success enforcing restrictive covenants than those groups where the patient relationship is more transient.

The business structure and cost sharing arrangements of physician groups will be reviewed closely to determine if a departing physician's future endeavors actually compete with the group they are leaving, or if the departure is a simple reshuffling of chairs that the court should not restrain.

Surely, the regulatory and market forces that are roiling the healthcare industry and driving the move towards greater integration and consolidation among physicians and hospitals will be given weight by courts as they attempt to determine if a legitimate business interest is served by enforcing a restrictive covenant.

The recent case law in effect levels the playing field between employers and departing physicians. This changed dynamic should also have the effect of inducing employers to negotiate a settlement, rather than litigate, a dispute over the interpretation of the terms or enforceability of a restrictive covenant. Even when a disputed employment or shareholder agreement does not provide a departing physician the option to "buy-out" of the restrictive covenant, the parties may find it in their best interest to negotiate a financial settlement that spares everyone the uncertainty of litigation and allows a quicker resolution of the case.

One thing is certain. The recent case developments require healthcare providers to pull out and dust off their physician employment and shareholder agreements and revisit the terms to

determine if they still reflect the realities of the group's practice structure and comply with the law. If they don't, those documents should be revised and redrafted to better suit the business interests of the practice.

Physicians who have been reluctant to explore employment opportunities out of a fear they would be sued by their group for violating a restrictive covenant may now find reason to be emboldened by the recent developments in Illinois law.

In the meantime, the fast moving trend in healthcare business arrangements towards greater integration of hospitals, health systems and physicians will continue. And the case law in Illinois on the enforcement of restrictive covenants will rapidly catch up to those trends.

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