PROTECTING YOUR CLIENT BASE

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As with many successful doctors, you may one day wish to hire an associate to work on your patients. Naturally, you want to be sure that if your associate does not work out for any reason, and leaves the practice, the associate won't try to take your clients away from you. At this point, you may wish to contact an attorney specializing in the medical/veterinary field and ask he or she to draft an employment agreement covering these concerns. Depending on that attorney's level of expertise, you may or may not end up with an employment agreement that prevents the associate from misappropriating your client lists and damaging your practice.

In this article, we discuss the two most common tools utilized by attorneys in preventing an associate's misuse of your client base. This article covers the effectiveness of non-competition agreements and trade secret agreements commonly contained in employment agreements with associates.

Non-Competition Agreements:

California Business & Professions Code §16600, enacted by the California Legislature in 1941, provides in part, the strong public policy against restraints on a person from engaging in their profession, by stating "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind, is to that extent void." Notwithstanding this language, the California legislature also enacted B&P §16601 and 16602 in order to provide limited exceptions under which non-competition agreements would be enforceable. These exceptions include:

1. The sale of the goodwill of a business wherein the seller agrees not to compete.

2. The sale by a shareholder of all of such persons' shares in a corporation.

3. The dissolution of a partnership by partners who agree not to compete.

4. The sale of an individual partner's interest in a partnership, wherein the remaining partner (or partners) carries on the business.

5. The sale of all or substantially all of the operating assets, including goodwill, of a corporation or its subsidiary or division.

The applicable statutes also provide that the seller agrees "to refrain from carrying on a similar business within a specified county or counties, city or cities, or a part thereof, in which the business so sold.... has been carried on," provided that the buyer or any person deriving title to goodwill or shares, "carries on a like business therein." B&P §16601 (also see B&P §16602). The foregoing restrictions also apply to the sale of interests in limited liability companies, but since medical professionals cannot form limited liability companies to operate their practices in

California, this article will not attempt to deal with such entities.

There have been many attempts by physicians and veterinarians to have non-competition agreements apply to their associate doctors. In Bosley Medical Group v. Abramson 207 Cal. Rptr. 477, 161 Cal.App.3d 284, the California Court of Appeal denied an attempt by a medical group to enforce a covenant not to compete against a plastic surgeon who had left employment with the group. The surgeon's employment contract provided that when he left the group, he must sell his entire stock interest back to the corporation. The court found the transaction to be a sham designed to avoid the prohibition against non-competition clauses, as the surgeon had been forced to buy a non-controlling interest in the corporation as a condition to employment, and was forced to resell the interest upon leaving. In order for the non-compete clause to be enforceable, the court said the interest sold must be substantial and must represent the goodwill of the corporation. While Bosley was later limited to the specific facts raised therein, in the case of Vacco Indus. v. VandenBerg (1992) 5 Cal.App.4th 34, the principal of Bosley was affirmed in Vacco, in that if the court found that a stock sale was a sham device to impose an otherwise illegal non-compete clause on the shareholder's future activities, it would not enforce it.

The courts have consistently held that employment agreements containing non-complete clauses preventing the employee from operating a similar, competing business in the same area, are not applicable unless the provisions of California Business & Professions Code §§16601-16602 are met; i.e., either the sale of goodwill or the sale of a business under the conditions outlined above. See for example, Golden State Linen Service, Inc. v. Vidalin (1977) 69 Cal.App.3d 1; see also Thompson v. Fish (1957) 152 F. Supp. 779. In one amusing case, involving the radio station mascot who dressed up and performed in a chicken suit at San Diego Padre baseball games, the court refused to enjoin the "chicken" from appearing at other baseball games and events wearing a similar chicken outfit, stating that since the "chicken" did not wear the radio stations call letters or claim that he represented the station, this was not competitive, even though the "chicken" continued to play the same fluid, clownish role he created spontaneously while serving as the station's mascot at the Padre's games. KGB, Inc. v. Giannoulas (1980) 104 Cal.App.3rd 844.

Generally speaking, non-complete clauses contained in employment agreements are not enforceable under current California law, and it is our policy to discourage the inclusion of such provisions in employment agreements with associates. In California it is well established that such provisions are unenforceable in employment contracts, and including them in employment contracts raises a red flag easily seen by a competent judge.

Trade Secrets:

What then is a veterinarian or another medical professional to do to protect himself and his client base, when hiring a new associate? The answer lies in preparing a carefully worded, trade secret agreement providing that the client lists and identities are secrets of the owner-doctor, and also providing appropriate sanctions which may be enforced by a judge.

The state of California enacted the Uniform Trade Secret Acts in 1984 (later amended) in an attempt to codify existing case law. This law has now been adopted in 42 states and the District of Columbia. California's version is contained at California Civil Code §3426.1-3426.11. It sets forth provisions under which an employer may seek to bar the misappropriation and misuse of trade secrets by employees and former employees. The definition of "trade secrets" under CC §3426.1 is information that "derives economic value, actual or potential, from not being generally known to the public or to the other persons who can obtain economic value from this disclosure or use; and is the subject of efforts that are reasonable under the circumstances to maintain its secrecy." (CC §3426.1) In veterinary and medical practices, patient and client lists clearly have independent economic value, and are not generally known to the public or to other persons. Provided doctors takes reasonable efforts to maintain the confidentiality of those client lists, the lists constitute trade secrets which are protected under such law.

In cases interpreting what a trade secret is for purposes of enforcing restrictions in an employment agreement, the courts have generally concluded that the employer must demonstrate that the information is confidential, that the employer took steps to maintain that confidentiality, and that the information on the lists is not information that can be readily ascertained by anyone. One of the most common areas of dispute regarding trade secret cases arises where former employees use customer lists provided to them while employed. In the medical/veterinary practice situation, these lists represent goodwill, and are often the most valuable asset of the practice.

The issue of whether customer lists are a trade secret largely depends on whether the names and other pertinent information, such as the amount and type of insurance they have, are confidential and not easily learned by a competitor. In Ingrassia v. Bailey (1959) 172, Cal.App.2nd C.A. 2d 117, 122, 341e.2d 370, a catering route owner sought to enjoin the defendant from soliciting the owner's industrial catering customers (employees of industrial plants), arguing that information concerning these employees was confidential information, as the caterer made the scheduling of trucks to make efficient stops at the right times, knew the number of employees interested in the service, and knew their particular preferences in food and beverage. The defendant argued that since the companies served could easily be ascertained from phone books and directories, it was not a trade secret. The court held that such lists were trade secrets, as this specific information was not easily discoverable. In State Farm Net. Auto Ins. Co. v. Dempster (1959) 174 Cal. App.2d 418, 426, an insurance company tried to prevent its former employee from soliciting insurance clients of the company that defendant had dealt with while working for the company in providing the clients with insurance. The court found that activities of the defendant while working for the insurance company in developing special knowledge of the customer's insurance habits, including the expiration dates of their policies and the vital statistics of the policy holder, were trade secrets. The California Supreme Court ruled in Aetna Bldg. Maintenance Co. v. West (1952) 39 C2d 198, that if customer identities were easily discoverable through consulting business directories and phone books, the lists did not constitute trade secrets. Other cases have similarly held that where the customers names were readily ascertainable through public records, telephone directories, trade directories, and similar sources, that the customer information could not be considered a trade secret, absent other special, "hard to find" information about the customer, such as the type found in the *State Farm Net Auto Insurance Co*. case cited above.

In a professional practice, particularly in a veterinary practice situation, it can be persuasively argued that the patient/client lists are confidential trade secrets which cannot be used by the former associate in order to solicit the clients. While the client names, addresses and telephone numbers may be ascertainable in a telephone directory, the fact that those patients have chosen the particular veterinarian for specific treatment is not readily ascertainable, nor are the health histories of your clients pets, the present needs of such patients, or the amount and type of insurance coverage possessed by the patients' owners However, it is very important to keep such material under "lock & key." Restrict access to computer patient files, with only the owner and the billing person having the computer codes. Applying the holding in Ingrassia, a court should have little trouble concluding that this is very specific patient information which employees cannot learn on their own and, therefore, constitutes protectable trade secrets. Therefore, we believe that such client lists are protectable, and owners of practices should be able to prevent the theft of such information by their associates.

It is crucial that the employer have their associates sign a confidentiality agreement regarding trade secrets. In one case decided under a sister state's version of the Uniform Trade Secret Act, the court found that the potential buyer of a game manufacturing company was not bound by a confidentiality agreement since no express agreement had ever been entered into, although other issues existed which prevented the court from granting the summary judgment sought by the game company. <u>Editions Play Bac, S.A. v. Western Publishing Co.</u> (SD NY 1993 31 USPQ 2d 1338. In another case, a court considered it to be very significant that the owner of a trade secret failed to get a written confidentiality agreement, although the owner also alleged an oral agreement which meant there was a triable issue of fact to be determined at trial. <u>Mayline Partners, L.P. v. Weyerhaeuser Co.</u> (ND Cal 1994) 31 USPQ 2d 1051. In the two aforementioned cases, it is the author's belief that had the owners of the trade secrets entered into written confidentiality agreements, and provided they showed violations of the confidentiality agreements, the owners likely would have prevailed at a summary judgment hearing, thus saving the owners significant litigation costs. Therefore, it is essential that such applicable agreements be properly drafted and be in writing.

Employment agreements should also contain enforcement mechanisms whereby the parties stipulate to filing for injunctive relief without proof of actual damages, so that a judge may issue a restraining order preventing client solicitations of the owner's patients. Often such agreements contain liquidated damage clauses which act as a "disincentive" to the associate violating the owner's trade secret rights. The inclusion of such provisions will make it much easier for the owner to protect his or her client base.

<u>**Summary:**</u>

Covenants not to compete are a poor vehicle for use in seeking to prevent an associate from competing with the doctor following termination. While covenants not to compete are enforceable against sellers in the context of a practice sale to a new doctor, they are generally not enforceable as against associates with no real ownership interest in the practice. However, if a carefully drafted employment agreement containing trade secret provisions is entered into between the owner and the associate doctor, these lists should be protectable under applicable law.

We strongly urge our clients who are thinking of hiring associates to have in place an appropriate employment agreement with trade secret provisions, in order to prevent the ambitious associate from converting the patient lists to the associate's own use.