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Valuing Covenants Not-to-Compete: an 11-Factor Checklist

By Gary Trugman

The most common approach to valuing a covenant not-to-compete involves a "with and without" analysis, in which the appraiser estimates value based on the difference of two discounted future benefits calculations. A similar method, the lost profits analysis, which projects the present value profits that the acquired company would lose if the seller continued to compete, will reach pretty much the same value. A third method, compensation-based, measures the income that the seller loses due to the CNC, but it is not always appropriate since it does not measure value to the purchasing party.

A covenant not-to-compete (CNC) is an agreement between parties to the sale of a business, by which the seller typically agrees not to compete in the same industry for a specified period of time and within a specific geographic period. A CNC can be part of a large corporate asset sale or divestiture, or it can accompany the sale of a solo professional practice or family business. In either case, the contract for sale may include the covenants, or they can appear in a separate, non-compete agreement.

CNC as an intangible asset. Since a CNC is based purely on a contractual agreement, it has value to the degree that it protects the value of the purchased assets of the business (both tangible and intangible) by restricting the seller's competitive conduct after the sale. As such, a CNC's value is dependent on factors such as:

- The ability of the seller to compete after closing the sale, which may implicate the seller's age, health, professional standing, etc.;
- The derivation of the non-compete; and
- The losses the buyer (company) would suffer if the seller, in fact, competed.

In most cases, an eight-step approach, "with and without," will provide a comprehensive and correct method for valuing the CNC. Except for the last two, these steps may not always follow in sequence:

1. Identify the legitimacy and "economic reality" of the CNC (explained in more detail below).
2. Determine the value of the company assuming enforcement of the CNC. The parties may have already allocated this value in their agreements or in forecasts used to determine acquisition price.
3. Develop projections assuming competition from the selling party, based on historical trends and margins, growth drivers, asset utilization ratios, capital expenditures, etc.
4. Determine the overall value of the company assuming competition from the seller, using the forecasts developed in step 3.
5. Determine the differential between the values derived in steps 2 and 4;
6. Quantify the impact of amortization (tax savings), depending on the purpose and function of the valuation. In effect, once you have valued the CNC, do another projection that uses the deductibility of the CNC amor-

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tization to adjust the future taxable income (and thus profits).

7. Calculate the final value of the CNC, with any additional adjustments based on the probability of the seller's competition.

8. Conduct a "sanity check." Does the concluded value make sense, taking into consideration the bigger picture of the business, industry, and other economic factors?

Obviously, the value of the CNC cannot exceed the total purchase price. Analysts can also check for reasonableness by examining the percentage of CNC value to total transaction values of other comparable sales.

11-factor test for economic reality. Many articles have addressed how to determine the "legitimacy" of CNCs. (Keep in mind that legitimacy does not equate to legal enforceability, which requires the opinion of legal counsel.) Several court cases have also developed tests by which to determine the "economic reality" of non-compete agreements. For instance, in *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979), the Federal Court of Claims summarized the four conditions that a CNC should meet to qualify for federal tax amortization:

- *Severability.* Whether the compensation paid for the CNC is severable from the price paid for the acquired goodwill;

- *Anticipated repudiation.* Whether either party to the contract is attempting to repudiate an amount knowingly that they both knowingly fixed or allocated to the CNC;

- *Intent.* Whether there is proof that both parties actually intended to assign a price to the CNC when they executed the sale agreement; and

- *Economic reality.* Whether the covenant is economically real and meaningful.

Clearly, the facts and circumstances in any individual case are important to consider. The sale documents, agreements, and discussions between the buyer and seller are also vital components to understanding the evolution and import of their deal and whether a CNC has economic substance and legitimacy.

Following *Forward Communications* and the cases cited therein, the Tax Court set forth an 11-factor test to determine the economic reality of a CNC in *Thompson v. Commissioner*, T.C. Memo 1996-468 (1996)(available at *BVLaw*). These 11 points also furnish a good basis for assessing the probability of the seller's competition:

9. *Grantor's business expertise.* What knowledge and skills are necessary to run a competing business? Does the seller (grantor of the CNC) have these requisite skills?

10. *Grantor's intent to compete.* Why did the grantor sell the company? Does the grantor intend to return to the market after the CNC expires?

11. *Grantor's economic resources.* Does the grantor have the financial capacity and resources to compete with the acquired company?

12. *Potential damage to the grantee.* Will the acquired company (grantee) lose business if the grantor chooses to compete?

13. *Grantor's network.* Did the grantor build relationships with customers, suppliers, and other contacts of the acquired business? Did customers and suppliers choose to do business with the acquired company or the grantor?

14. *Duration and geographic scope.* Where did the grantor do business prior to the sale of the company? Does the CNC adequately restrict the grantor from competing in this area?

15. *Enforceability.* Does state law permit the enforcement of the CNC? Are the consequences for breach of the non-compete agreement legal?

16. *Age and health of the grantor.* Given the age, health, and retirement prospects of the grantor, is it reasonable that he or she will be able to compete with the acquired company?

17. *Payment terms.* How do the sale agreements measure payments to the grantor? If they require payment over the term of the CNC, and if there is more than one selling shareholder, are those payments pro rata by ownership interest to all shareholders? Or is payment measured by contributions to the company prior to acquisition?

18. *Payment duration.* If the sale agreements require payment over the term of the CNC, what happens to that obligation should the grantor die or breach the contract?

19. *Negotiations.* Did the parties "vigorously" negotiate the terms and value for sale of the company and its assets?

Final check. This article is intended to provide a summary overview of the key issues surrounding CNC valuations and a practical approach to use when valuing such an asset. As with all other aspects of valuation, analysts must carefully consider all the particular facts and issues, conduct the proper research and due diligence, and measure the reasonableness of all inputs they have used to determine the value of the CNC.

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