

## "Valuation of a Covenant Not to Compete"

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### "Valuation of a Covenant Not to Compete"

A covenant not to compete attempts to sculpt the market. As with all art, beauty is in the eye of the beholder.

#### **OUTLINE OF THE LEGAL ANALYSIS**

A covenant not to compete attempts to control market participants. The parties to a covenant not to compete might share a variety of commercial relationships. Some of the most frequent are employer-employee and sale of a business or significant business asset. Because an employment relationship often generates a covenant embedded in an adhesion contract, this paper will focus on commercial relationships. Regardless of the initial relationship, central to the covenant not to compete (CntC) is the belief that the identity of your competitor has a material impact on market conditions and opportunities.

When an employee is significant to the success of a firm, either as a contributor or as risk, the employee should be and quite often is covered by a covenant not to compete. These ancillary contracts often are ignored once created, until the covenant is violated. Opportunities for valuation exist throughout the life cycle of the covenant. Violation presents one valuation opportunity. However, this paper will be much broader in focus. Rather than merely looking at an enforcement value, this paper will address valuation

concerns across the entire life cycle ranging from prior to the creation, through asset management, and to termination.

Let's start by quickly sketching out the legal dimensions of this asset. Covenants not to compete, in the USA, are permissible, but are not favored by the law. Such covenants restrain trade, but may be allowed if supported by another public policy. A valid covenant not to compete must be ancillary to a legitimate business purpose. For example, it is quite ordinary for covenants to protect the sale of good will or to protect trade secrets disclosed in the ordinary course of employment.

Each jurisdiction has its own law governing covenants not to compete, but the USA States are relatively uniform in their description of the boundaries of a valid covenant. All States allow covenants not to compete that are ancillary to or are proportional to the parties' legitimate business interests and which restrain no more than a reasonable time and a reasonable geographic area. While the States use the same words, they do not use the same meanings for those words. For example, in Nebraska a presumptively reasonable time and area is one year and one county; while in neighboring South Dakota a presumptively reasonable time and area is two years and one county. Upon proof to the court, the parties may enforce greater times and greater areas that are sufficient and necessary to protect the parties' legitimate business interests. To date, the greatest time and area allowed in Nebraska is five years and five counties for a specialist in farm and ranch taxation doing business in the center of that rural State.

An additional variation is each Stat's judicial reaction to an over broad covenant. The courts have three basic approaches of to an over broad contractual term that the law does not favor: reform versus sever versus void.

Assume a jurisdiction that requires covenants not to compete to be limited to no more than one year and one county. Next, assume the legitimate business interests of the parties can support such a covenant, but the parties (for whatever reason) enter a covenant protecting two years and two counties. What is the court to do? Some courts, like Colorado's, will reform the contract, limiting the enforcement of its terms to no more than the limit permissible in that context. Other courts, like Iowa's, will sever the offensive clause for the rest of the contractual relationship. As is ordinary for severing an offensive contractual provision, to be eligible for severing, the covenant needs to be [1] supported by its own consideration as well as [2] not be so central to the whole of the contractual relationship that severing the covenant would defeat the fundamental purpose of the whole contractual relationship. If either [1] or [2] are not satisfied, then the severing courts will void the entire contractual relationship as contrary to public policy, and force the parties into a court of equity. Still other courts, like Nebraska's, presume covenants not to compete serve a fundamental purpose and void the entire contractual relationship. A voiding court routinely deposits over reaching covenants and their related contracts into a court of equity.

A covenant not to compete is a personal contract: who are the parties is material. Accordingly, assignment of a covenant quite likely violates the parties' reasonable

expectations. If prohibited, then a purported assignment is more likely to work as an abandonment than as an effective assignment. Of course, preventative drafting can avoid this adverse result by expressly including the right to assign.

Important consequences flow from these judicial choices. The reform approach preserves the original contract and avoids enforcement beyond the bounds of the law, however it also encourages abusive over reaching by those so inclined. Conversely, a voiding court, by reducing the certainty of contract enforcement, discourages all covenants not to compete, not merely those that are over reaching.

### **OUTLINE OF ECONOMIC ANALYSIS**

Prior to June 30, 2001, it was far easier to treat covenants not to compete merely as human resource concerns or as legal concerns.<sup>1</sup> However, FASB 142, *Goodwill and Other Intangible Assets*, took effect on that date and it requires express valuation of covenants not to compete. FASB 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets.<sup>2</sup> FASB 142 addresses how intangible assets that are acquired individually or with a group of other assets should be accounted for in financial statements upon their acquisition.<sup>3</sup> FASB 142 also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.<sup>4</sup>

Previous valuation literature addressing covenants not to compete was focused in the realm of tax law. Now, valuation of covenants not to compete will be part of the balance sheet and a more explicitly managed asset.

The lack of an arm's length transaction was a major source of accountancy's reticence with valuing a covenant not to compete. While accountants often provide estimates of value, they usually can provide substantiation via comparable market transactions. This source of validation is not available for many forms of intangible assets. Notwithstanding that preferred validation mechanism, intangible assets have become so significant for many firms that accountancy could not avoid valuing such material assets.

The three most common validation methods are the market method, the income method, and the cost method. As noted, there is a paucity of comparable market transactions. While cost frequently can be known via historical arm's length transactions, with respect to intangible assets historical costs may bear no relationship with present

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<sup>1</sup> FASB 142 has three potential effective dates: fiscal years starting after March 15 may make an early adoption; June 30 applies to all new acquisitions of assets, and all fiscal years starting after December 15, 2001 are subject to FASB 142.

<sup>2</sup> FASB 142 supersedes APB Opinion No. 17, *Intangible Assets*.

<sup>3</sup> If an intangible asset is acquired in a business combination, then see FASB 141.

<sup>4</sup> See also, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, FASB Statement No. 2, *Accounting for Research and Development Costs*, and FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*.

value. Accordingly, the preferred valuation method for intangible assets under FASB 142 is the discounted present value of future net income streams. Of course, those future costs and future incomes must be estimated. Such DPV net income estimates can yield speculative values depending upon the relative certainties attached to the critical components of that estimation.

Valuing a covenant not to compete requires valuation of the known and the unknown. Much has been written on the role of asymmetric information in valuation (i.e., value estimation is more tightly dispersed with information than without). Unknown components of a covenant's value estimation can be, but need not be, reflective of asymmetric information. Often, neither party will know and neither party will be able to know. Many times it will not be a situation of asymmetric information: there will be an information void. Since fear springs from the unknown, it is important to bear in mind that fear is likely to generate an elevated value.

A covenant not to compete covers a reasonable time and a reasonable geographic area. While the law will require objective specificity of the reasonable time and area (e.g., one calendar year and one county), both of those markers, in practice, are inherently imprecise. While the county line may not move, the market lines are prone to move. Also, recall that a covenant that is drafted broadly (e.g., five years and five counties) runs a very real risk of covering far less.

Dynamic definitions of the covenant's time and area are the hallmarks of expert draftsmanship. A covenant with static provisions is likely to be crafted for application at a some specific, future date. Those static terms may be reasonable neither prior to nor after than specific, future date. All too often, the parties will default to a mean estimate of the appropriate time and area. For example, many a covenant is drafted assuming application will occur after a product has been fully introduced in the market. However, application of the covenant may occur in a market with aborted product introduction or in a dying market where the product is in substantial retreat as it nears the end of its life cycle. If the parties use static and expansive terms in a dynamic market, then that market dynamism may render abusive and unreasonable the expansive terms in either an aborted market or in a dying market. Both dynamic scopes and static scopes in a dynamic market increase greatly the difficulty of accurate estimation of value.

Let us now assume the parties both envision the same factual future. Their values still may diverge. The parties to a covenant not to compete may have different risk preferences (e.g., risk neutral versus risk averse) and/or different time value of a dollar preferences (i.e., discount rates). For example, because of existing cash flow requirements, one party may be risk averse towards short-term losses and risk neutral towards long-term losses. Alternatively, one party may have easy access to ample capital at prime while the other party can obtain neither the requisite magnitude of financing nor a tolerable interest rate.<sup>5</sup> These differences in constraints may generate different valuations<sup>6</sup> even when the parties predict the same factual future.

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<sup>5</sup> Commercial relationships, unlike employment relationships, are likely to present parties of substantially equal commercial sophistication with respect to the time value of money. However, it still is

A shared perception of the future will enhance the self-enforcement mechanism of a covenant. This is especially true if the parties specifically address and compensate individual risks. Some covenants bundle all risks and bundle all compensation within one simple term. Increase legal enforceability from making the contours of the parties agreement clear to the court are not the only benefits of specificity. The parties also will better perceive the covenant's incentives and rewards.

Every covenant not to compete has a value not of -one- thing, but has the value of many things added together. If the covenant covers more than a minute and more than a square inch, then many "markets" are aggregated to find the value of the covenant. This too prods the parties towards accepting an average time and area along with an average value. However, the mean rarely accurately describes any one individual, much less two unique parties. The parties must be attentive to their unique context and value. For example, the strategic effect of a covenant not to compete on a party depends upon the party in question. A small local selling firm may forego far more than the large national buying firm gains; whereas a large local buying firm may gain far more than the small local selling firm foregoes.

Every covenant not to compete seeks to sculpt the market. Accordingly, both the existing firms and the reasonably expected market participants should be well understood by both parties. The market consequences of a direct competitor in the market are quite different than the consequences of a strategic ally or a value chain partner. Clearly, added value springs from less competition pressure on prices. Accordingly, one undesirable consequence may be attention from antitrust enforcement officials.<sup>7</sup> While business acumen that prompts a competitor to secure access to competitive resources is laudable and privileged; less laudable is a competitor whose expenditures merely remove competitive resources from the market. That said, value may spring from increasing your competitor's cost of inputs. The DPV of the net income stream may increase because a covenant causes either revenue to increase and/or causes relative costs decrease.

The firm should have an active process for identifying the contours of the market and for vetting its covenants not to compete. That active process should recognize that markets are dynamic. Two particularly noteworthy sources of dynamism are cost structure and diffusion rate.

The cost structure of the firm and the cost structure of competitors generate significant impacts on market behavior and opportunities. Two important conditions

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possible for there to be material differences in sophistication that, alone, generate different perceptions of value. This could happen as a classic informational asymmetry: one party can and does perceive the contours of risk (e.g., complex and contingent payment structures) and the other does not.

<sup>6</sup> In a commercial transaction are parties are likely to negotiate the time and area. In the parlance of negotiation the parties can "create value" by trading their differences. However, those same differences can place a cloud the "genuine" value of the covenant since neither party places a value on the covenant equal to the agreed upon value. A split-the-difference negotiation tactic may yield a signed document but may not yield an enforceable covenant.

<sup>7</sup> Recall that the Clayton Act section 7 takes an expansive view of transactions that are "mergers".

issue from the cost structure: shut down and destructive competition. Broadly, total costs can be divided into fixed costs and variable costs. All firms seek to profit maximize. Not all firms can earn a profit, and a firm suffering losses seeks to minimize those losses. However, loss minimization may require staying open. Since fixed costs must be paid regardless of the level of output, shutting down does not reduce fixed costs. Thus, the minimum loss is equal to fixed costs. Shut down only minimizes losses when total revenue is less than variable cost. Accordingly, if a firm has high relative fixed costs (e.g., farming; airlines), rarely can the firm reduce losses by shutting down. Additionally, if this forced operation with losses is persistent (especially if many firms in the industry are similarly situated), then the firm enters destructive competition. Under destructive competition, there is a strong downward pressure on prices and total revenue, with total revenue driven down to variable costs.

How does the cost structure relate to covenants not to compete? Often, the payments required by a covenant are fixed. Increasing a firm's fixed costs, especially relative to its competitors, increases the risk of destructive competition and non-recovery of those fixed costs. Paradoxically, all of the variable cost payments on the covenant still will be made. If, however, the covenant is structured so that all of the payments are variable costs for the buyer, then the covenant increases the likelihood that the buyer will shut down. Obviously, the parties have something to negotiate.

In addition to cost structure, the diffusion rate can be a significant source of market dynamism. The purchaser of the covenant not to compete buys a resource. That resource is purchased either for the buyer's own use or to remove the resource from the market's stock of inputs. The particular competitive advantage that the purchase provides the buyer will dissipate as other resources diffuse into the market. Some diffusion rates can be very rapid, others may follow a normal curve. The diffusion rate of tangibles can be faster than intangibles, especially if the tangibles are fungible. However, intangibles that have unique characteristics, such as a network of acquaintances or an experience base in a market, often need to be replaced in near real time.<sup>8</sup>

### **CONCLUDING COMMENTS**

The freedom of contract and the freedom of allocating ownership both encourage covenants not to compete that are supported by sufficient legitimate business interests of the parties. A generic value should earn less respect from the courts than a valuation that reflects the contours of the market that the parties confronted and should have reasonably expected at the time of entering the covenant. The value of such covenants will be difficult to assets. However, the significance of those assets warrants making the estimates because the firm's failure to explicitly estimate that value merely means that the person is the best position to make the estimate will be silent. FASB 142 reflects this truth.

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<sup>8</sup> If replacement can not be rushed, then the cost approach to valuation is an appropriate method of valuation.