

Valued News



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Covenant Not to Compete: Need? Value?



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Any time a business is purchased, one of the elements which a buyer should consider is the need for a non-compete agreement or a covenant not to compete with the seller. The significance of having a non-compete agreement can vary greatly from business to business based upon the industry in which the company operates. While both parties may recognize the importance of having a non-compete, the challenge is negotiating a price that is acceptable to both the buyer and the seller. From a tax standpoint, neither party really wants to allocate much of the purchase price to the non-compete. For the seller, this represents ordinary income and for the buyer, the non-compete must be capitalized and expensed over a fifteen year period. Ultimately this agreement provides protection to the buyer that the seller will not take advantage of the existing customer/vendor relationships and setup a new company post-sale.

The value of this agreement is that it reduces the risk of the investment, thereby increasing the buyer's ability to succeed with the operations of the company. As the risk of any investment increases, the value of that investment decreases. An investor is willing to pay more for an investment that has a greater potential for success. The industry in which the company operates is generally the most critical component of determining the value of a non-compete. For example, if an industry has significant barriers to entry, then the value of a non-compete could be diminished greatly. Common barriers would be a highly capital-intensive business such as a warehousing or distribution center, or a highly regulated industry like nursing homes. Industries that could command a high value for a non-compete would be professional services such as doctors, dentists, lawyers and accountants. These businesses are built largely on the trust that the customer has with the service provider.

One of the greatest challenges in relation to non-compete agreements is that while an agreement may have legitimacy, it may not be legally enforceable. In 2005, the Tennessee Supreme Court issued an opinion stating that, "except for those specifically prescribed by statute, physician's covenants not to compete are unenforceable and void." One of the driving forces for this decision was whether the covenant was inimical to the public interest (basically it is in the patients' best interest to stay with the same physician). More recently, the Virginia Supreme Court ruled that a covenant not to compete was overbroad and unenforceable in a 2011 court case involving a pest control company and an employee.

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The court recited a general rule that non-competition agreements are enforceable in **Virginia** if they are narrowly drawn to protect the employer's legitimate business interests, not unduly burdensome on the employee's ability to earn a living, and not against public policy. While the **Tennessee** and **Virginia** cases were specifically related to employee/employer relationships, they highlight the challenges of legally enforcing a non-compete agreement.

In *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979), the Tax Court set forth an 11-factor test to determine the economic reality and legitimacy of a non-compete agreement. These factors are important in determining the risk of competition from the seller:

1. **Seller's business experience.** What skills and expertise are necessary to succeed in the industry? Does the seller have these necessary skills?
2. **Seller's intent to compete.** What was the reason for selling the business? What possibility is there that the seller would startup a new company? Did they sell to retire or for health reasons? Are the health reasons permanent?
3. **Seller's economic resources.** Does the seller have the capital/investment capacity to start a new competing company?
4. **Potential damage to the buyer.** If the seller decides to compete, will the buyer lose business?
5. **Seller's network.** Did the customers and vendors choose to do business with the company that was sold or did they decide to do business with the seller because of a relationship with the individual?
6. **Duration and geographic scope.** Does the non-compete restrict the seller from doing business in the area that the company did business in prior to the sale? Does the scope

of the duration and geographic area reach too broadly to be enforceable?

7. **Enforceability.** Does state law permit the enforcement of the non-compete?
8. **Age and health of the seller.** Is it reasonable to expect the seller to be able to compete based on his/her health and/or age?
9. **Payment terms.** If there are multiple selling owners, how are the non-competes valued among the various owners? Is it based on pro rata ownership or is it based on the individual seller's contribution to the company prior to the acquisition?
10. **Payment duration.** If payment is require over a period of time, what happens to the obligation should the seller die or breach the contract?
11. **Negotiations.** Did the parties negotiate the terms and value of the company and the underlying assets?

The real focal point of the non-compete agreement is for the transfer of the existing and critical business relationships from the seller to the buyer. It gives the buyer an assurance that those relationships will not be encroached upon over a specified time period. The non-compete agreement by itself is a passive method of transferring these relationships from seller to buyer. In order to solidify this transition, it is not uncommon for the seller to also have an employment agreement to more actively be involved in the transferring of those relationships. As with any business transaction, the fact and circumstances must be carefully weighed in order to navigate both the significance of having a non-compete as well as the inherent pitfalls of enforcing and defending them. Each of these eleven factors are significant drivers in the determination of the fair market value of a covenant not to compete.

Six Common Errors Found on Valuation Reports

1. **Failure to Define Purpose and Standard of Value** - Is there alignment of the standard of value with the purpose of the report? The standard of value may be Fair Market Value, Investment Value, Intrinsic Value, or Fair Value. Which is appropriate for the stated purpose? Is the standard of value that is utilized consistent with state or federal law?
2. **Failure to Discuss Critical Elements** - such as, company background, industry, market, competition, and economic environment.
3. **Mathematical Errors** - Mathematical errors, even de minimus, can generate scrutiny from report readers and regulatory bodies.
4. **Inadequate Financial Analysis.**
5. **Failure to Define Earnings** - Net Income (GAAP), After tax earnings, Cash flow, EBIT, EBITDA, Other.
6. **Leaps of Faith** - Does the report ask the reader to accept critical components of the valuation process without an appropriate explanation? These may include: capitalization rate, premiums, discounts, and value conclusions.

Subsequent Trinity issues will include other valuation report deficiencies and a more detailed description of the items in the above article.

Recognition



J. Andy Williams

Congratulations are in order for Trinity financial analyst J. Andy Williams, who recently passed all parts of the Certified Public Accountant Exam. Williams is now licensed as a CPA in the State of Tennessee. He is a *cum laude* graduate of ETSU with Bachelor degrees in Accounting and Corporate Finance and Investments and a Master of Accountancy.

CASE LAW - Excess Earnings Method

In the following cases, the excess earnings method was cited by the courts to determine the value of the spouses' business interest when determining an equitable division of marital assets. Though both courts utilized the same valuation method in appearance, in fact the iterative processes were different.

A.C. v. J.O., 2013 N.Y. Misc. Lexis
3524 (Aug. 12, 2013)

*Dentist
Business Goodwill*

The wife owned a third generation dental practice in New York City, New York. However, the wife did not own the office, an office lease, or dental equipment associated with the practice. In valuing the dental practice, the Court ruled that the excess earnings method was most appropriate since it considered the absence of tangible assets and the goodwill based on the three generations of dentists in the wife's family. The Court concluded that due to the lack of tangible assets, the value derived from the excess earnings method represented the goodwill of the practice.

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Cost of Capital

Treasury Yields ¹	4-Week: 0.04% 5-Year: 1.51% 20-Year: 3.31%	¹ Federal Reserve Board - Economic Research and Data, as of February 28, 2014
Prime Lending Rate ²	3.25%	² Federal Reserve Board - Economic Research and Data, as of February 28, 2014
Dow Jones Industrial Average ³	16,321.71	³ The Wall Street Journal - Stock Indexes: Closing Data Bank, as of February 28, 2014
LIBOR (US) ⁴	1-Month: 0.16% 6 Month: 0.33% 1-Year: 0.55%	⁴ The Wall Street Journal, as of February 28, 2014
S & P 500 P/E Ratio ⁵	18.09	⁵ The Wall Street Journal - Market Data Center - P/E Ratios on Major Indexes, as of March 7, 2014
Tax Exempt Municipal Bonds ⁶ (AAA Insured)	10-Year: 2.25% 20-Year: 3.55% 30-Year: 3.95%	⁶ FMS Bonds, Inc. - Municipal Bond Specialists - Bond Market Yields, as of March 10, 2014
CPI Annual Growth Rate ⁷	1.60%	⁷ Bureau of Labor Statistics - Economic News Release - CPI - January 2014, released February 20, 2014



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CASE LAW - Excess Earnings Method

Wright v. Wright, 2013 Virginia App. Lexis 53 (Feb. 19, 2013)

*Attorney
Business Goodwill*

The husband was an equity partner in a law firm with a high compensation level in comparison to other equity partners. According to Virginia law, only goodwill attributable to the business entity (the husband's law firm) qualified as community property. Goodwill resulting from the individual's efforts qualifies as separate property.

The Court did not provide details about the analysis but chose to cite *Howell v. Howell* in reference to the methodology performed to render the conclusion of value. Therein, the expert compared the husband's average income for three years to a peer group. The difference between the husband's average three year income and peer group was classified as "Excess Earnings." Conclud-

ing, said excess earnings were related to the husband's association with the law firm, not from his personal efforts. Accordingly, the expert projected the husband's excess earnings over his expected career with the same firm and discounted said excess earnings to calculate the present value of future excess earnings.

The expert's valuation did not calculate personal goodwill. The Court validated his argument by stating the wife's expert, "better isolated institutional goodwill by determining what an attorney's law firm interest value with husband's skill, knowledge, and experience value would be if he was in a firm that lacked the attributes of husband's law firm."

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