Purposes Requiring the Valuation of a Non-Compete Agreement

The valuation of non-compete agreements is a significant and critical consideration across multiple legal, financial, and regulatory frameworks. Entities engaged in corporate transactions, financial reporting, taxation, litigation, employment structuring, bankruptcy, intellectual property management, franchising, and estate planning must assess the economic value of such agreements to ensure compliance and mitigate risk exposure.

The necessity for such valuation arises in multiple circumstances, including but not limited to:

Section 280G of the IRC:

Section 280G addresses **"golden parachute payments,"** which are typically large, severance-like payments made to executives when they leave a company, often triggered by a change of control (like a merger or acquisition). The section is designed to limit the tax deductibility of these payments and to impose an excise tax on executives who receive them if they exceed a certain threshold.

Valuing **non-compete** agreements for **Section 280G** purposes is crucial in the context of **golden parachute payments** to mitigate or avoid adverse tax consequences. Here's why:

Understanding Section 280G

• **Section 280G** of the Internal Revenue Code applies to **excess parachute payme**nts made to certain executives in connection with a change in control (e.g., mergers, acquisitions).

- If the total parachute payments exceed **three times** the executive's **base amoun**t (average taxable compensation over five years), the **excess** is subject to:
- **No corporate deduction** for the excess amount.
- **A 20% excise tax** on the executive.

Role of Non-Compete Agreements

• Payments for **reasonable compensation,** including **non-compete agreements,** are not considered parachute payments under Section 280G.
• By properly valuing a non-compete agreement, companies can reduce the amount classified as parachute payments, thus minimizing or eliminating excise tax liability.

Strategic Importance

• Helps **reduce taxable parachute payments**, avoiding penalties.
• Allows businesses to **retain tax deductions** that would otherwise be lost.
• Strengthens the company's **justification** for the executive's compensation package in an acquisition.

Risks & Considerations

• If the **IRS challenges** the valuation as excessive or unenforceable, it may **reclassify** the amount as a parachute payment.
• Proper **documentation** and third-party valuation are recommended for **audit protection.**

Other Taxation & IRS Compliance

• **The Internal Revenue Service (IRS)** may scrutinize non-compete agreements to ensure proper tax treatment, particularly in distinguishing between **ordinary** income and **capital gains** in sale transactions.
• The allocation of purchase price between goodwill and non-compete agreements may impact tax liabilities for both buyer and seller.

Valuation is often necessary to support **Section 1060** asset allocation requirements.

Executive Compensation & Employment Agreements

• In executive employment agreements, non-compete provisions may carry **monetary value,** particularly if they include **garden leave** provisions or lump-sum compensation.

Employers may conduct valuation analyses to determine **severance package allocations** and **post-employment restrictions.**

Litigation & Dispute Resolution

• Non-compete valuation is critical in legal disputes involving **breach of contract, tortious interference**, or **wrongful termination** claims.
• Courts may require valuation evidence to assess **damages** resulting from a breach of a non-compete agreement.
• Expert testimony on the economic impact of a non-compete provision may be presented in commercial litigation.

Mergers & Acquisitions (M&A)

• In corporate acquisitions, the valuation of a seller's non-compete agreement is essential to determine its impact on the transaction's overall valuation.
• Non-compete agreements may be classified as **intangible assets** and assigned a distinct value separate from goodwill.
• The enforceability and duration of such agreements influence the buyer's risk assessment and post-closing integration strategy.

Financial Reporting & Accounting Compliance

• Under **Generally Accepted Accounting Principles (GAAP)** and **International Financial Reporting Standards (IFRS),** non-compete agreements may be recognized as identifiable intangible assets requiring valuation.
• The Financial Accounting Standards Board **(FASB ASC 805)** mandates the valuation of separately identifiable intangibles acquired in a business combination.
• Non-compete agreements must be assessed for amortization and impairment testing under **FASB ASC 350.**

Bankruptcy Proceedings

•In bankruptcy cases, non-compete agreements may be classified as **executory contracts** and subject to valuation for rejection or assumption under **11 U.S.C. § 365.**
•The valuation of a non-compete agreement may impact the determination of debtor assets and liabilities.

Intellectual Property (IP) & Trade Secret Protection

•Non-compete agreements are often linked to **trade secrets** and proprietary business information.
•The valuation of non-compete agreements in IP-related transactions ensures proper risk allocation in licensing or assignment agreements.

Franchise Agreements

•Franchise agreements often include **territorial non-compete clauses**, necessitating valuation to determine the economic impact of territorial exclusivity.
•The valuation of such agreements may influence franchise resale pricing and renewal negotiations.

Estate & Succession Planning

•In privately held businesses, the valuation of a non-compete agreement may be relevant in **estate tax calculations**, particularly when determining the fair market value of ownership interests.
•Non-compete agreements may factor into **buy-sell agreements** and business succession planning strategies.

Summary of U.S. State Non-Compete Laws and Pending Legislation

The legal landscape governing non-compete agreements across the United States exhibits significant variability, with each state implementing distinct statutes and regulations. The enforceability and regulation of non-compete agreements in the United States are subject to a complex and evolving legal framework that varies by jurisdiction. Employers and employees are advised to consult legal counsel to navigate the specific requirements and limitations applicable in their respective states. Ongoing legislative developments, both at the state and federal levels, necessitate continuous monitoring to ensure compliance and to understand the potential impact on employment practices.

Below is a comprehensive overview of the current status of non-compete laws in all 50 states, including notable pending legislation. **Note:** In general, these states have exceptions including in the Sale of a Business where a seller of a business, its goodwill, or a substantial ownership interest may be restricted from competing with the buyer within a reasonable geographic area where the business operates:

States Prohibiting Non-Compete Agreements:

•**California:** Non-compete clauses are generally unenforceable, reflecting the state's strong public policy favoring open competition and employee mobility.
•**North Dakota:** Similar to California, North Dakota law prohibits the enforcement of non-compete agreements, with limited exceptions.
•**Oklahoma**: The state maintains a prohibition on non-compete agreements, allowing only certain restraints that do not significantly impair an individual's ability to work.

States Restricting Non-Compete Agreements Based on Compensation Thresholds:

•**Washington:** Enforcement of non-compete agreements is restricted to employees earning above a specified compensation threshold, which is subject to annual adjustments.
•**Oregon:** Non-compete agreements are enforceable only for employees exceeding a defined salary threshold, ensuring that lower-wage workers are not subject to such restrictions.
•**Illinois:** The state enforces non-compete agreements primarily for employees earning above a certain compensation level, aiming to protect low-wage workers from restrictive covenants.

States Requiring Advance Notice or Consideration:

•**Massachusetts:** Employers must provide advance notice of non-compete agreements and offer fair consideration, particularly when presented after the commencement of employment.
•**New Hampshire:** The state mandates that employers disclose non-compete agreements prior to making a job offer, ensuring transparency and informed consent.
•**Maine:** Employers are required to provide prior notice of non-compete agreements and must offer consideration beyond continued employment to ensure enforceability.

States with Industry-Specific Restrictions:

•**Rhode Island:** Non-compete agreements are prohibited for certain low-wage workers and specific professions, including physicians, to promote workforce mobility in critical sectors.
•**Delaware:** The state enforces non-compete agreements with particular attention to protecting employees in key industries, ensuring that such covenants do not unduly restrict professional practice.
•**Texas:** While generally permitting non-compete agreements, Texas imposes specific limitations and requirements, particularly concerning the scope and duration of such covenants.

States with Recent Legislative Activity:

•**Nevada:** Recent amendments have refined the enforceability of non-compete agreements, focusing on protecting employees from overly restrictive covenants.
•**Virginia:** Legislation has been enacted to limit the use of non-compete agreements, especially concerning low-wage employees, to enhance labor market fluidity.
•**Maryland:** The state has introduced measures to restrict non-compete agreements for employees earning below a specified income threshold, aiming to safeguard worker rights.

Pending Federal Legislation

On April 23, 2024, the Federal Trade Commission (FTC) issued a rule banning nearly all non-compete agreements nationwide. The rule was published in the Federal Register on May 7, 2024, with an intended effective date of September 4, 2024. However, on August 20, 2024, the U.S. District Court for the Northern District of Texas issued an injunction blocking the rule, citing that the FTC lacked statutory authority to promulgate it. The FTC has appealed this decision to the U.S. Court of Appeals for the Fifth Circuit, and the matter remains under judicial review.