Factors To Consider When Valuing A Non-Competition Agreement

A non-competition agreement is a type of restrictive covenant setting out the rights and obligations of an employee post departure from the company. Usually, these restrictive covenants attempt to prohibit an employee from competing with an employer following departure from the company, regardless of the cause for departure.

Non-competition agreements usually relate to the individual goodwill held by employee based on their relationship with customers and employees, operational knowledge and certain other factors that influence the value of the business.

Estimating the value of a non-competition agreement is typically done by notionally determining the value of the business without a non-competition agreement. The result is then compared with the value otherwise determined in a notional market context or the price paid in an open market transaction, known as the with and without approach.

The with and without approach is a widely accepted theoretical approach to determine the incremental benefit of an intangible asset. The approach can be utilized by applying the following steps:

1. Determine the value of the business with the non-competition agreement in place;
2. Determine the hypothetical value of the business without the non-competition agreement in place; and,
3. Subtract the value in step 2 from the value in step 1.

When applying the with and without approach, consideration should be given to the following:

a) The Nature of the Industry

Generally, the potential value attributable to the non-competition agreement increases when the business competes in an industry where:

- Products are in the early stages of the product life cycle;
- The industry provides a ready opportunity to compete (i.e. joint venture opportunities or opportunities to enter into an employment contract with a competitor);
- A relatively weak competitive environment; and,
- The industry has the potential for a comparatively rapid near term expansion.

b) The Nature of the Business

Generally, the potential value attributable to the non-competition agreement increases when the business:

- Is relatively small;
- Sells non-proprietary products or services (ie professional services); and,
- Lacks management depth beyond the individual who is subject to the non-competition agreement being valued.

c) The Involvement of the Departed Employee

Generally, the potential value attributable to the non-competition agreement increases when the employee:

- Is relatively young and not expected to retire from the daily running of the business in the near term;
- Is in relatively good health;
- Has the financial ability to compete;
- Is expected to have a high level of interest in continuing the business or a similar business in the future;
- Has particular knowledge of the strategic plans of the business (both near term and long term); and,
- Retains personal knowledge and personal relationships with employees, customers, and suppliers. These relationships cannot be readily passed on and continue to reside with the employee following their departure from the company.

The allocation of a portion of the purchase price to a non-competition agreement has become a more prevalent topic in recent years, given the recent changes to the Income Tax Act involving the manner in which payments for restrictive covenants are treated for taxation purposes. As such increased attention must be placed on the factors to consider when allocating value to a non-competition agreement.

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