Covenants not to compete must be carefully drafted not only for their legal consequences, but also for their accounting and tax treatment. Covenants must meet the legislative and case law test of reasonableness to be enforceable. Furthermore, covenants must pass the U.S. Internal Revenue Code’s test of economic reality and mutual intent for price allocation and amortization. When the covenant meets these tests, the analysis can then utilize valuation methodology to determine economic damages due to breaches of a covenant, or allocation of purchase price to meet legal and/or tax allocation. This presentation will discuss some of the significant legal cases and tax codes that have an impact on defining and valuing covenants not to compete. Also, several valuation methods will be reviewed which can be utilized in determining the value of a covenant not to compete.

LEGAL ISSUES

One of the most litigated issues in the civil courts has been the determination of economic damages due to breaches of covenants not to compete, and the cases continue to increase. While these cases have helped define the necessary elements of a covenant, there have been many conflicting decisions which have lead to a great deal of uncertainty regarding enforceability and the value of economic damages. Being aware of the manner in which the courts have treated covenants in the past, the valuator can better determine the elements of value that will be upheld in the courts.

Anthony Valiulis, author of Covenants Not To Compete, Forms, Tactics, And The Law[^1], states that there are several trends that support the increasing need for covenants. The change from a manufacturing to a service economy wherein the relationship between the individual employee who provides the service and the customer becomes important to the employer’s business relationship with the customer. The growing emphasis on market specialization to develop market share requires investment in market research, product development, and long range marketing plans. These trade secrets must be protected from competition when an employee leaves or the business is sold and the former owner has the ability to compete. The growing number of new small businesses are often the result of employees leaving their jobs and starting their own businesses wherein they take the knowledge obtained from their former employers to jump start their new businesses.

Covenants not to compete are most frequently utilized in the following circumstances:

- In employment circumstances between employer and employee
- In the sale of a business between the seller and the buyer
- Between franchisors and franchisees
- In real estate transactions between landlords and tenants
- Between the parties to patent license or royalty agreements

While many of the concepts discussed in this presentation impact all of the above uses of a covenant, the emphasis herein will be on those covenants between the sellers of businesses and the buyers, including those hypothetical circumstances such as in marital dissolution.
The circumstances that normally require the valuation of covenants not to compete evolve around either economic damages or price allocation for legal or tax issues. The value of economic damages will need to be determined when a seller of a business or ownership interest breaches the covenant. Litigation or taxation issues often require the allocation of purchase price among various assets including a covenant not to compete.

The enforcement of covenants not to compete can be traced back to England in the seventeenth century when courts began to examine the reasonableness of the restraint in terms of competing interests of the employer and the employee. However, the courts recognized that covenants not to compete utilized in conjunction with the sale of a business were different from normal employee restrictive covenants. As the nature of the parties was different, different policy considerations applied. In 1613, Rogers v. Parrey was the first case in which the court upheld a covenant not to compete in the transfer of a business or business interest. In consideration for the payment of a sum of money, the defendant promised the plaintiff that the defendant would not pursue his trade in a certain shop for the twenty-one year period during which the shop was leased to the plaintiff. The court reasoned that "as this case here is for a time certain and in a place certain a man may well be bound and restrained from using of his trade."

The United States common law on restraints on trade developed in a similar fashion with English common law. Early cases applied mechanical rules that distinguished between partial restraints and general restraints. The treatment of covenants in the U.S. has differed from English common law in two important respects: first, American courts have viewed restraints on covenants as a state issue rather than a national issue; second, American courts began to apply the rule of reason and did not limit themselves to the terms of the contract. Most states have enacted business code legislation to regulate the enforceability of restrictive covenants.

Under the concept of rule of reason, two issues must be addressed for covenants to be enforced; first, the covenant must be ancillary to another valid contract; second, the restraints must be reasonable. If the covenants were solely intended to restrain competition, it was void. Two examples of the need for a covenant to be ancillary to another valid agreement are shown in Valiulis's Covenants Not To Compete Forms, Tactics, And The Law. The first example is Tuscaloosa Ice Manufacturing Co. v. Williams, wherein the Alabama Supreme Court struck down a contract in which the plaintiff agreed not to operate his ice plant for five years because the covenant was not ancillary to some other agreement; no sale of business or other contract was involved. The other example is United States v. Addyston Pipe & Steel Co. in which Justice Taft stated that, in order for a covenant restricting competition to be valid, it must be

ancillary to the main purpose of a lawful contract and necessary to protect the covenantee in the enjoyment of the legitimate fruits of the contract, or to protect him from the dangers of an unjust use of those fruits by another party.

The test for reasonableness is often case specific. One of the early cases developed a five step test for reasonableness. The Kentucky Supreme Court considered five factors:

1. whether the restriction reasonably protected the employer;
2. whether it unreasonably restrained the employee;
3. whether it was reasonably related to business of the employer;
4. whether it was reasonably related to the territorial extend of the employer's business; and
5. whether it was against public policy.

The underlying issues are what can be protected and at what costs.
State legislatures and the courts have historically looked with disfavor on any agreement restricting or restraining trade including covenants not to compete. The courts have scrutinized covenants to ensure that they are not unduly restrictive. They have been enforced when supported by valid consideration, not unreasonably harmful, and not otherwise against the public interest. When the covenants have been ancillary to the sale of a business, rather than ancillary to an employment contract, the courts have treated covenants much more broadly. There are several exceptions to this broad treatment of covenants. When business sales do not expressly include goodwill, the result may be different. In addition, a person not a party to the sale cannot be bound by the covenant. Furthermore, a personal covenant made by a seller of a business terminates upon the death of the covenantor.

In the January 2001 issue of the Texas Bar Journal, attorneys Ernest Garcia and Fred Helms authored an article reviewing recent Texas legislative codes and court cases impacting covenants not to compete and not to disclose. Their review reflects that there have been no new legislative actions impacting covenants since the State Legislature added sections 15.50, 15.51, and 15.52 to the Business and Commerce Code in 1989 and 1993. These code sections state that:

1. a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interests of the promisee.

In 1994, the Texas Supreme Court withdrew the opinion it rendered in the Light v. Centel Cellular Co. of the previous year and, for the first time, acknowledged that it was bound by Texas Business and Commerce Codes. Complaining that the legislature had failed to "provide any standards for assessing whether or not a covenant not to compete is ancillary to or a part of an otherwise enforceable agreement," the court declared, "that a restraint is not ancillary to a contract unless it is designed to enforce a contractual obligation of one of the parties." The court concluded:

1. the consideration given by the employer in the otherwise enforceable agreement must give rise to the employer’s interest in restraining the employee from competing; and
2. the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement

In the Light case, the Court explained that if an employer gave an employee confidential and proprietary information or trade secrets in exchange for the employee's agreement not to disclose them, then a covenant not to compete would be ancillary to an otherwise enforceable agreement. Thus, the authors of the article suggest that the simplest, most straightforward procedure would be to make the covenant not to compete ancillary to a covenant not to disclose. Nondisclosure covenants do not prohibit the former employee from using, in competition with the former employer, the general knowledge, skill, and experience acquired in former employment. The nondisclosure covenant prevents only the disclosure of trade secrets and confidential information acquired by the former employee. Because of these differences, covenants not to compete are against public policy unless they are reasonable, but nondisclosure covenants are not against public policy.

Based on the Light case and several other cases since then, Garcia and Helms conclude the protection afforded by a covenant not to disclose or even the protection afforded by the common law may be as effective as a covenant not to compete, and the time and effort necessary to draft and enforce a covenant not to disclose should be considerably less than what would be required to draft and enforce a covenant not to compete.
In a marital disposition matter, Rathmell v. Morrison,\(^{[13]}\) is a Texas landmark case on several fronts. First, the Court applied, for the first time, the issue of "personal goodwill" to a business other than a medical or law practice. Secondly, the court listed the following items that must be excluded from division of the marital estate:

- Value attributable to the Personal Goodwill of the owner
- Value attributable to the time, toil, and talent of the owner to be expended following the divorce
- Value attributable to the requirement of a covenant not to compete which would prevent an owner from earning a living at their chosen occupation.

Based on the case findings, valuations of businesses and ownership interests must specifically exclude any personal goodwill of the owner. While much to do has been made of this issue, from a valuation standpoint, other than having to state in the appraisal that personal goodwill has been excluded, there is no change as to how the business is appraised. The risks associated with the personal goodwill of the seller have been accounted for in either the projections of earnings or the capitalization factor used to convert earnings into value.

For there to be corporate or business goodwill value, a business must have two basic attributes: first, the business must have established customers/clients, established suppliers, an existing location, assembled assets, an experienced work force and a good reputation; second, the business must have earnings that are in excess of the required return on the tangible assets of the business. Without such earnings, value can only be attributable to the other assets of the business.

To totally exclude all goodwill, both personal and business would be to totally ignore the fact that the seller is being or hypothetically being compensated for his agreement not to compete in the price received for the business. Unfortunately, some appraisers miss this fact when they strive to use case law to minimize value.

Value attributable to the time, toil, and talent of the principals expended after the date of martial dissolution must be excluded from community property. This would include any value attributable to employment agreements and/or consulting agreements. While it is normal to exclude these items from the value of the business, this was the first time the courts have specifically excluded them.

However, the major valuation issue imposed by the court was that the business should be valued apart from the existence of a covenant not to compete which would be so restrictive as to not allow the principals to earn a living in their chosen occupation. Most buyers of businesses or business interests require that the seller sign a covenant not to compete which serves to prevent the loss of business goodwill and confidentiality. Covenants typically provide for economic damages in the event the seller competes with the buyer. In the event the seller was not willing to sign a covenant not to compete, the value of the business would likely be greatly diminished. The economic impact on the value of the business would be dependent up the seller’s ability to actively compete.

The court, in this case, has missclassified a covenant not to compete as an asset with additive value along with employment agreements and consulting agreements. The economic reality is that covenants represent negative services which result in negative values. They are more akin to notes and mortgages than they are to intangible assets. The key valuation issue here is how restrictive can the covenant not to compete be without preventing the seller or hypothetical seller from earning a living at their chosen occupation. Once again some appraisers are jumping at this issue to minimize value on behalf of their clients, thus ignoring the economic reality of the hypothetical sale.
There have been a few other marital cases which have rendered similar decisions to Rathmell. In an Iowa case, the marriage of Mally, the court agreed with the husband's claim that selling the practice would require a covenant not to compete, which would severely curtail his earning capacity and ability to pay his child support and alimony.

In a Nebraska case, Kriesfeld v. Kriesfeld, the court rendered that a covenant not to compete is a personal asset that should not be considered as a marital asset in dividing property. The court stated, "Any value which attaches to the entity solely as a result of the personal goodwill represents nothing more than probable future earnings capacity." Here the court misclassified the covenant as representing goodwill and future earnings which would be additive value after the date of divorce.

In a Washington case, Marriage of Monaghan, involving a dental practice, the courts had not previously addressed the treatment of a covenant not to compete in a dissolution context, but the appellate court cited cases from New Mexico, Idaho, and California where the covenant not to compete was considered personal property of the practitioner and the courts basically assessed the fairness of the covenant in relation to the other assets. If the apportionment was unfair because the assigned value comprised the majority of the business assets, then a more fair and objective apportionment was needed. The court found those cases persuasive and remanded the trial court to separate the value of the practice from the value of the covenant based on all of the evidence.

In a non-marital California case, Mart v. Severson, the First Appellate District San Francisco Court overturned the lower court's position that because a covenant not to compete was not in place at the date of the appraisal, the appraisers could not include the value of the covenant in the appraised value of the company. The result was an increase in the lower court's value of the company from $1.48 million representing the net assets, to $5.6 million based on the income method. Testimony from the panel of three appraisers clearly indicated that the income method value included a covenant not to compete given the hypothetical buyer. Here the court recognized that a covenant not to compete was a normal condition of a fair market value sale. Without the covenant, the value of the business would have been reduced to asset value which flies in the face of economic reality.

**TAX AND ACCOUNTING ISSUES**

In tax matters, covenants need to be valued for allocation of purchase price. The portion of the business values that are allocated to the covenants will impact the sellers' income tax treatment. Any value allocated to the covenant will be taxed at ordinary income tax rates rather than capital gains tax rates. From the buyers' standpoint, the amounts allocated to the covenant will be considered Class III assets which include most intangible assets and are amortizable over 15 years.

I.R.C. § 167(a) is one of the controlling provisions for the amortization allowance for intangible assets. Treas. Reg. § 1.167(a)-3 recognizes that an intangible asset may be amortizable under certain circumstances. The following factors need to be present before a deduction is allowable:

- The intangible asset is known from experience or other factors to be of use in a trade or business or in the production of income for only a limited period of time, the length of which can be estimated with reasonable accuracy.
- The deduction for depreciation is not for goodwill.
The IRS has developed several tests for determining the validity and value of covenants not to compete.

New code Section 197 was enacted on August 10, 1993, as part of the Omnibus Budget Reconciliation Act of 1993. Section 197 provides for the amortization of acquired intangible assets called "section 197 assets," including goodwill and going concern value over a 15-year period beginning with the month of acquisition, using the straight line method. No other deduction for depreciation or amortization is allowed for amortizable Section 197 assets. Exception for a limited election for intangibles purchased after July 25, 1991, the legislation is not retroactive.

Section 197 applies to most intangible assets acquired after the date of enactment; the 15-year amortization provision generally does not apply to self-created intangibles, churned assets, and certain specified intangibles, such as separately acquired mortgage servicing rights, sports franchises, and off-the-shelf computer software. The definition of "Section 197 assets" specifically includes covenants not to compete.

**Economic Reality Test**

The "economic reality" test applies when the Service has reason to question whether a covenant not to compete was really necessary or when there appears to be an excessive allocation to the covenant. This test may also be applied when one party to the transaction has ignored or denied the allocated amount for the covenant that is stated in the agreement.

The economic reality test is primarily concerned with whether a covenant not to compete has independent business or economic significance. This test was first enunciated in Schulz v. Commissioner, a ninth circuit 1961 case, in which the court stated that "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." Where the seller is, objectively, likely to pose a threat of competition, courts will probably sustain some allocation to the covenant. There are a number of factors that should be considered:

1. Did the seller have the ability to compete with the buyer? This question actually embraces a number of considerations:
   a. Does the seller have a significant customer network and experience?
   b. Does the seller have the financial ability to compete?
   c. Is the seller physically able to compete, i.e., age and state of health?
   d. Were there non-contractual restrictions that would have prohibited the seller from competing in absence of the covenant not to compete, such as the restrictions found in a franchise agreement, license agreement, or operating authority where the market entry is limited?
   e. Does the seller have intention to compete, either by acquiring or by starting a new business in the same market or by seeking employment with an existing competitor?

2. The issue goes to whether the amount purportedly paid for the covenant not to compete was
actually paid as an inducement for the seller to refrain from competition. It embraces such questions as:

a. Does the payment for the covenant realistically compensate the seller for his loss of earnings by not competing?

b. If the payment for the covenant is to be made in installments, are the payments to the seller conditioned on his/her survival, or is the remaining balance of payments payable to the estate?

3. Other factors that reflect the economic reality of the covenant include:

   a. Formalities of the covenant
   b. Enforceability of the covenant
   c. Scope of the covenant

**Mutual Intent Test**

Where a covenant not to compete was agreed to between the parties, but no specific amount of consideration has been allocated to the covenant, courts have looked to the "mutual intent" test to determine whether some allocation is called for.

The mutual intent test looks at whether the parties to the buy-sell agreement mutually agreed that some portion of the total consideration paid for the going concern was intended for the covenant not to compete. This test is applied where the agreement contains a covenant not to compete, but the purchase price is stated as a lump sum for the entire transaction, i.e., there is no express allocation of a specific amount to the covenant.

Mutual intent is usually found where the parties bargained over the inclusion of the covenant not to compete, or where it was understood that the covenant was an essential part of the agreement. The "economic reality test" plays a role in this inquiry. The covenant not to compete must also have some independent basis in fact such that the parties might bargain for it.

**Valuation Issues**

From the standpoint of valuing covenants not to compete, the basis is usually economic damages which is a negative concept. They represent payments for "negative" services. It is a negative value deducted from the fair market value of the business which assumes a complete covenant. Often the courts and many appraisers have misscharacterized the value of covenants as value separate and apart from the business. If there had been no business there could not have been any value to a covenant. While it is possible to value covenants, they must be in conjunction with a business that has confidential information to protect and/or business goodwill at jeopardy. Then the value of the covenant, if any, is considered to be a deduction from the price paid for the business.

The value assigned to a covenant not to compete should be carefully scrutinized for economic reality. Valuation becomes an issue when the allocation by one or both parties appears to be excessive. The taxpayer has the burden of proving that he is entitled to a deduction. In Welch v. Helvering, a 1933 federal tax case,[19] the court determined that because the amount paid for a covenant not to compete represents compensation to the covenantor, the taxpayer bears the burden of proof for establishing the proper amount attributable to the covenant.
The value allocated to the covenant must reflect economic reality. In making this determination, the courts have looked to the same factors as those listed in the discussion of the economic reality test. The value of the covenant to the purchaser comes from the increased profitability and the likelihood of survival of the newly-acquired enterprise that the covenant affords. The value to the seller, on the other hand, is measured by the opportunities foregone to reenter a particular market for a given period.

Courts will also look to the value claimed for the covenant relative to the values of the other assets acquired. For example, in Dixie Finance Co. v. United States, a 1973 5th Circuit case, the amount that the taxpayer allocated to the stock purchase was less than its fair market value, the court refused to allocate any of the purchase price to a covenant not to compete. Other cases have found that the excess purchase price paid for the assets was allocable to a covenant where the buyer was not interested in acquiring the goodwill of the seller, and thus the goodwill had a zero value.

Finally, there are situations where the same parties execute both a covenant not to compete and an employment contract. Both agreements need to be evaluated carefully because their provisions may overlap, and thus, so may their values. An employment agreement may convey similar benefits and cover the same time period as a covenant not to compete, and arguably its value is not separate and distinct from the value of the covenant.

VALUATION METHODS

Any consideration paid for a bona fide covenant not to compete forms the cost basis of a fixed-life, depreciable intangible asset. However, a covenant not to compete is not amortizable unless the objective facts show that (1) the covenant is genuine, i.e., it has economic significance apart from the tax consequences, (2) the parties intended to attribute some value to the covenant at the time they executed their formal buy-sell agreement, and (3) the covenant has been properly valued.

One method of valuing a covenant is the compensation-based approach. Under this method, the covenantor’s (seller’s) average compensation (including salary, bonuses, and benefits) is calculated, this amount is projected over the life of the covenant, and a discount rate is applied to adjust the figure to present value. This method measures the loss of earnings anticipated by the seller as a result of his forbearance from competing in the specified market.

In some complex buy-sell agreements a court may find the compensation-based approach too simplistic. Another method is to value what the buyer acquired, protection of the continued profitability of the business from the seller’s hostile use of his or her contacts in the market. This method calculates the present value of the economic loss to the buyer on the assumption that the seller reentered the market. Such an approach was sanctioned by the Tax Court in Ansan Tool and Manufacturing Co. v. Commissioner, T.C. Memo. 1992-121, where the compensation-based method was determined inadequate for the unique arrangement between the taxpayer and the seller in a stock buyout.

A version of the above method of valuation, which I will call Present Value of Economic Damages, includes first determining the fair market value of the subject business based on the assumption that the seller is willing to sign a complete covenant not to compete. Then estimate the present value of the economic damages over the economic life of the covenant which forms the basis of the discount applied to the fair market value of the subject company assuming a complete covenant not to compete. This discount is called Discount for Lack of Covenant Not To Compete (DFLCNC). The size of the discount will depend upon the terms of the covenant, and the economic risks that the seller will compete, or is allowed to compete, in the same or similar business.
The terms of a covenant not to compete are often negotiated. Case law typically limits the term of covenants to five years and to geographical areas currently being served by the subject company. A complete restrictive covenant will typically restrict the seller from working for a competitor, opening a competitive business, or being a owner, partner, or shareholder in the same or similar business. Sellers and buyers can and often do negotiate the terms of covenants where the term is less than five years, the geographic area is narrowed, and the scope of work that the seller is allowed to do is broadened. The price is often negotiated downward to account for these narrowing factors. As an example, a non-piracy covenant would typically restrict the seller from hiring any employees of the subject business and prevent the seller from serving existing customers for the term of the covenant; however, the seller would be allowed to work in the same or similar business and in the same geographic market area. Under the limited covenant, the seller is allowed to continue to earn a living within his chosen profession while being adequately reimbursed for giving up the subject company and not being able to hire their employees or take their customers. The non-piracy covenant overcomes the marital case law issue of not allowing value of covenants to be a divisible asset where it would restrict the seller or hypothetical seller from earning a living within his chosen profession.

The procedures for conducting the Present Value of Economic Damages method include the following:

1. Review the provisions of the covenant not to compete.
2. Determine the stated term of the covenant and verify its reasonableness.
3. Determine whether the restrictions represent a complete or limited covenant.
4. Forecast earnings on either a pretax or after tax basis over the economic life of the covenant assuming no discount for a restrictive covenant.
5. Determine the economic damages for each year of the forecast earnings based on a rigorous analysis of the risks associated with the seller's ability to compete with the subject company. The lost earnings, due to the lack of a complete covenant not to compete, represent the lost earnings for each year of the forecast.
6. Determine the present value of each year’s economic damages using the company's cost of capital adjusted for the same level of earnings used in the forecast.
7. Determine the value of the covenant not to compete, by deducting the present value of the economic damages resulting from the lack of a compete covenant, from the fair market value of the business, assuming a complete covenant not to compete.

Table One is an abbreviated summary of the factors that make up the risk analysis of the seller's ability to compete with a subject company. The chart reflects the rigorous risk analysis used to determine the economic damages.

Table Two reflects a worksheet used to forecast future earnings, develop the economic damages, and calculate the present value of the economic damages. Note that in the given example, earnings have been forecast on a pretax basis, and the cost of capital used to present value the earnings have also been adjusted to a pretax rate.

There is a growing need to value covenants not to compete. It is likely that more sophisticated methodologies will be developed in the near future; however, in the final analysis, any method used to value covenants must meet the criteria outlined in this presentation.
Covenants not to compete must be carefully drafted to be legally enforceable and meet the IRS requirements for price allocation and permitted amortization. Covenants must meet the legislative and case law test of reasonableness to be enforceable. Furthermore, covenants must pass the U.S. Internal Revenue Code's test of economic reality and mutual intent for price allocation and amortization. When the covenant meets these tests, the analysis can then utilize valuation methodology to determine economic damages due to breaches of a covenant or allocation of purchase price to meet legal and/or tax allocation.

Determining the value of a covenant not to compete or the economic impact for the lack thereof can be determined using a present value concept for the loss of future earnings. The procedures of this method include determining the present value of the loss of future earnings during the forecast of future earnings. Such a method was sanctioned by the Tax Court in Ansan Tool and Manufacturing Co. v. Commissioner, T.C. Memo. 1992-121.

The factors needed to determine the present value of the economic loss due to the lack of a complete covenant not to compete include:

* A base value of the subject Company given the assumption that the seller is willing to sign a covenant not to compete which would completely restrict the seller from reentering the market

* A measurement of the seller’s ability to reenter the market and effectively compete with the subject Company

* A forecast of future earnings for the subject Company, given the level of competition expected by a seller who has reentered the market during the restricted period

* A discount rate applicable to the level of earnings reflecting cost of capital

In the final analysis, any method used to value covenants must meet the criteria outlined in this presentation.
### Risk Analysis Chart

**Type of Covenant - Non-Piracy**

<table>
<thead>
<tr>
<th>Risk Factors</th>
<th>Highly Likely or Yes</th>
<th>Somewhat Likely</th>
<th>Somewhat Unlikely</th>
<th>Unlikely or No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller's financial ability to compete</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seller's health condition</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seller’s stated intentions to compete</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seller has ability to attract existing customers/clients</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seller ability to develop new business</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seller’s ability to establish same or similar product lines</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seller’s ability to hire existing employees or contractors</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The length of the agreement is less than 5 years</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The protected market area is reasonable</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other agreements which prevent Seller from competing</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Discount to First Year Earnings (%)**

- 31% + 21-30% 11-20% 0-10%

**Selected Earnings Discount** 15%

### Valuation of Covenant Not to Compete

**Type of Covenant - Non-Piracy**

<table>
<thead>
<tr>
<th>Projected Pretax Earnings Growth @ 7%</th>
<th>Fiscal Year</th>
<th>Discount Applied To Pretax Earnings</th>
<th>Projected Damage to Earnings</th>
<th>Discount Rate</th>
<th>Present Value Factor</th>
<th>Present Value of Discounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>$117,000</td>
<td>12/31/02</td>
<td>15.00%</td>
<td>$17,600</td>
<td>28.98%</td>
<td>0.8755</td>
<td>$15,409</td>
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<tr>
<td>$125,190</td>
<td>12/31/03</td>
<td>12.75%</td>
<td>$16,000</td>
<td>28.98%</td>
<td>0.6575</td>
<td>$10,520</td>
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<tr>
<td>$133,953</td>
<td>12/31/04</td>
<td>10.50%</td>
<td>$14,100</td>
<td>28.98%</td>
<td>0.4938</td>
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<td>$143,330</td>
<td>12/31/05</td>
<td>8.25%</td>
<td>$11,800</td>
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<td>$153,363</td>
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<td>$9,200</td>
<td>28.98%</td>
<td>0.2785</td>
<td>$2,562</td>
</tr>
</tbody>
</table>

**Value of Covenant Not to Compete**

$40,000 (Rounded)
Notes


4. 127 Ala. 110, 28 So 669 (1899)

5. 85 F. 271 (6th Cir. 1898), modified, 175 U.S. 211 (1899)


9. Id.


11. *Light v. Central Cellular Co. of Texas, 883 S.W.2d 642 (Tex. 1994).*


17. Mart v. Severson. 2002 DJDAR817


20. Dixie Finance Co. v. United States, 474 F.2d 501 (5th Cir. 1973),
Jeffrey D. Jones, ASA, CBA, FCBI

Jeff is nationally recognized as an experienced business appraiser and business broker and has earned senior level professional designations from national associations representing the appraisal and brokerage industry.

As president of Certified Appraisers, Inc., he manages the firm’s multidiscipline appraisal practice, which includes valuation of businesses, machinery & equipment and real estate. As chairman of Certified Business Brokers, LC he and his staff have been involved in over one thousand business sales since 1976.

He frequently testifies in depositions and courts of law as an expert witness on business valuation and machinery & equipment litigation matters. His clients include closely held companies, publicly held companies, financial institutions, the IRS and other governmental agencies.

Jeff has written many articles on the subject of appraising and selling businesses and is a frequent speaker at trade association meetings. He is the co-editor of the "Merger and Acquisition Handbook For Small and Midsize Companies" published by John Wiley & Sons.

As a consultant with SCORE, the Small Business Administration's consulting arm, he conducts seminars and provides consulting services for new and experienced entrepreneurs.

Jeff holds a Masters Degree from Pepperdine University. He is licensed by the Texas Real Estate Commission and the Texas Securities Board. He is a designated member of the American Society of Appraisers (ASA); the Institute of Business Appraisers (CBA); Texas Association of Business Brokers (BCB); and the International Business Brokers Association (FCBI).