The Noncompete Agreement Is Dead, Long Live the Noncompete Agreement

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The FTC Wants to Ban Noncompete Agreements but They Will Likely Endure in Certain Circumstances

By: Samantha L. Albert, ASA, ABV

Executive Summary

The FTC has updated its rulings concerning the enforceability of noncompete agreements while also making significant allowances for agreements arising from transactions. The elimination of noncompete agreements will shift some value from identifiable, amortizable assets to goodwill and may influence the attrition rates used to calculate the value of customer-related assets. The new ruling is expected to be met with substantial litigation before it becomes effective.

We don't typically see news about noncompete agreements on the first page of the *Wall Street Journal,* much less above the fold. But on April 24, 2024 the **FTC finalized** a rule that effectively prohibits the enforcement of existing noncompete agreements in most cases and disallows them going forward. While the ruling wasn't a complete surprise – the legality of noncompete agreements has been challenged **in many states** and the FTC has been **discussing** the topic for several months – its potential ramifications for intangible asset valuation and reporting are minimal, at least so far.

Essentially, the **FTC has declared** most existing noncompete agreements unenforceable. A few exceptions have been carved out for existing agreements, namely those with "senior executives." Additionally, entities outside of FTC purview, such as nonprofit organizations, are entirely exempt from the rule. For the most part, however, the FTC would like most noncompete agreements to go the way of dodos and passenger pigeons.

The full rule is over 570 pages and can be viewed **here**. But to spare our readers that burden, here are a few key takeaways from our reading of the rule and its potential impact on financial statement reporting and valuation:

- Noncompete agreements have occupied a fuzzy legal status for several years. As a result, noncompete agreements are typically ascribed minimal value during a purchase price allocation exercise. This might be due to a lack of enforceability or the particular facts and circumstances of the subject industry or covered individual.

- With respect to a transaction, "[t]he final rule does not apply to non-competes entered into by a person pursuant to a bona fide sale of a business entity" or in the sale of a division or subsidiary of an entity. This describes a great many of the noncompetes we encounter for purchase price allocations. While a noncompete agreement that previously existed may become unenforceable under the FTC's ruling, it appears that noncompete agreements arising in connection with a transaction would still be enforceable, and thus, may continue to have value. Interestingly, the transaction exception continues to make noncompete agreements relevant within the context of **Section 280G compliance**.

- Existing noncompete agreements are explicitly allowed to be enforceable for "senior executives." The final rule defines the term "senior executive" as someone earning more than $151,164 who is in a "policy-making position." The final rule does not permit new agreements with "senior executives," but does preserve those already in effect (and, presumably, recorded as intangible assets in a firm's financial statements).

- The FTC has permitted non-disclosure agreements (and estimates that over 95% of noncompete agreements already have NDAs). From a trade-secret perspective, the FTC clearly prefers NDAs to noncompete agreements. Likewise, non-solicitation agreements are still permitted, which may continue to give rise to a distinct intangible asset.

Within a day of the issuance of the final rule, the U.S. Chamber of Commerce and other business groups **jointly filed a lawsuit** against the FTC. Ordinarily, the final rule would become law after 120 days, but the actual implementation may be delayed as legal proceedings continue. At the current moment, the litigation continues the uncertainty surrounding noncompete agreements.

From a valuation perspective, eliminating the separate recognition of noncompete agreements would shift value from an identifiable, amortizable asset into goodwill. However, because noncompete agreements often comprise a relatively small allocation of total transaction value, the overall impact of this transfer of value may be minimal. Interestingly enough, a second-order impact of the elimination of noncompete agreements could be an increase in customer attrition rates used in the valuation of customer-related intangible assets. If customer accounts are more susceptible to competition and poaching, then the fair values ascribed to those assets might go down.

Mercer Capital has significant experience in the valuation of noncompete agreements for financial reporting and other purposes, such as **Section 280G compliance**. To discuss other ramifications of the FTC's new rule on noncompete agreements or any other financial reporting valuation matter, please contact a Mercer Capital professional.

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Professionals

Lucas Parris, CFA, ASA-BV/IA
parrisl@mercercapital.com
901.322.9784

J. David Smith, ASA, CFA
smithd@mercercapital.com
832.432.1011

Sujan Rajbhandary, CFA, ABV
sujanr@mercercapital.com
901.322.9749

Samantha L. Albert, ASA, ABV
alberts@mercercapital.com
901.322.9702

Zachary M. Barber, CPA/ABV
barberz@mercercapital.com
901.322.9718

Jeff Capwell, CPA
capwellj@mercercapital.com
901.322.9759