Properly craft non-compete provisions in a buy sell contract to avoid nightmares

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You have acquired your dream dealership. The transaction was cordial and uneventful. The Seller was a pleasant gentleman purportedly on his way to retirement. By all accounts, it was a good deal for both sides.

Unfortunately, a few months after closing you learn that the Seller invested in a competing store just 20 miles away. When you inquire, he explains that he just "took a small piece" and there was no need to worry. However, to your dismay, disturbing events begin to unfold:

- Some of your key employees depart for the other dealership, followed by several subordinates.
- You discover that your customers have received announcements of the store's grand opening (signed by the Seller).
- The customers are even offered free oil changes and other promos.

You paid the Seller significant blue sky money for the dealership and a substantial price for his real estate. How could any of this be happening?

You inquire immediately with your lawyer, hoping for some comforting reassurance. Instead, there is that dreaded pause, followed by the disturbing comment: “Let me check the contract on that one and circle back.” The nightmare becomes a stark reality: the very person that worked you over for major money for his dealership is now in direct competition with you. Worse, because of a defective contract, there is little that can be done to stop it.

As this hypothetical but very possible example illustrates, a properly-crafted non-compete provision in a buy-sell is essential to protect your investment. The absence of such a provision, or a defective one, can have disastrous consequences for a Buyer. These provisions also have ramifications for the Seller. Let’s explore the most significant components of a non-compete and address how these can impact the deal from your perspective.

A non-compete provision drafted in favor of a Buyer must impose the following restrictions against the Seller:

- A complete prohibition from re-engaging in a competing business for a specified period of time within a specified geographical area.
- For example, the Seller cannot own, operate or invest in a dealership of the same line make for a period of five (5) years (from closing) and within a twenty-five (25) mile radius of the dealership.
- This restriction must cover all phases of the business, including sales, service and parts.
- A prohibition from soliciting the dealership’s employees for a specified time period after closing. Optionally, this should prohibit re-hiring, irrespective of who solicited whom.
- A prohibition from soliciting the customers of the dealership for a specific period.
- A prohibition from using specified proprietary information of the dealership – e.g., customer lists.

These provisions typically extend to the owner of the selling entity, and prohibit both direct and indirect actions. It is problematic to extend these to key employees unless a separate compensation is paid to them.

Furthermore, the provision customarily entitles the Buyer to so-called injunctive relief so that a court application can be filed immediately to stop (enjoin) the non-compete violations. It also entitles the Buyer to recover damages, as well as legal fees and costs. If these restrictions were in place in the illustrative case above, the Buyer would have had the ability to stop the Seller’s actions and recover all his damages and fees.

The illustration also demonstrates another key aspect of a buy-sell provision. Sometimes, the most important feature of the agreement is not what is in it, but what is not in it! A weakly-drafted buy-sell that inadvertently or ignorantly omits a critical provision — such as a non-compete — can be extremely damaging.

The Seller's perspective

What about the Seller's perspective on all of this? Here are some important considerations:

- A non-compete should exempt any pre-existing dealership owned by the Seller that may fall within the protected area.
- Many Sellers want to exempt certain longtime employees from the non-solicitation provision.
- Many want the ability to rehire any employee for another (non-competing) dealership if the employee is terminated by the Buyer.
- In a role reversal, some Sellers want to restrict the Buyer from competing or advertising in an adjacent market where the Seller may have additional dealerships. The prohibition of billboard advertising in the adjacent market is an example.

As such, the non-compete aspect cannot also be overlooked by the Seller.

Finally, you should not overlook the tax implications of covenants not to compete. From a Buyer's standpoint, any monies in a deal allocated to the non-compete restrictions are subject to a 15-year write-off for Federal income tax purposes.

As for the Seller, any amount so allocated is considered ordinary income as opposed to capital gains. As such, it behooves the Seller to insist upon less allocation to a non-compete, and more to blue sky (which is taxed as capital gains). Of course, the parties are advised to consult with their accountant regarding such tax implications and to evaluate the same aspects as these are governed by the applicable state tax laws.

The properly-drafted buy-sell should cover the non-compete aspect in a manner that is protective of your position in the transaction. In the aftermath of the deal, you should be living the dream, not a nightmare.

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