Upcoming Events

MBBI Wisconsin Event
M&A Deal Killer - Culture
October 26, 2017 | 4:00 to 7:00 PM
Pier 465 – 465 Marina Lane
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Real Estate Strategies
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MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

MBBI Newsletter October 2017

The Hidden Value of Restrictive Covenants in M&A Transactions

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GERBERS LAW, S.C.

Restrictive covenants, namely in the form of non-competition and non-solicitation agreements, are routinely deployed in M&A transactions, yet often overlooked by advisors as being useful tools for negotiating deal terms. After all, it is well accepted that a prospective buyer will not agree to purchase a target business's assets or purchase the equity in a business unless the seller will be legally precluded from working for a competitor or opening a competing business after the transaction closes. Restrictive covenants are so commonplace in deals, in fact, that many advisors view them less as a "tool" and more as a practical reality of a transaction, which can be memorialized through boilerplate language under generally accepted "default" legal principles without much afterthought. Based on that misconception, many advisors fail to recognize the important legal nuances that exist concerning restrictive covenants, at least in Wisconsin, in the context of business transactions, resulting in negotiable deal points being left on the table after the transaction closes.

Wisconsin "Default" Laws Concerning Restrictive Covenants

In Wisconsin, restrictive covenants, within the employer-employee "default" context, are governed by Wis. Stat. §103.465. Wisconsin courts look upon restricting competition with disfavor and "the public policy underlying [Wis. Stat. §103.465] is that Wisconsin law favors the mobility of workers." Genzyme Corp. v. Bishop, 463 F. Supp. 2d 946 (W.D. Wis. 2006). With that in mind, a restrictive covenant is enforceable under Wisconsin law only if it satisfies all of the following: (1) it is necessary for the protection of the principal; (2) it provides a reasonable time period; (3) the restriction covers a reasonable territory; (4) the restriction is not unreasonable or oppressive in nature; and (5) the restriction is not unreasonable to the general public. Chuck Wagon Catering, Inc. v. Raduege, 88 Wis. 2d 740, 277 N.W.2d 787 (1979). If any single provision of a restrictive covenant is deemed unenforceable under any of the foregoing factors, the entire covenant is generally deemed unenforceable. Within the default context, it is widely accepted that a reasonable time period is two years, though the reasonableness of both duration and geographic scope will vary based on the facts and circumstances of each case.

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Restrictive Covenants Incidental to the Sale of a Business

Because of the Wisconsin's pro-competition predisposition, many M&A advisors incorrectly assume that the foregoing "default" laws concerning restrictive covenants also govern non-competition agreements in the M&A context. This, however, is not the case. In M&A transactions governed by Wisconsin law, a properly tailored agreement can provide a buyer with a much longer period of protection from seller competition than what would otherwise be deemed reasonable under the "default" principles. In Reiman Associates, Inc. v. R/A Advertising, Inc., 102 Wis.2d 305, 306 N.W.2d 292 (1981), the Wisconsin Supreme Court held that "covenants not to compete incidental to the sale of a business are not subject to exacting scrutiny [concerning the five elements above]" and that such covenants "benefit from full application of the rule of partial enforcement: even an unreasonable restraint will be enforced to the extent necessary and reasonable under the circumstances." In that case, concerning the purchase and sale of an agricultural advertising company, the court summarily held that a covenant not to compete for a period of six years was enforceable.

Opportunity for M&A Advisors

The Wisconsin Supreme Court's recognition that restrictive covenants incidental to the sale of a business must be viewed with less scrutiny than those arising under the traditional employer-employee context created an opportunity for M&A advisors to add value for their clients during the negotiation process of a transaction. The court's ruling in Reiman Associates, Inc. equipped advisors with an additional tool to deploy to negotiate more favorable deal terms for clients, achieved through leveraging a restrictive covenant's duration and scope. As such, the prudent buy-side advisor would put his or her client in an advantageous bargaining position by setting the initial term of a restrictive covenant in the range of five to seven years, depending on the industry of the business being acquired.

An example of a negotiation scenario is where a dispute arises regarding the calculation of working capital. If the issue of covenant duration were important to the seller, the buy-side advisor may offer to compromise on a reduced covenant period in exchange for a working capital formula more favorable to the buyer. On the other hand, if the seller intended to take the proceeds of the sale, retire, and move to Hawaii immediately after closing, the sell-side advisor may negotiate an extended covenant duration as a means of compromising to arrive at a formula more favorable to the seller. Another example arises when the transaction includes a seller financing component. In that situation, either advisor may purpose that the seller be entirely relieved of his or her covenant not to compete in the event the buyer defaults under the terms of the seller note. The true value of such a provision would ultimately correlate with the actual and perceived risk of buyer defaulting, however, the example offers another illustration of a negotiable term which may not have otherwise existed, or have been necessary, but for restrictive covenants being more liberally scrutinized in the context of M&A transactions.

Conclusion

Too often M&A advisors overlook the opportunity to use restrictive covenants as tools for developing other terms of the transaction. Much of this is the result of advisors incorrectly assuming that the enforceable provisions for restrictive covenants, in terms of duration and scope, is well-worn territory, incapable of any material deviation. As this article points out, this is simply not the case, and the terms and provisional byproducts of restrictive covenants are just as negotiable as any other part of the transaction. Equipped with this knowledge, advisors on both sides of the deal have an opportunity to add value for their client by strategically leveraging the intricacies made available by enlarged restrictive covenants as a means of further achieving client goals.

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