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Last in Line

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When a Contract Is Rejected, Does Its Noncompetition Clause Survive?

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Many types of contracts contain noncompetition clauses. The party extracting the noncompetition clause often claims that it will invest time or impart proprietary information and therefore needs assurance that the other party to the contract cannot become a competitor if things do not work out. Perhaps due to unequal bargaining positions or a desire to appear cooperative, the other contracting party often consents to the noncompetition clause and ignores its ramifications until there is a problem with the contract.

In the current recession, bankruptcy of one party is increasingly the "problem" that causes the other party to worry about the noncompetition clause. Although noncompetition clauses are common, the law is surprisingly murky on their enforceability after one party files for bankruptcy and the contract is rejected. Some cases hold that the covenant not to compete becomes unenforceable once the contract is rejected, while other cases hold the opposite. This lack of predictability on such an important and common issue is troubling.

There are several factors contributing to the disparate by the courts. First, under 11 U.S.C. § 365(g), contract rejection constitutes a pre-petition breach of the contract: Rejection does *not* terminate the contract or otherwise cause it to "vanish." Consequently, courts are left to answer the quintessential question of whether the noncompetition clause "survives" rejection of the contract. Second, covenants not to compete are often enforced through injunctive relief or other equitable remedies that do not constitute "claims" within the meaning of 11 U.S.C. § 101(5).[1] Because only "claims" are discharged in bankruptcy, the "nonclaim" status of equitable remedies leaves open the possibility that noncompetition clauses can be enforced against a debtor post-rejection and even post-discharge. Third, a court's willingness to enforce a noncompetition clause may depend on whether the bankruptcy case is a liquidation or reorganization. Fourth, noncompetition clauses are designed to govern the parties' behavior after their contractual relationship ends, so it might seem that contract rejection actually *triggers* the covenant not to compete. Lastly, noncompetition clauses can go "both ways": Most often the nondebtor party seeks to enforce a covenant not to compete against the debtor, but sometimes the debtor seeks to enforce the noncompetition clause against a nondebtor, such as an employee. With all these "moving parts," it is easy to see how the law became murky, but that does not help lawyers (or their clients) who crave predictability.

Shortly after the Bankruptcy Code was enacted, a line of cases developed holding that a noncompetition clause is unenforceable against the debtor after the contract is rejected. Relying on the axiom that an executory contract must be assumed or rejected in its entirety, these courts concluded that rejection of an executory contract renders its noncompetition clause unenforceable against the debtor. In *In re Rovine Corp.*,[2] the court stated that "[t]he effect of rejection is to relieve a debtor and its estate of the obligation imposed under an executory contract."[3] By holding that the noncompetition clause is unenforceable, these cases have the effect of discharging the nondebtor's claims for injunctive relief against the debtor, even though claims for injunctive relief do not constitute "claims" as defined in the

1 Bankruptcy Code § 101(5) defines "claim" to mean:
(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured: or
(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

2 6 B.R. 661, 666 (Bankr. W.D. Tenn. 1980).

3 *See also In re Norquist*, 43 B.R. 224 (Bankr. E.D. Wash. 1984); *In re Allain*, 59 B.R. 107, 109 (Bankr. W.D. La. 1986); *Silk Plants Etc. Franchise Systems Inc. v. Register*, 100 B.R. 360, 362 (M.D. Tenn. 1989).

Bankruptcy Code.[4] One case in this line, *In re JRT Inc.*,[5] left open the issue of whether post-rejection injunctive relief was a possibility. In *JRT*, the bankruptcy court held that the entire franchise agreement (including the covenant not to compete) may be rejected, but the court declined to determine whether the noncompetition clause could be subsequently enforced by injunctive relief.[6]

Another line of cases reached the opposite conclusion and held that the noncompetition clause remains enforceable against the debtor even after the contract is rejected. In *In re Don & Lin Trucking Co.*,[7] the court sidestepped the fact that 11 U.S.C. § 365(g) renders contract rejection a pre-petition breach and *not* a termination of the contract, reasoning:

> If the term "reject" in section 365 has any correspondence of meaning to the word "terminate," then perhaps, rejection of an executory contract terminates all of the mutual-performance obligations but does not affect others which deal with the effect of termination. By the specific wording of this contract, termination (by either party) springs into place the debtor's agreement not to compete. Thus, termination of the contract was not intended to mean that the parties then were free to act as if the ended relationship had never existed, and no such result is to be attributed to the bankruptcy statute.[8]

Thus, the court ruled that "the effect of the debtor's rejection of the...contract did not relieve it of the obligation not to compete in business."[9] In *In re Klein*,[10] the bankruptcy court concluded that although a contract can only be assumed or rejected in its entirety, the noncompetition clause in favor of the franchisor remains enforceable against the debtor franchisee (to the extent of applicable nonbankruptcy law) even after the rest of the contract is rejected because

> the very purpose of the covenant [not to compete] is to govern the relationship between the parties *after* the demise of the underlying contract, even though the covenant is not an executory contract in and of itself. Although executory contracts must be assumed or rejected in their entirety, the importance of the covenant, as ancillary to the franchise agreement, comes to the fore upon rejection of the franchise agreement.[11]

In *In re Steaks to Go Inc.*,[12] the court held that the franchisor could enforce the covenant not to compete against the debtor/franchisee after the franchise agreement was rejected, stating:

> As a general principle, assumption or rejection by a debtor in possession or a trustee is an assumption or rejection of the entire executory contract. The Bankruptcy Code does not specifically allow for selective assumption or rejection. However, some Courts have recognized the concept that an executory contract may be made up of several related but distinguishable components. As such, some of the components may be severable from the whole document depending upon the circumstances that are presented in the record.
>
> Other Courts have recognized that while the entire executory contract is rejected or assumed, rejection does not relieve all parties of their responsibilities to perform under a rejected executory contract.
>
> In the matter being considered here, the covenants not to compete are enforceable notwithstanding rejection of the Franchise Agreements.[13]

Even among these divergent rulings, there appear to be some trends. First, where there is evidence of bad faith in connection with the debtor's rejection of the executory contract, bankruptcy courts (as courts of equity) will enforce the noncompetition clause against the debtor, or deny the debtor's motion for rejection altogether.[14] Second, although *Rovine*, *Silk Plants* and *JRT* are all cases in which the franchisor lost its argument that the noncompetition clause remained enforceable post-rejection, in the more recent cases of *Klein*, *Steaks to Go* and *Sir Speedy* the franchisor won, and those courts held that noncompetition clauses are enforceable post-rejection. Hopefully for franchisors, these more recent cases represent a trend, perhaps because courts tend to view the covenant not to compete in the franchise relationship as being similar to enforceable covenants not to compete ancillary to the sale of a business.[15] In cases that do not involve franchise agreements, it is harder to predict whether a bankruptcy court will enforce a noncompetition clause after the contract has been rejected. The cases are fact-specific and look to state law on enforceability of covenants not to compete.

The current recession presents new issues as *employers* file for bankruptcy and seek to reject contracts with their employees. Those employment contracts often contain the employee's covenant not to compete with the employer. Does the nondebtor employee remain bound by a covenant not to compete after the debtor/employer rejects the employment contract? From a policy standpoint, it seems harsh for the noncompetition clause to survive and continue to bind the employee *after* the rest of the contract is rejected and *after* the debtor/employer no longer pays the employee. After all, the nondebtor employee party might have fully complied with the contract and generally has little or no control over the debtor/employer's decision to reject the contract. Why "excommunicate" the nondebtor employee from the job market simply because the employer filed for bankruptcy and thereby acquired the right to reject the employment contract?

On the other hand, in a reorganization case the debtor might argue that a failure to enforce the covenant not to compete in a rejected contract adversely affects the debtor's ability to reorganize. What if the debtor is trying to sell its business or assets in bankruptcy? Might the failure to enforce the noncompetition clauses in rejected contracts diminish the value of the debtor's assets or scare off potential purchasers? In *In re Annabel*,[16] the court ruled that the noncompetition

4 *See* 11 U.S.C. § 101(5).
5 121 B.R. 314, 323 (Bankr. W.D. Mich. 1990).
6 Even in this early line of cases, the courts recognized that a single document might include several independent or severable contracts. In *In re Allain*, 59 B.R at 109, and *In re JRT Inc.*, 121 B.R. at 323, the courts found that the noncompetition clauses at issue were neither independent nor severable from the rest of the contract, but they infer that if a noncompetition clause is found to be "independent" or "severable," then the covenant not to compete might remain enforceable even after the rest of the contract is rejected.
7 110 B.R. 562 (Bankr. N.D. Ala. 1990).
8 *Id.* at 567.
9 *Id.* at 568.
10 218 B.R. 787 (Bankr. W.D. Pa. 1998).
11 *Id.* at 790-91.
12 226 B.R. 35 (Bankr. E.D. Mo. 1998).
13 226 B.R. at 38. *See also Sir Speedy Inc. v. Morse*, 256 B.R. 657 (D. Mass. 2000); *In re Weathers*, 465 B.R. 782 (Bankr. N.D. Miss. 2011).
14 *See, e.g., In re Hirschhorn*, 156 B.R. 379 (Bankr. E.D.N.Y. 1993); *In re Carrere*, 64 B.R. 156 (Bankr. C.D. Cal. 1986).
15 *See, e.g., Jackson Hewitt Inc. v. Childress*, 2008 WL 834386, *7 (D.N.J. 2008).
16 263 B.R. 19, 28 (Bankr. N.D.N.Y. 2001).

clause did not survive contract rejection, but expressly noted that its ruling was limited because *Annabel* was a chapter 7 liquidation, and consequently, the court was not "required to consider the effect of the covenant not to compete on the debtor's ability to reorganize." In reorganization cases, however, courts will consider the effect of the covenant not to compete on the debtor's ability to reorganize. In an employer's chapter 11 case, this could result in painful post-rejection enforcement of noncompetition clauses against nondebtor employees unless bankruptcy courts—as courts of equity—protect the nondebtor employees.

It is challenging for practitioners that covenants not to compete are so prevalent and important, yet the law regarding their post-rejection enforcement is so unpredictable. Long ago, there was a similar uncertainty regarding intellectual property contracts post-rejection; ultimately, the Bankruptcy Code was amended to give us 11 U.S.C. § 365(n). Perhaps it is time to amend the Code to create certainty regarding when noncompetition clauses survive contract rejection, and how they can be enforced. abi

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