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

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Although contractual noncompetition clauses are common, the law is surprisingly murky on their enforceability after one party files for bankruptcy and the contract is rejected. This lack of predictability on such an important and common issue is troubling.

There are several reasons for the apparent confusion. First, 11 U.S.C. § 365(g) renders contract rejection a pre-petition breach of the contract: Rejection does not terminate the contract. Second, covenants not to compete are often enforced through injunctive relief that does not constitute a "claim" (see 11 U.S.C. § 101(5)). Because only "claims" are discharged in bankruptcy, the "non-claim" 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 might depend on whether the bankruptcy case is a liquidation or reorganization. Fourth, because noncompetition clauses govern the parties after their contractual relationship ends, some courts conclude that contract rejection actually triggers the noncompetition clause. Lastly, noncompetition clauses can go "both ways": Most often the nondebtor party seeks to enforce it against the debtor, but sometimes the debtor-employer seeks to enforce it against a nondebtor employee. With all of these "moving parts," it is easy to see how the law became murky.

An early line of cases held that a noncompetition clause is an integral part of the contract and is therefore unenforceable against the debtor after the contract is rejected. These cases are based on the axiom that an executory contract must be assumed or rejected in its entirety. See In re Rovine Corp., 6 B.R. 661, 666 (Bankr. W.D. Tenn. 1980); In re Norquist, 43 B.R. 224, 230-31 (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). One case in this line, In re JRT Inc., 121 B.R. 314, 323 (Bankr. W.D. Mich. 1990), left open the issue of whether post-rejection injunctive relief was a possibility.

A more recent line of cases reaches the opposite conclusion and holds that the noncompetition clause remains enforceable against the debtor even after the contract is rejected. In In re Don & Lin Trucking Co., 110 B.R. 562, 567-68 (Bankr. N.D. Ala. 1990), the court sidestepped 11 U.S.C. § 365(g) and held that contract rejection is akin to contract termination, at which point the noncompetition clause "springs into place." In In re Klein, 218 B.R. 787, 790-91 (Bankr. W.D. Penn. 1998), the court held that although a contract can only be assumed or rejected in its entirety, the noncompetition clause survives because its purpose is to govern the relationship among the parties after the demise of the underlying contract. See also **Sir Speedy Inc** . v. Morse, 256 B.R. 657 (D. Mass. 2000). In re Steaks to Go Inc., 226 B.R. 35, 38 (Bankr. E.D. Mo. 1998), reached the same conclusion, reasoning that "an executory contract may be made up of several related (but distinguishable) components that may be severable from the whole document depending upon the circumstances that are presented in the record."

Even among these divergent rulings, there are some trends. First, where there is evidence of bad faith regarding 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. 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). 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 an enforceable covenant not to compete ancillary to the sale of a business. See, e.g., **Jackson Hewitt Inc** . v. Childress, 2008 WL 834386, *7 (D.N.J. 2008). 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 recent recession presented new issues as employers filed for bankruptcy and sought to reject contracts with their employees. Does the nondebtor employee remain bound by a noncompetition clause after the debtor/employer rejects the employment contract? From a policy standpoint, that's a very harsh result for the nondebtor employee. Yet, in a Chapter 11 reorganization, the debtor/employer might argue that a failure to enforce the noncompetition clause adversely affects the debtor/employer's ability to reorganize or to sell the business. In In re Annabel, 263 B.R. 19, 28

(Bankr. N.D.N.Y. 2001), the court ruled that the noncompetition clause did not survive contract rejection, but stated that its ruling was limited because Annabel was a Chapter 7 liquidation and the court was not "required to consider the effect of the covenant not to compete on the debtor's ability to reorganize." In an employer's reorganization case, however, courts will consider the effect of the noncompetition clause on the employer/debtor's ability to reorganize. 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.
The unpredictability on this important issue is reminiscent of the confusion surrounding rejected intellectual property contracts before the advent of 11 U.S.C. § 365(n). Perhaps it is time to amend the Bankruptcy Code to include a provision that provides certainty on whether noncompetition clauses survive contract rejection, and when and how they can be enforced.

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