Noncompetition Agreements in Bankruptcy: Covenants (Maybe) Not to Compete

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A struggling young soap opera actress is offered a role on a prime time show on another network.1 Unfortunately, she has over two years left on her network contract, and that contract contains a noncompetition clause: if she terminates the contract, she cannot appear on any competing network for six months. However, just as opportunity is packing its bags, the actress talks to her attorney, who tells her that she can get around the restriction in her contract by, of all things, filing for bankruptcy. Under current case law, whether the attorney is a hero or a heel depends in large measure on where the bankruptcy petition is filed.2 Whether bankruptcy should offer such an escape is the subject of this Comment. It examines whether and when bankruptcy should defeat a nondebtor’s right to enforce a covenant not to compete against an individual debtor.3

The current treatment of covenants not to compete in bankruptcy law is at best a tricky, and at worst an incoherent, business. The issue of bankruptcy’s effect on covenants not to compete arises most frequently when a trustee rejects an executory contract4 under § 365 of the Bankruptcy Code (the


1 These facts are based on In re Carrere, 64 Bankr 156 (Bankr C D Cal 1986).

2 Unfortunately for Tia Carrere (who is no longer acting in soap operas and, judging from her appearances in films such as Wayne’s World and True Lies, no longer struggling either), she filed her petition in the Bankruptcy Court for the Central District of California, where the bankruptcy judge denied her motion to reject her three-year contract to perform on the soap opera “General Hospital” so that she could accept a more lucrative contract to perform on the “A Team.” See id at 160.

3 Much of the analysis in this Comment—particularly the textual analysis of the Bankruptcy Code—is germane to both individual and corporate bankruptcies. However, because space constraints preclude a full treatment of policy considerations peculiar to the corporate context, this Comment focuses on the enforceability of covenants not to compete against individual debtors. Moreover, because individual debtors generally file for bankruptcy under Chapters Seven and Thirteen, and only in unusual cases seek protection under Chapter Eleven, see Douglas G. Baird, The Elements of Bankruptcy 5 n 2 (Foundation, 1992), this Comment focuses primarily on the effects of proceedings under Chapters Seven and Thirteen on noncompetition covenants.

4 The precise definition of the term “executory” has been the subject of some debate. See generally Michael T. Andrew, Executory Contracts in Bankruptcy: Understanding
Unfortunately, the myriad complicated questions that surround § 365 and the treatment of executory contracts in bankruptcy cloud the central, wholly severable issue: the dischargeability of a nondebtor's right to enforce a covenant not to compete against a breaching debtor. However, because § 365 provides the context in which covenants not to compete are most often examined, and because of the heavy and often misleading emphasis that bankruptcy judges place on executory contract principles in determining the continued enforceability of such covenants, a complete analysis of this topic must begin with a discussion of the procedural posture in which the issue most often arises.

Section 365(a) permits a bankruptcy trustee to reject any executory contract of the debtor. Often, rejected contracts contain covenants not to compete. When a trustee rejects a contract containing an otherwise enforceable noncompetition covenant, the debtor-employee commonly acts as if he is no longer bound by the covenant, and the employer commonly seeks to enjoin this competitive conduct. Although a bankruptcy trustee possesses

"Rejection", 59 U Colo L Rev 845 (1988); Jay Lawrence Westbrook, A Functional Analysis of Executory Contracts, 74 Minn L Rev 227 (1989); Michael T. Andrew, Executory Contracts Revisited: A Reply to Professor Westbrook, 62 U Colo L Rev 1 (1991). Most courts have adopted Professor Countryman's definition, which states that an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, Executory Contracts in Bankruptcy, Part I, 57 Minn L Rev 439, 460 (1973). See, for example, In re Oseen, 133 Bankr 527, 529 (Bankr D Idaho 1991). This is also the definition cited in the legislative history of the Bankruptcy Code. See HR Rep No 595, 95th Cong, 1st Sess 347 (1977).


See Westbrook, 74 Minn L Rev at 228 (cited in note 4) ("Bankruptcy is that volume of the law that might have been written by Lewis Carroll ... In no chapter of that volume has the law become more psychedelic than in the one entitled 'executory contracts.'").

Covenants not to compete appear in a wide variety of contracts, including, for example, employment contracts, franchise and distributorship agreements, leases and subleases, partnership agreements, and contracts for the sale of businesses. In all cases, a breach by the covenantor gives rise to certain rights in the covenantee, such as a right to enjoin the prohibited activity. See generally Kurt H. Decker, 1 Covenants Not to Compete 43-73 (Wiley, 2d ed 1993). For the sake of simplicity, this Comment speaks generally of employment contracts and the employer's right to enforce a covenant not to compete against an employee, although the analysis applies equally to other covenant holders.

See, for example, In re Cox, 53 Bankr 829, 830-31 (Bankr M D Fla 1985) (debtor-employee went to work for competitor of employer).

When a bankruptcy petition is filed, § 362(a) automatically stays any judicial proceedings against the debtor based on prepetition claims. 11 USC § 362(a) (1988). Although
the undisputed power to reject executory contracts, many courts disagree about the effect this rejection and other bankruptcy processes have on the enforceability of covenants not to compete.\textsuperscript{10} Moreover, even courts that agree on the enforceability of such covenants offer varying justifications for their conclusions.\textsuperscript{11}

This Comment attempts to develop a consistent framework for the treatment of noncompetition agreements in bankruptcy proceedings. Section I summarizes the relevant provisions of the Code and the roles these provisions play in the analysis of noncompetition covenants. It also demonstrates that the current approach employed by many courts—analyzing the effect rejection has on the nondebtor's right to an injunction—asks the wrong question and confuses the power of the trustee to reject the contract with the consequences that flow from that rejection. Instead, the proper inquiry should examine the effect the bankruptcy discharge has on the nondebtor's rights. Section II examines the current case law in this area, canvassing the various approaches taken by courts and identifying the flaws in each. Finally, Section III examines both the policies underlying the bankruptcy system and the text and legislative histories of relevant Code provisions. Section III then proposes two solutions to the noncompetition covenant quandary. First, it proposes a legislative solution modeled on the Code's treatment of real property leases and technology licenses. Second, recognizing the practical difficulty of enacting corrective legislation, the Section argues that even under the current text of the Code, the right to

\textsuperscript{10} Compare, for example, \textit{In re Rovine Corp}, 5 Bankr 402, 404 (Bankr W D Tenn 1980) ("The effect of the rejection was to relieve the [debtor] and its estate of the obligations imposed via the covenant not to compete."). with \textit{In re Don & Lin Trucking Co}, 110 Bankr 562, 568 (Bankr N D Ala 1990) ("[T]he debtor's rejection of the [ ] contract did not relieve it of the obligation not to compete . . . .").

\textsuperscript{11} Compare, for example, \textit{Don & Lin Trucking Co}, 110 Bankr at 568 (holding that debtor remains bound by covenant because rejection merely relieves debtor of performance of burdensome contract provisions but does not relieve debtor of "the effects of such termination"), with \textit{Matter of Udell}, 149 Bankr 898, 907 (Bankr N D Ind 1992), rev'd, 149 Bankr 908 (N D Ind 1993), rev'd, 18 F3d 403 (7th Cir 1994) (concluding that debtor remains bound by covenant because right to injunction is not a "debt").
enforce a covenant not to compete should generally survive bankruptcy, notwithstanding the discharge of the debtor's other legal obligations.

I. THE BANKRUPTCY CODE AND NONCOMPETITION COVENANTS

At its core, bankruptcy aims to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." When a debtor files a petition for bankruptcy, the Code prevents his creditors from pursuing collection efforts outside of the bankruptcy proceedings and provides a procedural framework for the collective distribution of some of the debtor's assets to creditors. Upon completion of the bankruptcy proceedings, the debtor is generally discharged from personal liability for all prebankruptcy debts.

A. The Bankruptcy Code Provisions

1. Section 365: Rejection of executory contracts.

A debtor ordinarily enters bankruptcy possessed of certain assets, including claims against third parties, and certain liabilities, such as obligations owed to third parties. Broadly speaking, rights that the debtor has against third parties are treated as property of the bankruptcy estate under § 541(a), and obligations owed by the debtor are treated as claims against the estate under § 502. Because an executory contract imposing mutual performance obligations on the debtor and the nondebtor is conceptually no more than the combination of an asset and a liability, it could conceivably be treated under §§ 541 and 502, respectively. However, the Code treats the executory contract as a special case subject to special rules set forth in § 365.

Section 365(a) provides that the bankruptcy "trustee, subject to the court's approval, may assume or reject any executory con-

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13 See 11 USC § 362(a). See also note 9.
14 See 11 USC §§ 727(b), 1328(c).
15 The bankruptcy estate is composed of "all legal or equitable interests of the debtor." 11 USC § 541(a)(1).
16 11 USC § 502.
17 The performance owed to the debtor could be treated as property of the estate under § 541(a), the performance owed by the debtor as a claim under § 502. See Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 105-06 (Harvard, 1986).
The purpose of § 365(a) is to allow the trustee to abandon property that is burdensome to the estate. Thus, the trustee may assume contracts that it believes will benefit the estate, and reject contracts for which it believes the costs to the estate will exceed the benefits.

When the trustee rejects a contract, § 365(g) provides that such rejection "constitutes a breach of such contract . . . immediately before the date of the filing of the [bankruptcy] petition . . . ." Thus, contrary to a view often expressed or implied in many bankruptcy decisions, rejection does not cause a contract magically to vanish. The only consequence that flows from rejection is that the Code treats the contract as if the debtor had in fact breached it just prior to bankruptcy. The breach may have its own consequences, but these are not bankruptcy issues; instead, they are created and governed by applicable state or nonbankruptcy federal law. The crucial point is that the postrejection rights and obligations of the debtor and the nondebtor are exactly the same as they would have been had the debtor first breached the contract and then filed for bankruptcy.

2. Section 502: Allowance and estimation of claims.

Where a nondebtor has a right to an equitable remedy that in turn gives rise to a right to payment, § 502(c) requires the bankruptcy court to estimate this right to payment and to allow it as a claim against the estate. In effect, the choice between alternative remedies, which is in the hands of the nondebtor outside of bankruptcy, is made by the bankruptcy court under §

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18 11 USC § 365(a).
19 Lawrence P. King, ed, 2 Collier on Bankruptcy § 365.01 at 365-16 (Matthew Bender, 15th ed 1995).
20 See generally Westbrook, 74 Minn L Rev at 266-67 (cited in note 4).
21 11 USC § 365(g).
22 "[R]ejection' is not some mystical power to cause contracts to vanish, nor a power to terminate, cancel, or repudiate them. It is not even a 'power' to breach them in any meaningful sense . . . . Rejection is very simple. It is the estate's decision not to assume . . . . a contract, because the contract does not represent a favorable investment of the estate's resources. Rejection has the consequence of creating a deemed breach of the contract as of the date of bankruptcy so that there will be no question but that the nondebtor party has a claim." Andrew, 62 U Colo L Rev at 8 (cited in note 4). See also Texaco Inc. v Louisiana Land and Exploration Co., 136 Bankr 668, 663-64 (M D La 1992).
23 See Bouter v United States, 440 US 48, 54-55 (1979); Grogan v Garner, 498 US 279, 283 (1991) ("The validity of a creditor's claim is determined by rules of state law."). See also In re Audra-John Corp, 140 Bankr 752, 757 (Bankr D Minn 1992) ("State law [ ] must govern the parties' rights in consequence of a deemed breach under § 365(g) . . . .").
24 11 USC § 502(c)(2).
502(c). Rather than receiving full satisfaction of his claim in the form of an equitable remedy (for example, specific performance of the contract), § 502(c) forces the holder of the equitable remedy to participate in the distribution of the bankruptcy estate, receiving his pro rata share of the estate based on whatever value the bankruptcy court estimates and assigns to his equitable right.25

3. Sections 727 and 1328: The discharge provisions.

When the debtor successfully completes bankruptcy proceedings, he is granted a discharge of most or all of his prebankruptcy debts. The relevant provisions in each of the chapters under which a petition can be filed govern the procedure for obtaining a discharge as well as its scope.26 Although there are some differences in the scopes of the discharges granted under §§ 727 and 1328,27 each discharges "debts" of the debtor.28 Once the court discharges a debt, any judgment based on it, regardless of when obtained, becomes void. Moreover, the discharge enjoins the commencement or continuation of any action to collect that debt as a personal liability of the debtor.29

In determining the scope of the discharge in Chapters Seven and Thirteen, the Code draws a rough line between human capital and other types of assets. Specifically, the Code frees the

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25 Furthermore, § 502(g) provides that a claim arising from the rejection of a contract under § 365 "shall be allowed . . . or disallowed . . . as if such claim had arisen before the date of the filing of the petition." 11 USC § 502(g). Thus, where state law provides a damage remedy for breach of the rejected contract, the nondebtor's only recourse is to file a proof of claim against the estate, 11 USC § 501(a), and get in line with the gas company, the telephone company, and the rest of the debtor's unsecured creditors. See In re Financial News Network, Inc., 149 Bankr 348, 350 (Bankr S D NY 1993).

26 See 11 USC § 727 (Chapter Seven); 11 USC § 1328 (Chapter Thirteen). One of the principal differences between Chapters Seven and Thirteen lies in what the debtor must surrender to his creditors in exchange for his discharge. In a Chapter Seven proceeding, the debtor essentially turns over all of his current assets, and bankruptcy frees his future income from the creditors' claims. In a Chapter Thirteen proceeding, the debtor is allowed to retain a greater share of his current assets in exchange for some of his future income. In bankruptcy terms, a Chapter Seven debtor's future income is not property of the bankruptcy estate, see 11 USC § 541, whereas the income of a Chapter Thirteen debtor is, see 11 USC § 1306(a)(2).

27 For example, whereas § 523(a) enumerates twelve categories of obligations that are not subject to discharge in Chapter Seven, see 11 USC § 727(b), only three of those are excepted from discharge in Chapter Thirteen cases where the debtor completes a reorganization plan, see 11 USC § 1328(a)(2). None of the exceptions enumerated in § 523(a) encompasses obligations arising from an ordinary breach of contract, whether such breach occurs in fact or by operation of § 365(g). See 11 USC § 523(a).

28 See 11 USC § 727(b) ("a discharge . . . discharges the debtor from all debts"); 11 USC § 1328(a) ("the court shall grant the debtor a discharge of all debts").

29 See 11 USC § 524(a).
debtor's human capital, manifested primarily in future income, from the burden of preexisting debt. In exchange for this relief, the debtor surrenders many of his current assets for distribution to creditors.

4. Sections 101(5) and (12): What is a "debt"?

Given that bankruptcy discharges "debts," the definition of that term is crucial to the postbankruptcy enforceability of any legal obligation of the debtor. Section 101(12) of the Code defines "debt" simply as "liability on a claim." Section 101(5) defines "claim" as a:

(A) right to payment . . . ; or

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31 The Code does not draw this same line where the debtor is a corporation; whereas an individual's future earnings do not become property of the estate in a Chapter Seven proceeding, a corporation's future earnings do. See Baird, Elements of Bankruptcy at 94 (cited in note 3). As such, the discharge itself in Chapter Eleven does not put a corporation's future income beyond the reach of its prepetition creditors. For a discussion of the purposes and effects of discharge in the corporate context, see id at 62-82.

In addition, as Professor Thomas Jackson notes, the Chapter Thirteen option blurs the human capital line somewhat by permitting the debtor to pay his creditors out of his future income. See Jackson, 98 Harv L Rev at 1396-97. However, the maximum duration of a Chapter Thirteen plan is five years, see 11 USC § 1322(c), and Chapter Thirteen sets the distributions that creditors would receive under a Chapter Seven liquidation as the minimum value of the debtor's adjustment plan, see 11 USC § 1325(a)(4). Although § 1325(b) requires that all of a debtor's disposable income be applied to the adjustment plan if any creditor receiving less than full satisfaction of its claim objects, see 11 USC § 1325(b), the fact that the debtor can usually threaten to convert the proceedings to Chapter Seven often dissuades creditors from objecting to plans that pay them only the required minimum. See Baird, Elements of Bankruptcy at 55 (cited in note 3). Thus, even Chapter Thirteen insulates all of a debtor's human capital—that is, future income—beyond the five-year adjustment period, and in many cases, it protects human capital beyond the value of what the debtor's creditors would get in a hypothetical Chapter Seven liquidation.

32 11 USC § 101(12). The 1990 amendments to the Bankruptcy Code, Pub L No 101-647, 104 Stat 4867, added a new paragraph (3) to § 101 and redesignated, inter alia, the former paragraphs (3) through (23) of that section as (4) through (24). The amendment made no substantive changes to any of these paragraphs. Thus, the pre-1990 § 101(4) is now § 101(5), and the pre-1990 § 101(11) is now § 101(12). Many of the sources discussed in this Comment reference the pre-1990 Code. For the sake of clarity and consistency, the Comment refers to all paragraphs of § 101 by their current designations.

33 11 USC § 101(12). The definition of a "debt" as a "liability on a claim" makes clear that "[t]he terms 'debt' and 'claim' are coextensive; a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor." S Rep No 95-989, 95th Cong, 2d Sess 23 (1978), reprinted in 1978 USCCAN 5787, 5809; Bankruptcy Law Revision, HR Rep No 95-595, 95th Cong, 1st Sess 310 (1977). See also Pennsylvania Pub Welfare Dept v Davenport, 498 US 552, 558 (1990).
(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment . . . .

Thus, any right to payment enjoyed by a nondebtor as a result of a breach is a claim and, consequently, a debt. Therefore, any such right to payment would be discharged under either Chapter Seven or Chapter Thirteen. With respect to equitable remedies, however, no clear answer to the dischargeability question exists. Judicial construction of § 101(5)(B) in the context of noncompetition covenants has been inconsistent. As such, the case law offers little guidance to a court faced with an employer seeking to enjoin a debtor's breach of a noncompetition covenant.

B. The Noncompetition Covenant Context

Noncompetition covenants are increasingly common in modern commercial and judicial life. A recent empirical study reported that appellate decisions involving such covenants doubled in the twenty years from 1968 to 1988. This study also noted that "reported appellate decisions are only the tip of the litigation iceberg . . . .[E]xperience tells us that behind every appellate level decision are many trials where additional related legal issues are raised but not reviewed." A typical covenant may

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34 11 USC § 101(5).
36 See 11 USC §§ 727(a), 1328(a).
37 Compare In re Oseen, 133 Bankr 527, 530 (Bankr D Idaho 1991) (holding that right to injunction is a claim only when nondebtor has alternative right to payment addressing same purpose as injunction), with In re Hughes, 166 Bankr 103, 106 (Bankr S D Ohio 1994) (holding that right to an injunction is a claim any time performance requires expenditure of money by debtor, regardless of whether nondebtor has any right to payment), citing In re May, 141 Bankr 940, 943 (Bankr S D Ohio 1992). Moreover, the Supreme Court has encountered § 101(5)(B) in only two cases, both involving nondebtors entitled to the payment of money. See Ohio v Kovacs, 469 US 274, 282-83 (1985) (holding that environmental cleanup order was not enforceable in bankruptcy because it had been converted into an obligation to pay money upon appointment of receiver for debtor's assets); Johnson v Home State Bank, 501 US 78, 84 (1991) (holding that mortgage interest that survives discharge of personal liability is a "claim" under § 101(5) because the mortgage holder "still retains a 'right to payment' in the form of its right to the proceeds from the sale of the debtor's property").
38 See Phillip J. Closius and Henry M. Schaffer, Involuntary Nonservitude: The Current Judicial Enforcement of Employee Covenants Not to Compete—A Proposal for Reform, 57 S Cal L Rev 531, 532 (1984) ("Because of the increasing emphasis in the American economy on technically skilled employees and service oriented businesses, the covenant not to compete has become a standard addition to employment contracts.").
40 Id at 485 n 8, quoting Arthur J. Sabin, Constructing a Viable Restrictive Covenant
provide that for some period of time following the termination of the underlying contract and within a certain geographic area, an employee will not work for one of his employer's competitors or engage in other specified activities, such as soliciting any of the employer's clients or employees. Although courts have traditionally disfavored such restraints of trade, a comment to §186 of the Restatement (Second) of Contracts states that a noncompetition agreement is not "uneenforceable unless the restraint it imposes is unreasonably detrimental to the smooth operation of a freely competitive private economy." As a result, reasonable covenants not to compete are generally enforceable, usually through an injunction prohibiting the covenantor from engaging in the proscribed activity.

When a debtor enters bankruptcy as a party to an employment contract, §365(a) permits the trustee to reject the contract, freeing the debtor-employee from the burdensome performance

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41 See, for example, Lee/O'Keefe Insurance Agency, Inc. v Ferega, 163 Ill App 3d 997, 516 NE2d 1313, 1315 (1987) (five years and one hundred mile radius).

42 See, for example, In re Cooper, 47 Bankr 842, 843-44 (Bankr W D Mo 1985).

43 E. Allan Farnsworth, Contracts §5.3 at 335-40 (Little, Brown, 1982). See also Milton Handler and David E. Lazaroff, Restraint of Trade and the Restatement (Second) of Contracts, 57 NYU L Rev 669, 721-31 (1982).

44 Restatement (Second) of Contracts §186 comment a (1981) (emphasis added). This reasonableness standard reflects the need to strike a balance between a policy favoring freedom of contract and a competing policy disfavoring restraints of trade. See Empirical Study, 15 J Corp L at 486-87 (cited in note 39). On the freedom of contract side of the equation, Edward Schulman has recently identified three potentially welfare-enhancing bargains between employer and employee that may explain the existence of employee noncompetition agreements: such agreements (1) enable the employee to sell goodwill to an employer for a wage, without the employer having to worry about the employee leaving the firm and appropriating the goodwill by taking customers away from the firm; (2) enable the employer to freely share trade secrets and confidential information with the employee; and (3) permit the employer to spend larger sums training employees, confident that it will have time to recoup its investment. Edward M. Schulman, An Economic Analysis of Employee Noncompetition Agreements, 69 Denver U L Rev 97, 102-17 (1992).

45 Under the standard presented in the Restatement, a noncompetition covenant will be enforceable as long as (1) it is ancillary to an otherwise valid transaction or relationship, (2) the restraint it imposes is no greater than necessary to protect the promisee's legitimate interest, and (3) the promisee's interest is not outweighed by the hardship to the promisor and the likely injury to the public. See Restatement (Second) of Contracts §188(1).

46 See Donald J. Aspelund and Clarence E. Eriksen, Employee Noncompetition Law §8.02 at 8-19 to 8-23 (Clark Boardman Callaghan, 1994); Dan B. Dobbs, 3 Law of Remesdies: Damages—Equity—Restitution §12.22(2) at 496-99 (West, 1993). "The firm rule is that the employer may not specifically enforce an employee's personal services contract... [However,] the negative promise not to perform those services for others or to compete with the employer... can be enforced in some cases even when the affirmative covenant cannot be." Id at 496-97 (footnotes omitted).
obligations associated with it. However, this is not a free pass; when the trustee rejects the contract it does not cease to exist. Instead, § 365(g) treats the debtor-employee as having breached the employment contract just prior to bankruptcy. In addition, any “claims” that the employer may have under applicable nonbankruptcy law arising from this breach—for example, a right to be reimbursed by the employee if the employer has to pay a higher wage to the employee’s replacement—can be asserted against the bankruptcy estate. Thus, the employer is entitled to share pro rata in the distribution of the bankruptcy estate, but that is all the employer is entitled to; after the pro rata distribution, the balance of its claims is discharged.

Nonbankruptcy law may give the employer multiple rights as a consequence of the debtor-employee’s breach. Whether a particular right may be asserted against the estate and be discharged depends on whether § 101(5) defines that right as a “claim.” The enforceability of a noncompetition covenant thus hinges on the categorization of the employer’s right to require compliance. If the right to an injunction enforcing a noncompetition covenant is deemed a claim under § 101(5), then all that the employer can do is assert its claim against the estate under § 502(g), pocket its bankruptcy dollars (paid according to the court’s estimation under § 502(c)), grin, and bear its new rival. On the other hand, if the right to an injunction does not meet the definition of § 101(5), then the employer cannot partake in the distribution of the debtor-employee’s assets, but the right to enforce the covenant survives the debtor-employee’s discharge. As a result, the employer can still hold the debtor-employee to the terms of the covenant not to compete.

II. THE CURRENT STATE OF THE LAW

Bankruptcy courts differ greatly on whether nondebtors may enforce noncompetition covenants during and after bankruptcy. Some hold such covenants unenforceable. These courts gener-

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47 See 11 USC § 365(a) and text accompanying notes 4-20.
48 See 11 USC § 365(g) and text accompanying notes 21-23.
49 11 USC §§ 101(5), 502(g).
50 For example, the employer may have a right to recover monetary damages caused by the employee’s failure to perform his affirmative duties under the contract, as well as a right to specifically enforce negative obligations such as a covenant not to compete.
51 See, for example, In re Rovine Corp, 5 Bankr 402, 404 (Bankr W D Tenn 1980) (“Rovine I”); In re Rovine Corp, 6 Bankr 661, 666 (Bankr W D Tenn 1980) (“Rovine II”); In re Register, 95 Bankr 73, 75 (Bankr M D Tenn 1989), aff’d sub nom, Silk Plants, Etc.
ally invoke the rule that under § 365 a contract must be assumed or rejected in its entirety. Thus, these courts reason that where a contract containing a covenant not to compete is rejected, the covenant is also rejected, and, once rejected, the covenant ceases to exist and to be enforceable against the debtor.52

Courts holding noncompetition covenants enforceable generally rely on at least one of three grounds to reach this conclusion. Some hold that the contract at issue is not executory and is therefore not subject to rejection under § 365.53 Others reason that rejection under the Code only affects monetary rights, and thus does not disturb equitable, nonmonetary rights that arise because of the breach of contract.54 A third approach concludes that the nondebtor’s equitable right is not a “claim” under § 101(5) and is therefore not dischargeable.55

A. Courts Holding Covenants Not to Compete Unenforceable

Courts holding that covenants not to compete are unenforceable in bankruptcy generally invoke the rule that “[a]n executory contract must be rejected in its entirety or not at all.”56 In In re Rovine Corp (“Rovine I”),57 for example, a bankrupt Burger King franchisee rejected its franchise agreement. When the franchisor sought to enforce the agreement’s covenant not to compete, the bankruptcy court held that the covenant was executory, and thus

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52 See, for example, Rovine II, 6 Bankr at 666.
53 See, for example, In re Hughes, 166 Bankr 103, 105 (Bankr S D Ohio 1994) (employment relationship terminated prior to bankruptcy); In re Hawes, 73 Bankr 584, 586 (Bankr E D Wis 1987) (same).
54 See In re Carrere, 64 Bankr 156, 160 (Bankr C D Cal 1986) (dicta). See also In re Thomas, 133 Bankr 92, 95 (Bankr N D Ohio 1991) (“[E]quitable, nonmonetary rights . . . that arise as a result of the breach . . . are not disturbed.”).
55 See, for example, Matter of Udell, 149 Bankr 898, 905-06 (Bankr N D Ind 1992) (“Udell I”), rev’d, 149 Bankr 903 (N D Ind 1993), rev’d, 18 F3d 403 (7th Cir 1994); In re Oseen, 133 Bankr 527, 530-31 (Bankr D Idaho 1991). On the other hand, at least one court has taken this same approach and concluded that the right to enforce a covenant not to compete was a “claim” under § 101(5)(B). Silk Plants, Etc. Franchise Sys. v Register, 100 Bankr 360, 362 (M D Tenn 1989).
56 In re Rovine Corp, 6 Bankr 661, 666 (Bankr W D Tenn 1980) (“Rovine II”), citing In re Klaber Brothers, Inc., 173 F Supp 83 (S D NY 1959). See also In re Allain, 59 Bankr 107, 109 (Bankr W D La 1986) (“[B]ecause the court concludes that the agreement does not represent several separate contracts the rule that an executory contract must be assumed or rejected in its entirety precludes the lifting of automatic stay of section 362 as to the noncompetition clauses.”).
57 5 Bankr 402, 403 (Bankr W D Tenn 1980).
[t]he effect of the rejection was to relieve the [debtor] and its estate of [its] obligation[ ] . . . not to compete.”

This “entirety rule” implicitly assumes that once the noncompetition covenant is rejected, any rights given to the nondebtor by state law as a consequence of the breach will be dischargeable. However, contrary to this assumption, Congress neither intended nor provided that all equitable rights would be dischargeable. This is apparent from § 101(5)(B), in which Congress limited the definition of “claim” in the equitable remedy context to a “right to an equitable remedy for breach of performance if such breach gives rise to a right to payment . . . .” Had Congress intended for all equitable rights to be dischargeable, as the entirety analysis implicitly assumes, it would not have adopted such a qualified definition. Instead, Congress would have defined “claim” as simply “a right to an equitable remedy.”

This conclusion draws support from § 502(c), which requires the bankruptcy court to estimate for allowance as a claim “any right to payment arising from a right to an equitable remedy for breach of performance.” Again, had Congress intended that all equitable remedies be dischargeable, it would not have limited the bankruptcy court’s estimation power to equitable remedies that give rise to rights to payment. Instead, it would have said that the bankruptcy court must estimate for allowance as a claim “any equitable remedy.”

Thus, courts holding that restrictive covenants are unenforceable because “an executory contract must be assumed or rejected in its entirety” accurately state, but misapply, a well-settled rule and entirely miss the point of §§ 365(g), 502(c) and 101(5). As one bankruptcy scholar has noted, “[r]ejection of the contract in which [ ] a covenant [not to compete] is contained should be irrelevant; the determinative issue is the impact of the

Id at 404.

Absent this assumption, rejection would not necessarily relieve the debtor of the consequences of the breach, and an employer could potentially assert its right to equitably enforce the covenant.

11 USC § 101(5)(B) (emphasis added).

11 USC § 502(c).

See Udell I, 149 Bankr at 903 (“It is circular to argue that the power to estimate the right to payment arising from the right to an equitable remedy for a breach leads to the conclusion that the equitable remedy for a breach gives rise to a ‘right to payment.’ If this is the result Congress intended, it would have been much simpler and more direct to define debts and claims as all obligations of the debtor.”).

Allain, 59 Bankr at 109.

See King, ed, 2 Collier on Bankruptcy § 365.03 at 365-18 (cited in note 19).
debtor’s discharge.” The Rovine I court should have asked what obligations the breach of the covenant created under state law, and whether those obligations were subject to discharge. If they were, then the franchisor would not have been entitled to an injunction. If they were not, then the franchisor’s equitable right would have survived bankruptcy, and the franchisor would have been entitled to enforce it.

B. Courts Holding Covenants Not to Compete Enforceable

1. Nonexecutory contracts cannot be rejected.

Some courts have upheld noncompetition covenants by noting that if the contract is not “executory,” it does not fall within the scope of § 365, and therefore cannot be rejected. For example, in In re Hirschhorn, a landlord sought to enforce a covenant not to compete in a debtor-tenant’s sublease of office space. The debtor had already vacated the premises and the landlord had already terminated the sublease and triggered the covenant when the sublease was finally rejected. In response to the debtor’s contention that rejection rendered the covenant not to compete unenforceable, the court held that because “there are no remaining obligations owed by the parties save for [debtor’s] compliance with the covenant not to compete . . . the noncompete clause is not an executory contract which may be rejected . . . .”

The analysis in cases such as Hirschhorn, which focuses on whether the contract is executory, is misguided. As discussed above, rejection merely renders a contract breached. If a covenant not to compete has already been breached in fact, as it was in Hirschhorn, rejection is superfluous. The court should focus

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65 Andrew, 59 U Colo L Rev at 927 (cited in note 4).
66 See, for example, In re Hughes, 166 Bankr 103, 105 (Bankr S D Ohio 1994); In re Oseen, 133 Bankr 527, 529-30 (Bankr D Idaho 1991). Most courts espousing this view hold that an obligation to abide by a covenant not to compete, standing alone, does not make a contract executory. See, for example, In re Hirschhorn, 156 Bankr 379, 389 (Bankr E D NY 1993); Oseen, 133 Bankr at 529.
67 156 Bankr 379, 382-83 (Bankr E D NY 1993).
68 Id at 384-85.
69 Id at 389.
70 See 11 USC § 365(g). See also text accompanying notes 21-23.
71 This is likely the case on most occasions when a nondebtor seeks an injunction: unless an actual breach has occurred or is threatened—that is, unless the debtor is engaging in some conduct harmful to the nondebtor—the nondebtor would probably not consider it worthwhile to retain counsel and file suit.
on the disposition of the nondebtor's remedy. By holding a contract nonexecutory when it has already been breached in fact, the bankruptcy court refuses to recognize what has already occurred and thus completely dodges the pivotal question: whether the equitable right arising from the breach survives discharge of the debtor's debts. Because the injunction is issued on the narrow premise that § 365 does not apply, rather than on a judgment that the employer's right to enforce the covenant is nondischargeable, this approach needlessly prompts future litigation of the latter issue when the debtor violates the injunction, possibly on the belief that it is dischargeable like the rest of his debts.

2. Rejection does not affect equitable rights.

Courts holding that § 365 does not affect covenants not to compete sometimes assert that rejection affects only monetary, not equitable, creditor rights against the debtor. Although this assertion is commonly dicta, its presence in the case law presents a trap for the unwary. As noted above, the effects of discharge, not the fact of rejection, should determine the enforceability of a covenant not to compete. Technically, the proposition that "rejection does not affect equitable rights" remains correct, because rejection merely deems the contract breached. State law gives the nondebtor various remedies; whether such remedies are enforceable following bankruptcy depends in turn on whether they are discharged. Thus, to state that rejection does not affect equitable rights merely begs the question of whether such rights survive discharge.

3. The right to an injunction is not a "claim."

Several courts have properly recognized that the postbankruptcy enforceability of noncompetition covenants turns on the dischargeability of the equitable remedies for their breach. These courts ask whether the nondebtor's right to an

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72 See, for example, In re Carrere, 64 Bankr 156, 160 (Bankr C D Cal 1986); In re Noco, Inc., 76 Bankr 839, 844 (Bankr N D Fla 1987); Hirschhorn, 156 Bankr at 389. Compare In re Thomas, 133 Bankr 92, 95 (Bankr N D Ohio 1991) (stating that "equitable, nonmonetary rights against [debtor] as a result of [prepetition, actual] breach, including injunctive relief, are not disturbed").

73 See text accompanying notes 64-65.

74 See, for example, Matter of Udell, 18 F3d 403, 410 (7th Cir 1994) ("Udell III") (holding that district court erred in holding that "equitable relief sought by [franchisor]
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injunction is a "claim" under § 101(5)(B), an inquiry whose answer depends both on whether the nondebtor has a right to payment and on the relation of that right to the equitable remedy.\(^7^5\)

Some courts have construed § 101(5)(B) very broadly, holding that a right to an injunction is a "claim" any time an obligation's performance requires the debtor to spend money, regardless of whether the nondebtor is entitled to any payment.\(^7^6\) However, § 101(5)(B) plainly requires some right to payment in order for an equitable remedy to be a "claim." That the debtor must spend money to comply with an injunction does not mean that anyone, including the nondebtor, has a right to payment.\(^7^7\) Other courts have construed § 101(5)(B) more narrowly, holding that the right to payment in question must be a perfect substitute for the equitable remedy; that is, the nondebtor must have a choice between monetary damages and the equitable remedy.\(^7^8\)

An intermediate approach requires some relation between the right to payment and the equitable remedy, but does not require perfect substitution. In Matter of Udell ("Udell III"), an employer obtained an injunction in state court enforcing a covenant not to compete in a debtor-employee's employment agreement.\(^7^9\) Several days later, the debtor filed a Chapter Thirteen petition, arguing that the injunction was a dischargeable "claim" under § 101(5)(B).\(^8^0\) Specifically, the debtor argued that because the covenant entitled the employer to both an injunction and liquidated damages, the injunction was a "claim" under § 101(5)(B).\(^8^1\) In essence, the debtor argued that "a right to an

\(^7^5\) As noted at text accompanying notes 33-37, § 101(5)(B) includes in its definition of a "claim" a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment . . . ." 11 USC § 101(5)(B). See, for example, Udell III, 18 F3d at 406-10; Oseen, 133 Bankr at 530-31. Compare In re Aslan, 65 Bankr 826, 828-31 (Bankr C D Cal 1986) (holding that equitable right to specific performance of contract for sale of real estate is a "claim" under § 101(5)(B)).

\(^7^6\) See, for example, Hughes, 166 Bankr at 106, citing In re May, 141 Bankr 940, 943 (Bankr S D Ohio 1992).

\(^7^7\) If an employee, in order to comply with a covenant not to compete while remaining in the same business, elects to move to a new city or state, the employee would certainly have to spend money to effect this move. Nevertheless, it would be ridiculous to assert that this creates a "right to payment" in the former employer.

\(^7^8\) See, for example, Oseen, 133 Bankr at 530-31 (Although state law permitted award of damages for breach of a covenant not to compete, because "equitable relief serves a markedly different purpose than damages . . . . it is clear that the equitable remedy . . . did not give rise to a right to payment . . . . ").

\(^7^9\) 18 F3d 403, 405 (7th Cir 1994).

\(^8^0\) Id at 405-06.

\(^8^1\) See id at 406; 11 USC § 101(5)(B).
equitable remedy is a ‘claim’ whenever the breach of performance also gives rise to . . . any right to payment, even one that serves a separate remedial purpose from the equitable remedy.\textsuperscript{82}

The Seventh Circuit rejected this argument. Instead, it held that an equitable right is a claim only when the nondebtor also has a right to payment that arises “with respect to” the equitable right.\textsuperscript{83} The court noted that while a right to payment that is an alternative to the equitable remedy would clearly pass this test, “relationships other than outright substitution may also suffice.”\textsuperscript{84}

Applying this standard to the case before it, the court held that:

[The] injunction and . . . liquidated damages [were] cumulative and not alternative. . . . [The employer’s] right to liquidated damages [did] not arise “with respect to” its right to an injunction, . . . the two rights address[ed] entirely separate remedial concerns. . . . [Thus], the fact that both remedies [were] triggered by a single act [did] not mean that the right to an injunction [gave] rise to a right to liquidated damages.\textsuperscript{85}

As a result, the Seventh Circuit held, the bankruptcy judge was justified in relieving the employer from the automatic stay so that it could enforce its injunction in state court, and the district court had erred in reversing that decision on the ground that the injunction was a “claim” dischargeable in bankruptcy.\textsuperscript{86}

All of the cases in this Subsection ask the right question: is the nondebtor’s right to an injunction a “claim” and hence dischargeable? Unfortunately, these courts have not agreed on a consistent standard with which to answer it. As a result, parties have little guidance in determining before litigation whether the right to an injunction is a “claim.” Following the cases in this Subsection, the right to an injunction might be a “claim” in any of the following circumstances: (1) the debtor would have to spend money to comply,\textsuperscript{87} (2) the nondebtor has a right to payment that serves exactly the same purpose as the injunction,\textsuperscript{88}

\textsuperscript{82} Udell III, 18 F3d at 406.
\textsuperscript{83} Id at 408 (footnote omitted).
\textsuperscript{84} Id.
\textsuperscript{85} Id at 409 (emphasis added).
\textsuperscript{86} Id at 410.
\textsuperscript{87} See Hughes, 166 Bankr at 106.
\textsuperscript{88} See Oseen, 133 Bankr at 530-31.
or (3) the nondebtor has a right to payment that arises "with respect to" the injunction. A solution to this confusion is needed. Without a clear standard and with only a single appellate decision on point, even minor variations in state law regarding remedies for breaches of noncompetition covenants and their relation to one another will confuse bankruptcy judges and produce discordant interpretations of § 101(5)(B).

III. NONCOMPETITION COVENANTS IN BANKRUPTCY: THE PROPER ANALYSIS

A principled treatment of covenants not to compete in bankruptcy should accord with both the normative policies and the positive text of the Bankruptcy Code. This Section begins by discussing two fundamental policies that underlie the bankruptcy system—equality of distribution to creditors and the individual debtor's fresh start—and concludes that enforcing a covenant not to compete is at least not inconsistent with either. Next, this Section proposes a legislative path out of bankruptcy's noncompetition covenant quagmire. Specifically, Congress should enact a provision analogous to the Code's treatment of real property leases and technology licenses, thereby granting an employer a right to enforce noncompetition covenants but denying any other right to specific performance that the employer might have under state law. However, until Congress enacts such a provision, bankruptcy courts must follow the current Code. Therefore, this Section concludes by arguing for a textual approach to the treatment of covenants not to compete, focusing primarily on the dischargeability of the employer's right to an injunction. Contrary to the view of many bankruptcy courts, a textual analysis of the current Code permits the postpetition enforcement of noncompetition covenants in most cases.

A. Bankruptcy Policies

1. The creditor's concern: equality of distribution.

Bankruptcy provides a collective proceeding for parceling out an individual's assets to his creditors. A fundamental premise of this collectivization is that bankruptcy should preserve relative

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89 See Udell III, 18 F3d at 408.
90 See Jackson, Logic and Limits of Bankruptcy Law at 9-13, 21 (cited in note 17) (discussing bankruptcy as a solution to common pool problem of individual debt collection).
nonbankruptcy entitlements unless something in the shift to a collective proceeding requires deviation. Preservation of relative entitlements means that similarly situated creditors are treated alike; if the debtor owes the same amount to two unsecured creditors outside of bankruptcy, then they should receive equal payouts in bankruptcy.

At first glance, full enforcement of a covenant not to compete may seem inconsistent with this principle: it gives one unsecured creditor, the employer, full satisfaction, while other unsecured creditors receive only a fraction of their due. However, full satisfaction of a noncompetition covenant fundamentally differs from full satisfaction of a $100 debt or a right to specific performance that would remove some asset from the bankruptcy estate. Full satisfaction of these latter claims can come only at the expense of the debtor’s other unsecured creditors. As to monetary claims or claims that would compel the transfer of estate assets, creditors play a zero-sum game in which every dollar paid or asset transferred to one creditor comes out of the pockets of the others. To solve such a game, fairness and the Code demand pro rata distribution.

Full enforcement of a noncompetition covenant against an individual debtor does not have the necessary collateral consequence of diminishing the payouts to other unsecured creditors. A covenant not to compete affects only the employee’s future opportunities. Such covenants, if they reduce anything, reduce only future income. In a Chapter Seven proceeding, this income is not property of the estate and is therefore out of the creditors’ collective reach. Even in a Chapter Thirteen proceeding, where the estate includes the debtor’s future income, full enforcement of a noncompetition covenant should normally not prejudice other creditors. Section 1325(a)(4) guarantees that

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91 Id at 21.
92 For a discussion of the undesirable consequences of distorting relative entitlements in bankruptcy, see id at 21-27.
93 Although specific performance does not actually require that cash be paid out of the estate, it does result in the loss of an asset that could otherwise be sold by the trustee. The proceeds of such a sale, which would be divided pro rata among the debtor’s other creditors, are thus lost.
94 In fact, such payouts would be increased. If the employer’s right to an injunction is treated as a claim against the estate, the bankruptcy court would be required to estimate its value under § 502(c) and the employer would then be entitled to its pro rata share of whatever value is assigned. Because of the zero-sum nature of the distribution, this share would necessarily come at the expense of the other creditors.
95 See 11 USC § 541.
creditors in a Chapter Thirteen proceeding receive at least what they would have received in Chapter Seven. Moreover, even though § 1325(b) purports to make the debtor "pay until it hurts," by requiring that all of the debtor's disposable income be applied to the plan upon the objection of any creditor receiving less than full payment, the debtor can usually credibly threaten to convert the proceeding to Chapter Seven. As a result, many creditors do not object to plans that pay them only the required Chapter Seven minimum. Holding the debtor-employee to a covenant not to compete does not reduce these payments—indeed, given § 1325(a)(4), it could not. Thus, in neither Chapter Seven nor Chapter Thirteen does full enforcement of a noncompetition covenant undermine the principle of equality of distribution.

2. The individual debtor's concern: a fresh start.

In addition to providing creditors with equal treatment, bankruptcy also gives "to the honest but unfortunate debtor ... a new opportunity in life and a clear field for future effort, unhindered by the pressure and discouragement of preexisting debt."
Two bankruptcy processes facilitate the individual debtor's fresh start: the discharge granted by the Code and the rule of Local Loan Co. v Hunt, which provides that a debtor's assignment of his future wages does not survive discharge.

As a doctrinal matter, one could argue, as Dean Baird has, that the postbankruptcy enforcement of a covenant not to compete violates the rule of Local Loan by permitting an "ownership interest in [the debtor's] future income stream" to pass through bankruptcy. However, unlike the third-party interest in Local Loan—where the debtor executed an outright assignment of a portion of his future wages as security for a loan—a covenant not to compete is not the equivalent of a lien on the debtor's future income. Rather, the covenant merely narrows the permissible means by which the debtor can earn that income. In the example used in the Introduction to this Comment, while the soap opera actress was temporarily disabled from acting on another network show, she was free to act on stage, in movies, and in commercials, and would keep everything she earned in these ventures free of the preexisting claims of her creditors. Because a covenant not to compete does not amount to an ownership interest in the debtor's future income, its postbankruptcy enforcement against the debtor does not run afoul of the Local Loan principle.

As a normative matter, one could also argue that any enforcement of a covenant not to compete violates the fresh start policy by forcing the debtor to carry prebankruptcy baggage into his postbankruptcy "new" life. A fresh-start absolutist would urge that the debtor should leave all prebankruptcy obligations—legal and equitable—at the courthouse door. However, bankruptcy does not provide an absolute fresh start. The Code specifically exempts various types of debts from discharge, and it denies

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100 292 US 234 (1934).
101 The rule of Local Loan is an exception to the general rule that a creditor's lien survives bankruptcy and remains enforceable against the encumbered property notwithstanding the discharge of the debtor's personal liability for the secured debt. See Long v Bullard, 117 US 617 (1886). As Dean Baird notes, the Local Loan principle is needed as a separate element of the fresh start policy because discharge alone affects only "claims" against the debtor. See Baird, Elements of Bankruptcy at 43 (cited in note 3).
102 Baird, Elements of Bankruptcy at 44 (cited in note 3).
103 If the covenant not to compete in an employment contract were so broad as to prevent the debtor from earning a living, it would be unreasonable as a matter of nonbankruptcy law. See Restatement (Second) of Contracts § 188(1) & comment c (cited in note 44); id § 387 comment c (An injunction will not be granted if its probable result will be to leave the employee without other reasonable means of making a living.).
104 See 11 USC § 523. For example, the Code renders nondischargable any debt for "willful or malicious injury by the debtor to another entity or to the property of another
discharge entirely where the debtor has engaged in certain types of undesirable conduct.\textsuperscript{105}

An exception to the fresh-start policy that is particularly relevant to the analysis of noncompetition covenants is § 523(a)(8), which renders federally funded or guaranteed student loans nondischargeable.\textsuperscript{106} Congress felt this exception was necessary because students generally have few existing assets but large future income streams.\textsuperscript{107} In other words, human capital constitutes the vast majority of their wealth. If student loans were freely dischargeable, bankruptcy would be relatively painless for recent graduates yet yield substantial benefits, and recent graduates would likely file at a high rate.\textsuperscript{108} Because they cannot waive the right to discharge, students could not credibly promise to repay their loans.\textsuperscript{109} The consequence for student credit would be disastrous—if such loans were available at all, their cost would be exorbitant. Recognizing the critical role of student loans in facilitating investment in human capital, Congress narrowed the scope of the debtor's fresh start by carving out an exception to the debtor's otherwise broad discharge, thereby preserving the availability of such credit.\textsuperscript{110}

Just as student loans make it possible for students to invest in human capital, noncompetition covenants facilitate such investment by employers and employees.\textsuperscript{111} It is generally believed that employees often pay for general on-the-job training—that is, training that is useful to many firms besides the one

\textsuperscript{105} See 11 USC § 523(a)(8).

\textsuperscript{106} See 11 USC § 523(a)(8).

\textsuperscript{107} See Jackson, 98 Harv L Rev at 1430 n 121 (cited in note 30).

\textsuperscript{108} See id, citing United States Commission on the Bankruptcy Laws of the United States, Report of the Commission on the Bankruptcy Laws of the United States: Part II 140 (1973) ("It is not surprising that many students enthusiastically discharged their student loans before Congress disallowed the practice.").

\textsuperscript{109} Although a student might be able to solve this problem with a third-party (for example, a parent) guaranty, the student often needs a loan because his family lacks the resources to finance the education. It would not be surprising, then, if many of the students who needed such credit would be unable to offer such a guaranty.

\textsuperscript{110} See Jackson, 98 Harv L Rev at 1430-31 n 121 (cited in note 30).

\textsuperscript{111} See Paul H. Rubin and Peter Shedd, Human Capital and Covenants Not to Compete, 10 J Legal Stud 93, 95-100 (1981).
providing it—by accepting reduced wages. However, there are some types of training for which employees will not or cannot pay through reduced wages. For example, some training (such as teaching the details of a trade secret) is so valuable that an employee cannot pay for it through reduced wages. In such instances employers are reluctant to pay for such training when the employee could take the training and run. Because an employer cannot compel specific performance of an employment contract, the employer can ensure that the employee will not use the acquired training elsewhere only by having the employee sign an enforceable covenant not to compete. Just as the student's credible promise to repay loans from postgraduation income assures his lender that it will recoup its investment and permits it to extend such loans at an affordable cost to the student, a noncompetition covenant assures the employer that it will enjoy the fruits of its investment over the course of the employment relationship and thereby reduce the cost of the training to the employee. If, however, noncompetition covenants were dischargeable in bankruptcy, the employee could not credibly make this promise. As a result, such investment either would not occur or cost the employee more.

In making student loans nondischargeable, Congress found investment in human capital important enough to justify some infringement on the debtor's fresh start. Given that noncompetition agreements likewise facilitate such investment, permitting the employer's right to enjoin compliance with a covenant not to compete to survive the debtor's discharge is at least not inconsistent with Congress's vision of bankruptcy's fresh-start policy.

112 See Gary Becker, Human Capital 34-40 (Chicago, 3d ed 1993). See also Rubin and Shedd, 10 J Legal Stud at 93-96.
113 Rubin and Shedd, 10 J Legal Stud at 96 (cited in note 111).
114 Id at 96-97.
115 See, for example, Restatement (Second) of Contracts § 367(1) (cited in note 44) ("A promise to render personal service will not be specifically enforced.").
116 Although the covenant does not prevent the employee from quitting after being trained by the employer, it makes it less likely that he will do so by limiting his post-employment opportunities. Moreover, it prevents the employee from exploiting the training by going to work for a competitor willing to pay a higher wage because it does not have to train the employee itself. See Rubin and Shedd, 10 J Legal Stud at 97 (cited in note 111).
117 This suggests that even though it may be in an individual debtor's own interest to avoid a covenant not to compete once his financial situation has soured and he has entered bankruptcy, employees as a class, and even the individual debtor, would likely prefer ex ante to have such covenants be nondischargeable.
B. A Legislative Solution: Treat Covenants Not To Compete Like Intellectual Property Licenses

In addition to excepting certain debts such as student loans from discharge, the Code also subordinates the fresh start to contractual rights in certain types of transactions. This subordination crops up twice in § 365. Section 365(h)(1) protects a lessee of real property when a bankrupt lessor rejects the lease by giving the lessee a choice between treating the lease as terminated or remaining in possession of the property for the term of the lease.\textsuperscript{113} Section 365(n) affords similar protection to an intellectual property licensee when a bankrupt licensor rejects a license agreement.\textsuperscript{119} Generally, that section gives the licensee the choice between treating the license agreement as terminated or retaining its rights for the duration of the agreement.\textsuperscript{120} Specifically, § 365(n)(1)(B) permits the licensee “to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract . . . as such rights existed immediately before the case commenced . . . .”\textsuperscript{121} Thus, a licensee under an exclusive license agreement can enjoin the trustee or the debtor-licensor from giving the technology to a third party, but cannot get specific performance of other affirmative obligations—for example, advertising, technical assistance, or legal assistance in a patent infringement suit—even if state law would provide such a remedy.\textsuperscript{122}

The Code’s treatment of technology licenses offers considerable insight into a legislative solution for covenants not to compete, especially once the similarities between the two areas are

\textsuperscript{119} 11 USCA § 365(n). See also Intellectual Property Licenses in Bankruptcy, S Rep No 100-505, 100th Cong, 2d Sess 4 (1988), reprinted in 1988 USCCAN 3200, 3203 (“The [proposed § 365(n)] provides for treatment of intellectual property licenses under Section 365 in a manner that parallels generally the treatment of real estate leases in . . . Section 365(h)(1).”).
\textsuperscript{120} 11 USCA § 365(n)(1). If the licensee retains its rights, it must make all required royalty payments and, unlike the real property case, is deemed to waive any right to setoff and any administrative expense claim arising from performance of the contract. Id § 365(n)(2).
\textsuperscript{121} 11 USCA § 365(n)(1) (emphasis added).
recognized. Indeed, the policies that drive the Code's protection of licensees apply equally to covenantees. The legislative history of § 365(n) is particularly illuminating. Prior to the enactment of § 365(n), a bankrupt technology licensor could unilaterally terminate a licensee's rights by rejecting the license agreement. The Intellectual Property Bankruptcy Protection Act of 1988 ("IPBPA"), which added § 365(n) to the Code, was Congress's solution to what it perceived to be the unfair results caused by strict application of § 365 to these cases.

Its report on the IPBPA reveals that the Senate was particularly troubled by the chilling effect that unilateral termination rights would have on the use of licensing agreements and on the overall development of intellectual property. The Senate was concerned that the shadow cast by § 365 on a licensee's rights would discourage the use of licensing agreements and cause parties seeking intellectual property rights to insist on outright assignment or, if the technology holder were unwilling to assign, to abandon the transaction altogether. Section 365(n) eliminated the de facto avoiding power that debtor-licensors had acquired under § 365 and gave the licensee the option to retain its rights under the license agreement as they existed just prior to bankruptcy.

The anti-chilling effect policy embodied in § 365(n) applies with equal if not greater force to covenants not to compete. If an employer knows that its employee can avoid a covenant not to compete in bankruptcy, it might be unwilling to engage in the transaction that the covenant was intended to facilitate, or, if
it is still willing to bargain, it will seek compensation for the increased risk associated with the potential avoidance of the covenant. This distortion will be particularly severe where the potential employee is marginally solvent—that is, where the employer perceives a significant risk of bankruptcy. This in turn might encourage an employer to screen the solvency of its employees, thereby incurring costs which the employer might try to recapture (at least in part) by reducing wages.

The potential chilling effect of a de facto avoiding power might actually be more severe in the context of covenants not to compete than in the transfer of rights in intellectual property. A party seeking intellectual property rights could insist on an outright assignment of the technology, thereby avoiding executory contracts and § 365 altogether. Thus, regardless of § 365, unavoidable transfers of intellectual property rights could still occur. However, no existing mechanism allows an employee to unavoidably assign his ability to compete. The employer has no way to protect itself from the misappropriation of the human capital it bestows upon the employee other than through a covenant not to compete. As long as covenants not to compete can be negated in bankruptcy, employers cannot ensure that such misappropriation will not occur.

Perhaps the best argument for treating noncompetition covenants like technology licenses and real property leases derives from the uniqueness of the underlying commodity. In the legislative history of the IBPBA, Congress noted that:

[T]he problems associated with rejection of executory contracts are common with other special forms of property, such as real property leases. In both real estate leases and intellectual property licenses, the underlying property is unique. When the lessee or the licensee is threatened with loss of use of the property, it is not possible to obtain precise cover from another source.

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92 Congress specifically recognized this problem in the technology license context: "If the creator is unwilling to assign, in some instances, transactions simply are not completed. In others, the licensee discounts what he will pay to account for the risk now seen as inherent in Section 365. In short, Section 365 is resulting in undercompensation of U.S. inventors." S Rep No 100-505 at 4, 1978 USCCAN at 3203 (cited in note 119) (emphasis added).

932 Id (emphasis added).
This resembles the employer's position absent a covenant not to compete: no alternative source can provide the employer what the debtor had promised. The employer can replace affirmative obligations, such as a debtor's promise to spend forty hours each week in the employer's office. The employer can simply hire someone else to do the debtor's job. As such, affirmative obligations are appropriately dischargeable, and the employer must assert the replacement costs as a prepetition claim against the bankruptcy estate. However, the negative obligations embodied in a covenant not to compete are different: the employer cannot pay someone else to fulfill the debtor's obligation not to work for a competitor. Thus, the underlying interest in covenants not to compete—the negative obligation not to work for a competitor—is as unique as the interest underlying technology licenses and real property leases. Accordingly, covenants not to compete, technology licenses, and real property leases should be treated similarly.

Finally, and perhaps most significantly, Congress considered exclusivity provisions important enough to afford them explicit protection in the text of § 365(n). In a technology license, an exclusivity provision assures the licensee that it can safely invest resources in implementing the technology without fear that the technology will also be licensed to a competitor. Similarly, a noncompetition covenant assures an employer that it can invest resources in training and share trade secrets with the employee without fear that the employee will walk off with the human capital before the employer can recoup its investment. Furthermore, the licensor's cost to comply with an exclusivity provision in a technology license resembles the cost to an employee of complying with a covenant not to compete. In neither case does enforcement require any affirmative performance or prevent the debtor from earning a living. Furthermore, in both cases the burden lasts only for the term of the contract.

The Senate report on the IPBPA noted that when the Code was adopted, "[n]either the bar nor Congress then foresaw the need to protect [ ] the reasonable expectations of intellectual property licensees." Given the similarities between covenants

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131 See 11 USC §§ 365(g), 502(g).
132 11 USC § 365(n)(1) (licensee may retain the "right to enforce any exclusivity provision of such contract").
133 See note 103 and accompanying text.
134 S Rep No 100-505 at 4, 1978 USCCAN at 3203 (cited in note 119).
not to compete and technology licenses, and Congress's express recognition of the importance of exclusivity provisions in the latter, Congress probably likewise lacked foresight in the covenant not to compete context. Although Congress should continue to direct claims arising from breached affirmative performance obligations into bankruptcy distribution and discharge, it should remedy its shortsightedness in the noncompetition covenant context by amending the Code to explicitly permit covenantees to enforce the negative obligations of covenants not to compete against individual debtors. Such an amendment would be consistent with the purposes and policies of the Code and with its treatment of other unique interests.

C. A Textual Solution: A Covenant Not to Compete Does Not Give Rise to a "Claim"

Until Congress adopts such an amendment, courts must work within the current framework. Nevertheless, under a proper construction of the Code, an employer's right to enforce a covenant not to compete should almost always survive bankruptcy. Although the text of § 101(5)(B) is inconclusive, the legislative histories of that provision and of § 502(c) as well as relevant Supreme Court precedent demonstrate that an employer's right to an injunction should be a dischargeable "claim" only when the employer also has a right to payment that adequately substitutes for the debtor's compliance with the injunction. In essence, the alternative right to payment must be a "price tag" on the equitable remedy. Because injunctions and monetary damages generally serve different purposes, and because injunctions generally issue only where legal remedies prove inadequate, such instances of substitution will be rare. Accordingly, noncompetition covenants should generally be enforceable against bankrupt employees.

1. The "plain" language of § 101(5)(B).

At first blush, the text of § 101(5)(B)—which defines "claim" to include a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment"—appears problematic for an employer in any case where it has a right to collect money from the debtor-employee.

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11 USC § 101(5)(B) (emphasis added).
However, as Justice Frankfurter observed, "[t]he notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification. It is a wooden English doctrine ... to which lip service has on occasion been given here, but which since the days of Marshall this Court has rejected ... ." By focusing on whether the breach that creates an equitable right also creates some right to payment, § 101(5)(B) could be read to suggest that, in any case where as a result of the breach an employer is entitled to payment of any sum of money for any purpose, any equitable remedy to which it is also entitled would be a "claim."

Congress cannot have intended this. For example, suppose that a covenant not to compete provides that the employer is entitled to both an injunction and liquidated damages of ten dollars per day from the date of the breach through the date of the injunction. Absent the right to payment created by the liquidated damages provision, the employer's right to the injunction would clearly be beyond the reach of § 101(5)(B). However, given that the right to payment exists, a literal reading of § 101(5)(B) would deem the right to the injunction a "claim" merely because the same breach triggered both remedies, even though the liquidated damages and the injunction served to remedy two completely distinct harms, and even though the liquidated damages in no way substituted for or placed a price tag on the injunction. This approach would also deem a right to an injunction a "claim" if the employer were entitled to attorneys' fees, a payment wholly unrelated to any injury caused by the employee's breach. Although the plain meaning of legislation is generally conclusive, the Supreme Court has held that in cases in which "the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters ... the intention of the drafters, rather than the strict language, controls."

2. Through the looking glass: the legislative histories of §§ 101(5)(B) and 502(c).

The original version of § 101(5) passed by the House of Representatives in HR 8200 defined "claim" as a:

(A) right to payment . . . ; or
(B) right to an equitable remedy for breach of performance if such breach does not give rise to a right to payment . . . .

Under this definition, all obligations of the debtor—including both rights to payment and rights to equitable remedies—would have been "claims." The report accompanying this bill noted that it adopted the "broadest possible definition" of the term "claim" so that "all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."  

Unfortunately for the debtor-employee, this version of § 101(5)(B) did not become law. Instead, the Senate considered and passed its own version of § 101(5), which included only rights to payment and interest thereon and did not include any equitable remedies in its definition of "claim." This led to a compromise between the floor managers of the House and Senate that is the current § 101(5). According to Representative Edwards, one of the co-sponsors of HR 8200:

Section 101[(5)](B) represents a modification of the House-passed bill to include [in] the definition of "claim" a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment. This is intended to cause the liquidation or estimation of contingent rights of payment for which there may be an alternative equitable remedy with the result that the equitable remedy will be susceptible to being discharged in bankruptcy. For example, in some States, a judgment for specific performance may be satisfied by an alternative right to payment, in the event performance is refused; in that event, the creditor entitled to specific performance would have a "claim" . . . . On the other hand, rights to an equitable remedy for a breach of performance with respect to which such breach does not give rise

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138 HR 8200, 95th Cong, 1st Sess (July 11, 1977) (emphasis added).
139 HR Rep No 95-595 at 309, 1978 USCCAN at 6266 (cited in note 33) (emphasis added).
140 S 2266, 95th Cong, 2d Sess (Oct 31, 1977). Curiously, the Senate report accompanying S 2266 merely aped the language from the House report on HR 8200, including the statement that "[t]he definition also includes as a claim an equitable right to performance that does not give rise to a right to payment." S Rep No 95-989 at 21-22, 1978 USCCAN at 5808 (cited in note 33). Nevertheless, it is clear that the definition of "claim" in S 2266 was narrower than the definition of "claim" in HR 8200.
141 See King, ed, App 3 Collier on Bankruptcy at IX-1 (cited in note 19).
to a right to payment are not "claims" and would therefore
not be susceptible to discharge in bankruptcy.\textsuperscript{142}

In contrast with the text of § 101(5)(B), which focuses on whether a "breach gives rise to a right to payment" and suggests the counter-intuitive results noted above, its legislative history suggests that the proper inquiry is whether the equitable remedy gives rise to a right to payment. Specifically, Representative Edwards stated that an equitable right "with respect to which [right] such breach does not give rise to a right to payment"\textsuperscript{143} is not a "claim" under § 101(5)(B).

An example fleshes this out. In the specific performance hypothetical to which Representative Edwards referred, state law gives the nondebtor a choice between two remedies: performance of the contract or compensatory damages. Either remedy puts the nondebtor in the position he would have occupied had there been no breach. In effect, the monetary damages place a price tag on the equitable remedy. In such a case, the nondebtor's claim will not likely be undervalued in bankruptcy, and so the nondebtor should share in the pro rata distribution with the other unsecured creditors. On the other hand, if such a price tag were unavailable—where damages were not an alternative for the equitable remedy—then there would be no benchmark by which the bankruptcy court could value the equitable remedy. Absent a price tag, then, the nondebtor's equitable right should not be treated as a "claim."

The text and the legislative history of § 502(c) reinforce this reading of § 101(5)(B). As noted above, § 502(c) gives the bankruptcy court the power to estimate certain "right[s] to payment arising from a right to an equitable remedy" for purposes of allowance against the estate.\textsuperscript{144} According to Representative Edwards, the final version of § 502(c) reflected a compromise between the House and Senate proposals, and was "consistent with an amendment to the definition of 'claim' in section [101(5)](B) of the House amendment."\textsuperscript{145} Thus, the text of § 502(c), like the legislative history of § 101(5)(B), suggests that the proper inquiry is whether the equitable remedy, not the breach of performance,

\textsuperscript{142} Uniform Law on Bankruptcies, 124 Cong Rec H11090 (Sept 28, 1978); S17046 (Oct 6, 1978) (emphasis added).
\textsuperscript{143} Id.
\textsuperscript{144} 11 USC § 502(c). See notes 24-25 and accompanying text.
gives rise to a right to payment. Moreover, the legislative history of § 502(c) suggests that Congress thought this remedy-focused inquiry was consistent with § 101(5)(B).

Under § 101(5)(B) or § 502(c), the focus of the inquiry regarding the origin of the right to payment—breach or remedy—is crucial. As noted above, if the focus were in fact on the breach, then any time an employer had a right to liquidated damages or even attorneys’ fees, an equitable right arising from the same breach would be a “claim.” On the other hand, if the focus were on the remedy, the fact that an employer had a right to liquidated or even compensatory damages for a harm distinct from that remedied by the injunction would not bring the right to the injunction within § 101(5)(B).

Although it has never addressed § 101(5)(B) in the context of a covenant not to compete, the Supreme Court took a remedy-focused approach to § 101(5)(B) in an analogous situation. In Ohio v Kovacs, the debtor’s violation of state environmental laws had given rise to a stipulation and judgment entry that required the debtor to both clean up a hazardous waste disposal site and refrain from further pollution.\(^{146}\) The issue before the Court was whether the affirmative cleanup obligation was a “claim” within § 101(5)(B). Although the Court held that it was,\(^{147}\) the Court explicitly noted that its holding did not affect the enforceability of the debtor’s negative obligations.\(^{148}\) Thus, the Court unambiguously recognized that the debtor’s single environmental violation gave rise to multiple, distinct obligations. Notwithstanding its holding that the affirmative cleanup obligation was a “claim,” the Court stressed that the negative obligations—which arose from the same violation and were set forth in the same stipulation and judgment—remained unaffected.\(^{149}\) The most obvious difference between the negative obligations and the affirmative obligation to clean up the site was that the latter was capable of being, and in fact had been, reduced to a monetary obligation.\(^{150}\) To the extent that a negative obligation not to compete

\(^{146}\) 469 US 274, 276 (1985).

\(^{147}\) Id at 283.

\(^{148}\) “[W]e do not hold that the injunction against bringing further toxic wastes on the premises or against any conduct that will contribute to the pollution of the site or the State’s waters is dischargeable in bankruptcy; we here address . . . only the affirmative duty to clean up the site and the duty to pay money to that end.” Id at 284-85 (emphasis added).

\(^{149}\) Id.

\(^{150}\) In holding that the cleanup obligation was a “claim,” the Court relied heavily on the fact that the State had appointed a receiver and had instructed the receiver to take
cannot be monetized, as is ordinarily the case given the highly speculative nature of the employer's damages, the employer's equitable right would be in all relevant respects identical to those that the Kovacs Court specifically excluded from the scope of its holding.

3. The textual approach to covenants not to compete.

Applying §§ 101(5)(B) and 502(c) in light of the remedy-focused inquiry suggested by Kovacs, a court should find that a right to an injunction enforcing a covenant not to compete presents a "claim" only when the employer could elect monetary damages in lieu of the injunction, that is, if monetary damages could compensate for the same future harm that the injunction would have prevented. However, this will rarely be possible. According to the Restatement (Second) of Contracts, "an injunction will not be ordered if damages would be adequate to protect the expectation interest of the injured party."\(^5\) However, "the inadequacy of damages is generally not a seriously disputed issue in suits to enforce noncompetition agreements."\(^5\) Thus, a state court's holding that an employer is entitled to an injunction to prevent breach of a covenant not to compete generally implies a concomitant holding that the employer cannot be compensated by monetary damages. The employer does not have an alternative right to payment for the future injury that the debtor-employee's competition would cause.

Damages are particularly likely to be an inadequate substitute for an injunction as a remedy for a breach of a noncompetition covenant because an injunction, by its nature, prevents future continuing harm.\(^153\) Because neither the parties nor the court know what the future consequences of the debtor's

\(^{151}\) Restatement (Second) of Contracts § 359(1) (cited in note 44).
\(^{152}\) Aspelund and Eriksen, Employee Noncompetition Law § 8.02 at 8-36 (cited in note 46). Aspelund and Eriksen attribute this to two factors: the breach of a covenant not to compete is often a continuing breach; and the interests protected are often intangible. See also Comment, Enforcement of Restrictive Covenants in Pennsylvania Employment Contracts, 80 Dickinson L Rev 693, 713 (1976); Merrill Lynch, Pierce, Fenner & Smith, Inc. v Hagerty, 808 F Supp 1555, 1559-60 (S D Fla 1992), aff'd, 2 F3d 405 (11th Cir 1993).
\(^{153}\) See Aspelund and Eriksen, Employee Noncompetition Law § 8.02 at 8-36, 8-37 (cited in note 46); Black's Law Dictionary 784 (West, 6th ed 1990) (defining "injunction" as "[a] prohibitive, equitable remedy . . . forbidding the [defendant] from doing some act . . . or restraining him in the continuance thereof . . . . Generally, it is a preventive and protective remedy, aimed at future acts, and is not intended to redress past wrongs").
unlawful competition will be, they will find it extremely difficult to set a price for them.\textsuperscript{154} Damages, on the other hand, are effective compensation for past harms: the parties and the court are able to ascertain the precise extent of the injury that has occurred and place on it a fully compensatory price tag.\textsuperscript{155}

It is noteworthy that the example in the legislative history of § 101(5)(B) of an equitable remedy that could be a "claim" was specific performance, rather than injunction.\textsuperscript{156} Because an order for specific performance generally requires an affirmative act, it will often be subject to valuation in a way that an injunction is not. When the court is aware of the precise boundaries of an affirmative obligation, it can compare the position the nondebtor would have occupied if performance were completed with the position the it would occupy if it were not.

**CONCLUSION**

The current status of covenants not to compete in bankruptcy law is quite murky. Until clarified, parties entering into such covenants cannot predict whether the covenants will stand or fall when the covenantor goes broke. Moreover, the tendency of courts to get lost in the executory contract maze of § 365, and their failure to recognize that discharge is the proper place to wrangle over the enforceability of noncompetition covenants, only

\textsuperscript{154} See *In re Norquist*, 43 Bankr 224, 225 (Bankr E D Wash 1984) ("Under well settled principles of common law the breach of [noncompetition] covenants is deemed to create damages too speculative for accurate calculation.").

\textsuperscript{155} Although courts do in some cases award "future" damages, such as the present value of future lost earnings in wrongful discharge actions or future lost wages and "pain and suffering" damages in personal injury or wrongful death actions, such awards actually compensate for the future consequences of a past harm, not for some harm that has not yet occurred. Moreover, courts frequently have concrete evidence from which to calculate these "future" damages: the employee's salary at the time of the wrongful discharge or the decedent's income at the time he was wrongfully killed. On the other hand, when an employer seeks to enforce a covenant not to compete, it seeks to prevent future harms from occurring. As the Restatement notes: "The breach of a covenant not to compete may cause the loss of customers of an unascertainable number or importance [. . .]. In such situations, equitable relief is often appropriate." Restatement (Second) of Contracts § 360, comment b (cited in note 44).

\textsuperscript{156} Although specific performance is actually a type of injunction, an order for specific performance is generally an order compelling the defendant to do some affirmative act, such as convey a piece of property or deliver some unique good, whereas an injunction generally orders the defendant to refrain from doing something. *Black's Law Dictionary* defines "specific performance" as "[t]he actual accomplishment of a contract by a party bound to fulfill it," *Black's Law Dictionary* at 1138 (cited in note 153), whereas it defines an "injunction" as a "prohibitive, equitable remedy . . . forbidding the [defendant] from doing some act," id at 784.
further confuses the inquiry. As long as this confusion persists, employers may hesitate to invest in the human capital of their employees, and employees will be forced to work for wages lower than they would receive if they could credibly promise not to compete.

The best way out of this quandary is for Congress to amend the Bankruptcy Code to afford covenants not to compete protection similar to that afforded real property leases and technology licenses. Given the difficulty of legislative solutions, however, this Comment offers an alternate path, based on the language and legislative history of the Code, that permits the enforceability of covenants not to compete. Whether one gets there through the Congress or the courts, this result is consistent with, if not required by, both the text and legislative histories of the relevant provisions of the Code and the normative underpinnings of bankruptcy law in the United States.