ALM | LAW.COM

New York Law Journal

Noncompete Agreements Survive the FTC and a Noncompete Provision Survives Rejection

By Rachel Ehrlich Albanese, Dennis O'Donnell and Matthew Sarna
September 16, 2024

Noncompete agreements, set to be relegated to history as of this month, remain relevant for now in an increasingly complex environment for companies evaluating how to treat such agreements in a restructuring scenario. In addition to the outcome of a likely appeal of a Texas federal court's Aug. 20 nationwide injunction staying the effectiveness of a new federal rule banning such agreements, companies contemplating Chapter 11 must now grapple with a decision from the U.S. Bankruptcy Court for the Eastern District of Michigan which addresses, in a novel way, the enforceability of noncompete agreements under Section 365. Coupled with the now-stayed FTC rule on noncompete agreements, this decision raises challenging questions regarding the treatment of executory contracts and noncompetes going forward.

The FTC Rule and 'Loper Bright'

On April 23, 2024, the Federal Trade Commission (FTC) finalized a rule banning noncompete restrictions for US employees (the FTC Rule). The FTC Rule bans new noncompete agreements and renders most existing noncompetes unenforceable except with respect to certain senior executives and provides only the FTC with a private right of action to remedy violations.

Predicated on the Supreme Court's rejection of the *Chevron* agency deference standard in *Loper Bright*

Photo: Diego M. Radzinschi/ALM

Federal Trade Commission building in Washington, D.C, on January 12, 2022.

Enterprises v. Raimondo, 144 S. Ct. 2244 (2024), the FTC Rule has drawn legal challenges from parties contending that the rule exceeded the scope of the FTC's regulatory authority, including *Ryan LLC v. Federal Trade Commission*, No. 3:24-CV-00986-E, 2024 WL 3879954 (N.D. Tex. Aug. 20, 2024) (finding the FTC lacked authority to promulgate a final rule banning noncompetes and issued an injunction staying effectiveness of the FTC Rule).

Executory Contracts and Empower Central Michigan

On April 26, 2024, the bankruptcy court in *In re Empower Central Michigan*, 661 B.R. 222 (Bankr. E.D.

Mich. 2024), issued an opinion bifurcating into executory and nonexecutory components a franchise agreement containing a noncompete clause, among other provisions. The dispute arose from the debtor's motion to reject a franchise agreement and a separate but related confidentiality agreement, each with Auto Lab Franchising, LLC. The debtor argued that the franchise agreement was the debtor's largest expense and provided no ongoing, tangible benefit. Auto Lab objected and asserted that, while the franchise agreement itself was an executory contract, the noncompete provision embedded within was nonexecutory and, thus, not subject to rejection.

In an opaque decision, the *Empower* court—appearing to conflate the admittedly separate confidentiality and franchise agreements—ultimately held that "the confidentiality and noncompetition terms of this agreement would continue to bind the debtor" in the wake of any attempted rejection of either agreement. The court noted, "The distinction between executory and nonexecutory contracts is not particularly important here because even were the confidentiality agreement a rejectable executory contract, the result is the same—the equitable remedies contained in the franchise agreement and the confidentiality agreement cannot be reduced to a monetary claim and remain enforceable by Auto Lab"—and, by implication, are not susceptible to rejection by the debtor.

Under *Empower*'s novel interpretation of Section 365, unless the breach of the relevant contract effectuated by rejection will give rise to a "claim" for damages, the contract (or any relevant part thereof) is not subject to rejection. The court focused on the timing of rejection under Section 365(g) and the definition of a "claim" under Section 101(5). It also looked to the franchise agreement's liquidated damages provision, which entitles the nonbreaching party to both monetary claims and equitable relief and determined that a breach of the noncompete clause could only give rise to an entitlement to equitable relief, not a claim for monetary damages. The court held that, despite the franchise agreement being itself executory and subject to rejection, the noncompete clause embedded within, executory or not, would remain enforceable after rejection of the franchise agreement.

This ruling is inconsistent with established principles of executory contract analysis. In general, an executory contract contains material obligations outstanding on both sides as of the petition date. See, e.g., *In re Ionosphere Clubs,* 85 F.3d 992 (2d Cir. 1996). Courts have ruled that executory contracts must be assumed or rejected under Section 365 of the Bankruptcy Code as a whole, not piecemeal, consistent with the axiomatic principles of cum onere: a debtor cannot "assume the benefits of a contract and reject the unfavorable aspects of the same contract." See *Folger Adam Security v. Dematteis/Macgregor,* JV, 209 F.3d 252, 264 (3d Cir. 2000). There are exceptions, however, when a court determines a single contract contains separate, severable agreements. See, e.g., *In re Mirant*, 318 B.R. 100, 104 (N.D. Tex. 2004).

Empower turns this fundamental principle on its head. Unlike *Mirant* and its progeny, the bankruptcy court did not find that the noncompete provision constituted a separate, severable agreement. To the contrary, the franchise agreement was, without contrary allegation, a single agreement and controlling case law required that all of its provisions be assumed or rejected by the debtor in toto.

Moreover, the *Empower* court added a novel second prong to the basic Section 365 executory contract/rejection standard. Under the *Empower* analysis, to be deemed executory and subject to rejection, a contract must have material, bilateral obligations due and owing as of the petition date and give rise to a damage claim. In support of this new standard, the court pointed to *Kennedy v. Medicap Pharmaceuticals,* 267 F.3d 493 (6th Cir. 2001), and several related cases. However, these cases directly address only the issue of whether a debtor's obligation not to compete constitutes a claim or an equitable entitlement. In holding that breach of the noncompete provision of the franchise agreement could not yield a damage claim, the Empower court held—again mixing and matching relevant terminology—that this provision was "non-executory" and would remain enforceable even if the balance of the Franchise Agreement were rejected.

In reaching this conclusion, the *Empower* court added yet another approach to the "variety of

analyses" used by bankruptcy courts in evaluating the enforceability of noncompete clauses in the Section 365 context. See *In re Hirschhorn*, 156 B.R. 379, 388 (Bankr. E.D.N.Y. 1993). Courts have most often held that "rejection of an agreement is not a termination but instead is equivalent to a breach thereof," and that, consequently, other affirmative obligations continue, and, as a result, "the noncompete clause emerges unscathed following the rejection." See *In re Noco,* 76 B.R. 839, 844 (Bankr. N.D. Fla. 1987) ("Rejection under the Bankruptcy Code only affects the monetary rights of the creditor. It does not disturb equitable, nonmonetary rights that the creditor may have against the debtor because of the breach of contract [including] the creditor's right to seek an injunction so that the debtor cannot breach the negative promise not to compete").

Other courts, observing that noncompete agreements generally come into play only upon termination of the underlying agreement, have found that no bilateral obligations remain and, thus, deem the relevant agreement nonexecutory for section 365 purposes. See *In re Oseen,* 133 B.R. 527, 529 (Bankr. D. Idaho 1991) ("The only performance remaining for the plaintiff as the seller of his partnership interest was his duty not to compete with the defendant. This, standing alone, is insufficient to make his side of the contract executory."); *In re Cooper*, 47 B.R. 842, 844 (Bankr. W.D. Mo. 1985) (noncompetition clauses found incapable of rejection under Section 365 because, after employee's termination, employer had no further duties of performance).

Potential Ramifications and Recommendations

The looming effectiveness of the FTC Rule, a potential *Ryan* appeal, and the *Empower* decision—taken together and against the backdrop of the questionable status of noncompete agreements under Section 365—give rise to an array of scenarios that any company contemplating a Chapter 11 filing will now need to evaluate.

If the objective is to preserve the competitive benefits of noncompete agreements in contracts rejected for economic reasons, the first inquiry will relate to the status and impact of the FTC Rule. Subject to limited exceptions, the FTC Rule would invalidate such noncompete clauses, thereby making the preservation of such benefits impossible and resuscitation of such agreements under Section 365 problematic, although it may still be possible to argue that the FTC did not intend for the FTC Rule to be applied retroactively.

However, with or without the FTC Rule, Section 365's treatment of noncompete agreements remains clouded by ambiguity, and *Empower* renders the already unsettled state of the law even less clear.

Therefore, debtors should carefully consider the impact of these contingencies in evaluating whether noncompete clauses survive rejection. Stepping back, companies should also review how they use noncompetes and explore other methods of safeguarding confidential data, intellectual property and trade secrets. This could involve incorporating nondisclosure, narrowly tailored nonsolicitation, and confidentiality provisions in their agreements, all of which remain acceptable under the current FTC Rule, provided they do not operate as de facto noncompetes and are otherwise permissible under state law.

DLA Piper is tracking related developments closely and is available to provide assistance.

Rachel Ehrlich Albanese *is co-chair of DLA Piper's U.S. restructuring practice. She has more than 20 years' experience representing debtors, secured and unsecured creditors, equity holders, purchasers of distressed assets, and other parties in interest in a wide range of restructuring matters.*

Dennis O'Donnell *is a partner in the firm's restructuring practice. He has extensive experience in corporate reorganization and bankruptcy-related litigation matters representing debtors, lenders, and acquirors in Chapter 11 cases, Chapter 15 cases, loan restructurings and out-of-court workouts, among others.*

Matthew Sarna *is an associate in the firm's restructuring practice. He focuses his practice on corporate restructuring and bankruptcy and advises a variety of clients in complex business reorganizations and insolvency matters.*