

CREDITOR'S RIGHTS TOOLKIT

What Happens to Employment Agreements and Noncompete Agreements in Bankruptcy?

An employer's bankruptcy filing can significantly impact an employee's agreements with the debtor. While a reorganizing debtor may agree to continue to honor its obligations under employment agreements, the Bankruptcy Code gives a debtor broad powers that may allow them to significantly alter an employee's bargained-for rights.

It is crucial for counterparties to understand their legal footing and prepare accordingly. This article discusses how the provisions of the Bankruptcy Code may affect an employment contract and noncompete agreements in an employer's bankruptcy.

Key Issues

- **EMPLOYMENT AGREEMENTS AS EXECUTORY CONTRACTS**

Most employment agreements are considered executory contracts under Section 365 of the Bankruptcy Code, which the debtor has the power to assume or reject. If assumed, the debtor must cure any defaults (like unpaid wages) and continue to honor the contract. If rejected, the contract is treated as if the debtor had breached the agreement immediately prior to the bankruptcy filing. The employee is relieved of their obligation to perform, and the debtor is not obligated to pay out the remaining term. The counterparty instead has a claim for damages.¹

- **PERSONAL SERVICE CONTRACTS**

If an employment agreement is a personal service contract, it may not be assumable without the employee's consent. Personal service contracts involve individuals whose unique talents or expertise are central to performance (e.g., entertainers, consultants, and engineers). These agreements are generally nonassignable without consent due to their reliance on the individual's skills. Courts often bar assumption or assignment of such contracts in bankruptcy without the individual's agreement, and unauthorized assignment may result in the contract being deemed invalid.

¹ See [What Is Contract Rejection, When Does It Happen, and What are the Consequences?](#)

- **PAYMENT AND CLAIM TREATMENT**

An employee's claims under their agreement are treated differently based on when amounts due are earned. Wages, salaries, and benefits earned after the bankruptcy filing are entitled to payment in full as "administrative expenses" of the debtor's estate. If earned within 180 days before the bankruptcy filing, they are entitled to priority payment, up to a capped amount of \$17,150. Other prepetition amounts owed are treated as general unsecured claims and may recover little. Claims for breach of an employment contract are generally capped by Bankruptcy Code § 502(b)(7) at one year's salary plus unpaid compensation due under the contract. Severance payments may receive different treatment depending on the structure and timing of the agreement.²

- **NONCOMPETE AGREEMENTS**

Rejection of an employment contract does not necessarily invalidate a noncompete clause. Because rejection is treated as a breach, not rescission, some courts enforce noncompetes post-rejection. Other courts have disagreed, however, holding that the debtor's breach excuses the employee from performance. Enforceability may also turn on applicable state law, regardless of bankruptcy treatment.

Takeaway

Whether an employment agreement is assumed or rejected can have a significant impact on an employee's bargained-for rights and expectations. When an employer enters bankruptcy, employees should monitor the docket for motions and deadlines, and be prepared to file a proof of claim if their employment agreement is rejected. An experienced bankruptcy professional can help navigate these issues, including claims against the debtor, assumption/rejection strategies, and enforceability of restrictive covenants. Knowing your rights and asserting them on time can mean the difference between meaningful recovery and pennies on the dollar.

² See [What Will Happen to My Severance Payments if My Employer Files for Bankruptcy?](#)