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Feature

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Be Careful What You Settle For Rejection of an Executory Contract Can Do More than Just "Moot Out" Confirmation Objection



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On July 15, 2016, the Delaware Court of Chancery issued a post-trial memorandum opinion in *Hipcricket Inc. v. mGage LLC and Glenn Stansbury*² that should serve as a cautionary tale to bankruptcy practitioners, particularly those working on debtor-side representations. In short, the chancery court ruled that a debtor's rejection of an executory employment contract in order to "moot out" an objection to plan confirmation barred the debtor and its estate from later attempts to enforce the contract's noncompete and nonsolicitation provisions.

The chancery court's decision in this case is noteworthy for several reasons. First, it is common in complex restructurings to reject executory contracts in the run-up to confirmation to resolve confirmation objections. Second, the rejection rendered unenforceable under applicable state law a nonsolicitation provision that was valuable to the reorganizing estate. Third, the opinion was issued by Hon. Andre G. Bouchard, Chancellor of the Delaware Court of Chancery, which has been regarded as perhaps the most influential business court in the nation. This article discusses the relevant factual and procedural history of the underlying bankruptcy proceeding that influenced the chancery court's decision and concludes with some lessons that can be learned from this decision.

Hipcricket's Chapter 11 Proceeding

On Jan. 20, 2015, Hipcricket Inc. commenced its chapter 11 case in the U.S. Bankruptcy Court for the District of Delaware.³ Hipcricket continued to operate its business as a debtor in possession and

ultimately became a wholly owned subsidiary of ESW Capital LLC after it was sold pursuant to an auction and sales process approved by the Delaware Bankruptcy Court.⁴ At the time of the filing, Glenn Stansbury was Hipcricket's vice president of sales⁵ and had previously entered into a commission agreement with Hipcricket, which included the terms and conditions of his compensation and certain post-employment nonsolicitation restrictions (the "post-employment restrictions").⁶ The commission agreement expired by its own terms during Hipcricket's chapter 11 case at the end of February 2015, but the post-employment restrictions survived to prohibit Stansbury from soliciting Hipcricket's (1) customers for two years and (2) employees for one year.⁷ Whether these post-employment restrictions remained effective post-rejection was at the center of the dispute.

On March 5, 2015, Stansbury accepted a position with mGage LLC, a direct Hipcricket competitor.⁸ He officially stopped working at Hipcricket on March 13, 2015, and began his employment with mGage three days later.⁹ On March 18, 2015, Hipcricket's director of finance advised Stansbury that he would be paid the maximum \$12,475 amount as an administrative claim for pre-petition wages under § 507(a) of the Bankruptcy Code, leaving Stansbury with a \$30,831 general unsecured claim for his personal time off and commissions that accrued and were earned pre-petition.¹⁰

On March 20, 2015, Hipcricket filed a proposed reorganization plan, which it subsequently amended

⁴ *Id.* at *9.

⁵ *Id.* at *3.

⁶ *Id.* at *5.

⁷ *Id.* at *5-7.

⁸ *Id.* at *10.

⁹ *Id.*

¹⁰ *Id.* at *11.

¹ The views expressed in this article are those of the authors and do not represent the views of their firm or its clients.

² No. 11135-CB, 2016 Del. Ch. LEXIS 105, at *1 (Del. Ch. July 15, 2016).

³ *Id.* at *8.

on March 31, 2015.¹¹ As is typical, the plan provided for the rejection of contracts that were not expressly listed on a schedule of assumed contracts and unexpired leases.¹² The commission agreement was listed as a contract Hipcricket intended to assume, with a cure cost of \$0.¹³

Almost immediately after starting his employment at mGage, Stansbury began soliciting Hipcricket customers, which was prohibited under the terms of the commission agreement that was, at that time, listed as a contract to be assumed under the reorganization plan.¹⁴ On April 15, 2015, Hipcricket sent Stansbury a letter demanding that he cease and desist from further customer solicitations.¹⁵

On April 28, 2015, Stansbury responded via counsel asserting that the commission agreement was unenforceable due to Hipcricket's rejection of the agreement.¹⁶ On April 30, 2015, Stansbury filed an unsecured nonpriority claim for \$30,831 based on the calculations that he received from Hipcricket's director of finance in mid-March 2015.¹⁷ On May 11, 2015, Stansbury objected to the assumption of the post-employment restrictions without "curing" amounts owed to him: \$30,831 as reflected in his proof of claim.¹⁸ On the same day, Hipcricket submitted a brief in support of confirmation that acknowledged Stansbury's objection, but stated that it was "mooted out" by the removal of the commission agreement from the assumption schedule.¹⁹ On May 15, 2015, the Delaware Bankruptcy Court confirmed the plan, which rejected all executory contracts and unexpired leases that were not explicitly assumed, including the commission agreement.²⁰

Hipcricket Commences Proceeding Against Stansbury in Chancery Court

On June 11, 2015, Hipcricket filed a verified complaint in the chancery court²¹ against Stansbury and mGage.²² Hipcricket also filed a motion for a temporary restraining order and preliminary injunction, seeking to, among other things, enjoin Stansbury from soliciting Hipcricket customers in violation of the commission agreement's post-employment restrictions.²³ On June 17, 2015, the chancery court deferred ruling on the injunctive relief sought against Stansbury so that the parties could submit supplemental briefs addressing whether the commission agreement was enforceable given Hipcricket's commencement of chapter 11 proceedings.²⁴

On July 16, 2015, after receiving supplemental briefing, the chancery court denied Hipcricket's motion for a prelimi-

nary injunction against Stansbury because Hipcricket failed to demonstrate a reasonable probability of success of proving that the commission agreement was enforceable.²⁵ Even at this early stage, the chancery court found that the commission agreement was an executory contract that Hipcricket had materially breached as of the petition date by not assuming its obligations (*i.e.*, not curing the \$30,831 that was owed to Stansbury), which excused Stansbury from having to perform.²⁶ A trial on the merits was held on Dec. 1-2, 2015, and, after post-trial briefing and additional argument, the chancery court rendered its decision on July 15, 2016.²⁷

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The Chancery Court's Decision

In its memorandum opinion, the chancery court found that the significant issue governing most of Hipcricket's claims against Stansbury was whether the post-employment restrictions were enforceable given the commission agreement's rejection in Hipcricket's chapter 11 proceeding.²⁸ The chancery court focused on the legal effect of Hipcricket's rejection of the commission agreement and first looked to § 365(g) of the Bankruptcy Code to hold that the rejection of an executory contract constitutes a breach of that contract as of the petition date, and that state law must be applied to determine the parties' rights regarding the contract and subsequent breach.²⁹

Next, the chancery court turned to the applicable law of the state of Washington, which governed the commission agreement. The court held that under Washington state law, a party in a material breach of a contract may not demand performance from the nonbreaching party.³⁰ The court also held that an employer's breach of an employment contract excuses the performance of a noncompete agreement by an employee.³¹ As a result, the chancery court, in a "straightforward application" of Washington law, found that Hipcricket's breach of the commission agreement — through its rejection — excused Stansbury from complying with the post-employment restrictions as of Hipcricket's petition date.³²

The chancery court then addressed Hipcricket's arguments as to why the post-employment restrictions should remain enforceable despite its rejection of the commission agreement — two of which are particularly noteworthy to

11 *Id.* at *12.

12 *Id.* at *14.

13 *Id.* at *12.

14 *Id.* at *15.

15 *Id.* at *12.

16 At this point, however, the commission agreement was listed on the schedule of contracts to be assumed.

17 *Hipcricket*, 2016 Del. Ch. LEXIS 105, at *13.

18 *Id.*

19 *Id.*

20 *Id.* at *14.

21 The chancery court offered no explanation, nor did the parties explain in their briefs, why this case was filed in the court of chancery rather than the Delaware bankruptcy court. Hipcricket's reorganization plan provided for the Delaware bankruptcy court to retain jurisdiction over certain claims, including, presumably, Hipcricket's claims against Stansbury. However, the bankruptcy court may not have had jurisdiction over Hipcricket's claims against mGage. Hipcricket's claims against mGage alleged, among other things, violation of Washington's version of the Uniform Trade Secrets Act and tortious interference with business relations. Because the disposition of these claims had no effect on the disposition of the claims asserted against Stansbury, they are not discussed in this article.

22 *Hipcricket*, 2016 Del. Ch. LEXIS 105, at *26.

23 *Id.* at *26-27.

24 *Id.* at *27.

25 *Id.*

26 *Id.* at *28.

27 *Id.* at *29-30.

28 *Id.* at *32.

29 *Id.* at *32-33.

30 *Id.* at *34 (citing *DC Farms LLC v. Conagra Foods Lamb Weston Inc.*, 317 P.3d 543, 550) (Wash. App. 2014).

31 *Id.* at *35 (citing *Parsons Supply Inc. v. Smith*, 591 P.2d 821 (Wash. Ct. App. 1979)).

32 *Id.* at *36. The chancery court had previously ruled in connection with Hipcricket's motion for a preliminary injunction that Stansbury's claim against Hipcricket for \$30,831 was "material" to him. *Id.* at *36-37. In any event, Chancellor Bouchard independently found that this amount was "material" to Stansbury because it constituted more than 10 percent of his total 2015 compensation. *Id.* at *37.

bankruptcy practitioners. First, Hipcricket argued that the post-employment restrictions should be enforced because Stansbury began soliciting its customers in March 2015, prior to Hipcricket’s rejection of the commission agreement by operation of the reorganization plan in May 2015.³³ The court quickly dismissed this argument, noting that Hipcricket took no action to enforce its rights under the commission agreement once it learned of Stansbury’s alleged solicitation.³⁴ Instead, Hipcricket waited to file its verified complaint with the chancery court until after its plan was confirmed and the commission agreement had been rejected.³⁵

Second, the chancery court distinguished the line of cases cited by Hipcricket suggesting that post-termination obligations within executory contracts remain enforceable even after rejection by a debtor in bankruptcy.³⁶ The chancery court found that these cases were inapposite because they involved franchisee debtors where the question was whether a *debtor’s* obligation not to compete survived its own rejection of the contract containing that obligation.³⁷ In this instance, it was Hipcricket (the breaching debtor) that sought to enforce contract rights against Stansbury (the non-breaching party) after it refused to assume the contract and cure its breach.³⁸

In *dicta*, the chancery court addressed the policy reasons against Hipcricket’s argument that a debtor can reject a contract but continue to enforce its prohibitive restrictions post-rejection. Specifically, the court explained that allowing Hipcricket to reject the commission agreement and continue to enforce the post-employment restrictions was not only contrary to applicable law, but would contravene the optionality policy underlying the Bankruptcy Code’s treatment of executory contracts.³⁹ The court understood that the purpose behind affording a debtor the option to assume or reject executory contracts is to allow the estate to assume those contracts that it deems beneficial and reject those that are not.⁴⁰

At the same time, however, a debtor can only gain the benefits of a contract by electing to assume that contract and giving administrative priority to the burdens associated with that contract. In this sense, the chancery court equated a debtor’s choice to assume or reject an executory contract with a “decision to perform or breach.”⁴¹ Here, the court found that Hipcricket made the “conscious decision” to reject the commission agreement, which paved the way for plan confirmation and affirmatively left Stansbury with a general unsecured claim.⁴² The chancery court noted that Hipcricket inequitably would “have its cake and eat it, too” if it were allowed to reap the benefits of the commission agreement without giving Stansbury’s claim administrative priority.⁴³

Lessons to Be Learned from *Hipcricket*

Although it is common in complex bankruptcy cases to reject executory contracts to “moot out” confirmation

objections, the chancery court’s decision in *Hipcricket* should give bankruptcy practitioners pause before actually doing so. Practitioners must be mindful of any potential unintended consequences of the rejection of contracts before seeking to render objections moot in the press to confirm a reorganization plan. For example, debtors should identify the rights they are giving up in rejection and weigh the value — both intrinsic and financial — against the costs of assumption and cure.

Hipcricket could have paid Stansbury’s \$30,831 claim, enforced the post-employment restrictions, and avoided over a year of expensive and time-consuming litigation in chancery court. Instead, in order to “moot out” Stansbury’s confirmation objection and avoid paying a relatively small administrative claim, Hipcricket rejected the commission agreement and attempted to enforce certain of its provisions in chancery court — a strategy that may in hindsight have seemed shortsighted.

Practitioners also need to be mindful of their state laws governing contracts and how those laws treat breaches of contract. As Chancellor Bouchard pointed out, the Bankruptcy Code treats a rejected executory contract as a breach as of the petition date, but it is state law that determines the parties’ rights regarding the breach. Under a straightforward analysis of Washington state law, Chancellor Bouchard determined that Stansbury was excused from performance because of Hipcricket’s breach of the commission agreement. If Hipcricket were aware of this analysis ahead of time, it might have decided that the value of paying Stansbury’s cure claim outweighed the costs of rejection.

Finally, debtors should act quickly to enforce their contractual rights before choosing to assume or reject an executory contract. One of the reasons that the chancery court refused to enforce the post-employment restrictions is because Hipcricket took no action between the time it learned of Stansbury’s alleged actions and the filing of the chancery court proceeding — approximately a two-month span. Notably, Chancellor Bouchard suggested that had Hipcricket sought to enforce its rights in that two-month span, it may have been entitled to relief.

Moreover, this opinion serves as notice to practitioners that simply sending a cease-and-desist letter in the wake of learning about a contractual violation may not be sufficient. A debtor needs to diligently enforce its contractual rights as soon as possible, which in all likelihood means seeking relief prior to any decision to reject an executory contract. **abi**

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³³ *Hipcricket*, 2016 Del. Ch. LEXIS 105, at *37-38.

³⁴ *Id.* at *38.

³⁵ *Id.*

³⁶ *Id.* at *38-39.

³⁷ *Id.*

³⁸ *Id.* at *29.

³⁹ *Id.* at *39-40.

⁴⁰ *Id.* at *39-40 and n.154.

⁴¹ *Id.* at *40.

⁴² *Id.* at *43.

⁴³ *Id.*