Chapter 7: Commercial Law

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CHAPTER 7

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§7.1. Introduction. In recognition of the manifold nature of the decisions treated in this chapter — the diversity of issues presented by each case — the organizational structure departs somewhat from the traditional survey format. The amenability of the following decisions to analysis from several distinct, though inevitably related, perspectives places particular emphasis upon the individual section headings under which a given case is discussed.

§7.2. Uniform Commercial Code: Judicial disregard where applicable: Failure to apply Code principles by analogy. Disregard of the Uniform Commercial Code1 in cases to which it properly applies and misapplication of the Code when it is the applicable law selected by the court2 are two errors which recur with troubling frequency in Massachusetts cases of commercial consequence. Apt illustration is furnished by Regina Grape Products Co. v. Supreme Wine Co.3 and a companion case,4 in which a California wine seller claimed loss of profit resulting from failure of the Massachusetts buyer to purchase the amount of wine contractually stipulated, and in which the buyer sued for damages for breach of warranty of the wine's quality. Both claims were based upon breach of a contract for the sale of wine made in 1963. A preliminary conflict of laws issue was soundly resolved with the decision that Massachusetts law obtained. Proceeding upon the unquestionable premise that the transaction was a contract for the sale of goods falling within the scope of Article 25 of the Code, the Supreme Judicial Court cited the warranty sections in finding an express warranty by sample,5 an implied warranty of fitness for a

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§7.2. 1 The UCC was enacted as Chapter 106 of the Massachusetts General Laws. As corresponding section numbers are identical, all future references, unless otherwise indicated, are to the 1962 Official Text of the Uniform Commercial Code.
5 UCC §§2-102, 2-105 and 2-106(1).
6 Id. §2-313(1)(c).
particular purpose,7 and an implied warranty of merchantability.8 Inexplicably, however, the Code is nowhere mentioned in the Court's discussion of issues raised by the parol evidence rule, the requirement that buyer notify seller of breach of warranty, or the remedies which inure to an aggrieved buyer upon breach of warranty arising out of an installment sales contract. Each of these legal problems is expressly covered by Code provisions;9 and, significantly, the Code principles relating to these problems are, in many instances, different from antecedent common law contract principles. The probability that the outcome of the Regina case would not have been changed by appropriate application of apposite Code sections should not obscure the importance of analytically substituting express and controlling provisions of Article 2 for common law contract principles which ceased to obtain in Massachusetts with the 1958 enactment of the Uniform Commercial Code. The changes engendered by such enactment should not be ignored, especially 12 years after the Code's adoption.

Manganaro Drywall, Inc. v. Penn-Simon Construction Co.10 presents the opposite side of the conceptual problem raised by the Regina decision, to wit: the application of Article 2 principles to transactions which are clearly outside the scope of the article on sales. The principal case arose out of the breach of a compromise agreement regarding the amount due to plaintiff subcontractor for work and materials furnished in construction of several buildings. The compromise agreement provided for payment of the amount agreed to be due in installments without interest; but, if the contractor or surety should default in paying any installment, the remaining principal, plus interest at the rate of 6 percent per year (from the date of completion of performance) on the total amount agreed upon, would become immediately due and payable. The Supreme Judicial Court considered solely the issue of whether the provision for interest payment was unconscionable as alleged. While the compromise agreement was not held within the ambit of Article 2,11 and the Court did not refer to Section 2-30212 of

7 Id. §2-315.
8 Id. §2-314.
9 UCC §2-202 (parol evidence rule); UCC §§2-607(3)(a) (notification of breach of warranty); UCC §2-612 (installment contracts); UCC §§2-711 through 2-717 (buyer's remedies). For further discussion of these issues, see §§7.3, 7.5 and §7.6 infra.
11 See note 5 supra. The plaintiff apparently was a drywall installer. It seems highly improbable that the sale and installation of drywall in connection with a building construction project would be characterized as a transaction in goods within the scope of Article 2.
12 UCC §2-302 provides:

“(1) If the court as a matter of law finds the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may limit the application of any unconscionable clause as to avoid any unconscionable result.

“(2) When it is claimed or appears to the court that the contract or any clause
the Code, it nonetheless seems reasonable to conclude that the Court resolved the issue using the unconscionability principles of Article 2 by analogy. Such is a salutary common law approach,\textsuperscript{13} and expansion of Code application by analogy indeed was intended by its draftsmen.\textsuperscript{14} The remaining problem, however, is that the Court did not explicitly recognize or analyze the legislative analogy question. It is submitted that the Court should have considered the legislative purpose and policy in enacting Section 2-302, the current societal values which it reflects, and the comparability of the instant case to those factual settings to which the section directly applies.\textsuperscript{15} The not uncommon failure of the courts to thoroughly analyze the analogy issue should be avoided in the future.

\textbf{\S 7.3. UCC Article 2: Parol evidence rule.} The written portion of the contract for sale of wine in \textit{Regina Grape Products Co. v. Supreme Wine Co.}\textsuperscript{1} provided:

Since the time we started purchasing from you, a few years ago, we have used only your wine, even though we could have made purchases at a lesser price. However, recently we have been approached by more than one reputable firm with a $.47 per gallon price. I am not asking that you meet the above quoted price. I am willing to pay you $.52\frac{1}{2} per gallon for 125,000 gallons of Red Dry Wine. If this is acceptable please ship 8,000 gallons immediately. Please notify either way. Would you please indicate that this is agreeable to you by placing your signature below.\textsuperscript{2}

Both buyer and seller signed the writing. Prior to consummation of the contract in issue, the seller had furnished wine of satisfactory quality to the buyer over a period of more than 18 months; the buyer’s president had supplied samples of wine of desired color and quality to seller; and the parties had negotiated quality and color standards. The first shipment of wine under the new contract was unsatisfactory and the buyer complained. Subsequently, buyer notified thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

It could be argued that this section has broader application because it uses the term “contract” rather than “contract for sale”; however, this is a doubtful contention. See UCC §2-106.

\textsuperscript{13} See Pound, Common Law and Legislation, 21 Harv. L. Rev. 385 (1908).
\textsuperscript{14} UCC § 1-102, Comment 1; see also 1954 New York Law Revision Commission Report, General Statement to the Commission by Professor Karl N. Llewellyn, vol. I, pp. 19 et seq.
\textsuperscript{15} See Farnsworth, Implied Warranties of Quality in Non-Sales Cases, 57 Colum. L. Rev. 653, 664 (1957).

2 Id. at 946, 260 N.E.2d at 220. Interesting problems involving the proper mode of acceptance, and silence as acceptance, raised by this letter were not treated in the decision.
seller that the second shipment was satisfactory but that succeeding shipments were unsatisfactory. Buyer protested to seller and commenced the purchase of wine from another winery. The Supreme Judicial Court, without referring to UCC Section 2-202, held that parol evidence was admissible to establish the agreed color and quality of the wine because the writing was ambiguous and effected only a partial integration of the contract. The Court also stated that buyer's complaints were based upon prior negotiations, purchases and samples. The relevance of this latter statement to the operation of the parol evidence rule, as determined by the Court, is difficult to ascertain.

It is submitted that the Court should have adverted to UCC Section 2-202, which provides:

Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented

(a) by course of dealing or usage of trade (Section 1-205) or by course of performance (Section 2-208); and

(b) by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement.

Evidence as to the proper color and quality of the dry red wine to be sold would not "contradict" any term of the writing. The previous purchases constitute a course of dealing and the shipments under the contract in issue, together with buyer's notices and complaints, establish a course of performance. It could convincingly be argued, moreover, that negotiations as to quality of the wine would also be admissible because neither party intended the writing to be the "complete and exclusive statement." Therefore, the course of dealing, course of performance and oral agreements reached in previous negotiations are admissible under Section 2-202 to explain the meaning of "Dry Red Wine" and to supplement the writing.

3 UCC §1-205(1) provides: "A course of dealing is a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct."

4 UCC §2-208(1) provides: "Where the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement."

5 UCC §2-202, Comment 3.

6 Comment 2 to UCC §2-202 states in part: "Unless carefully negated . . . [course of dealing and course of performance] have become an element of the meaning of
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It should be noted that the Court properly received evidence of the sample furnished by the buyer's president. The parol evidence rule should rarely exclude evidence of an express warranty by sample. Perhaps the only instance of justified exclusion occurs when warranties by sample are expressly negated in writing. The parol evidence rule has no applicability to the implied warranties of fitness and merchantability. The related inquiry with respect to these warranties asks whether they have been excluded or limited in the manner prescribed by the Code.

§7.4. Unconscionability. In Manganaro Drywall, Inc. v. Penn-Simon Construction Co.,¹ the Supreme Judicial Court provided helpful guidelines in determining the pertinent factors which bear upon analyses of unconscionability. Concededly a case outside the technical purview of Article 2, Manganaro Drywall involved a contract compromising the amount due for services and materials furnished in several building construction projects. The sole issue presented to the Court was whether a clause providing for retroactive interest on the total compromise sum in the event of failure to pay any installment was unconscionable and contrary to public policy.² The Court, in sustaining the legality of the clause, indicated that the undefined term, unconscionable, assumes both a procedural and substantive content.³ The procedural content involves the bargaining, negotiating, and drafting phases of the contractual process. In this regard, the Court considered the following factors: (1) fraud; (2) overreaching; (3) breach of a fiduciary relationship; (4) conduct of negotiations on an arm's-length basis; (5) relative bargaining power of the parties (here, two substantial business firms); (6) clarity of the terms of the clause; and (7) inadvertence.⁴ The Court does not separate these factors in its

the words used." It is also possible that a usage of trade in the wine business might establish the color and quality of "Dry Red Wine," but no evidence of usage seems to have been presented. See UCC §1-205(2).


⁸See UCC §§2-302, 2-316 and 2-719. This was a commercial transaction but, in the future, it will be impossible to exclude the implied warranty of merchantability and the implied warranty of fitness for a particular purpose covered by Acts of 1970, c. 880, amending G.L., c. 106, by inserting §2-316A, discussed in Chapter 9.

⁷See UCC §§2-302, 2-316 and 2-719. This was a commercial transaction but, in the future, it will be impossible to exclude the implied warranty of merchantability and the implied warranty of fitness for a particular purpose covered by Acts of 1970, c. 880, amending G.L., c. 106, by inserting §2-316A, discussed in Chapter 9.


²According to the decision, the clause was not a penalty clause. Defendant sought to argue inadvertent failure to include necessary language in the clause, but his attempt was rejected because the argument was not made at trial.


⁴See note 2 supra. The Court failed to explicitly relate inadvertence to the issue of unconscionability. Its significance as a factor, however, should not be minimized since it merited mention by the Court and since it might be germane to unconscionability in at least two respects, to wit: lack of awareness of the clause or its
treatment of the unconscionability issue and, certainly, they are in many instances interrelated.

The substantive unconscionability issue, on the other hand, turns on whether the retroactive interest charge constituted an excessively disproportionate potential price to be paid by the defendant for the concessions made by the plaintiff in the compromise. The Court based its determination that the price was not unconscionable on three findings:

(1) Prior to the settlement negotiations and agreement, the plaintiff was entitled to interest on the entire principal sum from the date stipulated in the retroactive interest clause.

(2) The difference between the interest charges, depending upon whether or not the installment payments were considered in relation to the total transaction, were not so disproportionate to the damages caused by the defendant’s breach of the agreement “that it amounts to a penalty.” The retroactive clause may well be closely analogous to a liquidated damages clause. However, care should be taken in deciding that the “liquidated damages—penalty” cases are applicable to a determination of whether the contested price is unconscionable. Traditionally, the view has been that the parties’ freedom to fix the price is substantially greater than their power to agree to future damages. Price is one of the central terms which is usually the product of careful deliberation by both parties to the agreement. Perhaps, if the price were hidden by “easy monthly payments” language or similar camouflage, the penalty cases might be instructive.

(3) The mere fact that the interest rate exceeded the legal rate of 6 percent per year while not being usurious did not render the contract unconscionable or repugnant to public policy.

While the Court in Manganaro Drywall did not expressly distinguish between substantive and procedural unconscionability, the case provides the practitioner with useful guidance on the legal import of unconscionability in Massachusetts.

§7.5. Warranties: Products liability: Cases and legislation. The case of Necktas v. General Motors Corp. contains a catalog of the continuing horrors of Massachusetts products liability law. Envision an action for property damage and the death of the plaintiff’s son resulting from an automobile accident occurring in 1962 still lingering meaning, and failure to include proper language to render the intention(s) of the parties clear.

5 For other cases considering excessive price as a measure of unconscionability, see American Home Improvement, Inc. v. MacIver, 105 N.H. 435, 201 A.2d 886 (1964); Jones v. Star Credit Corp., 59 Misc. 2d 189, 298 N.Y.S.2d 264 (Sup. Ct. 1969).

in the courts in 1970, and the result of the Supreme Judicial Court's decision: another trial. Taking a strict view of the plaintiff's burden of establishing the negligence of each defendant, General Motors' Pontiac Division and the dealer from whom the allegedly defective automobile was purchased, the Court failed to even consider the possibility of imposing strict liability in tort. Furthermore, the majority (Justice Spiegel dissenting in an opinion joined by Justice Kirk) severely construed Massachusetts' archaic and absurd wrongful death statute by ruling that no recovery for wrongful death may be based upon breach of warranty. And finally, the obdurate doctrine of privity of contract in personal injury-products liability cases, successfully assaulted in other jurisdictions, has survived another test in the Massachusetts courts. This is indeed a discouraging state of affairs in a state which, in many respects, has become the national leader in consumer protection.

One of the more heartening signs, however, materialized during the 1970 legislative session, which saw the adoption of the following act:

The provisions of section 2-316 [permitting the exclusion or modification of implied warranties of merchantability and fitness in specified circumstances] shall not apply to sales of consumer goods, services, or both. Any language, oral or written, used by a seller or manufacturer of consumer goods and services, which attempts to exclude or modify any implied warranties of merchantability and fitness for a particular purpose or to exclude or modify the consumer's remedies for breach of those warranties, shall be unenforceable.

Any language, oral or written, used by a manufacturer of consumer goods, which attempts to limit or modify a consumer's remedies for breach of such manufacturer's express warranties, shall be unenforceable, unless such manufacturer maintains facilities within the commonwealth sufficient to provide reasonable and expeditious performance of the warranty obligations. [Emphasis added.]

This legislation effectively prohibits disclaimers of the implied warranties of fitness and merchantability, and it presumably disallows limitations of recoverable remedies resulting from breaches thereof. The statute also restricts repair and replacement limitation clauses on express warranties to situations in which the seller maintains an authorized repair center within the Commonwealth. Unfortunately, the new section does not squarely address the doctrine of privity of

4 G.L., c. 229.
contract. Legislation should be introduced and enacted abolishing privity of contract in products liability cases and adopting a modern wrongful death statute. The common law process in Massachusetts is evidently unlikely to eliminate, or significantly circumscribe, the privity doctrine; and it would be an exercise in strained statutory interpretation to render a liberal construction of the existing wrongful death statute.

In another case, discussed earlier in another light, Regina Grape Products Co. v. Supreme Wine Co., the Supreme Judicial Court nicely handled the distinctions among an express warranty by sample, the implied warranty of fitness for a particular purpose, and the implied warranty of merchantability. The facts of the case also serve to underscore the need for the buyer to give the seller prompt notice of the breach of warranty.

§7.6. Buyer's remedies. Although the Massachusetts Commercial Code received no mention on the remedies issue in Regina Grape Products Co. v. Supreme Wine Co., the Supreme Judicial Court held that the buyer who had received several defective shipments under a contract for the sale of wine could cancel the contract, buy wine elsewhere, and recover from the original seller the difference between the value of the wine promised and the value of the wine delivered, plus buyer's loss of profit. The opinion does not indicate whether the lost profits correspond to the whole contract, or only to the installments made up to the time of cancellation, or only to future installments. There is no discussion of the right to cancel a contract and still recover damages. It might have been hoped that the Court would have decided whether the defaults in the previous installments had substantially impaired the value of the whole contract; such a determination properly precedes any finding of breach of the whole contract. Only then would the inquiry devolve upon how the appropriate remedial provisions apply to the complete breach of an installment contract where a portion of the goods has been delivered and accepted while another portion remains undelivered. It is arguable that the contract should be severed for application of the Code's remedial sections, with UCC Section 2-714 pertaining to the accepted goods and Sections

7 UCC §1-313(1)(c).
8 Id. §2-315.
9 Id. §2-314.
10 Id. §2-607(3)(a).

2 UCC §2-612(3).
3 UCC §2-714 provides:
   "(1) Where the buyer has accepted goods and given notification (subsection (3) of Section 2-607) he may recover as damages for any non-conformity of tender the loss resulting in the ordinary course of events from the seller's breach as determined in any manner which is reasonable."
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2-711 through 2-713 applying to the future installments. Had such an analysis been undertaken in the present case, the buyer would have been entitled to the difference between "the value of the goods accepted and the value they would have had if they had been as warranted. . . ." The lost profits could have been recovered as stemming from "special circumstances" or as consequential damages. Admittedly, a problem of double recovery may possibly arise where the buyer recovers both value and profits. However, in Regina Grape Products, it is clear that the auditor used wholesale value in his assessment, since value and contract price were equal and any profit accruing to plaintiff would have resulted from retail sales.

It is not clear from the opinion, however, whether any of the lost profits recovered were attributable to future installments due after buyer's cancellation. Buyer did acquire wine from other sources, and the facts indicated that wine of the same quality may have been available at prices equal to or below the contract price. The Code does indicate that a buyer who rejects, or revokes his acceptance of, the goods may cancel the contract, recover the price paid, and either cover or recover damages. The cover remedy is apparently not mandatory, and the fact that the buyer acquired wine from other sources would presumably not bar him from bringing an action for damages under Section 2-713. However, if the buyer in fact entered into an extremely advantageous "cover" contract, his ability to do so would militate in favor of a de minimis damage recovery. The opinion of Justice Reardon seems consistent with Code principles, but it is unfortunate that the decision did not analyze the directly applicable Code sections and acknowledge, if not discuss, the variety of interesting issues presented.

§7.7. Depositary bank as holder in due course. Several aspects of the First Circuit Court of Appeals opinion in Bowling Green, Inc. v. State Street Bank & Trust Co. are troubling: omissions in the decision, the basic legal assumptions made, and the ultimate result. Plaintiff, the operator of a bowling alley, negotiated to Bowl-Mor, Inc. a United States Government check in the amount of $15,306 as the first

"(2) The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount.

"(3) In a proper case any incidental and consequential damages under the next section may also be recovered."

4 UCC §2-714(2). See note 3 supra.
5 Ibid.
6 Id. §§2-714(3), 2-715.
7 Id. §2-711.
8 Id. §§2-711(1)(a), (b) and 2-712.

installment on a conditional sales contract for candlepin-setting machines; such machines were never delivered to plaintiff. On the following day, a Bowl-Mor representative deposited the check in account with defendant bank. (No evidence was adduced as to whether Bowl-Mor supplied its own endorsement). At the time of the deposit, Bowl-Mor's account with the bank was overdrawn by more than $5000. Bowl-Mor was further indebted to the bank on other loans covered by perfected security interests on Bowl-Mor's chattel paper and the proceeds thereof. Upon learning that Bowl-Mor, later that day, had filed a petition for reorganization to Chapter X of the Bankruptcy Act, depositary bank immediately credited the check against the overdraft, leaving a balance in Bowl-Mor's account of $10,000. The evidence at trial established that the bank was aware of its depositor's serious financial problems, as previous loans totaling $2 million to Bowl-Mor had been written off as bad debts. In addition, the bank was one of Bowl-Mor's three major creditors; an officer of the bank had served as a director of Bowl-Mor up to about a month before the transaction in question; and the overdraft and deposit of the Government check involved, to the bank's knowledge, a continuing struggle by Bowl-Mor to meet its payroll obligations.

Plaintiff Bowling Green, in the district court, attempted to hold defendant bank as a constructive trustee of the proceeds of the check, which, inexplicably, was not introduced in evidence. The United States District Court for the District of Massachusetts found in favor of the defendant, holding that the bank was a holder in due course of the check; the United States Court of Appeals for the First Circuit affirmed.

As indicated earlier, there are two troubling omissions in the case: (1) the disputed check was not a part of the evidence, and (2) the appellate court opinion failed to discuss the possibility that the depositary bank had a perfected security interest in the item as proceeds under its floating lien. Defendant bank had the burden of proving its alleged status as a holder in due course. It is axiomatic that one may only be a holder in due course of a negotiable instrument. Since the check was not introduced, the court evidently presumed that all checks

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2 It would seem reasonable to assume that defendant bank had checked the proceeds box in the financing statement which it filed. See UCC §9-306(5)(a). If this were true, one might validly argue that the account constituted identifiable noncash proceeds, as described by UCC §9-306(4)(a), or that the account would be subject to the ten-day rule of UCC §9-306(d)(ii).

3 11 U.S.C. §§501 et seq. (1964). It should be noted that the events which transpired after the bank had notice of the Chapter X petition are irrelevant to the bank's status as a holder in due course.


5 Id. at 657.

6 See note 2 supra.

7 425 F.2d 81, 83 (1st Cir. 1970). See UCC §3-307(3).
are negotiable instruments. More severe difficulties are raised by the check's absence in evidence at trial. How the check was made out — to plaintiff as sole payee or to plaintiff and Bowl-Mor as joint payees — is an important but unanswered question. Nor is it known whether the United States Government check expressly required payee's endorsement, whether Bowl-Mor endorsed in blank or specially, or whether the check was properly stamped by the bank in order to supply its customer's missing endorsement. It seems doubtful that defendant could sustain its burden of proof in establishing its status as a holder in due course without introducing the check.

In affirming the district court opinion in Bowling Green, the court of appeals arrived at three central legal conclusions: (1) a depositary-collecting bank need not be a holder in order to be a holder in due course; (2) the bank's security interest, referred to in UCC Section 4-209 for purposes of giving value, includes all of the bank's security interests and not simply that provided for in Section 4-208; and (3) the record did not contain sufficient evidence of fraud or bad faith on the part of defendant bank to overturn the trial court's finding of good faith.

The first conclusion is erroneous. According to UCC Section 3-302(1), a "holder in due course is a holder who takes the instrument...." (Emphasis added.) Nothing in Article 4 eliminates that requirement. The court failed to recognize the basic assumption in Article 4 that the collecting bank may assume a dual role, to wit, that of agent and that of holder. The fact that the bank is a collecting agent does not necessarily make it a holder. Section 4-205(1), which gives the bank a power of attorney to supply the customer's missing endorsement either by signature or by statement (rather than eliminating the requirement that the bank be a holder), accentuates the necessity of negotiation for the bank to acquire holder in due course status. While the court of appeals also relied upon Section 4-209, this section merely refers to the value requirement of holder in due course status and in no way modifies any of the other elements. Furthermore, the court's statement that the bank was a holder because it took from a holder is tellingly significant in its inaccuracy. And, finally, the close rela-

8 Since checks are almost always printed and in simple form, such a presumption may not be unreasonable.
9 See UCC §2-202. Concededly, the definition of a holder in UCC §1-201(20) is vague, but it seems reasonable to conclude that one must take by negotiation in order to be a holder.
10 UCC §§3-202, 3-204.
11 Id. §4-205.
12 It is submitted that, had the check been destroyed or otherwise unavailable, the court might have taken a different view.
13 See UCC §4-201(1).
14 425 F.2d 81, 86 (1st Cir. 1970).
15 UCC §§3-302(1)(a).
16 UCC §§3-201(1) provides: "Transfer of an instrument vests in the transferee..."
tionship between the bank and Bowl-Mor at least raised the possibility of applying the consumer law and holder in due course statutes to the present case by legislative analogy. Even if the decision is accepted, it should be strictly limited to instances in which the only factor disqualifying the bank as a holder is the absence of its customer’s endorsement.

The conclusion of the court of appeals that the general security interest under the floating lien constituted value is likewise questionable. It, too, stems from the court’s failure to carefully consider the bank’s agency status. Article 4 predicates the rights of collecting banks upon the theory that they remain collecting agents until final payment. If the bank, prior to final payment, permits withdrawals or gives a credit for withdrawal as of right, the bank takes a security interest to the extent of the withdrawal or credit. Such an interest is essential to the theory of continuing agency, as contrasted with a theory which would hold the bank an owner of the item to the extent that it has permitted withdrawals or given final credit. Section 4-209, read in the light of the agency theory, would probably be limited to the security interest described by Section 4-208. An interesting and pertinent inquiry would be whether defendant bank gave credit for withdrawal as of right on United States Government checks. In any case, if the bank did not enjoy a priority security interest under the proceeds section of Article 9, it would appear that the bank would have no claim to the $10,000 in excess of the overdraft even if it qualified as a holder.

It deserves mention that the court of appeals correctly held that the “good faith” test for holder in due course status in Massachusetts is subjective, and that the handling of checks of, and extension of loans to, a business which the bank knew to be insolvent did not constitute fraud or bad faith. Banks must be allowed wide business judgment in dealing with marginal or insolvent businesses. Should a bank, however, continue to prop up a hopelessly insolvent concern to the detriment of third parties, it would then seem defensible, in some instances, to hold that such conduct amounts to fraud and bad faith.

§7.8. UCC Article 9: Assignee of private construction contract vs. surety on payment bond. Assuming that the United States Court

such rights as the transferor has therein. . .” It is the plaintiff, not the defendant, who is contending that defendant bank is in the same position as Bowl-Mor.


18 If the bank, for example, were disqualified as a holder because an endorsement necessary to negotiation prior to reception of the check by the bank’s customer had been forged, the bank would not then become a holder in due course. See UCC §§3-202, 3-204 and 3-404.

19 See UCC §4-201 and Comment thereto.

20 UCC §4-208.

21 See note 2 supra.

22 425 F.2d 81, 85 (1st Cir. 1970). See UCC §1-201(19).

23 Id. at 85, 86.
of Appeals for the First Circuit has properly interpreted Massachusetts law, the surety on both payment and performance bonds—whether the construction contract be governmental or private—will prevail, to the extent of the funds held by the owner at the time of the contractor's default, over an assignee of the contract. Under the principle of equitable subrogation, this result obtains even though the assignee perfected the assignment under UCC Article 9 prior to the time at which any rights attached to the surety. In *Framingham Trust Co. v. Gould-National Batteries, Inc.*,¹ plaintiff bank, pursuant to Article 9, perfected an assignment of all the present and future accounts receivable and contract rights of a building contractor who agreed to construct a factory addition for Gould-National Batteries, Inc. for $133,000. Five months later, defendant surety company issued payment and performance bonds on the private construction contract on which the contractor defaulted. Under the performance bond, the surety completed the project with an expenditure of approximately $3000; under the payment bond, the surety paid uncompensated laborers and suppliers who were not entitled to mechanics' liens to the extent of some $50,000. At the time of default, the owner, Gould-National, whose status in the action was that of stakeholder, held an unpaid balance in the approximate amount of $22,000.² As the bank conceded the surety's priority to the $3000 paid under the performance bond,³ the sole dispute turned on whether the surety also had priority to amounts expended under the payment bond to persons who apparently failed to perfect liens under the payment bond to persons who apparently failed to perfect liens under G.L., c. 254, §4.

The United States District Court for the District of Massachusetts decided in plaintiff bank's favor, holding that a surety on a private contract could share in withheld payments in owner's hands only to the extent of completion costs while not entitled to priority on sums paid under the payment bond.⁴ The court reasoned that subrogation by the surety to the position of the laborers and materialmen would not benefit the surety, since neither the laborers nor the materialmen had claims directly against the owner or rights under the mechanics' lien law. The court also concluded that the owner "had no rights under Massachusetts law to which the surety might be subrogated under the doctrine of equitable subrogation" because the owner had no right to pay the laborers directly.⁵

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² Although not expressly so stated, the sum must have included amounts both already earned and due, as well as retainages.
⁴ See Note, 31 Fordham L. Rev. 161 (1962), which indicates that New York makes a similar distinction between payment and performance bonds.
⁵ 307 F. Supp. 1008, 1013 (D. Mass. 1969). It is sometimes suggested that governmental contracts differ from private contracts with respect to payment bonds in that laborers and materialmen are not entitled to file mechanics' liens.

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The United States Court of Appeals for the First Circuit reversed the district court decision, finding no compelling difference between the equitable right of the Government and that of a private owner to pay laborers and suppliers. It is in the owner's interest to see that the project is completed with a minimum of disruption and expense, and this can best be accomplished by permitting the owner to pay the unpaid bills. The court also indicated that allowing the surety to prevail on the payment bond was not inconsistent with the policy of the Massachusetts lien statutes.

Thus, it may now be said that Massachusetts law on the conflicting rights of the assignee of contract rights and the surety has become simple and clear. The surety on both payment and performance bonds applicable to governmental and private contracts will have prior claim over the assignee to all sums due and retainages still in the hands of the owner at the time of the contractor's default. Apparently the bank will be entitled to retain all sums actually paid to it under the assignment. The Framingham Trust decision certainly affords adequate protection to the interests of the surety. Perhaps, however, the opinion does not adequately recognize the economic contribution made by banks which, in many instances, furnish the funds which permit builders to perform on their contracts. Banks will have to rely heavily upon the use of subordination agreements with sureties and provide, in those security agreements in which a continuing line of credit is extended, that the refusal of the surety to subordinate on any contract shall constitute a default.

The most disturbing aspect of the assignee-surety situation is that it is not expressly covered by Article 9. Equitable subrogation can, of course, be recognized in an Article 9 case; however, the failure of the Code's draftsmen to explicitly provide for these important and not

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6 The court of appeals relied upon National Shawmut Bank of Boston v. New Amsterdam Cas. Co., cited in note 3 supra, which held that the surety's right of subrogation (1) survived enactment of the UCC in Massachusetts and (2) prevailed over the security interest of the bank in the unpaid balance. See Note, National Shawmut Bank: Another Step Toward Confusion in Surety Law, 64 Nw. U.L. Rev. 582 (1969).


8 See 2 Gilmore, Security Interests in Personal Property §36.8 at 980 (1965), which suggests that the proper balance is to allow the assignee to recover for sums earned by the contractor prior to default and the surety to enjoy priority as to retainages.


10 UCC §§9-316.

11 Id. §1-103.
unusual competing interests is surprising. It does not seem desirable
to decide that the present Article 9 controls, and that the rights of the
assignee and surety will depend upon which one was first to file a
financing statement.\(^\text{12}\) It is submitted that Article 9 should be amended
to treat the assignee-surety situation. In most cases, the surety should
be afforded priority on funds still in the hands of the owner.

**§7.9. Bank's right of setoff.** In *Grant v. Colonial Bank & Trust Co.*,\(^1\) a debtor delivered the savings account books, each in the amount
of $10,000, to an escrow agent, or pledgee, to hold as security for the
payment of three notes guaranteed by the plaintiffs. Defendant
Colonial requested the debtor to increase the amount of his savings
accounts in the bank, because he had been borrowing from defendant
bank on unsecured notes since 1964; in response, debtor entered into
a second arrangement by which he substituted the collateral of a
Colonial bankbook for one of those bankbooks previously pledged to
the account held by the escrow agent. This bankbook substitution was
effected with the approval of the escrow agent and knowledge of the
officers of Colonial. Thereafter, debtor defaulted on obligations to a
creditor secured under the initial pledge and the escrow agent so
informed Colonial. Three days later, the escrow agent requested that
Colonial forward a check for the full amount of the account with ac-
cumulated interest. Colonial then accelerated its claims against debtor
and notified the escrow agent that it had applied the entire amount of
the savings account to debtor's obligations to the bank. In a suit for
declaratory relief, the trial court found (1) that the security interest
created by Colonial was subject to the prior rights of the plaintiffs and
that Colonial had actual knowledge of the existence of such rights, and
(2) that the escrow agent's possession of the disputed account "'created
an interest in the intangible represented by the book.'"\(^2\) Accordingly,
the trial court ordered Colonial to pay the full amount of the account,
plus interest, to the escrow agent; defendant bank, it was ruled, had no
right of setoff.

On appeal, the Supreme Judicial Court affirmed the trial court's
final decree. Colonial's knowledge of the pledgee's equitable interests
in the account was held dispositive of the case. The Court stated:

> It is decisive of this case that Colonial, through its president,
> knew of the security interest of the escrow agent at the creation of
> [the] account . . . and, indeed, directly participated (for its own
> benefit in increasing its deposits) in substituting [one account for
> another] . . . in which the escrow agent had a security interest.
> Because Colonial knew . . . of the equitable security interest of the

12 Id. §9-312(5). See Notes, 65 Colum. L. Rev. 927 (1965), 6 B.C. Ind. & Comm.
L. Rev. 798 (1965).


2 Id. at —, 252 N.E.2d at 341-342, quoting the trial judge.
escrow agent, it . . . could not appropriate by set-off the funds in
the account as wholly the property of [the debtor] . . . .

The Court aptly noted that the evidence did not establish that the
defendant's claim had become payable at the time of the bankbook
substitution or even that "the particular indebtedness (for which the
appropriation was made) was in existence at all" when the agreement
was executed.4

Bankbook pledges are outside the scope of UCC Article 9.5 However,
such pledges are recognized at common law and by statutes of
the Commonwealth.6 The depositary bank's right of setoff poses the
greatest threat to the validity of this type of security. The law of Massa-
chusetts, even after Grant, remains open on the issue of whether —
and, if so, when — the bank may properly exercise the right of setoff
of amounts on deposit in satisfaction of the depositor's indebtedness
to it.7 The discussion of the Court in Grant suggests that Massachusetts
courts may well decide that bankbooks are analogous to negotiable
instruments or negotiable documents of title in the sense that an entire
property interest is represented thereby. While such a view of bank-
books would be novel, it might yield desirable results in light of the
extensive use of bankbook pledges in Massachusetts and the possibility
of surprise resulting from the bank's exercise of setoff. One lesson of
Grant is that the pledgee of a bankbook should promptly notify the
depository bank of the existence of the pledge. Such notification would
probably prevent the bank from effectively setting off loans which
were made, or became due, subsequent to the time of the notice.

Another case decided during the 1970 Survey year which raises some
interesting points about the bank's right of setoff is Bowling Green,
Inc. v. State Street Bank & Trust Co.8 It is there suggested that, if the
bank is a secured creditor, its right of setoff is circumscribed by a
requirement that the security be inadequate. Also indicated is the pos-
sibility that the right of setoff may be affected by UCC Section 4-201,
which makes the collecting bank an agent for the depositor rather
than an owner of the item. It should be noted, however, that the
section repudiates such a reading by providing that "any rights of
the owner to proceeds of the item are subject to rights of a collecting
bank such as those resulting from outstanding advances on the item
and valid rights of setoff."9

§7.10. UCC Article 8: Transfer of stock certificates. In New

3 Id. at —, 252 N.E.2d at 343.
4 Ibid.
5 UCC §9-104(k).
8 425 F.2d 81 (1st Cir. 1970).
9 UCC §4-201(1).
Justice Spiegel of the Supreme Judicial Court rendered an informed and instructive opinion addressing the operation of UCC Article 8 upon the transfer of investment securities. In an action to recover the amount represented by certificates of preferred and common stock of the defendant issuer, Associated Textile Companies, the plaintiff administrator took exception to a Superior Court ruling which sustained the demurrer of the issuer and its transfer agent, Old Colony Trust Company. The pertinent factual allegations in plaintiff's declaration were that the trustees of defendant issuer called for the redemption of preferred and common stock; that a partial liquidating dividend was declared; that, prior to the call, plaintiff's intestate had purchased shares of Associated Textile and received certificates indorsed in blank from his transferor; and that presentment was duly made by plaintiff to Old Colony and payment refused. The primary basis of the defendants' demurrer was that neither plaintiff's intestate nor plaintiff had registered the transfer of ownership of the stock with the issuing company and, thus, the company's books and records “never reflected the transfer to [the] plaintiff's intestate and the true and lawful ownership” of the stock. Accordingly, defendants contended that no action for a dividend can accrue to a transferee who fails to apply for a transfer of the registered ownership of the company's stock.

As the Court aptly indicated, such an argument ignores the “overriding objective” of UCC Article 8, which “confers negotiability upon securities governed by this Article.” The Court stated:

Article 8 does not require that before a “holder” of securities can enforce rights under the securities he must be the “record owner” of those securities. A purchaser acquires the rights of his transferor [citing §8-301(1)]. Article 8 is first concerned with whether the instruments involved are securities within the definition expressed in §8-102(1)(a). In the instant case, the stock certificates are clearly “securities” and therefore fall within the ambit of §8-105(1).

As to the validity of the signatures on the securities in question, it was noted that no denial appeared in the pleadings. UCC Section 8-105(2) provides in pertinent part: “In any action on a security (a) unless specifically denied in the pleadings, each signature on the security or in a necessary indorsement is admitted.” And, once the signatures are admitted, “production of the instrument entitles a
holder to recover on it unless the defendant establishes a defense or a defect going to the validity of the security. 6 Lastly, under UCC Section 8-308(2), an indorsement in blank of an investment security does not defeat the rights of its transferee. 7

§7.11. Legislative developments. Statutes of consequence to consumer and banking interests were enacted during the 1970 regular session of the Massachusetts legislature. 1 One particularly significant statute, Chapter 457 of the Acts of 1970, further limits the rights of holders in due course within the context of consumer transactions. 2

6 Id. §8-105(2)(c).
7 Concededly, in Palmer v. O'Bannon Corp., 253 Mass. 8, 149 N.E. 112 (1925), the Supreme Judicial Court held that a pledgee's rights to demand and receive new certificates and have the ownership of the stock registered in his name were defeated by his failure to fill in the blanks on the transferred certificates with his name. The Palmer view was propounded, however, prior to the 1958 adoption of the UCC in Massachusetts.


2 Acts of 1970, c. 457, amending G.L., c. 255 by adding §12F:

"As used in this section the following words shall, unless the context requires otherwise, have the following meanings:

"'Organization,' a corporation, government or governmental subdivision or agency, trust, estate, partnership, cooperative, or association.

"'Person related to,' with respect to an individual means (a) the spouse of the individual, (b) a brother, brother-in-law, sister, or sister-in-law of the individual, (c) an ancestor or lineal descendant of the individual or his spouse, and (d) any other relative, by blood or marriage, of the individual or his spouse who shares the same home with the individual.

"'Person related to,' with respect to an organization means (a) a person directly or indirectly controlling, controlled by or under common control with the organization, (b) an officer or director of the organization or a person performing similar functions with respect to the organization or to a person related to the organization, (c) the spouse of a person related to the organization, and (d) a relative by blood or marriage of a person related to the organization who shares the same home with him.

"A creditor in consumer loan transactions shall be subject to all of the defenses of the borrower arising from the consumer sale or lease for which the proceeds of the loan are used, if the creditor knowingly participated in or was directly connected with the consumer sale or lease transaction.

"Without limiting the scope of the preceding paragraph a creditor shall be deemed to have knowingly participated in or to have been directly connected with a consumer sale or lease transaction if: (a) he was a person related to the seller or lessor; (b) the seller or lessor prepared documents used in connection with the loan; (c) the creditor supplied forms to the seller or lessor which were used
By supplementing the provisions of G.L., c. 255, §12C, eliminating holder in due course status for transferees of promissory notes executed in sales of consumer goods, the new section effectively precludes continuation of the common practice of avoiding existing prohibitions by simply referring the purchaser directly to the finance company for a loan of the purchase money.

The new statute presents several problems of interpretation. Incomplete guidelines are provided for determining when the creditor "knowingly participated" in the consumer sale. On one hand, mere knowledge that the proceeds are to be used to purchase consumer goods apparently would not constitute knowing participation. On the other hand, the stated requirements for a creditor to have knowingly participated in, or become directly connected with, the consumer sale or lease are minimal. Difficulties of construction may be generated by the provision ascribing knowing participation to a creditor who "was specifically recommended by the seller or lessor to the borrower and made two or more loans in any calendar year, the proceeds of which are used in transactions with the same seller or lessor, or with a person related to the same seller or lessor." Under such language, it would seem possible that a consumer could include within the group of recommended financiers one of the major banks in the community which had no direct connection with the seller; and if that bank had made two loans in any calendar year, it would be subject to defenses good against the seller. An additional problem involves the apparent failure of the statute to prevent a subsequent transferee of the original creditor from becoming a holder in due course.3

It is also noteworthy that, in the instance of a consumer loan made directly by the lending institution, the words "consumer note" would probably not be required to appear on the face of the note—such words rendering the instrument nonnegotiable under G.L., c. 255, §12C—because the creditor is not a retail seller.4 Thus, it would appear that, in transactions involving such direct loans, a transferee of a consumer loan note who satisfies all the requisites of holder in due course status takes the note free of any personal defenses which the consumer may have against his seller.

In sum, it is clear that the vague language of the new section provides substantial latitude for judicial interpretation. An express

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3 The term creditor is not defined in G.L., c. 255. The definition in G.L., c. 140C, §1(c) would not appear to include a transferee.

4 See G.L., c. 255, §12C and G.L., c 255D, §1.
prohibition of avoidance of defenses in consumer sale and lease transactions might have been more economic and desirable.

Another significant legislative development of the 1970 Survey year was the enactment of Massachusetts' first usury statute. The new act is very different from usury statutes of other jurisdictions. The typical legislative response to excessive interest charges has generally taken one of three forms: (1) declaring the entire loan void and un-

5 Acts of 1970, c. 826, amending G.L., c. 271 by adding §49:

"(a) Whoever in exchange for either a loan of money or other property knowingly contracts for, charges, takes or receives, directly or indirectly, interest and expenses the aggregate of which exceeds an amount greater than twenty per centum per annum upon the sum loaned or the equivalent rate for a longer or shorter period, shall be guilty of criminal usury and shall be punished by imprisonment in the state prison for not more than ten years or by a fine of not more than ten thousand dollars, or by both such fine and imprisonment. For the purposes of this section the amount to be paid upon any loan for interest or expenses shall include all sums paid or to be paid by or on behalf of the borrower for interest, brokerage, recording fees, commissions, services, extension of loan, forbearance to enforce payment, and all other sums charged against or paid or to be paid by the borrower for making or securing directly or indirectly the loan, and shall include all such sums when paid by or on behalf of or charged against the borrower for or on account of making or securing the loan, directly or indirectly, to or by any person, other than the lender, if such payment or charge was known to the lender at the time of making the loan, or might have been ascertained by reasonable inquiry.

"(b) Whoever, with knowledge of the contents thereof, possesses any writing, paper, instrument or article used to record a transaction proscribed under the provisions of paragraph (a) shall be punished by imprisonment in a jail or house of correction for not more than two and one half years, or by a fine of not more than five thousand dollars, or by both such fine and imprisonment.

"(c) Any loan at a rate of interest proscribed under the provisions of paragraph (a) may be declared void by the supreme judicial or superior court in equity upon petition by the person to whom the loan was made.

"(d) The provisions of paragraphs (a) to (c), inclusive, shall not apply to any person who notifies the attorney general of his intent to engage in a transaction or transactions which, but for the provisions of this paragraph, would be proscribed under the provisions of paragraph (a) providing any such person maintains records of any such transaction. Such notification shall be valid for a two year period and shall contain the person's name and accurate address. No lender shall publicly advertise the fact of such notification nor use the fact of such notification to solicit business, except that such notification may be revealed to an individual upon his inquiry. Illegal use of such notification shall be punished by a fine of one thousand dollars. Such records shall contain the name and address of the borrower, the amount borrowed, the interest and expenses to be paid by the borrower, the date the loan is made and the date or dates on which any payment is due. Any such records shall be made available to the attorney general for the purposes of inspection upon his request. Such records and their contents shall be confidential but may be used by the attorney general, or any district attorney with the approval of the attorney general, for the purposes of conducting any criminal proceeding to which such records or their contents are relevant.

"(e) The provisions of this section shall not apply to any loan the rate of interest for which is regulated under any other provision of general or special law or regulations promulgated thereunder or to any corporation subject to control, regulation or examination by any state or federal agency."
collectible; (2) making only the interest element collectible; or (3) reducing the interest recoverable to the legal rate. The Massachusetts usury statute provides for severe criminal punishment for interest charges in excess of 20 percent per year, and reposes equitable jurisdiction in the Supreme Judicial Court and Superior Court to declare any loan with a proscribed rate of interest void upon petition of the recipient of such a loan. It is important to note the use of the words “may be declared void . . .” presumably the court in equity might also decree lesser restrictions on the collectibility of the loan. Corporate borrowers are expressly excluded from the protection of the statute.

Subsection (d) of the new usury statute is the heart of the act. It is there provided that the criminal sanctions of the law shall not apply to any person who notifies the attorney general of his intent to engage in transactions which would otherwise violate the section. It would appear, then, that a lender may avoid the effects of the statute simply by notifying the office of the attorney general. The apparent purpose of subsection (d) is to facilitate proof of criminal violations by loan sharks and dishonest lenders, who, by failing to file and continuing to lend at exorbitant interest rates, will subject themselves to imprisonment for not more than ten years and/or fine of not more than $10,000. While the existence of this subsection might constitute some degree of psychological deterrence to the loan shark, it is doubtful that the activities of such lenders will be significantly circumscribed thereby. Most dishonest lenders probably will not register, will continue to charge high rates of interest and will employ coercion and violence if necessary to collect their loans. In addition, the concept of registration might well generate problems of self-incrimination similar to those related to the federal occupational tax on wagering.

Illusory statutes which purport to deal with a field of great social importance, such as excessive interest charges, tend to mislead the public into reliance upon false legal remedies. It can convincingly be argued that the previous absence of a usury statute in Massachusetts was beneficial to the legitimate segment of the financing industry. On balance, and in view of the imposition of maximum statutory limits in the most important areas of consumer transactions, perhaps it is undesirable to set a general statutory maximum on interest charges. In any case, it would seem undesirable to enact a usury statute which is, in operative effect, a nullity.

**STUDENT COMMENT**

§7.12. Employer protection: Restraints on competition by former employees. When one sells his business, he is in a position to deliver

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7 See, e.g., G.L., c. 140, §100 and G.L., c. 255D, §11.
to a buyer more than just real estate or goods. He can also deliver the business's "good will," which may be defined in economic terms as the probability that satisfied and loyal customers will continue their patronage after the ownership has changed hands. If the buyer of a business wants the benefit of this established clientele, the price he pays for the business will include a dollar value for the intangible good will. Having agreed to purchase this customer favor, the buyer will want to protect it from interference in order to secure the full value of the business. Most often he will require a covenant in the sales contract whereby the vendor agrees not to engage in a competitive business for a specified time within a designated geographical area. Leasing contracts would be subject to the same considerations described above for sales.

Covenants not to compete are also used in employment situations. An employer may wish to protect his business from economic harm at the hands of former employees, particularly those who have had close contacts with customers or access to confidential information during their employment. To protect his business interests, the employer may require certain employees to sign a noncompetition covenant. Therein the employee agrees that after termination of his employment for any reason, he will not work for a competitor of his present employer, or set up a competing business for himself, for a specified time and within a described geographical area. Unlike the buyer of a business, however, an employer does not need the restrictive covenant to secure for himself the full value of what he acquires by contract, for what he acquires is the current service of an employee. Instead, the employer looks ahead to his need for protection against the actions of former employees. The employee seldom bargains for his covenant not to compete, nor does he usually receive any additional compensation for his agreement. His restrictive covenant, on the contrary, is a price that he pays for his employment, and his continuing employment is consideration for the agreement.

Before the seventeenth century, English common law treated non-competition covenants as offensive to the principle of economic freedom and therefore unenforceable. No particular effort was made to distinguish between covenants made by a business vendor and those made by an employee, for both types were held to be void. Among the first decisions in England that broke with tradition and upheld a restraint on competition, the most influential was Mitchell v.

§7.12. 1 Black's Law Dictionary 823 (rev. 4th ed. 1968). See also Edgecomb v. Edmonston, 257 Mass. 12, 19, 153 N.E. 99, 101 (1926): "the tendency, from habit, of customers to resort to the plaintiff to obtain the services which he furnished and they were accustomed to receive at his office. . . ."

2 The obligation not to compete during the term of employment is derived from general agency principles. Restatement of Agency Second §395 (1958).

3 Blake, Employee Agreements Not to Compete, 73 Harv. L. Rev. 625, 631-632 (1960) [hereinafter cited as Blake].

4 Carpenter, Validity of Contracts Not to Compete, 76 U. Pa. L. Rev. 244 (1928).
Reynolds. Decided in 1711, that case involved a covenant which had been made incident to the lease of a bakery for five years. The bakery was in a small town, and the lessor had agreed not to compete in the baker's trade in that town for the duration of the lease. In upholding the covenant, the court reasoned in terms of an economic way of life very different from our own. The court's treatment of the issues, however, remains surprisingly similar to the treatment such issues receive today in most American jurisdictions.

The court in Mitchell v. Reynolds viewed the common law's rejection of noncompetition agreements as based on the "mischief" they created. In particular, the court pointed out that restraints on competition had limited value even to the person who sought them, while these restraints might deprive a man of his livelihood and the public of a useful worker. This idea of balancing the interests of covenantor, covenantee, and the public is still the basis upon which most American courts determine the validity of a given covenant. The court in Mitchell v. Reynolds stated that it would continue to reject any covenant wherein a person agreed not to exercise his trade in any part of England. No man was felt to need such broad economic protection in those times unless he was trying to form a monopoly, and forming a monopoly was a crime. The circumstances in Mitchell v. Reynolds, however, impressed the court as being different. There the lessee had required a covenant against competition which applied only to a small town and only for the duration of the lease. Such a limited restraint was determined by the court to be useful to the lessee and reasonable for the lessor. Consideration for the lessor's covenant was "good and adequate" in view of the price paid for the bakery lease. For these reasons the covenant was enforced, and the Court of Queen's Bench announced its intention to base future decisions on the facts in each case. "If . . . it appears to be a just and honest contract, it ought to be maintained."7

Most American courts distinguish, primarily on the grounds discussed above, between a vendor's covenant incident to the sale of his business with its good will and an employee's covenant which is made part of his employment contract. Vendor covenants are more readily enforced by the courts because of the bargain and exchange for value which usually takes place between the parties. Employee covenants, on the other hand, are viewed less favorably. American courts generally feel that there is unequal bargaining power in favor of the employer, and that freedom of employment should not be restricted

6 Id. at 190-191, 24 Eng. Rep. at 350: "[f]or what does it signify to a tradesman in London, what another does at Newcastle? . . ." Apparently London and Newcastle were competitive strangers in 1711.
7 Id. at 197, 24 Eng. Rep. at 352.
8 Blake, supra note 3, at 646.
9 Id. at 647, 648.
unlike necessary. The circumstances which may justify a restraint on freedom of employment will be considered later.

This comment will be limited to an examination of those covenants not to compete which apply to employer-employee situations. Because such covenants are enforced for the benefit of the employer, if they are enforced at all, it will be necessary to consider not only the economic interests which American courts have traditionally allowed employers to protect, but also the advantages of noncompetition agreements over other means of employer protection. The major portion of this comment will be concerned with the standards that American courts have come to apply in determining the enforceability of post-employment restraints, with particular emphasis on the position adopted by the courts in Massachusetts.

Employers have had some measure of common law protection for their legitimate business interests, even apart from the use of covenants not to compete. The law of unfair competition, for example, protects trade secrets and certain customer data to which an employee has had access during employment. An employer, however, faces certain problems in relying on the law of unfair competition for relief. As a prerequisite to recovering damages or obtaining equitable relief, he must prove that specific information qualifies as a trade secret, and that the information has been disclosed to his economic detriment. The employer must also demonstrate that what has been disclosed was not otherwise available to competitors through legal sources of information. These same evidentiary problems exist if the employer seeks to prove the misuse of certain customer data.

Another source of protection for the employer's business interests, absent a covenant not to compete, is the use of a covenant whereby the employee agrees specifically not to disclose confidential information learned on the job. After termination of an employment relationship, the employee would be free to work for a competing business as long as he honors his agreement not to disclose such information. This approach has been justifiably criticized as ineffective to protect an employer even from the actions of a former employee who attempts in good faith to honor his covenant.

11 "Because of its inordinate complexity, the law of trade secrets is unpredictable even within a particular jurisdiction. . . ." Note, The Trade Secret Quagmire—A Proposed Federal Solution, 50 Minn. L. Rev. 1049 (1966). See also Restatement of Torts §757, comment b (1939): "A trade secret may consist of any formula, pattern, device or complication of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be . . . a list of customers."
12 Blake, supra note 3, at 668, 671.
13 This position was advocated in Note, Contracts in Restraint of Trade: Employee Covenants Not to Compete, 21 Ark. L. Rev. 214 (1967).
14 Blake, supra note 3, at 669-670.
formed for a competitor by the former employee will inevitably compromise his good intentions. The employee cannot be expected to distinguish in his performance between what he has learned as confidential information and what he knows from his own general skills and knowledge. His work will disclose the full range of his experience, and his success in the new job will depend on full use of his talents. Policing of a covenant not to disclose confidential information would be virtually impossible. In *Novelty Bias Binding Co. v. Shevlin*, a former employee of the plaintiff company had signed both a covenant not to compete and a separate covenant not to disclose trade secrets. The ineffectiveness of the latter covenant was shown by evidence that the employee had disclosed information concerning confidential industrial processes. The Supreme Judicial Court recognized the difficulty of monitoring or preventing further wrongdoing if the employee were allowed to work for a competitor of plaintiff company. The Court, therefore, upheld the noncompetition agreement as the only meaningful protection available to his former employer.

Faced with the ineffectiveness of the other forms of economic protection noted above, employers have come to rely on the use of covenants not to compete. A typical agreement might recite that after termination of his employment for any reason, the contracting employee will not work in the same or a similar business, either for himself or for anyone else, within a designated geographical area and for a specified period of time. Such an agreement is easier to police and is more effective, from the employer's point of view, than a covenant not to disclose confidential information, for he need only monitor the subsequent business associations of contracting employees. Proving that certain information has been misused is not necessary. In addition, the use of an employment restraint precludes the problems of proof mentioned above in connection with the law of unfair competition.

For an employer, then, employee covenants not to compete are a primary source of economic protection. These covenants, however, are enforced as exceptions to the general rule against restraints of trade. Consequently, those who devise employment restraints must not seek to impose terms which overstep the boundaries which a particular jurisdiction has set. The court in *Mitchell v. Reynolds*, for example, announced its intention to hold void any restraint which applied over the whole of England. That same court was willing to enforce a limited covenant which it felt to be both useful to the covenantee and reasonable for the covenantor. The balancing of interests proposed by the court in *Mitchell v. Reynolds* has been adopted by most American jurisdictions as a test of "reasonableness." The Massachusetts expression of this test is fairly typical:

"It has long been settled in this Commonwealth that a covenant
inserted in a contract for personal service restricting trade or competition or freedom of employment is not invalid and may be enforced in equity provided it is necessary for the protection of the employer, is reasonably limited in time and space, and is consonant with the public interest. What is reasonable depends on the facts in each case.17

Like most expressions of the "reasonableness" test, the Massachusetts formulation is an outline which must be expanded by judicial decisions. The Massachusetts formulation does, however, put the employer on notice that he must look to equity for specific enforcement of a covenant not to compete. This is a reminder, in effect, that the court will look beyond the terms of the covenant and consider all the circumstances of the case, including the conduct of the parties. A case in point is Economy Grocery Stores Corp. v. McMenany,18 where the employee was manager of the meat department in a grocery store. The noncompetition covenant which he had signed was to apply for one year after the voluntary or involuntary termination of his employment. The covenant required that the employee refrain from engaging in "any branch of the grocery, meat and/or food supply business" within two miles of any store operated by the employer. The meat manager performed well in his job, but was fired without cause "and in circumstances involving some humiliation to him."19 The Supreme Judicial Court held that the employer had arbitrarily and unreasonably discharged the employee, even though the covenant allowed for involuntary termination of employment. Remarking that "[s]pecific performance . . . will not be granted if the conduct of the plaintiff [employer] is savored with injustice,"20 the Court refused to enforce the otherwise reasonable covenant.

The Massachusetts formulation of the "reasonableness" test includes, as its first element, the requirement that the covenant in question be "necessary for the protection of the employer." Massachusetts and most other American jurisdictions regard a covenant as necessary if it is intended in good faith to protect confidential information or established customer relationships. Where a company's training program for its salesmen was similar to programs used by three competing businesses, the Supreme Judicial Court refused to treat the training as confidential information21 and held, therefore, that the salesman's covenant was not enforceable. But where certain industrial processes were unknown to either competitors or customers, the processes were

20 Id. at 552, 195 N.E. at 748.
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considered confidential information, and a post-employment restraint of three years was upheld. 22

A company's favor with its established customers will always be vulnerable to normal competition by other businesses, and the Massachusetts courts will not interfere to protect a company from normal competition. 23 A former employee, however, might be in a better position to divert those established customers than other competitors would be, especially if he had extensive and personal customer contact during his employment. The courts in Massachusetts examine both the extent of the former employee's competitive advantage and the probability that at some point in time the advantage will diminish, leaving him a normal competitor. In Whiting Milk Cos. v. O'Connell, 24 the covenant in question restrained all the company's milk wagon drivers from selling any competitor's dairy products for a period of 90 days after termination of employment. The Supreme Judicial Court held that a milk wagon driver would gain a competitive advantage from his employment only with those customers whom he had actually served. The 90-day restraint, therefore, was limited by the Court to the solicitation of those customers. But in New England Tree Expert Co. v. Russell, 25 the Court upheld as necessary a restraint of three years which applied to areas "covered intensively" by other members of the company's sales force. The employee in that case had worked as a general salesman for the "arboricultural" services of the company, and had set up a competing business of his own after terminating his employment. The Court held that the employee had gained sufficient general customer information during his employment to provide a special competitive advantage in his own business. Counsel for the former salesman cited cases such as Whiting Milk Cos. v. O'Connell and contended that in Massachusetts a restraint was to be limited to an employee's former territory. 26 The Court disagreed:

... There is ... no such established principle of law in this Commonwealth. The test is reasonableness. ... [T]hose cases concerned businesses where the routes upon which the employee had worked for the employer were the important element, and where the relief granted was sufficient to afford reasonable protection to the good will of the business involved. 27

The Supreme Judicial Court has consistently refused to be bound by any fixed definition of reasonableness. What is a proper restraint for

26 Id. at 810, 28 N.E.2d at 1000.
27 Ibid.
a milk wagon driver may clearly not be a guideline for one of a company's seven general sales representatives.

Naturally, not all post-employment restraints pass the test of reasonableness. What is a court to do when it finds that one or more terms of an employee's covenant are unreasonable? The question is answered differently among the jurisdictions, but generally one of three approaches is followed. The first is to deny enforcement of the entire covenant if any part is found unreasonable. The few jurisdictions which take this approach rely on the policy that courts have no authority to vary the terms of a written agreement. A covenant stands or falls in its entirety, even though the court might feel that some reasonable restraint should be salvaged from the unreasonable terms. This "all or nothing" approach lumps together those employers who frame intentionally oppressive covenants and those who try, in good faith, to anticipate only so much protection as they believe they will need at some time in the future. For example, consider the problem of an employer who hires an engineer to oversee the development of confidential manufacturing processes. In deciding on terms for a non-competition agreement, the employer must allow for future contingencies and attempt to forecast the future relationship of the engineer to the company. Certain terms for the covenant would be reasonable early in the employment, but those terms might be unreasonable six months or a year after the engineer has begun work. In addition, otherwise reasonable terms might be rendered unnecessary and unreasonable if later a competitor developed processes similar to those which the employer had considered confidential. Frequently changing factors would necessitate frequently amended covenants. As the number of affected employees increased, so also would the administrative burden of revising covenants.

A second approach to the disposition of unreasonable covenants is referred to as the "blue pencil rule." If the covenant is so worded that the excessive terms can be crossed out and the remaining terms are sufficient to constitute a clear and valid covenant, the modified covenant will be enforced. The blue pencil rule allows a court to enforce what it feels are reasonable terms, but only if the terms of the covenant are severable. For example, if a court found unreasonable a restraint on competition "within the state of Connecticut," blue-pencilling could not be applied, for crossing out "within the state of Connecticut" would leave no territory designated in which the covenant could be enforced. On the other hand, if the unreasonable restraint was on competition "in Stamford, Greenwich, Darien and Bridgeport," and the court felt that a restraint limited to Greenwich would be reason-

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28 "[C]ourts have no authority to vary the terms of a written agreement, for to do so would simply be to make a new contract between the parties. We have repeatedly held that this will not be done." Brown v. Devine, 240 Ark. 838, 842, 402 S.W.2d 669, 672 (1966).

29 6A Corbin, Contracts §1390 at 66-68 (1962).
able, the other three area names could be deleted. Because time provisions in a covenant are generally not severable, the blue pencil rule cannot be used to reduce them. If a covenant is to operate "for three years," any crossing out will eliminate the entire provision.

The blue pencil rule involves the court in a mechanical exercise, limiting its reforming powers on the basis of whether a covenant is sufficiently severable. Yet this approach appears to have been the majority position at one time, and it is followed in the Restatement of Contracts.

The third approach to unreasonable covenants marks a trend away from the limitations of the blue pencil rule. It seems that in a majority of American jurisdictions, including Massachusetts, courts prefer to reform the covenant as a whole, without regard to the severability of its terms. On the facts in each case, the court decides what restraint would be reasonable and enforces that restraint. The court will not, however, reform the covenant to include terms which exceed those agreed to by the parties. This third approach has been criticized as inviting employers to fashion onerous and excessive covenants, secure in the knowledge that the courts will enforce whatever the courts feel is reasonable. The excessive restraints thus serve to intimidate those employees who respect their contractual obligations and those who cannot afford the costs of litigation. Competitors may also fear legal complications and refuse to hire a person who has a non-competition covenant hanging over his head.

The above criticisms would be valid if a jurisdiction made no attempt to examine the circumstances surrounding the covenant and the actions of the parties. However, the equity powers of a court are broad enough to deny relief to wrongdoers. As previously noted, the Supreme Judicial Court of Massachusetts has held an otherwise reasonable covenant unenforceable because of the arbitrary and unreasonable firing of the employee. It seems logical that the Court could also hold invalid a covenant which it found deliberately unreasonable and oppressive. The Supreme Judicial Court should make clear its intention to deny any enforcement where there is credible evidence that the employer failed to make a good faith attempt to fashion reasonable terms for the covenant.

The legislatures in some states have taken what might be listed as a fourth approach to the problem of unreasonable covenants: statutory restrictions on all restraints of employment. Such restrictions gen-

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31 Restatement of Contracts §518 (1932).
32 Professor Corbin considered this to be the best-reasoned approach. See 6A Corbin, Contracts §1990 at 70-74 (1962).
33 Blake, supra note 3, at 682-683.
35 For example, North Dakota, Oklahoma and Montana prohibit all employee
erally work against an employer, for they limit his ability to fashion what he believes in good faith to be necessary protection for his economic interests. The economic realities of his business and the nature of his employee's position may require a type of restraint not permitted by statute. Given the employment mobility and the emphasis upon competitive advantage in our economic system, restrictive statutes seem ill-adapted to the complex business relationships that have become commonplace. It is submitted that a rigid attempt to deal with the question of employment restraints ignores the inherent right in our system to protect and nurture one's economic interests.

In the 1970 Survey year the Supreme Judicial Court has again considered its test of reasonableness in determining the validity of an employee's covenant not to compete. The precedents established over a period of 40 years were followed in *Richmond Brothers, Inc. v. Westinghouse Broadcasting Co.*36 Defendant Jacoby, also known as Jerry Williams, was hired in 1957 by Boston radio station WMEX (Richmond Brothers, Inc.) as a radio announcer. When he left for a position in Chicago on August 28, 1965, Williams was the moderator of a successful talk show on WMEX. He was under contract to the station until 1967, and in negotiating a new contract which terminated his employment with WMEX, Williams agreed "not to engage in any employment in radio, television, or advertising in New England until October, 1970." Williams returned to Boston and began broadcasting for radio station WBZ (Westinghouse) on July 29, 1968.

The issue facing the Court was whether to enforce the covenant which the parties had signed in 1965. HELD: That the enforcement of the restraint was no longer reasonably necessary for the protection of plaintiff's business. In answering the contention of WMEX that Williams had signed a covenant reasonable in duration, the Supreme Judicial Court said, in effect, that what was reasonable in 1965 might not be reasonable three years later. Plaintiff did not claim that the time provision was needed because Williams had been given access to confidential information during his employment; the station's position apparently centered on the need to protect established customer relationships. As the Court recognized in its opinion, the customers of a radio station are its advertisers. Plaintiff, therefore, needed to demonstrate that some of its advertisers had been solicited by Williams, or that his affiliation with another radio station would be likely to draw customers from WMEX. Yet the Court found, on

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the contrary, that Williams had never contacted any WMEX or WBZ advertisers. Plaintiff also failed to present evidence that it had lost any advertising sponsors when Williams left WMEX or when he returned to Boston and began broadcasting for WBZ. In short, plaintiff failed to present evidence that the covenant was still necessary for the protection of its business.

The Court was thus able to phrase its decision in *Richmond Brothers v. Westinghouse* in terms of a limited statement: "We are of the opinion that the restrictive covenant in the 1965 contract is no longer reasonably necessary. . . ."37 (Emphasis added.) It was not necessary to decide whether the restraint was reasonable when signed, or whether a restraint of three years would have been found reasonable if the case had arisen in 1966 or 1967. However, the Court cited with approval the language of its decision in *Club Aluminum Co. v. Young*:

... [A]n employer cannot by contract prevent his employee from using the skill and intelligence acquired or increased and improved through experience or through instruction received in the course of the employment. The employee may achieve superiority in his particular department by every lawful means at hand, and then, upon the rightful termination of his contract for service, use that superiority for the benefit of rivals in trade of his former employer.39

If the Court had been presented with the fact situation of the *Richmond* case soon after the covenant was signed, it seems likely that the covenant would have been enforced only long enough to render Williams an ordinary competitor for WMEX's advertisers, if it were enforced at all. The Court might well have considered a year's restraint as sufficient protection for WMEX.

In the past 40 years the Supreme Judicial Court has not enforced a restrictive employment covenant for a duration longer than three years, and that maximum has been upheld in only three cases during the period. It is notable that in each instance the facts showed wrongdoing on the part of the former employee, which plaintiff WMEX failed to demonstrate in *Richmond Brothers v. Westinghouse*. In one of the three cases the employee had started his own business, supplying the same kind of service as did his former employer, after which he solicited customers of the former employer.40 In another case the employee went to work for a competitor, actively solicited customers of his former employer, and disclosed confidential industrial processes which were vital to his former employer.41 In the third case where a three-year term was upheld (having been reduced from

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37 Id. at 342, 256 N.E.2d at 307.
39 Id. at 226-227, 160 N.E. at 806.
five years), a district sales representative had begun soliciting clients of his former employer less than a week after resigning his position.\(^{42}\) Although employee wrongdoing was apparent in the aforementioned three cases, that element was not present in *Richmond Brothers v. Westinghouse*. If Williams had begun broadcasting on WBZ one or two years after leaving WMEX, the Court might well have decided that even a three-year covenant would be unnecessary, considering the facts of the case and previous Massachusetts decisions.

Even if the time provision of five years in Williams's covenant had been upheld, the Court, it is submitted, would probably have found the scope of the restraint excessive and unreasonable. Williams was a radio personality with WMEX, yet his covenant restrained him from "any employment in radio, television, or advertising." Presumably he could not, under those terms, accept a position as a television sports announcer or as personnel director for an advertising firm. It is questionable whether exclusion from those jobs would be necessary to protect WMEX from economic harm. If the scope of the restraint had been in issue, the Supreme Judicial Court, applying its test of reasonableness, would probably have pared the restrictive terms considerably.

Massachusetts was among the first American jurisdictions to reform and enforce an employee's covenant according to a court of equity's determination of what would be reasonable. In *Richmond Brothers v. Westinghouse*, the Supreme Judicial Court reaffirmed its adherence to this approach. Those practitioners who draft employee covenants not to compete have the assurance that the Massachusetts courts will not discard an entire covenant if one or more terms are found unreasonable. As has been suggested, however, this assurance seems predicated on the good faith effort of the employer to frame reasonable covenants. The employer should also take care to require these covenants only of employees whose later competition is likely to present an economic threat to his business. Such care can itself be offered as evidence that the employer regularly requires restrictive covenants only where necessary. If he has only a few affected employees, the employer should try to tailor the agreements to each. Where this would be impractical, he should fashion the covenants with a reasonable classification of employees in mind. Because it is in the best interests of the employer to avoid unnecessary litigation, he should also be willing to revise the terms of a covenant when those terms appear to be more than is necessary for his protection. A willingness to revise excessive restraints would be especially important at the time an employment relationship is terminated.

There may be a need to seek enforcement of a noncompetition covenant in a jurisdiction which applies the "blue pencil rule." If this is a possibility, the employer should separate the terms of the

agreement into severable elements. Special care must be taken to ensure that the time provision is not excessive, for it is not logically severable, and the whole covenant may fall if the duration is found unreasonable. An employer should be particularly willing, therefore, to review the time provision when an employee leaves and to revise it if it then seems excessive.

The Massachusetts test of reasonableness, as elaborated in judicial decisions, appears well suited to provide legitimate economic protection for employers and minimal interference with an employee’s right to seek the best job for himself. As with any subjective test, it will be difficult to predict what terms a court of equity will consider reasonable in a particular case. An employer’s best hope, since the covenant is intended for his protection, is in making its terms reflect only his actual needs.

TIMOTHY D. JAROCH