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In re Application Specialists, Inc.

February 2000

Restatement (Second) of Conflict of Laws

§ 187

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed at that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of §188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

(3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

§ 188.

(1) The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties….

(2) In the absence of an effective choice of law by the parties (see §187), the contacts to be taken into account ... to determine the law applicable to an issue include:

(a) the place of contracting,

(b) the place of negotiation of the contract,

(c) the place of performance,

(d) the location of the subject matter of the contract, and

(e) the domicile, residence, nationality, place of incorporation and place of business of the parties.

These contacts are to be evaluated according to their relative importance with respect to the particular issue.

(3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied ...

McGill v. Donaldson, Inc.
Franklin Supreme Court (1965)

Plaintiff appeals from an adverse judgment in an action for declaratory relief to establish his right to be reinstated in the employees' retirement plan of the defendant corporation.

Plaintiff left defendant's employ on July 1, 1960, after meeting all the requirements for benefits under the retirement plan. On October 24, 1960, he went to work for a competitor of the defendant. On December 5, 1960, the retirement committee that administers the plan notified plaintiff that his rights to receive payments had been terminated pursuant to § 7.1 of the plan on the ground that he had entered the employ of a competitor.[1] Plaintiff then brought this action against the corporation seeking a declaration that he was entitled to reinstatement on the ground that the section invoked by the retirement committee was against public policy and unenforceable. The trial court held that § 7.1 was valid.

Section 600 of the Franklin Fair Business Act provides that, "Every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." This section invalidates provisions in employment contracts prohibiting an employee from working for a competitor after completion of his employment or imposing a penalty if he does so.[2] Since the pension plan becomes part of the contract of employment (see *Bos v. US Rayon Co.* (Franklin Court of Appeals, 1958)), such provisions therein are also invalid.

As this Court said long ago:

> Equity will to the fullest extent protect the property rights of employers in their trade secrets and the preservation of their hard-won business advantages, but public policy and natural justice require that equity should be solicitous for the inherent right in all people, not fettered by negative covenants upon their part to the contrary, to follow any of the common occupations of life. A former employee has the right to engage in a competitive business for himself and to enter into competition with his former employer, even for the business of those who had been the customers of his former employer, provided such competition is fairly and legally conducted. *George* v. *Mossier* (Franklin Supreme Court, 1944).

That principle emanates from the common law and is embodied in § 600 of the Civil Code. It is true that a number of states have abandoned the common-law prohibition of covenants restraining competition in employment agreements, adopting instead an approach

[1] Section 7.1 provides: "The annuity payments to any retired Employee shall be suspended or terminated in the event such retired Employee at any time enters any occupation or does any act which, in the judgment of the Retirement Committee, is in competition with any phase of the business of the Employer."

[2] This section is to be read in tandem with § 602 of the Act, which provides: ..."unfair competition shall mean and include unlawful, unfair or fraudulent business practices and unfair, deceptive, untrue or misleading advertising." The imposition of an invalid non-competition agreement in an employment contract is a form of unfair competition within the meaning of § 602.

enforcing such covenants to the extent they are reasonable. It may even be correct to say that this "rule of reason" represents a majority rule among jurisdictions that have considered the question.

However, the Franklin courts, led by this court, have been clear in their expression that § 600 represents a strong public policy of the state that should not be diluted by judicial fiat.

The forfeiture imposed upon the plaintiff by the defendant corporation in this case violates that strong public policy.

The judgment is reversed.

The Tree Doctor v. Ryan

Supreme Court of Olympia (1975)

The question presented in this suit for damages is the validity of a restrictive covenant in an employment contract between a company engaged in the business of tree care and one of its former employees. Under the covenant, the employee agreed not to compete with his employer in the area of the five counties including and surrounding Bass County, Olympia for a period of two years after termination of his employment.

During his tenure as an employee of The Tree Doctor, Ryan solicited tree care work for his employer in the five-county area and was in charge of the Easton office. He contacted old customers and potential new customers, suggested that tree work be done, and quoted prices. Ryan's sales leads were secured through the advertising efforts of The Tree Doctor's main office. Ryan was the only person in the Easton office acting as a sales representative. No claim is made by The Tree Doctor that the information furnished to Ryan or its methods or customer lists are trade secrets.

The tree care business is the only means of livelihood Ryan has ever had. He was trained by his uncle from the age of fourteen, joined The Tree Doctor as a trimmer at the age of eighteen, and worked for that employer for twenty years until he resigned in 1972. After his resignation, he bought out and became the sole proprietor of Wye Tree Experts, specializing in the care of shade trees. He began soliciting customers whom he had serviced while working for The Tree Doctor.

The Tree Doctor initiated this suit seeking to enjoin Ryan from engaging in competition and to recover damages for lost business. Ryan defended on the grounds that the covenant not to compete is invalid as against public policy, that it violates his right to earn a lawful living, and that, in any event, it is unreasonable both as to its geographical scope and its post-termination duration.

The trial court, after a one-day bench trial, entered judgment for The Tree Doctor. We affirm with one minor modification.

The general rule in Olympia, as in most jurisdictions, is that restrictive covenants in contracts of employment, by which an employee agrees not to engage in a competing business upon the termination of his employment, are not *per se* invalid. They will be sustained if the restraint is confined within limits that are no wider as to area and duration than are reasonably necessary for the protection of his employer and do not impose undue hardship on the employee or disregard the public interest in avoiding the creation of monopolies.

The rule in Olympia is based upon the judicially made policy determination that employers have a legitimate interest in protecting the customer contacts they have been able to develop. In almost all commercial enterprises, contact with customers or clientele is a particularly sensitive aspect of the business. Ordinarily, the employer's sole or

major contact with customers is through its employees. The possibility is present that the customer will regard or come to regard the attributes of the employee as more important in his business dealings than the special qualities of the product or services of the employer, especially if the product is not greatly different from others that are available. Thus, some customers may be persuaded, or even very willing, to abandon the employer should the employee move to a competing organization or leave to set up a business of his own.

The Legislature has never acted to overrule or limit this judicially created policy, and it must therefore be accepted as a part of the public policy of the State of Olympia that employers within the state may lawfully restrict post-employment competition by agreement with their employees as long as the restrictions are reasonable.

In this case, we find that all the reasons for adhering to the policy are present and none of the reasons for avoiding it are. It is reasonable to prevent Ryan from soliciting the very customers whom he served as an employee of The Tree Doctor within the same area for which he was responsible during his employment. The public interest is not adversely affected because there is no risk that preventing Ryan from competing will result in creation of a monopoly.

The only respect in which we differ from the decision of the trial court is as to the duration of the restriction. In light of the fact that tree care is the only means Ryan has ever known of earning a living and because of the relative saturation of the market in the five-county area, we find that two years is too long a period because it imposes an undue hardship on him. We exercise our well recognized discretion to "blue pencil" the covenant not to compete and reduce the temporal restriction to one year.

Affirmed in part and reversed in part.

Music Makers, Inc. v. Seabird Orient Industries
Franklin Supreme Court (1998)

The sole issue before the Court is whether the law of Franklin or the law of Singapore should be applied to resolve this commercial dispute between the parties.

Music Makers, Inc. (MMI), a Franklin corporation with its principal place of business in Atterbury, Franklin, entered into a written "requirements" contract with Seabird Orient Industries (SOI), a Singapore corporation based in Singapore, for the purchase of all of MMI's requirements for compact disk "blanks," i.e., high quality plastic disks used to create digital recordings of music or "CDs." The contract was negotiated in Singapore, and the goods were to be manufactured there and shipped F.O.B. Singapore to MMI in Franklin.

SOI is alleged to have failed repeatedly to deliver the requisite quantities and, instead, to have sold to a competitor of MMI blanks it should have delivered to MMI. The contract between the parties contained the following choice of law clause: "ARTICLE 47. CHOICE OF LAW: This agreement and any dispute arising under the agreement shall be governed by and construed in accordance with Singapore law."

MMI sued SOI in the Franklin district court on a number of counts, including a claim for breach of the implied covenant of good faith and fair dealing (the "covenant"). The trial court dismissed the claim for breach of the covenant on the grounds that the parties had agreed that their contract would be governed by Singapore law and that Singapore law does not recognize such a covenant in commercial contracts of this type. MMI took this permissive interlocutory appeal.

The starting point for the resolution of any conflict of laws issue in any case is to inquire whether there is indeed a conflict. Some courts would say there is a conflict any time the laws are different. However, we apply the rule that there is a conflict when a different outcome would result under the two laws or where each state has an interest in applying its own law.

In this case, there is a conflict because each jurisdiction has its own interest in applying its own law. The law of Singapore does not countenance an implied covenant of good faith and fair dealing in a contract for manufactured goods between merchants. Singaporean law is based on the policy that contracting parties are presumed to be sufficiently sophisticated that they can express all covenants and conditions to their agreement. The law of the State of Franklin, on the other hand, presumes that such a covenant inheres in every contract. It is a principle adopted in the Franklin Commercial Code as well as in its common law.

In determining the enforceability of arm's-length contractual choice-of-law provisions, Franklin courts apply the "governmental interest analysis" set forth in the Restatement (Second) of Conflict of Laws § 187, which

reflects a strong policy favoring enforcement of such provisions.

Briefly stated, the proper approach under Restatement § 187(2) is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law.

If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a fundamental policy of the State of Franklin. If there is no such conflict, the court shall enforce the parties' choice of law.

If there is a fundamental conflict with Franklin law, the court must then determine whether Franklin has a materially greater interest than the chosen state in the determination of the particular issue. If Franklin does have a materially greater interest than the chosen state, the choice of law shall not be enforced for the obvious reason that in such a circumstance we will decline to enforce a foreign state's law contrary to this state's fundamental policy.[1]

We now apply the Restatement tests to the facts of this case.

Substantial relationship or reasonable basis: As to the first required determination (§ 187(2)(a)), Singapore clearly has a substantial relationship. SOI is incorporated and based there, the contract was negotiated there, and the goods were to emanate and be shipped from there. C.f., the factors set out in Restatement § 188. Indeed, a party's incorporation in a state is a contact sufficient to allow the parties to choose that state's law to govern their contract.

Contrary to a fundamental policy of Franklin: We perceive no fundamental policy of Franklin requiring the application of Franklin law to MMTs claim based on the implied covenant. The covenant is not a governmental regulatory policy designed to restrict freedom of contract, but an implied promise inserted in an agreement to carry out the presumed intentions of the contracting parties. As we observed in *Furley* v. *Interactive Components, Inc.* (1988), "When a court enforces the implied covenant, it is in essence acting to protect the interest in having the private promise performed rather than to protect, for example, some general duty to society which the law places on an employer irrespective of the contractual terms in agreements with its employees."

MMI has directed us to no authority exalting the implied covenant over the express covenant of these parties that the law of Singapore shall govern their agreement. Accordingly, the second exception to the rule of § 187 does not apply.

[1] A strict reading of § 187 of the Second Restatement would require us to make one additional inquiry, i.e., whether our state is also the state whose law would apply under a "most significant relationship" test. We believe that, when the question of a fundamental state policy is at stake, no such inquiry is necessary or appropriate. In such a case, we will apply our own law irrespective of which state has the "most significant relationship.

Materially greater interest than the chosen state: Let us assume *arguendo* that Franklin's law recognizing such a covenant does rise to the level of a "fundamental policy." The next and final step in the analysis would require us to determine whether Franklin has a "materially greater interest" than Singapore in the determination of the particular issue.[2]

We can conceive of situations where a Franklin statute (for example, one designed to protect employees' wages or freedom to contract for terms of employment) might predominate over the law of a chosen state where such protections are not available. In such a case we would refuse to enforce the parties' choice of the other state's law on the ground that Franklin's interest was materially greater. In the present case, however, we cannot conceive that Franklin's interest in enforcing an implied contractual covenant in a commercial contract outweighs Singapore's interest in indulging the presumption that the parties have expressed all conditions and covenants.

We affirm the judgment of the trial court.

2Many jurisdictions that have adopted the "governmental interest" Rest. § 187 approach to resolving conflicts issues also include a "comparative impairment" inquiry; i.e., which state's interests would be "more seriously impaired" by enforcement of the parties' chosen law. We find it unnecessary to extend the inquiry to include this step of the analysis. See *Addles Washing Town* v. *Dry Cleaners Supply* (Franklin Supreme Court, 1987).