RECENT DEVELOPMENTS IN THE INDIANA LAW OF CONTRACTS AND SALES OF GOODS

HAROLD GREENBERG*

INTRODUCTION

Article 2 of the Uniform Commercial Code[1] has supplemented or, in some instances, has replaced the common law of contracts with respect to the sale of goods. Therefore, it is appropriate for this Article to discuss important cases arising under Article 2 as well as those arising under the common law during this survey period.

I. THE INDEPENDENCE OF U.C.C. § 2-719(3) FROM U.C.C. § 2-719(2)

An issue not previously raised in Indiana, which has caused a split among the courts of other states, is whether an exclusion of consequential damages for breach of warranty, as permitted in section 2-719(3), is independent of section 2-719(2), which authorizes all Code remedies if a limited remedy fails of its essential purpose.[2] If dependent, the failure of essential purpose of a limited

---

* Professor of Law, Indiana University School of Law—Indianapolis; A.B. *summa cum laude*, 1959, Temple University; J.D. *magna cum laude*, 1962, University of Pennsylvania. The author expresses thanks to Jeffrey W. Ferrand, J.D., 2003 (anticipated), Indiana University School of Law—Indianapolis for his assistance in preparing this article.

1. IND. CODE § 26-1-2 (1998). This Article will use the generic section numbers to refer to Indiana's Uniform Commercial Code. For example, this article will cite to 2-719 instead of IND. CODE § 26-1-2-719 (1998) unless the version of the Code enacted in Indiana differs from the current official draft.

2. U.C.C. § 2-719 (1999) provides:

(1) Subject to the provisions of subsections (2) and (3) of IC 26-1-2-718 on liquidation and limitation of damages:

(a) The agreement may provide for remedies in addition to or in substitution for those provided in IC 26-1-2 and may limit or alter the measure of damages recoverable under IC 26-1-2, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of nonconforming goods or parts; and

(b) Resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy.

(2) Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in IC 26-1.

(3) Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not.

Compare Chatlos Sys., Inc. v. Nat'l Cash Register Corp., 635 F.2d 1081 (3d Cir. 1980); and Am. Elec. Power Co. v. Westinghouse Elec. Corp., 418 F. Supp. 435 (S.D.N.Y. 1976) ("independent" cases), *with* R.W. Murray Co. v. Shatterproof Glass Corp., 758 F.2d 266 (8th Cir. 1985) and Adams

remedy under section 2-719(2) automatically entitles the plaintiff to all Code remedies, including the recovery of consequential damages. If independent, the failure of essential purpose does not automatically invalidate an exclusion of consequential damages.

In *Rheem Manufacturing Co. v. Phelps Heating & Air Conditioning, Inc.*,[3] the Indiana Supreme Court ruled that the exclusion of consequential damages subsection, 2-719(3), should be construed and applied independently of the prior subsections of section 2-719. Based on this construction, the court reversed the denial of defendant Rheem's motion for summary judgment on the issues of limitation of remedies and exclusion of damages.[4]

Since the case was based on an interlocutory appeal from the denial of a motion for summary judgment, there should have been no facts in dispute, and all facts should have been viewed in the light most favorable to the nonmoving party,[5] plaintiff Phelps. However, as discussed below, the case may not have been the best vehicle for the supreme court's decision. The facts were somewhat unusual and the case left many unresolved questions. Indeed, the court may have resolved the main issue prematurely.

Rheem manufactures furnaces for use in homes and offices and, at the relevant times, sold them through a distributor, Federated Supply Corporation ("Federated").[6] Phelps, a heating and air conditioning contractor, purchased Rheem furnaces from Federated for resale to home builders or to private home owners and for installation by Phelps.[7] For approximately four years, substantially all of Rheem's high efficiency furnaces were defective, failed to function properly, and required many service calls and repairs by Phelps at substantial cost to it.[8] Rheem was unable to correct the initial problems with its furnaces for at least three and one half years but did supply replacement parts.[9] In addition, allegedly as a result of the poor performance record of the Rheem furnaces, Phelps also lost contracts for the sale and installation of furnaces in new housing developments.[10] In an action against Rheem and Federated, Phelps

---

v. J.I. Case Co., 261 N.E.2d 1 (Ill. App. Ct. 1970) ("dependent" cases).

3. 746 N.E.2d 941 (Ind. 2001) [hereinafter *Rheem II*]. This case is also the subject of brief commentary elsewhere in this survey issue. *See* Matthew T. Albaugh, *Indiana's Revised Article 9 and Other Developments in Commercial and Consumer Law*, 35 IND. L. REV. 1239, 1255-57 (2002).

4. *Rheem II*, 746 N.E.2d at 955.

5. *Id.* at 946.

6. *Id.* at 944.

7. Rheem Mfg. Co. v. Phelps Heating & Air Conditioning, Inc., 714 N.E.2d 1218, 1219 (Ind. Ct. App. 1999) [hereinafter *Rheem I*]. The Indiana Supreme Court referred readers to the court of appeals' decision for a more complete discussion of the facts. *Rheem II*, 746 N.E.2d at 944.

8. *Rheem II*, 746 N.E.2d at 944-45. Phelps incurred expenses of approximately $100,000 in servicing defective Rheem high efficiency furnaces. *Id.* at 953.

9. *Rheem I*, 714 N.E.2d at 1220.

10. *Rheem II*, 746 N.E.2d at 945; R. 22, 225.

sought to recover two basic types of damages: the expenses incurred in repairing the defective furnaces purchased by its customers and the profits it lost because of canceled sale and installation contracts. The former may be characterized as direct damages flowing naturally from the defects in the furnaces[11] and the latter as consequential damages.[12]

Every box in which a Rheem furnace was shipped contained a pre-printed warranty captioned "Limited Warranty—Parts." This document expressly warranted the component parts of the furnace against failure for a particular term, limited the duration of the implied warranties of merchantability and fitness for particular purpose, limited the buyer's remedy for breach of warranty to the furnishing by Rheem of replacement parts, and excluded both the cost of labor to install the replacement parts and the recovery of incidental and consequential damages.[13]

---

11. *See* U.C.C. § 2-714(2) (1999). "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." *Id.*

12. *See id.* § 2-715(2)(a). "Consequential damages resulting from the seller's breach include (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise . . . ." *Id.*

In a footnote, the court stated: "While Phelps seeks both consequential and incidental damages, the same analysis applies to each and we will discuss only consequential damages." *Rheem II*, 746 N.E.2d at 946 n.2. This statement ignores both the differentiation between incidental damages and consequential damages in U.C.C. section 2-715 and the language of U.C.C. section 2-719(3) that refers only to consequential damages. That there is a difference between the two is illustrated by Commonwealth Edison Co. v. Allied Chem. Nuclear Prods., Inc., 684 F. Supp. 1429 (N.D. Ill. 1988), in which the contract expressly excluded consequential damages, but one party recovered storage charges (incidental damages) of almost $300 million.

13. *Rheem II*, 746 N.E.2d at 944. The pertinent provisions of the typical Rheem warranty were as follows.

> GENERAL: Manufacturer, RHEEM AIR CONDITIONING DIVISION, warrants ANY PART of this furnace against failure under normal use and service within the applicable periods specified below, in accordance with the terms of this Warranty. Under this Warranty, RHEEM will furnish a replacement part that will be warranted for only the unexpired portion of the original warranty . . . .
>
> HEAT EXCHANGER: RHEEM warrants the heat exchanger for a period of TEN (10) YEARS commencing from the date of original installation and operation . . . . In the event of heat exchanger failure during the warranty period, RHEEM will furnish a replacement heat exchanger. If not available for any reason, RHEEM shall have the right to instead allow a credit in the amount of the then current suggested retail selling price of the heat exchanger (or an equivalent heat exchanger) towards the purchase price of any other RHEEM gas or oil furnace.
>
> ANY OTHER PART: If any other part fails within ONE (1) YEAR after original installation and operation, RHEEM will furnish a replacement part . . . .

Notwithstanding the exclusion of labor costs, during the problematic four-year period, Rheem issued numerous repair bulletins and allowed monetary credits to contractors making the necessary repairs.[14] After meetings with Rheem

---

> SHIPPING COSTS: You will be responsible for the cost of shipping warranty replacement parts from our factory to our RHEEM distributor and from the distributor to the location of your product . . . .
>
> SERVICE LABOR RESPONSIBILITY: This warranty does not cover any labor expenses for service, nor for removing or reinstalling parts. All such expenses are your responsibility unless a service labor agreement exists between you and your contractor.
>
> HOW TO OBTAIN WARRANTY PERFORMANCE: Normally, the installing contractor from whom the unit was purchased will be able to take the necessary corrective action by obtaining through his RHEEM air conditioning distributor any replacement parts. If the contractor is not available, simply contact any other local contractor handling RHEEM air conditioning products . . . .
>
> MISCELLANEOUS: . . . ANY IMPLIED WARRANTIES, INCLUDING MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE, SHALL NOT EXTEND BEYOND THE APPLICABLE WARRANTY PERIODS SPECIFIED ABOVE. RHEEM'S SOLE LIABILITY WITH RESPECT TO DEFECTIVE PARTS SHALL BE AS SET FORTH IN THIS WARRANTY, AND ANY CLAIMS FOR INCIDENTAL OR CONSEQUENTIAL DAMAGES ARE EXPRESSLY EXCLUDED.
>
> . . .
>
> RHEEM suggests that you immediately complete the information on *the reverse side* and retain this Warranty Certificate in the event warranty service is needed. Reasonable proof of the effective date of the warranty must be presented, otherwise the effective date will be based upon the date of manufacture plus 30 days . . . .

Id. at R. 105 (emphasis in original). Rheem's "90 Plus" furnaces had a lifetime warranty which contained the following language:

> HEAT EXCHANGERS: RHEEM warrants the primary heat exchanger and the secondary heat exchanger (condensing coil) to the Original Owner for his or her lifetime, subject to proof of purchase, provided the furnace is installed and used in the Original Owner's principal residence. For any subsequent owner (or the original owner where the above lifetime warranty conditions are not or cease being met), . . . RHEEM will warrant the primary heat exchanger and the secondary heat exchanger (condensing coil) for a period of TWENTY (20) YEARS commencing from the date of original installation and operation . . . . In the event of heat exchanger failure during the warranty period, RHEEM will furnish a replacement heat exchanger. If not available for any reason, RHEEM shall have the right to instead allow a credit in the amount of the then current suggested retail selling price of the heat exchanger (or an equivalent heat exchanger) toward the purchase price of any other RHEEM gas furnace.
>
> INTEGRATED IGNITION CONTROL: RHEEM warrants the integrated ignition control for a period of FIVE (5) YEARS commencing from the date of original installation and operation. In the event of an integrated control failure during the warranty period, RHEEM will furnish a replacement integrated ignition control.

Id. at R. 117.

14. *See, e.g., id.* at R. 353. Bulletin #SR-134 for Rheem Air Conditioning Division to All

representatives failed to yield results satisfactory to Phelps, Phelps brought suit against both Rheem and Federated for breaches of express warranty and of the implied warranties of merchantability and fitness for particular purpose.[15] Following some discovery, Rheem moved for summary judgment on the theories "that the damages sought by Phelps were excluded by the service labor exclusion, consequential damages exclusion, and incidental damage exclusion of Rheem's written limited warranties."[16] Rheem also asserted that a lack of privity with Phelps entitled it to summary judgment on the implied warranty claims.[17]

The trial court denied Rheem's motion with regard to all the warranty claims.[18] Subsequently, the trial court granted Rheem's motion to certify its ruling for interlocutory appeal.[19] As stated in the court of appeals' opinion, the pertinent questions certified were:

> Whether the failure of essential purpose of a limited warranty remedy under [Indiana Code section 26-1-] 2-719(2) is independent from [Indiana Code section 26-1-] 2-719(3) which reads consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable and whether, because the tests for the two subsections are different, a limited remedy of repair or replacement survives under subsection (2) unless it fails of its essential purpose, but a limitation of consequential damages survives under subsection (3) unless it is unconscionable.
>
> Whether an intermediate reseller of goods can avail itself of the doctrine of failure of essential purpose under 2-719(2) where the intermediate reseller has sold and therefore no longer owns the goods, and where the intermediate reseller has created additional express warranties with remedies of greater scope than that of the defendant manufacturer.[20]

The court of appeals ruled that, in accord with the "majority" view, sections

---

Air Conditioning Distributors (July 15, 1992); Letter from Micheal D. Kaasa, Rheem Vice President, Sales, to Michael D. Phelps, President, Phelps Heating & Air Conditioning, Inc. (July 12, 1994) (R. 390). In his letter, Mr. Kaasa stated: "We must acknowledge that the Update Program of the past two years placed an unwanted burden on the entire Rheem distribution network. At the onset, we made every effort to arrive at labor allowance levels that would minimize the costs to the dealer." *Id.*

15. *Rheem I*, 714 N.E.2d 1218, 1221 (Ind. Ct. App. 1999). Phelps also sued the defendants for negligence. *Id.* The trial court's ruling on the negligence issue is not part of this appeal.

16. *Id.*

17. *Id.*

18. *Id.* at 1221-22.

19. *Id.* at 1222.

20. *Id.* The grant of summary judgment in favor of Federated against Phelps and its principals on Federated's counterclaim for failure to pay an account due of approximately $106,000 was not part of the appeal and thus not a part of the supreme court's decision. Federated also filed a cross-claim against Rheem. *Id.* at R. 28-32.

2-719(2) and 2-719(3) should be read independently, with the former being governed by a standard of failure of essential purpose of the limited remedy and the latter by a standard of unconscionability.[21] The court did not rule on the unconscionability of the exclusion but remanded for a determination of fact: "whether the cumulative effect of Rheem's actions was commercially *reasonable*."[22]

With respect to Rheem's assertion that the absence of privity with Phelps precluded recovery for breach of implied warranties, the court of appeals stated that perfect vertical privity is not required, particularly when the distributor with whom the buyer is in privity acts as the agent of the manufacturer, as Phelps had alleged.[23] Whether Federated was Rheem's agent was a question of fact to be determined at trial.[24]

The supreme court, in a 3-1 decision,[25] granted transfer, declared that sections 2-719(2) and 2-719(3) should be read independently, summarily affirmed the court of appeals as to the implied warranty claims, held that the language of the express warranty precluded Phelps from recovering its labor expenses or incidental and consequential damages, and observed that Phelps may still have a valid claim for breach of implied warranty or indemnity.[26]

Reasonable judicial minds may differ on whether sections 2-719(2) and 2-719(3) were intended by the Code drafters to be construed dependently or independently. The current trend favors independence, and the court in *Rheem* followed that trend. However, independence still requires a consideration of all of the surrounding circumstances, including the failure of the essential purpose of the limited remedies. The court should have simply declared its construction of the relationship between sections 2-719(2) and (3), as requested by the trial court, and should have remanded for further proceedings.

II. THE INDEPENDENCE ISSUE

As both courts observed, there has been a split among the decisions in other states on the question of whether sections 2-719(2) and 2-719(3) should be read dependently or independently.[27] The supreme court stated that "[i]n light of the depth of disagreement among the courts that have faced this issue, it is evident

---

21. *Rheem I*, 714 N.E.2d at 1227.

22. *Id.* at 1228 (emphasis in original).

23. *Id.* at 1228-31.

24. *Id.* at 1231. This author has previously urged that Indiana should abolish the requirement of vertical privity in implied warranty cases. *See* Harold Greenberg, *Vertical Privity and Damages for Breach of Implied Warranty under the U.C.C.: It's Time for Indiana to Abandon the Citadel*, 21 IND. L. REV. 23 (1988).

25. Justice Dickson dissented and filed a short opinion. *Rheem II*, 746 N.E.2d 941, 956-57 (Ind. 2001) (Dickson, J., dissenting). Justice Rucker did not participate because he was a member of the court of appeals that previously decided *Rheem I*. *Id.* at 956.

26. *Rheem II*, 746 N.E.2d at 944, 948, 956.

27. *Id.* at 947; *Rheem I*, 714 N.E.2d at 1223; *see, e.g.*, cases cited *supra* note 2.

that the UCC is ambiguous on this point."[28] The court also noted that the "modern trend" appears to be that the two sections should be read independently of each other.[29]

After a discussion of the rules of statutory construction and the justifications for both views, the supreme court ruled, as had the court of appeals, that Indiana should follow the majority position and adopt the independent view.[30] The court stated:

> [T]he legislature's intent to follow the independent view is also supported by the UCC's general policy favoring the parties' freedom of contract . . . . [T]he independent view refuses to override categorically an exclusion of consequential damages and will give effect to the terms of the contract. Indeed, consistent with the principle of freedom of contract, the independent view allows the parties to *agree* to a dependent arrangement.[31]

The court expressly rejected the "commercial reasonableness" test of the court of appeals and, without discussion of whether Rheem's exclusion of consequential damages was unconscionable or whether Phelps had ever agreed to the exclusion other than by purchasing the furnaces for resale, reversed the trial court's denial of Rheem's motion for summary judgment on Phelps's claim for incidental and consequential damages.[32] The court declared that Phelps could not "escape the conclusion that these goods were relatively sophisticated and flowed between businesses [sic] entities."[33] In support, the court cited *S.M. Wilson & Co. v. Smith International, Inc.*,[34] a case involving the negotiation of specifications for the design, construction, and delivery of a $550,000 tunnel boring machine, the installation of which was to be supervised by an expert provided by the seller.[35] The court also relied on and quoted one of the leading cases supporting the independent view, *Chatlos Systems, Inc. v. National Cash Register Corp.*[36] In *Chatlos Systems*, the limitation of remedy and exclusion of consequential damages terms were in a contract that was negotiated over a period of months for a complex computer system expressly designed for Chatlos and to be installed and tested over an extended period of time.[37] The *Rheem II* court stated:

---

28. *Rheem II*, 746 N.E.2d at 948.

29. *Id.* at 950; *see* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 12-10(c) (4th ed. 1995).

30. *Rheem II*, 746 N.E.2d at 948-50.

31. *Id.* at 950 (emphasis in original).

32. *Id.* at 952.

33. *Id.* at 951.

34. 587 F.2d 1363 (9th Cir. 1978).

35. *Id.* at 1365-67.

36. 635 F.2d 1081 (3d Cir. 1980).

37. *See id.* at 1083-84.

> The limited remedy of repair and consequential damages exclusions are two discrete ways of attempting to limit recovery for breach of warranty. The Code, moreover, tests each by a different standard . . . . We therefore see no reason to hold, as a general proposition, that the failure of the limited remedy provided in the contract, without more, invalidates a wholly distinct term in the agreement excluding consequential damages. The two are not mutually exclusive.[38]

The court also relied upon Professors White and Summers.[39] They stated that the leading case supporting the independent view, and with which they agree, is *American Electric Power Co. v. Westinghouse Electric Corp.*[40] That case involved "a commercial agreement painstakingly negotiated between industrial giants" for a "highly complex, sophisticated, and in some ways experimental piece of equipment . . . . It is for this very reason that the . . . contract incorporates within it the limitation on the Seller's liability."[41] The contract itself was negotiated over a period of two years.[42] The contrast between the goods involved in these three cases and the prepackaged Rheem furnaces with their enclosed preprinted warranties is striking.

Furthermore, in *S.M. Wilson*, the court said the "holding [was] based upon the facts of this case as revealed by the pleadings and record and [was] not intended to establish that a consequential damage bar always survives a failure of the limited repair remedy to serve its essential purpose. Each case must stand on its own facts."[43] In *Chatlos*, the court stated:

> The repair remedy's failure of essential purpose, while a discrete question, is not completely irrelevant to the issue of the conscionability of enforcing the consequential damages exclusion. The latter term is "merely an allocation of unknown or undeterminable risks." U.C.C. § 2-719, Official Comment 3 . . . . Recognizing this, the question here narrows to the unconscionability of the buyer retaining the risk of consequential damages upon the failure of the essential purpose of the exclusive repair remedy.[44]

In these leading "independent" cases, the provisions of sections 2-719(2) and 2-719(3) were not totally independent of each other but the latter section was construed and applied in the context of the former, notwithstanding the differing standards by which each section is judged.

---

38. *Rheem II*, 746 N.E.2d 941, 948 n.6 (Ind. 2001) (quoting *Chatlos*, 635 F.2d at 1086).

39. *Id.* at 951.

40. 418 F. Supp. 435 (S.D.N.Y. 1976). *See* WHITE & SUMMERS, *supra* note 29, § 12-10(c). White and Summers suggest that the *American Electric* analysis should also apply in consumer cases. *Id.* This is briefly discussed in the text accompanying *infra* notes 45-46.

41. *Am. Elec. Power Co.*, 418 F. Supp. at 458.

42. *Id.* at 439.

43. 587 F.2d 1363, 1375-76 (9th Cir. 1978).

44. 635 F.2d 1081, 1086-87 (3d Cir. 1980) (internal citation omitted).

The court also relied on *Schurtz v. BMW of North America, Inc.*,[45] which reconciled the split between the "independent" and "dependent" cases on a contextual basis.

> In cases where the buyer is a consumer, there is a disparity in bargaining power, and the contractual limitations on remedies, including incidental and consequential damages, are contained in a preprinted document rather than one that has been negotiated between the parties, the courts have held uniformly that if the limited warranty fails of its essential purpose, the consumer should be permitted to seek incidental and consequential damages. The courts usually reach this result by reading the two subparts [of 2-719] dependently.... On the other hand, in cases where the parties are operating in a commercial setting, there is no disparity in bargaining power, and the contract and its limitations on remedies are negotiated, most courts have concluded that if a limited warranty fails of its essential purpose, any contractual limitation on incidental and consequential damages is not automatically void. The subparts are read independently and the surviving limitation ... remains valid absent a showing of unconscionability.[46]

The difficulty that *Rheem II* presents is that it falls somewhere between the two examples just posited. The transaction was commercial, but the warranty and its limitations and exclusions were found in a preprinted form inside the box that likely would not be opened until delivery at the ultimate buyer's residence or office. Nevertheless, the court assumed throughout its opinion that Rheem and Phelps were of equal bargaining power and had negotiated the terms of the warranty.

Unfortunately, *Rheem II* is made even more difficult by the court's observation, based on a reference to Phelps's brief, that "Phelps does not argue that the clause at issue was unconscionable."[47] The Code, however, states that unconscionability becomes an issue and evidence on it is required "[w]hen it is claimed or appears to the court that the contract any clause thereof may be unconscionable."[48] Phelps's failure to use the term "unconscionable" is

---

45. 814 P.2d 1108 (Utah 1991), *cited in Rheem II*, 746 N.E.2d 941, 947 (Ind. 2001).

46. *Schurtz*, 814 P.2d at 1113-14.

47. *Rheem II*, 746 N.E.2d at 947 n.5 (stating, *see, e.g.*, Appellee's Br. at 25-28).

48. U.C.C. § 2-302 (1999) states:

> (1) If the court as a matter of law finds the contract or any clause of 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 so 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 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.

regrettable. The tone of Phelps's various briefs, however, emphasized the unfairness of the exclusion, particularly in the light of Rheem's inability to produce a defect free furnace for almost four years and the apparent assumption by both parties throughout this phase of the litigation that the limited remedy failed its essential purpose. Although neither the trial court nor the court of appeals used the term "unconscionable," it is evident that both courts were concerned with the inherent unfairness of the exclusion on the facts as they had been developed as of the time of the motion for summary judgment.

In addition, throughout its opinion, the supreme court emphasized the freedom of the parties to negotiate, to set contract terms, and to allocate risks. The facts of the case do not reflect that Rheem and Phelps engaged in any negotiation and discussion of allocation of risk, particularly allocation of the risk that Rheem would be unable to manufacture furnaces that worked properly.

The consequence of *Rheem II* appears to be that in Indiana, whenever the transaction is between business entities of whatever size, the exclusion of consequential damages will be effective regardless of the failure of the essential purpose of the limited remedy and without the further factual analysis that the leading cases appear to require. Even following the line of cases established by *Chatlos* and *American Electric Power*, the question in *Rheem II* which the supreme court should have permitted to be resolved after the taking of evidence, was whether, in light of the failure of the limited remedy as assumed by the parties, it was unconscionable for Phelps to be financially responsible for Rheem's extended failure to manufacture defect-free furnaces.

In the words of the supreme court in a prior decision, "[a] substantively unconscionable contract is one that no sensible man would make and such as no honest and fair man would accept."[49] Perhaps this is what the court of appeals had in mind when it remanded for a finding of whether the exclusion was "commercially reasonable": In the light of Rheem's inability to produce defect-free furnaces, would a sensible contractor undertake the repair costs on all the furnaces for four years and would a fair manufacturer accept that undertaking?

Although the issue of unconscionability under section 2-302 is for the court to determine, the parties "shall be afforded a reasonable opportunity to present evidence."[50] Section 2-302 deals expressly with what happens "[i]f the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made."[51] Section 2-719(3) "makes it clear that [the limitations of remedies or exclusions of damages] may not operate in an unconscionable manner."[52] The plain implication is that the existence of unconscionability that would negate an exclusion of consequential damages under section 2-719(3) is to be determined after the failure of the essential purpose of the limited remedy under section 2-719(2) and in light of that failure.

Having interpreted the statute at the request of the trial court rather early in

---

49. Martin Rispens & Son v. Hall Farms, Inc., 621 N.E.2d 1078, 1087 (Ind. 1993).

50. U.C.C. § 2-302(2) (1999).

51. *Id.* § 2-302(1).

52. *Id.* § 2-719 cmt. 3.

the life of the litigation, the supreme court should have remanded for further proceedings that would have permitted Phelps to introduce evidence to demonstrate that the exclusion was unconscionable or perhaps did not apply to Phelps at all, as discussed in the next section. Thus, even under the independent view of section 2-719(3), the trial court's denial of Rheem's motion for summary judgment appears to have been correct.

III. WAS PHELPS BOUND BY THE LIMITATION OF DAMAGES AND THE EXCLUSION OF CONSEQUENTIAL DAMAGES?

A significant issue in *Rheem II* on which the court declined to express an opinion was whether Phelps was bound at all by the limitations and exclusions found in the warranty documents.[53] The language of those documents indicates that they were directed to the buyers, not to an intermediary, such as a distributor or contractor.

The court's reluctance to resolve whether the limitations and exclusions applied to Phelps is understandable. Phelps never raised the issue directly but seemed to argue around it. Phelps had based a major part of its claim on breach of express warranty. However, Phelps did argue that the transactions were not sophisticated and "that the warranties were simply found inside of the furnace box and were not the product of detailed negotiations."[54] The court responded that "Phelps's argument here may prove too much, i.e., that only the ultimate consumer, and not Phelps at all, was to benefit from the warranty,"[55] but that both parties "appear to assume" that Phelps was a beneficiary of the warranty.[56] Moreover, in discussing whether the essential purpose of the limitation to the furnishing of replacement parts and the exclusion of labor costs failed, the court stated very clearly: "The limitation is addressed to the end-user, warning them that they must look to the contractor for repairs: 'All such expenses are your responsibility unless a service labor agreement exists between you and your contractor.'"[57] Thus, the supreme court was aware that the issue, though not clearly delineated, was present in the case.

A reading of each of the warranties as a whole reveals that the entire warranty and its limitations and exclusions were directed toward the end-user-home-owner, not to any intermediate contractor. The length of the warranty period was to begin on the date of original installation and operation, not on the date of purchase by a contractor, and was to last for a period of years thereafter. The lifetime warranty on the "90 plus" series of furnaces ran "to the Original Owner for his or her lifetime . . . provided the furnace is installed and used in the Original Owner's principal residence."[58] And in the event Rheem could not

---

53. *Rheem II*, 746 N.E.2d 941, 947 n.4 (Ind. 2001).
54. *Id.* at 951.
55. *Id.*
56. *Id.*
57. *Id.* at 953. See *supra* note 13 for the language of the warranty.
58. *Rheem II*, 746 N.E.2d at R.117; *see supra* note 13.

furnish a replacement of a defective heat exchanger, it would "allow a credit in the amount of the then current suggested retail selling price of the heat exchanger . . . toward the purchase price of any other RHEEM . . . furnace."[59] It would have made no sense for Rheem to give credit for the retail price to a contractor such as Phelps. The logical allowance would be the wholesale price unless Rheem intended to give the contractor an allowance for loss of profit, a consequential damage for which Rheem had excluded liability. The court of appeals, commenting on Rheem's brief, stated that Rheem characterized the labor cost exclusion as being between itself and the home owner.[60]

Nor can it be claimed that Phelps was an intended beneficiary of the Rheem warranty. In most "pass-through" warranties,[61] the manufacturer states that the product is warranted for a specific time, that repairs of defects will be made at no cost to the buyer, and that the buyer should take the product to or call an authorized service facility for repairs.[62] In such situations, there is either an agreement between the manufacturer and the service facility for reimbursement to the latter of its costs of repair or the service facility can be considered an intended third-party beneficiary of the warranty agreement. The Rheem warranty made clear that Rheem did not intend to pay any costs of repair or to incur any obligation beyond furnishing the replacement parts to the ultimate buyer for installation at her own costs by her contractor.[63]

As noted earlier, the court emphasized agreements between two sophisticated business entities and an apportioning of the risk. In view of the language of Rheem's express warranties, one wonders whether there was ever any negotiation or discussion of risk apportionment. In its discussion of the limitation of remedy, the court did note a possible usage of trade[64] in the gas furnace industry,[65] but the issue of the details of that usage and its applicability to the case at hand is one usually left to the fact finder, not an issue decided by an appellate court.

---

59. *Id.*

60. *Rheem I*, 714 N.E.2d 1218, 1220 (Ind. Ct. App. 1999).

61. A "pass-through" warranty is "an express warranty packaged with the goods." Gary L. Monserud, *Blending the Law of Sales with the Common Law of Third Party Beneficiaries*, 39 DUQ. L. REV. 111, 142 (2000); *see* Harry M. Flechtner, *Enforcing Manufacturers' Warranties, "Pass Through" Warranties, and the Like: Can the Buyer Get a Refund?*, 50 RUTGERS L. REV. 397 (1998).

62. *See* Flechtner, *supra* note 61, at 398. The most frequent and difficult question that arises in connection with pass-through warranty litigation is whether the ultimate purchaser can revoke her acceptance and obtain a refund from the manufacturer whose warranty was passed through but with whom she in not in privity. *See id.*

63. *Rheem I*, 714 N.E.2d at 1220.

64. "A usage of trade is any practice or method of dealing having such regularity of observance . . . as to justify an expectation that it will be observed with respect to the transaction in question. The existence and scope of such a usage are to be proved as facts . . . ." U.C.C. § 1-205(2) (1999).

65. *Rheem II*, 746 N.E.2d 941, 953-54 (Ind. 2001).

IV. THE FAILURE OF ESSENTIAL PURPOSE

A further problem arises from several observations by the court early in part one of its opinion regarding the issue of the independence of section 2-719(3). The court stated that both Rheem and Phelps "appear[ed] to accept that the remedy provided by Rheem failed of its essential purpose"[66] under section 2-719(2);[67] that the trial court did not certify "the question of whether the [limited] remedy actually failed of its essential purpose and Rheem concedes that this issue 'is not in debate'";[68] and that both parties assumed "that the warranty and its remedy limitations are applicable,"[69]—all issues on which the court declined to express an opinion.[70] Nevertheless, in part two of its opinion, the court specifically ruled that the remedy limitation—covering replacement parts but excluding the cost of installation of those parts did not fail of its essential purpose and, therefore, Phelps was not entitled to its repair costs.[71]

Having found that the exclusion of consequential damages precluded Phelps from recovering its lost profits from canceled contracts,[72] the court turned to the question of whether Phelps was entitled to any other damages. Since section 2-719(3) relates only to exclusion of consequential damages, whether Phelps was entitled to any other damages depended on whether the limitation of remedies solely to Rheem's furnishing of replacements of defective parts failed of its essential purpose pursuant to section 2-719(2).[73] The drafters defined such a failure as occurring "where an apparently fair and reasonable clause because of circumstances fails in its purpose or operates to deprive either party of the substantial value of the bargain . . . ."[74] Notwithstanding the court's observations that the trial court had not certified the question of whether the remedy actually failed of its essential purpose, that Rheem conceded that the issue was not in debate,[75] and that a jury may determine "[w]hether a limited remedy failed of its essential purpose,"[76] the court proceeded to decide that the limited remedy and labor cost exclusion did not fail of its essential purpose.[77]

The court followed the analysis used in *Martin Rispens & Son v. Hall Farms, Inc.*,[78] stating

> that the method used to decide whether a particular limitation fails of its

---

66. *Id.* at 946.
67. *Id.*
68. *Id.* at 947 n.4.
69. *Id.*
70. *Id.*
71. *See id.* at 954-55.
72. *See id.* at 952.
73. *Id.* at 947.
74. U.C.C. § 2-719 cmt. 1 (1999).
75. *Rheem II*, 746 N.E.2d at 947 n.4.
76. *Id.* at 948.
77. *Id.* at 954-55.
78. 621 N.E.2d 1078 (Ind. 1993).

> essential purpose is to identify the purpose underlying the provision and determine whether application of the remedy in the particular circumstances will further that purpose. If not, and only then, is there a failure of essential purpose.[79]

However, the *Rheem* court's application of Professor Eddy's analysis is incomplete. At the conclusion of his article, Professor Eddy suggests a three-step analysis:

> The first, the most important, and the most ignored step is to examine carefully the context of a particular transaction and to seek from an understanding of the transaction some further understanding of what purpose a given type of limited remedy might serve in it. The second step is to determine whether application of the limited remedy to the particular situation before the court furthers that essential purpose. If the remedy's purpose may no longer be furthered by its application, it remains for the court thoughtfully to fashion, from the Code's generally available remedies, relief that will most closely reproduce the contours of the parties' original bargain. Finally, even if the remedy's essential purpose calls for application, a third step is required: scrutiny of the remedy clause under the Code's unconscionability provision.[80]

These issues are fact sensitive and should be determined by a trial court, not on appeal. Moreover, "[l]imitations of remedy are not favored in Indiana and are strictly construed against the seller on the basis of public policy."[81]

Martin Rispens involved a single sale of diseased watermelon seeds. The court limited the buyer's remedy to return of the purchase price and excluded any incidental or consequential damages.[82] The court rejected the buyer's argument that the presence of the disease "was a novel circumstance not contemplated by the parties"[83] and stated that the parties could have allocated the risk of disease as part of their bargain.[84] Later, however, the *Martin Rispens* court stated:

> Left unanswered, however, is whether the parties in fact agreed to redistribute the risk of a latent defect in the seed. The question is whether there was mutual assent to the limitation of liability contained on the . . . can [of seeds] and the . . . purchase order. Contract formation requires mutual assent on all essential contract terms . . . . Assent to a limitation of liability may be assumed where a knowledgeable party enters into the contract, aware of the limitation and its legal effect

---

79. *Rheem II*, 746 N.E.2d at 954 (quoting *Martin Rispens*, 621 N.E.2d at 1085-86 (citing Jonathan A. Eddy, *On the "Essential" Purposes of Limited Remedies: The Metaphysics of UCC Section 2-719(2)*, 65 CAL. L. REV. 28, 36-40 (1977))).

80. Eddy, *supra* note 79.

81. *Martin Rispens*, 621 N.E.2d at 1085.

82. *Id.* at 1086.

83. *Id.*

84. *Id.*

> without indicating non-acquiescence to those terms. However, the intention of the parties to include a particular term in a contract is usually a factual question determined from all of the circumstances.[85]

Accordingly, the court remanded for further proceedings on Rispens' warranty claims.[86]

Whether Phelps ever agreed to the warranty and its limitations has already been discussed.[87] Even if Phelps had agreed, the court all but ignored the contention that neither party ever contemplated that Rheem would be unable to produce defect-free furnaces for four years.[88] The court noted that Phelps either gave its own warranties to its customers or sold them extended warranties.[89] The court concluded that this practice assured Rheem that "it would not be obligated to make repairs,"[90] and that "[i]t was reasonable for Rheem to expect Phelps to use . . . [its own manpower and facilities] to go into local homes and offices to fix the furnaces,"[91] thus apparently allocating the risk of labor expenses.[92] However, the court's conclusion does not follow from its statement. Manufacturers frequently do not make repairs themselves but rely on others, whether independent contractors or franchisees, to make repairs to defective goods on their behalf.

The interesting feature of Rheem's warranty is that Rheem's only promise was to furnish replacement parts, and nothing more. It is as if Rheem was saying to the buyer, "Here are the parts; you fix it." However, as noted by Professor Eddy, "the typical limited repair warranty embodies an exclusive remedy of repair or replacement and an exclusion of consequential damages."[93] Section 2-719(1)(a) approves of "limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of non-conforming goods or parts."[94] The official comments note that "it is of the very essence of a sales contract that at least minimum adequate remedies be available"[95] and that there

---

85. *Id.* at 1087 (citations omitted).

86. *Id.* at 1091.

87. *See supra* Part II.

88. An interesting question is why Phelps continued to purchase Rheem furnaces during the entire four-year period. After a year, Phelps was certainly aware of Rheem's position as to remedies. Perhaps Phelps continued the purchases because of continued assurances from Rheem that the problems had been solved, thereby creating additional warranties. This is a factual issue for resolution at trial. Another question is whether, by reimbursing the costs of contractors installing and then repairing the defective furnaces, Rheem had actually waived the limitation of remedy. *See* discussion accompanying *infra* notes 99-101.

89. *Rheem II*, 746 N.E.2d 941, 954 (Ind. 2001).

90. *Id.*

91. *Id.* at 955.

92. *Id.* at 954.

93. Eddy, *supra* note 79, at 61.

94. U.C.C. § 2-719(a) (1999).

95. *Id.* § 2-719 cmt. 1.

must be "at least a fair quantum of remedy for breach."[96] Again, in the Phelps context, these appear to be issues of fact for a fact finder.

The *Rheem* court looked at the purpose of the limited remedy, decided that its purpose was to insulate Rheem from the costs of repairs, and concluded that the limitation served its essential purpose.[97] If the essential purpose of a limited remedy were only to insulate the warrantor from exposure to damages, no limited remedy would ever fail of its essential purpose. However, the limited remedy must also leave the buyer with a minimum adequate remedy, one that will give the buyer what was bargained for, namely, goods that are defect free and perform as they are supposed to perform.[98]

A further question not addressed by the court, and perhaps not ripe for discussion because of the procedural posture of the case, is whether Rheem waived the limitation of remedy when it engaged in its "furnace update program," which included the cost to contractors of making repairs to the defective furnaces. This conduct could have been a course of dealing that would have furnished a basis for interpreting the contracts pursuant to which Phelps purchased the furnaces[99] or to a course of performance that would have amounted to a waiver or modification of the labor exclusion.[100] "[W]hether there has been a waiver of a contract provision is ordinarily a question of fact."[101] However, by reversing the denial of summary judgment, the court foreclosed any discussion of this issue.

V. THE RIGHT TO DIRECT DAMAGES OR INDEMNITY

A further interesting point is that the court's statement that even if the limited remedy did fail of its essential purpose, Phelps would not be entitled to the costs incurred in repairing the defective furnaces.[102] The court observed that the cost of repair is the common measure of damages for breach of warranty[103] but concluded, without any citation of authority in support, that because Phelps was no longer in possession of the goods, this measure of damages would be inapplicable.[104] Instead, the court concluded that Phelps may have a cause of

---

96. *Id.*

97. *Rheem II*, 746 N.E.2d 941, 954-55 (Ind. 2001).

98. *See* U.C.C. § 2-719 cmt. 1 (1999).

99. *Id.* § 1-205.

100. *See id.* §§ 2-208, 2-209. "Subject to the provisions of the next section on modification and waiver, such course of performance shall be relevant to show a waiver or modification of any term inconsistent with such course of performance." *Id.* § 2-208(3).

101. Harrison v. Thomas, 761 N.E.2d 816, 820 (Ind. 2002).

102. *Rheem II*, 746 N.E.2d 941, 955 (Ind. 2001).

103. *Id.* "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 warrant damages of a different amount." U.C.C. § 2-714(2) (1999).

104. *Rheem II*, 746 N.E.2d at 956.

action against Rheem sounding in indemnity or subrogation.[105]

"'A right of indemnity exists where a party is compelled to pay damages that rightfully should have been paid by another party.'"[106] In determining whether Phelps has any claim for indemnity, the trial court would have to determine whether the home owners who purchased Rheem furnaces for installation by Phelps had any claims for damages against Rheem which were satisfied by Phelps. In order for the ultimate buyers to have any such claims, the trial court will have to find that the limitations and exclusions that the supreme court held to be effective against Phelps were not effective against the ultimate buyers. This would require a ruling that with respect to the ultimate buyers, the limited remedy and labor cost exclusion failed their essential purpose; otherwise, there would be no damages that rightfully should have been paid by Rheem. Since the indemnification issue was not before the court, there is no hint in the opinion whether these limitations and exclusions could be valid against one party, as the court found with respect to Phelps, and invalid against the ultimate consumer-buyer.[107]

The court also stated that Phelps may have a claim for breach of implied warranty.[108] It is unclear whether the court meant that Phelps may have such a claim against Rheem or against Federated, the distributor from which Phelps purchased the furnaces. If the court meant that Phelps may still have such a claim against Rheem, the fact there may have been implied warranties that Rheem breached will be of little comfort to Phelps in view of the court's construction and application of the limitation of remedies and exclusions of damages. The limitations and exclusions found in the printed Rheem warranties were expressly intended to apply equally to those express warranties and to the implied warranties of merchantability and of fitness for particular purpose.[109] Section 2-719 is intended to permit sellers to limit their liability for damages that flow from warranties that they have made, whether express or implied.[110]

VI. COVENANTS NOT TO COMPETE

During the survey period, the Indiana Court of Appeals decided two cases that dealt with covenants not to compete. The first, *Kladis v. Nick's Patio, Inc.*,[111] arose out of an agreement for the sale of a business. The second, *Burk v. Heritage Food Service Equipment, Inc.*,[112] arose out of contracts of employment. Although neither case breaks new ground in the law of Indiana, they are of

---

105. *Id.*

106. *Id.* (*referring to* Black v. Don Schmid Motor, Inc., 657 P.2d 517, 529 (Kan. 1983), quoting 41 AM. JUR. 2D Indemnity § 20 (1995)).

107. *See supra* notes 45-46 and accompanying text.

108. *Rheem II*, 746 N.E.2d at 944.

109. *See supra* Part III.

110. *See* WHITE & SUMMERS, *supra* note 29, § 12-9.

111. 735 N.E.2d 1216 (Ind. Ct. App. 2000).

112. 737 N.E.2d 803 (Ind. Ct. App. 2000).

interest because of the clarity with which they explain the applicable law.

A. The Scope of Noncompetition Agreements in Contracts for the Sale of a Business

In *Kladis,* Kladis, a restauranteur, sold his restaurant business to Samoilis and Radokis. In order to preserve the goodwill built up by Kladis over the years, the agreement of sale provided that Kladis would not engage as an employee, agent, or owner of any competing restaurant business located within a radius of five miles of his former restaurant.[113] Subsequently, Samoilis bought out Radokis' interest, but Radokis did not sign a noncompetition agreement. Thereafter, Radokis opened a competing restaurant within the five mile radius and hired Kladis to do roofing work and landscaping.[114]

Samoilis filed an action against both Kladis and Radokis seeking preliminary and permanent injunctions, damages, and a declaratory judgment with respect to Kladis' noncompetition agreement.[115] The trial court found that Kladis had assisted Radokis in opening the competing restaurant by performing landscaping services and roofing work, directing a laborer with respect to work being done inside the building, and meeting with Radokis on the premises, thereby threatening harm to Samoilis in violation of the noncompetition agreement.[116] The trial court entered a preliminary injunction against both Kladis and Radokis, from which Kladis and Radokis filed an interlocutory appeal.[117]

The court of appeals reversed and remanded for trial.[118] At the outset of its discussion of the merits, the court reiterated the essential difference between covenants not to compete in employment agreements and agreements for the sale of a business. Although both restrain trade to some degree, the former "are not favored in the law . . . [and] are strictly construed against the employer,"[119] in part because of unequal bargaining power between employer and employee.[120] Noncompetition provisions in the latter agreements, however, are not as "ill-favored"[121] because of more equal bargaining power between the parties and the

---

113. *Kladis,* 735 N.E.2d at 1218.

114. *Id.*

115. *Id.* The named plaintiff was the corporation owned by Samoilis; however, for purposes of simplicity, the plaintiff is referred to as Samoilis.

116. *Id.* at 1218-19.

117. *Id.* at 1219.

118. *Id.* at 1221. It should be noted that Samoilis failed to file a brief for the appellee. Although the court of appeals was not required to develop appellee's argument, and could have reversed if it had found that the appellants made a *prima facie* showing of trial court error, it used its discretion to consider the merits of the case. *Id.* at 1219.

119. *Id.* at 1220 (citations omitted).

120. *See id.* For further discussion of employment of non-compete agreements, see *infra* Part VI.B.

121. *Kladis,* 735 N.E.2d at 1220 (quoting Fogle v. Shah, 539 N.E.2d 500, 502 (Ind. Ct. App. 1989)).

business buyer's legitimate desire to preserve the goodwill of the business for which he paid by preventing the seller from competing for the same (and the latter's former) customers.[122]

Kladis agreed that Samoilis had a protectible interest in the goodwill of the restaurant.[123] However, the factual issue was, in the court's words, whether Kladis had "reentered the market to compete for the same customers."[124] The court concluded that the activities in which the trial court found Kladis had engaged, without more, did not demonstrate that Kladis had reentered the restaurant business to compete for his former customers and, therefore, did not come within the prohibition of the noncompetition agreement.[125]

With respect to Radokis, the court stated that under Indiana law, "one not a party to a noncompetition agreement may be enjoined from assisting a party to such an agreement from breaching" that agreement.[126] Since Samoilis had failed to demonstrate that Kladis had breached the agreement, the preliminary injunction against both Kladis and Radokis could not stand.[127]

B. The "Blue-Pencil" and Noncompetition Agreements in Employment Contracts

In *Burk v. Heritage Food Service Equipment, Inc.*,[128] a former employer (Tri-State) brought an action to enjoin and to recover damages from two former employees (Burk and Rody) and their new employer (Bowman Aviation), for their alleged violation of noncompetition and confidentiality agreements contained in the employees' contracts of employment with Tri-State.[129] At the very outset of its opinion, the court described its task as being "to revisit the complexities of restrictive covenants in employment agreements."[130]

As conditions of their respective employments at Tri-State, both Burk and Rody signed identical noncompetition and confidentiality agreements.[131] In the noncompetition agreements, the employees agreed, in essence, that for a period

---

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.* at 1221.

126. *Id.*

127. *Id.*

128. 737 N.E.2d 803 (Ind. Ct. App. 2000). The plaintiff-former employer did business as Tri-State Business Services and is referred to throughout the court's opinion as "Tri-State." In order to avoid confusion for readers of the opinion, this discussion will also refer to plaintiff as "Tri-State."

129. *Id.* at 810. Tri-State also sought damages for tortious interference with a contractual relationship, and defendants-former employees counterclaimed for violation of the Indiana Blacklisting Statute, IND. CODE § 22-5-3-2 (1998). *Id.* at 816-19. Neither of these issues is discussed here.

130. *Burk*, 737 N.E.2d at 807-08.

131. *Id.* at 808-09.

of two years following the termination of employment for whatever reason, he or she would not work for any competitor of Tri-State, would not solicit or acquire any current or past customers of Tri-State, and would not disclose, copy, or use any of Tri-State's marketing plans, ideas, product research or other trade secrets.[132] In the confidentiality agreement, the employee agreed that all information, training procedures and customer information was of a proprietary nature and that he or she would keep all such information confidential.[133]

Tri-State was in the electronic data storage business. Burk had worked for Tri-State as a clerical employee. Her duties included feeding documents into a computer scanner, but "she did not have access to or knowledge of Tri-State's customer pricing information."[134] She left Tri-State and became the office manager of its competitor, Bowman, where her duties varied considerably from those at Tri-State.[135] The trial court did not enter an injunction against Burk; her appeal was based on issues not pertinent to the present discussion.[136]

Rody, as a salesman for Tri-State, had "significant contact with Tri-State's past, current, and prospective customers," had access to customer lists, and was trained in Tri-State's marketing procedures.[137] Following his termination, he was hired by Bowman as its national sales manager and was ultimately charged with developing and selling Bowman's new electronic record storage services that

---

132. *Id.* The pertinent parts of the employment agreement were as follows:

> 2. Covenants Against Unfair Competition and Disclosure of Confidential Information.
> a) Employee agrees that during the term of employment, and for a period of two (2) years following the termination of Employment for whatever reason by any party thereto, Employee will not, directly or indirectly, do any of the following:
> i) Own, manage, control or participate in the ownership, management or control of, or be employed or engaged by or otherwise affiliated or associated as a consultant, independent contractor or otherwise with any corporation, partnership, proprietorship, firm, association or other business entity which competes with, or otherwise engages in any business of the Corporation . . . ;
> ii) Induce, solicit or acquire any current or past customers of the Corporation in the territory where the Corporation has or is currently conducting business as of the date of the execution of this Agreement for the purpose of engaging or soliciting sales, selling or competing with the Corporation in its business; . . .
> v) Disclose, divulge, discuss, copy or otherwise use or suffer to be used in any manner in competition with, or contrary to the interests of the Corporation, the marketing plans or strategies, inventions, ideas, discoveries, product research or engineering data, if any, or other trade secrets, pertaining to the business of the Corporation . . . .

Id.

133. *Id.* at 809.

134. *Id.*

135. *Id.*

136. *See supra* note 129.

137. *Burk*, 737 N.E.2d at 809.

competed with Tri-State's business. One of Bowman's new customers had been a prospective customer of Tri-State during Rody's prior employment and had become a customer of Tri-State after Rody had left.[138] The trial court enjoined Rody and Bowman from providing data storage services to entities that had been customers during Rody's employment at Tri-State.[139]

In reviewing the decision of the trial court, the court of appeals set forth what may be described as an outline of the law of enforceability of employees' covenants not to compete. Such covenants are in restraint of trade, are not favored in the law, are to be construed most strictly against the employer, and are to be enforced only if reasonable.[140] A finding with respect to reasonableness is to be based on whether the employer has a legitimate, protectible interest, whether the scope of protection is reasonable as to time, geography, and type of activity prohibited, and whether "'the former employee has gained a unique competitive advantage or ability to harm the employer . . . .'"[141] Using a process called "blue-penciling," "if a covenant is clearly divisible into parts, and some parts are reasonable while others are unreasonable, a court may enforce the reasonable, severable parts"[142] by striking the severable, unreasonable parts.[143] However, the court may not redraw unreasonable provisions to make them reasonable under the guise of interpretation or "blue-penciling," "'since this would subject the parties to an agreement they have not made.'"[144]

Applying the foregoing analysis, the court of appeals found that the noncompetition clause in paragraph 2(a)(i) of the employment agreement was overbroad and unenforceable because it prohibited Rody from working for any competitor of Tri-State in any capacity whatever. In an effort to interpret the clause so as to furnish reasonable protection to the former employer, the trial court had impermissibly rewritten the clause by adding a term and narrowing its scope to a restriction of employment in any "'competitive capacity.'"[145]

Turning its attention to the trade-secrets clause in paragraph 2(a)(v) of the employment agreement, the court noted the four general characteristics of a protectible trade secret: "1) information; 2) deriving independent economic value; 3) not generally known, or readily ascertainable by proper means by others who can obtain economic value from its disclosure or use; and 4) the subject of efforts, reasonable under the circumstances to maintain its secrecy."[146] Although the trial court had found that the identities of Tri-State's customers were easily ascertainable from the telephone directory, publicly known, and, therefore, not trade secrets, that court also found that Rody had breached the trade secrets

---

138. *Id.* at 810.
139. *Id.*
140. *Id.* at 811.
141. *Id.* (quoting Silsz v. Munzenreider Corp., 411 N.E.2d 700, 705 (Ind. Ct. App. 1980)).
142. *Id.*
143. *Id.*
144. *Id.* (quoting Smart Corp. v. Grider, 650 N.E.2d 80, 83 (Ind. Ct. App. 1995)).
145. *Id.* at 812.
146. *Id.* at 813.

clause by using the marketing information and sales strategy he had learned while employed at Tri-State.[147] Notwithstanding the apparent conflict between these two findings, the court of appeals ruled that one of them was sufficient to support the trial court's injunction against Rody from using any of Tri-State's marketing information or sales strategy.[148]

Finally, with respect to the nonsolicitation clause in paragraph 2(a)(ii) of the employment agreement, the court of appeals ruled that the trial court had properly "blue-penciled" the clause.[149] As originally written, the clause would have prohibited Rody from soliciting and selling to Tri-State's former or present customers any goods or services even if unrelated to Tri-State's business. The use of the "blue pencil" to delete the phrases "or past" "engaging or soliciting sales," or "selling" which the court of appeals deemed severable, meant that the overbreadth of the clause was eliminated and that Rody and Bowman would be prohibited for fourteen months from competing for the business of entities who had been customers of Tri-State during Rody's employment with Tri-State.[150]

Courts and scholars have hotly debated the use of the "blue pencil" in employment contract cases.[151] The dispute usually revolves around the issue of whether employers will draft overbroad restrictions to act *in terrorem* in order to discourage litigation by former employees without true regard for the protectible interest of the employer.[152] Some states have refused to follow the "blue pencil" rule even in cases of clear severability or the presence of severability clauses.[153] However, it has also been acknowledged that it is difficult for employers to draft individually appropriate noncompetition agreements for each employee based on his or her duties at the time of employment, or as those duties change thereafter.[154] It has been suggested, therefore, that if the interest of the employer merits protection and the employer appears to have acted fairly, the covenant should be "tailored" to give reasonable protection to the employer with minimum inconvenience to the employee.[155] However, this approach will likely act even more *in terrorem* than the "blue pencil" approach because employers will draft the broadest restrictions with the knowledge that the court will modify the contract if necessary.[156]

Without engaging in a lengthy analysis of the law of noncompetition

---

147. *Id.* at 813-14.

148. *Id.* at 814.

149. *Id.* at 814-15.

150. *Id.* at 815-16.

151. Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 681-82 (1960).

152. *Id.*

153. *See, e.g.*, Gary P. Kohn, Comment: *A Fresh Look: Lowering the Mortality Rate of Covenants Not to Compete Ancillary to Employment Contracts and to Sale of Business Contracts in Georgia*, 31 EMORY L.J. 635, 693 (1982).

154. *See* Blake, *supra* note 151, at 683.

155. *See id.*; *see also* Kohn, *supra* note 153, 694-98.

156. *See* E. ALLEN FARNSWORTH, CONTRACTS § 5.8, at 357 (3d ed. 1999).

provisions in employment agreements,[157] it appears that Indiana has followed a reasonable approach. The heavy burden remains on the employer to demonstrate that it has a protectible interest and that the former employee has threatened to violate that interest. If the employer has overreached by requiring an agreement more broadly drafted than necessary to protect its interest, the court should not rewrite that agreement. "Blue penciling" should be limited to clearly severable provisions, and the burden will also be on the employer to demonstrate that severability will not do violence to both its interest and the understanding of the parties.

157. For a more complete discussion of covenants not to compete in Indiana, see John W. Bowers et al., *Covenants Not to Compete: Their Use and Enforcement in Indiana*, 31 VAL. U. L. REV. 65 (1996).