IN THE COURT OF APPEALS

STATE OF ARIZONA

DIVISION ONE

THREE PHOENIX COMPANY, Plaintiff-Appellant, vs. PACE INDUSTRIES, INC., Defendant-Appellee.	No. 1 CA-CIV 4773 MARICOPA County Superior Court No. C-374993

APPELLEE'S ANSWERING BRIEF

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APPELLEE'S ANSWERING BRIEF

STATEMENT OF FACTS

The Statement of Facts contained in Plaintiff-Appellant's Opening Brief is essentially a paraphrase of the "Facts" section of Plaintiff's Response to Motion to Dismiss (Item No. 23 of the Record). The affidavit of one Donald E. Oglesby to the effect that he had read that statement of facts and that the same was true "of his personal knowledge" was attached to that Response. The Opening Brief departs from this statement of the facts in one significant respect, however, and Defendant takes sharp exception to this departure.

The one significant deviation from the "Facts" portion of the Response in the Opening Brief's Statement of Facts is the paragraph which appears at the bottom of page 9 and top of page 10 of the Brief. The corresponding

paragraph in Plaintiff's Response to Motion to Dismiss appears on page 6 of Item 23 of the Record. The paragraph in the Brief states that an oral agreement (presumably, one containing anti-competitive covenants which were -- again, presumably -- identical with the anti-competitive covenants contained in the written Wabash-Pace Agreement of October 11, 1973) was made prior to June 6, 1973, while the corresponding passage in the Response makes no such assertion.

The affidavit of one Louis R. Adams, attached to the aforementioned Response to Motion to Dismiss, is cited as the evidentiary support for this proposition. In fact, the Adams affidavit lends no support whatever to the allegation that such an oral agreement existed. It is not in the affidavit or in the verified "Facts" section of the Response that any suggestion of the existence of an oral covenant not to compete prior to the October, 1973, Wabash-Pace contract is to be found; in the trial court, the previous-oral-agreement theory was supported only by the arguments of Plaintiff's counsel. Specifically, on page 16 of the Response to Motion to Dismiss, Plaintiff's counsel suggested that the restrictive covenant which was the subject matter of

an assignment from Wabash to Three Phoenix "was indeed in existence on June 6, 1973; it simply was not embodied in a written agreement." Except for this statement of counsel, no allegation or evidence of the existence, prior to June 6, 1973, of an oral agreement between Wabash and Pace incorporating anti-competitive covenants was advanced by Plaintiff in the trial court.

ISSUES PRESENTED

1. Under 15 U.S.C. § 1 and A.R.S. § 44-1402, may the seller of an Arizona manufacturing business vending electronic products on a world-wide basis and two buyers of different parts of that business legally agree that the buyers will not compete in the lines of business respectively acquired, thus in effect dividing the market for such products between the two buyers?

2. Where the seller of business property, as part of the contract of sale, requires that the buyer promise not to compete with a third party who is a

stranger to the contract because the third party makes seller's obtaining such a promise a condition to further dealing with the seller, is the covenant not to compete "ancillary" to the transaction between seller and buyer-covenantor within the meaning of the rule that an anti-competitive covenant which is ancillary to a contract for the transfer of property may be enforced?

3. May a covenant not to compete which is silent as to any limitation of time and space be enforced?

4. Where a plaintiff elects to stand on a complaint which clearly alleges that defendant is obligated by, and stakes plaintiff's claim for relief upon, a certain written contract, may plaintiff, over defendant's objection, attempt to show defendant to be bound, not by the contract alleged in the complaint, but by a different oral agreement purportedly made several months previously?

5. Where the complaint on which plaintiff elects to stand alleges that a certain written contract constitutes an assignment to plaintiff of the benefit of certain promises contained in a second written contract, and clearly bases plaintiff's claim for relief upon the premise that the former contract constitutes a legal

assignment to plaintiff of rights arising under the latter, and the trial court finds that the former contract cannot have been effective as an assignment of rights arising under the latter because the latter contract was not yet in existence, may the plaintiff, on appeal from a summary judgment in defendant's favor, raise for the first time the theory of "equitable assignment"?

ARGUMENT

I. THE RESTRICTIVE COVENANTS UPON WHICH PLAINTIFF RELIES ARE PART OF A PATENTLY ILLEGAL SCHEME TO EFFECT A HORIZONTAL MARKET DIVISION.

A. Plaintiff's Own Affidavits Show That The Agreements And Covenants Here Sued Upon Are Part Of A Single Plan To Divide The Business of Wabash Computer Corporation Into Discrete Product Lines Upon Wabash's Withdrawal From The Computer Peripherals Business And To Allocate These Lines Between Plaintiff And Defendant On A Mutually Exclusive Basis.

Wabash Computer Corporation ("Wabash"), a wholly-owned subsidiary of Wabash Magnetics, Inc., was from 1967 until the middle of 1973 engaged in the business of designing, developing, manufacturing and selling electronic computer equipment. Among other things, it dealt in equipment designed and used to test (or "certify") magnetic discs used in computer systems as media for the store of information ("memory"). For the purpose of this litigation, there are two principal types of disc testing

equipment: single disc testers, which test a single disc at a time, usually at an earlier stage in the manufacturing process; and pack testers, which test several discs simultaneously after they have been assembled in a "pack," usually at a later stage in the process. The pack tester to some extent verifies the single disc testing, if it has been performed at an earlier stage, and also provides a more refined test for the finished product.

Both single disc and pack testers were manufactured and sold (to a world-wide market) by Wabash's Equipment Division, located in Phoenix. Until approximately mid-1973, Donald E. Oglesby, an incorporator and now the president of the plaintiff corporation, was the General Manager of the Equipment Division and Edward McDonald, an incorporator and now president of the defendant corporation, was the Manager of the Engineering Group of the Equipment Division.

During late 1972 or early 1973, Wabash decided to get out of the computer equipment business almost entirely. Wabash began to look about for means of disposing of its various business assets, and McDonald and Oglesby were among the prospective purchasers who expressed an interest in various aspects of the Wabash operation. Negotiations ensued, in which it was eventually proposed

that McDonald or the group or entity to be formed by him acquire the assets related to the Equipment Division's pack tester business while Oglesby or the entity or group to be formed by him acquired the balance of the Division's assets. In connection with these negotiations, Oglesby wanted assurances that the disc tester business he was to acquire would be a "viable" one. He was especially concerned that he not be faced with competition in the single disc tester business from McDonald if McDonald acquired the pack tester business. Accordingly, Oglesby insisted that McDonald or the group or entity formed by him to acquire the pack tester assets be required not to compete in the single disc tester business.

Contracts of sale were eventually arrived at between Wabash and Plaintiff (the corporation formed by Oglesby) and between Wabash and Defendant (the corporation formed by McDonald). The Wabash-Three Phoenix contract was negotiated by Oglesby on behalf of Three Phoenix and one William F. Boyd on behalf of Wabash. The Wabash-Pace contract was negotiated by McDonald on behalf of Pace and by Oglesby and one George E. Dashiell on behalf of Wabash. In formulating the Wabash-Pace agreement, Wabash gave great weight to the desires of Three Phoenix, to the

extent that Oglesby held virtual veto power over Wabash's transfer of pack tester assets to Pace. The two contracts were concurrently negotiated as, and at all times considered a part of, one plan for the disposition of the Equipment Division.

The Wabash-Pace part of this over-all plan consists of a written contract executed by Wabash and Pace on October 11, 1973, parts of which are reproduced in the Appendix to Appellant's Opening Brief. It will be noted that paragraph 9 is a single sentence which contains two principal clauses: the first restricting Pace's right to sell equipment which would perform the same operations as the Pack Scan III ("[Pace] shall not" through "competition therewith"); the second restricting Pace's right to sell other products which Wabash had designed, manufactured or sold ("nor shall [Pace]" through the end of the paragraph). Plaintiff claims that, as part of the "one plan for the disposition of the Equipment Division," Wabash assigned to Plaintiff the benefit of the restrictive covenants contained in paragraph 9 of the Wabash-Pace Agreement. For convenience, these clauses are hereinafter referred to as subparagraphs

9(a) and 9(b) of the Wabash-Pace agreement, respectively. Paragraph 10 expressly provides that Pace "shall not in any way compete with Three Phoenix in [certain] product lines and shall not engage in any business activity with respect to them."

All of the foregoing facts clearly emerge from Plaintiff's verified Complaint or from the verified "Facts" section of its Response to Motion to Dismiss.

B. The Plan Revealed By Plaintiff's Affidavits Clearly Amounts To A Scheme To Effect A Horizontal Division Of The Computer Disc Testing Equipment Market And Thus Constitutes A Per Se Violation Of Applicable Antitrust Laws.

The verified portion of the Response to Motion to Dismiss filed by Plaintiff in the court below describes a "new concept" developed at Wabash at about the time of its decision to withdraw from the computer equipment field. Plaintiff, in fact, summarizes the arrangement which was to define the bounds of competition (or rather, non-competition) between the remaining parties to the arrangement after Wabash's withdrawal

from the field in terms of a division of this "new concept" or "technology": "It seemed, and was, reasonable to divide this technology between Wabash's successors: the pack tester application to the Defendant; the single disc [tester] application to the Plaintiff." This is a very revealing description of the arrangements, though reflection will indicate a slight imprecision in the language used. It obviously was not the technology or "concept" which was divided, but rather the types of products to which the concept might be applied which were contractually parceled out between the successor entities. It should also be noted that the restrictive covenants imposed upon Defendant by the Wabash-Pace contract do not take the form of restrictions upon Defendant's use of any particular property, but of absolute bans prohibiting Defendant from competing with Plaintiff or with Wabash in designated product lines.

Summarizing the sharing-out of Wabash's business as disclosed by Plaintiff's own evidentiary material, then, it will be seen: that Plaintiff's organizer, Oglesby, was a dominant figure in Wabash's negotiations to sell its business assets to Plaintiff and to Defendant, that Oglesby, seeking to improve the

economic "viability" (meaning, presumably, the profitability) of the single disc tester business to be acquired by his organization, successfully insisted that the Wabash-Pace contract contain two provisions restricting Defendant's right to enter the single disc tester market, and that Oglesby's corporation was the intended final beneficiary of both of these restrictive covenants.

Now, if Oglesby had sought to insure the viability of his enterprise by obtaining Defendant's exclusion from a market defined geographically, rather than by product type, there could not be a moment's doubt of the illegality of such a scheme. *United States v. Topco Associates, Inc.,* 405 U.S. 596, 607-08 (1972). The arrangement now before the Court is clearly a horizontal restraint between competitors or prospective competitors at the same level of the market structure to allocate portions of the computer disc certification equipment market. However, the fact that Plaintiff seeks to maintain the division of that market between Defendant and itself by product type rather than by geographical territory is no ground for exempting this egregious horizontal restraint from the rigorous per se rule so unmistakably reaffirmed in *Topco.*

It is well established that schemes to apportion market shares between prospective competitors are equally offensive to the policy of the law regardless of the precise manner in which such division is attempted:

> [F]orms of market division can vary to an almost capricious degree. Collision with competitors can be avoided by agreements which parcel out exclusive territories, exclusive customers, or exclusive products, but all of this has long been assimilated and the law has displayed no tendency to draw overly fine distinctions between such alternative ways of dividing markets. Nor do variations between open agreements and hidden ones such as the "phases of the moon" conspiracy in the electrical industry, complicate the problem. Whether we call such devices imaginative or crude, once they have been found out they do nothing to drape over the fact that firms which might have given each other the competitive nudge have instead agreed to permit each other an abundant elbow room. L. SULLIVAN, HANDBOOK OF THE LAW OF ANTI-TRUST 213 (1977).

The courts have consistently applied the rule banning horizontal market divisions as per se violations of section 1 of the Sherman Act, 15 U.S.C. § 1 (1970), to schemes intended to partition markets by customer or

product type, as well as by territory. Citizen *Publishing Co. v. United States,* 394 U.S. 131, 135-36 (1969), (Corporations publishing morning and evening newspapers in Tucson agreed not to compete or to engage in other publishing in Pima County; *held* "the agreement was a division of fields ... banned by the [Sherman] Act.");

Las Vegas Merchant Plumbers' Ass'n. v. United States, 210 F.2d 732, 741 (9th Cir. 1954), *cert. denied* 348 U.S. 17, *reh. denied* 348 U.S. 889, (agreement to divide market for plumbing services on job-by-job basis through "allocation committee" *held* per se violation); *United States v. Grinnell,* 236 F.Supp. 244, 256 (D. R.I. 1964), *aff'd in part and rev'd in part on other grounds,* 384 U.S. 563, (allocation of market by "classes of customers" per se violation) (dictum); *United States v. Consolidated Laundries Corp.,* 291 F.2d 563, 574-75 (2d Cir. 1961), (allocation to each party of the business of its recognized "old customers" *held* per se violation); *Baldwin-Lima-Hamilton Corporation v. Tatnall Measuring Sys. Co.,* 169 F.Supp. 1, 28-29 (E.D. Penn. 1958), (market allocation by "field of use" restraints *held* per se violation);

Johnson v. Joseph Schlitz Brewing Co., 33 F. Supp . 176, 181 (E.D. Tenn. 1940), (division of market by allocation

of customers *held* per se violation).

As another commentator has said,

> [v]ery similar to agreements to divide territories from soliciting or selling in certain areas are agreements not to sell to specified customers. The effect is the same; in both cases competitors are agreeing to divide the available business. ... Illegal arrangements may also result from an agreement with a potential competitor not to sell a particular product or product line to specified customers. All these types of arrangements constitute per se violations of the Sherman Act. ANTI-TRUST ADVISOR (C. Hills, 2d ed. 1978).

Hence, it is clear that the plan for dividing the computer disc certification equipment market between Plaintiff and Defendant revealed by Plaintiff's affidavits -- that of allocating the manufacture and sale of pack tester devices to Defendant and single disc testing products to Plaintiffs -- constitutes a per se violation of section 1 of the Sherman Act. Plaintiff's own affidavits also point out the international scope of the computer disc testing equipment businesses conducted by Wabash, Plaintiff and Defendant, so that there can be no doubt regarding the jurisdictional predicate for

application of federal antitrust law. Even if the federal statute were not applicable, the corresponding Arizona statute, A.R.S. § 44-1402, which outlaws any contract in restraint of trade of commerce "any part of which is within this state," clearly would be. Under A.R.S. § 44-1412, this statute is to be construed analogously to the Sherman Act.

(Even though the contract in question was made prior to the effective date of A.R.S. § 44-1401 *et seq.,* the enactment of those statutes compelled the discontinuance of practices made illegal by it and foreclosed the enforcement of pre-existing contracts illegal by its terms. This was the view taken by the United States Supreme Court of the retroactive effect of the Sherman Act, and it would be applicable to A.R.S. § 44-1402 by virtue of the uniformity provision of A.R.S. 44-1412. *See United States v. So. Pac. Co.,* 259 U.S. 214, 234-35 (1922); *Addyston Pipe & Steel Co. v. United* States, 175 U.S. 211, 228 (1899); *United States v. Trans-Missouri Freight Ass'n,* 166 U.S. 290, 342 (1897).)

It would, of course, avail Plaintiff nothing to point out that Plaintiff and Defendant are not actual but merely potential competitors and that the effect of

the covenants which it seeks to enforce have not been to eliminate Defendant as a competing supplier of single disc testing equipment but rather to foreclose Defendant from entering that field. An agreement which forecloses competitors from a substantial market is a per se violation, since section 1 of the Sherman Act is broken as well by the prevention as by the destruction of competition. *Pennsylvania Water & Power Co. v. Consolidated Gas, Electric Light & Power Co.,* 184 *F.* 2d 552, 558 (4th Cir. 1950), *cert. denied* 340 U.S. 906. *Cf. International Salt Co. v. United States,* 333 U.S. 392, 396 (1947); *American* Federation *of Tobacco Growers v. Neil,* 183 F.2d 869, 873 (4th Cir. 1950).

Neither can Plaintiff, having revealed -- nay, having boasted -- that its own organizer, in order to protect the "viability" of his enterprise, supervised the Wabash-Pace negotiations with a plenary veto power and procured the imposition of the anti-competitive covenants which Plaintiff now seeks to enforce, and having castigated as an "artificial distinction" Defendant's reference to the Wabash-Pace and Wabash-Three Phoenix contracts as "two separate agreements instead of one agreement between all three parties," be permitted to

retreat to a position of urging enforcement of the Wabash-Pace contract or some part thereof in isolation, or of arguing for a determination of the validity of the restrictive covenants of that contract separate and apart from the "one plan for the disposition of" Wabash's computer equipment business so clearly disclosed by Plaintiff's own statements. Where a horizontal market division is effected through third parties who are not competitors or otherwise by indirection, the antitrust law will penetrate to the true nature and purpose of the arrangement, regardless of the instrumentalities through which an actor or actors at one level of the market structure attempt to control competition at that level. *United States v. General Motors Corp.,* 384 U.S. 127, 139-40, 142-43 (1966); *American Motor Inns, Inc. v. Holiday Inns, Inc.,* 521 F.2d 1230, 1242-43 (3rd Cir. 1975); *Ford Motor Co. v. Webster's Auto Sales. Inc.,* 361 F.2d 874, 878 (5th Cir. 1966).

C. The Rule That The Enforceability Of An Anti-Competitive Covenant Ancillary To The Sale Of A Business Is Dependent Upon Its Reasonableness Is Not Apposite To The Facts Of This Case.

It is familiar law, and it is shown by a number of cases cited in Appellant's Opening Brief, that a covenant not to compete ancillary to an agreement for the sale of a business or a transfer of business property will, if the restraint imposed is no greater than necessary to afford fair protection to the parties, and if the restraint is partial in nature and reasonably limited in scope, be enforced. The question, therefore, might very legitimately be posed: How is this rule to be reconciled with the *Topco* per se rule discussed above? If the seller of a business or the buyer of business property becomes or remains a prospective competitor of the other party, would not his promise to refrain from competing in a certain area necessarily amount to a horizontal restraint tending to exclude him from a part of, and thus to divide, the market? If the rule permitting reasonable, partial restraints ancillary to the sale of a business constitutes an exception to the *Topco* per se

rule, does that exception apply in this case? Defendant concedes that there is such an exception, but submits that it clearly has no application to the present case.

Of the cases dealing with restrictive covenants ancillary to the sale of a business or of business assets, nearly all involve covenants restraining the seller from competing against the buyer with respect to the business sold. The classic discussion of the rationale for upholding such covenants appears in *United States v. Addyston Pipe s Steel Co.,* 85 F. 271, 280-81 (6th Cir. 1898), by Judge (later Justice) Taft:

> It was of importance, as an incentive to industry and honest dealing in trade, that, after a man had built up a business with an extensive good will, he should be able to sell his business and good will to the best advantage, and he could not do so unless he could bind himself by an enforceable contract not to engage in the same business in such a way as to prevent injury to that which he was about to sell.
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> * * *
>
> Many ... partial restraints on trade are perfectly consistent with public convenience and the general interest, and have been supported. Such is the case of the disposing of a shop in a particular place, with a contract

> on the part of the vendor not to carry on a trade in the same place. It is, in effect, the sale of a good will, and offers an encouragement to trade by allowing a party to dispose of all the fruits of his industry.

The classic covenant not to compete incident to the sale of a business, in which the *seller's* right to compete is restricted in order to effectuate a transfer of the good will associated with the tangible assets sold, is obviously and diametrically opposed to the covenants which Plaintiff seeks to enforce in this case. The former is a necessary incident of the underlying sale transaction, since the seller cannot effectively alienate the intangible property which he has accumulated unless his vendee can have a valid contractual assurance that the seller will not promptly set himself up in opposition to the business which he has just sold; the covenants which Plaintiff seeks to enforce, on the other hand, have no necessary relationship to the Wabash-Pace transaction. They were added at the instance and for the benefit of a stranger to the contract -- a third party who happened to fear Defendant's potential competition and who happened to have sufficient economic power over Wabash and Pace to attempt to prevent such

competition by causing Wabash and Pace to enter into an anti-competitive contract for its benefit.

Disregarding cases involving restrictive covenants contained in employment contracts, the over-whelming majority of cases dealing with covenants not to compete involve promises by sellers of businesses or business property not to compete with their buyers. Although Plaintiff has not cited any, there are a few reported cases upholding the validity of buyers' pro-mises not to compete with sellers. The rationale for permitting this type of restriction was also stated by Judge Taft in *Addyston:*

> [W]hen one in business sold property with which the buyer might set up a rival business, it was certainly reasonable that the seller should be able to restrain the buyer from doing him an injury which, but for the sale, the buyer would be unable to inflict. 85 F. at 280.

For this reason, Judge Taft indicated that a covenant in partial restraint of trade might be upheld if it were an agreement "by the buyer of property not to use the same in competition with the business retained by the

seller," provided the restraint were found to be reasonably necessary "to the prevention of possible injury to the business of the seller from use by the buyer of the thing sold." *Id.* at 281.

So far as Defendant's counsel has been able to determine, all of the reported cases upholding non-compete covenants by buyers of business property contain the precise elements set forth by Judge Taft: It is not competition by the buyer in general which is restrained, but only the use of the particular property acquired from the seller; and the buyer is restrained from using that property to compete with the ongoing business of the seller. A good representative of these cases is *Tri-Continental Financial Corp. v. Tropical Marine Enterprises, Inc.,* 265 F.2d 619 (5th Cir. 1959). In that case, the plaintiff had for a number of years operated a certain steamship as a ferry transporting passengers and vehicles between ports in Florida and Cuba. When plaintiff sold this ship to defendant, a clause was inserted in the contract of sale whereby defendant promised not to use the vessel which it was purchasing for the transport of passengers and vehicles between Florida and Cuba for a period of ten years. Shortly after defendant took possession of the vessel,

it began operating it as a Florida-Cuba ferry and plaintiff brought suit to enforce the covenant not to compete. Affirming the district court's decree of specific performance, the court of appeals noted that the vessel and its name were to some extent associated with the good will which plaintiff had built up for its ferry service, that the law should allow the plaintiff to sell the vessel itself without transferring the associated good will to a competitor, and that neither the vessel nor its purchaser were unduly restrained since the ship could be used anywhere else in the world and the defendant could use any other vessel it might own or acquire as a Florida-Cuba ferry.

The restrictive covenants sought to be enforced in this case, by contrast, are not limited to restraining Defendant's use of specific property acquired from Wabash. They purport to prohibit Defendant from competing by any means in designated fields of commerce. Moreover, the purpose of the restrictions was not to protect Wabash's ability to continue in its business but were part of a plan for Wabash's cessation of operations and for the division of its business between separate successor entities.

Plaintiff has not cited and Defendant has not found any case applying the "rule of reason" to a covenant not to compete similar to the covenants at issue here. The restrictive covenants Plaintiff seeks to enforce restrain the competitive activities of the buyer of business assets, not of the seller of a going concern. They forbid Defendant's manufacture or sale of certain classes of products by any means, rather than merely restricting the use of specific property. The covenants were not necessary to effect or give shape to the underlying sale transaction, either by assuring Defendant's enjoyment of intangible property intended to be transferred along with tangible assets (for as restraints upon the buyer they could not have such an effect), or by preserving to the seller intangible assets associated with tangible property sold. Rather, they are part of an overall plan to dispose of Wabash's business by carving out separate market preserves for each of the two successor entities. Accordingly, it is clear that the per se rule against horizontal market division,
rather than the rule of reason applied to anti-competitive covenants ancillary to the sale of a business, is appropriate to the facts of this case.

II. EVEN DISREGARDING THE PER SE RULE BANNING HORIZONTAL MARKET DIVISIONS, THE TRIAL COURT WAS CORRECT IN HOLDING THE PROMISE OF DEFENDANT NOT TO COMPETE WITH PLAINTIFF CONTAINED IN PARAGRAPH 10OF THE WABASH-PACE AGREEMENT UNENFORCEABLE ON THE GROUND OF ILLEGALITY.

A. Even Regarding The Restrictive Covenant Contained in Paragraph 10 Of The Wabash-Pace Agreement In Isolation From The Over-all Horizontal Market-Division Scheme, Paragraph 10 Is Not Reasonably And Necessarily Related To The Main Purpose Of The Wabash-Pace Transaction And Is Therefore An Illegal Restraint Of Trade.

The general rule governing the application of the rule of reason to covenants not to compete may be summarized as follows: such a covenant may be upheld if reasonably and necessarily related to the lawful main purpose of the underlying transaction, but otherwise will be held contrary to public policy and void. But the concept of "necessary relationship" does not hinge upon the factual or circumstantial compulsion or needs of the parties conditioning their negotiation and

execution of the transaction, but rather upon the indispensability *vet non* of the restrictive covenant to give effect to the transfer of property rights agreed upon. A covenant not to compete is not "necessary" because it would be very advantageous to the covenantee, or because the covenantee could not economically enter upon or continue sore business without it, or because some third party with great economic influence over the covenanteee's conduct requires, as a condition to further dealing with covenantee, that covenantee obtain such a restraint.

A covenant not to compete is necessarily related to the underlying transaction only if that transaction contemplates that the covenantee obtain or retain property interests which by their nature require such a restrictive covenant for their protection. It is only such a covenant, and not simply any covenant which has a practical relation to the subject matter or which the parties choose to incorporate in the same contract, which is, in the legal sense, "ancillary" to the basic transaction:

> The restraint must be necessary to protect the covenantee in the legitimate enjoyment of the fruits of the contract or to protect him from the danger of an unjust use of those fruits by the other party. As commonly formulated, the rule is the covenant or contract by which the restraint is imposed must be incidental to, and in support of, another lawful contract or sale *by which the covenantee acquires some interest needing protection.* 17 *C.J.S. Contracts* § 241(2), Il10 (1963). (Emphasis supplied.)

In application of this rule, it has been held that a covenant by one acquiring business property not to engage in the same or a similar line of business as that of a third-party corporation, not a party to the contract, is invalid as an unreasonable restraint of trade and cannot be enforced by the third-party beneficiary. *Irving Investment Corp. v. Gordon,* 69 A.2d 725, 728-79 (N.J. 1949). This is precisely the character of paragraph 10 of the Wabash-Pace agreement, which purports to prevent Defendant from competing with the third-party beneficiary Plaintiff. This was one of the arguments presented by Defendant in its Motion to Dismiss in the trial court.

In its Opening Brief, Plaintiff responds to

this argument by pointing to the influence which, according to the verified portion of Plaintiff's Response to Motion to Dismiss, Oglesby had over the actions of Wabash: "Pace did not contest the fact that Wabash could not have sold its single tester to Three Phoenix nor could Pace have purchased the pack tester from Wabash had Pace not agreed to the covenant." Thus, Plaintiff argues, paragraph 10 was "necessary" to Wabash's attainment of its final objectives and accordingly did "protect and further the interest of Wabash." Plaintiff apparently believes that a covenant not to compete may be a legally "necessary" part of a transaction if, as a factual matter and given the bargaining positions and strengths of the parties, the transaction would not have occurred had the covenant not been agreed to. Plaintiff contends that *Irving Investment Corp. v. Gordon, supra,* is distinguishable because in that case "the party to be benefited by the covenant was a complete stranger to the underlying transaction and had no interest in it whatsoever."

Now, if "no interest in the transaction" is taken to mean that the third-party beneficiary had no direct proprietary interest in the subject matter of the

underlying transaction, so that no anti-competitive covenant could be needed to protect a legitimate interest acquired or retained by it as a result of the transaction, which is the sense in which the *Irving* court referred to the absence of "any interest whatsoever" on the part of the third-party beneficiary, this characterization of the facts of *Irving* is quite correct. But then it would apply equally well to the facts of the present case, since the substance of the Wabash-Pace transaction was the sale to Defendant of a product which Wabash had begun to design and market which was known as "Pack Scan III" and Plaintiff had no property interest in this product and consequently no legitimate interest requiring protection when the product was transferred by Wabash to Defendant.

On the other hand, if "no interest in the transaction" means that the third-party beneficiary was as a factual matter indifferent to the character or result of the transaction, or that the party to the transaction disposing of business property had no reason to be solicitous of the third-party beneficiary's desire to limit *its* potential competition, then this characterization of the facts is clearly quite inaccurate,

whether applied to *Irving* or to the present case. In *Irving*, the lessor-covenantee and the third-party beneficiary were business corporations intimately related by common ownership and control; the third party was clearly in a position to monitor the lessor-lessee negotiations and quite possibly had the same veto power over them which Plaintiff asserts its organizer, Oglesby, had over the Wabash-Pace negotiations. Moreover, because of their common purpose to benefit the same controlling group, the lessor-covenantee and the third-party beneficiary no doubt considered that the restrictive covenant would promote the interests and objectives of both corporations. In any event, the third-party beneficiary clearly had an interest in the covenantor-lessee's being prohibited from competing with it.

The court, however, held that such practical interests did not amount to an interest in the subject matter of the underlying transaction such as to require for its protection a restraint upon the lessee's right to compete. In the present case, however urgently Plaintiff might have desired a restrictive covenant running to its benefit such as paragraph 10 and however

active it may have been in procuring such a restraint, it clearly had no proprietary interest in the subject matter of the Wabash-Pace sale and the covenant not to compete contained in paragraph 10 was therefore not legally ancillary to that sale. It is immaterial whether Wabash could or could not have dealt with Plaintiff without obtaining these restrictive covenants, which are contained in and must be ancillary to the Wabash-Pace contract of sale. It is obvious, however, that the covenants are neither measurable by, limited to, nor subordinate to the reasonable necessities of that sale. *Cf. United States v. Holophane Co.,* 119 F.Supp. 114, 119 (S.D. Oh. 1954), *aff'd per curiam* 352 U.S. 903.

B. Paragraph 10 Is Invalid As A Restrictive Covenant Since It Is Silent As To Any Limitation Of Time And Space.

It will be seen that paragraph 10 itself contains no limitation of the spatial or temporal scope of the ban on Defendant's competition with Plaintiff which it purports to impose. A threshold question, for

purposes of the present discussion, is whether the contract as a whole is to be read as incorporating any such limitation upon the scope of this covenant. As this is a matter of the construction of a written contract, it is a question of law for the court and the intent of the parties must be determined from the four corners of the instrument. *Hofmann Co. v. Meisner,* 17 Ariz. App. 263, 265, 497 P.2d 83 (Div. 1, 1972).

It is conceded that there is no geographic limit on the operation of paragraph 10. It is also uncontested that paragraph 13 itself does not contain any provision as to the duration of the restraint which it purports to impose. The immediate questions, therefore, are whether such a temporal limitation can be supplied by construction and, if so, what limit should be supplied.

Covenants not to compete are not favored by the courts, and are (even when held valid) strictly construed against restraint and in favor of freedom of competition. *Keller v. California Liquid Gas Corp.,* 363 F.Supp. 123, 126 (D. Wyo. 1973); *Behn v. Shapiro,* 130 N.E.2d 295, 300-01 (Ill.App. 1955); *Howard D. Johnson Co. v. Parkside Development Corp.,* 348 N.E.2d 656, 660 (Ind.App. 1976); *Arthur Murray Dance Studios, Inc. v. Whitter,* 105 N.E.2d 685, 693 (Oh. Common Pleas 1352); *Thomas v. McCrery,*

147 So.2d 467, 469 (La.App. 1962); *Huddleston v. Mariotti,* 102 S.E.2d 527, 529 (W.Va. 1958). In application of this rule of strict construction, courts have refused to construe unclear or ambiguous restrictive covenants so as to incorporate appropriate time and space limitations and have instead construed such covenants as unlimited and hence invalid. *See, e.g., E. L. Conwell & Co. v. Gutberlet,* 429 F.2d 527, 528 (4th Cir. 1970).

Even applying the normal rules of construction, there are only two plausible interpretations of the duration of paragraph 10: (1) as an independent and self-contained covenant complete and absolute on its face, it may be deemed not to be limited by the terms of the contract; or (2) the general provision governing the term of the agreement as a whole, set forth in paragraph 4 of the agreement, may be deemed controlling. The implications of the former construction are discussed below. The latter construction would be of little use to the Plaintiff since the five-year term of the Wabash-Pace agreement provided in paragraph 4 thereof expired a few days after the filing of the Complaint in this action.

Plaintiff's contention that paragraph 10

should be construed as incorporating the same temporal limitation as is set forth in the second part of paragraph 9 is absurd. From some apparent or presumed similarity of the subject matter of the two paragraphs, Plaintiff infers that it was the "obvious intention of Wabash and Pace" that paragraph 10 be limited to the same duration as subparagraph 9(b). This, however, is an obviously improper invitation to the Court to go outside the terms of the written agreement and speculate as to the probable intent of the parties. And even if such speculation were proper, Plaintiff has hardly made a compelling case for the selection of the second part of paragraph 9 as the source from which the temporal limitation of paragraph 10 is to be derived. For instance, if we are to look to paragraph 9, why not use the separate time limitation contained in the first part of that paragraph? The reason, apparently, is that the time limitation of subparagraph 9(a) in turn incorporates the general five-year duration provision of paragraph 4. Subparagraph 9(b) is to be selected from all the provisions of the contract because it alone describes a period of duration which Plaintiff can (by a tortured and ridiculously expansive interpretation) contend is still running.

If the contract is not interpreted as limiting by its terms the operation of the covenant not to compete contained in paragraph 10, then paragraph 10 is clearly invalid since, under Arizona law, a covenant not to compete which is silent as to any limitation of time and space is unenforceable as a matter of law. *Wright v. Palmer,* 11 Ariz.App. 292, 294, 464 P.2d 363 (Div. 1, 1970). A covenant not to compete which is unlimited as to time and space is also illegal under section 1 of the Sherman Act. *Compton v. Metal Products, Inc.,* 453 F.2d 38, 45 (4th Cir. 1971), *cert. denied* 406 U.S. 1968. Contrary to Plaintiff's contention, neither *Wright* nor. *Compton* represents a departure from the Sherman Act "rule of reason" enunciated in *Standard Oil, Inc. v. United States,* 221 U.S. 1 (1910), or from the Arizona common law rule of reason mentioned in a dictum in *Esmark, Inc. v. McKee,* 118 Ariz. 511, 513, 578 ?.2d 190 (1978). Both rules have always incorporated the requirement that the restraint be "partial", i.e., limited in time and/or space. *Sound Ship Building Corp. v. Bethlehem Steel Co.,* 387 F.Supp. 252, 255 (S.D. N.Y. 1975); *Henderson v. Jacobs,* 73 Ariz. 195, 201, 239 P.2d 1082 (1952), (in which the "blanket rule" rejected was

not the rule against total restraints but the early common law rule against all restraints of trade, total or partial. *See Alger v. Thacher,* 36 Mass. (19 Pick.) 51, 53 (1837); *Dyer's Case,* Y.H. 2 Hen. V, f.5 pl. 26 (1415).)

Confronted by a covenant not to compete which is silent as to any limitation of time or space, a court has three options: (1) it can enforce the bargain as made, that is, it can hold the covenantor bound by a global and perpetual restraint; (2) it can make a new contract for the parties by determining what the appropriate and reasonable geographic and temporal scope of a restrictive covenant .incident to their agreement might have been; or (3) it can refuse to enforce the covenant. The course to be followed by Arizona courts was unequivocally indicated by this Court in *Wright v. Palmer, supra.* Defendant submits that the choice made was the correct one and is consistent with the law's traditional abhorrence of total restraints, general principles of contract construction, and the established policy of placing on a party who undertakes to procure a covenant not to compete from one with whom he deals a very heavy burden of certainty, precision and specificity.

III. THE TRIAL COURT DID NOT ERR IN HOLDING THAT PLAINTIFF CANNOT ENFORCE THE PROMISE OF DEFENDANT TO WABASH CONTAINED IN PARAGRAPH 9 OF THE WABASH-PACE AGREEMENT *AS* THE ASSIGNEE OF THE BENEFIT OF THAT PROMISE.

A. The Verified Complaint Upon Which Plaintiff Elected To Stand Clearly Stakes Plaintiff's Claim For Relief Upon The Written Wabash-Pace Agreement Of October 11, 1973, And Would Not Support Proof Of An Earlier Oral Agreement Containing Similar Restrictive Covenants.

In its Opening Brief, Plaintiff asserts that it is an "uncontested fact" that "the Wabash-Pace agreement," including the restrictive covenants contained in paragraph 9 of the written Wabash-Pace agreement of October 11, 1973 (presumably, *in been verba)* was in existence on June 26, 1973. This assertion, however, is not supported by a shred of evidentiary material in the record. If it is "uncontested," that is because it is not alleged or in any way put in issue by Plaintiff's Complaint.

The verified Complaint describes agreements between Wabash and Plaintiff and Wabash and Defendant,

"copies of which agreements are attached [t]hereto and by ... reference made a part [t]hereof." It alleges that Defendant made certain promises not to compete, "as provided in paragraphs 9 and 10 of the Wabash agreement with the Defendant which is attached [t]hereto as Exhibit A." It further alleges that "Wabash sold to the Plaintiff its rights under Exhibit A prohibiting Defendant from competing with Wabash." Plaintiff's Complaint clearly and unequivocally stakes Plaintiff's claim for relief on paragraphs 9 and 10 of the written Wabash-Pace agreement of October 11, 1973. Certainly, on a fair reading nobody would understand the Complaint as claiming the existence and benefit of some earlier and other Wabash-Pace agreement.

As this case was determined upon Defendant's Motion to Dismiss which the trial court treated as a motion for summary judgment, Plaintiff had at all times up until the entry of the formal order of dismissal the right to amend its Complaint under Rule 15(a), Arizona Rules of Civil Procedure. *Richardson v. United States,* 336 F.2d 265, 266 (9th Cir. 1964); *Bridgess v. Youree,* 436 F.Supp. 458, 460 (W.D. Okla. 1977). Also, when Plaintiff suggested in its Response to Motion to

Dismiss that the covenant not to compete might have been in existence in June, 1973, though "not embodied in a written agreement," Defendant objected to this contention as lying beyond the scope of the pleadings:

> Nonetheless, if Plaintiff wishes to institute an action founded upon the theory that a contract was made between Wabash and Pace prior to June 6, 1973 and to prove therein the existence and the terms of such contract, it no doubt has the right to do so. What is significant for the purposes of the present Motion is that no such allegation is to be found in the Complaint presently before the Court. Reply to Response to Motion to Dismiss, Item No. 24 of the Record, pages 3-4. (Emphasis in original.)

It is, of course, elementary that, absent proper amendment of the pleadings or a waiver of the right to object, the evidence must be confined to the issues made by the pleadings. *Starkovich v. Noye,* 111 Ariz. 347, 349, 529 P.2d 698 (1975), (by implication); *Richards v. Green,* 3 Ariz. 227, 234-35, 32 P. 266 (1890). When the Plaintiff declined to amend its Complaint, therefore, the trial court was not only justified in disregarding its argument based on the alleged existence of a previous oral contract, but was

obliged to do so.

In *Wright v. Palmer, supra,* this Court expressly reserved the question whether an oral covenant not to compete can be enforced in court. 11 Ariz.App. at 294. *In* any case, the purported oral promise not to compete, if indeed its terms were identical to those of paragraph 9 of the Wabash-Pace agreement, had a minimum duration of two years and would thus be unenforceable under our Statute of Frauds, A.R.S. § 44-101(5). These points of law are alluded to in order to indicate the kinds of defensive matters which Defendant could have raised by motion if the Complaint had alleged an oral covenant not to compete. It would be wholly unfair if Plaintiff were permitted to evade such defenses while the action was at the framing-of-the-issues stage by the use of a Complaint which is clearly based upon a written contract, and later, after doubt had been cast upon *its* right to enforce that written contract, to effect a complete shift to a theory based upon a purported prior oral agreement solely through the arguments of its counsel, without making any pretense of amending its pleadings.

it should be noted that the trial court prepared the judgment here appealed from with great care

and with an obvious intent to delimit the *res judicata* and collateral estoppel effects of the judgment with precision. Though it is not a question which is presented by or may be conclusively resolved on this appeal, it is at least probable that the judgment rendered does not preclude Plaintiff from instituting an action based upon the purported oral covenant not to compete. Plaintiff deliberately refused to make such an allegation in its pleadings in this action, and it obviously has no right to conduct its appeal as if it had.

B. The Wabash-Three Phoenix Agreement Of June 6, 1973, Did Not Operate As A Present Assignment To Three Phoenix Of The Benefit Of The Restrictive Covenants Contained In Paragraph 9 Of The Wabash-Pace Agreement Of October 11, 1973, And Plaintiff, Therefore, May Not Maintain An Action To Enforce Paragraph 9 As The Legal Assignee Thereof.

The written Wabash-Three Phoenix agreement also attached as an exhibit to Plaintiff's verified Complaint was executed on June 6, 1973. It provides for Wabash's assignment to Plaintiff of "Wabash's

rights under certain covenants not to compete." The written Wabash-Pace agreement whose enforcement is sought by Plaintiff's Complaint was entered into on October 11, 1973, more than four months later. Plaintiff brought this action directly against Defendant without any attempt to make Wabash a party -- claiming to be the assignee of the benefit of the restrictive covenants contained in paragraph 9 of the Wabash-Pace contract on the basis of the earlier Wabash-Three Phoenix agreement.

From the uncontested facts disclosed by Plaintiff's verified Complaint itself, the trial court found that the contract of which paragraph 9 is a part was not in existence when the Wabash-Three Phoenix agreement was made, and it accordingly concluded that the Wabash-Three Phoenix agreement did not constitute an assignment of these restrictive covenants. In reaching this conclusion, the court was merely applying the familiar rule that an assignment of rights expected to arise under a contract not yet formed or executed is ineffective to transfer these prospective rights. 6 Am.Jur.2d *Assignments* § 15, 200 (1963). As expressed in the RESTATEMENT OF CONTRACTS, § 154 (1932), the rule

is that "[a]n assignment of a right expected to arise under a contract ... not then existing is operative only as a promise by the assignor to assign the right and an authorization to the assignee to enforce it ... ." The corresponding provision (5 153) of the Tentative Draft of the RESTATEMENT (SECOND) OF CONTRACTS is, for the purposes at hand, identical.

Even assuming, what is far from clear from the written agreement itself, that the Wabash-Three Phoenix contract constitutes an assignment of rights expected to arise under a covenant not to compete to be obtained by Wabash from Defendant, such an attempted assignment could not have been presently effective and would only have constituted a promise by Wabash to assign the right if and when it should come into existence. The effect of the promise to assign, if there was one, is discussed below. It is sufficient for present purposes to observe that, deeming Wabash's actual assignment of whatever it had to assign to have occurred -- as undeniably it did -- on June 6, 1973, Plaintiff did not obtain Defendant's promise not to compete because

> [a]n assignee ordinarily obtains only the rights possessed by theassignor at the *time of the assignment,* and no more, since ... an assignment operates to transfer only such rights, title or interest as is possessed by the assignor at the time of the assignment.
>
> * * *
>
> The time of the assignment determines the rights of the assignee and not the time of the suit. 6A C.J.S. *Assignments* § 88, 738-40 (1975). (Emphasis supplied.)

C. Plaintiff May Not Assert The Theory Of "Equitable Assignment" For The First Time On Appeal.

The "promise to assign" which, under the RESTATEMENT, the attempt to assign rights under a contract not yet in existence constitutes has, as Plaintiff notes in its Opening Brief, been held to give the promisee an equitable interest in the contract rights when the contract is made. Equity, deeming that done which ought to have been done, considers an actual assignment to have been made when the contract came into existence and allows the promisee to seek a

remedy from both the promisor and the contract obligor. There are, however, two important reasons why Plaintiff should not be permitted to assert this doctrine of equitable assignment in the present action.

The first is the fundamental rule that, on appeal from a summary judgment, the appellant cannot advance new theories or raise new issues in order to secure a reversal of the lower court's determination. *Crook v. Anderson,* 115 Ariz. 402, 403-04, 565 P.2d 908 (App., Div. 1, 1971). *Cf. Cathemer v. Hunter,* 27 Ariz.App. 780, 785, 558 P.2d 975 (Div. 1 1976); *Douglas v. Vancouver Plywood Co.,* 16 Ariz.App. 364, 366-67, 493 P.2d.531 (Div. 2, 1972). As a perusal of the record will show, Defendant never asserted the theory of equitable assignment below. In response to Defendant's attack on the validity of the purported assignment in the trial court, Plaintiff contented itself with suggesting that an oral agreement between Wabash and Defendant had been in existence on the date of the Wabash-Three Phoenix agreement and questioning the applicability of the authorities cited by Defendant for the proposition that the attempted assignment made before the subject contract came into existence did not

constitute an effective legal assignment. Plaintiff never in any way raised or even hinted at the theory that the attempted assignment gave rise to a specifically enforceable promise to assign.

Secondly, if Plaintiff's claim to enforce paragraph 9 were based on an equitable assignment theory, promisor Wabash would be an indispensable party. Under the RESTATEMENT OF CONTRACTS § 166(2), if the promisee brings action against the obligor to enforce the subject contract, the defendant may require that the promisor be joined, presumably as a voluntary or involuntary plaintiff. Under the scheme adopted by the tentative draft of the RESTATEMENT (SECOND), the joinder of a specific performance action against the promisor with an action against the contract obligor to enforce the contract is apparently considered the appropriate procedure, without regard to any demand by the contract obligor that the alleged promisor be joined. RESTATEMENT (SECOND) OF CONTRACTS § 162 (Tentative Draft No. 7, 1973). Where the promisee brings a direct action based upon an equitable assignment theory and the alleged promisor-obligee is not in any way made a party to the action, the equitable assignment claim may be disregarded

by the court. *Momand v. Universal Film Exchange,* 43 F.Supp. 996, 1007 (D. Mass. 1942).

It is not easy to see why, after Defendant pointed out that the Wabash-Three Phoenix agreement would not have effected an assignment of rights arising under the later Wabash-Pace agreement, Plaintiff carefully refrained from raising any claim of equitable assignment in the trial court, unless it hoped to avoid making Wabash a necessary party. But Plaintiff should not be allowed to avoid the serious procedural obstacle of a Rule 19 motion by presenting the trial court with pleadings and arguments contending only that there had been a complete, legal assignment of extant contract rights and then, after this contention has been held to be unfounded, shift at the appellate level (where it is safe from a Rule 19 motion) to the equitable assignment theory.

IV. SUMMARY.

The factual materials adduced by Plaintiff itself show that the agreements and covenants here sued

upon are part of a patently illegal scheme to effect a horizontal division of the computer disc certification equipment market between Plaintiff and Defendant as successors to the business of Wabash Computer Corporation. The whole system of restrictive covenants and assignments upon which Plaintiff relies is therefore invalid, and the judgment for Defendant should be affirmed on that ground.

Disregarding the basic illegality of the overall plan to carve up the computer disc certification equipment market into exclusive preserves for Plaintiff and Defendant, the restrictive covenant contained in paragraph 10 of the Wabash-Pace agreement is nonetheless clearly illegal and unenforceable because: (1) it is not reasonably and necessarily related to the underlying Wabash-Pace transaction; and (2) it is silent as to any limitation of time and space.

With respect to the restrictive covenant of paragraph 9(b) of the Wabash-Pace agreement, it is clear that there has been no legal assignment of the benefit of that covenant to Plaintiff. Plaintiff waived the theory of "equitable assignment" by failing to assert it in the trial court.

CONCLUSION

For the reasons stated in the Argument and because Plaintiff-Appellant has failed to demonstrate the commission of any reversible error by the court below, the judgment appealed from should be affirmed.

Respectfully submitted,

BRIAN K. STANLEY *ATTORNEY FOR APPELLEE*

APPENDIX

Relevant Statutory Provisions

15 U.S.C. § 1 (1970) (Sherman Act, § 1)

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal [.]

A.R.S. § 44-1402 (Uniform State Antitrust Act, § 2)

A contract, combination or conspiracy between two or more persons in restraint of, or to monopolize, trade or commerce, any part of which is within the state, is unlawful.

A.R.S. § 44-1412 (Uniform State Antitrust Act, § 12)

This article [Article 1, Chapter 10, Title 44, A.R.S.] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this article among those states that enact it. It is the intent of the legislature that in construing this article, the courts may use as a guide interpretations given by the federal courts to comparable federal antitrust statutes.