

BUSINESS LITIGATION *Update*

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EDITORS' NOTEPAD

The *Business Litigation Update* is published by the ALFA International Business Litigation Practice Group. This issue focuses on methods of protecting assets which may be unique to your business: trade secrets, intellectual property and proprietary information. These case notes and articles demonstrate the different ways specific legislative and judicial bodies deal with the tension between an individual's right to earn a living utilizing skills obtained in the workplace with the right of businesses to protect their business interests in legitimately acquired confidential information and other assets.

As you know, the *Business Litigation Update* is a nascent publication which needs and depends upon the submission of articles, comments, case notes and summaries on important topics by members of the Business Litigation Practice Group. We also welcome articles and comments by clients of ALFA firms. Our next issue will address the topic of bringing added value to client engagements with a focus on alternative billing methods and the use of technology to improve efficiency in the delivery of high quality work product to clients engaged in business litigation. We invite you to submit any relevant materials addressing this topic which is more and more critical to our clients in the current economic times.

The *Business Litigation Update* is published on our website, and our primary method of distribution is by email. Electronic publication allows us to include [hyperlinks](#) for the use of our readers.¹ We encourage you to use the [hyperlinks](#) feature and our section headings to quickly get to the information that is most interesting to you. The section headings are as follows: Case Notes and Articles.

¹ All hyperlinks are in orange. Hyperlinks can be activated by placing the cursor on them and left clicking with the mouse. Links in the Contents go to specific points in the newsletter. Links to websites take you to the website, and links to email addresses open an email addressed to that person.

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NON-COMPETITION AGREEMENTS ANCILLARY TO THE SALE OF A BUSINESS

Arizona has adopted a more liberal view of non-competition covenants ancillary to the sale of a business than it employs in other context. Arizona courts asked to enforce non-competition covenants in agreements for the sale of a business consider the purpose of the covenant and the intent of the parties.¹ Arizona courts enforce the “letter and spirit” of the covenant often using Arizona’s implied covenant of good faith and fair dealing to achieve results beyond the plain language of the covenant itself.

Arizona has long imposed an implied covenant of good faith and fair dealing in every contract which prevents a party to a contract from acting to “impair the right of the other to receive the benefits which flow from their agreement or contractual relationship”.² When the plain language of the non-competition covenant will not proscribe the actions of the former owner, Arizona courts have used this implied covenant to fulfill the spirit of the covenant. In *Diagnostic Lab., Inc., v. PBL Consultants*, plaintiffs (two physicians) sold a histology and cytology testing laboratory to defendants. The sale contract contained a non-competition covenant which proscribed sellers from directly or indirectly engaging in clinical laboratory business or other professional activities which would be prejudicial to the buyer.³ Evidence showed that the sellers did not engage in any prohibited conduct themselves but provided assistance to another who was engaged in a business competing with buyer’s business. While no evidence showed that the sellers actually violated the express language of the non-competition covenant, their use of a subterfuge was found to be in violation of the implied covenant of good faith and fair dealing, thus injuring the buyer’s contractual right to be free of competition from the seller.

Arizona courts have extended the application of the covenant of good faith and fair dealing to enforce restrictions which do not actually appear in the contract and to impose restrictions on discretion retained under the contract.⁴ Arizona courts have gone so far as to effectively re-write the terms of the parties’ contract, while simultaneously stating that this implied covenant cannot contradict the express terms of the contract. In a case that did not deal with a non-competition clause, the Arizona Court of Appeals stated that instances “inevitably arise where one party exercises discretion retained or unexercised under a contract in such a way as to deny the other a reasonably expected benefit of the bargain.”⁵ The court stated that in Arizona, a party can breach the implied covenant of good faith and fair dealing both by act inconsistent with the express language and by acting in a way that while not expressly excluded by the contract’s terms bears adversely on the party’s expected benefits of the bargain.⁶ In *Bike Fashion Corp., v. Kramer*, Kramer, who controlled a corporation that was the managing partner of a general partnership owning real estate, caused his corporation to sell the principal asset of the general partnership without the consent of the other partners. The court held that while the express terms of the contract gave Kramer the discretion to sell, his exercise of that discretion violated the justified understanding of the parties.⁷ The court explained that the implied covenant may be breached even if the express terms speak to a related subject.

In *The Mastro Group v. American Restaurant Enterprises*, the court extended this concept beyond *Bike Fashion* and allowed the implied covenant of good faith and fair dealing to contradict the plain language of the parties’

1 *The Mastro Group v. American Restaurant Enterprises*, 2008 WL 4017948 (Ariz. App. Div. 1, 2008), citing *Centorr-Vacuum Indus., Inc., v. Lavoie*, 609 A.2d 1213, 1215 (N.H. 1992) and *Bicycle Transit Auth., Inc., v. Bell*, 333 S.E.2d 299, 305 (N.C. 1985).

2 *Bike Fashion Corp., v. Kramer*, 202 Ariz. 420, 46 P.3d 431 (App. Div. 1, 2002).

3 *Diagnostic Lab., Inc., v. PBL Consultants*, 136 Ariz. 415, 419, 666 P.2d 515, 519, (App. Div. 1983).

4 *Bike Fashion Corp., v. Kramer*, 202 Ariz. 420, 46 P.3d 431 (App. Div.1, 2002).

5 *Bike Fashion Corp., v. Kramer*, 202 Ariz. 420, 46 P.3d 431 (App. Div. 1, 2002) citing *Wells Fargo Bank v. Arizona Laborers, Teamsters & Cement Masons Local No. 395 Pension Trust Fund*, 201 Ariz. 474, 38 P.3d 12, (2002).

6 *Id.*, 202 Ariz. at 424, 46 P.3d at 435.

7 *Id.*, 202 Ariz. at 424, 46 P.3d at 435.

contract.⁸ In *Mastro*, plaintiff sold “Maloney’s Tavern” to the defendants.⁹ The sale contract contained a non-competition clause with a geographic scope of three miles. When the defendants stopped making royalty payments under the contract (with or without justification), the sellers opened a steakhouse under the name “Drinkwater’s City Hall Steakhouse” within three miles of the restaurant it sold. Defendants claimed that its steakhouse was not in violation of the non-competition clause because the non-competition clause only prohibited the defendants from the “operation of a ‘Maloney’s Tavern’ or a ‘Maloney’s On Campus’ bar business”.¹⁰ The court disagreed. Even though the express terms of the non-competition covenant addressed a “Maloney’s Tavern” or “Maloney’s On Campus” the court held that the reasonable expectation of the parties may have been a complete prohibition against operating any restaurant or bar business within the three-mile scope contained in the contract.¹¹

While non-competition clauses associated with the sale of a business are enforceable in Arizona, the plain language of the clause may not limit the scope of the non-competition clause. Arizona courts have used the implied covenant of good faith and fair dealing to extend the non-competition clause beyond its plain language in an attempt to effectuate the parties’ reasonable expectations, even when the parties fail to state those expectations in their written agreement.



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⁸ 2008 WL 4017948 (Ariz. App. Div. 1, 2008).

⁹ *The Mastro Group*, 2008 WL 4017948 (Ariz. App. Div. 1, 2008).

¹⁰ *Id.*

¹¹ *Id.*