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Expert Analysis

Court Extends Non-Compete Law To IP Licensing Agreements

A recent U.S. Court of Appeals for the Second Circuit decision, *Crye Precision v. Duro Textiles*, 689 Fed. Appx. 104 (2017), extends the common-law restrictions on non-compete provisions to a new area: intellectual property licenses.

Non-compete law has generally been applied to two kinds of contracts: employment agreements and agreements to sell a business. *Crye* appears to break new ground in applying this law to restrictions in an intellectual property license. Counsel who draft licensing agreements need to consider whether restrictions often found in such agreements would be enforceable under the non-compete principles.

Common Law Disfavor Of Non-Competes

The common law is generally hostile to non-compete provisions, and they will only be upheld under

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narrow circumstances. Traditionally, New York courts have viewed covenants not to compete "with high disfavor" and denounced them as "against the benefit of the commonwealth." *Purchasing Associates v. Weitz*, 13 N.Y.2d 267, 271 (1963).

This disfavor is particularly stringent where covenants not to compete restrict employees from working in their profession. New York law thus provides that "[c]ovenants not to compete should be strictly construed because of the 'powerful considerations of public policy which militate against sanctioning the loss of a [person's] livelihood.'" *Brown & Brown v. Johnson*, 25 N.Y.3d 364, 370 (2015).

A second type of contract relates to sale of a business. Here New York courts are more solicitous of covenants not to compete, since part of the bargain was purchase of the business's goodwill, and a non-compete enforces that bargain. See *Purchasing Assocs.*, 13 N.Y.2d at 271.

Ordinary commercial contracts that involve neither sale of a business nor an employment agreement fall somewhere in between. Non-compete clauses in ordinary commercial contracts are analyzed "under a simple rule of reason, bal-

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ancing the competing public policies in favor of robust competition and freedom to contract." *Mathias v. Jacobs*, 167 F. Supp. 2d 606, 611 (S.D.N.Y. 2001). This harkens back to the case of *Hodge v. Sloan*, 107

N.Y. 244, 249-50 (1887), where the Court of Appeals upheld a land-sale contract that contained a restriction not to sell sand mined from the land, as the restrictive covenant was "not larger than is necessary."

Typically, courts consider three factors in determining the enforceability of non-compete covenants in ordinary commercial contracts: (1) whether the covenant protects a legitimate business interest; (2) the reasonableness of the covenant with respect to geographic scope and temporal duration; and (3) the degree of hardship imposed upon the party against whom the covenant is enforced. The application of these factors depends on the totality of circumstances. See *Mathias,* 167 F. Supp. 2d at 611.

'Crye' Case

Crye Precision is the exclusive licensee for four patented camouflage patterns. One of them was developed for the U.S. Army in the early 2000s. Crye dubbed it the MULTICAM pattern, and licensed it to Duro Textiles, a printer, for products sold commercially, as well as to the Army. In 2010, the Army selected MULTICAM as the standard issue camouflage pattern for soldiers deployed in Afghanistan.

The license to Duro Textiles provided:

> Intellectual Property. [Duro] acknowledges and agrees that it *will not* disassemble, decompile, or reverse engineer MULTICAM or any other intellectual property right of CRYE, including patent, trademark, and copyrights, licensed from CRYE or, *during or after the term or expiration of this Agreement, make any products that are similar to MULTICAM through color palette, pattern or arrangement or placement of any elements incorporated in MULTICAM*. Furthermore, [Duro] agrees that it shall not make any additions to, new renderings of, or modifications, embellishments, derivative works, or other changes of or to MULTICAM or any other intellectual property rights of CRYE without CRYE's prior written consent and [Duro] agrees that all such additions, renderings, modifications, embellishments, derivative works or otherwise shall be and remain the sole property of CRYE. (emphasis added)

In 2014, the Army announced a switch to a new camouflage pattern, named SCORPION W2, with similarities to the MULTICAM. By that time, the Crye-Duro license had expired. Duro then contracted to supply the Army with the new-patterned camouflage fabric.

Crye brought suit for breach of contract (as well as trade dress infringement).

Both the district court and Second Circuit applied New York law of non-compete clauses to the "similar products" clause in the license to find it contrary to public policy. The district court balanced the three factors set out in *Mathias*. It acknowledged that Crye had a legitimate interest in protecting its intellectual property and avoiding unfair competition. In fact, it opined in dicta the contractual prohibitions against reverse engineering or creating derivative works would likely be upheld.

But the prohibition against creating "similar" patterns, it said, went far beyond protecting Crye's intellectual property. Apart from being overbroad, it was vague, and could be read to bar *any* production or sale of camouflage items. And, there was neither a geographic nor a time limitation. The district court found the term unenforceable.

The Second Circuit affirmed on the same basis. Its opinion made several notable points:

- It rejected Crye's argument that the court should look at the conduct of the parties, rather than the language of the agreement, to see if it is overbroad. "[T]hat argument fails because the non-compete clause is unreasonable on its face."
- It rejected the argument that Duro had wanted to include such a clause and had benefitted from it (since it shared in Crye licensing fees to third parties). Such an estoppel argument cannot be used to enforce a clause contrary to public policy.
- It rejected Crye's invitation to rewrite the "similar" clause under the "blue pencil" rule. The

blue pencil rule allows the court to excise unenforceable parts of a non-compete clause and then enforce the rest. But here, enforcing the clause would require the court to *add* to the agreement by defining its terms and adding in a temporal limit.

Is 'Crye' Good Policy?

The *Crye* decision is remarkable not only because it extends the non-compete law to a new area, licensing, but also because it applies it even where the parties bargained at arms' length and the licensee benefitted from the restrictive clause. The justification, presumably, is the public interest in free competition. One might question whether that was properly applied here.

'Crye' shows there are limits to licensing restrictions that courts are willing to enforce. IP owners and their counsel need to take these limits into account when drafting license agreements.

Duro Textiles is certainly not the only printer of camouflage-print fabrics in the country; there are no doubt many other printers who would be willing to print and sell such fabrics for use in military supplies. Would competition really be inhibited in enforcing a restrictive term against a single supplier—particularly where that supplier bargained for such a term at arm's length?

Lessons From 'Crye'

Whatever one thinks of *Crye*, it will no doubt be cited in future litigation over licensing terms. *Crye* shows that licensing terms and restrictions will be scrutinized for anti-competitive effect, and may be found unenforceable. In light of *Crye,* licensing counsel should consider whether restrictive terms will be enforceable and whether they can be more carefully crafted to maximize their enforceability.

The *Crye* decision does indicate that there is a place for contractual provisions to protect intellectual property. The district court opinion conceded that protection of intellectual property is a legitimate interest of a licensor that might support some contractual restrictions, such as those against reverse engineering.

The question, then, is what does a contractual restriction legitimately add to intellectual property rights? Remember, the IP owner can always assert the IP right. There is no need to sign a contract that merely says, "don't infringe on my IP."

What a contract does add is keeping a close party (like a licensee) farther away from the line of infringement—for example, by clarifying or simplifying what the IP owner legitimately considers to be an infringement, or barring things like reverse engineering that facilitate exploitation of IP.

A good exercise for licensing counsel is to consider how they would justify enforcement of such a provision. Among other points to consider:

- Does the restriction protect some IP right?
- What is the purpose of the restriction – how does it facilitate protection of IP against infringement by the other party?
- Is the restriction clear in its application, or could it be read as overbroad?
- Is the other party still free to compete outside the restriction? Or will it effectively exclude the other party from a market (as happened in *Crye*)?
- Is the restriction limited in time or geography? What justifies the scope of such a limitation, or if not, the lack of such limitation?

Conclusion

Licensing is a critical component of economic exploitation of intellectual property—it allows the IP owner to leverage the licensee's resources to exploit the IP to mutual benefit. At the same time, an IP owner must be careful that the license terms protect its IP interest, which might otherwise be lost or diluted. The *Crye* case shows there are limits to licensing restrictions that courts are willing to enforce. IP owners and their counsel need to take these limits into account when drafting license agreements.