Enforceability of Non-Compete Clauses – A Case Study

October 26, 2023

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The Basics: Non-compete clauses are found in a variety of technology-related agreements including, for example, in IP licenses and employment agreements. These clauses are intended to protect the licensor's/employer's legitimate interests in its trade secrets, confidential know-how or other proprietary information. To prevent the likely or "inevitable" use of the licensor's/employer's proprietary information, a non-compete clause prohibits the licensee/employee from competing in a specifically defined market(s) for a specified time. Non-compete clauses are generally enforceable, provided they are reasonably limited in scope (in terms of both geography and market) and duration. Courts will not enforce non-compete clauses that are broader in scope and/or duration than reasonably necessary to protect a legitimate interest.

In the employer-employee context, courts generally review the purported reasonableness of non-compete clauses with heightened scrutiny because the typical employee has inferior bargaining power and the public policy favors employee autonomy. Indeed, the U.S. F.T.C. has proposed a rule banning non-competes in employer-employee contracts. The proposed rule would supersede all contrary state laws and apply retroactively. In contrast, non-competes between sophisticated parties are generally reviewed with greater latitude, although they still must be reasonable in scope and duration. Finally, non-competes are evaluated under state law and, depending on the applicable law, an overly broad clause will either be rewritten ("blue-penciled") so that it is reasonable in scope and duration or, in a non-blue pencil state, disregarded altogether as unenforceable.

Case Facts: Our client, the licensee, entered into a patent and software license agreement that included, among other things, a non-compete clause preventing our client from entering a defined U.S. market for an unspecified duration. Thus, by the license's plain terms, our client was forever prohibited from entering the defined market regardless of whether it used the licensed patents, licensed software, or the licensor's know-how. The license agreement also stated that it shall be construed and enforced pursuant to the laws of Virginia. Several years into the license our client began selling products and services in the allegedly prohibited market. These products and services were not covered by the licensed patents, nor did they use the licensed software or the licensor's know-how. Pursuant to the license's dispute resolution clause, the licensor filed an arbitration proceeding alleging breach of the non-compete clause. Notably, the licensor did not allege patent infringement, copyright infringement or trade secret misappropriation.

Outcome: After a 3-day evidentiary hearing (which addressed a variety of issues ultimately rendered moot), the arbitrator held the non-compete clause unenforceable under Virginia law because it was unreasonable in duration. As the arbitrator noted, because no duration was specified, the non-compete clause effectively prevented our client from entering the prohibited market until the end of time – long after the expiration of the licensed patents and regardless of whether our client used the licensed software or licensee's know-how. Further, because Virginia was a non-blue pencil state, the arbitrator could not rewrite the non-compete clause to have a reasonable duration, although it appears that he may have been inclined to do so if permitted under Virginia law.

Takeaways: When including a non-complete clause, include an express acknowledgement that the licensor/employer is providing access to its confidential and proprietary technical and/or business information and make sure that the clause is reasonably tailored in both scope and duration to protect those interests. In evaluating what is reasonable, carefully consider case precedent, particularly in the agreement's controlling jurisdiction. Also consider whether the state is a blue-pencil state. In such a state, the consequences of an overly broad non-compete is likely a court re-write to make it reasonable in scope rather than outright unenforceability. However, even in a blue-pencil jurisdiction, the certainty of a non-compete that is reasonable in scope and duration is preferred over the uncertainty and litigation expense associated with a judicial re-write of an overly broad clause. Also, in the employer-employee context, be particularly sensitive to the reasonableness issue. What may be deemed reasonable in a commercial context between sophisticated parties may not pass muster in the employer-employee context.

A Final Thought: Be wary of patent/copyright misuse issues when an IP license includes a non-compete clause. In the above-discussed case, our client raised patent and copyright misuse defenses, which the arbitrator ultimately did not decide. Nevertheless, IP licensors should take care to avoid over-reaching non-compete clauses because the consequences of doing so may be more severe than merely an unenforceable non-compete. An unreasonably broad non-compete in an IP license agreement may, in certain circumstances, potentially lead to a finding of patent or copyright misuse (and theoretically perhaps even trademark misuse) rendering the licensed IP itself unenforceable against the licensee and everyone else. The argument being that the non-compete clause is not reasonably tailored to protect a valid interest (e.g., the licensor's proprietary know-how) but instead is the result of the licensor improperly leveraging (i.e., misusing) its IP by conditioning the license upon the licensee's agreement to refrain from competing with products and services that fall outside the scope (or duration) of the licensed IP.

For help with these or other technology contract issues, please contact Haynes Boone's Technology Contracts Litigation Practice Group.