
NEGATIVE COVENANTS IN
EMPLOYMENT CONTRACTS AND
ENFORCEABILITY

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Whenever Companies appoint key managerial personnel, it makes sure that the exit route for him is made difficult by prescribing a minimum time limit of service, prolonged notice period and negative covenant restricting the executive to join competitors during and beyond the term of the employment agreement.

With the increase in cross-border trade and an enhanced competitive climate in India, non-competent, confidentiality and other negative covenants are becoming increasingly popular.

In this regard, section 27 of the Contract Act, 1872 states that “every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.

Exception 1 – Saving of agreement not to carry on business of which goodwill is sold – One who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided that such limits appear to the Court reasonable, regard being had to the nature of the business.”

Every term in the agreement that puts restriction on the employee to leave the present employer or to join the other employer would not be termed as “restraint of trade” and would not be termed void.

For instance, an agreement of service under which an employee agrees to serve a particular employer for a certain duration, and that he will not serve anybody else during that period, is not hit by section 27 of the Contract Act, and is valid¹. If, an employee after having entered into such an agreement make a breach of the same and

takes up another job, an injunction can be issued against him restraining him from taking up the other employment².

In other words, the terms in the contract of employment requiring an employee to serve for a certain period is regarded as positive covenant and the term restricting the employee from seeking other employment is regarded as a negative covenant. A positive covenant in a contract for personal employment may not be enforced by Courts; however the negative covenants in such contracts may be enforced by Courts in India subject to certain limitations. One of the limitations being that the employee should not be put under any negative covenant beyond the expiry or termination of the contract.

The principles of section 27 were aptly summarized by the Supreme Court of India in *Percept D' Mark (India) Pvt. Ltd V Zaheer Khan*, in which the Supreme Court observed that under Section 27 of the Act a restrictive covenant extending beyond the term of the contract is void and not enforceable.

The court also noted that the doctrine of “restraint of trade” is not confined to contracts of employment only, but is also applicable to all other contracts with respect to obligations after the contractual relationship is terminated.

In the earliest times all contracts in restraint of trade, whether general or partial, were void. The severity of this principle was gradually relaxed, and it became the rule that a partial restraint might be good if reasonable, although a general restraint was of necessity void. The distinction between general and partial restraint was subsequently repudiated and the rule now is that the restraints, whether general or partial, may be good if they are reasonable and any restraint of on the freedom of contract must be shown to be

reasonably necessary for the purpose of freedom of trade. A covenant in restraint of trade must be reasonable with reference to the public policy and it must also be reasonably necessary for the protection of the interest of the covenantee and regard must be had to the interest of the covenantor. Contracts in restraint of trade are prima facie void and the onus of proof is on the party supporting the contract to show that the restraint goes not further than is reasonably necessary to protect the interest of the covenantee and if this onus is discharged the onus of showing that the restraint is nevertheless injurious to the public is on the party attacking the contract. The court has to decide, as a matter of law. (i) whether a contract is or is not in restraint of trade, and (ii) whether, if in restraint of trade, it is reasonable. The court takes a far stricter and less favourable view of covenants entered into between employer and employee than it does of similar covenants between vendor and purchaser or in partnership agreements, and accordingly a restraint may be unreasonable as between employer and employee which would be reasonable as between the vendor and purchaser of a business³.

When a seller or a manufacturer agrees to supply the whole of his product to a particular buyer only, or a buyer agrees to purchase his requirements of certain commodity from a particular seller or manufacturer only, such an agreement will not be hit by section 27 of the Contract Act, provided the object is not to corner goods or to monopolies trade⁴.

Contract restraining an employee to engage himself in similar duties, unless the same is unconscionable, excessively harsh or one-sided, is not in restraint of trade. Restraint of trade, if reasonably necessary, shall prevail unless contrary to public policy⁵.

The reasonableness of the restraint is not envisaged by section 27 of the Contract Act, under section 27 – restrictive covenant extending beyond the term of the contract is

void and not enforceable. That the doctrine of restraint of trade does not apply during the continuance of the contract of employment; and it applies only when the contract comes to an end, is not confined to a contract for employment, but is also applicable to other contracts. In other words, the doctrine of restraint of trade is the same for the contracts of employment as well as the other contracts and the restrictive covenant in the agreement to operate beyond the contract period is void and hit by section 27 of the Contract Act. Restrictive covenant is to apply during the period of contract, but shall fall under section 27 of the Contract Act where it is to operate after the contract was ended⁶.

It is important to mention here that section 42 of the Specific Relief Act, 1963 specifically allows injunction to perform negative agreement. Section 42 states as follows:

“Notwithstanding anything contained in clause (e) of the section 41, where a contract comprises an affirmative agreement to do a certain act, coupled with a negative agreement, express or implied, not to do a certain act, the circumstances that the Court is unable to compel specific performance of the affirmative agreement shall not preclude it from granting an injunction to perform the negative agreement:

Provided that the plaintiff has not failed to perform the contract so far as it is binding on him.”

With regard to a contract of employment sought to be enforced by an employer, injunction under section 42 against the employee may be granted only when all the following conditions are satisfied:

1. The contract of employment contains a positive covenant;
2. The positive covenant is coupled with a negative covenant; and
3. The employer has not failed to perform the contract so far as it is binding on him.

For instance, the defendant contracted to sing at the plaintiff's theater and not to sing at any other theater. While the court cannot compel the defendant to sing at the theater of the plaintiff it can restrain the defendant from singing at any other theater. The defendant agreed to act as a player in a jatra performance. The defendant was guilty of breach of contract. Court has discretion in granting injunction in the matter of negative covenant. Court by an order of injunction restrained the defendant from acting as a player for any stage or screen performance for a year⁷. Negative covenant that the seller will not sell the ore to anyone other than that buyer, buyer can obtain a temporary injunction restraining the seller from selling⁸.

Conditions to be satisfied to obtain injunction: The stipulation must be reasonable in reference to the interests of the contracting parties and the public⁹. A negative covenant not to serve elsewhere remains effective during the period of service contracted, a contract not to serve elsewhere beyond the contractual period of service being in restraint of trade is void². The power to grant injunction to enforce negative covenant is discretionary. It shall not be granted if the negative covenant is extremely harsh, unreasonable or unconscionable. It shall be refused particularly if such injunction compels a person to remain idle and restrains him from not doing any trade or profession¹⁰.

JOINING A COMPETITOR

Almost all the contract for employment contains strict covenants restricting employees from joining competitors even beyond the expiry or termination of their present employment contract. The cross employment of key personnel with competitors have been subjected to fierce legal battles, the Courts have almost on all occasions held that the employer has no legitimate interest in preventing an employee after he leaves his

service from entering the service of a competitor merely on the ground that he is a competitor.

The Hon'ble High Court of Delhi in *Pepsi Foods Ltd & Ors V Bharat Coca-cola holdings Pvt. Ltd.*, had summarized the reasons for refusal of grant of injunction to enforce the negative covenants, on the back ground of joining competitors, in the following words:

(a) The injunction, as prayed for by the Plaintiffs, if granted would certainly have a direct impact of curtailing the freedom of employees for improving their future prospects and service conditions by changing their employment.

(b) Rights of an employee to seek and search for better employment cannot be restricted by an injunction.

(c) Injunction cannot be granted to create a situation such as 'Once a Pepsi employee, always a Pepsi employee'. It would almost be a situation of 'economic terrorism' or a situation creating conditions of 'bonded labour'.

(d) Freedom of changing employment for improving service conditions is a vital and important right of an employee, which cannot be restricted or curtailed by a Court injunction.

(e) Interchangeability of service is an accepted norm of Service Jurisprudence which cannot be curtailed by a Court injunction.

(f) 'Employees' right to terminate their contracts also cannot be curtailed by Court injunction.

(g) An injunction can be granted only for protecting the rights of the plaintiffs, but cannot be granted to limit the legal rights of the defendants.

(h) An injunction cannot be granted where the Courts have a doubt in the credibility, veracity and truthfulness of the plaintiff's version.

(i) An injunction also cannot be granted in a case where the Court directly or indirectly gets the impression that the injunction has been sought for extraneous considerations or oblique motives.

(j) Rough and tumble of the business including stiff competition has to be faced in a free market economy. The problems which should be settled in the market place cannot be brought to Law Courts or settled by a Court injunction.

(k) In economic matters, while granting injunction, business realities have to be taken into consideration. The employees seek betterment and advancement of their careers, while they are in service. It is impracticable and unrealistic to artificially create a situation by a Court injunction when employees would first leave the employment and then look for better service conditions and job opportunities elsewhere.

(l) Most of the senior employees of the plaintiffs or the defendants were working with other multinationals or business organisations. They joined the plaintiffs or the defendants because attractive salaries and better service conditions were offered by them. The plaintiffs themselves have engaged a large number of employees who were working in other multinational or business organisations. They were appointed because they had work experience with other organisations. The same plaintiffs are not justified in seeking an injunction so that their employees may not join the defendants. All that is to be seen is whether the defendants had adopted unfair means in advancing their business interests or not.

(m) In a free market economy, everyone concerned, must learn that the only way to retain their employees is to provide them attractive salaries and better service conditions. The employees cannot be retained in the employment perpetually or by a Court injunction.

(n) Free, fair and uninterrupted competition is the life of the trade and business. This freedom in free market economy has to be zealously protected in the larger interest of

free trade and business. No injunction can be granted which is likely to restrict or curtail this freedom¹¹.

CONFIDENTIALITY

Confidential obligations, post-termination of employment will be enforced in limited circumstances so long as they remain reasonable and limited in time and scope and the employer can support that the information is confidential and proprietary to it.

A clause prohibiting an employee from disclosing commercial or trade secrets is not in restraint of trade. The effect of such a clause is not to restrain the employee from exercising a lawful profession, trade or business within the meaning of section 27 of the contract Act¹².

Indian Courts will in certain circumstances enforce the confidentiality agreements intended to protect an employer's proprietary rights. But the Courts remain sensitive to the possibility that employers may try to use these covenants as a back-door means of restraining employees from exercising their trade and will place an extremely high burden of proof on employers seeking to enforce these provisions.

Service covenant binding the employee not to divulge any confidential secret information acquired during employment cannot extend beyond employment¹³.

NON-SOLICITATION AGREEMENT

Non-solicit contract is to restrict either party from enticing each other employee away from their respective employments. Such contracts are not contract between an employer and employee and the covenants bar either party from offering inducements to the other's employees to give up employment and join them. As such, these

contracts by itself do not put any restriction on the employees and are therefore not covered within the purview of section 27 of the Contract Act.

Non-solicitation obligations post-termination of employment may be enforced in limited circumstances, based upon the facts of each individual case.

The judicial precedents discussed above and the combined effect of section 27 of the Contract Act and section 42 of the Specific Relief Act can be summarized in the following words:

1. A restrictive covenant extending beyond the term of the contract is void and not enforceable;
2. The doctrine of restraint of trade does not apply during the continuance of the contract for employment and it applies only when the contract comes to an end;
3. The aggrieved employer can claim damages for the losses suffered from the erring employee owing to the termination of the contract of employment.

Footnotes

1. I.L.R (1898) 23 Bom 103
2. AIR 1967 SC 1098
3. AIR 1995 SC 2372
4. AIR 1931 All. 539
5. AIR 1967 SC 1098
6. AIR 2004 Bom 362
7. AIR 1993 Cal 289
8. AIR 1996 Cal 67
9. AIR 1966 Guj 189
10. 1980 MPLJ 445, AIR 1995 SC 2372
11. 1999 VAD (Delhi) 93: ILR 1999 Delhi 193.
12. 2008 (2) BomCR 446
13. AIR 1997 Guj 177

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