

ENFORCEABILITY OF NON COMPETE CLAUSE IN INDIA

Non Compete Provisions: Restrictions in an agreement pertaining to exclusivity which are operational during the period of the agreement are valid. Any post-termination restriction of a non-compete nature will be prohibited by Section 27 of the Contract Act, which prohibits a restraint from exercising a lawful profession or trade or business of any kind. Such contracts are unenforceable, void and against the public policy.

The Indian Contract Act, 1872, which provides a framework of rules and regulations, governing the formation and performance of a contract in India deals with the legality of such non-compete covenants. It stipulates that an agreement, which restrains anyone from carrying on a lawful profession, trade or business, is void to that extent.

Agreement in restraint of trade is defined as the one in which a party agrees with any other party to restrict his liberty in the present or the future to carry on a specified trade or profession with other persons not parties to the contract without the express permission of the latter party in such a manner as he chooses. Providing for restraint on employment in the employment contracts of the employees in the form of confidentiality requirement or in the form of restraint on employment with competitors has become a part of the corporate culture.

Section 27 of the said Act governing the validity of agreements in restraint of trade states as under:

Every agreement by which anyone is restrained from exercising a lawful profession or trade or business of any kind, is to that extent void.

Exception: One who sells goodwill of a business with a 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 business.

Although the section states that all agreements in restraint of any profession, trade or business are void, the current trend as per various judicial pronouncements leads to the conclusion that reasonable restraint is permitted and does not render the contract void ab initio. Reasonableness of restraint depends upon various factors, and the restraint in order to prevent divulgence of trade secrets or business connections has to be reasonable in the interest of the parties to ensure adequate protection to the covenantee. The above section implies that to be valid an agreement in restraint of trade must be reasonable as between the parties and consistent with the interest of the public.

The Supreme Court of India in *Niranjan Shankar Golikari v. The Century Spinning and Manufacturing Company Ltd.* observed that restraints or negative covenants in the appointment or contract may be valid if they are reasonable. A restraint upon freedom of contract must be shown to be reasonably necessary for the purpose of freedom of trade.

The court held that a person may be restrained from carrying on his trade by reason of an agreement voluntarily entered into by him with that object. In such a case the general principle of freedom of trade must be applied with due regard to the principle that public policy requires the utmost freedom to the competent parties to enter into a contract and that it is public policy to allow a trader to dispose of his business and to afford to an employer an unrestricted choice of able assistance and the opportunity to instruct them in his trade and its secrets without fear of their becoming his competitors. Where an agreement is challenged on the ground of its being in restraint of trade, the onus is upon the party supporting the contract to show that the restraint is reasonably necessary to protect his interests. Once, this onus is discharged by him, the onus of showing that the restraint is nevertheless injurious to the public is upon the party attacking the contract.

A covenant in restraint of trade lies between two different principles of public policy. A person entering into a contract of his own free shall be bound by the same. At the same time it is necessary that he should have liberty to exercise his powers and capacities for his own and the community's benefit. Public policy requires that every man, even though at liberty to work for himself, is not at liberty to deprive himself or his labour, skill or talent by any contract that he enters into.

A negative covenant that the employee would not engage himself in a trade or business or would not get himself employed by any other manner with whom he would perform similar or substantially similar duties, is not therefore, a restraint of trade unless the contract as aforesaid is unconscionable or excessively harsh or unreasonable or one sided. A contract which is in restraint of trade cannot be enforced unless (a) it is reasonable as between parties and (b) it is consistent with the interest of the public.

The non-compete covenants used in agreements can be categorized into in term and post term covenants. In an employment contract, the basic interests of the employer which are required to be protected include trade secrets and business connections and other such confidential information. In case of restraints in contracts of employment the nature of business and employment is relevant in assessing the reasonableness of the abovementioned restraints. An employee owes a duty to the employer to not disclose to others or use to his own advantage the trade secrets or confidential information which he had access to during the course of employment and he could be restrained from or sued for divulging or utilizing any such information in his new employment. But once again, he cannot be prevented from taking up the employment. Also, the employer cannot prevent the use of employee's knowledge, skill or experience even if the same is acquired during the course of employment. Restrictive covenants are different in cases where the restriction is to apply during the period after termination of the contract than in those cases where it is to operate during the period of the contract.

Negative covenants operative during the period of contract of employment when the employee is bound to serve the employer exclusively are generally not regarded as restraint of trade and do not fall under *Section 27* of the said Act. A negative covenant, one that the employee would not engage himself in a trade or business or would not get employment under any other employer for whom he/she would perform similar or

substantially similar duties, is not a restraint of trade unless the contract is unconscionable or excessively harsh or unreasonable or one sided.

Negative covenants tied up with positive covenants during the subsistence of the contract, be it of employment, partnership, commerce, agency or like, are not normally regarded as being in restraint of trade, business or profession unless the same are unconscionable or wholly one sided and thus do not fall under *Section 27* of the said Act. During the period of employment, the employer has the exclusive right to the services of the employee. A restraint operating during the term of the contract fulfils one purpose, that of furthering the contract, such a restraint is designed to fulfill the contract. Where the contract of employment contains such a covenant and the employee leaves the service the negative covenant can be enforced to the extent that the unexpired part of the term or service would be essential for the fulfillment of the contract. However, even the restraints, which operate only during currency of employment, may be subject to the doctrine of restraint of trade, if the restraints are such that one of the parties is so unilaterally fettered that the contract loses its character of a contract for the regulation and promotion of trade and acquires the predominant character of restraint of trade.

The Supreme Court in the Golikari Case mentioned above considered the question of negative covenants. In this case an employee was given special training by his employer, on condition that he would serve the company for 5 years, and that if he left his employment before such period, he would not directly or indirectly engage in the same business and also pay liquidated damages. The Supreme Court held that that the negative covenants, which operate during the period of service, are generally not regarded as restraint of trade and therefore not fall within *Section 27* of the Act, unless the contract is unconscionable or unreasonable. It was therefore held that this was a valid contract.

Post term restrictive covenants have been held invalid through various judicial pronouncements. An employer is not entitled to protect himself against competition on the part of an employee after the employment has ceased. However, a purchaser of a business is entitled to protect himself against competition *per se* on the part of the vendor and it has been upheld that a employer has no legitimate interest in preventing an employee after he/she leaves his service from entering the service of a competitor merely on the grounds that the employee has started working with a competitor, unless the same leads to misuse or an unauthorised disclosure of confidential information, which has been provided to the employee during his course of employment.

Thus, the post-service restraint is only legally enforceable in cases where the employer has placed some reasonable restraints on the employee of the company to ensure that the latter shall not disclose any confidential information of the former to any business competitor even after the termination of the service. Such post service restraint has been held to be enforceable and falls outside the purview of *Section 27* of the said Act.

Apart from the non compete covenants in the employment agreements; another clause refers to the non solicitation or non poaching. Non-solicitation agreements are those agreements by which the employee promises not to solicit the employer's clients or one

party agrees to refrain from employing the employees of the other party for a given period after the termination of the employment. Generally, negative covenant during the period of the agreement is considered not to be hit by law but there are certain non-solicitation agreements which are prima facie negative in nature but still stand as an exception and are enforceable even after the conclusion of the employment and are held by the Courts to be valid in law.

General injunctions against non-poaching by the competitor may not be granted as such clauses may be viewed against public interest. However, where the individuals are the beneficiaries of specific ideas or skills or training that they have acquired by working with the employer, the employer may get a specific restraining order, pertaining to these employees.

The Supreme Court in the Golikari case, referred to earlier, considered the refusal of the employer to accept the resignation of the employee and who wanted to work with a competitor in the same line of business, for which he was specifically trained and in respect of which he had signed a non-compete clause. The injunction sought by the employers for preventing the employee from divulging secrets was not held to fall foul of *Section 27* of the said Act. The courts held that the confidentiality clause was not too wide or unreasonable for protection of interests of the respondent company.

Franchise agreements contain covenants relating to confidentiality in relation to know-how and other forms of intellectual property and the franchisor has legal recourse in cases where: an employee comes into possession of a trade secret, know-how and confidential information in the normal course of business and passes off such information, an unauthorized person incites such an employee to provide him with such information, or under a license for the use of know-how, a licensee is in breach of condition, either expressed in an agreement or implied from the conduct, to maintain secrecy.

Non-competition clauses are those, which oblige the franchisor or master franchisee not to operate a competing franchise within a certain radius or for a period after the termination of the franchise agreement. The enforceability of such clause varies widely and depends on its reasonableness.

In the case of *Gujarat Bottling Co. Ltd. and others v. Coca Cola Co. and others* An agreement for grant of franchise by Coca Cola to Gujarat Bottling Company to manufacture, bottle, sell and distribute beverages under trademarks held by the franchisor contained the negative stipulation restraining the franchisee to “ manufacture, bottle, sell, deal or otherwise be concerned with the products, beverages of any other brands, or trademarks/ trade names during subsistence of this agreement including the period of one years notice”. It was held that the negative stipulation was intended to promote the trade. Moreover, operation of the stipulation was confined only to subsistence of the agreement and not after termination thereof. Hence, stipulation could not be regarded as in restraint of trade.

It was observed by the Supreme Court '*There is a growing trend to regulate distribution of goods and services through franchise agreements providing for grant of franchise by the franchisor on certain terms and conditions to the franchisee. Such agreements often incorporate a condition that the franchisee shall not deal with competing goods. Such a condition restricting the right of the franchisee to deal with competing goods is for facilitating the distribution of the goods of the franchisor and it cannot be regarded as in restraint of trade.*'

In the case of *V.V. Sivaram and others v. FOSECO India Limited*, an employee was restrained from using secrets and confidential information, which he gained during job, even after moving out of the job. The employee had access to confidential information pertaining to several products including the patent 'Turbostop'. He left under voluntary retirement scheme. Injunction restraining him from manufacturing and marketing a product similar to 'Turbostop' was held to be not violating *Section 27*.

It can be understood from the above judgments that although non-compete clauses in franchise agreements are not seen as being in restraint of trade, they should not be excessively harsh or unreasonable in case of which the court may refuse to enforce it in its entirety.

Thus, it can be concluded that the non- compete covenants are usually opposed to freedom of contract and are likely to be easily charged as agreement in restraint of trade. The non compete covenants are generally considered to be valid during the time of employment though the Courts have been less willing to enforce agreements relating to post-employment restraints on the employee. The fundamental principle is that an agreement in restraint of trade is void to the extent of the restraint. It is for the courts to determine whether the contract is reasonable, and the test is whether it is prejudicial or not to the public interest, since these contracts are considered on grounds of public policy. This implies that the restraint must be reasonable in the interests of both contracting parties and also in the interests of the public.

One of the few instances in which non-competition clauses will generally be enforceable is in the context of the sale of a business, where the owners of the business will agree to a non-compete in exchange for consideration for the goodwill associated with the business (for example, in a stock sale where the promoters will sell their stock in the business to a buyer in exchange for consideration). To be enforceable, the non-compete will need to be reasonably limited in time and scope, and consideration will need to be attributed to the goodwill in the transaction, as evidenced in the documentation. Similarly, a non-compete clause in a joint venture in which shareholders mutually agree not to compete with each other on certain terms and conditions, which include time and geographic restrictions, will generally be enforceable in India.

Conclusion

To sum up the entire issue the following points may be considered:

1. When you purchase a business (and along with it, the goodwill), reasonable restraints may be included to prevent the seller from setting up a competing business after selling his business to you.
2. During the term of the shareholders' agreement, a shareholder can be prevented from setting up a competing business (as it is reasonable restriction).
3. After the termination of the shareholders' agreement, a shareholder can be prevented from setting up a competing business only if it would cause irreparable injury to the existing business and the balance of convenience lies in favour of issuing the order.

Therefore prima facie it may be concluded that while restraining covenants would be valid during the subsistence of the agreement however only in exceptional circumstances depending upon the facts and merits of each case can a post termination restrictive covenant be held to be valid.

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