Non-compete clauses: protection or restraint?

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Imagine: Before the advent of the Covid-19 pandemic, Company B, a private limited company, acquired Company A, another private company, with both companies incorporated in India. John Doe was the promoter of Company A, and as part of the acquisition, he signed up to a non-compete obligation that does not permit him to start a new business, or to take up employment, consultancy or enter into any other engagement with any entity competing with the business of Company A. His association with Company B and the non-compete restriction is contractually valid until December 2021. However, in the present times, as part of austerity measures, he has been asked to discontinue his services. Due to the pandemic, the market has become volatile and jobs are difficult to come by. Now, he has received an offer from a competing entity. John Doe is in a dilemma: he needs to take up the offer with the competitor, as his skills and expertise are limited to this sector; however, the possibility of Company B pursuing legal action against him for breach of contract is troubling him.

What does non-compete mean?

Non-compete clauses are standard in employment agreements, especially with senior executives, and also in M&A deals. Through non-compete clauses, founders and key executives exiting the business are bound by certain restrictions. Pursuant to a non-compete clause, a person agrees not to start a new business, or to take up employment or engage in any manner with any other competing entity. Such restrictions are usually limited by a period and by specific geography, which means that the person shall not be permitted to work in competing businesses during a certain period, within the identified geography. The rationale for binding senior executives by such restrictions is that they have access to confidential and proprietary information, and intellectual property relating to the company, the use of which during the service with a competing entity may cause an unfair business advantage. Similarly, in M&A deals, the commercial value of the acquisition becomes compromised if the exiting founders start or join a competing entity, as it leads to the loss of competitive advantage to the acquirer.

Legal position in India

As per section 27 of the Indian Contract Act 1872, an agreement by which anyone is restrained from exercising a lawful profession, or trade or business of any kind is to that extent void, unless they fall within the narrow exception carved out by the statute. The underlying principle behind this provision is that an individual is entitled to exercise its lawful trade or calling as and when it wills, and that the law guards against interference with trade, even if it means interfering with the freedom of contract.

The Supreme Court of India and various high courts have consistently taken the view that: (1) negative covenants can only be enforceable to the extent that they are reasonable;[1] and (2) the purpose of the covenant is to protect the legitimate business interests of the buyer. Even in the aforementioned circumstances, the restraint cannot be greater than necessary to protect the interest concerned.[2]

The approach adopted by Indian courts with respect to employees is that such restrictions during the period of employment are valid and considered legitimate for the protection of the business interests of the company and hence, do not violate section 27.[3] It is merely a tool towards the fulfilment of the employment contract and not a restraint of trade because it only requires the employee to serve the employer exclusively.

However, the survival of such restrictions beyond the period of employment is controversial. The courts have generally held that the right to livelihood of the employee must prevail over the interests of the employer, despite the existing agreement between the employer and employee. The Delhi High Court in *Affle holdings Pte Limited v Saurabh Singh*[4] held that a negative covenant in the employment contract, prohibiting carrying on a competing business beyond the tenure of the contract, is void and unenforceable.

Non-compete obligations in M&A deals

Interestingly, courts may not frown upon certain non-compete restrictions between purchasers and vendors extending beyond the period of engagement, where such restrictions accompany the sale of goodwill of a business. However, such restrictions are applicable within specified local limits, and such limits must appear to be reasonable to the court, having regard to the nature of the business. For instance, the Delhi High Court in *Ozone Spa Pvt Ltd v Pure Fitness & Ors* restrained the defendants from establishing, running or setting up any competing business in the local area where the premises of the plaintiff was situated.[5]

Certain principles espoused by Indian courts are: (1) there should be a legitimate business interest to be protected in order for the non-compete restriction to be valid; (2) the purpose of the covenant cannot be greater than necessary to protect the legitimate business interests;[6] and (3) non-compete restrictions cannot apply in perpetuity. If needed, these principles may be applied to enforce non-compete clauses agreed as part of the sale of a business, along with goodwill. The courts are unlikely to permit the enforcement of such restrictions beyond the period of their engagement if the enforcing party fails to establish that a sale has been effected along with the associated goodwill.

Uncertainty over the enforceability of a non-compete clause has resulted in the insertion of 'garden leave' clauses in acquisition agreements. Under 'garden leave' clauses, employees are paid their full salary during the period in which they are restrained from competing. The Bombay High Court in *VFS Global Services Private Limited v Mr Suprit Roy*[7] observed that the payment of compensation during garden leave does not renew the contract of employment; therefore, the garden leave clause is *prima facie* in restraint of trade and is affected by section 27 of the Contract Act. Nevertheless, the concept of 'garden leave' is popular and widely practiced in India. Additionally, Indian courts may enforce restrictions in the nature of the non-disclosure of confidential information and non-solicitation of customers and employees.

Comparison with laws in other jurisdictions

In the United Kingdom, certain post-termination restrictions are enforceable, provided they pass the test of reasonability, that is, the restraint is designed for the protection of some proprietary interest of the employer or buyer. Important factors for evaluating whether a non-compete provision protects a legitimate interest include an analysis of whether there is a material risk of misuse of confidential information and whether the covenant is wider than is reasonably necessary for the protection of those interests.

In the United States, an interesting principle adopted by courts in a few states is the 'blue pencil' principle, which refers to the power of the courts to reduce the unreasonable scope of a non-compete clause to something reasonable. This concept is similar to the principle of 'severability', whereby the enforceable portion survives after striking off the unenforceable portion, with the added power in the hands of the court to rewrite the provision to make it reasonable (referred to as reformation). Some of the factors that are considered by the courts while reforming a non-compete clause are the bargaining power of the parties, and the scope and extent of the restriction. The supporters of this principle are of the view that, considering the intent of the parties was to be bound by some restrictive covenant, it is only fair that the courts be permitted to modify the clause in a manner that it can be enforced. However, the critics of the 'blue pencil' principle are of the view that this power entitles courts to decide commercial arrangements between the parties, which should be left to the commercial wisdom of the parties. Further, such power in the hands of the courts would also lead to employers keeping the language of the restrictive covenant broad and leaving it to the courts to narrow down the scope in each case; thus, increasing disputes and litigation around such clauses.

Conclusion

There is no 'one-size-fits-all' concept for non-compete provisions, and the laws of the relevant jurisdiction will be the driving factor for enforcement. In order to enforce a post-termination covenant, it is important to ensure that there has been a sale of goodwill of a business, and this should be evident from the acquisition agreement. In India, neither the test of reasonableness nor the principle of the restraint being partial would be applicable unless it comes under the exception to section 27 of the Contract Act, that is, sale of goodwill of a business.

As far as John Doe is concerned, he can take up the offer from the competing entity with fewer concerns if the non-compete provision that he signed up for makes the non-compete restriction applicable in India because, considering the current situation with the pandemic, it is highly unlikely that the courts in India will enforce this restriction.

Notes

[1]*Niranjan Shankar Golikari v Century Spinning & Mfg Co*, (1967) 2 SCR 378 and *Mr V Rajagopalan v M/s Secan Invescast (India) Pvt Ltd*, 2013 SCC Online Mad 389.

[2]*Gujarat Bottling Co Ltd v The Coca Cola Co & Ors*, 1995 SCC (5) 545 and *Le Passage to India Tours & Travels Pvt Ltd v Deepak Bhatnagar*, 2014 SCC Online Del 259.

[3]*Niranjan Shankar Golikari v Century Spinning & Mfg Co*, (1967) 2 SCR 378.

[4]2015 SCC OnLine Del 6765.

[5] *Ozone Spa Pvt Ltd v Pure Fitness & Ors*, 2015 222 DLT 372

[6]*Gujarat Bottling Co Ltd v The Coca Cola Co & Ors*, 1995 SCC (5) 545.

[7]2008 (3) MhLj 266.

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