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VALIDITY OF NON-COMPETE COVENANTS IN INDIA

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The law has, as a matter of public policy, always opposed any interference with the freedom to contract and restraints on the liberty of an individual, unless injurious to the interests of the state. This principle is not confined to restraints of trade in the ordinary sense of the word "trade," but includes restraints on the right of being employed. (*Niranjan Shankar Golikari v. Century Spg. and Mfg. Co. Ltd.,* AIR 1967 SC 1098) An agreement in restraint of trade has been defined as "one in which a party agrees with any other party to restrict his liberty in the future to carry on trade with other persons who are not parties to the contract in such a manner as he chooses." (*Petrofina (Great Britain) Ltd. v. Martin,* (1966) Ch. 146 as cited in I, Pollock & Mulla, *Indian Contract and Specific Relief Acts* (12th ed.) at p. 794)

Section 27 of the Indian Contract Act, 1872 ("IC Act") stipulates that an agreement, which restrains anyone from carrying on a lawful profession, trade or business, is void to that extent. The reasoning behind this section is that agreements of restraint are unfair, as they impose an undue restriction on the personal freedom of a contracting party. However, as an exception, if a party sells his goodwill to another he can agree with the buyer that he will not carry on a similar business within the specified local limits.

As can be seen from the foregoing provision, Indian law is rigid and invalidates all restraints, whether general or partial. Neither the test of reasonableness, nor that of partial restraints applies to a case governed by section 27 of the IC Act, unless the restraint falls within the exception of that section. Upon a literal construction, section 27 of the IC Act invalidates all agreements that impose a total bar on the exercise of a lawful business.

The Supreme Court of India has held that to the extent the IC Act deals with a particular subject, importing principles of English law dehors the statutory provisions cannot be permitted, unless the statute is such that it cannot be understood without the aid of the English law. The question whether an agreement is void under section 27 of the IC Act must be decided upon the wording of that section alone. (*Superintendence Co. of India Pvt. Ltd. v. Krishan Murgai,* AIR 1980 SC 1717)

In *Superintendence Co. (Id.),* the contract of employment placed the employee under a post-service restraint preventing him from serving in any other competing firm for two years within the local limits of his last posting. As such, the restraint was operative for a period of two years after he left the company. The two substantial questions involved were:

(a) whether a post-service covenant in restraint of trade between the parties was void under section 27 of the IC Act; and

(b) whether the said restrictive covenant, assuming it to be valid, was on its terms enforceable at the instance of the employer against the employee?

The court concluded that the negative covenant during the term of the contract was not in restraint of trade, and that the doctrine of restraint of trade could never apply during the continuance of the contract. However, a restrictive covenant extending beyond the term of service was void. The court referred to *Madhub Chunder v. Rajcoomar Doss,* (1874) 14 Beng LR 76 at pp. 85-86, where it had been held that whether the restraint was general or partial, unqualified or qualified, if it was in the nature of a restraint of trade, it was void.

While deciding *Superintendence Co.'s (Id.),* the court observed that employee covenants in agreements should be carefully scrutinized, because there was an inequality of bargaining power between the parties; and, more often than not, no bargaining power, especially in cases where the employee was presented with a standard form of contract that he had to accept or reject.

Pursuant to the foregoing decisions, the Bombay High Court held that a restraint operating after termination of the contract to secure freedom from competition from a person who no longer worked within the contract, was void. The court refused to enforce the negative covenant and held that, even if such a covenant was valid under German law, it could not be enforced in India. *(Taprogge Gesellschaft MBH v. IAEC India Ltd.,* AIR 1988 Bom 157)

In another case filed by a former employer seeking to enforce an agreement to restrain the employee from adopting and using any of the processes invented by the former employer in a subsequent employment, the court held that the agreement was void, because an employee could not be restrained from using knowledge which he gained during the course of his previous employment, foreover. (*M/s. Sociedade de Fomento Indl. Ltd. v. Ravindranath Subraya Kamath,* AIR 1995 Bom 158)

On the basis of all the aforesaid judgments, the Supreme Court of India held that, since the underlying principle governing all contracts in restraint of trade was the same, the principle not only applied to contracts of employment but to other contracts as well. The court, however, ruled that a negative stipulation contained in a franchise agreement restraining the franchisee from dealing with competing goods was to facilitate the distribution of the goods of the franchiser and could not be regarded as a restraint of a right to trade. (*Gujarat Bottling Company Ltd. v.*

Coca Cola Company, AIR 1995 SC 2372) However, in an old case, where the defendant and the plaintiff used to carry on the business of ferrying boats and arrived at a business settlement whereby the defendant promised to pay a certain amount to the plaintiff in order that the plaintiff abstain from carrying on his boat business for a period of three (3) years, the court held that the agreement was void as the restraining covenant was a vital part of the agreement and did not fall under the "goodwill exception" to section 27 of the IC Act. (*Parasulla Mallick v. Chandra Kanta Dass,* AIR 1918 Cal 546)

In conclusion, covenants that prohibit employees from engaging in a business similar to or competitive with that of the employer beyond the term of employment are invalid. The same applies to non-compete agreements between companies, except franchise agreements, notwithstanding that, the popular view is that non-compete arrangements between companies are valid.

On many occasions, business exigencies require impositions of certain restraints. The attitude towards public policy has always been subject to change in tandem with the change and development in trade and economic thought. Therefore, the general principle applicable to agreements in restraint of trade needs to be suitably modified. In this regard, the Law Commission of India has recommended in its 13th report that section 27 of the IC Act should be amended so as to allow restrictions and contracts in restraint of trade, if they are in the interest of the parties as well as of the public. However, no action has been taken so far.

Under recent amendments to India's Income-tax Act, 1961, any sum received or receivable in cash or kind under an agreement for not carrying out any activity in relation to any business or for not sharing any know how, patent, copyright, trademark, licence, franchise, or any other business or commercial right of similar nature, or information or technique likely to assist in the manufacture or processing of goods of provision for services, will now be chargeable to tax as profits or grains from business or profession. Therefore, the revenue authorities seek to tax payments received by companies for entering into non-compete covenants as business profits. The issue that arises is whether taxability of such payments validates the underlying transactions. In our opinion, until judicial precedents to the contrary are pronounced, there will always be a question mark as regards validity of non-compete covenants.