



## NON- COMPETE CLAUSES DURING AND POST-TERMINATION OF AGREEMENT

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### INTRODUCTION

A non-compete clause prevents a person from starting a new business, taking up employment, or engaging with a competing entity. "Such clauses have long been controversial, as they conflict with **Section 27 of the Indian Contract Act, 1872**, which declares that any agreement restricting a person from pursuing a lawful profession, trade, or business is void, except in cases where goodwill has been sold."<sup>47</sup> It can be seen that "**Sections 54 and 55 of the Indian Partnership Act, 1932**, validate reasonable restrictions on partners from engaging in similar businesses upon dissolution or following the sale of goodwill."<sup>48</sup>



<sup>47</sup> The Indian Contract Act, 1872, (S) 27, No. 9, Acts of Parliament, 1872 (India).

<sup>48</sup> The Indian Partnership Act, 1932, (S) 27, No. 9, Acts of Parliament, 1932 (India).



**Article 19(g) of the Constitution of India** provides every citizen the right to practice any profession, trade, or business. This is not an absolute right and reasonable restrictions can be placed on this right in the interest of the public, the courts have always been wary of upholding such restrictions and have kept the interpretation of this provision flexible to ensure that principle of justice, morality, and fairness are aptly applied, depending upon facts and circumstances of each case.

Indian courts have delivered a range of judicial pronouncements that have progressively clarified the legal stance on non-compete clauses in agreements. The judicial approach has seen a gradual evolution, starting from early cases like "**Madhub Chunder Poramanick v. Rajcoomar Doss and Ors.**"<sup>49</sup> to more recent instances involving non-compete clauses in agreements of major IT companies such as Infosys.

To comprehensively understand the position of non-compete clauses under Indian law, it is essential to distinguish between non-compete clauses during the subsistence of an agreement and those post-termination of the agreement.

#### **ENFORCEABILITY OF NON-COMPETE CLAUSE DURING THE SUBSISTENCE OF THE AGREEMENT**

Various judgments indicate that non-compete clauses in agreements are enforceable while the agreement is active. This has been clearly established in cases such as "**Madhub Chunder Poramanick v. Rajcoomar Doss and Ors**"<sup>50</sup> and "**Percept D'Mark India Pvt Ltd v. Zaheer Khan**"<sup>51</sup> among plethora of other judgements.

"The Hon'ble Supreme Court in the case of **Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co. Ltd** held that, preventing an employee from providing services to the employer's competitor during

<sup>49</sup> *Madhub Chunder Poramanick v. Rajcoomar Doss and Ors*, (1874) Beng LR 76.

<sup>50</sup> *Ibid*.

<sup>51</sup> *Percept D'Mark India Pvt Ltd v. Zaheer Khan*, (2006) 4 SCC 227.

the course of employment is not void. It is essential for fulfilment of terms of the agreement and to protect the interests of the employer. "<sup>52</sup> "Thereby, not violating section 27 of the ICA. 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. In the case of **Percept D'Mark (India) Pvt. Ltd. v. Zaheer Khan and Anr**, "<sup>53</sup> the Apex Court observed,

"Under Section 27 of the Contract Act:

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 employment contract and is applied only when the contract comes to an end.
3. As held by this Court in *Gujarat Bottling v. Coca Cola*, this doctrine is not confined only to contracts of employment, but is also applicable to all other contracts"<sup>54</sup>

In short, a non-compete clause in an Indian employment agreement is enforceable as long as the employee is performing work for the company by the terms of that agreement.

#### **ENFORCEABILITY OF NON-COMPETE CLAUSE POST TERMINATION OF THE AGREEMENT**

The enforceability of post-employment restrictions in employment agreements is contentious and generally considered unenforceable. In "**Superintendence Company of India (P) Ltd. v. Krishan Murgai**"<sup>55</sup> and "**Pepsi Foods Ltd. & Ors v. Bharat Coca-Cola Holdings Pvt Ltd & Ors**,"<sup>56</sup> the Hon'ble Court ruled that

<sup>52</sup> *Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co. Ltd*, 1967 SCR (2) 378.

<sup>53</sup> *Percept D'Mark (India) Pvt. Ltd. v. Zaheer Khan and Anr*, (2006) 4 SCC 227.

<sup>54</sup> The Indian Contract Act, 1872, (S) 27, No. 9, Acts of Parliament, 1872 (India).

<sup>55</sup> *Superintendence Company of India (P) Ltd. v. Krishan Murgai*, (1981) SCC 246.

<sup>56</sup> *Pepsi Foods Ltd. & Ors v. Bharat Coca-Cola Holdings Pvt Ltd & Ors*, (1999) SCC Online Del 530.



contracts aimed at restraining trade are prima facie void. In commercial agreements, non-compete clauses may extend beyond the engagement period when linked to the sale of business goodwill. These restrictions must be reasonable, not against public policy, and confined to specified local limits. For instance, in "*Ozone Spa Pvt. Ltd. v. Pure Fitness & Ors*"<sup>57</sup>, a territorial limit of 4 km was deemed acceptable, and in "*GEA Energy System India Ltd. v. Germanischer Lloyd Aktiengesellschaft*"<sup>58</sup> a partial business restraint was permitted.

"The Supreme Court of India, in *Superintendence Company of India (P) Ltd. v. Sh. Krishan Murgai* raised the question that whether a post-service restrictive covenant would fall within the mischief of section 27 of the Contract Act. The court held that a contract, which had for its object a restraint of trade, was prima facie void."<sup>59</sup>

"The Delhi High Court in *Foods Ltd. and Others v. Bharat Coca-cola Holdings Pvt. Ltd. & others* observed, *It is well settled that such post-termination restraint, under Indian Law, violates Section 27 of the Contract Act. Such contracts are unenforceable, void, and against public policy. What is prohibited by law cannot be permitted by Court's injunction.*"<sup>60</sup>

#### **REASONABLENESS TEST FOR NON-COMPETE CLAUSES IN NON-EMPLOYMENT CONTRACTS**

Section 27 of the Indian Contract Act, 1872, states that "*Every agreement by which anyone is restrained from exercising a lawful profession, trade, or business of any kind, is to that extent void. The exception allows for agreements where the goodwill of a business is sold.*"<sup>61</sup> It has been well-established through various judgments that non-compete clauses are enforceable during the term of the agreement

but become void after the agreement's termination. However, in certain judgments, particularly those not related to employment contracts, the judiciary has recognized the reasonableness of non-compete clauses and, with limitations such as time period and geographical scope, has enforced them.

#### **"M/S Gujarat Bottling Co. (GBC) & Ors vs. Coca Cola Co"<sup>62</sup> –**

The court imposed a restriction on GBC from manufacturing, bottling, selling, or engaging in any business related to beverages for one year, with the geographical limitation confined to their plants in Ahmedabad and Rajkot. The court emphasized that such restraints on trade must pass the test of reasonableness. It also highlighted that the doctrine of restraint of trade, rooted in public policy, is subject to evolving interpretations based on changing views of public interest.

#### **"Ozone Spa Pvt. Ltd. vs. Pure Fitness & Ors"<sup>63</sup>–**

The court in the case of the Franchise Agreement restricted the franchise operation to a designated territory or within a 4 km radius of it after evaluating the balance of convenience and irreparable loss in commercial contracts, the court carefully weighed the competing interests of the parties.

#### **"GEA Energy System India Ltd. vs. Germanischer Lloyd Aktiengesellschaft,"<sup>64</sup> –**

The reasonableness in this case stemmed from the argument that allowing the respondents to form a similar business with a third party would cause incalculable harm to the joint venture. The restriction was not absolute, as it did not prevent all business activity only the activity similar to the earlier joint venture. The joint venture agreement was made on equal terms, and the contract was neither overly harsh nor one-sided. Therefore, the balance of convenience was interpreted to justify the

<sup>57</sup> *Ozone Spa Pvt. Ltd. v. Pure Fitness & Ors*, (2015) DLT 372.

<sup>58</sup> *GEA Energy System India Ltd. v. Germanischer Lloyd Aktiengesellschaft*, (2009) 149 Comp Cas 68.

<sup>59</sup> *Superintendence Company of India (P) Ltd. v. Sh. Krishan Murgai*, (1981) SCC 246.

<sup>60</sup> *Foods Ltd. and Others v. Bharat Coca-cola Holdings Pvt. Ltd. & others*, (1999) ILR 2 Delhi 193.

<sup>61</sup> The Indian Contract Act, 1872, (S) 27, No. 9, Acts of Parliament, 1872 (India).

<sup>62</sup> *M/S Gujarat Bottling Co. (GBC) & Ors vs. Coca Cola Co.*, (1995) 5 SCC 545.

<sup>63</sup> *Ozone Spa Pvt. Ltd. vs. Pure Fitness & Ors*, (2015 DLT 372).

<sup>64</sup> *GEA Energy System India Ltd. vs. Germanischer Lloyd Aktiengesellschaft*, (2009) 149 Comp Cas 68.



reasonability to enforce the non-compete clause.

### **“Orchid Chemicals/ Hospira Healthcare”<sup>65-</sup>**

“The Competition Commission was of the view that non-compete in a business transfer agreement (“BTA”) obligations should be reasonable particularly in respect of (a) the duration over which such restraint is enforceable; and (b) the business activities, geographical areas and person(s) subject to such restraint, so as to ensure that such obligations do not result in an appreciable adverse effect on competition.”<sup>66</sup>

### **CRITICAL ANALYSIS**

When critically analysing the provision of non-compete clauses in India, the first key observation is the difference in judicial approach when dealing with non-compete clauses in employment agreements versus non-employment (commercial) agreements. Indian courts have generally shown greater leniency towards enforcing non-compete clauses in commercial agreements post-termination, provided the clause is reasonable. This is primarily because, in commercial contracts, both parties are presumed to have relatively equal bargaining power while negotiating the terms, including restrictions. In contrast, in employment agreements, employees are often at a disadvantage in terms of bargaining power, which makes non-compete clauses post-termination more restrictive and less enforceable.

The courts' reasoning also considers the balance of convenience and irreparable loss to businesses in commercial cases, making such clauses permissible where the restrictions are reasonable in terms of geography, time duration, and nature of business protection.

However, these justifications typically do not extend to post-termination employment agreements, where the courts prioritize

protecting an individual's right to livelihood as recognized under Article 21 of the Constitution.

That said, there is a growing judicial recognition of the employer's need to protect their business interests. Employers often invest significant resources in training employees and entrusting them with confidential and sensitive business information. Allowing employees to join competitors immediately post-termination can cause substantial harm to the company.

To strike a balance, courts could allow for limited non-compete clauses post-termination, particularly for a reasonable period (e.g., less than six months), ensuring they do not violate Section 27 of the Indian Contract Act, 1872, which renders agreements in restraint of trade void. A reasonable restriction that safeguards business interests while respecting the employee's right to work could offer a more pragmatic and legally tenable solution.

It is imperative to note that depending on whether the covenant was issued in the context of a commercial transaction or as part of an employment contract, the methodology of the courts in resolving the question of reasonableness differs significantly.

Nevertheless, whether dealing with a non-compete provision in a business transaction or any employment contract, there are no set guidelines or limits to determine the extent to which such terms can be accepted, therefore each instance is unique.

To have a clear understanding, the reasonableness of these terms can be judged based on a variety of circumstances, and clauses that go beyond the limit of reasonableness are declared void. While it is a settled position of law that non-compete provisions bind employees during the term of their employment, the position of laws regarding the validity of such restraints on employees after termination of the employment contract is more contentious and adjudicated before the courts.

<sup>65</sup> Orchid Chemicals/ Hospira Healthcare, (C-2012/09/79).

<sup>66</sup> Ibid.



While there is an inherent lacuna in the codified law, with a limited capacity for determining the validity and enforceability of such restrictive covenants, employers have been urging the increasing need to enforce restrictive covenants through ever more ingenious methods. A strong argument in favour has been the vital need to guard enterprise value through reasonable methods.

While taking into the analysis, certain post-termination restrictions are enforceable in the **United Kingdom** as long as they pass the reasonableness test, which means that the restriction is intended to safeguard the employer's or buyer's proprietary interests.

The "blue pencil" approach, which refers to the ability of the courts to restrict the unreasonable breadth of a non-compete clause to something acceptable, is an intriguing idea that has been embraced by courts in a few states in the **United States of America**. This idea is comparable to the "severability" principle, which states that the enforceable part of a contract remains in effect after the unenforceable part is struck off. The court also has the authority to revise the clause to make it more reasonable. The parties' bargaining strength and the breadth and depth of the restriction are two aspects that the courts take into account while redrafting a non-compete agreement. The US Federal Trade Commission has released a "final rule" "banning non-competes nationwide" on April 23, 2024.

### **CONCLUSION**

The question arises whether reasonableness conflicts with Section 27 of the Indian Contract Act (ICA), as the plain reading of the section seems to disallow non-compete clauses. However, strict interpretation would void many modern commercial contracts. Indian courts have therefore adopted a more lenient approach, especially when dealing with partial restraints, evolving the doctrine of restraint of trade. Key principles established by courts include:

- (1) the restriction must protect a legitimate business interest;
- (2) the covenant should not exceed what is necessary for that protection; and
- (3) non-compete clauses cannot be perpetual.

By upholding reasonable non-compete clauses, the Indian legal framework seeks to foster a fair and competitive business environment while respecting individual freedom.

While the judiciary's position on the enforceability of post-termination non-compete covenants in employment contracts is well established, courts adopt a more flexible approach in commercial contracts, considering the specific facts and circumstances of each case to uphold principles of fairness and natural justice. Additionally, the validity of non-compete provisions varies across different agreements, with courts taking into account the negotiating power of the parties involved to assess the legitimacy of such restrictive covenants. The courts have consistently evaluated these clauses based on their reasonableness and the particular context of each situation.