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Restrictive covenants in employment contracts - Challenges and way forward

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"The drafting of a negative covenant in a contract of employment is often a matter of great difficulty. …It is well settled that employees covenants should be carefully scrutinised because there is inequality of bargaining power between the parties; indeed no bargaining power may occur because the employee is presented with a standard form of contract to accept or reject. At the time of the agreement, the employee may have given little thought to the restriction because of his eagerness for a job; such contracts "tempt improvident persons, for the sake of present gain, to deprive themselves of the power to make future acquisitions, and expose them to imposition and oppression." [Justice A.P. Sen in *Superintendence Company of India (P) Ltd.* v. *Krishan Murgai*[1]]

In the context of negative covenants in employment contracts, Section 27 of the Indian Contract Act, 1872 has been the subject matter of much discussion. Certain covenants in employment contracts have time and again been tested before courts in India on the touchstone of this provision whose prime purpose is to prevent contracts in restraint of trade. Section 27 reads as follows:

"27. Agreement in restraint of trade, void.- Every agreement by which anyone 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."

This provision is based on public policy and seeks to promote freedom of trade and calling. However, the broad scope of the Section has come for much criticism in view of the realization of the fact that the need to protect freedom of trade in the British India of 1872 must, in modern times, give way to need to protect freedom of contracting. And, this provision squarely interferes with the freedom of two discerning individuals from entering into a contract of their own volition. Be that as it may, so long as the provision remains on the statute book, it must be observed by all contracting parties.

Indian courts have trodden with caution while interpreting the scope of Section 27 in employment contracts. In *Niranjan Shankar Golikari*[2], the employee in question left his employment and joined a competitor. The employer was, *inter alia*, engaged in the business of manufacturing tyre cord yarn and the employee was engaged for the said tyre cord division and was imparted specialised training. He had signed a standard contract of employment agreeing to work exclusively for the employer for a period of five years. Further he would not join any competitor or start his own venture in similar business for the remaining period of term, in case he quit employment. An injunction based on the terms of the contract was challenged on the ground of

[1] *Superintendence Company of India (P) Ltd. v. Krishan Murgai*, AIR 1980 SC 1717

[2] *Niranjan Shankar Golikari v. The Century Spinning and Mfg. Co. Ltd.*, AIR 1967 SC 1098

being void under Section 27. The court held that the stipulation in the contract of employment was not struck by Section 27 as it operated during the term of employment and was necessary and reasonable for the protection of the employer's interest. The Court also noted that enforcing the negative covenant would neither drive the employee to idleness nor would he be compelled to go back to the old employer.

In *Krishan Murgai* (supra) a three-judge bench of the Supreme Court of India was called upon to decide the question of validity of a term in the service agreement which restrained the employee from joining any competitor or carrying on competing business "for a period of two years at the place of your (the employee's) last posting after you (the employee) leave the company." The employee, after termination of his services, started a competing business inviting suit for damages and injunction. Scope of the word 'leave' in the said provision was examined and the court held that the provision would apply only if the employee had voluntarily left the service of the employer, and not when his services were terminated by the employer. As a result, relief was denied to the employer. Sen, J., in his concurring judgement, examined the validity of the said negative covenant in the light of Section 27. He held that it was not correct to import the common law test of reasonableness to uphold a partial restraint. Quoting the observations of Sir Richard Couch, C.J., in *Madhub Chunder* [[1874] Beng L.R. 76] he held that under Section 27, a service covenant extended beyond the termination of service is void. To the contention that the said provision was obsolete, Sen, J. responded:

"A law does not cease to be operative because it is an anachronism or because it is antiquated or because the reason why it originally became the law, would be no reason for the introduction of such a law at the present time. Neither the test of reasonableness nor the principle of that the restraint being partial was reasonable are applicable to a case governed by Section 27 of the Contract Act, unless it falls within Exception 1."

In the *Zaheer Khan case* [AIR 2006 SC 3426], the Supreme Court of India had to decide on the validity of post-contractual covenant in an agreement giving right of first refusal to the celebrity endorsement and management company. The court rejected the contention that the right was merely regulatory in nature and not a restraint hit by Section 2. It reaffirmed the 'consistent, unchanging and completely settled' legal position with regard to post-contractual covenants that test of reasonableness or the principle of restraint being partial were not applicable, except in cases falling under the exception engrafted in Section 27. The court noted the following features of the provision:

"Under Section 27 of the Contract Act (a) a restrictive covenant extending beyond the term of the contract is void and not enforceable. (b) The doctrine of restraint of trade does not apply during the continuance of the contract for employment and it applied only when the contract comes to an end. (c) As held by this Court in Gujarat Bottling vs. Coca Cola[3] (supra), this doctrine is not confined only to contracts of employment, but is also applicable to all other contracts."

The Bombay High Court in *V.F.S. Global Services Ltd.* [2008 (2) BomCR 446] examined the validity of

[3] *Gujarat Bottling Co. Ltd.* v. *Coca Cola Co.*, (1995) 5 SCC 545

a Garden Leave clause in an employment contract. The employment contract stipulated that the employee would not engage in competing business for a period of three months after termination of or resignation from his services. In lieu thereof, the employee was entitled to receive compensation equal to three months' remuneration last drawn. The High Court held that the said Garden Leave clause was, prima facie, in restraint of trade and was therefore hit by Section 27. The silver lining for the employer came in the form of recognition by the court of the employer's legitimate interest in safeguarding its confidential information. The court noted that 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 Act.* The employee undertook not to part with any confidential information listed out by the employer in its affidavit, and the employer accepted the same.

It is notable here that the applicability of Section 27 would not ordinarily prevent an employer from safeguarding its intellectual property rights and trade secrets. The said provision does not bar all restraints, but only bars such restraints which prevent an employee from exercising a lawful profession or trade or business of any kind.

However, protection of trade secrets has not always been a cake walk for employers in India. For one, Section 27 does not leave room for applicability of the doctrine of Inevitable Disclosure[4] for safeguarding trade secrets. In case of restraints in contracts of employment, it is not enough that the employer's business will suffer from competition. It must be shown that the employee has entered into a contract with the customer, or has trade secrets of the employer.[5]

In the case of *American Express Bank Ltd.* v. *Ms. Priya Puri* [(2006) IIILLJ 540 Del] an employee of the bank had resigned to join a competitor. The bank sought an injunction to restrain the ex-employee from using or disclosing any information and trade secrets relating to the business and operations of the bank and to solicit or induce any of the customers of the bank. Denying the injunction, the Delhi High Court noted that such an injunction will facilitate the plaintiff to create a situation such as *'Once a customer of American Express, always a customer of American Express'*. In the garb of confidentiality the plaintiff cannot be allowed to perpetuate forced employment with American Express. Freedom of changing employment for improving service conditions is a vital and important right of an employee which cannot be restricted or curtailed on the ground that the employee has employer's data and confidential information of customers which is capable of ascertainment on behalf of defendant or anyone else, by an independent canvass at a small expense and in a very limited period of time.

From the above discussion, it is evident that negotiating a finely balanced employment contract, which shall stand judicial scrutiny, is a challenge in itself. Further, retention of talent and high attrition rates have posed challenges for employers across industries and, accordingly, employment practices globally have evolved over the years leading to adoption of new forms of employment contracts. MNCs have also brought in many of these new

[4] The doctrine recognizes demonstrated inevitability of trade secret misappropriation as a ground for granting injunction against an ex-employee from joining a competitor or engaging in competing business.

[5] Pollock & Mulla, *Indian Contract & Specific Relief Acts,* 13th Edition, 2006

practices to India. These new ideas are still in the process of getting assimilated in the Indian legal system. Therefore, while drafting the employment contract, the employer today must ensure that the conflicting interests of both sides are finely balanced, such that, neither the employer feels short-changed after the knowledge and skill accretion he has imparted nor the employee feels deprived of his right to pursue better opportunities for himself.

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Circulars & Notifications

Cost audit report and compliance report to be filed by 31-1-2013: Cost auditors and the companies concerned have been asked to file their Cost Audit Reports and Compliance Reports for the year 2011-12, in the XBRL mode, latest by 31-1-2013, without any penalty. Ministry of Corporate Affairs General Circular 43, dated 26-12-2012 notes that such report has to be filed within 180 days from the close of the company's financial year to which the report relates or by January 31, 2013, whichever is later.

LLP of professionals – NOC requirement: Ministry of Corporate Affairs has clarified that for Limited Liability Partnerships (LLPs) where one of their objects is to carry on the profession of Chartered Accountant, Company Secretary, Cost Accountant, Architect, etc., a No Objection Certificate of the concerned regulator/institute will be required at the time of incorporation/conversion into LLP. As per General Circular No. 40/2012, dated 17-12-2012 such NOC will be required at the time of making application for name approval in case of change of name of the existing LLP.

Softex Procedure - Applicability widened to include SEZs, EOUs also: The Reserve Bank of India (RBI) has widened the Softex procedure for certification of exports. As per A.P. (DIR Series) Circular No. 66, dated 1-1-2013 issued in this regard, now all software exporters under Free Trade Zones (FTZs) or Export Processing Zones (EPZs), Special Economic Zones (SEZs), 100% Export Oriented Unit (EOU) or Domestic Tariff Area, will be eligible to submit consolidated statements of exports in revised excel format for certification. The procedure was available for only Software Technology Parks of India (STPIs) earlier.

NBFC-IFC - ECB Policy further relaxed: The External Commercial Borrowing (ECB) limit for Non-Banking Finance Companies (NBFCs) categorized as Infrastructure Finance Companies (IFCs) under the automatic route has been increased from 50% of owned funds to 75% of owned funds, including outstanding ECBs. As per A.P. (DIR Series) Circular No. 69, dated 7-1-2013 issued for the purpose, ECBs to be availed beyond 75% of owned funds will fall under the approval route and require the approval of Reserve Bank of India. Hedging requirement for currency risk has also been reduced from 100% to 75% of the exposure of such entities.

Form 68 for rectification of mistakes – Last date for filing extended: Companies which have been incorporated before 2009 as also those which could not utilize the facility to file rectification of mistake in Forms 1, 1A and 44 have been allowed to do so within 180 days from 23-12-2012. General Circular No. 42, dated 21-12-2012 of the Ministry of Corporate Affairs issued in this regard allows filing of such rectification, under Form 68, electronically, on payment of applicable fees.

News Nuggets

Companies Bill receives Lok Sabha nod

The much awaited and highly debated Companies Bill, 2012 has been passed by the Lok Sabha with certain key amendments to the Companies Bill, 2011. The amended Bill mandates every company having net worth of Rs. 500 crore or more, or turnover of Rs.1000 crore or more or a net profit of Rs.5 crore or more during any financial year to spend at least 2% of the average net profits of the company made during the three immediately preceding financial years in Corporate Social Responsibility (CSR) activities. The Bill also tightens the noose around corporate frauds by empowering the Central Government to assign the investigation into the affairs of the company to the Serious Fraud Investigation Office (SFIO). Another major reform has been limiting the number of companies an auditor can serve to twenty, annual ratification of appointment of auditor and elucidating criminal liability of auditors.

The Companies Bill, 2011 introduced the concept of 'One Person Company' requiring only one member for incorporation. The Bill has also done away with the requirement of obtaining Certificate of Commencement of Business, holding statutory meeting and filing statutory report for public limited companies. The Bill regulates the decision making power of the Board of Directors of listed public companies by mandating minimum one third of the total number of directors to be independent directors and further empowers the Central Government to prescribe similar requirements for any class of public companies.

Banking Laws (Amendment) Bill cleared by Lok Sabha

The Lok Sabha has cleared the Banking Laws (Amendment) Bill, 2011 amidst much debate and with the Finance Minister ceding to certain key amendments. Due to these amendments in the draft bill, the prohibition on banks from undertaking any futures trading will continue and the ambition of Competition Commission of India (CCI) to regulate combinations in banking sector will remain unfulfilled. The Finance Minister opined that it was important to clear the bill before Reserve Bank of India (RBI) began issuing new bank licenses since the bill provides RBI greater power to regulate and penalize. Certain key reforms initiated through the Bill include removal of ceiling of INR 3000 crore on the amount of authorized capital of nationalized banks, allowing nationalized banks to issue bonus shares and rights issues and any acquisition of 5% or more of share capital of a bank requiring RBI approval.

EU's anti-trust commission imposes record penalty for fixing prices

European Union's anti-trust commission has imposed a record penalty on major electronic equipment manufacturers for manipulating prices of cathode ray tubes for television and desk-top computers. As per EC's Press Release, the manipulations lasted for more than 10 years starting from 1996 and that executives representing such firms met frequently during this period in order to fix pricing, share markets, allocate customers between themselves and to restrict their output. The Commission while

imposing fines/penalties totaling to around Euro 1.47 billion or USD 1.92 billion, which is considered to be the largest in recent times, on various major producers, noticed *"These cartels for cathode ray tubes are 'textbook cartels': they feature all the worst kinds of anticompetitive behaviour that are strictly forbidden to companies doing business in Europe."* As per latest reports, at least one electronics major has expressed its intention to appeal. In other developments in the European Union, the EU's competition head has stated that it is his "conviction" that Google, the multi-billion dollar corporation, is "diverting traffic" to its own services and hence could face sanctions for alleged abuse of dominance. Google has been given a clean chit by the US anti-trust authorities after a long investigation that lasted for almost 3 years.

Ratio Decidendi

Winding up of company – Procedure for advertisement

The Delhi High Court has held that the company court cannot order winding up of a company without granting an opportunity to the company to show why an advertisement should not automatically follow admission of the petition. The company court had, by a single order (a) admitted the winding up petition; (b) directed the company to be wound up; (c) appointed the official liquidator and directed him to take charge of the assets and records of the company and proceed in accordance with law; and (d) directed the citation to be published in newspaper. The High Court set aside the impugned order and allowed the appeal. [*Indo Rolhard Industries Ltd.* v. *M. K. Mahajan* – Delhi High Court Order dated 7-1-2013 in CO. APP. 19/2009].

Unfair trade practices – Maintainability of compensation application

The Supreme Court has held that application for compensation under Section 12B of the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act) is maintainable without any proceeding being initiated under Section 10 or Section 36B of the said Act. The Competition Appellate Tribunal had earlier rejected the compensation applications of the appellants under Section 12B as not maintainable after relying upon an earlier Supreme Court Order in the case of *Saurabh Prakash*. The Apex Court, in the present case, however held that the Competition Appellate Tribunal was wrong in relying on this decision as the Court in that order had not considered such question. The court noted that powers vested in the MRTP Commission under Section 12B of the MRTP Act, to make an inquiry and to determine the amount of compensation, are independent of its powers under Section 10 and Section 36B of the MRTP Act and that said Section was introduced as an independent remedy for a claimant in addition to a suit that he may file to claim any loss or damage. It was observed that there is no reference in Section 12B to the provisions of either Section 10 or Section 36B and vice versa and further there was absence of any such indication of such intention of Parliament. [*Girish Chandra Gupta* v. *Uttar Pradesh Industrial Development Corporation Ltd.* – Supreme Court Judgment dated 11-12-2012 in Civil Appeal Nos. 8920 & 8921 of 2012].

Competition and anti-dumping duty – Mere price increase not competition issue

Competition Commission of India has closed the case pertaining to alleged price increase by the Indian producer of melamine. The informant had alleged that the imposition of anti-dumping duty on the imports, where investigation was initiated after the application by the domestic producer, has enabled the producer to unilaterally increase the price of the product independently of the market forces. The Commission while observing that mere increase in price by the domestic producer is not a competition issue, noted that it cannot go into the facts whether the data produced by the domestic producer before the anti-dumping authorities was correct or not or the conclusion arrived by DA while recommending anti-dumping duty was as per law or not. It was held that there was no prima facie case of contravention of the provisions of the Competition Act, 2002 as the market share of the sole producer was less than 50% and despite anti-dumping duty, the imports had been increasing year after year. The Commission also noted that the market share of the producer was constantly declining which itself shows that there was enough competition in the market and the producer could not have increased the price arbitrarily under a danger of losing market due to its high price. [*Merino Panel Products Limited* v. *Gujarat State Fertilizers and Chemicals Limited* - Case No. 54/2012, decided on 9-1-2013].