

INDIA LEGAL UPDATE is a journal of Singhania & Partners which offers a legal perspective on the new business climate and opportunities in India in keeping with the existing laws, current happenings and events in Corporate India.

## LEGAL SUITE

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## Enforceability of Employee Non-Compete Covenants

By Sunil Kumar & Siddharth Dubey

### INTRODUCTION

Once an employers' employee, always an employers' employee. This is the scenario which every employer resorts to in order to control employee attrition or restricting them from seeking employment with rival competitors or setting up a competing independent business. This is primarily done by incorporating non-compete covenants in the employment agreements. Apart from curbing attrition, employers also impose restrictive covenants to avoid competition and protecting the trade secrets and business connections.

### RESTRAINT ON TRADE AND EMPLOYMENT CONTRACTS

In anticipation of having long-term business contribution from the employees, the employers provide substantial resources in training them with specific skills, talent and knowledge. But, in general practice, after gaining the requisite skills, talent and knowledge, employees become more inclined to shift towards more rewarding job opportunities. Thus, to restrict the employees from moving jobs, employers insert typical clauses in the employment agreement which restrict the employees from leaving the job for a fixed period after the training or taking up similar employment for a fixed time period, after they cease to be an employee. Undoubtedly, in such a scenario, the employer and employee have conflicting interests with respect to the negative

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*The legal position with respect to employment contracts is well established by Indian clients.*

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covenant in the employment agreement which runs the risk of being hit by Section 27 of the Indian Contract Act. The Indian Courts have considered such issues arising under Section 27 and tend to decide in favour of the employees.

Section 27 of the Indian Contract Act, 1872 states that any agreement which restricts a person from exercising a lawful profession, trade or business of any kind is void to that extent. The only exception is in relation to the sale of goodwill, where the buyer may restrict the seller from carrying on similar business within specified local limits. The act does not recognize any other valid restraint on trade, even if such a restraint is reasonable.

Ordinarily, there are three types of agreements in restraint of trade. First, there can be an agreement between master and servant whereby the servant covenants not to set up business on his own account on leaving his service or to enter into employment with a rival firm. Secondly, there can be an agreement between buyer and the seller of a business whereby the seller covenants not to carry on a business which will compete with that of the buyer. Thirdly, there can be an agreement between the traders whereby they contract to regulate their supplies or production or price of articles.



Here, we restrict ourselves to employment contracts only. The legal position appears to be well established with reference to the employment contracts. The broad principles as laid down by Indian courts are:

- i) after the expiry of the term of employment, the agreements which prevent an employee from working elsewhere would be restraint of trade, unless there is a proprietary interest of the employer, and
- ii) an employee may be restricted from serving any other person or carrying on independent business during the term of employment.

### NON-COMPETE DURING EMPLOYMENT

During the term of employment, an employer can legally restrain an employee from competing with it or taking any other employment while the employment contract is in force.

The Hon'ble Supreme Court of India recognized this principle for the first time in **Niranjan Golikari vs. Century Spinning and Manufacturing Co Ltd.**, where the Court discussed the issues and held that considerations against restrictive covenants are different in cases where the restriction is to apply during the period after the termination of the contract than those in cases where it is to operate during the period of the contract. Negative covenants operative during the period of the contract of employment when the employee is bound to serve his employer exclusively are generally not regarded as restraint of trade and therefore do not fall under section 27. A negative covenant that the employee would not engage himself in a trade or business or would not get himself employed by any other master for 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.

Though, in one of the rulings of High Court of Calcutta in **Shree Gopal Paper Mills Ltd. vs. Surendra K. Ganeshdas Malhotra**, it was held that restraints that operate during the term of employment may not be enforceable if they are one-sided and intensely favour the employer. In this case, the plaintiff appointed the defendant to serve for a period of 20 years, during which the defendant could not give his service or advice to any other person or company, nor become interested or engaged in any enterprise or undertaking either alone or jointly with other or any other in any business or trade. The other harsh covenants of the contract were the increase in pay being marginal and the arbitrary power vested with the employer to terminate the plaintiff's service without notice. In such circumstances, the Court held that the agreement was oppressive, one-sided, and unreasonable. Therefore, the restrictive covenant preventing the employee from working at another place was unenforceable.

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Thus, it can be deduced that the non-compete covenant during the term of employment would not attract the doctrine of restraint of trade. The only exception to this would be if the contract and the non-compete covenant thereof is unconscionable or excessively harsh or unreasonable or one-sided.

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*Upon cessation of the employment contracts, the restrictive covenants restricting the employees from working elsewhere or setting up their own business are generally not enforceable.*

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### NON-COMPETE AFTER EMPLOYMENT ENDS

Upon cessation of the employment contracts, the restrictive covenants restricting the employees from working elsewhere or setting up their own business are generally not enforceable. It is seen in some cases that the employers have tried to enforce the non-compete covenant, upon termination of the employment period, on grounds of reasonableness and have also argued that such restrictive covenant should be enforced if it is a partial restraint.

There are several cases in which Indian courts have consistently refused to enforce post-termination non-compete clauses in employment contracts, viewing them as "restraint of trade" impermissible under Section 27 of the Indian Contract Act, 1872 (the Act), and as void and against public policy because of their potential to deprive an individual of his or her fundamental right to earn a livelihood.

The principles of Section 27 were rightly summarized by the Supreme Court of India in **Percept D' Mark (India) Pvt. Ltd v Zaheer Khan and Anr.** In this case, the appellant company entered into a Promotion agreement with Zaheer Khan on 01.11.2000 for a period of three years commencing on 30.10.2000 and expiring on 29.10.2003. Clause 31 (b) of the Promotion agreement contained a right of first refusal clause. As per this clause, Zaheer Khan could not accept any offer for endorsements, promotions, advertising or other affiliation with regard to any product or services. If he intended to accept any such offer, he would have to give in writing all the terms and conditions of such third party to the appellant to match such third party offer. The appellant had sent a letter for extension of the Promotion agreement which was not accepted by Zaheer Khan. After the expiry of the Promotion agreement, Zaheer Khan entered into another agreement with Adidas without complying with Clause 31 (b).

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*AIR 1967 SC 1098*

*AIR 1962 Cal 61*

*AIR 2006 SC 3426*

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The Supreme Court held that under Section 27 of the Act, a restrictive covenant extending beyond the term of the contract is void and not enforceable. The Court further held that if the restrictive covenant is enforced then it would curtail Zaheer Khan's freedom to enter into fiduciary relationships with persons of his choice and create a compulsion on him to forcibly enter into a fresh agreement with the appellant. This, as such, is a restraint of trade and is void.

### COMPARATIVE ANALYSIS OF DOCTRINE OF RESTRAINT OF TRADE

It is interesting to look into as to why the Indian Courts feel that no useful purpose would be served in deciding the issue of enforceability of restrictive covenants in line with the English law.

Under English law, the English Courts have held that a man is entitled to exercise any lawful trade or calling as and where he wills. It may be seen that the approach of English courts with regard to enforceability of the restrictive covenants is based upon the following tests, such as:

- i) whether a contract is or is not in restraint of trade,
- ii) whether, if is in restraint of trade, it is reasonable,
- iii) whether, it must protect employer's proprietary interest, such as confidentiality, trade secrets, technical know-how, and
- iv) whether, it is against the public policy.



Unlike English law, the Indian courts have taken much stricter and less favourable view towards the enforceability of the restrictive covenants enumerated in the employment contract and has upheld such covenants only in employment contracts during their subsistence, provided the restrictions are reasonable. In so far a commercial contract (other than an employment contract) is concerned, the Supreme Court has held that the question of reasonableness of restraint is outside the purview of Section 27 of the Indian Contract Act. Therefore, the question of reasonableness and also the question whether the restraint is partial or complete are not required to be considered at all whenever an issue arises as to whether a particular term of a contract (other than the commercial contract) is or is not in restraint of trade, business or profession except in the case of sale of goodwill.

## CONCLUSION

When the issue of restraint of trade comes up before the Indian courts for interpretation, the courts invariably compare the Indian position with that of the position under the common law. Under the Indian law, the courts have to follow the statute as worded whereas under English law, the courts follow the common law.

In my considered view, reasonability must be a ground in deciding the doctrine of restraint of trade in all contracts. This would certainly make the Indian position on restraint of trade commercially acceptable. In view of the same, the Law Commission of India in its 13th Report, way back in 1958, strongly recommended that Section 27 be amended, since the constraints that it imposes on Indian business and contracts are commercially undesirable. However, the Government has not taken any action in order to implement the same.

Thus, Section 27 should be amended in a way that the restraint is judged on the test of reasonableness and also provides a window to safeguard the parties' interest.



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## COURT ROOM

### SUPREME COURT - SCHEME OF AMALGAMATION

By Shilpa Shah and Sharan Kukreja

The Supreme Court recently revisited the law on Scheme of Amalgamation in the case of *Sesa Industries Ltd. vs. Krishna Bajaj & Ors.* The Court once more reiterated the principles laid down in *Miheer H. Mafatlal vs. Mafatlal Industries* and decided on the question whether a scheme of amalgamation can be held up, merely on the ground that the conduct of Official Liquidator is found to be blameworthy.

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#### BACKGROUND

Mrs. Krishna Bajaj, the Respondent No. 1 was the holder of 0.29% shares in the Appellant Company [SIL]. SIL was a subsidiary company of SGL. The directors of SIL resolved to amalgamate SIL with SGL and filed respective applications with the Company Court in this regard. The Respondent No.1 objected to the said applications and relied on observations made in Inspection Report submitted by the Director of Inspection and Investigation, Ministry of Company Affairs to the Regional Director under Section 209A inter alia that the entire control of the company is being managed by Mitsui & Co. Ltd., Japan and the minority shareholders of SIL have been cheated through the systematically siphoning the funds by SGL to the ultimate holding company i.e. M/s Mitsui & Co. Ltd.

The Single Judge allowed SIL and SGL to convene a General Body Meeting and also directed the Company to disclose as a part of the Explanatory Statement of the said meeting, relevant observation from the Inspection report. The shareholders of SIL and SGL, by 99% majority, approved the scheme and subsequently approached the High Court for according approval to the amalgamation scheme.

It is relevant to note that the Registrar was acting as a delegate of the Regional Director and also in the capacity of the Official Liquidator. He had filed Affidavits under both capacities without revealing that in his Affidavit. Moreover, while discharging his duties as an Official Liquidator, he submitted clear report relying only upon the Auditors' Report, in spite of knowing very well about the Inspection Report and observations therein, while remained non-committal, while filing affidavit in the capacity of delegate of the Regional Director.

The Company judge sanctioned the scheme.

The Division Bench reversed the order of the Single Judge and held that when serious irregularities have been found in the Inspection Report and the proceedings on the basis of the said report were still pending and no further decision had been taken in this behalf and moreover the Registrar as a delegate of the Regional Director who was in possession of such Inspection Report, should not have filed affidavits in dual capacities. The court also held that as per the provisions of Section 394, the Registrar as well as the Liquidator are required to submit separate reports and both function in different capacity. Since this was not as per the statutory provisions, the court cannot mechanically sanction a scheme of amalgamation even though the same has been approved by the majority of shareholders.

On appeal, the Supreme Court held and confirmed that the OL's Report was vitiated as he had not examined and applied its mind to the findings contained in the Inspection Report under Section 209A and hence failed to discharge his duties under the second proviso to Section 394(1). The court further added that "report of an official liquidator is of seminal importance and in fact facilitates the Company Judge to record its satisfaction as to whether or not the affairs of the transferor company had been carried on in a manner prejudicial to the interest of the minority and to the public interest". The Court also held that it would neither be proper nor feasible to lay down absolute parameters on whether the sanction of a scheme of amalgamation can be held up on the fact that the OL's report was blameworthy. It held that the same would depend on the facts and circumstances of the case and added that the Company Judge would be the final Arbiter on this issue.

### EVALUATING THE DECISION

In its judgment, the Hon'ble Supreme Court held that "An Official Liquidator acts as a watchdog of the Company Court, reposed with the duty of satisfying the Court that the affairs of the company, being dissolved, have not been carried out in a manner prejudicial to the interests of its members and the interest of the public at large." However by taking a broad approach it held that the scheme of Amalgamation should not be held up merely on account of failure by the concerned authorities in discharging their duties and responsibilities provided the Company Judge has before him material facts, having direct bearing on sanction of the Scheme and all material information is disclosed to shareholders. This decision indirectly lays down that a scheme of amalgamation should not be bogged down or stalled due to procedural irregularities.



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# NEWSQUEST

By Sunayna Jaimini

## FDI deals should not come with any strings attached: RBI

The Reserve Bank is hardening its stand on FDI deals to drive home the point that there should be no strings attached to such inbound flows. In eight out of 10 FDI, foreign investors have a right to sell back shares to Indian promoters if certain conditions are not fulfilled.

[SOURCE](#)

## Bill to strengthen nuclear safety measures introduced

A Bill aimed at establishing a legal framework to address nuclear safety issues and set up an autonomous atomic energy watchdog was introduced in the Lok Sabha recently.

[SOURCE](#)

## Big ticket deals may push FDI in India to US\$ 35 bn in FY 2012

Foreign direct investment (FDI) in India may cross US\$ 35 billion in 2011-12 as against US\$ 19.4 billion in the last fiscal, on account of major deals like RIL-BP and Posco.

[SOURCE](#)

## IRDA promises quick clearances for share transfer in insurance firms

The Insurance Regulatory and Development Authority (IRDA) paved the way for stake purchase by Reliance Industries (promoted by Mukesh Ambani) in Bharti Axa (life and general) and stake sale by Reliance Life Insurance (promoted by Anil Ambani) to Nippon Life as it came out with a new circular stating that transfer of shares beyond certain limits in the industry would be registered after they seek prior approval of the authority through an application in Form 'A'.

[SOURCE](#)

## Frame a policy on overseas investments: RBI to government

The Reserve Bank has asked the government to frame a policy on overseas investments to prevent Indian companies from setting up operations in tax havens through a puzzling structure of subsidiaries.

[SOURCE](#)

## CCI pitches for regulatory framework for realty sector

The Competition Commission of India (CCI) recently said that the Centre as well as state governments should come out with regulatory framework for the realty sector to protect consumers from unfair trade practices.

[SOURCE](#)

## IRDA may revisit guidelines for bancassurance

The proposed deal between Punjab National Bank (PNB) and Metlife, which saw the bank getting a discount of nearly US\$ 167 mn, may result in the Insurance Regulatory and Development Authority (Irda) revisiting its recommendation on compensation and discounts for the bancassurance model.

[SOURCE](#)

## FDI inflow to rise sharply to US\$ 19.5 billion in FY12: CMIE

The net foreign direct investment (FDI) inflow in India is expected to improve sharply to US\$ 19.5 billion during FY 12 as compared to US\$ 7.1 billion in FY 11 on account of robust and sustainable economy, the Centre for Monitoring Indian Economy (CMIE) said in its monthly review.

[SOURCE](#)

## Malaysians urged to invest in rising Indian property market

Experts are foreseeing a large growth in the Indian property market, with current values projected to multiply five or six times over the next five years. Malaysian Deputy Minister Datuk S.K. Devamany is urging his countrymen to invest in Indian land now and take advantage of its strong future, according to Bernama.

[SOURCE](#)

## Ministry mulls new aviation policy, new policy will allow more foreign carriers to operate from India

India plans to allow more foreign carriers under an upcoming policy to keep pace with rising demand for international travel that domestic airlines are unable to service. India has bilateral air service agreements with 97 nations, but about half of them are not being utilised because the routes are unprofitable. Opening the domestic aviation sector to more foreign operators would not only improve international connectivity but also give consumers competitive rates.

[SOURCE](#)

### FDI in telecom sector at US\$ 1.21 bn in June quarter

The foreign direct investment in the telecom sector US\$ 1.21 bn during the quarter ended June 30, 2011, Parliament was informed recently. The country has received a cumulative total of US\$ 8.21 bn as FDI in telecom sector in the period from April 2008 to June 2011, Minister of State for Communications and IT Milind Deora told the Lok Sabha in a written reply.

[SOURCE](#)

### Hands-off policy on FDI in pharma

India is unlikely to impose any restriction on foreign direct investment in pharma amid worries of foreign takeovers in the industry hiking medicine prices. A committee set up by the Prime Minister and headed by Plan panel member Arun Maira is sharply divided over a proposal to whittle down foreign investment in pharma to 49 per cent from 100 per cent by declaring the sector "sensitive". The health and industrial policy departments, which are represented by their secretaries, are apprehensive of easy takeover opportunities threatening cheap medicine supplies to the poor.

[SOURCE](#)

### 123 FDI proposals worth US\$ 4.38 bn cleared in Apr-Aug 23

The government said it has cleared 123 foreign direct investment (FDI) proposals worth US\$ 4.38 bn during the current fiscal till August 23. As of August 23 this year, 21 proposals are pending before the Foreign Investment Promotion Board (FIPB), Minister of State for Commerce and Industry Jyotiraditya Scindia said in a written reply to the Lok Sabha.

[SOURCE](#)

### WTO asks India to train other emerging economies in negotiation skills

In an endorsement of the hard bargaining by India in trade negotiations, the World Trade Organisation (WTO) has asked New Delhi to train other emerging economies in evolving trade policies and developing negotiation skills.

[SOURCE](#)

### FIs to get leeway in infra bond investments

A subdued response from foreign institutional investors (FIIs) vis-a-vis long-term infrastructure bonds has prompted the finance ministry to ease norms for investing in these papers. To lure FIIs, it has reduced the residual maturity limit and the lock-in period for investment in such bonds.

[SOURCE](#)

### India 'critical to America's success'

Describing India as a friend "critical to America's success", a leading US presidential aspirant has underlined the need for Washington to immediately start discussion with it on a bilateral free trade pact.

[SOURCE](#)

### Coastal shipping norms to be eased

The shipping ministry is considering relaxing the coastal shipping rules for container movement in order to promote transshipment activity at the International Container Transshipment Terminal in down-country Kochi.

[SOURCE](#)

### Kerala resort to launch solar-powered boats

Billed as a first-of-its-kind initiative, the Poovar Island Resort near Kovalam in Kerala is set to launch four solar-powered boats for its guests. The boats, costing Rs.3.5 lakh each, would be officially launched by state Tourism Minister A.P. Anil Kumar.

[SOURCE](#)



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## SYNAPSE



### S&P, legal counsel to NHAI in a land acquisition matter

S&P appeared for the National Highway Authority of India (NHAI), challenged the legality of the Supplementary awards passed by the Competent Authority appointed for purpose of land acquisition. Since the National Highways Act, 1956 does not give powers to the Competent Authority and the act is silent with regard to supplementary awards being passed by the competent authority on the same subject matter, S&P contended that the same were illegal and hence were liable to be quashed. The Hon'ble High Court of Karnataka conclusively laid down the law by stating that supplementary award passed on lands where award has already been passed is illegal and untenable and such award passed is without jurisdiction.

#### JUDGEMENT

### S&P, legal counsel to Aviotech for drafting/execution of aircraft lease agreements

S&P is acting as legal counsel to Aviotech, a part of the Deccan Chronicle group and a major player in corporate aviation and defence aerospace segments in India. It is currently advising Aviotech in negotiations and drafting/execution of aircraft lease agreements for obtaining Challenger CL604 AIRCRAFT, Falcon 2000 LX and Bombardier Global 5000 LE. Aviotech will use these aircrafts for providing aircraft services to corporate sector across India.



### S&P, Lender's Legal Counsel to Bhushan Power & Steel Limited

S&P has been mandated by a consortium of 21 leading banks with Axis Bank Ltd. as the lead bank to act as Lender's Legal Counsel to Bhushan Power & Steel Limited, one of the leading steel and steel products manufacturers in India, for the Term Loan Facility of an aggregate sum of US\$ 1.17 bn including a subordinate Debt Facility US\$ 144 mn for the company's brownfield expansion of its integrated Steel Plant at Orissa, India. The mandate includes drafting of the loan and security documents, creation of securities, and advise on all legal compliances necessary for disbursement of the loan.

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