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# **ENFORCEABILITY OF NON-COMPETE CLAUSES IN EMPLOYMENT CONTRACTS UNDER INDIAN LAW**

AUTHORED BY - ISHA BHARTI

## **ABSTRACT:**

It is a common practice among employers in India to include provisions in employment contracts that restrict employees from engaging in activities contrary to the business interests of the employer. While these restrictions are enforceable during the term of employment, the question arises: *what happens to these restrictions after the employment relationship ends?* Many people and judges have held that post-employment restrictions should not apply once employment has ceased.. However, The law states something else even though the actual legal position on this matter is not entirely clear. The wordings of the section 27 of Indian Contract Act 1872 provides that there are differing views on the applicability of Section 27 of the Indian Contract Act, 1872, which states that “agreements restricting someone from exercising a lawful profession, trade, or business are void.”

Interestingly, Section 27 itself provides an exception *where a non-compete agreement is made in the context of the sale of goodwill. This suggests that the rule in Section 27 may not be an absolute one, and there could be other exceptions where post-employment restrictions may be enforceable.* The paper aims to explore and explain the legal position on whether enforceability of *Non-Compete Clauses* in employment contracts under Indian Law is valid or not? The analysis delves into the nuances and complexities of this legal issue, providing a more comprehensive understanding of the topic.

**Keywords:** Post-employment restrictions, Employment contracts, Non-compete agreements, Enforceability, restrictions, Legal uncertainty.

## **INTRODUCTION**

Before explaining and diving deeper into this concept, we must clear our basics and understand

### **What is the meaning of a non-compete clause?**

Basically, Non-compete clauses are prevalent in employment contracts, particularly with senior executives, and in mergers and acquisitions (M&A) transactions. These clauses impose specific restrictions on founders and key executives who are departing the business. Under a non-

compete clause, an individual agrees not to establish a new business, accept employment, or engage in any manner with a competing entity. These restrictions are generally confined to a certain period and geographical area, prohibiting the individual from working in competing businesses during that specified time and within the designated region.

The rationale behind imposing such restrictions on senior executives or employees is their access to confidential and proprietary information, as well as intellectual property related to the company. Utilising this information in the service of a competing entity could result in an unfair business advantage. Similarly, in the context of M&A deals, the commercial value of the acquisition may be compromised if the existing founders initiate or join a competing entity, thereby eroding the competitive advantage of the acquiring party.

In India, it is a common practice for employers to include provisions in employment contracts that restrict employees from engaging in activities that could harm the employer's business interests. While it is established that such restrictions are enforceable during the period of employment, their applicability after employment ends raises important questions. Many believe these restrictions do not extend beyond the employment term, but whether this belief reflects actual legal standing or is merely an assumption remains debatable.

This discussion often begins with *Section 27 of the Indian Contract Act, 1872*, which states that “Agreement in restraint of trade, void.—Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.”

However, this section also contains exceptions, particularly regarding non-compete agreements linked to the sale of goodwill, suggesting that it is not an absolute rule. To understand the true nature of Section 27, it is essential to examine its historical context, the evolution of the Indian Contract Act, and relevant judicial interpretations over time, starting with cases as early as 1874.

### **BACKGROUND:**

Section 27's origins can be traced back to the *Field's Draft Code for New York*, which was never adopted. Its intent was to address concerns about the extent to which contracts restricting trade had been permitted. Additionally, during the late 1800s, there was a perception that trade in India was still developing, leading lawmakers to limit exceptions to the general prohibition against trade restraints. However, this perspective seems questionable, given India's rich trade

history prior to British colonisation, which paradoxically served as the impetus for British interest in the region. The First Law Commission of India, established in 1955, strongly criticised the rigid provisions of the Indian Contract Act, particularly Section 27. In its Thirteenth Report (1958), the Commission recommended amendments to permit exceptions to the restrictions, provided they were reasonable and took into account the interests of both the parties involved and the public. This suggestion was significant as it aimed to balance the rights of contracting parties with the broader public interest.

Proponents of Section 27 often invoke the concept of public policy to justify its extensive restrictions. However, the Commission's recommendation highlights the need for a more nuanced approach that recognizes the legitimate interests of all parties while ensuring that public welfare is also considered. This ongoing debate underscores the complexity surrounding the enforceability of non-compete agreements in India and the need for thoughtful legal reforms.

The Indian legal system is recognized as a positivist legal framework. Despite the Supreme Court's extensive powers under *Article 142* of the Indian Constitution,<sup>1</sup> and the inherent powers granted to courts by *Section 151 of the Code of Civil Procedure and Section 482 of the Code of Criminal Procedure*,<sup>2</sup> The Indian legal system remains largely consistent with the statutes. The Supreme Court, in *Prem Chand Garg v. Excise Commissioner*,<sup>3</sup> asserted that any order made to ensure complete justice must align with both the Constitution's fundamental rights and the substantive statutory laws. This decision emphasised that the Supreme Court's powers under Article 142 are not limitless. The Indian legal system adheres to the principles of legal positivism, as articulated by *H.L.A. Hart*, asserting that laws are *human commands and there is no intrinsic connection between law and morality*.<sup>4</sup> For instance, if the legislature repeals

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<sup>1</sup> **Article 142 of the Indian Constitution:** . Enforcement of decrees and orders of the Supreme Court and orders as to discovery, etc.—(1) The Supreme Court in the exercise of its jurisdiction may pass such decree or make such order as is necessary for doing complete justice in any cause or matter pending before it, and any decree so passed or order so made shall be enforceable throughout the territory of India in such manner as may be prescribed by or under any law made by Parliament and, until provision in that behalf is so made, in such manner as the President may by order1 Prescribe.

<sup>2</sup>**CPC section 151.** Saving of inherent powers of Court.—Nothing in this Code shall be deemed to limit or otherwise affect the inherent power of the Court to make such orders as may be necessary for the ends of justice or to prevent abuse of the process of the Court.

**CrPC section 482.** Saving of inherent powers of High Court.—Nothing in this Code shall be deemed to limit or affect the inherent powers of the High Court to make such orders as may be necessary to give effect to any order under this Code, or to prevent abuse of the process of any Court or otherwise to secure the ends of justice.

<sup>3</sup> *Prem Chand Garg v. Excise Commissioner*, UP (1963 SCR Supl. (1) 885)

<sup>4</sup> HLA Hart - Positivism and Separation of Law and Morals (1958), 71 Harvard Law Review 593, 601-602).

Section 27 of the Indian Contract Act (IC Act),<sup>5</sup> The remaining provisions continue as law. Public policy is enforceable only when backed by statute, though laws must pass constitutional scrutiny, failing which they can be invalidated, as evidenced by the Supreme Court's striking down of Section 87 of the Arbitration and Conciliation Act, 1996,<sup>6</sup> for violating Article 14 of the Constitution. The recommendations by the First Law Commission would have effectively balanced commercial interests and public policy.

Section 27 of the IC Act itself is not absolute, allowing for exceptions such as contracts involving the sale of goodwill. Section 1 of the IC Act clarifies that it does not override existing statutes, customs, or contractual terms that are not inconsistent with the Act. The IC Act was designed as an amending and consolidating measure, not a comprehensive and exclusive code on contracts. The Privy Council in Ramdas Vithaldas Durbar v. Amarchand & Co<sup>7</sup> noted that the Act aimed to define and amend parts of the contract law, thus serving both amending and consolidating purposes.

The Indian Contract Act (IC Act) does not purport to be a comprehensive code governing contracts. This principle was succinctly expressed in **Burn & Co v. McDonald<sup>8</sup>**, which stated, "Where a law is codified, it is of little avail to enquire what is the law apart from that codification. The code itself must be looked to as the guide in the matter." Despite this, the IC Act is not a self-contained code on contracts. Various other Indian laws, such as the Sale of Goods Act and the Specific Relief Act, provide for different types of contracts and contractual remedies, while statutes like the Factoring Regulation Act comprehensively address special contracts.

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<sup>5</sup>**Section 27 of the Indian Contract Act (IC Act)**- Agreement in restraint of trade, void.—Every agreement by which any one 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 good-will is sold.—One who sells the good-will 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 good-will 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.

<sup>6</sup>**Section 87 of the Arbitration and Conciliation Act, 1996**, -Effect of arbitral and related court proceedings commenced prior to 23rd October, 2015.—Unless the parties otherwise agree, the amendments made to this Act by the Arbitration and Conciliation (Amendment) Act, 2015 shall— (a) **not apply to**— (i) arbitral proceedings commenced before the commencement of the Arbitration and Conciliation (Amendment) Act, 2015 (23rd October, 2015); (ii) court proceedings arising out of or in relation to such arbitral proceedings irrespective of whether such court proceedings are commenced prior to or after the commencement of the Arbitration and Conciliation (Amendment) Act, 2015; (b) apply only to arbitral proceedings commenced on or after the commencement of the Arbitration and Conciliation (Amendment) Act, 2015 and to court proceedings arising out of or in relation to such arbitral proceedings.

<sup>7</sup> Ramdas Vithaldas Durbar v. Amarchand & Co (43 IA 164)

<sup>8</sup> Burn & Co v. McDonald (ILR 36-37 Cal 208)

The IC Act serves as a guide but is subordinate to special laws, as reaffirmed by the Supreme Court in *R.S. Raghunath v. State of Karnataka*<sup>9</sup>, which held that a special law prevails over a general law. Therefore, the IC Act cannot claim to be the exclusive code on contract law in India.

Promulgated in 1872, the IC Act's scope was questioned shortly after its enactment. In *Madhub Chander v. Rajcoomar Das*<sup>10</sup> The Calcutta High Court had to determine whether the law of restraint of trade, which Hindu contract law did not prohibit, applied under the IC Act to disputes involving exclusively Hindu parties. The court ruled that the IC Act applied universally. Pollock & Mulla's commentary on the Indian Contract Act & Specific Relief Act asserts that "the Contract Act did not cover the entire field of contract law."

Examining precedents, the Supreme Court's rulings hold paramount authority under Article 141 of the Constitution, which states that "the law declared by the Supreme Court shall be binding on all courts within the territory of India."

In *Niranjan Shankar Golikari v. Century Spinning and Manufacturing Company Ltd.*<sup>11</sup>, the Supreme Court addressed the enforceability of non-compete and confidentiality clauses in employment contracts. The court considered a case where an employee, after acquiring training and confidential information, resigned to join another employer. The Supreme Court upheld the reasonableness of such restraints, stating, "The rule now is that restraints whether general or partial may be good if they are reasonable. A restraint upon freedom of contract must be shown to be reasonably necessary for the purpose of freedom of trade. A restraint reasonably necessary for the protection of the covenantee must prevail unless some specific ground of public policy can be clearly established against it"<sup>12</sup>. The judgement emphasised balancing the principles of freedom of contract with public policy considerations.

### **Purpose of Non-Compete Clauses:**

#### **1. Protection of Trade Secrets:**

Non-compete clauses serve to protect employers by safeguarding valuable information

<sup>9</sup> R.S. Raghunath v. State of Karnataka (1991 SCR Supl. (1) 387)

<sup>10</sup> Madhub Chander v. Rajcoomar Das ((1874) 14 BLR 76)

<sup>11</sup> Niranjan Shankar Golikari v. Century Spinning and Manufacturing Company Ltd. (1967 AIR 1098),

<sup>12</sup> E. Underwood & Son Ltd. v. Barker [(1899) 1 Ch 300 CA]

and trade secrets. Employees often gain access to confidential data, client lists, business strategies, and proprietary knowledge during their employment. The clause ensures that this sensitive information is not exploited for competitive purposes after the employee leaves the company.

2. **Protecting Employer Interests:**

These clauses help employers protect their interests by preventing former employees from starting similar businesses or accepting employment with direct competitors. This restriction helps maintain the employer's market position and prevents potential business losses.

3. **Prevention of Unfair Competition:**

Non-compete clauses aim to prevent unfair competition by restricting an employee's ability to work for a competitor within a specified timeframe and geographic area. This protects the company's investment in the training and development of its workforce and its competitive advantage.

**Constitutional Safeguard in India:**

Article 19(1)(g) of the Constitution of India grants citizens the right to practise any profession or to carry on any occupation, trade, or business, subject to reasonable restrictions under Article 19(6). While non-compete clauses are mutually agreed upon between parties, they do not violate Article 19(1)(g). It is important to note that Article 19 is enforceable against the state, and the apex court has reiterated that this article applies to any state or body.

This structured overview highlights the critical purposes of non-compete clauses, emphasising their role in protecting business interests, preventing unfair competition, and aligning with constitutional provisions.

**Validity of Restraints of Trade:**

A restraint of trade is considered valid only if it is reasonable and necessary to protect the legitimate interests of the party seeking to enforce it. Several factors are assessed to determine the reasonableness of such restraints:

- Nature of the Trade or Business: The type of business or profession significantly impacts the validity of the restraint. For instance, a restriction preventing a doctor from practising medicine is more likely to be deemed unreasonable compared to one preventing a salesperson from selling products for a competitor.

- *Duration of the Restraint:* Restraints lasting longer periods are more likely to be considered unreasonable compared to those that are shorter.
- *Geographic Scope of the Restraint:* A restraint covering a vast geographic area is more likely to be seen as unreasonable than one limited to a smaller region.
- *Impact on the Employee:* Restraints that hinder an employee's ability to earn a livelihood are more likely to be judged unreasonable than those with minimal impact on the employee's earning capacity.

### **Consequences of Invalid Restraints:**

If a restraint of trade is deemed invalid, it becomes void and unenforceable, meaning the involved parties are not bound by the restriction and may engage in the previously restricted trade or business. Additionally, the party adversely affected by the invalid restraint may be entitled to damages, which can include compensation for lost profits, loss of goodwill, and other expenses incurred due to the restraint.

This detailed analysis outlines the key considerations for the validity of restraints of trade and the potential consequences when such restraints are found to be invalid, emphasising the balance between protecting business interests and ensuring fairness to employees.

### **Comparison with Laws in Other Jurisdictions**

In the United Kingdom, certain post-termination restrictions are enforceable, provided they pass the test of reasonability. This means the restraint must be designed to protect some proprietary interest of the employer or buyer. Key factors for evaluating whether a non-compete provision protects a legitimate interest include assessing the material risk of misuse of confidential information and determining if the covenant is broader than necessary for protecting those interests. In the United States, some states adopt the 'blue pencil' principle, which allows courts to reduce the unreasonable scope of a non-compete clause to something reasonable. This concept is akin to the principle of 'severability,' where the enforceable portion remains after striking out the unenforceable part. The courts have the added power to rewrite the provision to make it reasonable, a process known as reformation. Factors considered by courts while reforming a non-compete clause include the bargaining power of the parties and the scope and extent of the restriction. Supporters of the 'blue pencil' principle argue that, given the parties intended to be bound by some restrictive covenant, it is fair for courts to modify the clause to ensure its enforceability. However, critics argue that this power allows courts to

decide commercial arrangements that should be left to the parties' commercial wisdom. Additionally, this power could lead employers to draft overly broad restrictive covenants, expecting courts to narrow them down, thereby increasing disputes and litigation around such clauses.

### **CONCLUSION:**

Non-compete clauses play a crucial role in protecting employers' interests, particularly in safeguarding trade secrets, confidential information, and customer relationships. However, these clauses also raise significant concerns regarding their impact on employees' career mobility and opportunities. The Indian Contract Act, 1872, particularly Section 27, presents a complex legal landscape where the general prohibition against restraints of trade is subject to notable exceptions, such as those related to the sale of goodwill.

The historical and legal analysis indicates that while Section 27 broadly renders agreements in restraint of trade void, its exceptions and judicial interpretations provide a nuanced understanding. Landmark judgments, such as those by the Supreme Court, have underscored the importance of reasonableness in determining the enforceability of non-compete clauses. Factors such as the nature of the business, duration and geographic scope of the restraint, and its impact on the employee are critical in assessing the validity of such clauses.

Challenges remain for both employers and employees in navigating the enforceability of non-compete clauses. Employers must carefully draft these clauses to ensure they are reasonable and justifiable, while employees need to be aware of their rights and the potential impact on their career prospects.

In conclusion, the enforceability of non-compete clauses in Indian employment contracts is a dynamic and evolving area of law. Future legal developments and judicial interpretations will continue to shape the balance between protecting employers' legitimate interests and preserving employees' rights to pursue their professions freely.