Enforcing Employee Non-Compete Covenants

Changing employment patterns in India mean the interests of employees and employers are diverging. This is creating challenges for employers, and non-compete covenants are becoming a popular way of trying to lower employee turnover. This in turn is putting a strain on the court system, as the legal position on these often controversial covenants is worked out. Issues such as restraint on trade, favouritism and protection of trade secrets must be considered.

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More and more Indian workers are defecting as the economy grows and multinational corporations enter the market. This creates a challenge for human resource managers in all industry segments. To control employee attrition, companies often resort to restricting their workers from seeking employment with rivals or setting up a competing independent business. The information technology industry was surprised recently when Infosys introduced a non-compete clause in its employment contract. The clause restricts employees from joining rival companies within six months of the end of employment. However, curbing attrition is not the only reason why employers impose non-compete covenants on employees. Avoiding competition and protecting the trade secrets and business connections of the employer are other motivations. This article explores the important question of legal enforceability of non-compete clauses in employment contracts.

Restraint on trade and employment contracts

It is common for employers to invest considerable resources in training employees with specific skills and knowledge, in anticipation of their long-term business contribution. On the other hand, after gaining the requisite skills and knowledge, employees tend to look for more rewarding job opportunities, frequently disregarding honour and integrity. Employers often restrict employees from taking up similar employment to curb competition and safeguard their interests. Clearly, the employer and employee have conflicting interests in such a scenario.

However, the law is clear and tends to be pro-employee. Section 27 of the *Indian Contract Act* 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.

The courts have taken a far stricter view of the covenants between master and servant than they have of similar covenants between vendor and purchaser or in partnership agreements. An employer is not entitled to protect himself against competition on the part of the employee after employment has ceased.

The legal position appears to be well established as far as employment contracts are concerned. Indian courts have ruled that contracts preventing an employee from working elsewhere after the expiry of the term of his employment are in restraint of trade, unless there is a proprietary interest of the employer that requires protection. However, an employee may be restricted from serving any other person or carrying on business on his own account during the term of employment.

Non-compete during employment

It is well settled that an employer can legally restrain an employee from competing with them or taking any other employment while the employment contract is in force. An employer has the right to obtain the exclusive services of the employee during the term of employment.

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The Indian Supreme Court recognized this principle for the first time in *Niranjan Golikari vs. Century Spinning and Manufacturing Co Ltd. [AIR 1967 SC 1098]*, where the respondent company was obliged to keep secret the technical know-how of its foreign collaborator. The respondent had signed a standard form contract for a term of five years. One of the clauses in the employment contract stated that in the event the employee left or resigned their service before the contract's expiry, he must not directly or indirectly engage in or carry on of his own accord or in partnership with others the business at present being carried on by the employing company. The appellant received training in relation to the technical know-how and was restricted from serving in any capacity in any business during the term of the agreement. Also, the employment contract restrained the employee from taking up similar employment during the remaining period of employment, in case the employee resigned during the five-year term. The Supreme Court upheld this restraint as it operated during the period of service and was in relation to work similar to that of the employer. Moreover, it could be proved that the employee attempted to disclose the technical know-how by seeking employment with a rival firm. The court held that in such a scenario it was important to protect the proprietary rights of the employer.

It cannot be said that in every case of premature termination the employee will be restricted from setting up his own business or taking up employment elsewhere during the unexpired period of his contract. In *Superintendence Company of India Pvt. Ltd. vs. Krishan Murgai [AIR 1980 SC 1717]*, the employee's contract prohibited him from taking up work with any competitor or setting up his own business at the place of last posting for two years. Such a condition was operative even if the employee left the services of the employer. The employee started his own business on similar lines upon termination of his employment. In a suit filed by the employer, it was held that the restrictive covenant applied only to an employee's voluntary resignation and not in cases where his services were terminated.

Even restraints that operate during the term of employment may not be enforceable if they are one-sided and intensely favour the employer. In *Gopal Paper Mills vs. Ganesh Das Malhotra [AIR 1962 Cal 61]*, the plaintiff appointed the defendant to serve for a period of 20 years, during which the defendant could not serve any other person or divulge any information relating to the plaintiff. The increase in pay was marginal, and the employer had arbitrary power to terminate the plaintiff's service without notice. In such circumstances, the court held that the agreement was oppressive and one-sided. Therefore, the negative covenant preventing the employee from working at another place was unenforceable.

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Non-compete after employment ends

Employment contracts that restrict employees from working elsewhere or setting up their own business upon termination of employment are generally not enforceable. In some cases, employers have attempted to enforce the non-compete obligation beyond the employment period on grounds of reasonableness. In such cases, employers have argued that the post-termination restraint should be upheld if it is applicable for a short duration or if it is a partial restraint. Though such an exception is recognized under English law, the courts in India have refused to hold that post-termination non-compete obligations may be enforced if they are reasonable. It is only in cases of protection of proprietary interests of the employer that the courts have upheld non-compete obligations operative beyond employment.

In *Pepsi Foods Ltd. and Others vs. Bharat Coca-Cola Holding Pvt Ltd. and Others [81(1999) DLT122]*, the Delhi High Court refused to grant an injunction restraining the employees of soft drink maker Pepsi from joining its rival Coca-Cola. The court held that a negative covenant under an employment contract restraining employees from undertaking employment for 12 months after they left the plaintiff's service was in violation of Section 27 of the *Indian Contract Act*. It was held that such contracts are unenforceable, void and against the public policy, and that what is prohibited by law cannot be permitted by a court injunction.

There are a number of cases where the courts have struck down non-compete clauses that continue beyond the term of employment. Indian courts have permitted employees to exercise any trade or profession, irrespective of the terms and conditions agreed with the previous employee under the employment contract. Courts have recognized the rights of an employee to explore business opportunities, as this stems from their fundamental right to earn a livelihood by practicing a trade or profession of their choice. However, the conduct of the employee should be in good faith, and he must protect the proprietary rights of his previous employer. The employee may be restrained if his intentions are otherwise.

Protection of employers' trade secrets and business connections

In *Chesire & Fiffot's Law of Contract* (10th Edn., p.360), it is stated that a restraint imposed upon a servant is never reasonable unless there is some proprietary interest owned by the master that requires protection. The only matters in respect of which the master could be said to possess such an interest are his trade secrets and business connections. An employee owes a duty of fidelity towards his employer and should not misuse or disclose trade secrets and confidential information relating to the employer's business after employment ends. Similarly, an employee should not entice away his employer's customers. The law recognizes the proprietary interests of the employer, and any restraint imposed on the employee in order to protect the proprietary rights of the employer cannot be considered as a restraint on trade.

In the Golikari case, during training the defendant employee acquired knowledge of technical know-how which the employer was obliged to keep confidential due to an agreement with its foreign collaborator. Accordingly, the employer entered into secrecy agreements with its employees. The plaintiff contended that confidentiality had been breached when the defendant sought employment with his employer's rivals. The Supreme Court held that the plaintiff's interest in the secret manufacturing process should be protected by restraining the defendant from divulging trade secrets to competitors.

In *Jet Airways Ltd. vs. Mr. Jan Peter Ravi Karnik [2000 (4) Bom CR. 487]*, the appellant company employed the defendant as a pilot. The company had organized training to enable the defendant and other pilots to fly new generation aircraft. The defendant agreed to serve the appellant for a period of seven years and not to take up similar employment with any other organization during that period. However, the defendant resigned within six months of completion of training. The Bombay High Court refused to restrain the defendant from taking up employment with a rival airline on the grounds that the negative covenant was one-sided and unreasonable. The court held that there was no proprietary interest of the employer that required protection.

The court distinguished the facts of the Jet Airways case from that of Golikari's case, and held that the training received by the defendant in the former was not a secret. Even the employees of the competitor airline received the same training. The defendant had not received any special knowledge of any trade secret that belonged exclusively to his employer. In addition, the appellant could not claim to have any interest in the training acquired by the defendants as this was a skill which exclusively belonged to the defendants.

Section 27 of the *Indian Contract Act* does not validate any restraint on trade, even if it is reasonable. This stems from the fundamental right of every person to practice any trade or profession.

In *Diljeet Titus vs. Mr. Alfred A. Adebare and Others [2006(32) PTC 609 Del]*, the defendant, an advocate, was in full-time employment at the plaintiff's law firm. Upon cessation of employment, the defendant took away crucial business data, such as client lists and proprietary drafts, belonging to the plaintiff. The defendants contended that, since the relation between parties was not that of an employer and employee, they were the owners of the copyright of the work done by them during their employment. The court rejected this contention and ruled that the plaintiff had a clear right in the material taken away by the defendant. Accordingly, the court restrained the defendant from using the information taken away illegally. It should be noted that the court did not prohibit the defendants from carrying on a similar service. The defendants were only restrained from using the information they took, as this was necessary to protect the interest of the plaintiff.

An employee may be restrained from taking up employment elsewhere if it can be proved that the employer is justified in fearing that the employee may, on joining a competitor, divulge confidential information and secrets learned while in the employer's service. In *Sandhya Organics Pvt Ltd. vs. United Phosphorus Ltd. [AIR 1997 Guj 177]*, the plaintiff and defendant were manufacturing the same industrial chemical. The defendant hired a former employee of the plaintiff, who was required not to divulge trade secrets after the end of employment. It was proved that the defendant was carrying on the same business even before the employee joined their services. Therefore, the court held that the employee could not be restrained from joining the defendant on grounds of protection of the employer's proprietary interests.

Conclusion

Section 27 of the *Indian Contract Act* does not validate any restraint on trade, even if it is reasonable. This stems from the fundamental right of every person to practice any trade or profession. As far as employment contracts are concerned, Indian courts have allowed restrictions on competition from the employee during the term of employment, unless the restrictions favour the employer intensely. Furthermore, an employer can lawfully prohibit his employee from

accepting, after the end of his employment, a position where the employee is likely to use the proprietary rights of the employer acquired during the course of employment. However, an employer cannot restrain an employee, after expiry of employment, from taking up employment elsewhere or setting up his own business that involves using the skills and knowledge gained during the course of employment. The employer is only protected against misuse of his proprietary rights and not against competition. Despite this, companies have not stopped imposing non-compete restrictions that operate after the end of employment, as more often than not they act as a psychological deterrent.

There have been significant changes in employment patterns as times have changed and Indian companies have gone global. As employee attrition becomes more widespread, the Indian workforce needs a radical shift in its thought process and needs to understand that growth and opportunities can still come even if they commit to one organization. The constant judicial efforts required to reconcile the divergent interests of employers and employees need to be reconsidered if high attrition rates are to be curbed. If the free economy model is to be sustained long term, judicial activism is essential to protect and balance the interests of both parties.

About the authors

Priti Suri is the proprietor of PSA, Legal Counsellors. She has more than two decades of experience on three continents in diverse areas of international commercial law, mergers and acquisitions, joint ventures, technology transfers and arbitration and litigation. After earning an LL.M. in the United States, she took part in the ABA's International Legal Exchange programme and worked at law firms in the US. Based in Paris in the early 1990s, she returned to India in February 1997 to set up the practice in New Delhi. She continues to represent several clients in a broad spectrum of industry ranging from automobiles, defence, energy, information technology, infrastructure, pharmaceuticals and telecommunications. Suri has also authored and edited two books, Open Source and the Law *(the first book on the subject in India) and* FDI Notifications: An Anthology, *both published by LexisNexis Butterworths, India.*