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Corporate & Commercial Laws

Buying an Indian Company - how about the non-compete clause?

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Negotiating the non-compete clause in an agreement is no mean task. A key question often surrounds the allocation of the purchase price between cost of shares and apportionment towards non-compete. Buyers usually want to eliminate or, at least, minimize the possibility of competition from the exiting shareholders(s) and, to that end, apportion some consideration from the deal price. The exiting shareholder(s) are concerned with tax implications as payments towards non-compete constitute business income i.e., higher tax liability while comparing with short/long-term tax gain on sale of shares. The restraint on the seller(s) has to be balanced between their ability to manipulate knowledge about the company versus interference with the individual liberty of trading.

Under Indian law, non-compete clauses are not a means to dissuade competition. Section 27 of the Contract Act states "Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind is to that extent void." This stringent rule is subject to a single exception i.e., for a seller of the goodwill of a business. Indian jurisprudence has shown that, depending on the facts and circumstances, courts will enforce a restrictive contractual covenant after a seller leaves a business provided it is reasonable and not against public policy. The validity of a contract in partial restraint of trade depends on the existence of proper limitations of time and space, and a valuable consideration.

JUGGLING ADEQUATE CONSIDERATION

FOR UNLISTED COMPANIES

There is no thumb rule about the method of quantification of the non-compete sums or a minimum payable. It depends on the negotiations, based on parties' perception of loss in the event the sellers establish a competing activity. A covenant to avoid competition will lack contractual force unless a value has been given for it. Absent a specific statute for unlisted companies, while apportioning the sum, guidance used to be taken from the Takeover Code for listed companies which, while not providing any minimum amount, stipulated a non-compete fee of up to 25% of the price. Last year, this was scrapped on the premise that the promoters should be treated equally as

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the other shareholders. If sellers start a successful competing business, the buyer's recourse will be to seek injunctive relief, and claim monetary damages for breach.

In such cases, court will analyze if the consideration is reasonable, fair, and if the breach leads to an irreparable injury for the buyer. This would involve consideration of multiple factors including inability to quantify damages due to the nature of the loss, reduction of competitive position in the market place, loss of goodwill and loss of opportunity to manufacture and distribute unique products because of loss of trade secrets. The seller(s) defense can potentially be that consideration was low. Absent specific statutory provisions, it is necessary to rely on jurisprudence. Courts usually attach importance to bargaining power, nature and productivity of business and the disparity between parties.

FOR LISTED COMPANIES

On September 12, 2012 in the case of International Paper Company where the Securities Appellate Tribunal ("SAT") adjudicated upon the legality of the non-compete fee under the Takeover Code. SAT's position was that non-compete fee cannot be paid to shareholders who do not pose any competitive threat to the company after exiting, even if such shareholders are part of or related to the promoter group. In this case, the US-based buyer executed an agreement with a listed Indian company where the purchase price for the promoter group consisted of two components – price per share and an additional sum towards non-compete. In contrast, the offer to buy the other shares was at a lower price, with a nominal figure for non-compete. In other words, two different share prices were offered for the two groups. While assessing this, SEBI's view was the price should be the same on the basis that the non-promoter group was unlikely to pose any competitive threat to the target company after exiting. The buyer appealed to SAT.

Amongst other things, SAT held that (a) SEBI has the power to scrutinize the justification for payment of non-compete, (b) if it is of the view that non-compete fee is paid to shareholders who do not have the ability to compete with the target entity, then, SEBI can direct the buyer to pay the same offer price and not give greater fiscal benefit to the promoter group. This was in sync with the change introduced in regulation 8(7) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 which clearly specified that the price shall include the sum paid in any form in any agreement, whether termed as control premium, non-compete fees or otherwise. This change was made to prevent selective promoters from receiving additional payment camouflaged as non-compete, thereby depriving other shareholders from getting a just price.

The important point is whether all the sellers are at par in terms of their ability to compete. Clearly, SAT felt that was not the case for listed companies where many shareholders are not close to the business or management; they do not possess any special knowledge that can be used to set up a competing venture. Accordingly, they directed the buyer to pay the same offer price for all the shareholders.

The benchmark may be different if the buyer is buying a listed or an unlisted company. Caution has to be exercised and any judicial forum will consider multiple factors which include the seller's ability to use critical proprietary technology and trade secrets, engagement in the company's management as well as motivation to compete.

PRITI SURI is the founder-partner of PSA and a seasoned lawyer with over twenty-six years' experience spread across three continents. In the course of her career, Priti has developed the firm and represented its international and domestic clients in the full range of cross-border M&A transactions, strategic investments, joint-ventures including tender and exchange offers, venture capital financings, structuring private equity deals, leveraged buyouts and divestitures. Priti is currently the Chair of the Women Business Lawyers' Committee of the Inter-Pacific Bar Association, as well as the Co-Chair of the India Committee of the American Bar Association's International Law Section. She is also the Co-Chair of Public Policy Committee of International Technology Law Association and the Co-founder member and President of Society of Women Lawyers-India (SOWL-India), a newly created platform for women lawyers across India.