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Non-compete clauses: soft asset, hard negotiations (buyer beware!)

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Disputes among joint venture partners are not unusual. Often they emanate from the issue of funding the joint venture, regardless of whether the joint venture company is co-managed or one party has majority control. The acquisition by one party of another party's shares is by no means a simple process. Using a case study, this update examines the issues surrounding a critical point in the acquisition of an existing joint venture manufacturing business where the minority shareholder sells its shares to the majority shareholder.

Hypothetical facts

Assume the following hypothetical facts. The closely held, private limited joint venture company is heavily dependent on imports and unable to localize, thereby increasing its operating costs leading to a negative cash status. The financial health of the joint venture company is poor. The principal reason why it is not bankrupt is because the majority shareholder's payments for supplies remain outstanding. In other words, the majority shareholder and owner of the proprietary technology subsidizes the operations. Efforts to infuse equity fail, leading to an impasse between the parties, as the minority partner fails to agree to provide proportionate additional funding. In such cases the relationship starts to break down as the quality of the exchanges deteriorates with both parties levelling accusations at one another. This stage is also interspersed with frequent threats of invoking the dispute resolution mechanism and is probably the most challenging phase in the entire process, which by now has become vitriolic. The accusations range from blocking the operations of the joint venture company to oppression, mismanagement and use of financial muscle by a large multinational against a smaller Indian company. Some arguments appear to be an attempt by the minority shareholder to increase the stakes in the dispute by ostensibly preparing a file claiming the "mismanagement" of the joint venture company and "oppression of the minority shareholder". The majority view is that the minority is obstructing the proper operation of the joint venture company and jeopardizing its survival with a continued refusal to inject funds and an insistence on undertaking debt at an early stage, which could be detrimental for the shareholders.

At some point it becomes clear that one party must exit in accordance with the joint venture company agreement provisions. The parties start serious discussions and present their respective viewpoints. It is realized that localization is not necessarily controlled by a party unilaterally; instead, the majority of factors are material, including customer validation requirements of the products. The global business environment contributes towards a sharp market decline, resulting in lower volumes and postponed projects. Endless debates ensue and price negotiations are tough, but somehow the parties eventually reach an in-principle agreement whereby the minority shareholder agrees to exit from the joint venture company at the agreed price. However, the question remains: what happens to the non-compete clause in the agreement? The majority shareholder (the buyer) wants to apportion a reasonable consideration from the deal price so that the agreement is valid and enforceable for its entire duration. The minority shareholder is concerned with the tax implications, as payments towards a non-compete consideration are part of business income leading to a higher tax liability in comparison to short-term or long-term tax on the sale of shares.

Non-compete clauses and Indian law

Generally, a non-compete agreement, or a covenant not to compete in an agreement, is a contract in which one party agrees not to compete with another in exchange for payment of some consideration. Such contractual covenant/agreement protects the buyer from potential competitive activity by the seller that could damage the business as a result of the selling shareholder having had access to the joint venture company's know-how, technology, trade secrets and other proprietary confidential information. By restraining the seller contractually, the buyer wants to ensure that the exiting shareholder does not manipulate its knowledge regarding the joint venture company's weaknesses and strengths. Yet this concern must be balanced with interference with individual trading liberty, as well as the free flow of resources for the proficient functioning of a market economy.

Under Indian law, non-compete clauses are not a means to dissuade competition. Section 27 of the Contract Act expressly states that "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:

"*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.*"

Indian jurisprudence has shown that, depending on the facts and circumstances, Indian courts will enforce a restrictive contractual covenant. The judicial perspective in this regard is based more on common law than on contract law. Non-compete provisions can be validly enforced after a member leaves a joint venture, provided that they are reasonable and not against public policy. While a contract in total restraint of trade is against public policy and invalid, one in partial restraint of trade is not necessarily so. However, its validity depends on the existence of proper time and space limitations and a valuable consideration.

Adequate consideration - the juggling act

The understanding is that when a contracting party agrees to stay away from a business, it demands compensation for such abstinence. There is no rule governing the method of quantification of the sum for non-compete compensation, nor any minimum amount to be paid. It depends on the parties' negotiations, based on the perception of loss in the event that the seller establishes a competing activity. What is clear is that a covenant to avoid competition lacks contractual force unless some value has been given for it. While apportioning the sum, guidance can be taken from the Takeover Code (applicable only to listed companies), which, while providing no minimum amount, stipulates that:

"*an acquirer can pay a seller a non-compete fee of up to 25% of the price offered to shareholders in an open offer and anything more than 25% has to be included in the open offer price.*"

Allocation

In the absence of statutory guidelines on the percentage of allocation for non-compete consideration, parties tend to rely on the share price, the value of the company's business and future projections. On May 4 2010 the Reserve Bank of India issued a notification (retroactively effective since April 21 2010), which stated that a transfer of shares of an unlisted company by residents to non-residents "shall be at a price which is not less than the fair value to be determined as per the discounted free cash flow method".

However, a fundamental question remains regarding the validity of the non-compete clause, regardless of which method is applied. Ascertaining business plans and future projections and determining the price, based on the discounted cash flow methodology, for the transfer of shares between shareholders is somewhat far-fetched. While the Reserve Bank of India notification relates only to the valuation method for transfers of shares and not to the method of quantification of non-compete considerations, in practice sellers tend to rely on the price per share and take a percentage of that figure. Hence, the reference to the Reserve Bank of India guidelines becomes pertinent.

What about the buyer?

If the selling shareholder contravenes the non-compete clause and starts a successful parallel competing business, the buyer's recourse will be to file a case seeking injunctive relief and claiming monetary damages for such breach. However, often monetary damages are inadequate. The court will analyze whether the consideration paid for non-competition is reasonable and fair, and will evaluate whether the breach leads to an 'irreparable injury' for the buyer. If the conclusion is affirmative and the balance of convenience lies in favour of granting the injunction against the seller from setting up a competing business, the court will issue the injunction. The occurrence of an irreparable injury due to breach of the non-compete clause greatly enhances its enforceability. From a buyer's perspective, the determination of an irreparable injury would involve the consideration of factors such as:

- an inability to quantify damages due to the nature of the loss;
- a reduction of a competitive position in the marketplace;
- loss of goodwill; and
- loss of opportunity to manufacture and distribute unique products because of loss of trade secrets.

The seller may claim that the restraint is unreasonable and the non-compete consideration too low. In the absence of a specific statutory provision on what ought to be an appropriate figure, it is necessary to rely on jurisprudence. Courts usually attach importance to factors such as:

- bargaining power;
- the nature and productivity of business; and
- the disparity between the parties regarding the amount of consideration paid.

Comment

Going back to the hypothetical facts, a reasonable and fair non-compete fee can be between 15% and 20% of the total value. The non-compete obligation is a soft asset (like IP rights and goodwill), and its allocation is linked with the total deal value, not the value per share. For the buyer, it is crucial that the non-compete agreement remain valid for its entire duration. In order to determine its fairness, any judicial forum will consider several factors, including:

- the seller's ability to use or access critical proprietary technology and trade secrets;
- relationships with key existing customers;
- motivations to compete;
- the buyer's perceived valuation of the business; and
- financial and human resources.

Non-compete agreements are difficult to enforce and must be carefully drafted to conform to the regulations of the jurisdiction in which the agreement is to be performed.

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