"Negative Covenant" in Contract of Employment does not curb Employee's Freedom to seek Employment elsewhere after Termination of Contract

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Negative covenants are introduced in contracts of employment to deter the employee from leaving the services. Notwithstanding such negative constraints/ restraints, is it open to the employees to seek employment elsewhere after termination of the contract of employment, is the question probed herein.

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With the opening up of the Indian economy and the entry of many foreign companies in the Indian scene, both in the manufacturing and in the services sector, the employment opportunities in the Indian industries have grown tremendously and lucrative remuneration packages are being offered to qualified and experienced persons. Employment pages of leading newspapers are full with advertisements for recruitments and opportunities for employment have opened up in the IT and IT Enabled Services companies; and also in the tourism and travel industry; insurance companies; broadcasting and tele-communication and entertainment industry and the hotel industry etc. However, the disturbing fact remains that even though there is a significant growth in the number of companies engaged in these sectors, there is also a scramble for qualified and experienced employees to manage these companies. Therefore, not only solicitation takes place by the companies themselves and/ or by the HR Consultants on behalf of their clients to hire the experienced employees, the increase in attrition rate of key employees in these industries leads the Industry to devise ways and means to prevent employees leaving the companies and joining elsewhere even after termination of employment contracts. Serious efforts are made by the employers to devise methods to tie down an employee from leaving the current employer and to somehow prevent him from seeking employment elsewhere and almost all the companies take extra care to draw up elaborate and complicated employment contracts so that a fear psychosis is put on the minds of the employees from the thought of leaving the employer. Rather than drawing a simple employment contract on the letterheads of the company which was generally the norm earlier, now-a-days employment contracts are entered into on non-judicial stamp papers and such contract contains lot of negative covenants so that the employee does not dream or think of leaving the services of the current employer. Also, in the name of providing "training" to qualified persons while on job, the employers are demanding bank guarantees for specified substantial sums and the employees are compelled to give Bank Guarantees and routinely the employees are also required to sign Bonds to continue in employment for a specified number of period and in case of breach of this condition, the employees are dragged into protracted litigations and are compelled to pay hefty sums to get out of the contractual bond.

Considering the importance of this subject, an attempt has been made in this Article to highlight the Constitutional provisions and the relevant provisions of Section 27 of the Indian Contract Act, 1872 and how the Courts have interpreted the law of the land and how the Courts have liberated the trapped employees from the clutches of such employment contracts which are against the law of the land.

First of all, Article 19(1)(g) of the Constitution of India confers fundamental rights on the citizens of India and this Article allows the citizens the right to practice any profession or carry on any occupation, trade or business subject to reasonable restrictions in public interest. Thus, any restriction on this fundamental right of any citizen goes against the protection granted and guaranteed in the Constitution. Yet, the employers rampantly violate this fundamental

rights of the citizens and through arm-twisting tactics and fine tuning the contract of employment creates impediments in the enjoyment of this fundamental right by the citizen.

Undisputedly, the most important legal provision which safeguards the rights of the employees is contained in Section 27 of the Indian Contract Act, 1872 which reads as under : -

> "27. **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.
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> **Exception-1** : **Saving of agreement is not to carry on business of which good is sold** – One who sells the goodwill 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 goodwill 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."

While interpreting Section 27 of the Indian Contract Act, 1872, a 3 Judge Bench of the Supreme Court of India in *Superintendence Company of India Pvt. Limited* v *Shri Krishan Murgai* (1981-2 SCC 246) had the occasion to deal with a negative covenant restricting right of the employee, after he left the company, to engage in any business similar to, or competitive with that of the employer and whether such restraint was void under Section 27 of the Indian Contract Act. The Court examined the following term (Clause 10) in the contract of employment between the Appellant and the Respondent : -

> "That you will not be permitted to join any firm of our competitors or run a business of your own in similarity as directly and/or indirectly, for a period of two years at the place of your last posting after you leave the company."

The appellant therein had terminated the services of the respondent, who subsequently started his own business at Delhi on identical lines to that of the appellant. The appellant brought action claiming damages on account of the breach of the aforesaid negative covenant contained in the said Clause 10. Two concurring opinions were rendered; one by Justice Untwalia and Justice Tulzapurkar, and the other by Justice A.P. Sen .

Justice Untwalia and Justice Tulzapurkar held that : "Assuming that the negative covenant contained in Clause 10 is valid and not hit by Section 27 of the Contract Act, what requires to be determined is whether the said covenant is on its terms enforceable at the instance of the appellant company against the Employee? In terms of Clause 10 it provides that the restriction contained therein will come into operation "after you (respondent) leave the company". According to the plain grammatical meaning, that word in relation to an employee would normally be construed as meaning voluntarily leaving of the service by him and would not include a case where he is discharged or dismissed or his services are terminated by his employer. Having regard to the context in which the expression "leave" occurs in Clause 10 of the service agreement and reading it along with all the other terms of employment, it seems clear that in the instant case, the word "leave" was intended by the parties to refer only to a case where the employee has voluntarily left the services of the appellant company of his own, *and since here the respondent's services were terminated by the appellant-company, the restrictive covenant contained in Clause 10 would be inapplicable and therefore, not enforceable against the respondent at the instance of the appellant-company*.

Justice A.P. Sen in his concurring judgment held that

(1) *Under Section 27, which is general in terms, a service contract, which has for its object a restraint of trade, whether general or partial, unqualified or qualified, extended beyond the termination of the service is* prima facie *void*. Unless a particular contract can be distinctly brought within Exception-1 to Section 27, there is no escape from the prohibition. The onus rests upon the Covenantee to prove that the restraint is reasonable. In the present case, the agreement in question is not a "goodwill of business" type of contract and, therefore, on the part of the Respondent puts a restraint even though partial, it is void, and therefore, the contract must be treated as one which cannot be enforced.

(2) There exists a difference in the nature of interests sought to be protected in the case of an employee and of a purchaser of business and therefore, as a positive rule of law, the extent of restraint permissible in the two types of cases is different.

It was held therein that employee covenants should be carefully scrutinized because there is inequality of bargaining power between the parties; indeed no bargaining power may occur because the employee is presented with standard form of contract to accept or reject. The Courts view with disfavor a restrictive covenant by an employee not to engage in a business similar to or competitive with that of the employer after termination of his contract of employment. The true rule of construction is that when a covenant or agreement is impeached on the ground that it is in restraint of trade, the duty of the Court is, first to interpret the covenant or agreement itself, and to ascertain according to the ordinary rules of construction what is the fair meaning of the parties. If there is an ambiguity, it must receive a narrower construction than the wider. The employed ought to have the benefit of doubt. The restraint may not be greater than necessary to protect the employer, nor unduly harsh and oppressive to the employee.

In this case, the Supreme Court held that on a true construction of Clause 10 of the agreement, the negative covenant not to serve elsewhere or enter into a competitive business does not arise when the employee does not leave the services, but is dismissed from service. It was held that wrongful dismissal is a repudiation of contract of service which relieves the employee of the restrictive covenant. Therefore, Clause 10 of the agreement was not given too wide an interpretation, as it would have violated the

provisions of section 27 of the Indian Contract Act and was thus subjected to a narrower construction.

Another interesting decision that deserves to be mentioned here is that of the Delhi High Court in *Pepsi Foods Limited and Others* v *Bharat Coca-Cola Holdings Pvt. Ltd. and Others* (1981-1985 DLT-122) wherein the learned Single Judge of the Delhi High Court had denied injunction to the plaintiffs, *inter alia*, on the ground that if the injunction was granted, the same would have the direct impact of curtailing the freedom of employees for improving their future prospects and service conditions by changing their employment. It was also observed that the rights of an employee to seek and search for better employment cannot be restricted by an injunction. It was also observed that an injunction cannot be granted to create a situation such as "Once a Pepsi employee, always a Pepsi employee". *It was observed that such a situation would amount to "economic terrorism" or a situation creating conditions of "bonded labor*". It was also observed that freedom of changing employment for improving service conditions is a vital and important right of an employee, which cannot be restricted or curtailed by a Court injunction. However, this decision was not one based on interpretation of employee's contract of employment but was a fight between two soft drink giants Pepsi Foods and Coca-Cola who were allegedly involved in a battle over their employees. There was no agreement between the two parties and the entire scope of the decision fell within the parameters of law of torts and not under the law of contract and definitely not relating to restrictive covenants of nature contemplated under Section 27 of the Indian Contract Act, 1872.

Another decision of the Delhi High Court also deserves mention here. The learned Single Judge of the Delhi High Court in *Ambience India Private Limited* v *Naveen Jain* [(2005) 122 DLT 421] observed that the law is well settled that all contracts in restraint of trade are void and hit by section 27 of the Contract Act. The Court observed that an employee, particularly after the cessation of his relationship with his employer is free to pursue his own business or seek employment with someone else. However, during the subsistence of his employment, the employee may be compelled not to get engaged in any other work or not to divulge the business / trade secrets of his employer to others and especially, the competitors. In such a case a restraint order may be passed against the employee because section 27 of the Indian Contract Act does not get attracted to such a situation. It is also added that a trade secret is some protected and confidential information which the employee has acquired in the course of his employment and which should not reach others in the interest of the employer. The Court observed that, however, routine day-to-day affairs of employer which are in the knowledge of many and are commonly known to others, cannot be called "trade secrets". A "trade secret" can be a formulae, technical know-how or a peculiar mode or method of business adopted by an employer which is unknown to others.

In this case, the Delhi High Court after considering the pleadings of the parties and particularly Clauses (6), (7) and (8) of the Agreement dated 30th August, 2003 which was before the Court, came to the *prima facie* view that the agreement between the parties prohibiting the defendant for two years from taking employment with any present, past or prospective customer of the plaintiff is void and hit by Section 27 of the Indian Contract Act. *This stipulation was* prima facie *against public policy of India and an arm-twisting tactic adopted by an employer against a young man who was looking for a job.* The contract between the plaintiff and M / s. Indigo Orient Limited has already come to an end and as such no *prima facie* case remains in favor of the plaintiff to restrain the defendant from remaining in the employment of the said company. The employment contract between the plaintiff and defendant was determinable in nature and as such the defendant was entitled to determine the same and seek another employment. *Everybody has a right to strive for progress in career. The restrictions imposed upon the defendant in the agreement, therefore, were void and unconscionable.*

Two judgments of the Bombay High Court also deserve special mention in the context of this article. In the first one, i.e. *Star India Private Limited* v. *Laxmiraj Seetharam Nayek and Another* (2003) 3, Maha LJ 726 the Court had to deal with the question of right of an employee to resign from the employment and to seek better employment and to seek better avenues of employment and how the Court dealt with alleged argument of passing off of "trade secrets" in such a scenario. The learned Single Judge was of the view that anyone in employment for some period of time would know certain facts and would come to know certain information without any special efforts and the same cannot be said to amount to trade secrets or confidential information. As regards acquisition of excellence, the Court observed that in the very long process in the careers of every person, no one else can have proprietary rights or interest in such acquisition of excellence. The Court observed that if the plaintiff had right to terminate the contract on the ground of misconduct, it cannot be said that the Defendant had absolutely no right to resign from the employment on account of better prospects or other personal reasons. If he finds a better employment with better remuneration and other service conditions, he cannot be tied down under the terms of the service contract. The Court held that any agreement restraining an employee, post-termination, from seeking employment elsewhere, as held in *Superintendence Co. Ltd.* (*supra*) would be in restraint of trade and would be hit by Section 27 of the Indian Contract Act, 1872.

The point in controversy was very well discussed and dealt with in another judgment of the Bombay High Court in *Taprogge Gesellschaft MBH* v. *IAEC India Limited* AIR (1988) Bom 157. In this case, the plaintiff company (a German company) was engaged in the business of manufacturing cooling water filters and allied products and appointed the defendant, an Indian company, as its agent to sell its goods in India. Under the contract, there was a restriction to sell the Defendant's own products. Disputes arose

and the contract was rescinded. The plaintiff company claimed an injunction restraining the defendants from recommending, offering or selling any of the covered products for a period of five years after the contract was rescinded. The defendant took the plea that the negative covenant embodied in the clause was in restraint of trade and therefore void under section 27 of the Indian Contract Act. The High Court held that the negative covenant embodied in the clause of the contract between the parties to the suit could not be enforced in India. Therefore it refused to grant injunction in favor of the plaintiff. The Court observed that : -

> "The distinction between the restraints imposed by a contract, operative during the subsistence of the contract and those operative after the lifetime of the contract is of a fundamental character. The purpose, incidence and consequences of the two types of restraints need to be borne in mind before proceeding to determine the validity of the restraint sought to be enforced in this notice of motion. While guarding jealously the freedom of contract to engage in any trade, business or profession as one wills, the law abhors monopoly which prohibit a person from pursuing a lawful trade, business or profession. This being the policy of law, any restraint on the freedom of trade, business or profession, is considered void. The law enacted by section 27 of the Act is founded on the public policy which disapproves and negates the restraints on trade, business or profession. Though this is the general rule of law, all corners are not alike, and the restraints imposed by them are varied in their nature and effect. The contracts between the vendor and purchaser of businesses are generally marked by equality of strength and bargaining power. In the contracts between master and servant, this may not be so.
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> …. Again, the purpose which a restraint is expected to serve determines the character of the restraint. For instance, the restraints which operate during the term of the contract have to fulfill one kind of purpose viz. furthering the contract. On the other hand, the restraints operative after the termination of the contract strive to secure freedom from competition from a person who no longer works within the contract. There is, thus, a natural difference which marks the restraints which tend to further the contract as in *Gaumont British Picture Corpn. Ltd.* v *Alexander* (1963) 2 ALL ER 1686 or *Brahamaputra Tea Co.* v *Scath* (1885) ILR 11 Cal 545. An implied covenant in such exclusive agreements preventing an employee from serving anywhere else during the term of the contract is intended to ensure the fulfillment of the contract and, therefore is not in restraint of trade, business or profession – [*Gaumont British Picture Corp.* v *Alexander* (1963) 2 All ER 1686] unless the contract is unconscionable, excessively harsh or one sided.
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> …..Generally speaking, the negative covenants operative during the term of the contract are not hit by section 27 of the Contract Act because they are designed to fulfill the contract and not to restrict them. On the other hand, when a restriction applies after the contract is terminated, the restriction on freedom of trade, business or profession takes the form of restraint of trade, business or profession. This distinction which is of a fundamental nature has to be borne in mind; otherwise the perspective will be lost."

Also, the Division Bench of the Calcutta High Court in *Electrosteel Castings Limited* v *SAW Pipes Limited and Others* (2005) 1 CHN 612 observed that if an employee has a right to terminate his employment with a month's notice and somebody induces the employee to serve that month's notice, it is no inducement to commit breach of contract. The answer as to why this should be so is very simple. A person inducing an employee in this manner is not inducing him to break the contract, but only inducing him to end it. Such an inducement is not a known tort.

On the question of enforcement of a negative covenant in a contract of employment *vis-à-vis* the provision contained in Section 42 of the Specific Relief Act, 1953, particularly with regard to the Court's power to grant an injunction in the case of a negative covenant, the Supreme Court of India in *Gujarat Bottling Co. Ltd. & Others* v *Coca-Cola Co. & Others* (1995) 5 SCC 545 observed as under : -

> "In India, Section 42 of the Specific Relief Act, 1963 prescribes that notwithstanding anything contained in Clause (e) of section 41, where a contract comprises an affirmative agreement to do a certain act, coupled with a negative agreement shall not preclude it from granting an injunction to perform the negative agreement. This is subject to the proviso that the Plaintiff has not failed to perform the contract so far as it is bind on him. *The Court is, however, not bound to grant an injunction in every case and an injunction to enforce a negative covenant would be refused if it would indirectly compel the employee either to idleness or to serve the employer* (*See Ehrman* v. *Bartholomew* (1898) 1 Ch.671 ; (1895) 99 All ER Rep.Ext.1680 ; *N.S. Golikari* 1967-2-SCR-378 ; AIR 1967-SC-1098)."

Interestingly, with regard to the present day trend of poaching employees from the competitors and on the question as to whether the non-solicitation clause in question between two business entities amounts to a restraint of trade, business or profession, the Delhi High Court while deciding an application under section 9 of the Arbitration and Conciliation Act, 1996 in *Wipro Limited* v. *Beckman Coulter International* (2006) 131 DLT 681observed that two things are material viz.

(1) the contract in which the non-solicitation clause appears is a contract between the petitioner and the respondent whereby the petitioner was appointed as the sole and exclusive canvassing representative / distributor of the respondent for its products in India; and

(2) it is not a contract between an employer and an employee. The Court further observed that if one considers the non-solicitation clause, it becomes apparent that the parties are

> restrained for a period of two years from the date of termination of the agreement from soliciting, inducing or encouraging any employees of the other party to terminate his employment with or to accept employment with any competitor, supplier or customer of the other party, it is a covenant which essentially prohibits either party from enticing and / or alluring each other's employees away from their respective employments. *It is a restriction cast upon the contracting parties and not on the employees.*

The later part of the non-solicitation which deals with the exception with regard to general advertising of positions makes it clear that there is no bar on the employees of the petitioner leaving its employment and joining the respondent and vice-versa. The bar or restriction is on the petitioner and the respondent from offering inducements to the other's employees to give up employment and join them. Therefore, the clause by itself does not put any restriction on the employees. The restriction is placed on the petitioner and the respondent and therefore has to be viewed more liberally than a restriction in an employer-employee contract. The learned Judge was therefore of the view that the non-solicitation clause does not amount to a restraint of trade, business or profession and would not be hit by Section 27 of the Indian Contract Act, 1872 as being void.

The learned Single Judge of the Delhi High Court went on to observe that however the question that arises is what happens when the respondent has solicited and / or induced or encouraged employees of the petitioner to leave and / or resign from such employment and join the respondent. Can an injunction be granted restraining the respondent from giving employment to such employees? There are only two possible situations. The first is that an injunction is granted and the second is that an injunction is not granted. If an injunction is granted, it would imply that the respondent cannot employ such employees who have responded to the advertisement which is held to be solicitation. But it would also mean that the employees who did not have any such restrictive covenant in their employment contracts would be barred from taking up employment with the respondent. In other words, the Court would be reading into their employment contracts a negative covenant that they would not seek employment after termination of their present employment, with the respondent. If such a term were to be introduced in their employment contract, then, it, in view of the settled legal principles, would be void being in restraint of trade. Consequently, when such employees cannot be restrained from directly seeking the employment of the respondent, they cannot be restrained indirectly by preventing the respondent from employing them. Therefore, an injunction cannot be granted restraining the respondent from employing even those employees of the petitioner company who were allured by the solicitation held out by the respondent in the said advertisement. But, the respondent can be injuncted and restrained from making any such or other solicitation in future during the period of two years w.e.f. 31.12.2005 to any other employees of the petitioner.

As regards the solicitation already made by the respondent in the advertisement, the petitioner, if it is able to substantiate this in the arbitration proceedings, would be entitled to be compensated by the grant of damages. So, it is not as if a breach of the non-solicitation clause would leave the petitioner without a remedy. The remedy lies in the claim for damages and an injunction against solicitation in future. It does not lie in the grant of an injunction preventing its employees from resigning and taking up employment with the respondent. Accordingly, the Court disposed of the application under section 9 of the Arbitration and Conciliation Act, 1996 with the following directions :-

(i) the respondent is restrained during the pendency of the arbitration proceedings from taking out any other or further advertisements or to do anything to solicit, induce or encourage the employees of the petitioner to leave the petitioner's employment and take up employment of the respondent and / or its agents and / or representatives and / or competitors;

(ii) the employees of the petitioner would, however, be free to take up employment with the respondent, even in response to the said advertisement which has *prima facie* been held to be solicitation, but, the respondent would be liable to compensate the petitioner for such breach of the non-solicitation clause, if so established in the pending arbitration proceedings.

Apart from the above mentioned legal provisions and decided cases, some experts also suggest that provisions of section 368 of the Indian Penal Code can be invoked by the victimized employee on the ground of forceful and wrong confinement against the free will of the employee.

CONCLUSION

The judicial decisions point out that the Courts have observed that restrictive covenants in the employment contracts may be termed as "economic terrorism" and encourage employers to resort to "bonded labor" which is otherwise legally prohibited in this country. In addition, the Court decisions cited above support the cause of employees who are otherwise subjected to victimization by the employers taking undue advantage of the need for employment by the employment-seekers, who sign on dotted line contracts containing the restrictive covenants. It is felt that the employers need to appreciate the value and importance of human resource in this competitive business environment and through appropriate remuneration packages and participation in profits can strengthen the human asset base. Happy and satisfied work force spreads positive feedback for the company in the employment market, whereas protracted litigations to victimize and terrorize employees make the task difficult to get experienced employees and obviously the industry cannot allow this unhealthy trend. ❑