

NON-COMPETE AND NON-SOLICIT IN THE CONTEXT OF M&A TRANSACTIONS

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Non-Compete and Non-Solicit clauses serve as an important means by serving crucial roles in protecting the acquiring company's interest that is the buyer. An absence of such clauses can have serious implications and devastate a company. These clauses form integral parts of shareholders' agreements, employee contracts, and share purchase agreements. In contracts such as employee contracts, these clauses prevent the employees from leaving to solicit clients and start competing businesses of the same nature after such termination. Violating such clauses could possibly lead to various significant problems such as payment of liquidated damages, financial losses, or injunctions imposed on such a company. Therefore, clearly knowing the scope and application of such clauses is very important to avoid future problems. The authority in India that ensures that such non-compete clauses and non-solicit clauses in M&A transactions are reasonably aligned and do not adversely affect competition in the market is the Competition Commission of India (CCI). However, the enforceability of such clauses in India must specifically comply with the reasonability test and all the legal provisions. This is done by carefully drafting such provisions so that no negative implication later happens or takes place.

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It is very important to maintain commercial relationships and a competitive advantage in the market. These clauses are very important, therefore, various aspects have been highlighted through this article to develop a clear understanding of this particular topic and its importance, scope, and parties involved, among other things coincidental to its understanding. An employee's and employer's relationship is worth protecting; therefore, expansion in the legal framework is needed for the growth of the private sector. Not only benefits but such clauses have inherent risk involvement in it as well.

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INTRODUCTION - MEANING

A Non-compete and non-solicit clause in a merger and acquisition transaction:¹

Non-Compete Clause:

- A clause prohibiting the selling or merging party from carrying out operations that directly threaten the acquiring firm's operations for a specified period and within a defined geographic region.
- This provision intends to stop the selling party from forming a new firm that might undermine the purchasing company's market share or competitive advantage by exploiting the information, contacts, or resources obtained during the transaction.

Non-Solicit Clause:

- It is a clause that prohibits the party selling or merging from approaching or employing important personnel, clients, suppliers, or other business associates of the firm they are purchasing.
- This clause is meant to safeguard the relationships of the purchasing company and keep the selling party from stealing important and valuable talent or severing vital commercial ties.

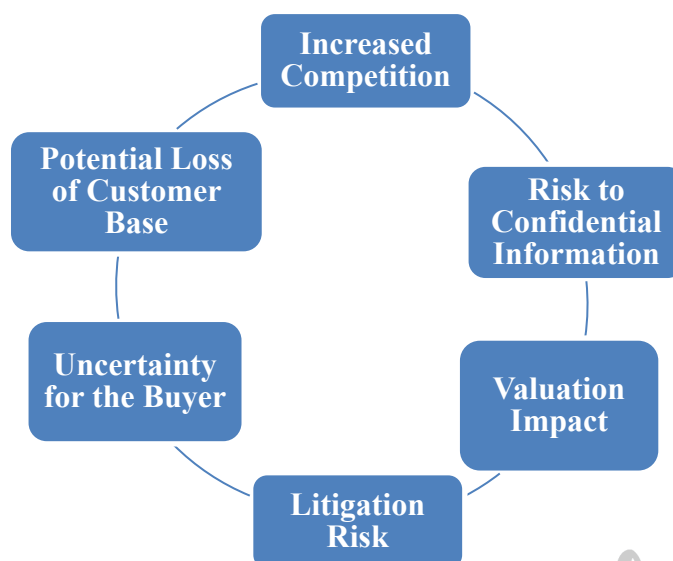
PARTIES INVOLVED IN A MERGER & ACQUISITION TRANSACTION

The Seller, also known as the target company that owns the business, assets, or shares being acquired, is looking to sell those to the buyer. It might be an association of shareholders, a corporation, a partnership, or even a single proprietorship. Inspired to sell due to factors like retirement, dire financial circumstances, or strategic realignment.

The Buyer, also known as the acquiring company intends to purchase the business, assets, or shares from the seller. Typically, the goal of buying the seller's company is to grow its operations, penetrate a new market, create synergies, or accomplish other strategic objectives. The purchaser may be an individual investor, a venture capital firm, a private equity firm, or another corporation.

¹ Michael Wekezer, 'M&A Vocabulary – Experts explain: Non-Compete and Non-Solicitation clauses in M&A Transactions' *Roedl* (14 November 2022) <www.roedl.com/insights/ma-dialog/2022-11/ma-vocabulary-experts-explain-non-compete-non-solicitation-clauses-ma-transactions> accessed 03 June 2024

WHAT HAPPENS IF AN AGREEMENT HAVING THESE CLAUSES IS NOT MADE TO BE SIGNED BY THE SELLER IN M&A TRANSACTION?



THE KEY IMPORTANCE AND SIGNIFICANCE OF THESE CLAUSES

- 1. Protecting Buyer's Investment:** It Helps the buyer to protect the investment by preventing the seller from participating in activities that could directly compete with the buyer's business or poach key employees, customers, or suppliers & realize expected benefits of the transaction, maintain customer base, and preserve competitive advantage.
- 2. Preserving Relationships:** The non-solicit provision ensures that the seller cannot utilize these connections for personal advantage or redirect them away from the acquiring firm and the success of an acquired business depends on the relationships it has formed with customers, suppliers, and employees.
- 3. Safeguarding Confidential Information:** The buyer obtains access to the seller's private and sensitive data during the M&A process, including trade secrets, client lists, financial information, and intellectual technology. These provisions prohibit the vendor from using it for personal gain or divulging it to rival businesses. Thus, preserving the buyer's edge over competitors.
- 4. Mitigating Risks:** M&A transactions come with inherent risks, such as uncertainties related to financial performance, market conditions, and integration challenges. These clauses help

mitigate some of these risks by limiting potential competitive threats and preserving customer loyalty

5. Enhancing Market Value: These clauses in an M&A agreement can enhance the market value of the acquired business by giving assurance to the buyer that the seller will not immediately compete against them or disrupt critical business relationships. This certainty can lead to a higher purchase price, better deal terms, or a smoother transition, benefiting both parties involved.

NON-COMPETE & NON-SOLICIT CLAUSE IN AN EMPLOYMENT CONTRACT VIS-À-VIS SHAREHOLDERS AGREEMENT OR A SHARE PURCHASE AGREEMENT²

1. Contract of Employment: A non-compete clause restricts an employee from starting a competing business for a specified period within a defined geographical area after leaving the company. It helps to protect the employer's trade secrets, client relationships, and confidential information. On the other hand, a non-solicit clause in such a contract prohibits an employee from soliciting the company's clients, customers, or other employees for a certain period after termination of employment. The goal is to prevent employees from taking valuable business contacts with them if they leave the company.

2. Shareholders' Agreement: This is an Agreement between the shareholders of a company outlining their rights, responsibilities, and obligations. Here, the non-compete and non-solicit clauses are used to regulate the behaviour of shareholders.

- Individual shareholders are prohibited from participating in activities that might directly compete with the help of a non-compete clause. The business of the company helps to ensure that the shareholders do not work against the best interests of the company they are so invested in.
- The non-solicit clause restricts the shareholders from soliciting the company's clients, customers, or other shareholders to divert business from the company or interfere with its operations.

² “Negotiating Effective Non-compete Clauses In Shareholders’ Agreement”, (31 AUGUST 2022)
<www.cmadvocates.com/en/blog/negotiating-effective-non-compete-clauses-in-shareholders-agreement

3. Share Purchase Agreement: A share purchase agreement is by which 1 party buys a company's shares from another party. Here, Non-compete and Non-solicit clauses are included to protect the interests of the acquiring party.

The non-compete clause here is used to bind the selling shareholders, i.e., the promoters or key individuals, from starting a competing business or joining a competitor for a specified period after the sale of their shares, which ensures that the sellers' actions do not undermine the value of the purchased shares.

On the other hand, the Non-solicit clause prevents the selling shareholders from enticing key employees or customers of the company to leave or do business elsewhere, which could impact the company's stability and value.

REPERCUSSIONS FROM A VIOLATION OF THE NON-COMPETE AND NON-SOLICITATION CLAUSE IN AN AGREEMENT

Damages: To make up for the losses suffered as a result of the breach, the non-breaching party may pursue monetary damages. The damages may include direct financial losses, loss of business opportunities, and harm caused to the goodwill of the company.

Specific Performance: The non-breaching party can request that the breaching party be directed to fulfill their obligations as outlined in the non-compete or non-solicitation agreement.

Restrictive Injunctions: Courts in India have the power to grant restrictive injunctions, which can restrain the breaching party from engaging in certain activities for a specific period, such as competing with the business of the acquiring or target company or soliciting its clients or employees during such period.

Liquidated Damages: Some Non-compete and Non-solicitation agreements may include a provision for liquidated damages. These are predetermined amounts specified in the contract that the breaching party must pay as compensation for the breach.

Non-compete agreements are often enforced cautiously by Indian courts since they could be seen as restricting commerce and job prospects. For these provisions to be enforceable, the limitations' rationality about duration, geographic reach, and type of activity is crucial.

WHAT THE COURTS HAVE HELD?

Agreements in restriction of trade are covered under Section 27 of The Indian Contract Act 1872, which expressly prohibits them. It states, “Every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.”³ However, it allows one exemption for contracts prohibiting operating a firm in which goodwill is sold.

The Indian law does not carve out an exception for partial and absolute restraint of trade, and both are considered void ab initio.

1. Mitchel v Reynolds (1711)⁴ It is a Judgement throughout the development of the restraint of trade, handed down in 1711. It is generally cited for establishing that reasonable restraint of trade is permissible and enforceable, unlike unreasonable restraints of trade, and not a basis for civil or criminal liability.

It was reasonably required to accomplish the primary goal and was annexed to the lawful transaction (the sale or renting of the bakery business). Its scope was restricted to what was required to fulfil the transaction's primary goal.

2. Wipro Ltd. v. Beckman Coulter International SA⁵ In this case, after serving in that capacity for 17 years, the Petitioner was named the Respondent's exclusive distributor of canvassers. Following this appointment, the Respondent chose to launch a stand-alone company in India and began hiring.

The Court noted that, in contrast to contracts in the relationship between an employer and employee, non-solicitation agreements operating between business partner and distributor contracts or similar partnership arrangements do not draw the Bar under Section 27. As a result, non-solicitation rules are more sacred when they are included in partnerships and other agreements when there is a strong implicit assumption that all parties have an equal chance to negotiate and that neither side has the upper hand in terms of will.

³ The Indian Contract Act 1872, Section 27

⁴ Mitchel v. Reynolds ((1711) 1 P Wms 181)

⁵ 2006(2) CTLJ57(DEL)

3. United Biotech Pvt Ltd v Orchid Chemicals & Pharmaceuticals Ltd & Ors⁶- According to the CCI, a non-compete clause must pass the "reasonability" test regarding its geographic and spatial restrictions to be enforceable.

The US-based corporation Hospira, through its Indian subsidiary Hospira Healthcare, in this case, chose to acquire the active pharmaceutical ingredients (API) business of Orchid, an Indian pharmaceutical company. The two applied for and received merger control permission from CCI because the purchase would not negatively impact domestic market competition and their combined domestic sales would be insignificant. However, the length and breadth of the company transfer agreement's non-compete clause raised concerns from the regulator.

The CCI was of the view that non-compete obligations, if deemed necessary to be incorporated, should be responsible, particularly in respect of:

- (a) the period over which such restraint is legally binding and
- (b) To prevent such obligations from having a greater negative impact on competition, business operations, geographic regions, and parties subject to such constraint.

The same objection was raised by CCI when US pharmaceutical significant Mylan made an offer to buy a wholly-owned subsidiary, Agila Specialties, of Indian pharmaceutical corporation Strides.

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The non-compete clause, in this case, had a 6-year duration. Despite the target companies' involvement in the business of injectable products that fell under a few therapeutic categories, the non-compete clause attempted to impose a general prohibition on injectable products across all therapeutic categories.

Besides, even if products in the oncology and ophthalmology categories were not already produced by the target firms, the scope included all of them. Additionally, it imposed limitations on the nonexistent creation of new molecules. Therefore, it was pointed out that the non-compete clause should only encompass goods that the target companies are either now producing or selling or are in the process of developing. Therefore, the acquiring company was

⁶ LPA No.679 of 2011

required to furnish a comprehensive rationale for the length of time and range of business operations prohibited by the non-compete clause.

4. Affle Holdings Pte Limited v Saurabh Singh and Others⁷ - A non-compete clause in a share purchase agreement that forbade a promoter from operating a business similar to the target company for 36 months was deemed valid by the Delhi High Court in an interim order here. This ruling was later upheld and confirmed by the Court in its judgment dated January 22, 2015. In reaching its decision, the Court considered that the promoter had been paid in full for the sale of the share and had also given the investor the goodwill in the company, which was a crucial prerequisite under Section 27 of the Indian Contract Act.

5. Arvind Singh and Another v Lal Pathlabs Private Limited and Others⁸ - Lal Pathlabs Private Limited (respondent) had acquired 100% of the shareholding of M/s. Amolak Diagnostics Private Limited and its goodwill from Dr. Arvind Singh (appellants) and another non-compete clause in the share purchase agreement allowed Lal Pathlabs Private Limited (respondent) to purchase all, i.e., 100% of M/s. Amolak Diagnostics Private Limited's shareholding and goodwill from Dr. Arvind Singh (appellants) and another individual. This acquisition placed restrictions on the appellants.

After ruling that the condition was enforceable, a single bench of the High Court issued an order of injunction prohibiting the appellants from working as radiologists or pathologists in the Indian city of Udaipur for 5 years. The Delhi High Court later overturned this ruling, arguing that a profession's operations are not comparable to Lal Pathlabs Private Limited's commercial operations and do not, therefore, fall within the Act's Section 27 exemption. However, the court clearly stated that the appellants could not "form a venture where the organizational entity is the overt or covert carrier of a business of running a path lab or an X-ray Diagnostic Center."

In American Express Bank Ltd. v. Priya Puri - After one of the Bank's employees quit to work for a rival, the Bank filed for an injunction order to prevent the former employee from utilizing or divulging any trade secrets or business-related information, as well as from approaching or coercing any of the Bank's clients.

⁷ Vivek Bajaj, "Scope of non-compete clauses in private M&A transactions" (1 Jun 2020) <www.azbpartners.com/bank/scope-of-non-compete-clauses-in-private-ma-transactions/> Accessed on 4 June 2024

⁸ FAO (OS) 473/2014 & CM No.20860/2014

The Delhi High Court denied the injunction, stating that it would allow the plaintiff to set up a situation as “once a customer of American Express, always a customer of American Express.” The plaintiff cannot continue to be forced to work in forced labour while wearing the garment of secrecy. An employee's right to freely change jobs to improve working conditions is essential and powerful. It cannot be restricted or limited on the grounds that the employee possesses employer data and customer confidential information that could be discovered, at minimal cost and within a short amount of time, by an independent canvass on behalf of the defendant or anyone else.

CONCLUSION

What is enforceable with respect to Non-compete and Non-solicit clauses concerning mergers & acquisitions?

- In deals for M&A, such non-compete clauses are essential to safeguard the buyer's capacity to manage the acquired company successfully, provide him with some degree of security against direct competition from the seller, help cultivate client loyalty, and make full use of the knowledge gained.
- In India, the CCI used to examine such non-compete restrictions of the parties before approving merger deals. Still, following the 2020 Amendment to the Merger Regulations, the onus has been shifted to the parties themselves. Now they have to ensure that their non-compete agreements comply with all the relevant competition provisions & draft these balanced non-compete clauses and self-assess such clauses.⁹
- Depending on the clause's purpose, extent, and jurisdiction, care must be given while constructing it. A poorly drafted provision might invalidate it and eliminate the protection a buyer could legitimately need.

In India, a non-compete or non-solicitation clause in the agreement is only enforceable if three requirements are met:

- of being reasonable,
- in furtherance of promoting trade and commerce rather than creating an impediment to it, and

⁹ Payaswini Upadhyay, “CCI’s Non-Compete Concerns, www.ndtvprofit.com/bq-blue-exclusive/reliance-future-group-deal-the-cci-scrutiny-or-kishore-biyani-mukesh-ambani Accessed on 5 June 2024

- not operate to curtail employees' fundamental right to trade commerce and livelihood.

Nonetheless, it is legally binding to stop the infringement, transfer, or exposure of an employer's proprietary information, secrets, or sensitive data, particularly to rival businesses. It may also be used more successfully in the interactions between distributors, business partners, and other parties.

CCI's position on non-compete is mostly in line with international practice. Such as, the European Commission allows non-compete clauses of 3 years duration when the transfer of business includes the transfer of goodwill and know-how & where only goodwill is included, the duration is 2 years. The EC considers a non-compete clause unnecessary when the transfer is limited to physical assets or industrial and commercial property rights.

In India, the sale of a business's goodwill is an exemption to section 27 of the Contract Act. Hence, neither the reasonableness test nor the concept of partial restraint would apply. Non-compete clauses that last beyond employment have only been upheld by the courts when they safeguard the employer's proprietary interests.

The fundamental right enshrined under Article 19(1)(g) of the Constitution of India guarantees that all the citizens shall have the right "to practice any profession, or to carry on any occupation, trade or business."¹⁰ However, the right to carry on a profession, trade, or business is not unqualified. It can be restricted and regulated by the authority of law. The restrictions have to be reasonable and in the public interest. Moreover, fundamental rights have almost no scope when the relationship is between a private employer and an individual employee. They are exercised only against the State and hence are relevant only when the employer is the Government or a government undertaking.

As the economy evolves and the importance of the private sector grows in the Indian economy, there is a strong argument for extending the definition of the State to include large-scale private sector units that enjoy a dominant position no different from that of the State. The law aims for fair play. There is always a potential to misuse the law. An employee cannot evade all restrictions and responsibilities by hiding behind protective provisions of law.

¹⁰ The Constitution of India, Article 19(1)(g)