

## Legal Issues in 'IP As Property Versus Contract'

Issue: Does Enforcement of Negative Covenants in a Licensing Agreement  
Amount to Restraint of Trade?

# Introduction

## ❖ What is a negative covenant?

- A negative covenant is an agreement that restricts a company from engaging in certain actions—it is a promise not to do something.

## ❖ What is the statutory position on negative covenants?

- Agreement in restraint of trade is defined as the one in which a party agrees with any other party to restrict his liberty in the present or the future to carry on a specified trade or profession with other persons not parties to the contract without the express permission of the latter party in such a manner as he chooses. Negative covenants operative during the period of contract when the licensee is bound to serve the licensor exclusively are not regarded as restraint of trade and do not fall under Section 27 of the Indian Contract Act, 1872 .
- Section 27 of the Act implies that to be valid an agreement in restraint of trade must be reasonable as between the parties and consistent with the interest of the public. What is declared to be void by virtue of Section 27 is any Agreement to restrain any person from exercising his right to carry on a profession or trade or business and any restraint thereupon by an Agreement would be void.

## Relevant Legal Provisions

### ❖ Section 27, The Indian Contract Act, 1872–

*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.*

*Exception 1.—Saving of agreement not to carry on business of which good-will is sold.—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, regard being had to the nature of the business.*

## Relevant Judicial Decisions

### ❖ *Gujarat Bottling Co. Ltd. and Ors. vs. Coca Cola Company and Ors.* [1995 AIR 2372]

*“While construing the provisions of Section 27 the High Courts in India have held that neither the test of reasonableness nor the principle that the restraint being partial or reasonable are applicable to a case governed by section 27 of the Contract Act, unless it falls within the exception. The Law Commission in its Thirteenth Report has recommended that the provision should be suitably amended to allow such restrictions and all contracts in restraint or trade, general or partial, as were reasonable, in the interest of the parties as well as of the public.”*

4 *“Traditionally the doctrine of restraint of trade applied to covenants whereby an employee undertakes not to compete with his employer after leaving the employer's service and covenants by which a trader who has sold his business agrees not thereafter to compete with the purchaser of the business. The doctrine is, however, not confined in its application to these two categories but covenants falling in these two categories are always subjected to the test of reasonableness. Since the doctrine of restraint of trade is based on public policy its application has been influenced by changing views of what is desirable in the public interest.”*

## Relevant Judicial Decisions (Contd.)

### ❖ *Percept D'Markr (India) Pvt. Ltd vs Zaheer Khan & Anr [2004 (2) BomCR 47]*

*“The legal position with regard to post-contractual covenants or restrictions has been consistent, unchanging and completely settled in our country. The legal position clearly crystallised in our country is that while construing the provisions of Section 27 of the Contract Act, neither the test of reasonableness nor the principle of restraint being partial is applicable, unless it falls within express exception engrafted in Section 27.”*

### ❖ *Simran Music Company vs. Prit Brar and Ors. [2007 (35) PTC (Del)]*

*“It is an established principle of law that negative covenants operative during the period of employment when the employee is bound to serve his employer exclusively are not to be regarded as restraint of trade, and, therefore, do not fall under section 27 of the Indian Contract Act, 1872*

*Public policy demands that freedom of contract must be founded upon equality of bargaining power between contracting parties. However, it is perhaps an inherent feature of capitalist society that contracts entered into between the parties possessing wholly disproportionate or unequal bargaining power are seldom or almost never, concluded on fair and reasonable terms.”*



## Relevant Judicial Decisions (Contd.)

❖ ***Global Music Junction Pvt. Ltd v. Annapurna Films Pvt. Ltd., & Ors. [2023/DHC/000064]***

*“The contract of representation and services is based on mutual trust and if the trust is lost between the parties, one party cannot be compelled by the Court to keep the contract alive. I also consider that in view of Section 27 of Indian Contract Act, the restrictions cannot be put on a player from terminating the contract of an agency of one company and giving it to some other company. Section 27 disapproves and negates the restrain or restriction on the trade and business or profession.”*

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## Relevant Judicial Decisions (Contd.)

### ❖ *Wipro Limited v. Beckman Coulter International S.A.* [2006 (3) ARBLR 118 Delhi]

*“Agreements of service, containing a negative covenant preventing the employee from working elsewhere during the term covered by the agreement, are not void under Section 27 of the Contract Act, on the ground that they are in restraint of trade. Such agreements are enforceable. The reason is obvious. The doctrine of restraint of trade never applies during the continuance of a contract of employment; it applies only when the contract comes to an end. While during the period of employment, the courts undoubtedly would not grant any specific performance of a contract of personal service...”*

*“The words 'restraint from exercising a lawful profession, trade or business' do not mean an absolute restriction, and are intended to apply to a partial restriction, a restriction limited to some particular place, otherwise the first exception would have been unnecessary.”*

*“Whether or not the contract is in restraint of trade would depend upon whether the contract was unreasonable, unfair or unconscionable. A contract imposing a general restraint would, in all probability, be void. Partial restraint would prima facie be valid and, therefore, enforceable... In the case of covenants of restraint between master and servant two question necessarily arise. First what are the interests of the employer that are to be protected. Second what is the remedy available to the employer to protect the interest....”*

## Relevant Judicial Decisions (Contd.)

### ❖ *Rallis India Ltdl. vs Nuziveedu Seeds Limited* [1 Com.A.S.57/2009 in the Bangalore District Court]

*“The clause No.17 of the agreement states that "The Party of the second part shall have the right of first refusal/ pre-emptory rights over all the technologies and traits developed by the party of the first part for cotton during the subsistence of this agreement“*

*“Now, the Court has to see whether learned Arbitrator is right in treating right of first refusal is a valid clause as stated in the service agreement.”*

*"that a contract for pre-emption is an enforceable contract and the benefit of it can be assigned by an intending purchaser“*

*“... I do not find that the very observation is against the public policy or law of the land, as such liable to be set aside.”*



## Relevant Judicial Decisions (Contd.)

❖ *Messer Holdings Limited v Shyam Madanmohan Ruia and Ors [Appeal No. 855 of 2003 in the High Court Of Judicature at Bombay]*

“The shareholder has freedom to transfer his shares on terms defined by him, such as right of first refusal, provided the terms are consistent with other regulations including to repurchase the shares at the prevailing market price when such offer is made. The fact that shares of public company can be subscribed and there is no prohibition for invitation to the public to subscribe to shares, unlike in the case of private company, does not whittle down the right of the shareholder of a public company to arrive at consensual agreement which is otherwise in conformity with the extant regulations and the governing laws.”

## Relevant Judicial Decisions (Contd.)

### ❖ *Vinod Kumar Jain vs. Blumac Electricals India* [2005 128 CompCas 190 Delhi]

*“The registered owner in terms of the agreement dated March 23, 1992, had full authority to grant a license in favor of the defendant and indeed, by agreeing that the defendant would have the right of first refusal so far as the assignment of the trade mark was concerned...”*

*“...the covenant granting the first refusal of assignment to the defendant partakes of the nature of a negative covenant, which would ordinarily be enforced.”*

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## Conclusion

- ❖ Although the courts have divergent views on the validity of such restrictive covenants, the emerging trends in the global markets warrant inserting of restrictive covenants in commercial as well as employment contracts, owing to the increasing rate of commercial disputes and litigations. While the enforceability of such covenants has been dealt with in a plethora of cases, the courts have broadly examined such clauses in the light of facts and circumstances of each case, giving due regard to the reasonableness of the restrictions set out in such agreements.

# THANK YOU!

## Questions?

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