Scrutinizing Non-Compete Agreements under the Indian Competition Regime

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RESEARCH PAPER FOR THE COMPETITION COMMISSION OF INDIA

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ACKNOWLEDGEMENT

I sincerely thank all the officials responsible for providing this valuable internship at Competition Commission of India (CCI). I take this opportunity to express my sincere thanks to Dr. Sanjay Kumar Pandey, Joint Director of Competition Commission of India for his valuable guidance. I am highly thankful to Dr. Anil Kumar Sharma, Assistant Director (Economics), Competition Commission of India for having made my stay pleasant all along the internship. I also thank the entire staff of Competition Commission of India for providing me continuous support and encouragement throughout the internship.
**Introduction**

Modern business practice uses a myriad of tools to uphold and strengthen their positions and power. However a constant threat exists that these tools could become too powerful for a healthy functioning of the market.

One of these tools which are being frequently used today are market restrictive covenants which are often used to prevent competitors from accessing valuable inputs about the business. These restrictive agreements come in various shapes and forms. But inherently they serve the same purpose i.e., consolidate an economic position.

In fact the irony is that free markets enabled the creation of these tools which are now being used to overcome the freedom of trade in the market. Therefore a need to check their growth and to arrest any negative spillover from them is necessary.

Restrictive covenants can be in various forms. They can be non-compete agreements, no-solicitation agreements, garden leave clauses etc. Out of these non-compete agreements offer the widest and all encompassing protection to the party enforcing it. It also posses risk of impeding the general competition in the market.

Non-compete agreements attempt to prohibit any trade or profession by the signatory of the agreement to enable the protection of the enforcer. However it poses a significant risk under the competition regime as it is largely unchecked from a competition law perspective. In particular respect of sale of business, they can in fact have a harmful effect on the total completion in the market.

It is to check this negative effect arising out of such agreements that the author has selected this topic. That does not mean that all non-compete agreements in a sale of business are condemned, rather a plea is made that their implication on the competition regime be considered. This prevents any blatant generalization as to their validity and also prevents us to be prepared to deal with them.

At present the Competition Commission has yet to focus its attention beyond the acquisitions under Sec 5 and 6. However, non-compete agreements are slyly but surely slipping in and it seems
prudent to consider their implication. This is attempted in this paper.

Chapter I

1.1 Non-Compete Agreements- The Content and the Scrutiny

It is widely recognized that all agreement restricts some competition in the market; all contracts restricts the parties from entering some future transactions from which they would benefit. However, the dynamics of modern economics have attributed optimal utilizations to contracts. Therefore the validity of any contract has to be seen in terms of the efficiency it promotes.

Correspondingly, the tradeoffs from a contract can often result in restricting trade. Knowledge is considered an important component for ensuring market power and efficiency. If it appears that there can be a poaching of this important component, any enterprise would want to check its outflow. Non-compete Agreements attempt to protect an enterprise from such tradeoffs by ensuring that no future contracts are entered into for a period whereby dissemination of this valuable knowledge by a rival takes place.

A Non-compete agreement has been defined as a contract which restricts participation in a certain market by a business or individual under specific circumstances. Non-competes clauses are generally aimed at protecting the business knowhow which gives an enterprise a competitive edge. They are generally signed by employers to ensure employees leaving the enterprise and joining a rival enterprise do not compromise on the business security of the enterprise. However, they are not confined to employment contracts but have often resorted to between businesses. They are increasingly being resorted to in cases of distribution agreements, licensing, joint ventures and partnership dissolution agreements and also in case of sale of businesses.

When signed at a horizontal level especially in a sale of business scenario, they bring a direct or indirect obligation upon a party to the acquisition agreement not to manufacture, purchase, sell or resell independently like goods or services which compete with the buyers, generally in respect to a certain geographical market. Such an obligation on the seller of the assets guarantees that the acquirer receives the full value of the assets transferred and hence is normally considered as

http://www.investorwords.com/3308/non_compete_agreement.html#ixzz1TBKY7ogc
ancillary to the main agreement.  

These contracts are entered mainly because of the imperfect and asymmetrical information associated with such proprietary rights. Non-compete agreements mainly protect all proprietary rights in the form of intellectual property, business knowhow, trade secrets and information falling short of trade secrets which determine the competitive edge enjoyed by an enterprise. Being information centric, they can generally shift from one enterprise to another with relative ease when an employee relocates or where the seller opens a new business. Any infringement of such proprietary rights would be therefore difficult to pin down because of the lack of appropriate knowledge as to the point where an infringement of rights occurs. Further an actual infringement occurring due to the activities of such an individual is also hard to establish. This ambiguity regarding the source of infringement results in an insecurity. Further, the cost associated with monitoring any infringement is very high. So prevention is considered better than cure. The common law is however defunct in considering the efficiency implications and any affect on the overall competitive market when it comes to scrutinize non-compete agreements. Since such agreements apparently impede competition in the market, a formal analysis of its repercussion on the national competition regime needs to be analyzed.

In India Sec 27 of the Indian Contract Act, 1872 explicitly prohibits entering any agreement that restricts trade. However while all agreements to some extent restraint trade, only those agreements which results in the restraining some trade or professions is declared to be void under the Act. The term ‘restraint of trade’ therefore refers not to a particular list of agreements. Rather it refers to particular economic consequence which may be produced by quite different sort of agreements in varying times and circumstances.

This same meaning is also accorded to the term restraint of trade under the Competition Law jurisprudence. Seen in such terms, an agreement in restraint of trade under Section 27 and the prohibited agreements under Section 3 of the Competition Act both aim at curbing such an agreement which results in detrimental restriction of the trade and profession in the market.

However, the treatment accorded to such agreements under the two systems is widely different. Section 27 provides to annul per se any such agreement which results in a ‘restraint of trade’. However it makes an exception in case of sale of goodwill by a company. Where a like business is

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3 http://www.concurrences.com/article.php?id_article=12156&lang=en as obtained on 16-08-2011 at 7:30 A.M.
being carried on by the buyer, no competing business can be entered into by the seller which he had engaged prior to his sale.

A hitch in this simple story however arises when we consider that presently all major sale of business contracts are accompanied by a non-compete agreement. While the acquisition itself may be scrutinized from a competition point of view, the impact of the non-compete agreement itself on the competition regime is difficult to establish. Any scrutiny by the Competition Commission would therefore have to look into whether the agreement would have an adverse effect on the competition in the relevant market.

1.2. Party Autonomy and Doctrine of Restraint of Trade

Any agreement results from a negotiation between contracting parties. Therefore party autonomy cannot be ignored. At the same time the parties have some benefit in entering the contract. In fact the starting point of a contract is the assumption that a transaction must be mutually beneficial. This ‘Bargain Theory’ is fundamental under common law.4 Under such an arrangement, it is naturally assumed that both parties have considered their optimal benefit arising out of such a transaction. It follows that in a competitive market, efficiency requires that the terms of trade reflect scarcity of resources and ensure that goods and services flow to those who value them the most.

The rule of party autonomy has been recognized under the common law as a guiding principle for legitimizing contracts. This rule was laid down in the case of Hadley v Baxendale.5 Under the rule, where losses were assumed to arise from a breach, only liability arising for a ‘foreseeable’ or ‘reasonable’ damage is to be compensated.

However while being largely accepted, the rule faces a major hurdle in the present business practice. The rule at times discards considerations of efficiency and justice.6 While party autonomy cannot be ignored, it is pertinent to point out that inequality in bargaining power does not always lead to correct economic outcome.7 Further, the terms of the contract may not always be based on party autonomy but may be shaped by impersonal market forces. A transaction may

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5 (1854) 156 ER 145
6 Vol. 80, No. 3, May, 1992
often be entered due to asymmetrical information between the parties to the transaction. In this case the lack of information robs the transaction its legitimacy in terms of the free will of the party. Any suggestions of free will in this case would therefore be a charade. This results in an imbalance of power between the parties. Further, the contract may involve one party signing the deal not out of choice but necessity. In a perfectly competitive market differs from the real market in such scenarios and therefore party autonomy is often a misnomer. Most importantly any interference with individual trading liberty and the the free flow of resources such be allowed only rarely to enable the proficient functioning of a market economy.

This was also reflected in *Transfield Shipping v. Mercator Shipping.* In this case the court said party autonomy rule may often ignore the reasonable intentions of the party. The implications of the decision would mean that a party may have entered an agreement under asymmetrical information or due to lesser bargaining power on his part. Therefore the transaction may not provide him optimal benefits. However the ascertainment of an external criteria of ‘reasonableness’ may result in the transaction losing actual value for the parties and the economy as a whole; thus it may lead to inefficiency. As a result modern business practice would benefit more from a convergence of party autonomy and efficiency principles.

However, in case of non-compete agreements such an intention is largely expressly stated. The party autonomy can therefore is expected to be considered as supreme in such cases. However, *arguendo,* it cannot be said that any reasonable person would limit his opportunities and bar himself from further business opportunities which harms his interests. Since the decision to sign such an agreement may be influenced of many factors such should not be bracketed’ as the reasonable intention of the party.

Further even though a deviation from the party autonomy appears too ambitious, Contract Law does not consider situations where onerous conditions in negotiations may result in offsetting adjustments in other areas such as prices which might be more suitably looked into from a *Competition Law* perspective.

Therefore, party autonomy would often place a curtain over the real facts and therefore should be overlooked where appropriate. In fact this has been recognized under the common law contracts where certain inherent restrictions on party autonomy has been are implied. One of these

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8 [2008] UKHL 48
restrictions is the common law doctrine of restraint of trade.

1.3. **Doctrine of Restraint of Trade**

The doctrine of restraint of trade, one of the cardinal principals guiding Competition Law is derived from the common law. It states that any contract which has the effect of preventing competition is prima facie void unless they are shown to be reasonable and not contrary to public policy and protecting some business interest. Though all contracts to some extent restrain some trade, under the common law two categories of restraint will be scrutinized. They relate to restricting contracts firstly, in case of sale of business and secondly, in case of employment. The present paper deals with the former. 

The reasonableness of the restraint is seen from the perspective of the duration and the area of restraint. This should not be too broad though courts having looked into the nature of business have upheld even broad non-compete agreements. However it is a very factual situation and is a rarity rather than the general rule.

1.4. **Position under Indian Contracts Act**

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". These restraints not only diminish individual livelihood but also deprive the public of the skills and services of capable persons and discourage enterprise. However, the Supreme Court till recently has defined the contours of this section very narrowly; restraint whether partial or total is prohibited per se. No requirement of reasonableness is to be shown as seen from the majority of the decisions of the court.

The principles of Section 27 were aptly summarized by the Supreme Court of India in *Percept D’Mark (India) Pvt. Ltd v. Zaheer Khan* in which the Supreme Court observed that under Section 27 of the Act a restrictive covenant extending beyond the term of the contract is void and not enforceable.

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10 AIR 2006 SC 3426
This stand was again affirmed in the case *Desiccant Rotors International Pvt Ltd v Bappaditya Sarkar & Ans*\(^{11}\) where the Supreme Court had to decide a non-compete clause signed by a senior manager. The manager in spite of the existing covenant, signed as a Director with a direct competitor of his old employer. The court while accepting the argument he had access to confidential information of the company including trade secrets, nevertheless ruled that in the clash between the attempt of employers to protect themselves from competition and the right of employees to seek employment wherever they choose, the right of livelihood of employees must prevail.

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."

In fact the courts have recently shown that where there is reasonableness the restrictive covenant may be upheld. This is even for the general Sec 27. In the *Gujarat Bottling v. Coca Cola Company*\(^{12}\) case, Coca Cola entered into a bottling agreement with Gujarat Bottling Company. However, Gujarat Bottling Company transferred its shares to some companies which had agreements with Pepsi. Coca Cola dragged Gujarat Bottling to court on the basis of the non-compete clause with Gujarat Bottling according to which Gujarat Bottling could not carry out any of these services with other brands during the subsistence of the agreement. The Court held that if Coca Cola could show that the breach of the non-compete clause led to an irreparable injury to them as well as the balance of convenience lay in the favour of granting the injunction order, the Court would grant it.

Again in *Niranjan Shankar Golikari v. The Century Spinning and Manufacturing Company Ltd*\(^{13}\) the court observed that negative covenants may be valid if they are reasonable. A restraint upon freedom of contract must be shown to be reasonably necessary for the purpose of freedom of trade. Where an agreement entered voluntarily by a person is challenged on the ground of its being in restraint of trade, the onus is upon the party supporting the contract to show that the


\(^{12}\) AIR 1995 SC 2372

\(^{13}\) AIR 1967 SC 1098
restraint is reasonably necessary to protect his interests. Once, this requirement is discharged by him, the onus of showing that the restrain is nevertheless injurious to the public is upon the party attacking the contract.

A covenant in restraint of trade must satisfy two different principles of public policy. A person entering into a contract of his own free shall be bound by the same and should not be allowed to backtrack from it in the future. At the same time it is necessary that he should have liberty to exercise his powers and capacities for the benefit of himself and the community. Public policy requires that every man, even though at liberty to enter into a contract, is not at liberty to deprive himself of his labour, skill or talent by any contract that he enters into. Indian jurisprudence has therefore 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 sells a business, provided that they are reasonable and not against public policy and aim to protect a legitimate business interest. 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.

**Chapter II**

2. **Entering the Competition Domain**

While non-compete agreements seek to protect the competitive edge of the buyer, it also impedes competition in the market. Therefore a scrutiny of where the non-compete agreement enters into the scheme of the Indian Competition Act must be made.

2.1 **Agreement causing appreciable adverse effect on competition**

Section 3 of the Act provides that no enterprise or association of enterprises or person or association of persons shall enter into any agreement which causes ‘appreciable adverse effect’ on competition in India and any such agreement would be declared void.\(^\text{14}\)

The section has two important components; a) there must be an ‘appreciable’ effect on

\(^{14}\) Section 3(1) and 3(2) Competition Act, 2002
competition i.e., not minimal\textsuperscript{15} b) should actually effect or be expected to affect competition.

Further though not explicitly mentioned in Section 3, to determine the adverse effect on competition by the agreement, the first step is to determine the ‘relevant market’\textsuperscript{16} where the agreement is complained to have an adverse effect. This would also be a prime consideration under Section 3. It is only when the relevant market has been established, (which can be further divided into relevant product market and geographical market) can the effect of the agreement said to be anti-competitive, be determined. In fact this must be approach adopted in examining all anti-competitive practices.

To bring in the application of Section 3, it is pertinent that the effect on competition must be ‘appreciable’. However the determination of ‘appreciable’ has proved to be a central dilemma under the Competition Act. The author T.Ramappa considers that to be considered ‘appreciable’, the effect has to be substantial.\textsuperscript{17} However, this may not be in tune with Indian economic interests. A more suitable meaning can adduced from the definition of ‘appreciable’ in Law Lexicon. Accordingly, ‘appreciable’ is defined as ‘capable of being estimated, weighted, judged of or recognized by the mind’ which is ‘perceptible but not a synonym of substantial.’ However this approach is also vague as a starting point for any practice to be deemed anti-competitive is not clear. For the most practical purposes ‘appreciable’ has to be more than just a detectable effect but may not be substantial.

It is submitted that the determination of ‘appreciable’ effect on competition is purely the realm of estimation, dependent on the facts of the case and is therefore subjective. Whether the effect will be appreciable or not will vary on the facts and circumstances of the case. It is to be noted that the determination of appreciable effect will have to be judged from not only the interest of the industry, but the total effect it has on the market. In this sense ‘appreciable’ would involve a situation where the pro-competitive effects of the transaction are offset by the anti-competitive effects. This is the reason why there is no statutory illustration of anti-competitive behavior. This is therefore an economic test and no straight jacket legal rule can be provided.

\textsuperscript{15} SM Dugar and U P Mathur, Guide to Competition, Nexis Lexis, 5\textsuperscript{th} Ed. (2010)
\textsuperscript{16} Sec 2(r): ‘market which may be determined by the by the commission as the relevant product market or the relevant geographic market or with reference to both the markets.’
\textsuperscript{17} T.Ramappa, Competition Law In India-Policy, Issues and Development, Oxford India Paperbacks,2nd Ed (2009)
However under Section 19 (3) of the Act requires the Commission to have due regard to the various factors specified therein in clauses (a) to (f) to determine ‘appreciable effect’. Among the factors which are of probable consideration in case of a non-compete agreement are sub-clause (a) creating barriers for new entrants, sub-clause (c) foreclosure of competition by hindering entry into the market and sub-clause (d) accrual of benefits to consumers.

It is also pertinent to note that under Section 3 an actual to competition is irrelevant. It provides for an effect based test rather than looking into the actual intention of the parties. Therefore, if can be shown that a non-compete agreement would have the tendency to impede competition adversely in the market, it would be condemned under the Act.

Another consideration is determining the relevant market where the agreement is said to have impeded competition. While Sec 3 has not expressly used the term relevant market, it is difficult to argue that the concept of relevant market is alien to Sec 3. The primary focus of delineating a “relevant market” is to pinpoint both the sphere and the periphery of practices and activities, including agreements that are said to have an *appreciable adverse effect on competition*. In fact any firm is not able to have a significant effect on the conditions of sale if the customers are in a position to easily switch to available substitutes or suppliers. Therefore determining the relevant market is a tool for determining the more important question of anti-competitive effect.

Indeed, as per the European Commission Notice on the definition of relevant market for the purposes of Community Competition Law, the role and significance of market definition is elaborated as such:

“*Market definition is a tool whose purpose is to identify in a systematic way the competitive constraints that the undertakings involved face. The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining their behaviour and of preventing them from behaving independently of any effective competitive pressure.***”

In the European Union, the relevance of market determination is recognized because the European Commission’s policy on vertical and horizontal agreement restraints takes into account the market share limits. This has been recognized across the EC policy and also national legislations.

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1897/C 372/03 Para 2
19Under Article 81 (3), if the relevant market share of the concerned undertaking is below 30% (except for R&D and other special cases), then the vertical agreement is covered by the block exemption, subject to the
Guidelines to such agreements under EC also refer to the use of the Herfindahl-Hirschman Index (i.e. HHI), which can only be calculated once the market has been defined.

In its move towards a more systematic and coherent approach, the Commission’s guidelines stress the role of studying ‘market shares’ to analyze the effects of agreements on competition. The significance of specifying market share thresholds for block exemptions also indicate the importance of relevant market definition under agreements.

Hence, to study whether an agreement has the effect of restricting competition, or whether it appreciably restricts competition, or under block exemptions containing market share tests, for example Regulation 2790/99 on vertical agreements, it becomes necessary to define relevant markets.21

This also applies to the Competition Act, 2002. Under the umbrella clause of Section 3(1), an agreement to be anti-competitive must have an appreciable effect on ‘competition in India’. The phrase ‘competition in India’ offers a broad scope of interpretation and would infuse the concept of ‘relevant market’ in its domain. Reading with Sec 2(r), (s) and (t), it means that the Commission is empowered to determine the particular market where competition is adversely affected within the economic market in India.

In fact, it is self evident that the determination of the effect on competition of any practice should always be in reference to a market for a product or service. In case of agreements the determination of relevant market is not so pressing, however it is useful in determining the competitive constraints faced by a firm and market share it enjoys. This principle should be adopted in determining all practices, including agreements under the Act.

How are Non-Compete Agreements Anti-competitive?

Non-compete agreements generally target a product market and restrict competition in a geographical market. Non-compete agreements restrict competition in the market by denying entry to new firms and foreclosing competition by preventing the seller from engaging in a new competing business.

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Since the Act requires an effect based determination of anti-competiveness, the actual effect of the agreement has to be determined from the total prevailing market conditions. An individual wrong is generally addressed through action through civil courts in a contractual claim. A simple obstruction of competition for the seller therefore may not warrant an action being taken where interests of the community of competitors is not jeopardized.

However factors like the market power, market force acquired from such non-compete agreements, total number of competitors in the market etc. may be determinants which make the presence of other competitors irrelevant from a competition point of view. Further an imitation of a competitive market due to the presence of fringe competitors often hides their actual capacity to withstand a surge by the acquiring enterprise and enables an abuse of dominance on the part of such enterprise in the future. Further for high end industries the market is often oligopolistic. In such a situation the entry ban on a single market player can have a profuse impact on the total competition in the market.

Once it is understood that non-compete agreements apparently can be considered under the Competition Act comes the second stage of investigation. Section 3(1) covers all agreements in general which have an appreciable effect on competition in India without spelling out the categories of agreement which might be considered as anti-competitive. Section 3(3) however lists certain agreements which would be ‘presumed’ to have appreciable adverse effect on competition in India.

Non-compete agreements in a sale of business are agreements which prevent the seller from entering into a particular geographical market to act as a competitor to the buyer. Therefore, they generally define the market where the seller cannot do business. This would be a typical case of market allocation agreement.

Section 3(3) (c) provides that any agreement which ‘shares the market....by way of allocating of geographical area of the market, or type of goods or services or number of customers in the market or any other similar way. Non-compete agreements in a sale of business do just that. They limit the production and supply of goods and services in a certain geographical market and foreclose the geographical market for the seller to do business.
In a vertical agreement, however, the terms of the agreement must be seen as the enforcer of such non-compete agreement is a manufacturer or actual seller who tries to protect his turf from competition by an erstwhile supplier or middle level distributor. The adverse effect from such an agreement, if any, is however not the domain of this paper.

**Standard to determine anti-competiveness**

Non-compete agreements are in effect market allocating agreements and would therefore be covered by Sec 3(3) of the Act. As per the scheme of the Act, it would be classified as a ‘per se’ condemned agreement. However there is an inherent negation to such a stance. This stems from the fact that Section 3(3) covers agreements which are ‘presumed’ to be anti-competitive. However in case of non-compete agreements, due to the nature of the interests protected, the test of ‘reasonableness’ is a very dominant. The buyer has a legitimate interest deriving from the common law to protect the advantage gained from such acquisition. Therefore, such an agreement should not be ‘per se’ condemned as anti-competitive.

This contradiction seeks us to clarify the actual position stance in respect of agreements listed under Section 3(3) of the Act. Following the Raghavan Committee Report, it appears that the ‘presumption’ of anti-competitiveness is actually a ‘per se’ test. This seems apparent from the heavy reliance by the Commission on the position in USA in reference to certain condemned market restrictive agreements. However in spite of the approximately 112 years of American jurisprudence before us, the specific omission of a ‘per se’ classification for such agreements under the Act is astounding. This should especially surprise those proponents who are convinced as to the ‘per se’ nature of this agreement.

It is proposed that is not a mere matter of semantics that a ‘presumption’ and not ‘per se’ status is accorded to such agreements. The former warrants a limited scope for discretion, interpretation and analysis on the part of the prosecuting and adjudicating authority. This stance may be further elucidated on seeing the evolution of the ‘per se’ rule in US.

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The U.S. Sherman Act Section 1 effectively reads ‘every agreement in restraint of trade is declared to be illegal’.\(^{23}\) This section has generally been interpreted to mean agreements which cause a restrain in trade in so much as the anti-competitive effect arising out of it overrides any pro-competitiveness justification. While this is the general standard, the US Supreme Court has also held that certain agreements are so unlikely to have any precompetitive effect that they are better condemned anti-competitive ‘per se’ without any case by case inquiry into their net effect.\(^{24}\)

If the ‘per se’ rule does not apply, the general ‘rule of reason’ persists. Under this test, the court analyzes each agreement to see its pro-competitive justification. The plaintiff is offered a chance to prove the anti-competitive effect of the agreement either through direct proof or market power. If a plaintiff proves his share, the burden shifts to the defendant to show that the challenged conduct has a precompetitive justification outweighing the mischief.

In simpler words the “rule of reason” calls for an elaborate inquiry into the “reasonableness” of an alleged anti-competitive agreement whereas the “per se” rule condemns an agreement as anticompetitive on the existence of certain parameters without the need for further inquiry.\(^{25}\)

From its earliest application, ‘per se’ restrictive agreements are condemned without the need to demonstrate any unreasonable results (such as unreasonably high prices). Of greater interest, however, per se status has also been understood to permit condemnation of restraints (i) without need to demonstrate market power or anticompetitive effects or (ii) without need to consider a defendant's justifications.\(^{26}\)

In *Jefferson Parish Hospital Distt. No.2 v. Hyde*\(^{27}\), the court observed that the rationale for “per se” rule, in part, is to avoid a burdensome inquiry into the actual market conditions in situations where the likelihood of anti-competitive conduct is so great as to render unjustified the costs of determining whether the particular case at bar involves anti-competitive conduct.

In part the justification for these “per se” rules is rooted in administrative convenience and clarity. The “per se” rule reflects a judgment that costs of identifying exceptions to the general rule so far


\(^{24}\) Northern Pacific Railway Co v United States, 356 U.S. 1,5 (1958)

\(^{25}\) United States v. General Motor Corp, 384 U.S. 127 (1966)

\(^{26}\) 7 Phillip E. Areeda, Antitrust Law ¶ 1510a (1986)

\(^{27}\) 466 US 2 (1984);
outweigh the costs of occasionally condemning conduct that might upon further inspection prove
to be acceptable, that is it is preferable not to entertain defenses to the conduct at all. Further,
noticing the limitation of courts in ascertaining the economic implications of a conduct, a
guideline was attempted to be created for a consistent line of action.

In *Northwest Wholesale Stationers Inc v. Pacific Stationary and Printing Co*\(^28\), this has been
recognized where it was observed that the courts have long held that concerted refusals to deal or
group boycott are likely to restrict competition without any need to show any offsetting gains, so
they should be condemned as “per se” violations of section 1 of the Sherman Act.

This reference to precedents had been a major source for the ‘per se’ rule achieving its status of
absoluteness. Courts had often declared that the burden of history was too great for the courts to
ignore and the past precedents were was a constant guardian keeping a vigilant watch on
condemned behaviour. However with time, the U.S. courts have been bold enough not be
overawed by the past and have consistently tried to adapt with time and situation in hand. This
enabled it take a progressive view as to the whole per se/ rule of reason dichotomy.

In fact this evolution of the whole per se rule reflects the inherent tensions underlying it. On one
hand the claim of absolute accuracy leads to resource conservation and administrative
convenience. On the other hand the cost at which we achieve ‘clarity of action’ will always haunt
the adjudicator.

It was this anomaly which persuaded the court to consider the real objective of an anti-trust suit.
Any such analysis must answer the real question of whether any anti-competitive effect results
from the transaction; the determination of such effect is through the means of the ‘per se’ rule or a
‘rule of reason’. This illuminates the basic understanding that economic models of behavior that
spawn these predictions of per se and rule of reason are not equally applicable in all situations.

Therefore instead of a literal characterization of a conduct as “per se” unlawful, the Courts have
considered whether the practice ‘facially appears to be one that would always or almost always
tend to restrict competition and decrease output’.\(^29\)

\(^28\) 472 US 284 (1985)
\(^29\) Broadcast Music, 441 U.S. at 19-20, 99 S.Ct. at 1562;
This apprehension of generalizing conducts so minimally have enabled U.S courts to attend to the business justifications in determining whether to characterize even joint price-setting practices as per se unlawful. This enhances the accuracy of decision making with some sacrifice in clarity of guidance and predictability of result. The evolution is well illustrated by a comparison between the Supreme Court's opinions in *United States v. Topco Assocs.*, 30 and *Broadcast Music, Inc.(BMI) v. Columbia Broadcasting System* 31.

The earlier case, Topco favored clarity and predictability over accuracy. The case involved a joint venture among 25 small and medium-sized supermarket chains for purchasing items for distribution under Topco-owned private labels. At issue was a restraint preventing members from selling Topco-brand products outside designated territories. Topco argued that by ensuring exclusivity, the territorial divisions gave its members the private-label tool they needed to compete with larger chains; that is, Topco contended that although its horizontal agreement may have restricted intrabrand competition among stores selling Topco-brand goods, it enhanced interbrand competition between stores selling Topco-brand goods and the larger chains who had their own private-label products. Reasoning (i) that the Sherman Act mandates independent rather than joint choices between interbrand and intrabrand competition and (ii) that the courts are ill-equipped to make the complex economic assessments required in weighing one form of competition against another, the Supreme Court rejected Topco's justification. It concluded that the restraint was a horizontal territorial restriction and therefore per se illegal.

Just seven years later, in 1979, the Court's BMI opinion took a very different approach. The case involved the legality of joint pricing for blanket licenses to an entire collection of copyrighted musical compositions that two associations issued on behalf of thousands of musical copyright owners. The associations set fees for the blanket licenses. CBS sued, alleging that the blanket licenses constituted price fixing and were illegal per se under the Sherman Act.

The Supreme Court agreed that the associations had literally fixed price, but held that this alone did not mandate per se status. The Court explained:

“*[T]his is not a question simply of determining whether two or more potential competitors have

30 405 U.S. 596 (1972)
31 441 U.S. 1 (1979)
"literally "fixed" a "price." As generally used in the antitrust field, "price fixing" is a shorthand way of describing certain categories of business behavior to which the per se rule has been held applicable. . . . When two partners set the price of their goods or services they are literally "price fixing," but they are not per se in violation of the Sherman Act.”

The Court noted that the blanket license was not a naked restraint of trade but rather accompanied an integration of sales, monitoring, and enforcement against unauthorized copyright use. It saw that blanket licenses substantially lowered costs and served an aggregating function beneficial to both sellers and buyers. The Court concluded that the blanket licenses did not warrant automatic condemnation under the per se rule, but rather required more discriminating examination under the rule of reason.

Thus, in a setting where the potential business justifications were clear and the possibility of error was high, the Court traded off the clarity and predictability of literalness in order to obtain greater accuracy.  

The courts thus recognized that the per se condemnations must at least inquire into the market power and a basic anti-competitive effect. This flexibility shown by the courts may be considered as leading to the birth of a quick rule of reason approach developed in the California Dental case where the courts observed that the ‘quick-look’ analysis under the rule of reason, [from which] an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets. That standard is to be applied where “the great likelihood of anticompetitive effects can easily be ascertained.”

Two general approaches for blending per se and rule-of-reason analyses into a "truncated" or "quick look" rule-of-reason have emerged. One preserves the per se rule's presumption of likely competitive harm as a basis for plaintiff's prima facie case unless and until defendants can demonstrate by argument and evidence a procompetitive business justification. The other employs a "flexible enquiry" examining likely anticompetitive effects, market power, and efficiencies to

32 http://www.ftc.gov/opp/jointvent/1Persepap.shtm as obtained on 21-07-2011

the degree necessary to understand a challenged restraint's competitive consequences.\textsuperscript{34}

The author humbly submits that while the intricacies of this differentiation has to be seen as per conditions in India and are in fact an analysis for another paper, it appears prudent in not adapting a ‘per se’ rule and rather going for a flexible rule of ‘presumption’ of anti-competitiveness. In fact this is given greater credence because the Raghavan Committee had considered the ‘per se’ rule and had more than a century of case laws before it. Still the Act had not adopted the term ‘per se’ anticompetitive while describing agreements under Section 3(3).

However it must be understood that this dominant test of ‘reasonableness’ which drives the analysis of non-compete agreements is derived from the common law and is not the same as the ‘rule of reason’. Reasonableness of the agreement determines effect of the agreement on the parties while the rule of reason determines the effect of the agreement on the market as a whole. In fact it is in consideration of this affect on individual parties that the Competition Act provides protection for intellectual labour under Sec 3(5). An agreement may be reasonable between the parties yet be declared to be in violation of the Competition law.\textsuperscript{35} However, the reasonableness of such an agreement should not out rightly be rejected while looking into the anti-competitive effect of the agreement because of the legitimate interests protected.

2.2 Protection of Proprietary Rights

The purpose of signing a non-compete agreement is to protect the interests transferred upon the buyer which may be general proprietary rights, intellectual property like patents, trademark or industrial secrets or any business interests like trade secrets or information falling short of trade secrets. A Non-compete agreement not only enables the buyer to protect himself from competition by the seller using such proprietary rights conferred upon him. It also enables the seller to protect some ‘legitimate business interests’ or ‘reasonable business interests’.

By restraining the seller contractually, the buyer wants to ensure that the seller does not manipulate their knowledge regarding the businesses weaknesses and strengths. Therefore protecting such legitimate business interests becomes optimal. These interests are a combined form of intellectual property, confidential information, business knowhow etc.

\textsuperscript{34} As obtained from http://www.ftc.gov/opp/jointvent/3Persepap.shtm as on 27-07-2011 at 2:30A.M.
\textsuperscript{35} Letrovend Corp, 500 F Supp 332. 1980-82 Trade Cas.
Protection of Intellectual Property under the Act


The High Level Committee on Competition Policy and Law had recognized that intellectual properties had the potential to raise Competition Policy/Law problems. Though the incentives for creation cannot be curtailed, it was recognized that there is a need to curb and prevent anti-competitive behavior that may surface in the exercise of Intellectual Property Rights.

The Committee further recognized the dichotomy between intellectual property rights and Competition Law Policy. It said that the former endangers competition while the later engenders competition. During the existence of any right, if any anti-competitive trade practice or conduct is visible to the detriment of the consumer interest or public interest, it ought to be assailed under the Competition Law.

Under the Competition Act, 2002 Section 3(5), protection has been provided for the five types of Intellectual Property listed under sub-section (5) clauses (a) to (f). The effect of Section 3(5) is that the entire Section 3 dealing with prohibition of anti-competitive agreements will not apply where the owner of any of the intellectual property rights under the enactments set out in Sec 3(5) (a) to (f) does anything in the exercise of his right to restrain the infringement of any of those rights, or impose reasonable conditions as may be necessary for the protection of any of those rights. Therefore in any business acquisition these types of intellectual property are deemed to always protected.

Non-compete agreements are basically enforced because of the asymmetrical knowledge of the seller’s activities. In that respect the protected intellectual properties covered the Act under Section 3(5) are strong rights. No pro-competitive justifications are required to be shown for protecting them.

The owner of such intellectual rights can always impose a ‘reasonable condition’ for the protection of his intellectual property where there can be an infringement. However if the seller
infringes any of the above intellectual properties, there is always an action available with the respective authorities who enforce them.

In an innovation based market economy every manufacturer has to bring about newer products to be relevant in the market or perish. However even before exploring such opportunities are allowed to be explored, any blatant restriction of entering into the competitive mainframe is an outright violation of not only individual liberty but also would have detrimental effect on the economy. Non-compete agreements cannot be justified where they seem not to infringe the intellectual properties but only seem to foster the unwarranted apprehension of the buyer. They can be prohibited once it is shown that the seller cannot reasonably use such prohibited intellectual property in his business.

However trade secrets and confidential information’s, are not protected under the Competition Act, 2002. This does not mean that are not protected; they do not warrant a blanket protection. It is here that the test of reasonableness becomes a very dominant while looking into the validity of non-compete agreements under Section 3. Therefore for looking into the protection of such proprietary rights of the buyer, the acceptance of the non-compete agreement would depend upon the factors like duration, period, reasonableness, nature of industry etc. It is in fact a factual situation with no straight jacket formulae.

2.3 **Cumulative Application of Section 27 and Competition Law**

Since the inception of non-compete agreements in the Competition Law regime is addressed, the secondary question which needs to be answered is how the conflict of jurisdictions under 27 of the Indian Contracts Act and the Competition Law, 2002 would be tackled.

A covenant not to compete may be declared illegal either as an unreasonable restraint under the Contracts or as an unreasonable restraint of competition within Competition Act, since the common law and the competition laws seem cumulatively applicable. Both would look into the reasonableness of the agreement.

For any action under the competition law, it would require address three main questions:

- Whether the main transaction which the covenant was designed to protect valid?
- Was the covenant reasonably necessary to protect the transaction?
- Is the restrain which it imposes on competition reasonable?
All these questions are also needed to be answered under Section 27 of the Indian Contract Act. However, it must be understood that the effect of the agreement has to be on the market as a whole for the non-compete agreement to be declared anticompetitive as against an effect on the competitors under Contract Act. A non-compete agreement can therefore can be unreasonable between the parties but may still be declared to be valid under Competition Act.

This was recognized in U.S v General Motors Corp.\textsuperscript{36}. The Supreme Court said that a restrictive covenant will violate the antitrust laws if it conflicts with general antitrust policies or is imposed in pursuance of a plan to restrain competition, create monopoly or coerce competitors, or evidences a misuse of a dominant market position.

One aspect which needs to be pointed out is that in most acquisitions non-compete agreements form an ancillary agreement. Therefore the Commission may need to look into the validity of the acquisition to determine the validity of the non-compete agreement. A ‘combination’ causing appreciable adverse effect on competition under Section 5 would automatically make the non-compete agreement invalid as means to an end.

However, in case it is not a ‘combination’ under Section 5, who would determine the validity of main transaction is an issue to be resolved. In this case though the acquisition may not have an adverse effect on competition, the agreement not to compete may indeed be anti-competitive.

\textbf{Conclusion}

Non-compete agreements are yet to be scrutinized under the Competition Act, 2002 in spite of the apparent possibilities of infringing the competitive spirit of the market. This is understandable as the Act is still at a nascent stage.

The present paper shows that the inquiry of non-compete agreement is within the ambit of the Competition Act as it fulfills the conditions of Sec 3. However, a point of contention is which types of non-compete agreements in a sale of business are to be scrutinized. In India, where the Competition jurisprudence has not yet evolved and where the resources are not abundant as case of the US antitrust authorities, it might be prudent to adopt a structured dealing of such non-compete agreements.

\textsuperscript{36} 384 U.S. 127, 86 S. Ct. 1321, 16 L. Ed. 2d 415 (1966)
One way to overcome the apparent confusion regarding the types of non-compete agreements to be scrutinized is to have a market share mechanism whereby firms reaching a particular market share on acquisition are to be scrutinized *suo motto* by the Commission. However considering the inherent conditions in India, it would also be prudent to allow applications for competition scrutiny wherever a claim to that effect is made by the victims. This would prevent the burden on the Competition authority and at the same time give it a broader mandate.

Further, it would also be necessary to determine the authority to be approached when a non-compete agreements is to be scrutinized. This is necessary as a remedy exists under both the Contract law and under Competition Act. In the interest of litigants, a clear set of rules must be laid down so that time and effort spent on litigation can be saved.

It follows from this paper that non-compete agreements are part of a market allocating arrangement which however dispense the requirement of being demonized summarily due the inherent nature of the interests protected. They must be seen in a way that the balancing of individual and societal rights is not neglected.
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