

DOES SALE OF SHARES INCLUDE SALE OF GOODWILL: A NEED FOR INTERLINKING CONTRACT AND CORPORATE LAW

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INTRODUCTION

Contracts form the basis of all commercial transactions. Corporate law being a concoction of commercial law, competition law and property law it is deemed that the contracts law will to some extent govern and dictate application of corporate laws.²¹⁷ Whatever may be the nature of the agreement between the parties the general principles of contracts would always apply and every agreement enforceable by law has to adhere to these basic principles. One such principle is that an agreement in restraint of trade is void as enshrined under Section 27 of Indian Contract Act, 1872. Share Purchase Agreement is one such agreement whereby a party holding the majority of shares along with the other shareholders agrees to sell his share wholly or in part to another party. This type of selling is similar to any sale of business agreement but due to technical development of specific law in the field of company holdings has resulted in creating a distinction between share transfer agreement and other business sale agreement. Hon'ble courts of the country have refused to grant protection to the vendee company under the non-compete principle and as a result promoters of companies have on several occasions misused this provision of law by joining, starting up or running a competing company immediately after selling the shares of the erstwhile company of which they were promoter.

This matter of has come to light in the present day scenario due to a revolutionary ruling by Hon'ble Delhi High Court in this context showing brilliant application of mind and contractual principle.

LEGISLATIVE INTENT

The section lays down a very rigid rule invalidating unnecessary restraints on starting a competing business not only of general nature but also partial ones and rendering the contract so formed as

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²¹⁷ John Armour, Henry Hansmann, Reinier Kraakman; *The Essential Elements Of Corporate Law*; Journal by Harvard John M. Olin Center For Law, Economics, And Business

void.²¹⁸ This type of contractual clause though not restricted to, is typically used in cases of employment and sale of goodwill.²¹⁹ The only exception to the rule being that in case of sale of goodwill of a business, the seller may agree to the buyer to refrain from carrying on a similar business within specified local limits, so long as the buyer or any other person is deriving title to the goodwill from him. However such restrictions must appear to be reasonable to Court.²²⁰²²¹

Due to the restriction imposed by the Contract Act of such rigid nature the provision has often been subject to criticism since its very initiation. In the Thirteenth Report of Law Commission of India, 1959 the editors of the work have criticised this section as “unfortunate” for not being in adherence to the principles of similar law in England.²²² As per the rule in England there are strictly limited exceptions to the rule of agreements being rendered void being in restraint of trade.²²³ This rule was framed whence trade in India was undeveloped and in order to protect trades from any kind of restraints. But it was then decided that with the development of trade, a liberal approach should be adopted and the Law Commission recommended that the section be amended in order to accommodate further exception and facilitate a liberal reading of the law.²²⁴

Therefore from the intent of the Act itself it is clear that the rule was intended to be opened up for liberal reading at a future date as and when the scope of trade develops in India.

SITUATION REQUIRING ENLARGEMENT OF SCOPE

As trade developed in India company form of business came into picture where ownership and liabilities got limited to the individual holders. With the change in the type of trade the way of transferring the ownership also changed. Practically ownership got transferred in three ways, being: Asset Sale agreement, Business Transfer agreement, and via Sale of shares. Traditionally business transfer agreements²²⁵ and asset sale agreement²²⁶ were considered such agreements which can contain clauses of non-compete as it was held that from the intention of the parties it is

²¹⁸ Section 27 of Indian Contract Act, 1872; Pollock & Mulla, *Indian Contract Act*, First Edition p142

²¹⁹ *Petrofina(Great Britain) v. Martin*;[1966] 1All ER

²²⁰ Exception I of Section 27 of Indian Contract Act, 1872

²²¹ *Mason v. Provident & Supply Co.*[1911-13] All ER Rep 400

²²² *Law Commission of India; Thirteenth Report, 1959* para 55

²²³ *Mason v. Provident & Supply Co.*[1911-13] All ER Rep 400

²²⁴ *Law Commission of India; Thirteenth Report, 1959* para 55

²²⁵ *Nordenfelt v. The Maxim Nordenfelt Guns and Ammunition Co., Ltd*; [1891-94] All ER Rep 1

²²⁶ *Yellowbook Inc. v. Steven M. Brandeberry American Telephone Directories, Inc.*; 837 F.3d 708(2013)

clear that the buyer had not only intended to buy the business but also the goodwill along with it. Although no protection is given to the covenantee against competition per se²²⁷ but the purchaser is definitely entitled to protection from competition by vendor.

Subsequently a new question of law arose before the courts that when ownership of such holdings get transferred via sale of shares whether the promoter can be treated as a vendor, and whether the contract of such sale of unit can contain the clause of non- compete or not, thereby protecting the buyer from the competition of the vendor.²²⁸ With more and more public interest being involved in such cases the transfer of ownership came to be primarily be guided by regulations prescribed by Securities and Exchange Board of India,²²⁹ income tax authorities, the Registrar, respective stock exchanges, the Official Liquidator, the Competition Commission of India²³⁰ or any other sectoral regulators or authorities which are likely to be affected by such arrangements.²³¹ The Honourable judiciary drew a straight line of distinction between other types of takeovers and ones by sale of shares so much so that contractual aspect of such transfers agreement came to be overlooked. It was held that unless there was an express mentioning about sale of goodwill Non-Compete Agreements would not be held valid. The reasoning given behind this was that shareholders cannot claim any portion of the property of the company since a shareholder has no right in the assets or goodwill of the company; he cannot transfer the same to anybody.²³²

RECENT DEVELOPMENT

Such scenario arose before the Hon'ble Delhi High Court in the *LE Passage to India tours and travel case* (2014) where a sigh of relief was heaved by legal critics when the Honourable Delhi High Court in its interim order dated 27th September 2013 restrained the defendant i.e. the promoter of the vendor company from carrying on any activity which was in contravention with the non compete agreement. The court placed reliance on non – compete clause in the share purchase agreement entered into by Deepak Bhatnagar he was also employed by the acquiring company and such agreements contained clauses which prevented the defendant or his agents from carrying on or engaging himself in such activity which will result in competing with the acquiring company.

²²⁷ Herbert Morris Ltd. v. Saxelby; [1916-1917] All ER Rep 305

²²⁸ *Superintendence Company Of India v. Krishan Murgai*; 1980 AIR 1717, 1980 SCR (3)1278

²²⁹ *Proviso to Section 230(11) of Companies Act, 2013*

²³⁰ Section 7(1) of Competition Act, 2002(12 of 2003); Formation of Competition Commission of India

²³¹ Section 230(5) of the Companies Act 2013

²³² *Bharat Hari Singhania & Ors. v. Commissioner of Wealth Tax (Central) & Ors.*; 1994 Suppl. 3 SCC 46

For the first time the court acknowledged that there has been a sale of goodwill however the court again at a later date reverted back from its earlier order because the wordings of the agreement were considered to be very wide and contrary to the principles of law.²³³ However the conclusion was reached on the grounds that the term “business” exception I of Section does not include the term “profession” and that scope of the meaning of restriction cannot be enlarged so as to include complete pervasive restriction.²³⁴

This decision of the court was heavily criticised in the judgement of *Arvinder Singh v. Lal Pathlabs Pvt. Ltd. & Ors.* for not interpreting the term “business” in context of the principle of *ejusdem generis*. While selling their business also transfer/sell the goodwill, it would be an affront to justice to permit these persons to carry on activities using their personal skills as professionals. It was held conclusively that management can be termed as a profession which forms the basis of the goodwill of the case and can be read in to within the meaning of business under exception I of Section 27 of Indian Contract Act. Thereby levying an embargo on key managers and promoters to open a similar venture where the organization structure has the attributes of business.²³⁵ However in this case none of the two managers engaged in the management in the previous business engaged into the running of the rival business i.e. they did not have any shareholding in it. Not allowing them to carry on any profession after serving Lal Pathlabs was neither restricted by the contract nor could it permitted under law. The only reasons the respondents got away was due to faulty drafting on the part of the petitioners.

AFFLE HOLDINGS PTE LTD. v. SAURABH SINGH AND ORS²³⁶

Finally in the case of *Affle Holdings Pte. Ltd. v. Saurabh Singh & Ors²³⁷* for the first time the court gave a decision in the favour of the vendee company. In this case the promoter and other shareholders had entered into a share purchase agreement with the owners of Affle Holdings Pte. Ltd. and at the same time employment contract was executed whereby the promoter of the acquired company was employed. Such employment contracts generally are used to prevent the promoters of the company to form a competing start-up company. However in this case the petitioners were

²³³ *LE Passage to India Tours & Travels Pvt. Ltd. v Deepak Bhatnagar*; 209(2014)DLT554; pp 9

²³⁴ *Supra LE Passage case*; pp 10

²³⁵ *Arvinder Singh v. Lal Pathlabs Pvt. Ltd. & Ors.*; MANU/DE/0936/2015

²³⁶ *Affle Holdings Pte. Ltd. v. Saurabh Singh & Ors.*; MANU/DE/0152/2015

²³⁷ *Affle Holdings Pte. Ltd. v. Saurabh Singh & Ors.*; MANU/DE/0152/2015

unable to take protection under the employment contract because the respondent was an employee of the parent company Affle Appstudioz Pte. Ltd. (Singapore HQ) and Affle Holdings being a mere shareholder of that company cannot claim protection under the employment contract that subsisted between the parent company and the employee. Moreover the employment contract was terminated and non-compete clause cannot operate post termination. Therefore the only resort that was left with was the non-compete clause under the Share Purchase Agreement. But keeping in account the previously decided cases²³⁸ the result seemed highly unlikely. However the Hon'ble Court relied on the correct reading of the law and gave a judgement which is best expressed as stated:

“Quite clearly, the petitioner had bought the entire controlling interest of ATPL, with a view to acquire its business along with its goodwill. The fact that a substantial consideration stands paid to respondent no.1 for acquisition of those rights is not disputed. Given these circumstances, the petitioner's case in my view would fall in exception 1 to Section 27. Such a clause, in my view, does not fall foul of Section 27 of the Contract Act. The prohibition, on respondent no.1, in indulging in competitive business or commercial activity, in my view, is reasonable both in time and space and, therefore, cannot be held to be in restraint of trade.”²³⁹

CONCLUSION – A NEED FOR INTERLINKING

The judgement was given by a two judge's bench in Delhi High Court and there is certainly a doubt as to the binding nature of the judgement. However it is definitely a relief from hyper-technical faulty reading of law.

The following scenario explains that when specific law develops over general law even the most brilliant and reasonable minds of the country tend to overlook the basic principles. Interlinking the two laws which in this case are contract and corporate law has resulted in proper and reasonable interpretation. Although the instance merely cites an example but technical laws should be read in consonance with the existing general law to prevent similar erroneous reading in any such future circumstances.

²³⁸ *LE Passage to India Tours & Travels Pvt. Ltd. v Deepak Bhatnagar*; 209(2014)DLT554; *Arvinder Singh v. Lal Pathlabs Pvt. Ltd. & Ors.*; MANU/DE/0936/2015

²³⁹ *Affle Holdings Pte. Ltd. v. Saurabh Singh & Ors*; MANU/DE/0152/2015; pp 9