INTERPLAY BETWEEN COMBINATIONS & COMPETITION WITH SPECIAL REFERENCE TO NON-COMPETE AGREEMENTS

RESEARCH PAPER SUBMITTED TO COMPETITION COMMISSION OF INDIA

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“A mind troubled by doubt
Cannot focus on the course to victory”

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Abstract:

In connection with a merger or a joint venture, the parties often enter into contractual arrangements that limit their freedom of action in the market, but are essential to guarantee the economic success of the transaction. These restrictions may be necessary to facilitate the buyer to reap full benefits of the purchase but at the same time these restrictions may be anti-competitive which raises concerns for competition authorities.

The Non Compete agreements capture a broad set of arrangements i.e. they may be supplementary, ancillary, collateral (so called under European and US Competition Jurisprudence) to the combination transaction. The position regarding treatment of the Non-Compete agreements, forming part of combination transactions and other restructuring transactions, under the Competition Act, 2002 is not settled. This poses significant challenge for the Competition Commission of India (CCI), the business community and their advisors.

The situation becomes more complex in cases where the jurisdictional thresholds are not met and thus the question arises in these cases that whether the restrictive clauses are susceptible to continual challenge under Section 3 of the Act.

Currently, the CCI has insufficient decisional practice or case law on which it can issue guidance. Therefore, an insight into the foreign jurisdictions is required to give clarity to some of the controversial aspects to raise the level of regulatory certainty for the business community.

This article briefly discusses the status of Non Compete agreements under India Contract Act, 1872 and other laws and describes how Non Compete Agreements related to combinations and other transactions have been and are currently subject to the competition regime in the European Union (EU) and other international jurisdictions.
Chapter 1: Non Compete Agreements

Introduction: Non Compete agreements

The best economic and social results are achieved in an environment of free competition. Accordingly, competition laws prohibit unreasonable restraints on competition and acts of monopolization.

When a parent company sells a subsidiary to a rival as a means of exiting the market in which the subsidiary trade, there may well be included in the sale agreement a clause preventing the old parent from engaging in any rival business for a fixed period of time and within a fixed geographical area. For the purchaser such clauses are material in that they are guarantees that the full commercial value of the business has been properly transferred. The interest of the competition authorities lies in ensuring that the old parent is not unduly restricted from possible re-entry to the market. While re-entry might never actually occur there remains a valid interest in ensuring that it is at least a possibility.\(^2\)

Non Competition clauses may take different forms including restrictions on the amount of time during which the vendor is precluded from competing with the buyer; restrictions on the territory the vendor may recomplete in; restrictions on disclosing information obtained during the running of the transferred business; restrictions on the scope of activities the vendor may engage in; and restrictions on the solicitation or purchasers employers.\(^3\)

The ‘Law of Contract’ after replying on Connors Bros. Ltd & Ors. v. Connors\(^5\) succinctly states the law governing Non Compete agreements as under:

“A person who sells shares in a company which he controls may covenant not to compete in respect of the business carried on by the company. Such a covenant may be valid if it was in substance the seller who, through his control of the company, carried on the business.”


\(^3\)Id., at 694 Para 11.95

\(^4\)TREITEL, LAW OF CONTRACT, 455, SWEET & MAXWELL, 11\(^{th}\) Edition.

\(^5\)[1940] 4 All ER 179
In *Herbert Morris Ltd v. Saxelby*[^6], Lord Shaw while addressing an argument relating to restrictive covenants in relation to the sale of a business observed:

“When a business is sold, the vendor, who, it may be, has inherited it or built it up, seeks to realize this piece of property, and obtains a purchaser upon a condition without which the whole transaction would be valueless. He sells, he himself agreeing not to compete; and the law upholds such a bargain, and declines to permit a vendor to derogate from his own grant. Public interest cannot be invoked to render such a bargain nugatory: to do so would be to use public interest for the destruction of property. Nothing could be more sure deterrent to commercial energy and activity than a principle that its accumulated results could not be transferred save under conditions which would make its buyer insecure”.

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**Non Compete Agreements: Position under Indian Laws**

**Indian Contract Act, 1872:**

The law has, as a matter of public policy, always opposed any interference with the freedom to contract and restraints on the liberty of an individual, unless injurious to the interests of the state. An agreement in restraint of trade has been defined as “one in which a party agrees with any other party to restrict his liberty in the future to carry on trade with other persons who are not parties to the contract in such a manner as he chooses”[^7].

Section 27[^8] of the Indian Contract Act, 1872 stipulates that an agreement, which restrains anyone from carrying on a lawful profession, trade or business, is void to that extent. The reasoning behind this section is that agreements of restraint are unfair, as they impose an undue restriction on the personal freedom of a contracting party. However, as an exception, if a party sells his

[^6]: [1916] AC 688
[^8]: S. 27: (1) 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.”
goodwill to another he can agree with the buyer that he will not carry on a similar business within the specified local limits.

The most celebrated interpretation of section 27 of the Indian Contract Act, 1872, is that all restraints of trade, howsoever reasonable are void i.e. the reasonableness inquiry is beyond the scope of this section. However a closer scrutiny of the jurisprudence developed concerning requirement of reasonableness in deciding upon the “restraints” indicates otherwise. The present issue transpired in the year 1967 when the Supreme Court for the first time discussed the same in Niranjan Shankar Golikari case. It has to be noted that the decision restricted itself to the statement that post contractual restraints are to be treated differently from restraints during subsistence of contracts. The court was silent on when the post contractual restraints are valid.

Later on in Krishan Murgai case, the above issue was discussed and it was held that section 27 bars all contractual restraints, and does-not permit reasonableness inquiry.

The apex court decision in Gujarat Bottling marked a substantial departure from the previous case laws and probably points to the future. The court stressed upon the need of differentiating between the contracts facilitating trade and those restraining trade by referring to the following statement of Lord Pearce in Esso Petroleum Case:

“Somewhere there must be a line between those contracts which are in restraint of trade and whose reasonableness can, therefore, be considered by the courts and those contracts which merely regulate the normal commercial relations between the parties and are, therefore, free from doctrine”.

In present case the court had to deal with facts to which the obvious and legislated exceptions to Section 27 did not apply. Here, Coca Cola had licensed Gujarat Bottling Co. to bottle and sell the beverage, subject to restriction that Gujarat Bottling could not manufacture, sell, deal or

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9 A detailed analysis of relevant judgments dealing with Section 27 is beyond the scope of this paper. However a summary analysis of the same has been done.
11 Superintendence Co. v. Krishan Murgai, AIR 1980 SC 1717: Hereinafter referred to as Murgai. Minority judgment pronounced by Justice A.P. Sen decided upon this issue, while the majority refrained from commenting on the issue as the appeal was capable of being disposed off on other issues. It is worthwhile to mention that Supreme Court has refrained from approving these obiter observations of Justice Sen in subsequent cases.
12 Gujarat Bottling v. Coca Cola Company, AIR 1995 SC 2372
otherwise associate with competing products. When Gujarat Bottling breached the covenant, the matter went up to the Supreme Court, which held that “a negative covenant that the employee would not engage himself in a trade or business or would not get himself employed by any other master for whom he would perform similar or substantially similar duties, is not therefore a restraint of trade unless the contract as aforesaid is unconscionable or excessively harsh or unreasonable or one sided....”

However, the court has not commented on the issues of post contractual restraints. It is also pertinent to note that inspite of Justice Sen’s opinion in Murgai being before it, the Court chose not to comment on it at all.

This decision represented a substantial departure from previous case law and probably points to the future. Naturally, reasonableness must be judged from case to case but guidance comes from a succession of decisions on what constitutes reasonableness. Illustratively, restraints were upheld by the Delhi High Court in Modern Food Industries14, which has held that the validity of a restraint will generally depend on (a) the proprietary interest sought to be protected; (b) the reasonableness of the restriction; and (c) the larger public interest. In conclusion, it is clear that in the years to come, non-compete clauses are likely to be upheld even if they kick in after contractual relation ends.

**Issue of Non-Compete Fee: Take-Over Code**

Non-Compete Fee is the fee that is paid to the selling promoter(s) so that they do not re-enter the same business and pose a threat to the acquired company. The logic for the non-compete fee is that the promoter has certain unique skills and possesses industry knowledge, and if he were to start the same business again, he could become a formidable competitor and hence buyer would not be able to reap full benefits of the purchase.

**Legality of Non-Compete Fee:**

The recommendations made by Bhagwati committee15 recognize the legitimacy of non-compete fees payable to outgoing seller. The recommendations of the committee were accepted by SEBI

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14 Modern Food Industries India Pvt. Ltd. v Shri Krishna Bottlers Pvt. Ltd., AIR 1984 Del 119
15 The takeover code, as originally framed did not contain any provision governing the payment of non-compete fee by the acquirers. The matter was referred to committee under chairmanship of Justice P.N.Bhagwati. The
and accordingly Regulation 20(8)\textsuperscript{16} was inserted which puts a cap on non-compete fee that can legitimately be paid to promoters/seller.

Later on, in order to review the takeover regulations, SEBI constituted the Takeover Regulations Advisory Committee in September, 2009 under chairmanship of Mr C. Achuthan. The committee felt that \textit{there was a strong merit in the view that non-compete fee, if any, should accrue to the company and not to one group of shareholders as this is in the nature of compensation for the loss of potential value on account of opportunity scarified}. The committee accordingly concluded that \textit{in keeping with the spirit of equal treatment for all shareholders, and the scope for abuse of non-compete payments, the Takeover Regulations ought to be explicit that consideration paid for the shares in any form to the selling shareholder and his affiliates, concurrent with the purchase of shares, whether termed as control premium, or non-compete fees or otherwise must be added to the negotiated price per share for the purpose of determining open offer pricing}.

\textbf{Judicial Response to Non-Compete Fee:}

The regulator of Stock Markets, SEBI, is increasingly frowning upon the practice of Non-Compete fees in takeovers. The \textit{Tata Tea Case}\textsuperscript{17} is notable for some interesting observations of the tribunal on the issues on Non Compete fee and matters of restraint of trade with respect to Section 27. The Appellate tribunal observed:

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“When an acquirer takes over a business from the outgoing seller(s), it is obvious that the seller(s) have specific knowledge of that business and have access to and are in possession of crucial trade secrets of the target company which if disclosed or misused would be detrimental to and could cause irreparable harm to the target company and its continuing shareholders and by virtue of their association with that business, they (outgoing sellers) are capable of offering competition to the business being taken over. In such cases, it would be legitimate for the acquirer to enter into a
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\textsuperscript{16} Recommendations of committees were accepted by board and Regulation 20 of the code was recast in September 2002 providing, interalia, for a regulatory framework for payment of non-compete fee.

\textsuperscript{17} Tata Tea Ltd. vs. Securities and Exchange Board of India and anr., [2010] 103 SCL 140.
non-compete agreement with the promoter sellers if he feels threatened by a lurking fear of competition from them.

An acquirer has a right to protect his investment/business from competition by a seller of the business and this right is a long standing customary element in business sale transactions and is even recognised by law. Section 27 of the Contract Act recognizes that non-compete agreements are not in restraint of trade if the restrictions placed are reasonable “.

The court further noted that, when examining the validity of the non-compete fee, the question to be addressed is whether the outgoing sellers are capable of providing competition to the business alone or in association with third parties and not whether the business was dependent on the outgoing sellers. The decision of the tribunal has been affirmed in *E-Land Fashion China Holdings Limited*18.

➢ **The Interaction between Contract and Competition Law**

When compared to contract law, competition law is a relatively recent discipline with a much shorter duration. Competition as a distinct discipline as we know it today emerged at the end of twentieth century, when the landmark Monopolies and Restrictive trade Practices Act, 1969 was enacted in India. The last decades have unfolded the loopholes in the existing law, and have therefore brought about big changes for competition law regime & by now new law has been established which provides a fresh normative framework for development of competition jurisprudence.

That competition law interacts with economics is a natural consequence of its nature and its close links with industrial organization. For similar reasons, frictions between contract law and competition in the context of Non Compete agreements are frequent since both ‘have used the competitive process as a focal point. While the former typically regulates the relation between the contracting parties and the reasonableness of agreements, the latter regulates the possible external effects of those same contracts. The effect of the later has to be on the market as a whole for the non-compete agreement to be declared anticompetitive as against an effect on the

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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.

**Effect of a Restrictive Covenant:** A covenant or clause restraining a person from carrying any lawful profession, trade, profession or business is void ‘to that extent’. The court will not enforce it. But if the parties wish to implement it, they would not be acting illegally, and the court cannot intervene to prevent them from doing so\(^\text{19}\). Practices falling within the definition of ‘restrictive trade practices’ under The Monopolies and Restrictive Trade Practices Act, 1969 can be challenged under that law\(^\text{20}\). Thus it can be inferred from the above discussion that an agreement in restraint of trade under Indian Contract Act, 1872 may be implemented by parties if they desire so, however parties to an agreement in restraint of trade, which has an appreciable adverse effect on competition within the meaning of the Competition Act, may not be allowed to implement it and commission is likely to intervene to prevent the parties from enforcing it.

\(^{19}\) **Boddington v Lawton.** [1994] ICR 478

Chapter 2  
Combinations

Introduction to Combinations:

“If you think you can go it alone in today’s global economy, you are highly mistaken”

...Jack Welch

The air over corporate India is thick with the heady scent of mergers and acquisitions (M&A’s). In an economy, long suppressed by the license and control regime, this is an entirely new experience and has been accompanied with a sense of nationalistic euphoria. Undoubtedly, many of these mergers present much for the country to be proud of.

In the western economies, M&A’s are commonplace, being a normal feature of a vibrant economy. Firms may grow organically or they may choose the M&A route. M&A’s are undertaken by firms to achieve economies of scale and accompanying efficiencies, gain entry to new markets, or access to new technologies. But unfortunately, sometimes the motivation may be less driven by economics and more by personal ambition, as achieving a big presence over a market can be very ego-massaging\textsuperscript{21}.

Therefore relevant provisions have been provided in Competition Act 2002 in order to curb these Anti-Competitive practices. The Competition Act, 2002 regulates combinations that consist of mergers, amalgamations and acquisitions\textsuperscript{22} with a view to ensure that there is no appreciable adverse effect on competition in India. The provisions of Section 5 of the Act have been sought to check concentration of economic power. Even the erstwhile MRTP Act (Monopolies and Restrictive Trade Practices Act, 1969) regulated mergers, amalgamations and takeovers by providing for their approval by Central Government. An acquisition where the acquirer is acquiring control, shares, voting rights or assets of the enterprise will be considered as a combination\textsuperscript{23}. If such a combination meets the specified threshold levels under section 5 (a), it is subject to regulation by the Competition Commission of India. An acquisition of control by a person over an enterprise when such a person has already direct or indirect control over another enterprise engaged in production, distribution or trading of a similar or substitutable goods or

\textsuperscript{21} VINOD DHALL, ESSAYS ON COMPETITION LAWS AND POLICY 26, Available at http://cci.gov.in/images/media/articles/essay_articles_compilation_text29042008new_20080714135044.pdf (Last accessed on February 8\textsuperscript{th}, 2012)

\textsuperscript{22} The Competition Act, 2002, Sec. 5

\textsuperscript{23} The Competition Act, 2002, Sec. 5(a)(i)
service is also considered to be a combination\textsuperscript{24}, if the same meets the requisite threshold level under section 5 (b). Further, every enterprise created by way of merger or amalgamation that meets the requisite threshold level stipulated under section 5 (c), shall also be considered to be a combination that shall be regulated by the Commission. Provisions of Section 5 of the Competition Act, 2002 (as amended by 2007 Amendment Act) makes the pre-combination notification to the commission mandatory.

Therefore in India, for the merger regulation to be attracted, the transaction must qualify the thresholds as stated under section 5 of the Act. Section 6 of the Act seeks to regulate combinations covered by Section 5. Under sub-sections (1) to (3), any person or enterprise which proposes to enter into a combination has to approach the commission, by giving notice in the prescribed form with fee, for seeking its approval.

\textbf{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\textsuperscript{25}. On the parallel lines Section 6 of the act dealing with regulation of Combinations stated that no person or enterprise shall enter into a combination which causes or is likely to cause an “\textit{appreciable adverse effect on competition within relevant market in India \textquoteright}”.

The above expression can be broken into three components, viz., (i) adverse affect of competition should be within India; (2) affect should be appreciable, and (3) it should actually effect or is expected to affect competition. The affect on the competition should be the result of the agreement, as defined. The consequential effect may even be unintentional\textsuperscript{26}.

The starting point of the inquiry into appreciable adverse effect on competition calls for determination of the market where the competition complained of as having been adversely effected. The relevant market again has to be divided into relevant product market and relevant geographic market relating to the product or the service supplied. One thing that merits consideration is that there is no uniformity in the act, while Section 3(1) and 3(4) use the phrase

\textsuperscript{24} The Competition Act, 2002, Sec. 5(b)(i)
\textsuperscript{25} Section 3(1) and 3(2) Competition Act, 2002
‘appreciable adverse effect on competition in India’, sub-section (3) simply refers to ‘appreciable adverse effect on competition’ and Section 6(1) refers to ‘an appreciable adverse effect within relevant market in India’. It is axiomatic that any examination of the effect on competition of any practice is always with reference to a market for a product or a service, the said market being further sub-divided into a product market and geographical market27. Thus it flows from the above discussion that while scrutinizing an agreement, combination etc., the relevant market determined would be same for purposes of either section 3 or section 6.

The term “appreciable adverse effect” has not been defined in the act. The word ‘appreciable has been defined in Law Lexicon as capable of being estimated, weighted, judged of or recognized by the mind which is ‘perceptible but not a synonym of substantial’. According to author T. Ramappa in order to be “appreciable”, the effect has to be substantial28. The determination of ‘appreciable effect’ depends on facts and circumstances of each case and is therefore a subjective test.

Section 19(3)29 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’ within meaning of section 3(3). Similarly Section 20(4)30 lays down various factors that are to be taken into consideration

27 T.RAMAPPA, COMPETITION LAW IN INDIA-POLICY, ISSUES AND DEVELOPMENT, 71 Oxford India Paperbacks,2nd Ed,2009
28 Id.
29 S. 19(4) (4) The Commission shall, while inquiring whether an enterprise enjoys a dominant position or not under section 4, have due regard to all or any of the following factors, namely:—
(a) market share of the enterprise;
(b) size and resources of the enterprise;
(c) size and importance of the competitors;
(d) economic power of the enterprise including commercial advantages over competitors;
(e) vertical integration of the enterprises or sale or service network of such enterprises;
(f) dependence of consumers on the enterprise;
(g) monopoly or dominant position whether acquired as a result of any statute or by virtue of being a Government company or a public sector undertaking or otherwise;
(h) entry barriers including barriers such as regulatory barriers, financial risk, high capital cost of entry, marketing entry barriers, technical entry barriers, economies of scale, high cost of substitutable goods or service for consumers;
(i) countervailing buying power;
(j) market structure and size of market;
(k) social obligations and social costs;
(l) relative advantage, by way of the contribution to the economic development, by the enterprise enjoying a dominant position having or likely to have an appreciable adverse effect on competition;
(m) any other factor which the Commission may consider relevant for the inquiry.
30 S. 20(4) (4) For the purposes of determining whether a combination would have the effect of or is likely to have an appreciable adverse effect on competition in the relevant market, the Commission shall have due regard to all or any of the following factors, namely:—
by the commission to determine whether a combination would have effect of or is likely to have an appreciable adverse effect on competition in the relevant market.

**Overview of EU and US Competition Laws:**

In the European Union, Article 101(1)\(^{31}\) (formerly Article 81(1)) European Commission\(^{32}\) prohibits all agreements or understandings which have as their object or effect the prevention, restriction or distortion of competition. In the United States, Section 1\(^{33}\) of the *Sherman Act*, 1890 prohibits contracts, combinations or conspiracies that unreasonably restrain trade.

Restraints of competition under Article 101 (1) (formerly Article 81) EC are divided into two types: Vertical and Horizontal restraints. The United States does not specifically differentiate

(a) actual and potential level of competition through imports in the market;
(b) extent of barriers to entry into the market;
(c) level of combination in the market;
(d) degree of countervailing power in the market;
(e) likelihood that the combination would result in the parties to the combination being able to significantly and sustainably increase prices or profit margins;
(f) extent of effective competition likely to sustain in a market;
(g) extent to which substitutes are available or are likely to be available in the market;
(h) market share, in the relevant market, of the persons or enterprise in a combination, individually and as a combination;
(i) likelihood that the combination would result in the removal of a vigorous and effective competitor or competitors in the market;
(j) nature and extent of vertical integration in the market;
(k) possibility of a failing business;
(l) nature and extent of innovation;
(m) relative advantage, by way of the contribution to the economic development, by any combination having or likely to have appreciable adverse effect on competition;
(n) whether the benefits of the combination outweigh the adverse impact of the combination, if any.

\(^{31}\)Article 101(1) The following shall be prohibited as incompatible with the internal market all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular those which:
(a) directly or indirectly fix purchase or selling prices or any other trading conditions;
(b) limit or control production, markets, technical development, or investment;
(c) share markets or sources of supply;
(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts***

\(^{32}\)EU equivalent rules to Section 3 of the Competition Act, 2002 dealing with Anti-Competitive agreements.

\(^{33}\)Hereinafter referred to as EC

\(^{33}\)S. 1 Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony*** (US equivalent rules to Section 3 of the Competition Act, 2002 dealing with anti-competitive agreements)
between horizontal and vertical restraints in its statutes, but both types of conduct could violate US Antitrust Law.

In the EC, horizontal restraints refer to agreements or coordinated practices between companies acting on the same level of trade, e.g. relationships between actual or potential competitors which restrict the competition freedom of the partners or third companies.

Vertical restraints refer to agreements or coordinated practices restricting competition between companies acting on different levels of trade, e.g. relationships with distributors and customers, licensees, suppliers or licensors that restrict the competition freedom of the partners or third companies.
Chapter 3 Ancillary Restraints

Position in European Union:

- **Evolution of the Doctrine:**

One of the early decisions where European Commission developed its position with regard to ancillary restraints is *Reuter/BASF*[^34], related precisely to the sale of a business. Given the role this case played in subsequent jurisprudence on restraint of trade clauses, it merits a detailed examination.

This case concerned the non-competition clauses imposed on Dr. Reuter by BASF upon the transfer of assets, know-how and technology in the relevant field from Dr. Reuter to BASF. First, Reuter was prevented from engaging directly or indirectly in any activity in relevant field in Germany or elsewhere for eight years, except for some limited activities. Second, for eight years, Reuter was required not to divulge any protected or unprotected know-how and experience in the relevant field and he was also prevented from carrying out research in the relevant field.

The Commission found that the non-competition clauses eliminated Reuter as BASF’s competitor in the relevant field, reasoning that, but for the clauses, Reuter's personal and technical knowledge and experience would have enabled him to engage in activity in all the relevant fields covered by the noncompetition clauses.

Since *Reuter/ BASF* represents the first significant occasion on which the Commission had the opportunity to decide on this issue, it is worth quoting from the Commission's opinion:

> “It is recognized that it may be necessary in certain cases to provide safeguards to ensure the effective performance of an agreement. These may take the form of a contractual noncompetition clause in cases where not only the material assets of an undertaking but also its commercial goodwill, including relations with customers, are to be transferred to the purchaser. In such cases it is essential to prevent a seller from reacquiring his old customers either- directly or indirectly through cooperation with the purchaser's competitors in the period immediately following the transfer. Compliance by the seller with such a non-competition clause means no more than that he must respect his obligation under the agreement to transfer the full value of

the undertaking. Application of Article 85(1)\textsuperscript{35} to such a non-competition clause in an agreement can be excluded in such cases, since it would make more difficult or even impossible, transactions which are generally recognized as legitimate”.

However, the protection afforded to a purchaser must be limited to the period required by an active competitive purchaser to take over the undertaking's market position such as it was at the time of transfer. In cases of transfer of know-how, technology, the protection afforded to the transferee should be limited in time, since the transfer of legally unprotected know-how confers no exclusive rights on the purchaser.

Likewise in respect of geographical extent, the non-competition clause must in normal circumstances be confined to those markets in which the undertaking was active before its sale, or in which it may be regarded as a potential competitor on the basis of its relevant and demonstrable activity.

Thus the commission in present case narrowed down the scope of Art. 85 by enabling a purchaser to fully replace the seller on its market position prior to the acquisition. It is important to note that the Commission reached this conclusion without examining the impact on competition of Reuter's elimination as a competitive force. Thus, the legality of the non-competition clauses in Reuter/BASF did not rest on their impact on market conditions but rather on their ability to bring about the transfer of value in terms of goodwill and know-how.

Accordingly, in narrowing the application of Article 85, the Commission articulated a version of the ancillary restraints doctrine, according to which, the legality of some restrictions depended exclusively on their connection to the main transaction and not on their independent impact on competition.

In the Nutricia\textsuperscript{36} decision, the commission while following the Reuter/BASF decision noted that the level of protection accorded to the purchaser must be limited to what is objectively necessary for the purchaser to assume, by active competitive behavior, the place in the market previously occupied by the seller.

**Test Articulated:**

Regarding the applicability of Article 85(1) to noncompetition clauses in the context of the sale of a business, the Court stated that in order to determine whether or not such clauses fall within

\textsuperscript{35} Now Article 101 of EC.

the prohibition in Article 85 (1) it is necessary to examine the competitive environment as if those clauses did not exist. If, in the absence of such clauses, the vendor and the purchaser would have remained competitors after the transfer, the agreement for the transfer of the undertaking could not have been given effect. The vendor, with his particularly detailed knowledge of the transferred undertaking, would still be in a position to win back his former customers immediately after the transfer and thereby drive the undertaking out of business. As a result, non-competition clauses incorporated in an agreement for the transfer of an undertaking, in principle, have the merit of ensuring that the transfer has the effect intended. 

As a result, non-competition clauses incorporated in an agreement for the transfer of an undertaking, in principle, have the merit of ensuring that the transfer has the effect intended.

In order to be ancillary, restrictions must have a direct link to the creation of the joint venture/combination, be subordinate to theirs’ main object, be necessary and be proportionate to what joint venture requires.  

➢ Merger Regulation in European Union:

The European Commission Merger Regulation (hereinafter ECMR) was enforced in September, 1990 to govern large scale mergers in the European Union. The Regulations provide for various control and mechanisms to ensure no anti-competitive activities are caused due to mergers.

Since its inception in 1990, the merger review system introduced by the European Merger Control Regulation 38 (“ECMR” or “Merger Regulation”) has rapidly matured and continuously grown in complexity. The Merger Regulation was substantially amended on March 1, 1998 and May 1, 2004. The Merger regulation applies to all concentrations having a community dimension 39.

The Merger Regulation recognizes the need of treating the consequential Non Compete restrictions along with main transaction and accordingly provides: “A decision declaring the concentration compatible shall be deemed to cover restrictions directly related and necessary to the implementation of the concentration” (ECMR Article 6(1)(b) sub-para. (2); Article 8(1) sub-para. (2) & Article 8(2) sub-para. (3).

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39 Article 1(1), Article 1(2), Article 1(3)
The Commission makes an assessment of restrictions only if a case presents a “novel and unresolved question giving rise to genuine uncertainty”, i.e., if the question is not covered by the Ancillary Restraints Notice\(^{40}\) or a published Commission decision\(^{41}\). The Ancillary notice is the Commission’s 2004 notice on “restrictions directly related and necessary to concentrations”. It states the interpretation to be given to "restrictions directly related and necessary to the implementation of the concentration" both in general terms and to specific clauses, including: non-competition covenants, licenses of industrial and commercial property rights and know-how, and purchase and supply agreements usually included in the different types of transactions covered by the regulation, such as transfers of undertakings, joint ventures, and joint acquisitions.

- **Three pronged test for permissible restraints:**

  Under the Ancillary Restraints Notice, a restrictive arrangement must meet the following criteria in order to be considered “directly related and necessary to” the concentration:

  - **Restriction “directly related” to concentration:** The restrictive arrangement must have a direct link to the concentration and be subordinate in importance to the main object of the concentration. The mere fact that it is included in the same context or agreement as the concentration, or is entered into at the same time, is not in itself sufficient to find a direct link\(^{42}\).

  - **Restriction “necessary” to implementation of concentration:** The restriction must be objectively necessary to the implementation of the concentration, i.e., without such a restriction, the concentration could not be successfully implemented. A restriction satisfies this condition if it ensures the implementation of a concentration, or minimizes the uncertainty, cost, or completion time of the transaction\(^{43}\).

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\(^{40}\) Commission Notice, OJ. C 203/05 (1990) [hereinafter Ancillary Notice]

\(^{41}\) Recital 21 ECMR: The Ancillary Restraints Notice (para. 5, footnote 2) indicates that for the purpose of this Notice, “a decision is considered to be published when it is published in the Official Journal of the European Union or when it is made available to the public on the Commission’s website”.

\(^{42}\) See Ancillary Restraints Notice, para. 12)

\(^{43}\) See Ancillary Restraints Notice, para. 13( Agreements that protect the value transferred, maintain the continuity of supply after the breakup of a former economic entity or enable the start-up of a new entity are often believed necessary to implementation of the transaction).
The mere fact that the parties claim that they would not have entered into the transaction unless certain restrictions were attached to it does not automatically make these restrictions necessary to the implementation of the concentration.

- **Rule of Proportionality:** The third limb of the test is the most important in practice. Building on precedents of the European Court of Justice, the Commission applies a “rule of proportionality”, under which the restriction’s duration, subject-matter and geographic field of application may not exceed what is necessary to implement the concentration successfully. If alternatives are available, the parties must choose the one that is least restrictive of competition\(^44\).

- **Scope of Ancillary Restraints in the 2004 Notice:**

  According the provisions of Ancillary Notice, to be deemed “directly related and necessary to the concentration”, a noncompetition, non-solicitation or confidentiality clause must satisfy several conditions:

  - The transferred business must involve know-how and/or goodwill, not mere physical assets or exclusive industrial and commercial property rights\(^45\).
  - The seller may bind itself, its subsidiaries, and its commercial agents, but not third parties, such as resellers or users\(^46\).
  - The clause must be limited to products and services that form the economic activity of the undertaking transferred\(^47\).
  - The clause must be geographically limited to the areas where the seller has sold goods or performed services in the past\(^48\).
  - The clause must be of limited duration. The Commission’s “rule of thumb” is that a three-year period will be acceptable when both goodwill and know-how are transferred. A two-year period will be acceptable when the transfer involves only goodwill. The Commission may accept longer periods in exceptional circumstances\(^49\).
  - The Commission stresses that only the buyer requires the assurance of a non-compete clause, so that it will be able to recoup its investment. Restrictions that benefit the vendor are

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\(^{44}\) Id.

\(^{45}\) See Ancillary Restraints Notice, para. 21.

\(^{46}\) See Ancillary Restraints Notice, para. 24.

\(^{47}\) See Ancillary Restraints Notice, para. 23.

\(^{48}\) See Ancillary Restraints Notice, para. 22.

\(^{49}\) See Ancillary Restraints Notice, para. 20.
generally deemed not directly related and necessary to the concentration and, when they do meet that standard, are unlikely to need to be as extensive in scope or duration as those that would benefit the buyer\(^{50}\).

- **Treatment of Non Ancillary Restraints:**

As a general rule decision declaring the concentration compatible shall be deemed to cover restrictions directly related and necessary to the implementation of the concentration. However in case the restrictions which cannot be regarded as directly related and necessary to the implementation of the concentration continue to be governed by Article 81 and 82 of EC Treaty and other relevant competition rules and notices\(^{51}\).

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**Position in USA:**

- **Emergence of Doctrine of Ancillary Restraints**

The concept of ancillary restraints is developed by Common Law. Ancillary restraints are those restraints which are reasonably necessary to the functioning of an otherwise lawful joint venture or other combination\(^{52}\). The concept was imported into Sherman Act jurisprudence by Judge Taft's 1898 *Addyston Pipe*\(^{53}\) opinion, wherein it was stated that:

"No conventional restraint of trade can be enforced unless the covenant embodying it is merely ancillary to the main purpose of a lawful contract, and necessary to protect the covenantee in the full enjoyment of the legitimate fruits of the contract, or to protect him from the dangers of an unjust use of those fruits by the other party."

\(^{50}\) See Ancillary Restraints Notice, para. 17.

\(^{51}\) Recital 7 of Ancillary Restraint Notice: To the extent that restrictions are directly related and necessary to the implementation of the concentration, Article 21(1) of the Merger Regulation provides that this Regulation alone applies, to the exclusion of Council Regulations (EC) No 1/2003 (1), (EEC) No 1017/68 (2) and (EEC) No 4056/86 (3). By contrast, for restrictions that cannot be regarded as directly related and necessary to the implementation of the concentration, Articles 81 and 82 of the EC Treaty remain potentially applicable. However, the mere fact that an agreement or arrangement is not deemed to be ancillary to a concentration is not, as such, prejudicial to the legal status thereof. Such agreements or arrangements are to be assessed in accordance with Article 81 and 82 of the EC Treaty and the related regulatory texts and notices (4). They may also be subject to any applicable national competition rules.

\(^{52}\) JOINT VENTURES: ANTI TRUST ANALYSIS OF COLLABORATIONS AMONG COMPETITORS, ABA Publishing, 2006

\(^{53}\) *United States v. Addyston Pipe & Steel Co.*, 85 F. 271 (6th Cir. 1898), aff'd as modified, 175 U.S. 211 (1899). (Judge Taft's opinion is often cited for his colorful rejection of consideration of the reasonableness of non-ancillary restraints).
Robert Bork explained in 1959 that, in the context of joint ventures, an "agreement not to compete may be necessary in order that each participant may be safe in contributing his best efforts and his resources to the joint enterprise". In its 1978 decision in *Professional Engineers*, the Supreme Court of United States cited Judge Taft's opinion for the proposition that the *rule of reason* is the "standard for testing the enforceability of covenants in restraint of trade which are ancillary to a legitimate transaction."

The Supreme Court commented in *Business Electronics* that an ancillary restraint in the common law "enhances the value of the contract, or permits the 'enjoyment of its fruits.'" The Ninth Circuit observed that the "proper function of ancillarity in antitrust analysis is to remove in some instances the per se label from restraints otherwise falling within the category."  

- **Collateral Restraints:**

A collateral restraint is ancillary if, and only if, it is reasonably necessary to make the venture operate more efficiently or effectively at the time the restraint was entered into. The more important of the two words in "reasonably necessary" is the first. Defendants are required to show only that the ability of their legitimate joint venture to function efficiently or effectively was compromised in a significant way that was sensibly addressed by the restraint.

Restraints collateral to the formation of a legitimate joint venture is "ancillary" only if it has an "organic connection" to the venture's operations and serves to make the venture operate more efficiently or effectively. The effectiveness of a joint venture may be enhanced by restraints that reduce the incentive or opportunity for participants in the venture to expropriate or undermine its value.

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54 ROBERT H. BORK, ANCILLARY RESTRAINTS AND THE SHERMAN ACT.
56 The Rule of reason is a legal approach by competition authorities or the courts where an attempt is made to evaluate the pro-competitive features of a restrictive business practice against its anticompetitive effects in order to decide whether or not the practice should be prohibited. (OECD Glossary of Statistical Terms, Available at http://stats.oecd.org/glossary/detail.asp?ID=3305, Last Accessed on February 16, 2012.)
58 *Aydin Corp. v. Loral Corp.*, 718 F.2d 897,901 (9th Cir.) 1983.
60 A corollary of the necessity of an "organic connection" is an insight in Chief Judge Ginsburg's opinion in *PolyGram Holding, Inc. v. FTC*, 416 F.3d 29,31-32 (D.C. Cir. 2005): "A restraint cannot be justified solely on the ground that it increases the profitability of the enterprise....". For instance, the price fixing, by Joint Venture participants, in unrelated products may make the joint venture profitable when it otherwise would not be, but that does not make the price fixing ancillary.
Whether a collateral restraint is ancillary, depends on the particular circumstances faced by the participants in the joint venture. Consider two scenarios in which participants in joint ventures adopt restraints eliminating price competition. First, suppose joint venture participants sell competing differentiated consumer products marketed primarily through the Internet, and that the venture owns and operates a facilities for taking, processing, and fulfilling orders. An agreement between the participants to sell their competing products at the same price probably is not ancillary because the benefits of sharing on-line sales functions probably do not depend on collective pricing.

Second, suppose joint venture participants sell a liquid chemical dispensed to customers by a tank, the venture built and operates. An agreement between the participants to sell their competing products at the same price probably is ancillary because they could not charge two different prices for the same thing at the same place at the same time.61

➢ Agreements Not to Compete: Judicial Instances

The most popular kinds of Non-Compete agreements usually adopted along with a joint venture or other combination transaction are discussed below:

- Participants’ Agreements Not to compete with the joint venture:
  Participants in a valid, pro competitive joint venture generally may agree not to compete with the venture. It was stated in United States v. Addyston Pipe & steel Co62., agreements by the participants not to compete with the venture should be upheld as ancillary where they are made “with a view of securing each partner’s entire effort in the common enterprise”. Even if the restraints are imposed on the parties to joint venture later on, they are upheld, if it appears reasonably necessary to promote the effectiveness of the venture.63

- Agreements Restricting Competition Between Joint Venture Participants in Markets Outside the Joint Venture:
  Agreements that the participants will not compete outside the market in which the joint venture participates generally are invalidated as naked restraints. Courts are far less likely to find that a

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61 GREGORY, Supra Note 59, at 11
62 Supra Note 53
challenged restraint is ancillary when it goes beyond the defined scope and purpose of the joint venture agreement\textsuperscript{64}.

- **Competition among the Joint Ventures and its Participants:**

  Situations in which the participants in a joint venture are permitted to compete with joint venture are not free from potential challenge. Although allowing the collaboration and its parents to compete may enhance competition, competition among the parents and the joint venture also could result in collusion. Consequently, it is important to built safeguards against coordination into the joint venture agreement itself\textsuperscript{65}.

  - **Position in India:**

    The position regarding treatment of Non-Compete agreements forming part of combination transactions and other restructuring transactions under the Competition Act, 2002 is not settled. In India, there is no classification of restraints which may be regarded as ancillary or non ancillary restraints. Consequently, restraint clauses in a combination transaction which have appreciable adverse effect on competition are likely to be scrutinized under Section 3 of the Competition Act, 2002 read along with Section 19(3).

    Alternatively Non Compete agreements forming part of Combination transaction may be scrutinized along with the transaction under Section 6 read along with Section 20(4).

    From both the procedural and substantive standpoint, it makes little sense to assess these restrictions separately from rest of the transaction and subject them to different rules.

    Furthermore, Non Compete agreements, in transactions which does not qualify the thresholds specified in Section 5 of the Act would be susceptible to continual challenge by Commission, in cases they cause or are likely to cause appreciable adverse effect on competition in relevant market.

\textsuperscript{64} *Timken Roller Bearing Co. v United States*, 341 U.S. 593 (1951), Supreme Court struck down a joint venture in which the parents of the venture allocated territories outside the scope of the venture.

\textsuperscript{65} In *Re General Motors Corp.* 103 F.T.C. 374 (1984), the commission while approving a joint venture for the manufacture of subcompact automobiles between the first and the fourth largest automobiles manufactures in the United States, required a consent order prohibiting the exchange of certain types of information and imposed other requirements to ensure that joint venture was not used to facilitate the exchange of competitively sensitive information like marketing plans, production plans etc., unnecessary to its operation.
CONCLUSION: THE WAY FORWARD

To air differences and still remain friends, the essence of civilized existence, don’t you think?

...Lan McEwan

The merger control law in India has all the elements of a progressive law and has imbibed several practices from the EU and US competition regimes. Despite its nascent existence, it has achieved tremendous success. However, there are certain factors which need to be deliberated upon and need further skilled escalation.

The non-compete agreements related to combinations/transactions are yet to be scrutinized by Commission. While there exists a merit in allowing non-compete agreements in order to enable the purchaser to enjoy the full commercial value of the business transferred, there exists a significant risk that transferor may be unduly restricted from possible re-entry to the market. International regimes can be of some assistance for the purpose of serving a broad guideline or a roadmap. However precise routes taken by Europe and US need not be necessarily adopted as the standards of reasonableness of restrictions vary according to socio-economic scenario of a jurisdiction.

As discussed above that the concept of Ancillary Restraints has been evolved in foreign jurisdictions to deal with cases of Non Compete agreements forming part of combination transactions. The practical "effect of a finding of ancillary is to 'remove the per se label from restraints otherwise falling within that category." Indeed, Professor Hovenkamp has suggested that "the most frequent application of the rule of reason involves restraints that are 'ancillary' to some underlying productive joint venture".

The competition jurisprudence in India is indeed in nascent stage and there is benefit in ensuring that the regime is not so out of sync with the competition principles and practices around the world. The doctrine analogous to ancillary restraints, as followed in European Union and United States, may be applied in India by the commission while dealing with Non Compete Agreements. For this, the Competition Commission of India ought to establish an exhaustive framework for

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66 Los Angeles Mem’l Coliseum Comm’n v. NFL, 726 F.2d 1381, 1395 (9th Cir. 1984)
treatment of Non Compete agreements in due course of time. This would help a great deal especially in cases where the jurisdictional thresholds are not met i.e. where the restrictive clauses are susceptible to continual challenge under Section 3 of the act. Existence of detailed guidelines to determine the reasonableness of restraints will allow the parties to transaction to structure their deals in a better way and thus providing a welcome safe harbor of regulatory certainty.
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