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Non-Compete Restrictions Under Indian Law: From The Lens Of The Mufg-Shriram Finance Deal

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MUFG Bank Limited (MUFG), a Japanese corporation being part of the world's largest financial groups (Mitsubishi Financial Group), has agreed to subscribe to a 20% equity stake in the Indian non-banking financial company and publicly listed company, Shriram Finance Limited (Shriram Finance).

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MUFG Bank Limited (MUFG), a Japanese corporation being part of the world's largest financial groups (Mitsubishi Financial Group), has agreed to subscribe to a 20% equity stake in the Indian non-banking financial company and publicly listed company, Shriram Finance Limited (Shriram Finance).

As a part of the transaction, the promoter of Shriram Finance, i.e., Shriram Ownership Trust (SOT), will be paid a one-time fee of USD 200 million for agreeing to certain non-compete restrictions. The key tenets of these restrictions are to ensure that SOT shall not, directly or indirectly: (a) carry out the current line of business of Shriram Finance and any future lending and financing businesses (with certain exceptions including for similar existing business already carried out by SOT and its affiliates); (b) use the 'Shriram' brand for any competing business; and (c) undertake any

partnership with any Japanese financial institution or any of their affiliates where such entities propose to engage in any business competing with a business that requires a license from the Reserve Bank of India.

Reported as the largest cross-border deal in India in the financial services sector, the transaction has prompted discussion on how the non-compete restrictions imposed on SOT and the associated fee payable to SOT for accepting such restrictions, may test certain principles under Indian law.

RESTRAINT OF TRADE OR BUSINESS

Non-compete restrictions are required to stand on the test stone of Section 27 of the Indian Contract Act, 1872 (Section 27) which provides that agreements in restraint of lawful profession, trade or business are void except for such agreements for the sale of goodwill.

In line with the principles of Section 27, typically in M&A deals, a fee is paid in exchange of imposition of non-compete restrictions on a promoter who is exiting a business or selling its goodwill so as to protect the legitimate business interest of the buyer by ensuring that the promoter (who is equipped with the requisite knowledge and skill regarding the business purchased) does not enter into a competing business.

However, in the present case, strictly speaking, the restrictions being imposed on SOT may be argued as not falling within the exception to Section 27, given that the transaction comprises MUFG subscribing to new shares rather than transfer of shares from the promoter group to MUFG. That is, there is no element of 'sale' of goodwill in the conventional sense. In fact, SOT will continue to be a shareholder in Shriram Finance with controlling interest. Further, such fee being paid by a minority shareholder (i.e., MUFG) to a controlling shareholder (which has greater skin-in-the-game to protect the value of the business) also muddies the water regarding the legitimacy of such restriction.

Having said that, jurisprudence has evolved with time and Indian courts have shown greater willingness to uphold narrowly drafted restrictive covenants that are ancillary to a subsisting commercial arrangement and protect genuine business interest. Various factors are assessed in this context such as reasonability (which, in turn, is contingent on criteria such as scope of the restraint such as in terms of time period) and necessity.

In the instant transaction, as per the public documents of Shriram Finance, it has explained that: (a) SOT (along with its affiliates) is engaged in various financial services businesses in India and the restrictions would prevent any potential conflict of interest between the business of Shriram Finance and other businesses of SOT and its affiliates; (b) SOT possesses influence over its affiliates, and the brand equity, deep

institutional relationships, market knowledge and influence that would enable it to enter into or expand competing financial services activities; and (c) the restrictions will survive until MUFG continues to hold a minimum of 10% of the share capital of Shriram Finance. Accordingly, considering these factors collectively, the restrictions may be defensible as a calibrated means of protecting MUFG's legitimate investment by preserving exclusivity so long as MUFG is a material shareholder in Shriram Finance.

REGULATION 26(6) OF LODR

As per Regulation 26(6) of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), 2015 (LODR), a promoter or key personnel of a listed company is restricted from entering into any agreement either for itself or on behalf of any other person, with any third party, for obtaining any compensation or profit sharing in connection with dealings in the securities of such listed entity. However, such restriction will not apply if the transaction is approved by the board of directors as well as the public shareholders of the listed entity with interested persons abstaining from voting at such general meeting.

Regulation 26(6) of the LODR was introduced by the Securities and Exchange Board of India (SEBI) as a result of a case wherein the promoter and key employee of PVR Limited (PVR), an Indian listed company, had entered into an upside sharing arrangement with an investor in PVR. This arrangement was not disclosed by PVR on the basis that the payments would not be made by the listed company but by the investor. However, SEBI had issued a show-cause notice to PVR, and subsequently, with a view to strengthening corporate governance and transparency, amended the LODR to require requisite approvals to be obtained prior to entering into such arrangements. While SEBI acknowledged that such arrangements are not unusual, it considered it necessary to regulate such arrangements to negate the possibility of unfair trade practices and conflict of interest between promoters / key personnel on the one hand, and the company and its other shareholders on the other.

Basis the above, the thrust of Regulation 26(6) of the LODR appears to be to ensure that there is no unequitable treatment between shareholders, and that promoters / key personnel are not provided with gains that may encourage them to act in their personal interest (or that of select shareholders) for a short-term and eventually lose incentive to act in the larger interest of the company and other shareholders.

With this background, the question arises as to whether non-compete fee arrangements could be viewed as being regulated under Regulation 26(6) of the LODR. The key assessment that matters in this context is whether the payment is inseparable from the securities transaction or whether the transaction value is effectively being split in a way that advantages a select shareholder under a separate label.

In the context of the present case, since the payment will be made only upon the preferential allotment of shares to MUFG, one may argue that the economic inseparability argument is somewhat strong, and therefore, SEBI may examine this transaction as payment of "compensation" which is connected to a transaction involving the securities of Shriram Finance under Regulation 26(6) of the LODR.

It is interesting to note that Shriram Finance has erred on the side of caution and procured the necessary approvals for this arrangement while noting that, in its view, Regulation 26(6) of the LODR would not be attracted. This is a prudent structuring approach for dealmakers.

This brings to light the fact that Regulation 26(6) of the LODR is broadly worded to apply to any "compensation" "in connection with dealings in the securities of such listed entity" and may, depending on the facts of the case, extend to non-compete fee payment arrangements if it appears that such arrangements are structured for providing any unfair advantage to promoters as compared to the other shareholders of the listed entity or disincentivising them from working towards promoting the business for all shareholders in the longer run.

Conclusion

Lessons from the MUFG–Shriram Finance transaction emphasises on the need for dealmakers to give greater attention to: (a) the commercial justification for promoter restraints absent a full exit; and (b) the governance architecture around any promoter-linked payment and its substance, particularly in transactions involving listed entities and promoter control.

The content of this document does not necessarily reflect the views / position of Khaitan & Co but remain solely those of the author(s). For any further queries or follow up, please contact Khaitan & Co at editors@khaitanco.com.

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