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The Law relating to Agreement in Restraint of Trade

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This article deals with the agreement in restraint of trade which is defined as a contract that prohibits a person from exercising his right to engage in a particular profession or business with any other people without first obtaining consent from the contracting party. Indian courts have often ruled that it is invalid to prevent someone from engaging in or starting a certain legal profession, trade, or company as a result of the implications of an agreement.

Keywords: *trade, agreement, restraint, contract act, section 27.*

INTRODUCTION

The universal principle of contracts is based on the concept of free will; whenever a contract is formed, it is assumed that the parties have free will and a real purpose in a contract. The Contract Act only provides a broad framework for regulating or governing the entry into and enforceability of contracts; it is not concerned with the precise terms of the contract agreed upon between the parties, save in limited circumstances. Contracts were once thought to be lawful because they embodied the free will of the contracting parties, however, the legitimacy of some contracts has been called into question due to the existence of undue influence during the contract's execution. This is when terminology like undue influence, misrepresentation,

void, and so on come into play. Every agreement in its ultimate analysis is the result of a proposal from one side and acceptance by another.¹Section 2(e) of the Indian Contracts Act 1872 defines agreement as *“Every promise and every set of promises, forming the consideration for each other, is an agreement”*². An agreement in restraint of trade is when one or both the parties prevent another party to the contract from exercising a lawful profession in some way or limiting their freedom to work or profession (or business). Such agreements are void because they conflict with public policy as they unduly interfere with an individual's freedom. All agreements are not contracts and they can be regarded as one, only when it becomes enforceable by the law. The contract for “restraint of trade” was considered to be against public policy and therefore unenforceable by law. The terms and conditions for enforceability are stated in Section 10³ of the Indian Contract Act which states *“All agreements are contract if they are made by the free consent of the parties competent to contract, for a lawful consideration and a lawful object, and are not hereby expressly declared to be void.”*⁴ The contract for “restraint of trade” was considered to be against public policy and therefore unenforceable by law.

SECTION 27 OF THE INDIAN CONTRACTS ACT

The constitution of India provides its citizens with the fundamental right to free trade and profession, as the legislature cannot take away someone's fundamental rights, the individual shouldn't also be allowed to do so by the way of agreement. “Everyone should have complete liberty to exercise his power and rights for his good and his community.” Therefore, an agreement that prevents a person from exercising his rights is against public policy, and the provisions of the “Indian Contract Act” make this - agreement in restraint of trade void, it states-

S.27. “Agreement in restraint of trade, void. – every agreement by which anyone is restrained from exercising a lawful profession, trade, or business of any kind, is to that extent void.

¹ Avatar Singh, *Contract & Specific Relief* (12th edition, Eastern Book Company 2017) 3

² Indian Contract Act, 1872, s 2(e)

³ Indian Contract Act, 1872, s 10

Exception 1. – Saving of agreement not to carry on the business of which goodwill 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 reasoned, regard being had to the nature of the business.”⁴

The question arose whether partial or general restraint is covered by this section? The Calcutta High Court was the first to take up this question in *Madhub Chander v Raj Coomar*⁵, in this case, the plaintiff and defendant had shops in the same neighbourhood, and the defendant offered to pay the plaintiff some amount of money if he would close his business operation in that neighbourhood, the plaintiff did so but the defendant refused to pay him. The “plaintiff” contended that the restriction in question was only partial and such restrictions have been upheld in English law. The court however held the agreement void. COUCH J, held that the phrase “restrained from exercising a lawful profession, trade or business of any kind” does not mean only absolute restriction it also means partial restriction. “If the agreement on the part of the plaintiff is void, there is no consideration for the agreement on the part of the defendant to pay the money; and the whole contract must be treated as one which cannot be enforced.”⁷ Thus an agreement to close the working of a mill for 3 months of a year and a party would only sell beef for 14 days has been held void. This section in its general terms declares all agreements in restraint void, except in cases specified in the exception. The Law Commission of India observed that this section was enacted at a time when trade was yet undeveloped and the object underlying the section was to protect the trade from restraint. But when trade in India has developed to a larger extent, there is no reason why a more liberal attitude should not be adopted by acknowledging such restraints as are reasonable⁶, it is recommended that this section must be amended.

Both India and England follow the same general principle that an agreement whether partial or absolute, that restraints a person from practising a lawful trade or business are void. The

⁴ Indian Contract Act, 1872, s 27

⁵ *Madhub Chander v Raj Coomar* (1874) 14 Beng LR 76

⁶ Law Commission of India, *Contract Act, 1872* (Law Com. No. 13 1958) para 55

<<https://lawcommissionofindia.nic.in/1-50/Report13.pdf>> accessed 21 June 2022

major difference between the laws in both countries is that in England if the restriction is reasonable, it will be held valid whereas in India a restriction is valid only if it is an exception created by the legislature or by judicial interpretation. The English stand is quite flexible in this regard because it gives the court freedom to adapt to changing times. Whereas the Supreme of India in the case of *Gujrat bottling Co Ltd v Coca-Cola Co.*⁷ held that,

“The question of the reasonableness of restraint is outside the purview of Section 27 of the Contract Act and need not be proceeded on the basis that an enquiry into the reasonableness of the restraint is not envisaged by Section 27”. It was decided in this that the Indian courts need not worry about the reasonableness of the restraint because it is outside the purview of Section 27 of the Indian Contract Act, 1872. The only thing the Indian Courts need to focus on is whether the contract is of restraint of trade or not.

However, the Indian Courts have not been completely sterile in the matter, wherever necessary the courts have laid stress on the phrase “restrained from exercising a lawful profession, trade or business” in this Section, The High court of Kutch in the case of *Revashanker Shamji v Velji Jagjivan Kukama*⁸ regarded it as an agreement to monopolise the activities of performing religious service in the village as a void agreement as it considered this as “a profession, trade or business” and therefore held void under Sec 27 of the Act. Whereas an agreement in the case of *Pothi Ram v Islam Fatima*⁹, in which the landlords in the same neighbourhood to avoid competition decided to not conduct the market for the sale of cattle on the same days.” The Allahabad High court, in this case, held that “the landholder by collecting tolls or fees by allowing to conduct a cattle market on his land is not exercising trade or business and therefore the agreement doesn’t fall within the purview of Section 27 of the Act.

⁷ *M/S Gujarat Pottling Co. Ltd. & Ors v The Coca Cola Co. & Ors.*, (1995), AIR 2372

⁸ *Revashanker Shamji v Velji Jagjivan Kukama* AIR 1951, Kutch 56

⁹ *Islam Fatima and Ors. v Pothi Ram and Ors.*, (1915) ILR 37 All 212

RESTRAINT OF TRADE UNDER ENGLISH LAW

In the landmark case of *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co.*,¹⁰ the House of Lords dealt with the issue of restraint of trade in England. In this case, the seller of goodwill agreed with the buyer on two terms: first, not to practise the same trade for 25 years, and second, not to engage in any business competing or liable to compete in any way with the business for the time being carried on by the company. The court held that the first part of the agreement which restrained the seller from practising the same profession for a period of 25 years was completely valid as it was mandatory for saving the interest of the buyer, but the second part of the agreement which prevented the seller from engaging in any competing business for the time it is carried on by the buyer was void as it was unreasonable. LORD MACNAGHTEN observed, “the public have an interest in every person’s carrying on his trade freely: so, has the individual. All interference with the individual liberty of action in trading, and all restraint of trade of themselves, if there is nothing more, are contrary to public policy and, therefore, void. That is the general rule. But there are exceptions.

Restraint of trade.... may be justified by the special circumstances of a particular case. The only justification is that the restriction should be reasonable” In this case, it was laid down that all restraint of trade whether partial or absolute is a void, but a certain exception to this rule is that the restriction imposed must be reasonable which is done to save the interest of the party in whose interest restriction has been imposed and at the same time is not against the general public. The principle of the Nordenfelt Case was applied in the case of *McEllistram v Ballymacelligott Coop Agricultural & Dairy Society*¹¹, here the agreement between the parties where a former member agreed to sell for an unlimited time all his milk to a creamery run by the society was held to be void.

COMPARISON BETWEEN INDIAN AND ENGLISH LAW

Both India and England follow the same general principle that an agreement whether partial or absolute, that restrains a person from practising a lawful trade or business are void. The

¹⁰ *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co.*, [1894] AC 535

¹¹ *McEllistram v Ballymacelligott Coop Agricultural & Dairy Society* [1919] AC 548

major difference between the laws in both countries is that in England if the restriction is reasonable, it will be held valid whereas in India a restriction is valid only if it is an exception created by the legislature or by judicial interpretation. The English stand is quite flexible in this regard because it gives the court freedom to adapt to changing times. Whereas the Supreme of India in the case of *Gujrat bottling Co Ltd v Coca-Cola Co.*¹² held that “the question of the reasonableness of restraint is outside the purview of Section 27 of the Contract Act and need not be proceeded on the basis that an enquiry into the reasonableness of the restraint is not envisaged by Section 27”. It was decided in this that the Indian courts need not worry about the reasonableness of the restraint because it is outside the purview of Section 27 of the Indian Contract Act, 1872. The only thing the Indian Courts need to focus on is whether the contract is of restraint of trade or not.

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¹² M/S Gujarat Pottling Co. Ltd. & Ors., (n 7)

¹³ Revashanker Shamji (n 8)

¹⁴ Islam Fatima and Ors., (n 9)

EXCEPTION

There are mainly two kinds of exceptions to the provisions of “Section 27 of the Indian Contract Act” i.e. some are created by the statute and some arose by judicial interpretation of Sec 27.

STATUTORY EXCEPTIONS

- *SALE OF GOODWILL*

The exception of the sale of goodwill has been expressly mentioned in Sec 27. It states – **“Saving of agreement not to carry on the business of which goodwill 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 too the Court reasoned, regard being had to the nature of the business”¹⁵, The primary goal of this exception is to preserve the goodwill buyer's interests. A careful reading of the main section and the exception establishes beyond a shadow of a doubt that there is only one exception to the law as it stands currently, and that exception can only apply in circumstances of goodwill and similar activities conducted by the purchaser. In such a scenario, the court must determine whether the agreement's limitations are reasonable in light of the nature of the business.¹⁶

WHAT IS A GOODWILL? LORD MACNAGHTEN in the case of *Ann Trego v George*

*Stratford Hunt*¹⁷ explained this “often it happens that goodwill is the very sap and life of a business without which the business would yield little or no profit. It is the whole advantage, whatever it may be, of the reputation and connection of firm, which may have been built up by years of honest work gained by the lavish expenditure of money.”

¹⁵ Indian Contract Act, 1872, s 27

¹⁶ P C Markanda, *The Law of Contract* (4th Edition, Volume 1, Lexis Nexis 2018)

¹⁷ *Ann Trego v George Stratford Hunt* [1896] AC 7, 23-24.

An agreement to prevent competition, in disguise of the sale of goodwill, will be void. In the case, of *Vancouver Malt & Sake Brewing Co Ltd v Vancouver Breweries Ltd*.¹⁸, a company was licensed to manufacture liquor and beer, but it confined its operations to the production of Sake alone (a kind of Japanese liquor), the company agreed with another company where it sold its business and goodwill of manufacturing liquor and wine but not sake. The agreement was declared void because the company's sole activity was sake brewing, and the goodwill of its licence to sell sake was expressly prohibited from sale. The corporation didn't have any goodwill to sell in exchange for beer. This exception allows a buyer of a company's goodwill to obtain a covenant from the company's vendor, although it is limited in scope and time. This exception restricts the region by stating that it can only act if the restraint is within 'Specified local limits'.¹⁹ The restraint's local bounds must be specified in the agreement. Only the buyer or any person deriving title to the goodwill from the seller can be barred from carrying on a similar business for the period during which the business sold is carried on by the buyer or any person deriving title to the goodwill from him.¹⁹

- **PARTNERSHIP ACT**

Certain provisions and terms of the Indian Partnership Act, 1930 makes restrictions of certain kind valid. "Section 11 of the Indian Partnership Act" states that "Agreements in restraints of trade. – (2) Notwithstanding anything contained in section 27 of the Indian Contract Act, 1872 (9 of 1872), such contracts may provide that a partner shall not carry on any business other than that of the firm while he is a partner."²⁰ According to this section during the partnership, the partners will not carry any business other than that of the firm.

Similarly, Sec 36 of the Indian Partnership Act enables the partner to prevent an outgoing partner from carrying out a similar business within a specified period or within specified local limits. According to this section, "A partner may agree with his partners that on ceasing to be a partner he will not carry on any business similar to that of the firm within a specified period or

¹⁸ *Vancouver Malt & Sake Brewing Co. Ltd. v Vancouver Breweries Ltd.*, [1934] 39 LW 618

¹⁹ Pollock and Mulla, *Indian Contract Act and Specific Relief* (15th edition, Lexis Nexis 2018) ¹⁹Avatar Singh, (n 1) 300

²⁰ Indian Partnership Act, 1930, s11

a specified local limit; and, notwithstanding anything contained in section 27 of the Indian Contract Act, 1872 (9 of 1872), such agreement shall be valid if the restrictions imposed are reasonable.”²¹ In the absence of an express covenant, a partner, on dissolution, may carry on the same or similar business in his name and not in the name of the old partnership, and may deal with the same customers of the former partnership, but may not persuade them to deal with himself and not the old firm.²²

UNDER JUDICIAL INTERPRETATION TRADE COMBINATION

The traders around the globe carry out their work in a certain way to better organize their business. The main objective of such associations or organisations is to regulate business operations and not restrain them. For example, the decision to keep all the shops of the market closed on Monday is done in the interest of trade itself and not to restrain a business. In *Municipal Committee Khurai v Firm Kaluram Hiralal*²³, the court held that “regulations as to opening and closing of business in the market, licensing of traders, supervision, and control of dealers and the mode of dealing are not illegal” the courts do not allow a restriction which is disguised as a trade regulation, for example, agreement that a certain people will carry out the business with people of their caste only have been held void.

A landmark case in this regard is *Kores Mfg Co Ltd v Kolok Mfg Co Ltd*²⁴, in this case, both parties were involved in a similar business and a similar technical process was used by both companies, the employees of both companies were likely to acquire the trade secrets during employment. Both the parties agreed according to none of the parties would hire an employee from the previous five years of the other company without the consent of that company.

The agreement was held to be void, because according to the agreement even if a person was employed by the other company for a very brief period such as a day or a week and in a humble capacity such as an unskilled labourer and a person who was dismissed will not be

²¹ Indian Partnership Act, 1930, s 36(2)

²² Pollock and Mulla (n 19)

²³ *Khurai v Firm KaluramHiralal* AIR 1944, Nag 73

²⁴ *Kores Mfg Co. Ltd. v KolokMfg Co Ltd.*, [1958] 2 WLR 858 (CA)

hired by the other company's consent. The agreements regarding the regulation of prices and output are mostly considered valid, for example, "the agreement fixing the uniform rate for ginning cotton and equally distributing the earnings in proportion." The part where both the parties equally distribute the earnings is not against Sec 27, but the uniform fixation of rates has been held void in English courts.

SOLUS OR EXCLUSIVE DEALING AGREEMENTS

A very common business practice is that a manufacturer likes to distribute his goods through a sole agent and the agent agrees in turn not to deal with goods of any other manufacturer. This involves the restrictions on a franchisee's right to deal with competing products during the subsistence of the franchise agreement. In *M/S Gujarat Bottling Co. Ltd. v The Coca-Cola Co*²⁵. The Supreme Court held that some terms of commercial contracts have passed into the accepted currency of contractual or conveyancing relations and aim at promoting trade and business. Such terms due to their nature and purpose cannot be said to enter the field of restraint of trade. In this case, the Supreme Court held that a negative stipulation in a franchising agreement, restraining the franchisee from dealing with competing goods, during the subsistence of the franchising agreement, could not be regarded as restraint of the franchisee's right to trade.

RESTRAINT UPON EMPLOYEES

- **RESTRAINT DURING EMPLOYMENT**

There is an agreement that prevents an employee from working elsewhere during the period of employment. This is done to save trade secrets, the names of the customers, etc. all this information is objective knowledge, and such things are the property of the master and the servant has no right to give to someone else. Due to this, the servant can be restrained in participating in the direct competition of the master. Agreements for the protection of trade secrets are not unreasonable, the possibility of using the client lists and other confidential information by an ex-employee cannot be ignored.

²⁵ *M/S Gujarat Bottling Co. Ltd. & Ors., (n 7)*

In *Charlesworth v MacDonald*²⁶, B was a surgeon practising in Zanzibar, and an agreed to work for three years as an assistant to B. the agreement was subject to the clause against practising. A left his job within a year and began practising on his own. The court stopped A from doing so, it held that such agreements don't fall within the ambit of Sec 27 if they did then all agreements for personal services for a fixed period will be void. The Bombay HC in the case of *V. N Deshpande v Arvind Mills Co. Ltd.*²⁷, granted an injunction to stop the defendant who agreed to work as a weaving master in a mill for three years and agreed not to serve anywhere else during that period.

- RESTRAINT AFTER TERMINATION OF EMPLOYMENT-

The agreement to prevent a former employee from competing with his/her former employers may not be allowed by the court of law. In *Brahmaputra Tea Co Ltd v E Scarth*²⁸, the employers tried to prevent the servant from competing for five years after the period of service, the court held that “*Contracts by which persons are restrained from competing, after the term of their agreement is over, with their former employers within reasonable limits, are well known in English Law, and the omission to make any such contract an exception to the general prohibition contained in Sec 27 indicates that it was not intended to give them legal effect in this country.*” These principles were approved by the Supreme Court in *Niranjan Shukla Golikari v Century Spg&Mfg Co. Ltd.*²⁹, The Supreme Court ruled that limits apply only when an employee is contractually obligated to serve his company and are never considered restraints of commerce under common law or Section 27. As a result, where a clause imposes a partial constraint restricting the employee from performing services in the same industry as the employer for the duration of the agreement, such restraint would not violate Section 27.³⁰

²⁶ *Charlesworth v MacDonald* (1898) ILR 23 BOM 103

²⁷ *V. N Deshpande v Arvind Mills Co. Ltd.*, (1946) 48 BOMLR 90

²⁸ *The Brahmaputra Tea Co. Ld. v E. Scarth* (1885) ILR 11 Cal 545

²⁹ *Niranjan Shukla Golikari v Century Spg & Mfg Co. Ltd.*, [1967] 2 SCR 378

³⁰ Seyfarth Shaw LLP, ‘What you need to know about non-compete covenants in India’ (*Lexology*, 1 August 2014) <<https://www.lexology.com/library/detail.aspx?g=0768340a-1e05-42a4-8c45-378719f307e0>> accessed 14 March 2019

- RECOVERY OF TRAINING EXPENSES -

An agreement between the employer and the employee in which the employee will be put into service for 5 years after returning from training abroad at the cost of the employer and if the employee left after service before their completion of the service period, he would have to pay Rs. 30,000, the court held that there was no restriction because the employee can go after paying an unrecovered portion of expenses of training. (*Nazir Maricar v Marshall Sons & Co.Ltd.*³¹).

- AGREEMENT BETWEEN EMPLOYERS

In *Kores Mfg. Co Ltd v Kolok Mfg. Co. Ltd.*, the court held that an agreement between the two employers that neither would hire an employee, from the previous five years of the other company without the consent of that company, this agreement was held void as the restriction imposed was too wide and placed unreasonable restriction upon freedom of free trade. If an employee is prematurely removed from the company without his fault the restriction of this kind will cease to exist. The Supreme Court also observed that a restraint beyond the term of service would be prima facie void and the only ground on which it could be justified is by showing it is necessary for the protection of the employer's goodwill.³²

CONCLUSION

At present section 27 of the Indian Contract Act, 1872 doesn't allow any restriction in trade except in cases of sale of goodwill and also in cases that are judicially interpreted. The judiciary has tried to interpret section 27 on grounds of reasonableness instead of strictly following it in black and white. This section should be made more flexible like in English law by the inclusion of reasonableness which will help this law to adapt to changing times. Even the Law Commission of India in its 13th report suggested that certain provisions of this section must be amended.

³¹ *Nazir Maricar v Marshall Sons & Co. Ltd.*, (2004) A.S. No. 606/1990

³² Avatar Singh (n 1), 313