



The Indian Journal for Research in Law and Management

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Editor-in-Chief – Dr. Muktai Deb Chavan; Publisher – Alden Vas; ISSN: 2583-9896

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CONTRACTS RESTRICTING TRADE AND THEIR EXCEPTIONS

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INTRODUCTION:

The Indian Contract Act of 1872, prescribes the law related to contract and plays an important role in solving the disputes related to contract. According to the Indian Contract Act of 1872, “an agreement enforceable by law is contract” [S2 (h)]. Now there are many questions which arise, of which few of them are listed below,

1. Can an agreement which restricts trade is a valid contract?
2. Extent to which the restriction can be placed.
3. If such imposing of restriction is void under law, then what is the penalty or punishment?
4. What are the factors, according to the court, which determines reasonable restriction on trade?
5. Franchise agreements often include clauses of restriction of trade. Does that make the agreement void?
6. Does S27 endanger the companies which rely on its trade secrets?

Now let's see what law says on restriction of trade. In section 27 of The Indian Contract Act, it is mentioned that any agreement on restriction of trade is void. But as always there are some conditions and exceptions are also there. Before interpreting the S27 lets see the exact statement.

Section 27 of the Indian Contract Act:

“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.

Exception 1: Saving of agreement not to carry on business of which goodwill is sold: One who sells the goodwill 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 goodwill from him, carrying on a like business therefrom, provided that such limits appear to the Court reasonable, regard being had to the nature of the business.”

WHAT IS RESTRICTION ON TRADE?

Restriction on trade is not a new term or a concept to us. It was practiced even before British rule. Here let me give five examples. (a) Guild Restrictions (Shreni System) - where Trade guilds (*shrenis*) regulated economic activities by controlling who could enter a trade or profession. (b) The **Arthashastra** (by Kautilya) mentions that the state had monopolies on commodities like metals, forest products, and liquor to prevent private competition. (c) Kings appointed **market superintendents (Panyadhyaksha)** to regulate trade practices and prevent excessive competition. (d) Different kingdoms imposed **entry taxes, tolls, and levies** on traders from other regions, limiting free trade across territories. (e) The **Varna system** dictated economic roles, with certain castes being restricted to specific trades and occupations.

What is this trade restriction? Trade restriction is an artificial restriction which is placed to protect people from the negative effect of competition. Article 19 clause 1 sub-clause g [19(1)(g)] of our constitution which we call the mother of all acts provides the right of an individual to do or carry out any business, trade, occupation or profession. What is the intention behind this article? The drafter's intentions were very clear. It's for the development of the Indian economy through trade, business and to promote positive competition. Now there is a question. Does section 27 of the Indian contract act contradicts article 19(1) (g)? If you clearly see in article 19(6), it states that

states have been empowered to impose certain reasonable restrictions in the interest of the general public. Normally we expect a positive competition in case of article 19(1) (g). But it is not the case all the time. We need to consider small scale business ventures as they struggle to survive in a heavy competition. In some cases it is used to secure their trade secrets and there are many reasons too. That's where restriction of trade comes in.

HISTORY OF LAWS RELATED TO RESTRICTION ON TRADE:

History of law related to restraint of trade can be classified into pre-independence, post-independence and now. During the pre-independence period, English common law was applied. It disfavored restriction on trade except some circumstances which include protecting the trade secret, under reasonable reasons. In 1872, section 27 was enacted which states about the restriction of trade. Precedents also play an important role in the history of laws related to restraint of trade.

In the 13th report of the law commission, it was recommended to take certain reasonable restraints in the interest of the general public. In the UK, the restriction of trade placed on any person is valid only if the employer proves that the restraints placed were reasonable or it was needed to protect the secret of his/her business. This was what was mentioned in common law. The law commission also recommended this.

Restriction can be of two types, namely absolute and partial restriction. There was a lot of confusion/ambiguity during post-independence regarding section 27. One of which was whether the restriction of trade is void for absolute restriction or partial restriction. In *Madhub Chander v. Rajcoomat Dass*¹, it was held that absolute restriction of trade is void by using internal aid of interpretation. In section 28 of Indian contract act, it was clearly mentioned about absolute and partial restraint of trade. Hence by using that as an aid of interpretation the court held the above judgment.

There are many other ambiguities. For example, what is the validity of restraint of trade during the employment and post-employment? In *Niranjan Shankar Golikari v. The Century Spinning Mfg Co Ltd*², Niranjan was employed by The Century Spinning Mfg Co Ltd which has a partnership

¹ Madhub Chander v. Raj Coomar (1874) 14 Beng LR 76

² Niranjan Shankar Golikari v. The Century Spinning and Manufacturing Co. Ltd. AIR 1967 SC 1098.

with a German company. The German company shared their trade secret to Century Spinning Mfg Co Ltd. Hence, Niranjana also had access to these trade secrets. But, Niranjana left the Century Spinning Mfg Co Ltd before term ends and joined another company. The court held that the restraint of trade was necessary to protect the trade secret and interest of the business. This clearly states as a best case reference for restraint of trade during employment. For post-employment, *Superintendence Company of India private Ltd v. Krishna Murgai*³ is a best case reference. In this case, Krishna Murgai was terminated from his job. So, he established his own company with the same business nature as his previous business and the area of service also was the same as the previous business. But in the restrictive clause by Superintendence Company of India private Ltd clearly mentions that the employee will not be permitted to join any firm of their competitors or run his own business which is similar to them directly or indirectly for the period of two years at the place of last posting after he leaves the company. The court interpreted the term “leave” in a wider term which included termination of contract and the geographical and duration restriction was also reasonable.

LEGAL PRINCIPLE AND JUDICIAL PERSPECTIVE RESTRICTION ON TRADE:

We saw restraint of trade, its history and evolution in India. Restraint of trade in India evolved through precedents just like how contempt in face of court evolved through precedents in UK. Through precedents now we can know the factors for a reasonable restriction clauses to make a restrictive contract valid and not only that, judiciary also balanced both public policy and contractual freedom. Through judicial precedents we came to know about the other exceptions such as non-competitive clause, solus agreement, Non-solicitation of customers & employees etcetera which are not directly mentioned in section 27 of Indian contract act.

Through *Niranjana Shankar Gollkari v. The Century Spinning Mfg Co Ltd*, court **distinguished during and post-employment restrictive clauses**. While courts have recognized that **reasonable restrictions** in business transactions, such as **non-compete clauses** in the sale of a business (*Madhub Chunder v. Raj Coomar*, 1874) and **partnership agreements** (*Percept D’Mark (India) Pvt. Ltd. v. Zaheer Khan*, 2006⁴), may be enforceable if they serve a legitimate business interest and are limited in scope and duration.

³ *Superintendence Company of India (P) Ltd. v. Krishna Murgai* (1981) 2 SCC 246.

⁴ *Percept D’Mark (India) Pvt. Ltd. v. Zaheer Khan* (2006) 4 SCC 227.

*M/S Gujarat Bottling Co. Ltd. & Ors. v. Coca Cola Co. & Ors*⁵ is an important case reference where the Supreme Court held that a solus agreement is valid unless it is not reasonable. In this case M/S Gujarat Bottling Co. Ltd entered into an exclusive contract (solus agreement) with Coca Cola. The clause 14 of this agreement had a restrictive covenant stating that this clause prohibited M/S Gujarat Bottling Co. Ltd from entering into contract with another soft drink company for selling of bottles during the subsistence of this contract. The Supreme Court held that the clause 14 of this solus agreement is valid as it has reasonable duration and the restraint was not absolute. It was also stated that it was necessary to protect the interest of Coca Cola Company. We will see about the solus agreement in upcoming headings in detail.

Thus, Indian courts balance contractual freedom with the public policy principle that no person should be unduly restrained from earning a livelihood.

EXCEPTIONS IN LAW RELATED TO RESTRICTION ON TRADE.

When we say restriction, we can include,

- a. One which is under section 27 of Indian contract act.
- b. Indian partnership act.
- c. Competition act
- d. Solus agreements
- e. Non-solicitation of customers & employees.

a. Sale of goodwill:

Lord Macnaghten, in 1901, said that goodwill is a benefit or an advantage that an individual takes from a business which has reputation, good name, and connection. This good will is something which attracts the customer. It is clearly mentioned in section 27 of Indian contract act. *RC Cooper v. Union of India* is a landmark case which is also called as bank nationalization case. In 1969, Indira Gandhi, prime minister of India, nationalized approximately 14 major banks under an

⁵ *M/S Gujarat Bottling Co. Ltd. & Ors. v. Coca Cola Co. & Ors. (1995) 5 SCC 545.*

ordinance. There were many beneficial reasons backed up this ordinance by the government for the people but, one of the shareholders of the major bank, R.C. Cooper challenged the constitutional validity of this ordinance. According to them, this ordinance violated article 19 (1) (f), 19 (1) (g) and article 31. The Supreme Court held that nationalization of banks was unconstitutional and violated the fundamental rights under article 31 which says about property rights. It was also directed that the government can pursue nationalization but they have to follow a balanced approach while keeping in mind the fundamental rights of the citizen.

b. In Indian partnership act:

Indian partnership act talks about laws related to partnership. Section 11(2) of Indian partnership act talks about restriction during partnership Section 11(2) of Indian partnership act states as follow: *“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”*. So, by this we can clearly understand that the partners in partnership can restrain partners in partnership not to carry out any other business other than their firm during the period of partnership. Section 36(2) talks about restriction on outgoing partners, section 54 talks about restraint on partners after dissolution and section 55(3) talks about sale of good will.

c. Competition act:

The Trade Restriction's India Governing Phase was passed under the Competition Act of 2002, which explicitly states that trade Competition must be regulated through its provisions within the act. There are anti-competing collusions to curb, as well as domineering abuse, and unfair practices to protect the interests of consumers. Section 3 of competition act states that agreements that cause an “appreciable adverse effect on competition (AAEC)” are void. **Section 4** prohibits dominant firms from abusing their market position through **predatory pricing, unfair conditions, or denial of market access**. For example, digital platforms imposing exclusive contracts on sellers may face regulatory action. Such laws are advocated by the Competition Commission of India (CCI) who provide fair competition for businesses to compete freely. The competition regulation of digital markets coming under the eye of regulations has led to American tech companies like Amazon & Google trying to mask their monopoly behavior with Multi-national trade deals, promoting legally

defined interests and simultaneously seeking economic autonomy using law. This statement protects the freedom of the consumer while safeguarding innovation.

d. Solus agreement:

Solus agreements are special type or exclusive agreements in which a party exclusively enters into an agreement to buy a product from a single supplier for a particular period of time. The best case reference for this type of agreement is *M/S Gujarat Bottling Co. Ltd. & Ors. v. Coca Cola Co. & Ors*, which we have seen in legal principle and judicial perspective restriction on trade. Solus agreements are generally observed in franchise contracts and some industries like fuel distribution and exclusive dealership agreements. The court validates the solus agreement based on fairness and necessity. Reasonableness of Restriction, Protection of Legitimate Business Interests, Voluntary Agreement between Parties, Compliance with Competition Law, Restriction during Employment or Partnership are considered while checking validity of these agreements. In *Percept D'Mark (India) Pvt. Ltd. v. Zaheer Khan*, A cricketer, Zaheer Khan, was bound by an exclusive endorsement agreement with Percept D'Mark. After termination, Percept claimed an extension based on a restrictive clause. The Supreme Court ruled that post-contractual restraints are generally void under Section 27 of the Indian Contract Act, 1872, unless they are reasonable and protect legitimate business interests.

e. Non-solicitation of customers and employees:

Consider an example. Suppose an employee is working in a company where he has to deal with customer details such as name, email, phone number, customer history etc. so, if that employee leaves the company and joins another company or he or she starts a new business similar to the previous business then there is a threat to the previous company as that employee can use the customer details which he or she had access. To prevent this type of issues arising these non-solicitation of customer and employee clauses are included in the agreement which prevents the employee from using the company's customer details. Reasonableness of Restriction, No Absolute Restriction on Employment or Trade, Protection of Legitimate Business Interests, Voluntary and Clear Agreement are some key components which are required for a valid non-solicitation clause in an agreement. In *Desiccant Rotors International Pvt. Ltd. v. Bappaditya Sarkar & Another*⁶, the

⁶ *Desiccant Rotors International Pvt. Ltd. v. Bappaditya Sarkar & Anr. (2008) 149 DLT 262.*

defendant was a former employee of Desiccant Rotors International (DRI). His employment contract included a non-solicitation clause preventing him from contacting former customers or employees for a set period after leaving. After resignation, he joined a competitor and allegedly approached DRI's clients and employees.

REASONABLE REASON THAT COURT ACCEPTS ON RESTRICTION OF TRADE:

Restraint placed on any trade, profession or business is valid only if the condition of restriction is reasonable. We cannot see a problem in a one sided way. Why is there a need for trade restriction? It helps in protecting the secrets of business. Hence, the nature of the business is an important factor determining whether the restriction is reasonable or not.

Next is the time period. For example, consider a traditional handloom workers are made to enter into a contract that they need to handloom only for that particular company for the next 30 years. Is it reasonable? No, it's not. It clearly violates article 19 (1) (g). The reasonable time period may differ with the nature of business. In the Shaikh *Kalu v. Ram Saran* case, a comb manufacturer in Patna entered into a contract with Ram Saran Bhagat which has a restraining clause stating that they have to sell all the comb exclusively to him and his heirs. If there was a breach of contract, there will be a penalty of Rs.100. It was held that the restraint placed was unreasonable, oppressive. *Brown v. Brown* can also be taken into reference for this factor.

Geographical factors are another factor. The main aim for placing such restrictions was to create a monopoly. Hence, it was held that the contract is void. In *Brown v. Brown*, Robert and Leonard Brown operated an oil drilling business. Robert bought Leonard's share and Leonard agreed to sign a sale agreement which has a clause of restriction on trade. According to that Leonard was prevented from competing with him for next 20 years in New Zealand as a well oil driller. The court held that the restriction placed was unreasonable in both geological and time period.

It is important to note that a test of reasonableness whether the restraint is total or partial has no applicability in case of post service. Restriction on trade can only be applied (exception) if the employee/trainee has access to trade secret, sensitive data during his/her training in the company/organization or his/her employment under the company/organization and these

restrictions should be geographically , time periodically reasonable. Courts prioritize the right to livelihood of people/employees in restraint of post-employment clauses.

Even some contacts which partially restrains someone can be held void by court if it is presumed to be bad and rebuttable or against public policy. In *Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co Ltd*⁷, a successful Swedish high quality armaments manufacturer, Thorsten Nordenfelt, sold his business to the respondents and entered into the contract which has a restraint stating that he cannot work for any competitor of the respondent's company for the period of 25 years across globally. The respondent paid a considerable amount for that. However, Nordenfelt breached the contract and got employed in a competitor's company. It was held that as global restraint was reasonable in context with the nature of business and the consideration amount paid was also deemed to be reasonable.

Consideration plays an important role in any contract. Here too its plays a vital role. Consideration can be used to determine whether parties involved have given free consent or both the parties are satisfied with the consideration.

Impact on restricted parties also plays an important role.

Specificity and clarity is the last factor. The restrictive clause must be specific and clear. It must not be in a broad sense and there must not be any ambiguity. In some exceptional cases the broad sense of the restrictive clauses can also be considered to be valid (*Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co Ltd*) but, mostly the restrictive clauses must be specific.

CONCLUSION

In conclusion, Section 27 of Indian Contract Act balances the individual interest and public Interest when it comes to trade restriction. While the general principle is that any agreement restraining trade is void, judicial interpretations and statutory exceptions reveal that such restraints may be upheld if they are reasonable, limited in scope, and serve a legitimate purpose—such as protection of trade secrets, goodwill, or ensuring fair competition. Thus, contracts restricting trade cannot be

⁷ *Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co. Ltd. [1894] AC 535 (HL).*

viewed in absolute terms; their validity depends on the context, reasonableness, and necessity of the restraint imposed.

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