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A Critical Analysis on Agreement in Restraint of Trade

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ABSTRACT

The Indian Contract Act, 1872, Section 27 is one of the most contentious provisions of the Indian law of contract, portraying the clash between personal economic freedom and protection requirements of business. This research paper elaborates upon the history, statutory provision, judicial interpretation, exceptions, comparative aspects, and contemporary challenges pertaining to agreements in restraint of trade in India. It also addresses the contentious topic of reform, taking a middle road between the requirements of free competition and legitimate commercial needs.

KEYWORDS

Restraint of trade, Void agreement, Lawful profession, Goodwill exception, Public policy.

INTRODUCTION

According to Section 27 of the Indian Contract Act, 1872, is a cornerstone section in Indian law of contracts which discusses the legality of agreements abridging one's right of trade, profession, or business. The philosophy behind this section is based on the general philosophy of economic freedom, which is felt to be necessary for individual freedom and the encouragement of competition in society. The Act, which was introduced while the British were still in colonial rule, was largely influenced by English common law but in the end took a much stricter approach to agreements in restraint of trade than did the English counterpart.

Essentially, Section 27 states that any contract restraining any person from pursuing a legal profession, trade, or business of any nature is void to the extent. This entails that both total and partial restraints are unenforceable, whether or not the restraint seems

reasonable or is consented to by the parties. The only exemption provided for in the Act is where goodwill is sold, on which the vendor can agree that he will not continue a like business within a certain local area, if the restraint is reasonable in the view of the courts.

The roots of Section 27 lie in the English common law doctrine that suspected restraints of trade on the grounds of fears about the emergence of monopolies and stifling of competition²⁵. English law has since developed to permit reasonable restraints, as long as they aim to safeguard bonafide business interests and are not against public policy. Contrariwise, Indian law, as enacted in Section 27, does not accept the doctrine of reasonableness. Even limited or purportedly reasonable restraints are void unless they are within the narrow statutory exception. This strict statutory formula provides for little judicial discretion and means that Indian law is much more restrictive than English law in this regard.

The reason for such strictness is twofold. It protects individual liberty by preventing any individual from being unjustly denied the opportunity to employ their skills and resources in order to earn a living. It also demonstrates a public policy to encourage free competition and to bar anti-competitive conduct that would hurt the economy at large. The courts have affirmatively interpreted this against allowing any such contract which restricts an individual's capacity for carrying on lawful business and is violative of the basic right to trade as guaranteed under Article 19(1)(g) of the Indian Constitution. The constitutional protection additionally reinforces the trade restraint policy, even though Article 19(6) permits the State to subject the freedom in the interests of the public at large to reasonable restrictions by a law of general application and not by a private agreement.

The ambit of Section 27 is wide and absolute. It applies to all contracts which, in some way or other, limit a man's freedom to pursue a legal trade, profession, or business, whether the restraint is direct or indirect, complete or partial. It has been held by courts time and again that the test of reasonableness does not apply under this section, and there is only one exception, i.e., the sale of goodwill, which is valid. This has resulted in the invalidation of a number of contractual terms, including post-employment non-competition agreements, exclusive dealing contracts, and other covenants to restrict a party's future commercial endeavors, except to the extent they are reasonable under the statutory exception or covered by other independent legislation, such as the Indian Partnership Act.

Section 27's strict approach has been welcomed and criticized. On

the positive side, it has been praised for maintaining economic liberty and avoiding monopolistic activity. It has, on the other hand, been criticized as being in conflict with the requirements of contemporary commerce, in which companies may have competing interests in safeguarding trade secrets, customer relationships, and investment in training personnel. The Law Commission of India and some legal scholars have, in some instances, suggested reforms to permit reasonable restraints, yet the statutory wording remains the same.

Freedom to follow any legal trade, vocation, or business is an economic freedom's spine and is well secured under Indian law. Section 27 of the Indian Contract Act, 1872, embodies this principle by declaring that every contract to restrain any person from carrying on a lawful trade, business, or profession is void to the extent stated. This provision derives its force from public policy in promoting free competition and discouraging monopolistic tendencies that would injure the nation's economic fabric.

According to Section 27 is also made all the more important by its coincidence with the constitutional protection of economic freedom under Articles 19(1)(g) and 301-307 of the Indian Constitution, which protects the liberty to engage in any profession or trade. By invalidating contracts in restraint of trade, the law ensures that people have the option to still pursue legal economic activities without excessive interference.

But there are exceptions to this absolute prohibition. Indian law only permits limited instances of restraint of trade to be legal, one of which is selling business goodwill, whereby a seller promises not to compete within reasonable local limits in order to protect the interest of the buyer. Even in these limited exceptions, however, the rule is that freedom of trade must continue to rule supreme, and any contractual attempt to restrict it is viewed with suspicion by Indian courts.

HISTORICAL AND LEGAL CONTEXT

Origins in English Law

The genesis of Section 27 is rooted in English common law principle of restraint of trade, which used to render void those contracts that unduly restricted a person's ability to trade. Even though English law evolved to permit "reasonable" restraints, Indian law was more restrictive. The founders of the Indian Contract Act, in view of the socio-economic conditions of colonial India, sought to ban restraint of trade and protect the economic freedom of the citizens. To this end, Section 27 was enacted in

absolute terms and made void all contracts in restraint of trade, whether partial or total, except where they are specifically exempted by law.

The Indian Contract Act, 1872

Section 27 of the Indian Contract Act, 1872, is stated as:

"Every agreement by which any person is restrained from carrying on a lawful profession, trade, or business of any nature, is to that extent void."

The provision is general in its language and does not distinguish any difference between restraints total or partial, or reasonable or unreasonable restraints. The only statutory exception is in regard to the sale of goodwill.

Constitutional Backdrop

The importance of economic freedom is also reflected in the Indian Constitution. Article 19(1)(g) secures to all citizens the right to take up any profession, or to carry on any occupation, trade, or business. Similarly, Articles 301-307 secure the freedom of intercourse, trade, and commerce across India. Section 27 thus imbibes constitutional thinking regarding a free and open market economy.

Objectives of Section 27

- To safeguard the right of each individual to pursue any lawful trade, business, or profession freely.
- To encourage wholesome competition in business or commerce by rendering null and void any contract which amounts to restraint of trade or business, and thus thwarting monopolistic practices.
- To reflect a firm public policy mindset that contracts preventing trade are, as a rule, contrary to public interest.
- In order to assist compliance with constitutional guarantees protecting the freedom to carry on any profession or follow any trade, or business in India.
- In order to ensure maximum certainty for businesses and individuals in their dealings, reducing uncertainty in contractual arrangements and restricting litigation over restraint of trade covenants.

Elements of Agreement in Restraint of Trade

- There must be a contract or agreement between two or more people, express or implied, which tries to impose a restraint.

- Restraint on Legal Profession, Trade, or Business: The agreement must restrain a party or parties from pursuing at least one lawful profession, trade, or business, either completely or in part.
- As per Section 27, such an agreement is void to the extent of the restraint, i.e., cannot be enforced before a court of law.
- Exception – Sale of Goodwill: The sole statutory exception to this rule occurs where goodwill of a business is being sold and the owner of the business promises not to carry on similar business within a reasonable local area, provided that the restraint is reasonable in the eyes of the court.
- Unlike in English law, Indian law does not care if the restraint is reasonable or not; restraints are always invalid except under the statutory exception regarding goodwill.
- The section has a public policy foundation, aiming to avoid unjustified restraints on individual liberty and to promote open and competitive markets.

SCOPE AND JUDICIAL ATTITUDE

Broad Interpretation by Courts

Indian courts have always interpreted Section 27 strictly and literally. The Supreme Court and other High Courts have expressed the view that any contract, whether a complete or partial restraint, is void if it restricts the right to carry on a lawful trade, business, or profession. The courts do not analyze whether the restraint is reasonable or unreasonable, nor do they distinguish between direct and indirect restraints.

Important Judicial Dicta

- *Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co. Ltd.*¹: Negative covenants operative under the period of service are not hit by Section 27, if they are reasonable and are necessary for protecting the interests of the employer. Restrictive post-employment clauses are generally void.
- *Superintendence Company of India (P) Ltd. v. Krishan Murgai*²: The Supreme Court once again held that restraints post-service, such as non-compete clauses, are contrary to Section 27, even if reasonable⁶.
- *Madhub Chander Poramanik v. Rajcoomar Doss*³: The Calcutta High Court held that any agreement inhibiting

¹ (1967) 2 SCR 378.

² 1980 AIR 1717.

³ (1874) 07 CAL CK 0003.

trade, complete or partial, is void as per Section 27. This case gave a clear meaning to the term "trade restraint" in India and laid down a future precedent.

Exception: Sale of Goodwill

The sole express exception under Section 27 is in regards to the sale of goodwill. The seller of goodwill of a business may agree that he will not establish a similar business within specified local limits, provided the restraint is not excessive and is required to protect the interest of the buyer. This exception relies upon the assumption that the buyer of goodwill should be allowed to reap the complete benefit of the acquired business.

Other Exceptions

- **Provisions of Partnership Act:** Certain of the restrictions between partners, such as restrictions to avoid a partner from starting a competing business during the partnership or on retirement (for a reasonable time and place), are permitted under the Indian Partnership Act, 1932.
- **Trade Combinations:** Agreements among traders to dominate business, fix prices, or harmonize goods are permissible if they do not create a monopoly or unreasonably restrict competition. However, the agreements must not violate the Competition Act, 2002.
- **Employment Contracts:** Restrictive covenants in force during the period of employment (such as confidentiality or non-solicitation agreements) are generally enforceable subject to the condition that they are reasonable and necessary to protect the employer's legitimate interests.

COMPARATIVE LAW PERSPECTIVE

English Law

English law, which has historically influenced Indian contract law, has evolved a more mature approach to restraints of trade. English common law declares such restraints to be prima facie void, but reasonable restraints are enforceable having regard to the interests of the parties and the public interest. The reasonableness of the restraint is determined by the English courts considering the duration, geography, and the interests sought to be protected³.

Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co. Ltd.⁴

⁴ [1894] AC 535.

The House of Lords held in this timeless case that a contract in restraint of trade is enforceable if it is reasonable in the interests of the parties and the public. The court formulated the "test of reasonableness," which involves whether or not the restraint is necessary to protect an interest which is legitimate and is not contrary to public policy³.

United States

Enforceability in the United States of non-compete clauses and other restraints of trade varies from state to state. Every state allows reasonable restraints which are in a legitimate business interest, but a few states, including California, have Section 27-type laws which render most non-compete clauses void.

Other Jurisdictions

A few countries like Australia and Singapore have utilised a test of reasonableness, weighing up the public interest as well as the interests of the parties. This is more elastic and holds in today's commerce requirements.

Indian Law: The Rigid Approach

By contrast, Indian courts do not proceed to pose such an inquiry. The reasonableness of the restraint is not a consideration under Section 27. This deviation generally causes practical inconvenience to Indian businesses in a globalized economy where cross-border transactions and multinational employment contracts are common³⁵.

RATIONALE AND PUBLIC POLICY

Public Policy Considerations

The underlying policy basis for Section 27 is to stop the formation of monopolies and keep markets open to competition. The statute assumes that any restriction on trade is contrary to public policy, as it hinders individual liberty and economic opportunity. The goal is to balance the freedom of contract and the public interest generally in favour of encouraging competition and economic growth⁶.

Theoretical Underpinnings

The rationale of the strict standard under Section 27 is that there is a need for free competition to bring about economic growth and public interest. The legislation presumes that any restraint on trade is presumptively detrimental to the public because it restricts the ability of people to acquire a livelihood and lessens

consumer choice. This presumption holds true except in exceptional cases, i.e., sale of goodwill, when the restraint has to be made to protect the genuine interests of the buyer³⁶.

Practical Implications

Section 27 has significant implications for all types of commercial contracts in India:

1. Contracts of Employment

- *Non-competition Clauses*: Post-employment non-compete clauses are generally void, regardless of their reasonableness. This is a significant departure from a number of Western jurisdictions²⁶⁸.
- *Non-solicitation and Confidentiality*: Clauses that restrict employees from soliciting customers or disclosing confidential information while in the course of employment are generally enforceable. Post-employment restrictions under such clauses are analyzed and often declared invalid except when such restrictions protect trade secrets or proprietary information.

2. Sale of Business

Restraint agreements by the seller from competing with the buyer are only enforceable if they are not excessively long in time, nor overly wide geographically, and only needed to protect the buyer's interests in the goodwill acquired.

3. Commercial and Franchise Agreements

Such provisions can be declared void on the grounds that they unduly restrict trade beyond what is reasonably necessary to safeguard a valid business interest.

4. Partnership Agreements

The Partnership Act permits reasonable restrictions on retiring partners, but not Section 27 itself.

KEY JUDICIAL DECISIONS

Indian case law has consistently reaffirmed the strict construction of Section 27:

- *Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co. Ltd.*⁵: The Supreme Court distinguished

⁵ (1967) 2 SCR 378.

between post-employment restraints and restraints during employment (which can be allowable). The Court upheld negative covenants in effect during employment but ruled out post-termination non-compete agreement.

- *Gujarat Bottling Co. Ltd. v. Coca Cola Co.*⁶: The Supreme Court recognized that exclusive dealing arrangements are not per se in restraint of trade if they are ancillary to the main agreement and do not unjustifiably restrict competition.
- *Madhub Chander Poramanik v. Rajcoomar Doss*⁷: This was an early case in Calcutta's High Court that set the precedent that even a partial restraint is void under Section 27, following the precedent for judicial interpretation.
- *Superintendence Company of India (P) Ltd. v. Krishan Murgai*⁸: The Supreme Court held that post-employment non-compete clauses are not valid, even if they are reasonable, because Section 27 does not permit such exceptions.

MODERN CHALLENGES AND BUSINESS REALITIES

Challenges of Contemporary Commerce

The strict application of Section 27 presents numerous challenges in the current business context. It is difficult for Indian companies to protect their confidential data, trade secrets, and client relations through contractual ways. Non-solicitation and non-competition clauses, common in global business culture, become largely unenforceable in India after termination of employment.

This legal approach on occasion deters overseas investment and complicates mergers, acquisitions, and business transfers, where fair competition is most necessary. Companies have thus increasingly resorted to other instruments such as rigorous confidentiality agreements and intellectual property protection to secure their interests.

Impact on Start-ups and Innovation

India's start-up ecosystem has grown manifold over the past few years with a boost from innovation and entrepreneurship. However, the lack of enforcing non-compete agreements with former employees or co-founders leaves it possible to compromise confidential information and competitiveness. This has led to calls for reforming Section 27 to allow reasonable restraints safeguarding legitimate business interests without unnecessarily

⁶ 1995 SCC (5) 545.

⁷ (1874) 07 CAL CK 0003.

⁸ 1980 AIR 1717.

stifling competition or personal freedom.

Law Commission and Expert Opinions

The Law Commission of India and several expert committees have, at times, suggested amending the law to permit reasonable restraints, subject to judicial review. This reform would align Indian law with international best practice and offer more certainty and flexibility for businesses. Any amendment must, however, be carefully drafted so as not to be abused and to avoid undermining the fundamental principle of economic freedom.

INTERNATIONAL COMPARISONS

Comparison of Restraint of Trade Agreements Across Jurisdictions

- **India:** Under Section 27 of the Indian Contract Act, 1872, all agreements in restraint of trade are considered void, with the sole exception being an agreement related to the sale of goodwill. The concept of “reasonableness” is not taken into account in assessing the validity of such agreements.
- **United Kingdom:** Restraint of trade agreements are void unless they are reasonable in respect of both the contracting parties and the public interest. Courts assess reasonableness based on factors such as the duration of the restraint, the geographical scope, and the nature of the restricted activity.
- **United States:** The enforceability of restraint of trade agreements is subject to a “reasonableness test,” and varies by state. While states like California generally prohibit most non-compete clauses, others allow reasonable restrictions to protect legitimate business interests.
- **Australia and Singapore:** These jurisdictions also apply a reasonableness test, considering the agreement’s impact on both the contracting parties and the public. Enforceability depends on whether the restraint is justified and proportionate.

CONCLUSION

Moreover, Section 27 of the Indian Contract Act, 1872, is a distinctive and stringent response towards the topic of restraint of trade. Although it has been important in advancing economic liberty and checking monopolistic activity, its inflexibility is a major problem in the light of contemporary business. With ongoing economic integration in India, there is a need to revisit

the law and weigh up reforms that balance preserving individual freedom with giving scope for valid commercial concerns.

The controversy surrounding reform continues, the requirements of finding a precarious balance between upholding personal freedom and being sensitive towards valid business concerns. Until such legislative reform is done, Indian courts will keep interpreting Section 27 stringently so that contracts in restraint of trade continue to be largely unenforceable except for the limited exceptions acknowledged by law.

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