**VOID AGREEMENTS**

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**4. AGREEMENT IN RESTRAINT OF TRADE**

**Section 27 of the Indian Contract Act, 1872 : Agreements in Restraint of Trade**

Agreement in restraint of trade is void under Section 27 of the Act. That is, any agreement that debars one person from starting or continuing his trade or profession, in return for some consideration is void. Therefore, any agreement stopping a person from trading in the manner he likes or wherever he likes, on an agreement with other party, in which the other party benefits from him stopping his trade or profession, will be called an agreement in restraint of trade. Apart from two exceptions, which we will discuss below, all agreements in restraint of trade are void. The two exceptions lie in Sale of Goodwill and Partnership Act.

## ****Common Law****

The background for delegitimizing an agreement in restraint of trade lies in the history of conflict between free markets and the freedom of contracts. Ensuring freedom to the contract would mean legitimizing agreements in restraint of trade, which would result in parties agreeing to curb competition. Under the common law, the current position is derived from the case of- ***Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co Ltd[[1]](#footnote-1)***

In this case, Thorsten Nordenfelt was a manufacturer of guns in Sweden and England. Thorsten sold his business to a company, which then transferred the business to Maxim Nordenfelt. At this time, Thorsten entered into an agreement with Maxim that he would not engage in the manufacture of guns for 25 years, other than what he manufactures on behalf of the company. Later, Thorsten broke his vow claiming that the agreement was not enforceable as it was in restraint of trade. The decision of the court was in Thorsten’s favour.

In common law, a*test of reasonability* is followed. An agreement in restraint of trade is valid, if:

1. There is a valid interest that the party imposing the restraint is trying to protect.
2. The restraint is no more than that which is necessary to protect this interest.
3. Restraint is not contrary to public interest.

## ****Position in India****

Section 27 of the Indian Contract Act declares all agreements in restraint of trade, void *pro tanto*, with the only exception being Sale of Goodwill. Yet, it is important to understand that these agreements are *void,*not *illegal.*Which means, these agreements are not unlawful to make, they are just not enforceable in a court of law if either of the parties fails to perform his part of the agreement. Unlike the common law, even partial agreements in restraint of trade or reasonable restraint are not valid under the Contract Act.

### **Illustration**

Shalini has a business of office supplies and books in a locality in Bareilly. A person Zahida is planning to open her business of similar goods in the same locality. Fearing competition in the market, Shalini enters into an agreement with Zahida not to open her business in the area for 15 years, and as a consideration promises to pay a certain sum of money to her every month. Later, Shalini fails to pay the sum agreed upon. Zahida tries to take the matter in a court of law. The agreement being void, Zahida has no case.

### **Cases**

**Madhub Chunder v. Rajcoomar Dass[[2]](#footnote-2)**

In this case, the parties were businessmen in Calcutta. The defendant, Rajcoomar suffered loss due to the plaintiff’s competition and entered into an agreement with the plaintiff that if he closed his business there, he would pay him all the advances he had made to his workmen. When the defendant failed to pay, the plaintiff filed a suit to recover the amount but failed to do so because it was an agreement in restraint of trade, therefore not enforceable in a court of law.

***Superintendence Co. of India Pvt Ltd. v. Krishan Murgia[[3]](#footnote-3)***

In this case, the Supreme Court came to the conclusion that Sec 27expressly declares all agreements (apart from one exception) to be void and the section cannot be attributed two meanings. The test of reasonability as applicable in England cannot be applied in India.

### **EXCEPTIONS TO RESTRAINT OF TRADE**

Section 27 of the Act mentions only one exception validating restraint of trade, i.e., Sale of Goodwill. Another exception is found in the Partnership Act.

## ****Sale of Goodwill****

Goodwill is an intangible asset of a firm, that is, it exists, yet it is not material or physical. It essentially means the reputation or status of the firm in society. Goodwill has its origin in brand value, employee morale, reputation, customer advantage etc. It is an important asset because a customer is expected to engage with the same favorable firm, that he was engaged with earlier, because of its name and reputation. This why Goodwill of a firm holds a value.

Like other assets of the firm, the goodwill of the firm can also be sold. Once the goodwill of a firm is sold, the buyer acquires some rights:

1. He/she can use the firm’s name.
2. He/she can represent the firm.
3. He/she can restrain the seller of the goodwill from being in contact with the previous customers of the firm.

After a sale of goodwill, the seller continues to enjoy the right to carry out a competing business. But, in case,it is agreed upon through a contract that the seller will not enter into any such agreement, such rights extinguish.

### **Conditions that make restraint of trade valid**

There are certain conditions that make a restraint on trade during a sale of goodwill valid, these are:

1. The seller can be restrained only from carrying out a *similar*business.
2. The restraint can be applied only to certain *local limits.*
3. The limits/restraint should appear to be reasonable.

### Case

***Chandra v. Parshulla***

Here, the plaintiff was the owner of a fleet of buses that used to ply between Pune and Mahabaleshwar. The defendant also had a similar business in the same area. To avoid competition, the plaintiff bought the defendant’s business along with the goodwill, and by contract made him agree not to open a similar business in the area for 3 years. The defendant did not comply and started his business. It was held by the court that the agreement was valid, as it fell within the exception to S.27.

## ****Partnership Act****

Another exception to the rule of limitation on agreements in restraint of trade is provided under the Partnership Act, 1932. The Act lays down three exceptions. These are:

1. An agreement with a partner of the firm to not carry out his own business so long as he/she is a partner in the said firm will be valid under Sec 11(2) of the Partnership Act.
2. An agreement between partners to not engage in a similar business as that of the said firm within specified territorial and time limits (period of restraint). (Sec 36 (2))
3. In anticipation of dissolving the firm, the partners may come to an agreement in restraint of carrying out a similar business within specified territorial and time limits so long as this restraint is *reasonable.*

### **Case**

***Firm Daulat Ram vs. Firm Dharm Chand***

In this case, two similar business owners, in a partnership, came to an agreement that only one of their factories would work at a time and the profit will be shared between them. This restraint was held to be valid.

**5.AGREEMENT IN RESTRAINT OF LEGAL PROCEEDINGS**

**Section 28 in The Indian Contract Act, 1872**

28 Agreements in restraint of legal proceedings, void. —17

[Every agreement,—

(a)by which any party thereto is restricted absolutely from enforcing his rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals, or which limits the time within which he may thus enforce his rights; or

(b) which extinguishes the rights of any party thereto, or discharges any party thereto, from any liability, under or in respect of any contract on the expiry of a specified period so as to restrict any party from enforcing his rights, is void to that extent.]

Exception 1.— Saving of contract to refer to arbitration dispute that may arise. —This section shall not render illegal a contract, by which two or more persons agree that any dispute which may arise between them in respect of any subject or class of subjects shall be referred to arbitration, and that only the amount awarded in such arbitration shall be recoverable in respect of the dispute so referred.

Exception 2.— Saving of contract to refer questions that have already arisen. —Nor shall this section render illegal any contract in writing, by which two or more persons agree to refer to arbitration any question between them which has already arisen, or affect any provision of any law in force for the time being as to references to arbitration.

Illustrations:

(a) A, in Bombay, enters into a contract with B in Madras with a condition that all disputes will be subject to Bombay jurisdiction. This limits the right of B to sue only in Bombay Court in case of dispute. Such an agreement is valid.

(b) Where two courts have jurisdiction to try a suit and parties agree that the suit shall be filed only in one of these Courts, such a stipulation is valid.

(c) Agreements which do not limit the time for enforcing any rights, but only provide that failure to enforce them within the stipulated time shall operate as a release or forfeiture of such rights are binding between the parties.

According to the Indian Limitation Act, the time limit for bringing an action for breach of contract is 3 years from the date of breach. A clause restricting this right below the stipulated period is void. Therefore, if the clause states that no suit to recover under the life insurance policy shall be brought after one year from the death of the assured, such clause shall be void.

***Agreement in Restraint of Legal Proceedings***

Any agreement between the two parties that debars either or both of them from going to a court of law in case of non-compliance of the contract, is a void agreement. Sec 28 of the Indian Contract Act says that any agreement that restricts an aggrieved party from enforcing his rights to approach a relevant court or tribunal in case of a breach of contract, or limits the time within which he may do so, is a void agreement. It further says, any agreement that extinguishes the rights of any party or discharges either of the parties from liability is a void agreement.

In simple terms, all agreements are void, if:

1. They render it invalid, by agreement, for a party to approach a relevant court or tribunal if the parties rights have been violated.
2. Limit the time within which the aggrieved party can approach such a court or tribunal.
3. Make a party immune from liability by agreement.

## ****Exceptions****

There are two exceptions to Section 28, as mentioned in the Act. Agreements in restraint of legal proceedings are valid, if:

1. A future dispute or a past dispute is referred to arbitration. That is if there is an arbitration clause in the said agreement.
2. Agreements stating the limit of time as per the Limitation Act, 1963. For instance, as per the Limitation Act, 1963, a suit for breach of contract may be brought within the period of three years from the date of the breach.

### **Case**

***Food Corporation of India v. New India Assurance Co. Ltd***

In this case, the Supreme Court held that the terms of an agreement should not be so construed as to bar the other party from seeking the remedy of the suit.

**Restriction on Legal Proceedings** **:**

As stated above Section 28 renders every agreement in restraint of legal proceedings void. This is in furtherance of what we studied under the definition of a ‘contract’, namely, agreement plus enforceability at law is a contract. Thus if an agreement inter-alia provides that no party shall go to a court of law, in case of breach, there is no contract and the agreement is void ab-initio. In this connection, the following points must also be borne in mind:

(a) The Section applies only to rights arising from a contract. It does not apply to cases of civil or criminal wrongs or torts.

(b) This Section does not affect the law relating to arbitration e.g., if the parties agree to refer to arbitration any dispute which may arise between them under the contract, such a contract is valid (Exceptions 1 and 2, Section 28).

(c) The section does not affect an agreement whereby parties agree ‘not to file an appeal’ in a higher court. Thus where it was agreed that neither party shall appeal against the trial court’s decision, the agreement was held valid, for, section 28 applied only to absolute restriction on taking the legal proceedings, whereas here the restriction is only partial as the parties can go to court of law alright and the only restriction is that the losing party cannot file an appeal (Kedar Nath vs. Sita Ram).

(d) Lastly, this Section does not prevent the parties to a contract from selecting one of the two courts which are equally competent to try the suit. Thus in A. Milton & Co. vs. Ojha Automobile Engineering Company’s Case, there was an agreement which inter-alia provided – “Any litigation arising out of this agreement shall be settled in the High Court of Judicature at Calcutta, and in no other court whatsoever,” The defendants filed a suit in Agra whereas the plaintiff brought a suit in Calcutta. It was held that the agreement was binding between the parties and it was not open to the defendants to proceed with their suit in Agra.

1. [1894] AC 535  [↑](#footnote-ref-1)
2. (1874) 14 BLR 76. [↑](#footnote-ref-2)
3. AIR 1980 S.C. 1717 [↑](#footnote-ref-3)