

Unconscionability and the Clash Between Contractual Justice and Freedom of Contract in Malaysia

Mohd Faiz Abdullah* and Rozanah Ab. Rahman**

Malaysian courts apply conventional principles in determining cases involving contract law. They tend to emphasise the importance of form and procedure over substance and are inclined to enforce a contract as long as it satisfies the basic requirements of validity. The courts are averse to intervening, let alone declare an entire contract nugatory. The doctrine of unconscionability, though much in use in England and other common law jurisdictions appears retarded in Malaysia's jurisprudence, caught in the clash between contractual justice and freedom of contract. This paper argues in favour of the former and states the case as to why courts should administer justice, and just law.

JEL Codes: K12, K20

"I would remind you that extremism in the defence of liberty is no vice. And let me remind you also that moderation in the pursuit of justice is No virtue" – Barry Goldwater

1. Introduction

Civil courts in Malaysia apply conventional principles and standards in their determination of cases involving contract law. In ascertaining whether or not a contract or a contractual clause is valid, Malaysian courts tend to emphasise the importance of form and procedure over substance. Subject to a few exceptions, they are inclined to enforce a contract against a party as long as the documents are properly executed and the circumstances in which the contract was entered into satisfy the basic requirements of validity. These requirements according to the Contracts Act 1950 include offer and acceptance, consideration, intention to create legal relations and capacity. Subsumed under these is the overall requirement of consent. The factors that would vitiate consent and thus enable the court to intervene include coercion, undue influence, fraud and misrepresentation.

The decided cases indicate generally that the courts are averse to intervening, that is, to strike down a term considered to be invalid, let alone declare an entire contract nugatory (Nazura 2008). The rationale for this position is that because freedom of contract is an essential feature of all free societies, individuals must be allowed to contract according to their own terms and, subject to the general restrictions, courts should not interfere in this process.

The question arises: How does such a position impinge on contractual justice? Various common law jurisdictions have answered this with the

*Mohd Faiz Abdullah, Faiz & Co., Advocates and Solicitors, Kuala Lumpur, Malaysia, Email: mdfaizabdullah@yahoo.com

** Assoc. Prof. Dr. Rozanah Ab. Rahman, Faculty of Economics and Management Universiti Putra Malaysia, Email: rozanah@econ.upm.edu.my

Abdullah & Rahman

doctrine of unconscionability striking down contracts which would otherwise have been valid and enforceable. However, in the context of Malaysian contractual processes, it is contended that this principle takes a back seat or if indeed it has taken the pilot's seat, it has not been able to take off. We contend that the concept of contractual justice that could challenge the bedrock upon which parties' freedom of contract lies has received scant attention by both academics and judges alike. In fact, none of the cases related to contractual transactions has specifically mentioned the general notion of contractual fairness (Shaik 2002). Consequently, it plays a minimal role, if any, in the judicial deliberation on the validity of a contract.

On the other hand, other common law countries have taken a different approach. Contractual validity is no longer tied to the traditional principles associated with freedom of contract and outward indicia of consent but now depends on a host of other principles including the principles of good faith, *caveat venditor*, *culpa in contrahendo*, and equity and good conscience. Equity and good conscience has evolved into the generic doctrine of unconscionability which forms the core of our present discourse. A survey of Malaysian cases reveal next to nothing which approaches these concepts with the exception of a landmark Court of Appeal decision.¹

1.1 The Statement of the Problem

In the adjudication of contractual cases, Malaysian courts are handicapped by a narrow approach to the doctrine of contractual justice and unless and until they break free from this fetter, little progress will be made to enable our system to keep abreast with the progressive developments in other jurisdictions. Should the court take a more holistic view of the concept of fairness in a contract? Should it not free itself from the fetters of the freedom of contract doctrine in determining a contract's validity?

1.2 Purpose and Significance of the Study

The primary motivation of this study is founded on the need to fill in the paucity in the existing body of knowledge in the field of contractual justice in Malaysia. It is envisaged that the conclusions drawn may provide the basis for advocating legislative changes in the field with a view of making the progress intended.

2. Literature Review

Though studies have been conducted on the subject of contractual justice in other jurisdictions in general, none has been specifically done in respect of Malaysia, let alone one that is exclusively focussed on contractual justice on a comparative perspective between Malaysia and the said jurisdictions. The doctrine of contractual justice in the Malaysian and Southeast Asian context is generally explored in the inaugural lecture of the late Professor Shaik Alam (Shaik 2002) which gives a bird's eye-view treatment of the subject and an incisive analysis of procedural and substantive justice but does not go into the details of freedom of contract or its countervailing influence on the courts in Malaysia. Another study which would have some bearing on the current intended study is an unpublished thesis which deals with the subject of unconscionability in contracts but the study is confined to the area of franchise agreements in Malaysia. It is neither an exhaustive study on the issues

Abdullah & Rahman

of contractual justice nor a comparative study of two different jurisdictions (Zahira 2007).

There have been calls for the Malaysian regulatory authorities to take steps to intervene in certain aspects pertaining to business practices in franchising and agency through legislation so as to counter unconscionable conduct and unethical business dealings (Zahira and Shaik 2009). Posner on the other hand argues that the provision of welfare in a free market produces perverse incentives to take excessive credit risks or what is in the language of the International Monetary Fund, moral hazard. Laws against unconscionable contracts are therefore necessary to deter this socially costly behaviour (Posner 1995).

Michael Rosenfeld postulates on the traditional clash between the two doctrines - classical contract law and social contract theory and takes the view that the nexus between contract and justice is essential in deliberating private contracts entered into between individuals. Lending credence to our view, he argues that contractual disputes centre not merely on form but on the issue of justice either explicitly or implicitly (Rosenfeld 1985).

Since the publication of Atiyah's classic treatise on freedom of contract, much water has flowed under the doctrine's bridge though its jurisprudential underpinnings and historical overview remain very much relevant (Atiyah 1980). A landmark comparative study on good faith and freedom of contract written more than five decades ago is still particularly instructive for common law jurisdictions and could be an invaluable source for Malaysian courts (Kessler and Fine 1964) while the debate on substantive versus procedural justice is well covered in Braucher's exposition on the regulatory role of contract law and how it impinges on the issue of consent (1990, p.697). Braucher contends that when an adjudicating body attempts to divine the element, crucial as it may be, it is tantamount to an act of legal control. Nevertheless, we are of the view that this argument taken to its logical conclusion would extend to all other vitiating factors.

3. Research Methodology

In terms of the philosophical framework, the position taken may be categorized as that of a participatory worldview with an agenda advocating reform. This paper is therefore intended as a starting point to ignite the discourse on influencing the judicial approach and jurisprudential doctrine in respect of contractual issues in the country, the specific question being the notion of contractual justice.

4. Discussion

In England as well as other common law jurisdictions such as Australia, Canada and even India, the party seeking to set aside a term of a contract or the entire contract itself on the ground of unconscionability is first required to prove a flaw in the bargaining process, and then, prove that the term under attack is unfair (Nazura 2008). Once that is established, the court can decide whether or not the contract is bad on account of such unconscionability and if it decides that it is, then it may set aside a term or even an entire contract. In Malaysia, such a situation appears to be the exception rather than the rule. In any event, the unconscionability principle here is generally regarded to be at its early development (Zahira and Shaik 2008).

Abdullah & Rahman

A party seeking rescission has to prove the existence of a substantive element such as unfair surprise or the imposition of a term on a party who has no choice in the matter. This comes under the doctrine of duress but it is for the party claiming it to prove it. The case law indicates that the plea of duress seldom succeeds on account of the high standard of proof imposed by the court.

There was an attempt at taking a tentative bite at the doctrine by the High Court following English equity principles. Thus, on the question of the validity of a lease, the court said that the party who wishes to free himself from the obligations of a contract “must show that the bargain or some of its terms was unfair and unconscionable.” It must be shown “that one of the parties to it has imposed an objectionable term in a morally reprehensible manner, that is to say, in a way which affects his conscience or has procured the bargain by some unfair means.”ⁱⁱ

In *Saad Marwi*, the locus classicus on the issue in Malaysia, the Court of Appeal had occasion to take a more catholic view of this doctrine its views eminently articulated by Gopal Sri Ram JCA. The English position as generally adopted in Australian and New Zealand jurisdictions as well, is that the courts would only interfere in exceptional cases where as a matter of common fairness it was not right that the strong should be allowed to push the weak to the wall.ⁱⁱⁱ Unconscionable bargains do indeed vitiate consent and hence invalidate a contract but a transaction will be unconscientious only if the party seeking to enforce the transaction has taken unfair advantage of his superior bargaining power, or of the position of disadvantage in which the other party was placed.^{iv}

A contract may be unfair because of the unfair manner in which it was brought into existence, or because the terms of the contract are more favourable to one party, the former being known as ‘procedural unfairness’ and the latter as ‘contractual imbalance’. This imbalance may be so extreme as to raise a presumption of ‘victimization,’ and hence unconscionable dealing, in which case equity will step in to free the party from being bound.^v However, Canadian courts appear to have moved beyond the constraints and adopted a more general doctrine of unconscionability. A person who is not equal to protecting himself will be protected against his being taken advantage of by those in a commanding and superior bargaining position.

The preceding overview was critically laid out and analyzed by Sri Ram JCA who expressed the view that Malaysian courts should recognise the wider doctrine of inequality of bargaining power and should go beyond the constraints of the English position and the Specific Relief Act. His lordship said that on account of the inadequacy of statutory protection, the vast majority of the population would be vulnerable to sharp practice in the hands of unscrupulous businessmen unless the courts take a flexible approach aimed at doing justice according to the particular facts of a case. The most just solution would be to adopt the English doctrine but apply it in a broad and liberal way as in Canada. This will achieve practical justice within a framework of principle. Most unfortunately, these pronouncements have not only fallen on deaf ears but appear to have been disputed for shortly after *Saad Marwi*, the Court of Appeal comprising a different of coram, declined to follow the decision and said to the effect that such a doctrine has no definitive place in our jurisprudence, placing freedom of contract at the forefront instead.^{vi}

4.1 Free Market v. Legislative/Judicial Intervention

We have proceeded on the discussion on the assumption that the two concepts – contractual justice and freedom of contract – are given doctrines with clearly defined semantic and jurisprudential boundaries. It is now necessary to clear the deck. “Contractual justice” as a term may be quite meaningless if by its reference we hope that it will tell us the meaning of justice itself. The fact that since time immemorial philosophers and jurists have cogitated on the subject and still have not found the Holy Grail is indeed testimony to the concept’s amorphous nature. As a starting point, let us agree the term refers to justice pertaining to contracts in as much as say criminal justice would relate to crimes, constitutional to the constitution and so on.

As for the meaning of justice itself, without getting too embroiled in the philosophical underpinnings of the discourse, we predicate our understanding of the term on the notion of justice as expounded by John Rawls in his magnum opus (Rawls 1971) which has since been reformulated in *Political Liberalism* (Rawls 2005). According to Rawls, an integral element of justice is fairness, which in turn is predicated upon three key prerequisites, summarised as follows: Firstly, liberty is paramount and constraints on basic freedoms are anathema; secondly, everyone is entitled to the fundamental freedoms of social life and the distribution of all forms of social goods; and thirdly, inequalities of opportunity on account of birth or wealth must be eliminated. It is clear that the Rawlsian justice-as-fairness doctrine has its core in distributive justice and this is seen as being conjoined in a remote way to the Hobbesian classical social contract doctrine the umbilical cord being “the original position” characteristic of contractarian advocates. But this is misconceived because while traditional contractarians were apologists for state power, Rawls being a full blooded liberal, if not altogether libertarian, makes no attempt at justifying such political legitimacy.

As for freedom of contract, if the Rawlsian yardstick for contractual justice is used, it would appear at the outset that the two are diametrically opposed. A commitment to the latter would shift the focus on validity not to just conventional principles as crystallized from common law and equity but to the dynamics arising from distribution of economic power. We can see this in the formulation of principles of inequality of bargaining power between the contracting parties either separately or conjointly giving rise to the doctrine of unconscionability. At the micro level, we may regard this as a function of the inequities in income distribution while from a broader perspective, they are essentially externalities generated by market forces. Viewed in this light, contractual justice is then about the intervention of the legislature and where it fails, the encroachment by the judicial system in the distribution of economic resources in society as a whole. Different legal jurisdictions have evolved different ways of dealing with these externalities which may be regarded as striking at the core of their economic systems. The upshot is the centripetal tension between the demands of contractual justice and the expectations arising legitimately from the freedom to contract.

Both sides of the divide have compelling arguments. Contractual freedom advocates fall back on the bargain principle which presupposes that the parties have entered into a contract on a willing buyer and willing seller basis. Both parties have agreed on the price or the consideration of the subject matter. No one may be compelled to

Abdullah & Rahman

enter into a contract if the consideration or the terms are unacceptable but once entered, there is a presumption that it is done so of one's free will, and one must be held to one's bargain. The rationale is that contractual freedom engenders sanctity of contract which may not be violated by some subjective notion of contractual justice.

Proponents of contractual justice are quick to reply that reality bites hard as the bargain principle is a mere fiction in many situations and that the presupposition of a willing buyer-willing seller scenario flies in the face of economic or commercial reality. Is there anything equal in the bargaining position between a public corporation with a market capitalization of \$500 million and a private entity with a paid-up capital of \$500,000, or between a bank and an individual borrower or a rich man and a pauper? Under these circumstances, the notion of sanctity of contract flies out the window of contractual freedom.

Hence, it is argued that inequality of bargaining position is the rule rather than the exception. This begs the question from the other side: Does this automatically justify the courts to render otherwise valid contracts into voidable transactions? Should judicial intervention be allowed to assail the foundation of contracts on account of agreements arbitrarily deemed to have been entered from unequal bargaining positions? Surely, they contend, this would not just strike at the core of commercial dealings but tears apart the *raison d'être* of contract law itself. The riposte is equally compelling: if contract law is to serve society, then the demands of societal welfare must warrant a departure from the formalistic constraints of the law. Limits must be set on contractual freedom because "unlimited freedom of contract, like unlimited freedom in other directions, does not necessarily lead to public or individual welfare" (Williston 1921).

On the other hand, in the United States, it is said that the courts will not permit themselves to be used as instruments of inequity and injustice. The courts will not enforce transactions in which the relative positions of the parties are such that one has unconscionably taken advantage of the necessities of the other. Fraud and physical duress are not the only grounds upon which courts refuse to enforce contracts. The law is not so primitive that it sanctions every injustice except brute force and downright fraud. More specifically, the courts generally refuse to lend themselves to the enforcement of a 'bargain' in which one party has unjustly taken advantage of the economic necessities of the other.^{vii}

5. Conclusion

The major and significant legislation pertaining to contract law as well as judicial decisions in Malaysia indicate preponderance towards non-interference of freedom of contract even as similar jurisdictions appear to have moved ahead.

The key issues arising from the absence or lack of commitment to contractual justice centre on the failure to move with the times and a general apathy in the articulation of jurisprudential doctrine in contractual disputes. *Saad Marwi* and the progressive perspectives expressed by Gopal Sri Ram JCA unfortunately have been disregarded by an appellate court of equivalent jurisdiction leaving the lower courts free to go one way or the other when faced with a similar issue. Unfortunately, at least from the view point of pro-contractual justice advocates, there has been no decision by the courts since that could give occasion to believe that *Saad Marwi* has gained any traction.

Abdullah & Rahman

The doctrine of unconscionability therefore remains a mirage in the Malaysian judicial landscape apparent only to academics and contractual justice minded judges who are few and far between.

Nevertheless, the silver lining in this gloom rests upon the fact that the areas of divergence between the Malaysian and selected common law jurisdictions in the adjudication of contractual cases are not cast in stone. Judges could do well to be reminded that courts of law are established not for the administration of law but of justice; indeed in the words of Earl Warren, "It is the spirit and not the form of law that keeps justice alive."

6. Limitation

This study is limited by the constraints of space and must be taken as a preliminary exposition on the subject.

Endnotes

ⁱ *Saad Marwi v. H.H.Chan* [2001] 2 AMR 2010.

ⁱⁱ *Fui Lion Credit & Leasing Sdn Bhd v Kim Leong Timber Sdn Bhd* [1991] 1 CLJ 522.

ⁱⁱⁱ Lord Denning MR in *Lloyds' Bank Ltd v Bundy* [1974] 3 All ER 757 at 763; [1975] QB 326 at 336.

^{iv} *Commercial Bank of Australia Ltd v Amadio* (1983) 152 CLR 447.

^v *New Zealand Hart v O'Connor* [1985] AC 1000.

^{vi} *American International Assurance Co Ltd v Koh Yen Bee (f)* [2002] 2 MLJ 301.

^{vii} Frankfurter J, in *U.S. v Bethlehem Steel Corp* (1942) 315 US 289.

References

Atiyah, PS 1980, *The Rise and Fall of Freedom of Contract*, Oxford Clarendon Press, Oxford.

Braucher, J 1990, 'Contract Versus Contractarianism: The Regulatory Role of Contract Law', *Washington & Lee Law Review*, vol. 47, pp. 697.

Kessler, F and Fine, E 1964, 'Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study', *Harvard Law Review*, vol. 77, issue. 3, pp.1-50.

Nazura, AM 2008, 'Enforceability of Database Licensing Agreement: A Comparative Study between Malaysia and the United States of America', *Journal of Politics and Law*, vol. 1, no. 3. pp. 102-117.

Posner, E A 1995, 'Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws and the Related Limitations on the Freedom to Contract', *The Journal of Legal Studies*, vol. 24, no. 2, pp. 283-319.

Rawls, J 1971, *A Theory of Justice*, Harvard University Press, Massachusetts.

Rawls, J 2005, *Political Liberalism*, Columbia University Press, New York.

Shaik, A. H. 2002, *Contractual Justice in Asean: A Comparative View of Coercion*, Inaugural Lecture, Universiti Putra Malaysia Repository.

Rosenfeld, M 1985, 'Contract and Justice: The Relation between Classical Contract Law and Social Contract Theory', *Iowa Law Review*, vol. 70, pp. 769-868.

Williston, S 1921, 'Freedom of Contract', *Cornell Law Quarterly*, vol. 6, pp. 365-374.

- Zahira, MI 2007, 'Unconscionability in the law and practice of franchising', PhD thesis, Graduate School of Management, Universiti Putra Malaysia, Serdang
- Zahira, MI and Shaik, AH, 2009 'Unconscionability – Statutory Prevention of Unethical Business Practices', *International Journal of Economics and Management*, vol. 3, no. 1, pp. 151-169.