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# Good Faith In The Creation Of A Contract: Analysis Of The *Lai Fee* Case

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As is common in most commercial transactions, each contracting party will inherently assume the honesty and good faith of the counterparty prior to the formation of a contractual agreement. Absent such assumptions, parties would simply not deal. What happens then if parties execute the contract only to discover that the assumption was wrong?

In the UK Supreme Court case of *Takhar v Gracefield Developments Ltd* and others [2019] 3 All ER 283, it was held that "*the law does not expect people to arrange their affairs on the basis that other people may commit fraud*". This principle was recently applied by the Federal Court in *Lai Fee & Anor v Wong Yu Vee & Ors* [2023] 3 MLJ 503 concerning a contract for sale of shares in a company.

## Brief Facts

The appellants (i.e. Lai Fee and another person) were owners of a partnership with timber logging rights. They agreed to sell their partnership to the respondents for RM 7 million. To facilitate the transaction, the respondents used a dormant company in which they were directors (Company A), to sign the sale and purchase agreement (SPA). Upon signing of the SPA, the appellants transferred their interest in their partnership to the respondents, who then became the new owners of the partnership. The respondents made part-payments of the purchase price via a third company but the full sum was unpaid. The appellants then applied to the High Court for a declaration that the respondents had carried on the business of Company A with intent to defraud the appellants and that the respondents should be held personally liable to pay the remaining unpaid purchase price owed by Company A pursuant to Section 540 of the Companies Act 2016.

However, this claim was dismissed by the High Court and also the Court of Appeal. Dissatisfied, the appellants appealed to the Federal Court, where their appeal was unanimously allowed.

## The Federal Court Ruling

The Federal Court highlighted 4 unusual facts in relation to the transaction between parties:

(1) Company A was a company with no assets, no funds and no business activities, hence, there was no prospect of the company paying the purchase price.

(2) Payment was made by a third company which was not a party to the SPA and had no contractual obligations with the appellants.

(3) The partnership was transferred to the respondents, despite Company A being the designated buyer under the SPA.

(4) The SPA provides for the immediate transfer of the partnership upon execution of the SPA, even prior to the payment of the full purchase price.

Considering the peculiar set of facts, the Federal Court found that:

(1) The respondents had orchestrated a scheme to insulate themselves against any personal liability for the purchase of the partnership.

(2) The appellants had been induced to agree to the immediate transfer of the partnership to the respondents on the representation that the purchase price would be paid by Company A in the future.

(3) The use of Company A and the third was intended to create corporate layers to obfuscate the respondents from the transaction.

This led the Federal Court to rule that the respondents acted dishonestly. There was sufficient evidence of the intention of the respondents to defraud the appellants. As such, the respondents as directors of Company A were held liable to pay the appellants the balance purchase price.

## Analysis

The law governing all contracts in Malaysia is the Contracts Act 1950 (Contracts Act). As highlighted by the Federal Court in the *Lai Fee* case, the Contracts Act starts on the assumption that all contracts are valid. If it is proven that the consent of parties to enter into the contract was procured by coercion, undue influence, fraud or misrepresentation, the contract becomes voidable at the option of the innocent party. In essence, the Malaysian position is that contracts are valid unless proven otherwise.

Given the fact the Contracts Act is grounded on this fundamental principle, it follows that parties to a contract are not expected to arrange their affairs on the basis that counterparties may commit fraud against them. It is for this reason that the Federal Court held that the appellants could not be faulted for failing to anticipate the respondents' fraudulent intentions even if they were aware that Company A was incapable of paying the purchase price.

At first glance, the decision in the *Lai Fee* case may seem to expand the application of the doctrine of good faith within the Malaysian jurisprudence (i.e. the duty to act honestly). However, the Federal Court has drawn a distinction between "the duty of good faith in contractual performance" and "the duty of good faith in the creation of a contract", carefully limiting its application of the doctrine to the context of "creation of contracts". In this regard, the basic rule that there is no general implied duty of good faith in commercial contracts remains.

In a nutshell, the law operates on the assumption that parties engaged in contractual negotiations will conduct themselves on the expectation of honesty, good faith and fair dealing. Nonetheless, it is imperative for contractual parties to exercise due diligence prior to entering to an agreement and to ensure that contracting parties are able to adhere to the terms and conditions of the contract.

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