EARNEST, DEPOSITS AND PENALTIES*

JOE BRINCAT

MOST preliminary agreements of sale of immovables contain a clause which makes provision for the case in which either party resiles from the obligation. It is necessary that the juridical nature and effects of such clauses should be examined, as they have already caused conflicts in interpretation. The Civil Code deals with earnest and with penalty clauses, but does not cover deposits currently paid on such agreements.

EARNEST

The Maltese Civil Code considers earnest in relation to promises of sale. Section 1409 states that where in any promise to sell, earnest has been given, each of the parties shall be at liberty to recede from the contract, the party giving the earnest forfeiting such earnest, and the party receiving the earnest returning double the amount thereof, saving any other usage in regard to the particular contract in respect of which earnest has been given.

In the opinion of James Mackintosh[1] this institute owes its origin to the Phoenicians, a commercial and maritime nation, whose subjects dispersed and settled over the whole Mediterranean basin, carrying with them this custom, and accidentally the name, to Greece and Italy. As a confirmation of the conclusion of a bargain, a sum of money or a valuable thing was given by one of the parties, generally the buyer, and as we read in the Digest, this often took the form of a ring.[2] Gaius says, 'Quod saepe arrae nomine preemptione datur, non eo pertinet, quasi sine arra conventio nihil proficiat, sed *ut evidentius probari* possit convenisse de pretio.' The texts emphasise that the giving of earnest was meant to prove the conclusion of the contract in a more tangible manner, not that this was required for the completion of the agreement.

During the classical period, earnest was a common accompaniment of the contract, and the idea of forfeiting the 'arra' to be re-

*This paper is taken from the LL.D. thesis presented by the writer.

[1] Mackintosh – The Roman Law of Sale, p.68.

[2] Digest 14.3.5, 15.

leased from the obligations was still unknown. It was also distinct from part-payment of the price, when the execution of the contract was postponed, although if money was given as earnest, it could be imputed to the price.[3] The buyer forfeited it to the seller if he availed himself of the 'lex commissoria'. This type of earnest called 'arra confirmatoria' was the only form recognised in the Pandects.

Justinian, while leaving the practice of 'arra confirmatoria' untouched, created another form in later legislation. In the Codex[4] we read: 'Illud etiam adicientes, ut et in posterum, si quae arrae super facienda emptione cuiuscumque rei datae sunt sive in scriptis sive sine scriptis, licet non sit specialiter adiectum, quid super isdem arris non procedente contractu fieri oporteat, tamen et qui vendere pollicitus est venditionem recusans in duplum eas reddere cogatur, et qui emere pactus est, ab emptione recedens datis a se arris cadat, repetitione earum deneganda.' Two views prevail regarding the interpretation of this passage. One opinion holds that this passage contemplates a sale in the making, and therefore the earnest referred to is the same as given in promises of sale under modern codes, the forfeiture of which gives the right to resile from the contract. The other opinion, referring to the passage of the Institutes quoted in Chapter One which reproduces with some variations the extract from the Codex, holds that the earnest refers to completed sales and that the forfeiture of the arra was meant to limit the damages for non-fulfilment of the obligation to that amount, or that this was an additional penalty on that which was due by way of damages.

Professor Jolowicz[5] states, 'In the classical law arra served purely evidentiary purposes; but as ... in Greek law, where the rule of consensual sale is not so fully developed as at Rome, its object was the much more important one of serving as a forfeit in case the giver (normally the buyer) failed to fulfil his contract, while the recipient, if he failed, had to restore the arra and as much again. The arra could thus be said to have a 'penitential' function i.e. either party could withdraw from the bargain, provided he was willing to lose the amount of arra. This penitential function Justinian tried to fuse with the Roman evidentiary function when he enacted what is precisely the common Greek rule that on failure

[3] ibid. 18.3.6, 2; ib. 8.
[4] Codex 4.21.17.2.
[5] Jolowicz – Historical Introduction to Roman Law, p. 525.
[6] Pothier – Opere Part VI ch. I, para. 498 et seq.

to fulfil the sale, the giver forfeits the arra and the recipient restores twice the amount.'

Pothier[6] opines that there are two types of earnest, that which is given on conclusion of the contract of sale, and that which is given at the time when a future contract is agreed to. The 'arra poenitentialis' is considered by him as a separate contract, with its particular physiognomy, which need not be stated in express terms, for as soon as one of the parties gives a thing to the other, the agreement as to earnest is concluded. This is a 'real' contract, because it postulates the delivery of the thing, of which the receiver becomes the owner, if and when the party giving it fails to conclude the sale. The receiver of earnest, if he resiles from the preliminary agreement, is bound to return double, or the thing and its value. In case the contract is no longer possible due to supervening causes, which are not imputable to either party, the receiver is bound only to restore the thing. If the sale is concluded, the party receiving is bound to return the thing, but if this is a sum of money, he should impute it to the price.

Regarding earnest which is given on conclusion of the contract, Pothier considers that these are given on account of the price and should be imputed to it. In cases of doubt whether the earnest has been given as proof of conclusion of the sale or of the projected sale, one should look to all attendant circumstances.

Earnest seems to be a legal multi-headed hydra, especially in modern legal doctrine. In Farrugia vs. Fenech[7] the Commercial Court stated that, in legal terminology, the word 'earnest' has different meanings, and distinguished the three cases of earnest given in promises of sale, in concluded sales, and as instalments of the purchase price. Clauses in promises of sale have evolved which create other shades of meaning, and one may meet with such expressions as 'earnest/deposit'.

In the above-quoted judgment, the Court of Appeal stated that the particular character of the agreement regarding earnest often resolves itself in an enquiry into the intention of the contracting parties. The Court of Appeal also found itself in difficulties to define a similar agreement in 'John Grima vs A.I.C. Arthur Cutugno et.'[8] The Commercial Hall excluded the possibility of a particular agreement being considered as earnest, and the Court of Appeal, disagreeing with the first judgment stated that *'it resembles in*

[7] Vol. XL, I, p. 515.
[8] Court of Appeal: 22.3.68.

some features an agreement regarding earnest'. The rather undefined locution of the Court of Appeal shows that this particular institute of law very often baffles pigeon-hole classification.

PENITENTIAL EARNEST

There can be no doubt that our Civil Code legislates on penitential earnest, and that the most important feature of Section 1409 is that it gives the parties the right to resile from the agreement, without being bound to the specific performance of the contract or damages and interests. Taken in this aspect, it represents damages assessed in anticipation. But this subsidiary aspect should not be allowed to predominate over the principal feature, that is the right to recede.

It, therefore, follows that the intention of the parties to grant each other the right to resile should be beyond doubt. If the agreement on the payment of a sum of money expressly or impliedly excludes the intention of allowing either party the power to recede, the payment cannot be considered as earnest. Furthermore, this right should be given to both parties, as from the wording of the law it appears clear that earnest operates bilaterally.

The question arises whether earnest should be stipulated in the written instrument, in promises of sale of immovables. The solution seems to depend on whether we consider earnest as a totally accessory or totally independent agreement. The Civil Code[9] lays down that such promises must be expressed on pain of nullity in a written instrument, and therefore if earnest is considered as a totally accessory agreement, it must also be expressed in writing, on the general principle of law 'accessorium sequitur principale'. In George Farrugia vs Alfred Vella[10] the plea was raised that the agreement about earnest was null as there was no written promise, and it was held that, 'a promise of this genre without a written instrument is null. Whereas earnest is an accessory obligation, and has no life or meaning except in relation to the principal obligation, it is evident in this case – where both parties agree that there was no written promise – that the stipulation regarding the earnest is null ... The argument brought forward by counsel for defendant, that the agreement regarding earnest should be considered independent from the promise, appears to be wholly unfounded.'

[9] Section 1277 (1)(a).
[10] First Hall 21.7.67.

A distinction should be made in this respect. If there is no written promise, then there can be no principal obligation from which to recede, and the giving of earnest is, therefore, to no effect. But if there is a written promise, and earnest has been agreed to verbally and actually given, the same reasoning, it is submitted, should not apply. Earnest is a 'real contract' consisting in the delivery of the thing. The written instrument is not necessary to cover such an agreement, and once the original obligation is valid, there can be no doubt that a 'real contract' regarding that obligation should be valid. The principle, 'accessorium sequitur principale', is not applicable to such a case, as the 'accessorium' is a real contract, while the 'principale' is a consensual contract.

The wording of Section 1409 seems to imply that the right to resile is invariably the consequence of the payment of any sum of money on the conclusion of the promise. This cannot be the rule, if the intention of the parties does not support it, in each particular case. As was stated in Alfonso Zammit vs. Antonio P. Abela[11] the intention of the parties must be examined specifically on the point whether the parties intended to grant each other the right to recede. In John Micallef vs. Giulia Briffa[12] the payment of a sum of money was declared to be an incentive to conclude the contract, rather than subject to forfeiture or payment of double the amount, as would be the case under Section 1409. The examination of the intention of the parties is the starting point in the enquiry of the juridical nature and effects of such payments.

DEPOSITS

This nomenclature has made its appearance recently, perhaps for the benefit of foreigners buying real property, who are not familiar with the institute of earnest. But the particular features which it has assumed have raised already important legal discussions, including two rather conflicting judgments as to their true juridical nature.

In Chetcuti vs. Thurston[13] the juridical nature of these deposits was examined in a very elaborate judgment. The facts of the case were as follows: the purchaser, on signing the preliminary agreement deposited the sum of three hundred pounds with a third party,

[11] Vol. XXI, I, p. 569.
[12] Vol. XL, I, p. 187.
[13] First Hall, 'in parte' 10.10.67. The case was ceded on the 14th March, 1968.

which was to be handed over to the prospective vendor, if he refused to appear on the deed of sale without a reason valid according to law. In the writ of summons the vendor asked for payment of the deposit, as the sale was not effected due to the unwillingness of the purchaser, which deposit was qualified as being 'earnest-money', though the nomenclature was not used in the preliminary agreement. The defendant purchaser pleaded that the 'causa petendi' was erroneous as the deposit could in no way be considered as earnest as this was a penalty clause. On the grounds that 'earnest' or 'arra' can have more than one meaning, the Civil Court held that the plaintiff was fully entitled to use the term 'Kapparra' (earnest) to give a 'nomen iuris' to this deposit, which term was then to attract its particular shade during the hearing of the case. The Court could in no way doubt that the plaintiff was certainly referring to the 'arra poenitentialis'.

'The essential difference', Caruana Curran J. said, 'between "arra poenitentialis" and a penalty clause is to be found in the fact that in the former there is *an anticipated or actual delivery* of the sum of money, while in the penalty clause there is *only a promise*.' Earnest implies immediate forfeiture, while a penalty clause postulates a future demand for the payment of the penalty.

In Dr. Remigio Zammit Pace vs. Joseph M. Galea, L.P.[14] the decision is diametrically opposed to Chetcuti vs. Thurston. A deposit of £M1260, ten per cent of the purchase price, was made on the signing of the preliminary agreement on account of the price, which amount the buyers were to forfeit in favour of the vendors in case they failed to appear on the deed of sale. The Court argued that, 'if the money was paid by way of earnest, this would have been expressly stated, as earnest has a *bilateral effect*, since according to Section 1409 its recipient has to refund twice the amount. Therefore, the plaintiff is right in asserting that this is only a penalty clause, and according to Section 1163(2) has the option to demand the execution of the contract.'

Such deposits are made by the consent of the parties, and as such they are free to regulate their internal relations, within the limits of the law. Some deposits are specifically contracted as being subject to forfeiture in favour of the vendor, if the purchaser recedes without being legally justified. The question to be answered is whether such deposits, without any express stipulation

[14] First Hall 26.6.69. An Appeal has been lodged.

as to their nature, are to be considered as earnest-money or not. 'Dr. Remigio Zammit Pace vs. Joseph Galea' makes it imperative that there should be an express agreement about earnest, and if the parties do not state that this is earnest money, then the rules of Section 1409 are not applicable.

That the intention of the parties should be clear is not challenged, but that it should be expressed by a particular 'nomen iuris' is not required, as it is rightly stated in Chetcuti vs. Thurston, especially in promises of sale of immovables which require simply a private writing, without the attendance of any legally qualified person.

Giorgi[15] distinguished three types of arra, and it is submitted that his classification solves the question regarding the juridical nature of deposits. He considers that 'arra' may be:

(a) Purely confirmatory, given as a symbolic proof of the conclusion of the contract (arra in signum consensus interpositi data), generally an object of small value;

(b) Penally confirmatory, given as an anticipated liquidation of damages, and has all the characteristics of a penalty clause, with the difference that it consists in the actual delivery of the earnest money rather than in a promise of future payment;

(c) Penitential, which gives the right to either party to resile.

Although the distinction between the first and the other two types is not difficult, he says, the boundary between penally confirmatory earnest and penitential earnest is not easy to trace. The penitential earnest is given on the understanding that either party may resile on forfeiting the earnest-money or on paying double the amount. The penally confirmatory type is a guarantee of the future payment of damages, in case of non-fulfilment. The party, still faithful to the obligation, may either ask for the forced execution of the contract, or retain the money, or ask for double the amount, if he had paid it.[16]

There is no doubt that Section 1409 deals with 'arra poenitentialis', as the law specifically lays down that it grants to either party the right to recede from the agreement. Studied in conjunction with Section 1407(1), earnest neutralises the rights to specific performance or to damages and interests, and when it is given, these remedies are not available to either side in a bilateral promise.

[15] Giorgi – Op. cit. Vol. IV, para. 466.

[16] Giorgi – op. cit. para. 469.

The insistence on the fact that penitential earnest affects bilateral promises is important. Although our legislator has considered the unilateral promise in Section 1407,[17] when dealing with the question of earnest, it cannot be doubted that the bilateral promise was held in view. This is supported by the consideration that our section faithfully reproduces the French provision.[18] Furthermore, as the right to resile is given to both contracting parties, the natural corollary is that the penitential earnest is possible only in bilateral promises. This is also the conclusion reached in Zammit Pace vs. Galea.

If earnest, in the sense just explained, is given, the non-guilty party has no alternative. The sum given in earnest is the measure of liability of the defaulting party, and twice the amount if he is the recipient.

A bilateral promise, it has been argued, can be resolved into two unilateral promises, and the obligations assumed by one party may not have corresponding obligations. In bilateral promises, either party may assume additional obligations, unless they are prohibited by law. Much depends on the bargaining powers of the parties, and the ability to heap duties on and to extract benefits from the other side.

The deposits which are currently being demanded on bilateral promises of sale of immovable property are essentially *unilateral*, binding the purchaser, in favour of the vendor, without a corresponding obligation on his part. The locution adopted, 'the *purchaser shall forfeit* ...' clearly implies that the vendor is not assuming any liability, except that which the law imposes regarding the execution of the contract, if he resiles. If one may investigate the intentions of the vendor in such stipulations, one has to concede that the seller, who is keeping the immovables to be transferred outside the market, wants to have a guarantee that this loss of other opportunities is not futile. These deposits are a development of the present boom in real estate, and a product of estate agency business. The demand for a deposit subject to forfeiture for change of intention relieves the estate agent of troublesome and expensive law-suits, as it binds the purchaser in stronger bonds. Suing the defaulting purchaser for specific performance is not a very attractive proposition to the agent, who prefers financial and psychological pressures, which have an immediate impact

[17] cfr. Chapter One.
[18] French Civil Code Art. 1590.

on the will, to legal remedies, which may be elusively unpredictable at times. If one considers these deposits from this angle, the classification of Giorgi, that they fall within the class of 'arra confirmatoria penale', is very applicable, for the following reasons:

(a) It is 'confirmatoria': The deposit is a 'real' confirmation of the obligation of the purchaser, who in his unilateral promise binds himself to buy. The payment is not made so that the purchaser may resile, if there is a change of mind. Moreover, there is an actual payment.

(b) It is 'penale': The forfeiture of the deposit may be one of the alternative remedies open to the vendor in case the purchaser defaults.

The availability of alternative remedies distinguishes the deposit from penitential earnest. The defaulting purchaser cannot force the vendor to choose, as would be the case if the deposit falls under Section 1409. The vendor has two alternatives: either to demand the execution of the contract or else to keep the deposit, in which latter case he need not action, unless the deposit is in the hands of third parties, as was the particular circumstance of Chetcuti vs. Thurston. The wording of such forfeiture clauses certainly does not bar the demand for the execution of the contract, especially since the deposit is usually *qualified as part of the price*. The action of the vendor would, indeed, amount to a demand for the remainder of the price. If the deposit were to be considered as penitential, it would be *imputed* to the price on *voluntary execution*.

The question arises about what action is competent to the purchaser if the vendor refuses to sell. The answer is that the purchaser has no option but to demand specific performance or damages and interests, as the case may be, as provided under Section 1407(1). If specific performance is still possible, he cannot demand damages and interests. If through loss of the immovable or alienation to third parties such a sale is no longer possible, then is the assessment of damages predetermined by the amount of the deposit? As has already been argued, the deposit is unilaterally binding, and therefore it cannot serve to calculate the damages caused by the party in favour of whom it is made, but whom it in no way binds. The purchaser, it is contended, would only have the ordinary remedies, and has to prove the damages suffered and their amount.

Penalty Clauses

It is not within the scope of this thesis to discuss penalty clauses in general, but only in so far as they affect promises of sale, and particularly the current clauses which are being inserted in preliminary agreements for the sale of immovable property. A penalty clause, as defined by Section 1161, is a clause by which a person, in order to secure the fulfilment of an obligation, binds himself to something in case of non-fulfilment. The function of a penalty clause is to fix damages for non-fulfilment by agreement. It is a coercive measure, to which one submits 'sponte sua'.

The sole judges of the penalty are the parties, for it represents the compensation for damages which the parties suffer from the non-fulfilment of the obligations assumed by the other party. Section 1165(1) expressly states that the Court cannot abate or mitigate the penalty, even if it is obviously excessive, as the judge cannot substitute his subjective discretion for the will of the parties.

The most important feature of this clause is that the creditor cannot demand the performance of the obligation and payment of the penalty, unless this has been expressly stipulated for mere delay (Section 1163). The choice of the remedy, however, is wholly in the hands of the creditor, who cannot be forced to demand either in preference of the other. The stipulation of a penalty together with specific performance is not incompatible, but the same cannot be said regarding a penalty and damages and interests. These may be demanded only for what the penalty clause does not cover.[19]

The juridical difference between this clause and earnest is to be found in that a penalty clause is *a promise of future payment*, while earnest consists in the *effective and actual delivery* of what shall be forfeited, as was stated in Chetcuti vs. Thurston. This aspect of a penalty clause makes it imperative for the creditor to demand the penalty, while in the case of earnest, if the creditor is the recipient, there is no need for such a judicial demand.

A recent practice, which resulted to the writer from an examination of preliminary agreements, tries to make the penalty exigible without judicial recognition. Where a penalty clause is to be stipulated, the preliminary agreement is made by public deed, on the belief that it would be considered as an executive title under Section 251(b) of the Code of Organisation and Civil Procedure,

[19] Giorgi – op. cit. para. 460.

which dispenses with the judicial recognition of claims which result from a contract received by a Notary Public. Although this case has not come before the Courts, it may be quite correctly stated that even if a penalty results from a public deed, it is still necessary that there should be a judgment ordering its payment. The penalty, is wholly different from earnest and deposits, is wholly dependent on the principal obligation, which is an obligation of doing, as has been argued in Chapter Two. Section 251(b) excludes a public deed as being an executive title when the obligation consists in the performance of an act. The distinction between personal and physical acts and other acts in general is not applicable to this case, as the provision clearly limits the public deed as an executive title only to debts which are certain, liquid and due, when the judicial recognition of the claim may be almost unnecessary. The penalty only becomes due in default of fulfilment of the principal obligation, which consists in the performance of an act, and therefore, it is submitted, it must be proved that the principal obligation was not performed, without good grounds at law, even if this clause has not been expressly stated in the preliminary agreement.