Pacta sunt servanda and good faith in contracts – re-visited

Id Dritt Volume XXIII

1. Introduction

A recent ruling by the Court of Appeal, affirming a judgement of the First Hall Civil Court,[1] has raised a number of controversial issues, both of a procedural and a substantive nature. In this article, I will be focusing on the latter.

The rationale of this article is not a specific critical analysis of the judgement itself, although I shall refer to this case extensively as the last judicial pronouncement on the point in terms of local jurisprudence. In this article I question and challenge the underlying rationale of what seems to be evolving as a tendency of our Courts to resort to principles of equity, a concept which is alien to our civil law tradition, with a view to achieve, what the Court itself considers to be a level of 'fairness' in a contractual relationship, notwithstanding that the will of the contracting parties, as evidenced by the contract does not sustain the Court's view of 'fairness'.

In my view there is no instance when, faced with a contract that is clear and unambiguous, in the absence of a specific provision of law that calls for Court intervention,[2] or issues of mandatory law or public policy a Court should ever intervene to establish between the contracting parties a relationship they did not contemplate, or create effects that were never agreed to. This is in respect of the sanctity of contract and the old maxim of pacta sunt servanda.

2. The Judgement in the Calleja Urry Case[3]

The facts of this case are as follows: Mr and Mrs Calleja Urry bought three apartments with a view to renting them out. The apartments formed part of a rather large block, and were at the time, in shell form. The common parts were also in shell form but the developer, Mr Portelli, agreed to complete them within 8 months from the date of the contract. The parties agreed that if Mr Portelli failed to complete the common parts on time, then he would be liable to a penalty of € 234 per day. This penalty was stated to be 'għas-sempliċi dewmien u ma tantx [sic] tkunx sindakabbli minn xi Qorti'. [5]

The Calleja Urrys alleged that Mr Portelli finished the common parts some 632 days late, and therefore claimed some €14,700 by way of penalties.

[1] Mark Calleja Urry et vs Joseph Portelli et, Court of Appeal, 25 February 2011
[2] Such as in the case of contracts protected under the Consumer Affairs Act.
[3] Ibid (1)
[4] The penalty was Lm 10 per day. All conversions used in this paper are rounded.
[5] This is the language of the contract as quoted in the judgment.

Mr Portelli replied that the works in the common parts had been substantially completed on time. There were, he said, only snags left to be dealt with after the deadline, adding that these could only be dealt with after all the apartments in the block were finished by their owners.[6]

A simple enough case, one would have thought: did Mr Portelli complete the works on time, or didn't he? If he was late, did the delay amount to 632 days or less? The answer was simple matter of evidence.

The evidence showed, quite conclusively, that the Calleja Urrys' allegation was correct: the common parts were completed (more than) 632 days after the date when they should have been ready. Case closed, one would have thought: the facts as alleged had been proved, the contract was clear and the defence appears to have failed miserably.

Not quite said the Courts, both at first and second instance.

Although Mr Portelli was - to put it kindly - somewhat economical with the truth when he filed his sworn defence, and although he did not bother to amend his defence at any time, the Courts allowed him to argue that he was not answerable for the full extent of the delay: at least some of it, he said, was due to shortcomings on the part of apartment owners or to factors beyond his control.[7] If this was so, then one would expect that the number of days of delay attributable to Mr Portelli would be reduced and that the penalty clause would be applied to that reduced number of days. However, what the Court did was actually the inverse: it reduced the penalty clause significantly since Mr Portelli was found not to be at fault for the entire 632 days of delay.

The Courts, in upholding the argument of Mr Portelli, and - acting arbitrio boni viri - awarded a penalty of €4,700 instead of the €14,700 claimed by the Calleja Urrys. The Court referred to the legal systems of other civil law countries, such as Italy, Germany and France,[8] and held that these legal systems dealt with penalties in the most sensible way. In addition, and what is perhaps one of the most striking points in this judgment, the Court acknowledged that in terms of Maltese law, the Court did not have the power to reduce penalties and interfere in contracts and yet, in the same paragraph, it states that the system allowing a reduction of penalties is a good

[6] Contracts of works often expressly provide that penalties for delays do not apply if the works are substantially complete. In this case, it does not appear that the contract had an express provision to this effect. The Court did not have to address this point.
[7] This is another moot procedural point, namely whether Mr Portelli should, from a procedural perspective have been allowed to argue this point given that it was not included in his statement of defense, nor did he request for his statement of defense to include it. This is a procedural point, which I shall however overlook for the purpose of this article.
[8] In such legal systems, the Courts have the power to reduce 'manifestly excessive' penalties.

one because irrespective of what the parties agree,[9] it prevents absurd consequences:

> Fil-fehma tal-Qorti din is-sistema hi dik li l-iktar tagħmel sens in kwantu tiżgura li irrispettivament ta' dak li jkunu ftehemu l-partijiet, ma tinħoloqx il-possibilta' li jkun hemm konsegwenzi assurdi. Fil-liġi Maltija ma nsibu l-ebda provvediment li jgħid li l-Qorti għandha l-jedd li tnaqqas il-penali fejn din tirrizulta li hi eċċessiva. Il-prinċipju ġenerali hu li l-kuntratt jirrifletti l-ftehim tal-partijiet u l-kuntratt għandu jkun eżegwibbli.

Had this finding been based purely on an assessment of the facts, this ruling would have been unremarkable from a substantive standpoint. But in coming to this conclusion, the Courts make some rather startling statements of law, in particular on the part that good faith and equity play in our legal system. It is to some of these statements that I now turn.

3. Article 1122 of the Civil Code

The Calleja Urrys responded to Mr Portelli's argument, and supporting evidence, that he was not totally to blame for the delay by pointing to article 1122 of the Civil Code. This provides that:

It shall not be lawful for the Court to abate or mitigate the penalty except in the following cases:

> (a) if the debtor has performed the obligation in part, and the creditor has expressly accepted the part so performed;
>
> (b) if the debtor has performed the obligation in part, and the part so performed, having regard to the particular circumstances of the creditor, is manifestly useful to the latter. In any such case, however, an abatement cannot be made if the debtor, in undertaking to pay the penalty, has expressly waived his right to any abatement or if the penalty has been stipulated in consideration of mere delay.

It was argued by the Calleja Urrys that because the penalty had been stipulated for mere delay, the Court's hands were tied and it could not abate the penalty.

The Court did not take kindly to this argument. After an elaborate – and somewhat tortuous – argument, it concluded that:

[9] Presumably, also irrespective of the fact that Maltese law has not followed its continental counterparts in addressing this issue.

> Il-fatt li l-partijiet iddikjaraw fil-kuntratt li l-penali "... ma tkunx sindakabbli minn xi Qorti" ma jfissirx li l-Qorti għandha idejha marbutin.

The Court held that it could – and in fact did – 'abate' the penalty because, on its finding of the facts, the delay was not entirely Mr Portelli's fault and this, in the Court's view, justified interference with the parties' freedom to contract, irrespective of what the law had to say on the matter:

> Minkejja dak li jipprovdi l-Artikolu 1122 kif tista' Qorti tikkundanna d-debitur li jhallas penali fejn ma jkollux htija ghad-dewmien jew fejn id-dewmien m'huwiex kollu tort tieghu.

To be fair, and despite this rather strong language, the Court did not just ignore article 1122, at least not overtly. It argued somewhat tortuously that that the first proviso applied because the Calleja Urrys had accepted the partially executed obligation.[10]

More importantly, it held that article 1122 needs to be read and applied in the light of good faith requirement set out in article 993 of the Civil Code and, therefore, in the light of the maxim 'in omnibus quidem, maxime tamen in jure, aequitas spectanda sit'.

Having said that, although the Court acknowledged and re-affirmed the importance of the principle of pacta sunt servanda, it appears to have completely pushed it one side, on the basis of the doctrine of good faith. The conclusion one could reach therefore is that these two concepts are contradictory rather than complementary from the words of the Court of Appeal:

> Il-ġurisprudenza tal-Qrati tagħna dejjem applikat dan il-principju[11] ad litteram. Izda reċentement gie aċċettat mill-ġurisprudenza nostrali li penali eċċessivi jistgħu jiġu riveduti u mibdula u dan abbażi tal-prinċipju tal-bona fede senjatament li l-kuntratti għandhom dejjem jiġu esegwiti bil-bona fidi.

It is to this issue that I now turn – namely that Maltese jurisprudence has in recent pronouncements accepted that excessive penalties may be revised and this on the basis of the principle of good faith and notwithstanding the contractual provisions and article 1122 of the Civil Code. The principles of pacta sunt servanda, good faith in contract and equity all seem to play a role in this case and, I shall therefore briefly revisit each of them in turn.

[10] This argument is, unconvincing, but this point will not be dealt with at this stage.
[11] *Pacta sunt servanda*

4. Pacta Sunt Servanda

The principle of pacta sunt servanda, i.e. that agreements must be honoured, has provided a standard of conduct for society from time immemorial. The sanctity of contract is a universal concept and can be found in all legal systems, in all periods of history, in all cultures and in all religions.[12] For Grotius it lay at the centre of the international legal order,[13] and according to Ulpian 'what is so suitable to the good of mankind as to observe those things which parties have agreed upon'.[14]

As a basic and universal principle, pacta sunt servanda has been codified in International Law in Article 26 of the Vienna Convention on the Law of Treaties,[15] and is recognized in Article 1.3 of the UNIDROIT Principles of International Commercial Contracts.[16] It is unquestionably, and understandably, a paramount feature of contract law. It is and remains the principle that provides the predictability of result that contracting parties aspire to as the very reason why they execute contracts in the first place.

Like many others, Maltese law has codified the principle of pacta sunt servanda in its Civil Code, whereby Article 992 states that 'contracts legally entered into shall have the force of law for the contracting parties'. The said article goes on to provide that contracts may be revoked only with the parties' consent or on grounds allowed by law.

The Maltese Courts have on countless occasions made reference to this principle and have acknowledged that it is of fundamental importance in contract law:

> Il-prinċipju kardinali li jirregola l-istatut tal-kuntratti jibqa' dejjem dak li l-vinkolu kontrattwali għandu jiġi rispettat u li hi l-volonta tal-kontraenti kif espressa fil-konvenzjoni li kellha tipprevali u trid tiġi osservata. Pacta sunt servanda.[17]

In the Calleja Urry case, the Court cited a judgment of the Court of Appeal wherein it had stated that:

[12] W Paul Gormley, 'The Codification of Pacta Sunt Servanda by the International Law Commission: The Preservation of Classical Norms of Moral Force and Good Faith' (1969) 14 St. Louis U. L.J. 367, 373
[13] De Jure Belli ac Pacis, lib. III ch. 25, sec. 1.
[14] Digest 2, 14, 7, para. 7
[15] Vienna Convention on the Law of Treaties (adopted 23 May 1969, entered into force 27 January 1980) 1155 UNTS 331; ME Villiger, *Commentary on the 1969 Vienna Convention on the Law of Treaties*, 365; Pacta sunt servanda lies at the heart of the Convention. It applies without exception to every treaty".
[16] UNIDROIT, UNIDROIT Principles of International Commercial Contracts, 2004, 2nd ed.
[17] Gloria mart Jonathan Beacom et vs L-Arkitett u Nġinier Ċivili Anthony Spiteri Staines, Court of Appeal, 5 October 1998

> … il-prinċipju jibqa l-istess, cioe dak tal-liberta kuntrattwali bil-korollarju tiegħu li l-eċċezzjonijiet għal dik il-liberta m'għandhomx jiġu estiżi lil hemm mil-limiti tal-liġi li tistabilixxi l-eċċezzjoni ... l-art 1035[18] tal-Kodiċi Ċivili li jagħti lill-kuntratti mgħamulin skont il-liġi is-saħħa tal-liġi stess, li hija l-aqwa liġi, cioe l-liġi tal-partijiet, il-mezz u l-miżura tal-indipendenza personali tagħhom fil-kamp kontrattwali, u li ma jistgħux jiġu mħassra ħlief bil-kunsens ta' xulxin jew għal raġunijiet mgħarufin mil-liġi.[19]

Yet, the Courts have found a way to interfere in contracts validly executed even where the terms are clear and unambiguous, and they are doing so on the basis of equity and good faith – which are the very underpinnings of the doctrine of pacta sunt servanda. This can be seen in a number of recent Court judgments, some of which will be analysed further on in this article.

5. Good Faith in Contract

As a concept, good faith applies far beyond contracts to all of society itself. Aristotle set out the broad parameters that 'if good faith has been taken away, all intercourse among men ceases to exist'.[20]

Defining 'good faith' is a quite a formidable task, a task which goes far beyond the purpose of this article. Powers describes it as 'an elusive term best left to lawyers and judges to define over a period of time as circumstances require'.[21] Yet, he goes on to define it as 'an expectation of each party to a contract that the other will honestly and fairly perform his duties under the contract in a manner that is acceptable in the trade community'.[22] Like the principle of pacta sunt servanda, good faith is an internationally recognised and accepted doctrine and is often associated with the legal rules of honesty, reasonableness and fairness, including that of pacta sunt servanda.[23]

The Maltese Civil Code, like those of other civil law systems,[24] provides that contracts have the force of law as between the contracting parties, enshrining the principle of sanctity of contract. However, the performance of a contract is subject to the requirement of good faith independently of the parties' volition and it has

[18] What is now article 992 of the Civil Code.
[19] Avukat Dr Guiseppe Maria Camilleri vs William Parkey nomine, Court of Appeal, 7 September 1973
[20] Cited by Hugo Grotius in De Jure Belli ac Pacis, Libri Tres (1625)
[21] PJ Powers, 'Defining the Indefinable: Good Faith and the United Nations Convention on the Contracts for the International Sale of Goods' (1999) 18 J.L. & Com. 333
[22] Ibid
[23] William Tetley, 'Good Faith in Contract' (2004) 35 JMLC 561-616; JF O'Connor describes good faith as 'a fundamental principle derived from the rule *pacta sunt servanda*, and other legal rules, distinctively and directly related to honesty, fairness and reasonableness, the application of which is determined at a particular time by the standards of honesty, fairness and reasonableness prevailing in the community which are considered appropriate for formulation in new or revised legal rules'.
[24] For example France and Germany

therefore been argued, that this incursion into the domain of freedom of contract allows for judicial intervention and the introduction of controls of substantive fairness into the contractual arena.[25]

The doctrine of good faith can be found in Article 993 of the Maltese Civil Code which states 'contracts must be carried out in good faith, and shall be binding not only in regard to the matter therein expressed, but also in regard to any consequence which, by equity, custom, or law, is incidental to the obligation, according to its nature'. When dealing with matters of contract, the Maltese Courts have held:

> Din il-Qorti tifhem li fil-kunċett tal-bona fidi jidħol ukoll ċertu element ta' ekwita kif ukoll ta' sens prattiku u morali li jiġi vjolat mhux biss meta konfrontat b'aġir speċifiku doluż biex jagħmel il-ħsara, iżda wkoll b'dak il-komportament li jkun għal kollox spoporzjonat u li ma jkunx aċċettabli skond in-normi stabbiliti tas-soċjeta u tal-loġika ġuridika.

Good faith is a concept developed from principles of fairness, reasonableness and honesty. There can be little doubt that the doctrine of good faith is as fundamental in contract law as the doctrine of pacta sunt servanda – indeed they are complementary and the dictates of the doctrine of good faith itself requires that contractual terms are to be honoured and respected. However, as we will see further on, in a number of cases which have recently been decided before the Maltese Courts, in applying the doctrine of good faith, the principle of pacta sunt servanda appears to have been pushed aside – in most cases citing the more elusive concept of good faith as the reason for displacing the time honoured principle of pacta sunt servanda.

6. Equity (In omnibus quidem, maxime tamen in jure, aequitas spectanda sit)[26]

The word equity is used in a wide variety of contexts with meanings which vary from one context to another. For Aristotle, the concept of Equity (epieikeia) denoted a correction of strict guidelines to produce a more pleasing fit with particular circumstances: '... it is a rectification of law where law is defective because of its generality. In fact this is the reason why things are not all determined by law: it is because there are some cases for which it is impossible to lay down a law, so that a special ordinance becomes necessary'.[27]

[25] Kelda Groves, 'The Doctrine of Good Faith in Four Legal Systems' (1999) Construction Law Journal, 265
[26] In all affairs, and principally in those which concern the administration of justice, the rules of equity ought to be followed.
[27] G Watt, *Equity Stirring, The Story of Justice Beyond Law* (Hart Publishing, Oxford 2009) 27

The legal meaning of equity has been moulded by history, however, there can be little doubt that, throughout the long international history of the idea of equity, it is in the jurisprudence of the English Court of Chancery[28] that this concept has received closest scrutiny.[29] It was this same Court of Chancery which, by addressing situations in which there was either no form of action or the remedy at law was insufficient, eventually led to the creation of Courts of equity.[30]

Over time certain doctrines became firmly established within 'equity' such as the defence of the unconscionability of contracts. At law, parties are viewed as having freely negotiated the terms of a contract so that the contract per se cannot be seen as unfair. At equity, the Court is free to take into consideration the fact that certain contracts, depending upon the bargaining positions of the parties, can be grossly unfair, in other words, unconscionable.[31]

There is no comparable law of equity in civil law countries.[32] Unlike common-law systems where the law often reflects and consists of rules of law enunciated in judicial decisions, civil law countries have comprehensive codes covering an abundance of legal topics. Such a system of codes however, would not permit the growth of another branch of law outside the framework of the system. Equity would disrupt the legal certainty required by a civil law system. Therefore, any equitable principles and remedies, to the extent they exist in the civil-law tradition, would be built into the structure of the codes as part of the overall system.[33]

7. A review of some Maltese Court judgments

The Calleja Urry was not the first judgment of the Maltese Courts where the relationship between these principles has been elucidated. Neither is it the only case where our Courts have felt compelled to intervene and it is unlikely to be the last. However, Courts have more willingly intervened to reduce of they considered to be 'excessive' penalties, but less so in disturbing the contractual relationship between parties in more substantive matters.

[28] The position at the end of the thirteenth century, even after the last of the three common law Courts to evolve out of the Curia Regis had become separate, was that a residuum of justice was still thought to reside in the King. If, therefore, the common law Courts for any reason failed to do justice, an aggrieved person might petition the King or the King's Council. The Lord Chancellor, in addition to being the Keeper of the Great Seal and the head of the Chancery, which by this time had become an important department of state, was the head of the King's Council and, from early times, petitions seeking the King's 'extraordinary justice' were referred to him. This procedure steadily became more frequent and, by the end of the fourteenth century, petitions began to be addressed to the Chancellor alone. A body of case law gradually evolved within the Court of the Chancery addressing situations in which there was no form of action or the remedy at law was insufficient. The legal institution of equity developed as a result of this 'divide' in the English legal system.

[29] Watt (27) 37

[30] Most common-law systems have, today, fused law and equity.

[31] L Carlson, *American Business Law, A Civil Law Perspective* (Coronet Books Inc, Philadelphia 2004)

[32] Certain laws empower the arbiter to decide claims in accordance with equity, for instance, claims relating to consumer affairs or small monetary values. This is a measure which has been introduced in various jurisdictions, for example, article 113 of the Italian Code of Civil Procedure which expressly empowers the *guidice di pace* to decide claims involving small monetary values according to equity.

[33] JG Apple and RP Deyling, *A Primer on the Civil-Law System* (Federal Judicial Centre, Washington 1995) 35

The import of the principle of pacta sunt servanda has been heavily and properly emphasised in Maltese jurisprudence highlighting that principle's significance as a cornerstone of contract law. This has been the case even when defences based on equitable principles were raised before the Court. Maltese Courts have however expressed differing views on the extent to which the time-honoured doctrine of pacta sunt servanda and the provisions of article 992 of the Civil Code ought to be displaced in the face of the unambiguous intention of the parties to a contract.

There remains a long string of authoritative judgements that sustain the position – that there is no room for a Court to impose its own view of fairness on the parties to a contract where the intention of the parties is clear. It seems that this position remains, with the exception of penalty clauses, the law on the matter.

In **Edward Rizzo noe. vs Lt. Col Charles E. Dawson**,[34] plaintiff entered into a contract with the Director of Supply and Transport from January to June 1948 for the consignment of frozen meat from the Port to the Cold Stores. Plaintiff was instructed to transport the goods only during the night. At a point in time he was ordered to continue the works well into the day. Plaintiff had to pay the workers extra and at a different rate for the additional hours of work. He was never indemnified for the additional wages paid to the workers. Plaintiff requested the Court to declare that the defendant should be liable to pay the additional cost in light of the fact that it was his decision to go against the contract originally entered into and he arbitrarily and without prior notification changed the manner of performance of the contract. The Court disagreed with plaintiff's claims, stating that the contract was clear and unambiguous and that where an agreement between the parties exists which is not contrary to law, it is not permitted to substitute the will of the parties with the principles of equity. The Court also quoted a judgement of the Commercial Court,[35] where it was stated that a particular law could never be extended in such a way to allow the Court to impose on one party an obligation not agreed to by that party even explicitly because in doing so, the Court would go against the law itself, since the law specifically states that an agreement between two parties has the force of law between those parties.

In **Baggit Enterprises Limited vs Jeffrey Chetcuti and Glenn Chetcuti**,[36] the case concerned the payment of a penalty and the Court accepted that the contractual provisions relating to the payment of penalties ought to be upheld. Defendants had allegedly breached the contract between the parties by not buying the quantities stipulated in the contract and additionally by contacting the foreign suppliers to

[34] Court of Appeal – Civil Superior, 15 May 1953
[35] Gerada vs Pace, Commercial Court, 15 December 1938
[36] 15 April 2002

start buying directly from them. The Court stated that the penalty clause is a form of pre-liquidated damages as a consequence of which the creditor does away with the requirement to prove he suffered damages since he relies on the fact that the debtor did not perform his obligations on time as agreed to in the contract. The Court concluded that the €23,300[37] penalty ought to be applied in strict application of Article 1122 which emanates from the respect to Article 992 (1) of the Civil Code that a valid agreement between the parties has the force of law. The Court ought never to interfere with such agreements unless they are affected by a defect, which makes the agreement unenforceable.

In a more recent decision, also delivered by Mr. Justice R. Micallef,[38] plaintiff had leased premises to defendant for three months. The contract stipulated that for every day that defendant fails to evict the premises, he would incur a penalty of €233.[39] The Court, applying article 992 of the Civil Code, declared that a contract had the force of law between the parties and enforced the penalty. However it still declared that the penalty was specifically included for mere delay and that the fact that defendant did delay his eviction from the premises was proven without room for doubt the Court upheld plaintiff's request for the penalty to be enforced and ordered defendant to pay plaintiff the sum of €19,500.[40]

In **Marie Debono vs Saviour sive Silvio Cassar**,[41] the Court of Appeal overturned a decision of the first Court which had reduced the penalty due by defendant to plaintiff for the delay in the works that ought to have been carried out. The works related to a residential building and defendant contractually agreed to finish the works by a specific date. The agreement also included a penalty clause of €7[42] for every day of default. The first Court disagreed with the findings of the legal expert and diminished the penalty from €14,400 to €4,200,[43] since in its opinion the amount was inequitable when compared to the sale price of the property, which was that of €19,800.[44] This reduction was made irrespective of the fact that the Court had agreed that the delay had caused damages to the plaintiff since she could not make use of the apartment.

On appeal the plaintiff sought a judgement declaring that equity should not be a part of the Court's reasoning as the case ought to be decided in accordance with the maxim pacta sunt servanda. Plaintiff also pointed out that the contract between the

[37] Lm 10,000
[38] Mary Rose sive Mary Falzon Manduca vs Mario Grima, 8 March 2005
[39] Lm 100
[40] Lm 8,400
[41] Court of Appeal – Civil Superior, 07 October 1997
[42] Lm 3
[43] From Lm 6,200 to Lm 1,800
[44] Lm 8,500

parties was still in force and the Court should have been satisfied with the stipulated amount agreed to by the parties. The Court of Appeal agreed with this view and stated that the comparison of the penalty with the sale price should not have been made by the first Court and declared that the quantum of the penalty was only imputable to the actions of defendant. The penalty was not to be considered excessive in light of the fact that such reasoning would reward the party, which was in default for an extended period of time. The Court of Appeal in overturning the decision of the first Court, awarded the whole amount to plaintiff as was stipulated in the contract.

The case of **Malta Football Association vs Emmanuel Portelli**,[45] was not one concerning penalty clauses, but a case of non-fulfilment of the obligations agreed in a contract. Defendant had agreed to manage all the bars at the national stadium against payment. He subsequently defaulted in payment and argued that the sum agreed to in the contract was excessive since the MFA had carried out works in parts of the stadium which reduced his business earnings and that additionally, the MFA had allowed food stalls to be set up in the parking area, which also affected his business.

The first court concluded that contracts must be entered into and performed in good faith and also that the additional proof against or in addition to a contract is only allowed when the intention of the parties is expressed in an ambiguous manner. In the case at hand the Court believed that the intention of the parties was clear and that therefore the maxim pacta sunt servanda ought to apply. The Court held:

> Il-prinċipju kardinali li jirregola l-istitut tal-kuntratti jibqa' dejjem dak li l-vinkolu kontrattwali għandu jiġi rispettat u li hi l-volonta' tal-kontraenti kif espressa fil-konvenzjoni li kellha tipprevali u trid tiġi osservata – pacta sunt servanda.

In **Francis Paris et vs Maltacom plc**,[46] both the First Court and the Court of Appeal upheld the plaintiffs' claim. A contract between the employees and Maltacom stipulated that the employer would create a pension scheme for its employees similar to that adopted by the Government. This scheme was, however, never created and the employees sued defendant. The First Court presided by Mr Justice Tonio Mallia declared that when the contract is clear and establishes specific criteria to be adhered to, if one party refuses to perform its obligation in accordance with that contract, the Court can in those circumstances ensure that that obligation is performed without imposing its own beliefs on the parties:

[45] Court of Appeal, 26 June 2009
[46] Court of Appeal – Civil Superior, 7 July 2008

> Dan hu konformi mal-prinċipju li la darba bejn il-partijiet hemm ftehim li jirregola r-relazzjonijiet ta' bejniethom, hu preżunt li qabel ma ffirmaw dak il-ftehim qisu ċ-ċirkustanzi tal-każ u l-interessi tagħhom, u allura la darba iffirmaw il-kuntratt, huwa dak il-kuntratt li jissanzjona r-relazzjonijiet ta' bejn il-kontendenti, u mhux xi prinċipju ieħor, anchorche' bażat fuq l-ekwita'. Il-prinċipju tar-rispett għall-volonta' tal-partijiet huwa wieħed fondamentali u dak li ftehmu fuqu il-partijiet għandu 'forza ta' liġi' għalihom (artikolu 992 tal-Kodiċi Ċivili), u l-Qorti m'għandhiex tuża d-diskrezzjoni tagħha biex tissostitwixxi għal dak li ftehmu l-partijiet il-volonta' tagħha.

The above string of judgements may give the impression that the matter is fully and completely determined and that the doctrine of pacta sunt servanda will, within the precincts of the above judgements, prevail over any issues of equity raised after the execution of the contract. However, the Calleja Urry judgement is not alone and our Courts have on several occasions indicated their willingness to intervene in contracts, on the basis of equitable principles. What is conspicuous however is that whilst Courts feel evidently uncomfortable in displacing the doctrine of pacta sunt servanda in substantive contractual matters they are less so when it comes to revising, of course downward, penalty clauses to bring them in line with their own perception of fairness or to avoid 'harsh consequences'.

In the case of **Michael Pace vs Richard Micallef pro et noe,**[47] the Court of Appeal overturned the decision of the First Hall and decided to reduce the penalty due by the defendant. In this case plaintiff sued defendant for the execution of the contract as well as for the payment of the penalty for the delay of works; the penalty was of €230 for every day defendant was in breach. Defendant had been notified of the breach and called upon by a judicial letter in order to complete the work and pay the penalty.

The First Court referred to Article 1122 of the Civil Code and stated that it was not applicable in the case at hand. It concluded that although this could result in harsh consequences for the defendant, the Court could not interfere with a valid agreement between the parties when such agreement was in no way vitiated; this in light of the maxim pacta sunt servanda. The Court declared that it would weaken the legal system built on the contractual freedom of the parties. In order to avoid consequences such as those suffered by the defendant one must simply either not enter into such agreement or else adhere to the contract.

The Court of Appeal overturned the decision of the First Court and drastically reduced the penalty imposed at first instance. It stated that the First Court applied

[47] Court of Appeal – Civil Superior, 15 December 2004

article 992 (1) ad litteram and ignored Article 993 that requires good faith in contracts. The Court was of the opinion that the concept of good faith also incorporates an element of equity as well as a moral and practical sense, which can be violated with actions, which are disproportionate and unacceptable in accordance with the norms of society and juridical logic. Why the norms of society and juridical logic, which the Court left undefined and only generically referred to them, ought to have any bearing on the contract entered into between the parties remains somewhat confusing. This is even more so in the light of the applicable provisions of law and indeed this reasoning was not followed by the Court of Appeal in a later judgement discussed above[48]. The Court therefore decided the case on the basis of Article 993 and asked whether the plaintiff could have been in good faith when requesting such exorbitant damages (€318,400)[49] for work which amounted to €35,000.[50] It also declared that the plaintiff ought to have tried to minimise the damage as much as possible.

The Court of Appeal also concluded that the First Court ignored Article 1122 (1)(a) of the Civil Code, whereby it had the power to abate the penalty since proof that the plaintiff expressly accepted the part performed was brought forward. The Court believed that the unperformed part of the obligation amounted to 1% and thus reduced the penalty to €3,200.[51]

In the case of **Angelo Bartolo for and on behalf of B&B Construction Limited vs Emanuel Zammit**,[52] the Court also concluded that the penalty should be reduced on equitable grounds. The facts were as follows; plaintiff wanted to build a guest-house in Bugibba and entered into a contract with B&B Construction Limited to carry out the works. The contract expressly stipulated a penalty clause of €116 daily for mere delay. The works were completed at a later stage than that contemplated in the contract. Plaintiff proceeded for the recovery of €159,000[53] in penalty claims. The Court again quoted Article 1122 (1)(a) which provides that the Court may reduce the penalty only when the debtor has partly performed the obligation, and the creditor expressly accepted the completed part of the work. Nevertheless this article was not applicable in this case, since plaintiff had not accepted or made use of the property before all works were completed.

However the Court subsequently quoted the decision of the Court of Appeal in **Pace vs Micallef**,[54] and referred to various foreign jurisdictions[55] whereby the legislator

[48] Francis Paris et vs Maltacom plc, Court of Appeal – Civil Superior, 7 July 2008
[49] Lm 136,700
[50] Lm 15,000
[51] Lm 1,367
[52] 19 January 2006
[53] Lm 68,250
54 Court of Appeal, 15 December 2004

gives express power to the adjudicator to reduce a penalty when this is excessive. The Court also quoted the Italian jurist De Cupis who explains that the reduction of a penalty by a judge should be construed as a corrective measure of the punitive function of a clause and this is done in order to curb abuse. It is the judge's obligation to ensure that no injustice is done.

Moreover the Court referred to Bocken and De Bondt[56] dealing with good faith and unforeseeable situations:

> … now the parties did foresee what would be their rights and duties, but the obligee is acting in a manifestly unreasonable way, so that his use of a contractual right denigrates into an abuse. Abuse of contractual rights is sanctioned by the corrective function of good faith...the use of a right can only be qualified as an abuse, if it is manifestly clear, if there is no doubt whatsoever, that a reasonable man would not have acted in the same manner as the defendant.

Thus the Court came to the conclusion that since most of the works were completed on the due date, the penalty to be paid by defendant was that of €58,200.[57]

In **Emmanuel Borg vs The Two Divers Company Limited**,[58] the contract entered into by the parties was a lease agreement of premises, which included a penalty clause that was applicable in the eventuality of the dissolution of the contract by one party prior to the termination date. The defendant was managing a diving centre in Mellieħa. Prior to the termination of the contract, the defendant was not operating the diving centre in line with the agreement due to medical reasons. He suggested that other people, namely his mother, manage the business but plaintiff refused. Defendant was also defaulting on the payment of rent. The First Court presided by Mr Justice Michael Mallia stated that the penalty clause was clear in the agreement and once one party dissolved the contract prior to the termination date, he was bound to pay the full penalty. It was concluded that once the contract provided for the penalty, the Court did not have the power to decide otherwise arbitrio boni viri. The contract is the law for the parties to it and plaintiff had a right at law to request indemnification in accordance with the terms of that contract.

However this decision was overturned by the Court of Appeal, which reduced the penalty on the basis of the application of the principle of good faith in contracts. The Court declared that Article 1122(1) granted power to the Court to reduce or modify

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[55] Namely German, French, Belgian and Italian law
[56] H Bocken and W De Bondt, *Introduction to Belgian Law* (Kluwer Academic Publishers, 2001)
[57] Lm 25, 000
[58] Court of Appeal – Civil, Inferior, 27 February 2008

the penalty in certain instances where it finds that it is excessive. The Court pointed out that defendant partially adhered to the contract and additionally plaintiff benefited from the premises being leased as a diving centre since it is still being utilised as such to this day. Thus the penalty was reduced by half 'wara kollox, l-istess attur kien hu ukoll aċċetta f'xi żmien li jitlob biss in-nofs tal-penali'.

Another recent decision of the Civil Court First Hall has been concluded with a reduction in the penalty which was due to plaintiff.[59] The latter had acquired an apartment in Sliema and works on the common parts of the apartment block and the garage had to be completed by defendant by not later than 31 December 2005. In the event that defendants would be in default for more than 30 days after the agreed completion date, a penalty of €233 daily would be incurred. Plaintiffs were requesting the payment of €14,400[60] for the delay in relation to the common parts of the apartment block and €5,600[61] in relation to the garage complex. The Court found that no penalty should be incurred with respect to the latter since the works giving rise to the delay were carried out by defendants without any obligation to do so under the contract. However, the payment in relation to the common parts was still due and the Court stated:

> L-applikazzjoni ta' din id-dispożizzjoni,[62] minkejja l-konsegwenzi iebsa li jistgħu jinsiltu minnha fil-prattika, ġejja mir-rispett li jrid jingħata lill-prinċipju li ftehim validu bejn il-partijiet għandu s-saħħa ta' liġi bejniethom (pacta sunt servanda), u l-ebda Qorti m'għandha tindaħal fi ftehim bħal dan dment li dak il-ftehim ma jkunx milqut b'xi difett li jġibu ma jiswiex. Madankollu illum huwa aċċettat li l-applikazzjoni tar-regola minsuġa fl-Art.1122 tal Kap.16 trid tiġi nterpretata wkoll fid-dawl ta' prinċipju ieħor ewlieni tad-dritt jiġifieri li l-kuntratti jiġu esegwiti in bona fede ... Kwindi ... huwa possibbli li l-effett u l-applikazzjoni litterali ta' klawsola penali jiġu ridimensjonati jekk jirriżulta li dawn joffendu jew jiksru s-sens prattiku u morali ta' l-obbligazzjoni billi jkunu jidhru sproporzjonati jew inaċċettabbli skont in-normi stabbiliti tas-socjeta' u l-loġika ġuridika.

The Court took into consideration the fact that defendants provided plaintiffs with a free and temporary supply of electricity for two months until a permanent supply was available and thus the Court found that the days of default two and not sixty two as claimed by plaintiffs. Thus it reduced the penalty from €14,400 to €465.

[59] Edward and Pauline sive Ina Carbone vs Virtu Holdings Limited, Civil Court First Hall, 29 September 2011
[60] Lm 6,200
[61] Lm 2,400
[62] Civil Code, Chapter 16 of the Laws of Malta, Article 1122(1)

8. Penalty clauses and pre-liquidated damages – the common law and civil law traditions compared

The area of penalty clauses seems to be the one which gives rise to much debate. In this field one of the most distinctive features among civil and common law systems is the extent of the judicial review of the sum stipulated in the contract. Put simply, in common-law systems, penalty clauses are not enforceable while liquidated damages clauses are. In other words, a payment clause is enforceable when it functions as a liquidated damages clause, but disregarded where it is held to be a penalty clause. The rationale behind this 'rule against penalties' is that the essence of a penalty clause is a payment of money in terrorem whereas the essence of a liquidated damages clause is a genuine pre-estimate of damage.[63] Since the purpose of an award of damages is to compensate the claimant for his loss, it follows that to include a clause which allows for recovery of damages in excess of the actual loss suffered or sufferable would be wrong. The damages would be more of a deterrent, designed to discourage breaches of contract, than compensation and this is said to be inconsistent with the common law treatment of damages.[64]

Diplock L.J in Robophone Facilities Ltd v Blank stated:

> I make no attempt, where so many others have failed, to rationalise this common law rule. It seems to be sui generis. The Court has no general jurisdiction to re-form terms of a contract because it thinks them unduly onerous on one of the parties... But however anomalous it may be, the rule of public policy that the Court will not enforce a 'penalty clause' so as to permit a party to a contract to recover in an action a sum greater than the measure of damages to which he would be entitled at common law is well established, and in these days when so often one party cannot satisfy his contractual hunger à la carte but only at the table d'hôte of a standard printed contract, it has certainly not outlived its usefulness.[65]

Unlike the common law tradition, in civil law systems Courts do not distinguish between penalty clauses and liquidated damages clauses. In fact, the penalty clause generally operates to secure two somewhat conflicting objectives. Its hybrid character allows it to encourage the performance of contractual obligations as well to act as a pre-estimate of damage for breach of a contractual obligation. This can be seen in Maltese law itself, whereby Article 1118 of the Civil Code states:

[63] Lucinda Miller, 'Penalty clauses in England and France: a Comparative Study' (2004) International & Comparative Law Quarterly. 79
[64] Hamish Lal, 'Liquidated Damages' (2009)Construction Law Journal, 569
[65] *Robophone Facilities Ltd v Blank*, UK Court of Appeal [1996] 1 W.L.R 1428

> A penalty clause is a clause whereby a person, for the purpose of securing the fulfilment of an agreement, binds himself to something in case of non-fulfilment.[66]

This affirms the coercive function of the clause. It contains an in terrorem element, exerting pressure on the obligor to do what he has contracted to do. The second function of this type of clause can be seen in Article 1120:

> The penalty represents the compensation for the damage which the creditor sustains by the non-performance of the principal obligation.[67]

Many civil law countries have another provision in their Civil Codes which, although found in Maltese law, is significantly different. This provision relates to the power given to the Court to mitigate a contractual penalty. In French law, for instance, the judge may intervene and either decrease or increase the sum where it is manifestly excessive or derisory and the parties are not able to contract otherwise.[68] Similarly, in accordance with the German Civil Code provisions, a penalty which is disproportionately high, may, upon the obligor's request be reduced to an appropriate amount.

Broadly speaking, the principle of non-enforcement of contract penalties prevails in common law systems and the principle of enforcement of penalties subject to reduction controls applies in civil law. It is arguable therefore that, in the field of penalties, the concept of equity has any role to play both in civil and common law systems.

In contrast to many civil law systems, Maltese law does not endow the Court with any power to reduce a sum stipulated in a contract by way of a penalty for mere delay. In fact, Article 1122, referred to earlier in this article in connection with the Calleja Urry case, specifically prohibits the Court from interfering and reducing the penalties except in very limited circumstances.

9. Conclusions

Our Courts seem to have found misplaced comfort in the principle of good faith to enable them to sustain their intervention in contracts where the law itself clearly establishes that there is no room for such intervention. It is true that the principle of good faith is remarkably elusive and may lend itself to all sorts of applications, but it is unlikely that good faith can or should be used to displace the will of contracting

[66] This type of provision is common to many civil law systems. The equivalent provision in the French Civil Code can be found in Article 1226.
[67] The equivalent French Civil Code provision is Article 1229.
[68] The equivalent French Civil Code provision is Article 1152.

parties and indeed create contractual relations that were never intended or contemplated by the parties to the contract. When the contract leaves no doubt as to the intention of the parties and in the absence of evidence that the parties did not execute the contract in good faith, there should be no room to second-guess the will of the parties and accordingly the contract should be properly given effect to.

The predictability of result that contracts are aimed to attain between contracting parties goes to the heart of contract law and it would be extraordinary if Courts were to displace the will of contracting parties for their own; in the name of some superior concept of fairness or to avoid 'harsh consequences' from ensuing to one or more of the parties. This approach completely dismisses the fact that those same parties whom the Courts attempt to protect – are the ones who actually executed the contract – they are the ones who actually designed the very same consequences in the contract. Any argument that places the principles of good faith and pacta sunt servanda as contradictory must be wrong - the very underpinnings of the doctrine of pacta sunt servanda are good faith and equity – the fairness lies in allowing contracting parties themselves to develop and design the consequences of their acts and ultimately to have certainty as to the outcome of what they have agreed and therefore that their legitimate expectations are met. Any intervention by any other person that could possibly alter or re-form that relationship is, on the other hand, intrinsically unfair.

Why a Court should even consider that it ought to intervene in the workings of a contract irrespective of the will of the parties – defies all logic underlying the very philosophy of contract law. One striking feature of Maltese jurisprudence is that whilst all Courts addressing the matter re-affirm the sanctity of contracts as a cornerstone of Maltese Contract law – they find it less invasive to displace that acknowledged rule when it comes to dealing with the revision of penalty clauses, as if that same lauded cornerstone of contract law should not apply. There is indeed no reason why that same rule should not apply to all provisions of a contract, including penalty provisions – clearly so when the penalty is one which the law itself clearly considers as not subject to abatement by a Court of law.

Whilst the development of the law with respect to the abatement of penalties in other jurisdictions is certainly a matter to be kept in mind in terms of the future development of the philosophical underpinnings of our provisions of the Civil Code on the same matters – until such time as Maltese law changes in the same direction it would be, to say the least premature, for our Courts to follow the legislative developments in other jurisdictions rather than the clear provisions of our own law. Indeed, the converse ought to be right. The fact that other jurisdictions have

developed their laws in the area of penalties in a manner that allows Courts to intervene and revise them whilst our legislator has consciously (or otherwise) chose not to follow this same line – should suggest a further reinforcement of the status of the Civil Code provisions and that our Courts should not intervene with a view to revise penalty clauses. Yet, our Courts, as is apparent in the Calleja Urry case, seem to prefer legal systems that in their view make more sense rather than apply the clear provisions of Maltese law. This has been remarkably expressed by our Courts as:

> Fil-fehma tal-Qorti din is-sistema hi dik li l-iktar tagħmel sens in kwantu tiżgura li irrispettivament ta' dak li jkunu ftehemu l-partijiet, ma tinħoloqx il-possibilta' li jkun hemm konsegwenzi assurdi.

It is truly remarkable that our Courts overtly disregard the will of the parties unambiguously expressed in a contract and substitute that will by their own perception of fairness – based on the elusive principles of good faith and equity – in the context of a system of law that does not allow the intervention of the Court to re-form the terms of a contract – is truly remarkable. So far our Courts have been amenable to use the good faith provisions of article 993 as a basis for displacing the applicability of article 992 of the Civil Code, and limitedly to the revision of penalty clauses. There seems to be reluctance in taking this approach beyond the revision of penalty clauses, indeed even in those cases where the Courts have revised penalty clauses, they first re-affirm the general rule of pacta sunt servanda as enshrined in article 992, only to then make exceptions based on good faith and equity. This may be a slippery slope because good faith, as a concept, is very broad and could possibly be used as a justification for judges to interfere not only in the field of penalties but in other areas of contract law if the circumstances present themselves.

Contracts are entered into in good faith to be honoured in all of their aspects – in the absence of any element that would, at law render a contract unenforceable. It is only the contracting parties that design it in a manner which fits them, they are the ones who need to operate within its structures, they are the ones who are best placed to determine the outcomes and effects, and they are indeed the ones who are best placed as to whether those outcomes are 'harsh', 'absurd' or not; and whether they fall within their own parameters of fairness. Courts determine disputes that may arise from contracts; disputes where contracts may be unclear and therefore where Courts need to use rules of interpretation in order to decipher the will of the parties and apply it – because that is what the parties intended. When the intention of the parties is clear in contract, then there is no room for the Court to apply its own discretion and subjective judgement in determining the will of the parties – its role

is therefore to apply that will as evidenced by the contract independently of the outcome or effect.