Conveyancing and Split Deposits – Instalments or Penalties ?

Justice Darke shines a light on the dangers of "split deposits"

Introduction[1] **(000s)**

Recent Supreme Court decisions have cast doubt on a vendor's ability to recover the entire 10% deposit where the deposit has been 'split' into instalments and the purchaser has subsequently defaulted before paying the second instalment. This is due to the second instalment often falling foul of the 'law of penalties', from which conveyancing deposits are usually exempt. Special clauses added to the contract[2] may expose the vendor to the risk of the court striking them out as a penalty

Whilst this walks a fine line between allowing parties the freedom to contract as they choose, and intervening to strike down an 'unfair' condition, courts nonetheless have been willing to do just that if they deem the condition to be a penalty, chiefly where:

1. The amount of the stipulated payment is "extravagant or unconscionable" compared to a "genuine pre-estimate of damages" the wronged party may suffer
2. The character of the payment does not appear to be a deposit

There is an overall belief that a vendor is entitled to retain or recover the full 10% deposit upon a purchaser's default, under Clause 9 of the Standard Contract for the Sale and Purchase of Land[3]. But a somewhat surprising exception to this general rule has been quietly developing in the Equity courts, with several recent cases highlighting the risk that a vendor may be unwittingly exposed to potentially losing the ability to recover the full deposit, particularly where an initial deposit of less than 10% has been agreed. Whilst many of these cases contain special clauses, they also indicate that the standard clause 9 may not save a vendor if such clauses are struck out by the court for being 'penalties' rather than deposits

In other words, whilst traditionally conveyancing deposits have not been caught by the 'law of penalties', provided they are truly deposits[4], the sacrosanct nature of such deposits may attract equitable scrutiny if a special clause veers into penalty territory, as the vendor is open to the deposit being, essentially, reclassified by the court as a penalty, leading to an inability by the vendor to recover any unpaid portion of the 10%

[1] This paper is an abbreviated version of a paper presented to a Workshop for regional solicitors in Forster NSW on 14 May 2021. A copy of the full paper is available upon request

[2] No matter how tightly drafted

[3] Clause 9 is the remedies available to a vendor in the event of a purchaser's default (see page 12 below)

[4] In other words, a maximum 10% of the purchase price, generally paid on exchange

“a deposit is a deposit because it is a deposit”

(or words to that effect)

Purpose/nature of a deposit

A long line of case law has established that a deposit is more than just a ‘guarantee’ from the purchaser, it is also a “genuine covenanted pre-estimate of damage”[5] which must not be “extravagant and unconscionable in amount” compared to the loss likely to result if a purchaser defaults. In conveyancing, there is a long-established doctrine of a 10% deposit being accepted as a genuine pre-estimate of damages which may be suffered by the non-defaulting party (usually a vendor)

Deposits are also characterised as being ‘an earnest of performance’: money paid as an earnest commitment from the purchaser as to his/her intentions of honouring the bargain struck between the parties, or, in other words, a payment “designed to demonstrate the sincerity of the contracting party who is to pay it”

So, in essence, a deposit has two markers:

1. It is a genuine pre-estimate of likely damages in the event of default
2. It is an ‘earnest of performance’

But in the world of conveyancing, a third element (or more accurately, a ‘sub-category’ of the first element) has emerged, which has important implications for vendors who choose to accept either a reduced deposit or a deposit payable by instalments

A deposit is a deposit because it is a deposit, or, as Justice Bryson said in *Luu*: “…a deposit…is the deposit because it was deposited”. This is a rather fun (if rudimentary) way of distinguishing between a deposit and a penalty: if the money can be deposited (i.e. before settlement) then it could reasonably be said that it is a deposit in earnest of performance rather than a penalty. Justice Bryson importantly goes on to say that “(o)nly a deposit falls within the exemption from penalties law, not any other payment of 10% of the purchase price” [15]

[5] For case references, see page 4 (below) and/or refer to the full paper in the Workshop folder

What can be gleaned from this is that it is the timing of the deposit payment which is crucial: if it is (comfortably)[6] before settlement, then it is more reasonable to argue that such a payment is (still) in "earnest of performance" and therefore a deposit. His Honour went on to say (in a much-quoted sentence)[7]

> **"The exception from the law relating to penalties relates…only to deposits, that is, to payments which truly have the character of earnest money paid…in relation to entering into the Contract, and although provisions of contracts almost always establish what the deposit is, it is not open to parties to avoid the operation of penalties law by designating a payment or an obligation as a deposit if it does not otherwise have that character"** [24] (emphasis added)

That which we call a rose by any other name would smell as sweet…a deposit by any other name would smell as sweet…not

(in other words, the names of things do not affect what they really are / their true nature / character)

Split Deposits and Special Conditions

In recent years, it has become increasingly common for vendors to accept either a reduced deposit[8] or agree to a 'split' deposit scenario, usually in two instalments. However, in the event of a purchaser's default, this practice may also potentially expose a vendor to claims from a purchaser that only the amount already paid (i.e. on exchange) is truly a deposit, and that any demand for the full 10% should be rejected on the basis that it is not a true deposit but rather, a penalty, and therefore unenforceable

It is clear, however, that there is no 'one size fits all', and courts examine each case on its merits; each contract may have its own/different 'special clauses'. What is becoming evident, however, is that clauses drafted on an "on or before completion" basis are at particular risk of being classified as penalty clauses

[6] There does not appear to be a definitive timeline as to when a court will consider a deposit to be genuinely 'before settlement', but the authorities seem to indicate that anything less than three months (at a minimum) prior to settlement will run a serious risk of not being deemed a deposit
[7] See, for example, *Iannello* [31], and *Rana* [46] (refer page 4 below for case references)
[8] In other words, less than 10%

Recent Case History

There have been several recent cases which, whilst all being decided on their own facts, indicate that courts are not disinclined to strike out deposit clauses if they have the flavour of a penalty rather than a deposit:

1. *Ashdown v Kirk* [1999] 2 Qd R 1
2. *Luong Dinh Luu v Sovereign Developments Pty Ltd & 2 ors* [2006] NSWCA 40
3. *Iannello & Anor v Sharpe* [2007] NSWCA 61
4. *Rana v Dalla Costa* [2014] NSWSC 1113
5. *Sydney Developments Pty Limited v Perry Properties Pty Limited* [2016] NSWSC 515
6. *Cole v Raykir Holdings Pty Ltd* [2019] NSWSC 1017

1

Ashdown v Kirk (1999)

- Residential property sale ($2.6m)
- Split deposit
  - First instalment - $50 to be paid 180 days from date of exchange
  - Second instalment - $200 to be paid 360 days from exchange
    - Total deposit $250 (9.6% of the purchase price)
- Purchasers failed to pay the first instalment of $50
- Vendors sued for the entire deposit ($250)
- Vendors won

The court essentially held that both deposit payments were truly deposits, because they were both due before settlement, and therefore 'in earnest of performance'. The vendors succeeded in their claim to recover the full deposit

2

Luu v Sovereign Developments (2006)

This was not a split deposit case, but it is important because it examined the issue of conveyancing deposits being deemed to be penalties

- Sale of vacant land ($6.6m)
- First page of the contract specified the deposit to be $65
  - i.e. 1% of the purchase price
- Purchaser defaulted
- Vendor sued for full 10% deposit (under a special clause) but not for damages

- Vendor won at first instance (District Court)
- Purchaser appealed to the Court of Appeal (CoA) on two grounds:
  - The "true" deposit was $65
    - i.e. it was 1% not 10%
  - Anything above that (under the special clause) was a penalty and therefore unenforceable
- Purchaser won

Whilst the CoA unanimously decided that the deposit amount was indeed 1%, it also explored, in some detail, the characteristics of a conveyancing deposit:

> **"…$65 paid on exchange…is not only designated by the parties as the deposit…in a completely clear manner; it has the character of a deposit…that…is earnest money paid at the time of making the Contract;…it is the deposit because it was deposited. The same cannot be said of…money payable on the happening of some later event as provided for…(in the) special (clause)…that sum is not a deposit. Only a deposit falls within the exemption from penalties law, not any other payment of 10% of the purchase price."** [15]

The court also examined the 'default' circumstances as stipulated in the contract, and determined that it allowed the vendor to terminate on any default by the purchaser no matter how trivial, but also noted that, ordinarily, the purchaser will not get his 'earnest money' back if he does not complete the sale. However, Bryson JA went on to say that this depends on the 'earnest commitment' (i.e. character) of the money paid for such purposes; anything other than a reasonable deposit is "open to challenge", and that parties cannot "avoid the operation of penalties law by designating a payment…as a deposit if it does not otherwise have that character" [24]

this paragraph [24] and the last sentence in particular (see page 3 above) **has been quoted with approval in almost all the following cases**

Luu, on its own facts, concludes that the amount in question did not have the character of a deposit, and the vendor was entitled to retain only the 1% already paid

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Iannello v Sharp (2007)

- Residential property purchase ($4.5m)
- Spilt deposit
  - 5% on exchange ($225)
  - 5% due "if the purchaser defaults" in relation to any essential obligation
- Purchaser defaulted

- Vendor terminated
- Vendor sued for:
  - Balance of deposit under special clause
    - (if purchaser defaults, the full 10% is due)
  - Damages
- Vendor lost at first instance
  - Due to an 'unauthorised' alteration in the contract (deemed material) which served to void the contract
- Vendor appealed
- Vendor won on appeal (partially)
  - Vendor allowed to retain the 5% deposit already paid
  - Vendor not allowed to recover the unpaid 5% because it was deemed a penalty

The CoA determined that the unauthorised alteration to the contract was not material, because it did not change the effect of the special clause, which meant that the court had to (then) decide if the special clause constituted a deposit or a penalty. The CoA looked particularly at *Luu* and Hodgson JA expressed his "opinion" as follows:

- **the obligation to pay the second $225 would only arise…where the vendors have lost their bargain…it cannot be considered a pre-estimate of damages** [29]
- **if the second $225 is not part of a deposit, provision for its payment would be a penalty and not enforceable** [30]
- **the obligation to make the second payment of $225 is not an obligation to pay a deposit or part of a deposit. There never would be a time when this second $225 …would be paid…to show that the purchaser is in earnest in committing himself to pay the rest…the only time…the purchaser …(is obligated)…to pay this sum is when the purchaser has demonstrated that he is not in earnest, and indeed the termination of the contract means that he would not be able to complete the contract** [32]

The CoA ruled that the vendors were entitled to retain the $225 deposit already paid, but were not entitled to recover the $225 unpaid portion "because it was a penalty"

4

Rana v Dalla Costa (2014)

- Residential property sale ($1.25m)
- Contracts exchanged in April 2011
- Settlement due in November 2011
  - Seven month settlement period
- Split deposit - $50 in total (4%)
  - $25 on exchange
  - $25 due 70 days post exchange
    - June 2011 – five months before settlement

- Second deposit instalment (June) not paid
- Negotiations ensued
- Second deposit cheque paid in November 2011 bounced
- Vendors terminated
- Vendors sold the property for $20 less than the original contract
- Vendors sued for:
  - Unpaid deposit of $25
  - Damages
- Vendors won at first instance
  - They argued that 'the deposit was a deposit'
- Purchaser appealed
  - They argued that the deposit was a penalty
- Purchaser lost on appeal

In this case Associate Justice Harrison attempted to bring together the strands of the preceding cases in an attempt to define and clarify the differences between deposits and penalties; after reviewing numerous cases[9], Harrison AsJ noted that:

- **"(t)he question of whether the second (payment) is a deposit or a penalty turns on how it is characterised under the contract"** [58]
- **…"what is important in these cases is the timing stipulated in the contract for when the second payment is due** [59]

In *Rana*, the vendor relied both on clause 9.1 (keep or recover the deposit) and the special condition which stipulated that the second payment was due nearly five months before settlement. Harrison AsJ concluded that the second payment retained the characteristics of a deposit because it was "earnest in complying with the contract" but that if the second payment had been due at settlement, then clause 9.1 would not have saved the payment from being classified as a penalty. Ultimately, her Honour determined that the timing of the second deposit meant that it could be characterised as a deposit and, thus, was recoverable by the vendors

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Sydney Developments (2016)

- Residential property sale ($4.6m)
- Contracts exchanged September 2015, with settlement due June 2016
- Split deposit
  - 10% on exchange ($466)
  - 10% due 122 days post exchange (January 2016)
    - If not paid, the purchaser forfeits the 10% paid on exchange
- Purchaser did not pay the second deposit instalment in January 2016

[9] Refer to my full paper in your Workshop folder for an expanded discussion of these cases

- Vendor terminated
    - Purchaser also claimed to have terminated
- Purchaser sued for:
    - Damages for vendor's 'repudiation'
    - Return of 10% deposit paid at exchange
        - The vendor did not cross-claim for the second/unpaid deposit instalment

The court primarily had to look at the special condition in the contract which called for, effectively, a 20% deposit, which, the purchaser argued, was "extravagant or unreasonable", thereby rendering the entire clause a penalty

Justice Darke found that:

> **The first payment is plainly in the nature of a deposit. The position is less clear in relation to the second payment. It is not payable until about four months after exchange…(which) is still some five months prior to the…completion date, so the second payment is capable of being characterised as a payment made as an earnest of performance…**[42]

Darke J concluded that the special condition was not a penalty clause, and that, under both the special clause and standard clause 9.1, the vendor was entitled to retain the 10% deposit which was paid on exchange. The purchaser lost on all counts, including costs

6

Cole v Raykir (2019)

- Residential property purchase ($2.83m)
- Six month settlement period
- Split deposit
    - 5% on exchange ($141.5)
    - 5% due "on or prior to completion"
- Purchaser failed to settle
- Negotiations ensued
- Vendor terminated
- Vendor subsequently sold the property for $2.23m
    - Deficiency of $600
- Vendor sued for:
    - Unpaid deposit of 5% ($141.5)
    - Damages
        - Deficiency on resale

Pertinent to the issue of the deposit was the purchaser's contention that the special clause was "penal in nature". Justice Darke said as follows:

> **…Under...the special clause…the Balance Deposit is required to be paid "on or prior to completion"…(h)owever, it seems to me that, despite its description, the Balance Deposit lacks the character of a deposit. If the contract was performed in accordance with its terms, the Balance Deposit would not have to be paid before the actual completion of the contract. In those circumstances the Balance Deposit could not be characterised as an earnest of performance…If that is correct then…(the special clause)…would appear to be penal in nature. So, too, would cl 9.1**

This last point is important: the standard clause 9.1 would not have saved the vendors in the circumstances, as his Honour considered it to (also) be "penal in nature". This is significant, because it casts doubt on a vendor's ability to "recover" any unpaid portion of the 10% deposit in the event that the purchaser does not complete the contract, unless the vendor can demonstrate that the unpaid portion retains the characteristics of a deposit; a payment due "on or before settlement" is unlikely to have such a character, in other words, his Honour is saying that:

- The timing of the second deposit is crucial
- A vendor won't be saved by the standard clause 9.1
  - If the timing is/can be "at settlement"

← noteworthy

As it happened, his Honour did not have to decisively rule on this point, given that the vendors subsequently sold the property for $600 less than the original purchase price, and were entitled to recover this shortfall under standard clause 9.3.1 (offset by the 5% deposit paid on exchange)

10% deposit ≠ 10% deposit when paid in instalments – beware the "payable on or before settlement" stipulation

What does this all mean

Essentially, it means that – where a deposit is payable in instalments – the second instalment must have the character of a deposit, otherwise it is unlikely that a vendor will persuade a court that s/he is entitled to recover the outstanding deposit balance. In other words, if a deposit is split into two instalments, with the first instalment paid upon exchange and the second "on or before settlement", the second instalment may lose its character as a deposit because, if it can be due "at settlement", it is not a payment "in earnest of performance"[10]

[10] As the purchaser has already performed under the contract, by completing

And, in the event that the purchaser defaults before settlement, the vendor is, under this theory, suing for the second instalment not as a deposit (because it is not earnest of performance) but, rather, as damages for breach of contract. And if the instalment is in the nature of damages rather than a deposit, it loses its 'exemption' from the law of penalties, opening the door for equity to step in

Note that the common law right to sue for damages remains intact, and, as seen in *Cole*, a vendor will likely succeed on such a claim if there are damages suffered.[11] But if the vendor re-sells for a higher amount, and therefore doesn't sustain (significant) damages, s/he may fall foul of the law of penalties because clause 9.3.1 (or at least, the first part) is now unavailable to the vendor (leaving only the second part of 9.3.1 ("reasonable damages") available)[12] because, based on Darke J's *obiter* comments in *Cole*, clause 9.1 will be considered a penalty clause in such circumstances (and, therefore, is also unavailable to the vendor). The upshot is that a vendor - depending on the differential between the increased sale price and the unpaid deposit portion – may end up being significantly out of pocket if a purchaser defaults

What happens if a vendor subsequently sells for a profit ?

Let's put this in context

I was recently involved in the following case[13] decided by Justice Darke:

- Vendor sold a residential property (approx $2m)
- Split deposit:
  - $ 80 (4%) payable at exchange
  - $120 (6%) payable "on or before settlement"
    - Payable in the event of default by the purchaser
- Six month settlement period
- Purchaser did not complete
- Vendor terminated
- Purchaser refused to:
  - Authorise release of the $80
  - Pay the balance of the deposit ($120)
- Vendor subsequently re-sold the property for $2.04m
  - An increase of $40 over the original sale price

[11] most usually, a deficiency on re-sale under clause 9.3.1
[12] Which needs to be quantified (and which may be considerably less than the full 10%)
[13] *Blanco v Wan* [2021] NSWSC 273

- Vendor sued for:
    - Release of the $80 deposit
    - Payment of the remaining deposit $120
    - Damages due under the contract
        - Including interest and specific (sundry) fees

The facts are reasonably similar to *Cole*, except that in *Cole*, the vendors later sold for a significant loss (over $600) which allowed them to claim damages under 9.3.1. However, in this case, the vendor sold the property for $40 more than the original contract, so he could not avail himself of (the first part of)[14] clause 9.3.1, and as Justice Darke (in *Cole)* considered 9.1 to (also) be penal in nature in such circumstances, we had an uphill battle to convince the court that the vendor was entitled to "recover" the unpaid portion of the 10% deposit under 9.1

Not surprisingly, given the above authorities, we were unsuccessful; the vendor was awarded the portion of the deposit already paid (4% / $80) but <u>not</u> the unpaid portion ($120) which effectively left him $80 worse off.[15] If the vendor had resold the property for a loss, then *Cole* suggests that he could successfully sue for the loss sustained on the sales price, but – because he sold for a profit (albeit a modest one) – he was not successful in recovering the unpaid deposit balance. In other words, <u>selling for a profit (even if only for a small amount) effectively renders the unpaid deposit unrecoverable</u>, which has the potential to leave a vendor financially worse off (especially if s/he seeks to file suit)[16]

Just as *Cole* settled the issue of what a vendor is entitled to sue for when s/he sells the subject property for a loss, so too has this case settled the question of what a vendor is essentially entitled to seek from a defaulting purchaser when the property is subsequently sold for a profit. The takeaway from this is that a vendor should very carefully consider his/her options when a purchaser seeks to pay a deposit of less than 10% and/or pay on an instalment basis. Such an agreement, no matter how carefully drafted, will put the vendor at risk of being unable to recover any unpaid portion of the deposit in the event of a purchaser's default

Danger particularly exists for a vendor when the property is subsequently sold for a higher price; if the profit is less than the 'lost' deposit, then the vendor may be significantly worse off financially (on paper at least)

[14] As discussed above (page 10) the second part of 9.3.1 requires that damages be quantified, which would likely be far less than the unpaid portion of the deposit
[15] The unrecoverable portion of the deposit ($120) less the profit on the re-sale ($40) – a difference/loss (on-paper) of $80
[16] The vendor will need to weigh up the potential costs of litigation compared to the amount of the unpaid deposit; in the event that most of the damages actually sustained as a result of the default were covered by the portion already paid, it may not be commercially viable to sue on the contract

<u>Standard Property Contract of Sale - Clause 9 (and Clause 2) – a reminder</u>

The remedies available to a vendor when a purchaser defaults:

<u>Clause 9</u>

9 Purchaser's default

If the purchaser does not comply with this contract (or a notice under or relating to it) in an essential respect, the vendor can terminate by serving a notice. After the termination the vendor can –

9.1 Keep <u>or recover</u> the deposit (to a maximum of 10% of the price)

9.2 Hold any other money paid by the purchaser under this contract as security for anything recoverable under this clause –

9.2.1 for 12 months after the termination, or

9.2.2 if the vendor commences proceedings under this clause within 12 months, until those proceedings are concluded, and

9.3 sue the purchaser either –

9.3.1 where the vendor has resold the property under a contract made within 12 months after the termination, to recover –

- <u>The deficiency on resale</u> (with credit for any of the deposit kept or recovered and after allowance for any capital gains tax or goods and services tax payable on anything recovered under this clause), and
- Reasonable costs and expenses arising out of the purchaser's non-compliance with this contract or the notice and of resale and any attempted resale, or

9.3.2 to recover damages for breach of contract

(emphasis added)

Note also Clause 2:

Deposit and other payments <u>before completion</u>

2 Deposit and other payments before completion

2.1 The purchaser must pay the deposit to the depositholder as stakeholder

2.2 Normally, the purchaser must pay the deposit on the making of this contract, and this time is essential

2.3 If this contract requires the purchaser to pay any of the deposit by a later time, that time is also essential

(full clause not shown) (emphasis added)