Split-deposit clauses and penalties reconsidered

Kye Tran-Tsai is Special Counsel at Nolan Lawyers and **Benjamin Adams** is Associate at Baker McKenzie. Both are members of the Law Society Property Law Committee.

BY KYE TRAN-TSAI AND BENJAMIN ADAMS

Snapshot

- The courts have accepted that the principles relating to penalties do not apply to deposits paid on contracts for the sale of land that are true deposits and are for reasonable sums.
- There have been some decisions where 'split-deposit' special conditions have fallen outside of that exception and have been characterised as a penalty clause and held to be unenforceable.
- In light of recent cases, solicitors need to carefully consider the drafting of their 'split-deposit' special conditions and should advise vendors that they may not be able to recover a second or subsequent instalment of a deposit, which is due on breach of the contract.

Consider the following scenario: a vendor under a contract for sale of land allows the purchaser to pay the usual 10 per cent deposit of the purchase price by instalments, with 5 per cent due on exchange, and the balance on completion or default. The special condition makes clear that the payment in two instalments represents the deposit. The purchaser subsequently defaults in an essential respect. Can the vendor recover the second instalment?

According to clause 9.1 of the standard contract, the answer is yes. The standard contract clearly allows the vendor to keep and recover the 10 per cent deposit where the purchaser does not comply with the contract in an essential respect. However, the issue with special conditions allowing for a 'split-deposit' or 'top-up' is whether the subsequent instalment of the deposit can be characterised as part of the 'deposit'. Several cases over the past decade have held that where the subsequent instalment falls short of its characterisation as a true deposit, then it will be necessary for a court to consider whether the amount is a genuine pre-estimate of damage or a penalty. If it is a genuine pre-estimate of damage, it will be upheld. If not, it will be struck down as a penalty and the vendor will be unable to recover that instalment.

The penalty rule

As a matter of commercial convenience, parties can agree in advance what damages will be payable in the event of a breach of contract. However, the agreed sum must be a 'genuine pre-estimate of damage' in order not to be characterised as a penalty. The problem with a penalty clause is in its nature – to punish by imposing an additional or different liability to be discharged upon breach or non-observance of a contractual stipulation (*Legione v Hateley* (1983) 152 CLR 406; [1983] HCA 11 per Mason and Deane JJ).

Dunlop v Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1915] AC 79 (***Dunlop***') is the accepted authority for the proposition that an agreed sum will be a penalty if it is extravagant, exorbitant or unconscionable such that its imposition has no other purpose than to punish the offending party. This English decision was subsequently affirmed by the High Court in *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71. Whilst it is a longstanding policy of the common law courts to avoid intervening in a bargain struck by parties with comparable bargaining power, the courts may read down a clause that would make it unconscionable for a party to enrich themselves at the expense of the other in circumstances where:

- an agreed sum, which is forfeited upon a breach, is out of all proportion to the damage; and/or
- the clause operates *in terrorem* (in a way that coerces) a party into compliance, rather than to represent a genuine pre-estimate of damage.

Whether a clause falls foul of the penalty rule 'is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach' (*Dunlop* at 86-87 per Dunedin LJ). The onus of showing that a clause in the contract operates as a penalty is borne by the defendant.

The genuine, reasonable deposit exception

The courts have historically accepted that a genuine 10 per cent deposit, forfeited in the event of a purchaser's failure to complete, will not invoke the penalty rule. Therefore, where a vendor is able to prove that a subsequent instalment retains the character of a deposit and is reasonable in amount and not excessive, the principles concerning penalties will *not* apply to the stipulation (*Luu v Sovereign Developments Pty Ltd* [2006] NSWCA 40 at [25]; *Iannello v Sharpe* [2007] NSWCA 61 at [31]). This position was recently affirmed by Darke J in *Sydney Developments Pty Ltd v Perry Properties Pty Ltd* [2016] NSWSC 515, however '[a]dvantage cannot be taken of this exception merely because the parties to the contract have labelled or designated a payment as a deposit' (at [38]).

A 'genuine' deposit is a payment which demonstrates commitment to complete the contract - an 'earnest for performance' (see *Howe v Smith* [1881 - 85] All ER Rep 201). There is no legal reason why a genuine deposit cannot be paid in instalments (*Romanos v Pentagold Investments Pty Ltd* (2003) 217 CLR 367; [2003] HCA 58 at [20]), however each *instalment* of the deposit must retain its character as a deposit.

A 'split-deposit' clause will become subject to the rule against penalties if one or more of the instalments does not either retain the true character of the deposit, or comprise a reasonable sum.

Decisions in which 'split-deposit' clause was upheld

Cloud Top Pty Limited v Toma Services Pty Limited [2008] NSWSC 568 ('***Cloud Top***') – Einstein J upheld the plaintiff's claim seeking payment of the last deposit instalment under a contract for sale of land entered into with a contract for sale of business. His Honour held that the amounts specified as deposits were not extravagant or unconscionable and did not possess any character of a penalty. The effect of the respective terms was to require payment of the final 5 per cent instalment on the 42nd day after the contracts were made, whether or not completion of the contracts actually occurred on that date and did not arise by reason of termination of the contracts.

Rana v Dalla Costa [2014] NSWSC 1113 – Harrison AsJ held that the vendor was permitted to recover and retain the second instalment of the deposit in this case on the basis that the second instalment was due 140 days prior to completion and not on completion. Her Honour held that this was effective for the instalment to retain its character as a true deposit, acting as an earnest or guarantee of performance of the contract.

Sydney Developments Pty Ltd v Perry Properties Pty Ltd [2016] NSWSC 515 – Darke J held in this case that a 20 per cent deposit payable in two 10 per cent instalments was not a penalty, allowing the defendant vendor to forfeit the first instalment because it was considered to be a valid deposit. Furthermore, the second instalment was not a penalty because the amount was not forfeited in the event that the contract was terminated upon breach by the purchaser. However, his Honour made clear that only 10 per cent of the purchase price may be forfeited consistent with settled principles and clause 9.1 of the standard contract.

Decisions in which 'split-deposit' clause was struck down as a penalty

Luu v Sovereign Developments Pty Ltd [2006] NSWCA 40 ('***Luu***') and *Iannello v Sharpe* [2007] NSWCA 61 – In both cases, the Court of Appeal found the clauses ineffective. In *Luu*, Bryson JA held that the special condition was a penalty because it required the purchaser to pay 10 per cent of the purchase price on any default, whether trivial or serious. In such a case, the payment was not a genuine pre-estimate of damage. His Honour also held that the exception from the law relating to penalties relates only to deposits truly having the character of earnest money paid on or in relation to entering the contract. The Court also confirmed that the exception does not extend to other payments.

Boyarsky v Taylor [2008] NSWSC 1415 – Brereton J held that the second instalment was not 'an earnest for performance' and was exacted on the purchaser's breach of contract, and in those circumstances was a penalty and void. His Honour stated that 'an unconditional promise to pay an amount on default cannot itself count as a deposit, because that is the very sort of promise that would normally amount to a promise to pay a penalty, unless it is a genuine pre-estimate of damages' (at [50]).

Kazacos v Shuangling International Development Pty Ltd [2016] NSWSC 1504 – White J followed Brereton J in *Boyarsky v Taylor* and held for the purchaser, and the vendor was not entitled to recover the deposit because the second instalment (5 per cent) would become payable if the purchaser defaulted on the contract. Therefore, it was not 'an earnest for performance', but a payment that was payable on default.

In view of these decisions, it is likely that a vendor will encounter difficulties in attempting to recover additional instalments of the deposit where payment of that instalment is due on completion or linked to breach of the contract. However, the vendor can still sue for damages on ordinary principles in those circumstances.

Practical considerations

Solicitors acting for vendors should:

- advise the vendor that they may encounter difficulty enforcing a second or subsequent deposit instalment in the event of default;
- carefully draft their 'split-deposit' clauses so that instalments can be properly characterised as true deposits, being a sum in 'earnest of performance';
- require payment of the balance of the deposit *before* completion with a precisely drafted special condition. When drafting, note that the courts have held that a clause which requires payment of an instalment on a date which coincides with completion can be characterised as a penalty – we caution against following the approach taken in *Cloud Top*;
- insist on payment of the full 10 per cent deposit upfront in the form of a deposit-bond, enlivening clause 3 of the standard contract and provide a standing instruction to the selling agent;
- consider other statutory remedies which have impact on the retention of the deposit by a vendor, including section 55 of the *Conveyancing Act 1919*; and
- ensure any estimates for liquidated losses are contained within reasonable limits and not 'out of all proportion' to the loss suffered by the vendor. Consider stipulating a ceiling or cap to be placed on any total liquidated damages amount, where an amount is specified. **LSJ**