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IS IT A DEPOSIT OR A PENALTY?

Two recent decisions of the NSW Court of Appeal confirm that in conveyancing transactions, only amounts paid to the Vendor by the Purchaser which can be truly characterised as a deposit are safe from the law of penalties.

In conveyancing transactions it is common for the purchaser to demonstrate to the vendor that the purchaser is serious about buying a property and also that they are acting bono fide and are keen to be bound by the terms of the contract, by paying a deposit to the vendor on exchange of contracts. Normally, the amount paid by way of deposit is 10% of the purchase price. However, in recent times, it has become common for the amount of the deposit paid to be reduced to 5% (or even less) of the purchase price. This trend to smaller deposits has presumably come about to induce purchasers to enter into contracts for the sale of a property by allowing them to find less money "up front" on exchange of contracts.

In situations where the deposit paid is less than 10% of the purchase price, it is common for the special conditions of the contract to contain a clause which provides that if the Purchaser defaults on one or more of its obligations under the contract (for example, by not completing on the date specified for completion), that an amount



equal to 10% of the purchase price will become due and payable by the Purchaser to the Vendor.

The Courts have had occasion recently to examine whether such special conditions are enforceable by the vendor or whether they are rendered void by the law of penalties.

The law of penalties exists to ensure that conditions in contracts that are unfair, or provide for payment by one party to another of amounts which are far in excess of losses or damage likely to be suffered by the aggrieved party (ie amounts that exceed a genuine pre-estimate of the damages caused by the breach of that contract by the guilty party) should be struck down as an unlawful penalty.

In examining such potentially penal conditions in contracts, the Courts need to carry out an analysis of the relevant condition in the contract to determine



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whether or not the condition was penal in all the circumstances. In general, Courts will find that a condition in a contract is a penalty and hence void, where the condition requires the payment of a sum which is extravagant and unconscionable in comparison with the greatest loss which could be proven to have been suffered by the person claiming the loss.

Two recent cases, *Luong Din Luu v Sovereign Developments Pty Limited* (2006) NSWCA 40 and *Iannello v Sharpe* (2007) NSWCA 61, examine these issues.

In 'Din Luu', the front page of the contract recorded the purchase price as \$6,600,000.00 and the deposit was stated to be \$65,000.00. A special condition was contained in the contract which provided:-

"In the event that the purchaser pays less than 10 per cent (10%) of the purchase price as deposit then if the purchaser commits a default hereunder the whole of the 10 per cent deposit shall become due and payable notwithstanding that this contract is not completed. This clause shall not merge on completion and the vendor shall be entitled to sue for recovery of so much of the 10 per cent deposit that remains outstanding as a debt due by the purchaser to the vendor".

The purchaser failed to complete the contract on an essential date and the vendor terminated the contract and sued the purchaser for the balance of the 10% deposit which amounted to \$616,000.00.

At first instance, the Court gave Judgment for the vendor on its claim. The purchaser then appealed the matter to the Court of Appeal on the following grounds:

1. The special condition could not have any operation as the front page of the contract clearly stipulated that the deposit was \$65,000.00; and



2. The vendor's entitlement to recover a 10% deposit was a penalty and therefore unenforceable.

The Court held that the relevant special condition was a penalty, and hence void, because it required the purchaser to pay 10% of the purchase price on any sort of default (whether minor or serious) and, such a payment would have been grossly excessive and bore no relationship to any genuine pre-estimate of damages that the vendor might have suffered as a result of the purchaser's default.

The second case of *Iannello v. Sharp*, although slightly different on its facts from the *Din Luu* case, arrived at the same result.

In summary, these cases demonstrate that only amounts which can truly be characterised as genuine deposits (up to a maximum of 10% of the purchase price) will be held by the Courts to be valid and will not infringe the law of penalties. Special conditions of the type which are common to recover the balance of the 10% purchase price on payment of a lesser amount of deposit run the risk that they may be held by the Courts to be unenforceable as penalties.



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