Wilberforce CHAMBERS

DEPOSITS IN CONVEYANCING TRANSACTIONS: HOW DOES THE PENALTIES DOCTRINE APPLY?

COMMENTARY BY JOSEPH STEADMAN, 25 OCTOBER 2019

1. Anyone who has been involved in a conveyancing transaction – and many people who haven't – will know that it is customary to pay a 10% deposit on exchange of contracts. In fact, most of those involved in ordinary residential property transactions probably assume they have no choice in the matter.

2. When all goes well, the 10% deposit is simply the first step in the buyer's payment of the purchase price of the property. But if – beset with financing difficulties or struck by a change of heart – the buyer fails to complete (and if the seller is ready, willing and able to do so) then the ordinary course is for the 10% deposit to be forfeited by the buyer and retained by the seller.

3. In *Cavendish Square Holding BV v Makdessi*,[1] the Supreme Court affirmed the longstanding principle that the penalties doctrine would not prevent the forfeiture of the customary 10% deposit in a conveyancing transaction, but – in a departure from the courts' traditional approach in England and Wales – the majority found that the penalties doctrine was capable of applying to prevent the forfeiture of "excessive" deposits.

4. This paper starts by considering the traditional approach to deposits before *Cavendish*, then goes on to explore how the penalties doctrine might now apply in practice to conveyancing transactions. It concludes by identifying three questions that the courts will need to grapple with in the future—and suggesting some answers.

Deposits before *Cavendish*: the limited availability of relief from forfeiture

5. Provisions for the forfeiture of sums *already paid* have traditionally been treated differently from contractual terms requiring the payment of a *further* sum on breach. Whilst the penalties doctrine could apply to prevent the enforcement of the latter, the former was subject only to the more limited doctrine of relief from forfeiture.

6. An illustration of the restrictive approach taken by the courts to relief from forfeiture is found in *Stockloser v Johnson*.[2] The majority of the Court of Appeal held that there were two requirements before relief could be granted, namely:

   (a) that the forfeiture provision had to be of a penal nature, in the sense that the sum forfeited was out of all proportion to the damage; and

   (b) that it had to be unconscionable for the vendor to retain the forfeited sum.

7. This approach was considerably less generous – and considerably less of an interference with parties' freedom of contract – than the approach taken by the courts to further sums payable on breach. In the latter case, the provision requiring payment would not be enforced unless it was a "genuine pre-

[1] [2016] AC 1172.

[2] [1954] 1 QB 476.

estimate of loss"—the familiar test from *Dunlop Pneumatic Tyre Co v New Garage and Motor Co Ltd*.[3] Otherwise, it would be a penalty, and therefore void.

8. In addition, there were other substantive consequences of the courts applying relief from forfeiture over the penalties doctrine. For example:

   (a) In considering whether a provision is a penalty, the courts looked at the position when the contract was entered into. In contrast, the question whether relief from forfeiture should be granted was considered in light of the circumstances at the time it was sought, and so the courts could take into account the parties' conduct.[4]

   (b) A provision for the payment of a sum on breach, if found not to be a penalty, gave the claimant the right to that sum but acted as a cap on recoverable damages. In contrast, the forfeiture of a deposit did not preclude the claimant from recovering additional damages, provided that credit was given for the amount of the deposit.[5]

9. The result was a clear divergence between the courts' approach to provisions permitting the forfeiture of deposits and those requiring the payment of penalties.

Deposits before *Cavendish*: relief in conveyancing transactions

10. In the case of contracts for the sale of land, the courts' equitable jurisdiction to grant relief from forfeiture was (and remains) supplemented by section 49(2) of the Law of Property Act 1925, which provides:

    > *Where the court refuses to grant specific performance of a contract, or in any action for the return of a deposit, the court may, if it thinks fit, order the repayment of any deposit.*

11. But in cases under both the general equitable jurisdiction and the specific statutory jurisdiction, the courts held up the forfeiture of a customary 10% deposit as an example of when relief should be refused, and emphasised that exceptional circumstances would be required before they would order its return.[6]

Deposits before *Cavendish*: a distinction without a difference

12. In *Stockloser v Johnson*,[7] Denning LJ sought to justify the difference in treatment between provisions permitting the forfeiture of deposits and those requiring the payment of penalties as follows:

    > *In the present case, however, the seller is not seeking to exact a penalty. He only wants to keep money which already belongs to him. The money was handed to him in part payment of the purchase price and, as soon as it was paid, it belonged to him absolutely. He did not obtain it by extortion or oppression or anything of that sort, and there is an express clause – a forfeiture clause, if you please – permitting him to keep it. It is not the case of a seller seeking to enforce a penalty, but a buyer seeking restitution of money paid. If the buyer is to recover it, he must, I think, have recourse to somewhat different principles from those applicable to penalties, strictly so called.*

13. However, Denning LJ's distinction was more a matter of form than substance. Whether a party has already paid the sum which is to be forfeited, or whether they are required to pay over an additional

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[3] [1915] AC 79.

[4] This difference was highlighted by Eder J in *Cadogan Petroleum Holding Ltd v Global Process Systems LLC* [2013] EWHC 214 (Comm).

[5] For example, in *Lock v Bell* [1931] 1 Ch 35, a deposit of £120 was forfeited and an inquiry directed as to the damages, if any, suffered by the vendor beyond that £120.

[6] See *Stockloser v Johnson [1954] 1 QB 476* and *Omar v El Wakil* [2001] EWCA Civ 1090.

[7] [1954] 1 QB 476 at 489.

sum, the result is that they lose the benefit of that sum—and the other party, correspondingly, gains the benefit of it.

14. The illusory nature of the distinction – and the inadequacy of Denning LJ's justification for treating deposits differently from penalties – is brought out by the fact that, if a deposit was due but had not been paid before the contract came to an end, the seller could sue the buyer for it: *Griffon Shipping LLC v Firodi Shipping Ltd*.[8]

Deposits after *Cavendish*: applying the penalties doctrine

15. The Supreme Court decision in *Cavendish Square Holding BV v Makdessi* was a landmark reconsideration of the penalties doctrine.

16. In place of the old "genuine pre-estimate of loss" test – which remains a relevant consideration for the courts – the new question in determining whether a provision is a penalty is whether it:

> *…imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.*[9]

17. As part of determining this new proportionality test, the Supreme Court made clear that as between commercial parties of equal bargaining power, the strong presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.[10]

18. On the application of this reformed penalties doctrine to the forfeiture of deposits, the Supreme Court's observations included the following. [11]

    (a) The forfeiture of a deposit is capable of being challenged as a penalty.

    > *The fact that a sum is paid over by one party to the other party as a deposit, in the sense of some sort of surety for the first party's contractual performance, does not prevent the sum being a penalty, if the second party in due course forfeits the deposit in accordance with the contractual terms, following the first party's breach of contract*

    (b) The purpose of a customary 10% deposit is as "earnest money" rather than a penalty, but a larger deposit will require special justification in order not to be a penalty.

    > *I conclude therefore that in both English law and Scots law (a) a deposit which is not reasonable as earnest money may be challenged as a penalty and (b) where the stipulated deposit exceeds the percentage set by long-established practice the vendor must show special circumstances to justify that deposit if it is not to be treated as an unenforceable penalty.*

19. Strictly, these observations were obiter dicta: none of the parties alleged before the Supreme Court that the provisions in issue were forfeitures from which relief could be granted. Nevertheless, they will have persuasive force—at least at first instance.

Deposits after *Cavendish*: three questions for the future

20. Where does that leave the law on forfeiting deposits in conveyancing transactions? For the time being, it is difficult to predict how the courts are likely to respond in all but the simplest cases. To my mind, there are three key questions which the courts will need to grapple with in the future.

21. Can a customary 10% deposit ever be recoverable?

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[8] [2013] EWHC 593 (Comm), affirmed on appeal [2013] EWCA Civ 1567.

[9] [2016] AC 1172 at [32].
[10] [2016] AC 1172 at [35], [152], [282].
[11] [2016] AC 1172 at [16] and [238].

(a) It is hard to envisage the courts finding that a customary 10% deposit is a penalty. There is wide recognition that a 10% deposit is reasonable as earnest money, and the practical ramifications in disrupting the longstanding practice of the property market would be enormous.

(b) Conceptually, it would be possible for a court to find a provision for forfeiture of a deposit not to be a *penalty* because – at the time it was entered into – it did not impose a disproportionate detriment but nevertheless to grant *relief from forfeiture* because – by the time of the hearing – the circumstances were such that it would be unconscionable for the deposit to be retained. In line with the courts' approach to their section 46(2) jurisdiction, we can expect this only to be in exceptional cases.

22. When will a larger deposit be recoverable?

(a) Just as the courts will be slow to order the return of a 10% deposit, it is likely that their suspicion of larger deposits will continue.

(b) The new approach of presuming that commercial parties can take care of themselves and should be held to their bargains is likely, to an extent, to limit the courts' willingness to intervene where a larger deposit is stipulated.

(c) However, as the post-*Cavendish* decision in *Vivienne Westwood Ltd v Conduit Street Development Ltd*[12] shows, the commercial context is no bar to the application of the penalties doctrine—it is simply one factor to be weighed by the court in determining whether the detriment is out of proportion to the innocent party's legitimate interests.

23. Where the courts permit a deposit – large or small – to be retained, will further damages be available?

(a) If the penalties doctrine has subsumed the courts' jurisdiction to grant relief from forfeiture, then the logical consequence would be that the retention of a deposit would preclude any further claim to damages.

(b) The better view is that the *principles* of the penalties doctrine are now aligned with those concerning relief from forfeiture, but that the jurisdiction to do so – and the substantive differences identified in paragraph 8 above – remains intact.

(c) This approach is supported by the editors of *Chitty on Contracts,*[13] who suggest that the Supreme Court's intention was not to depart from this aspect of the law on deposits.

24. With so much left open, and the magnitude of the potential consequences in large property transactions, we can expect these issues to be back in the appellate courts before too long. For now, though, we are left with uncertainty as to how the law operates in relation to the forfeiture of deposits—exciting for us, but a headache for our clients.

For more information on our Property practice, please click here.

[12] [2017] L&TR 23
[13] 33rd edition, ¶26-250.