

## **DEPOSITS – SIZE, ALTERNATIVES AND FORFEITING**

### **Introduction**

In the current economic climate, and with dropping land and property prices, a number of buyers are either unwilling or unable to complete contracts for the purchase of land and/or property.

Many buyers can no longer afford to buy property which they are contractually committed to acquire because of withdrawn mortgage offers arising from the "credit crunch" restricting the availability of bank finance. Declining property prices may mean that there are problems with buyers of their existing home or further down the chain. Developers are also affected as declining land values may mean that projects are no longer viable and they too have problems with funding.

A seller is at a greater risk than previously of a buyer rescinding the contract or failing to comply with a notice to complete, on the basis that a lender has withdrawn the availability of finance. Banks will generally only lend a percentage of the present value of the property and, recently, this has been set at 75% of the present value whereas, historically, banks have lent up to 90% of the present value and some have even lent 100%.

The majority of contracts provide for a deposit equal to 10% of the purchase price to be paid to demonstrate the buyer's intention to complete the purchase.

In other words if the buyer defaults and completion does not take place, the deposit acts as compensation for the seller.

It is sometimes the case that the parties agree to a reduced deposit. Where a buyer has paid a 5% deposit (or less), there is often a clause in the contract that states that even if a lesser sum is accepted as a deposit, the balance (up to 10%) will remain due and payable.

Where a buyer defaults the seller will be entitled to ask for the balance of the deposit and any accrued interest to be paid immediately. In these circumstances it will be an advantage if the seller's solicitor is holding the deposit "as stakeholder" as the monies are then more easily recovered.

A seller should be aware that it may be able to claim additional costs, expenses and/or losses arising from the buyer's default.

A buyer may also be liable to make up any shortfall if the seller subsequently sells the property for a purchase price which is less than the price agreed with the original buyer.

### **Seller Beware**

Some sellers who are considering selling to "risky" buyers, are demanding larger deposits to protect against any default by the buyer.

Care should be taken when negotiating larger deposits, as it may well be the case that a court will consider any payment of a large deposit (either in terms of the amount or as a percentage of the purchase price), a penalty (which is void under English law) and as a consequence the buyer may be entitled to recover the deposit in full.

Under section 49(2) of the Law of Property Act 1925 ("the LPA") the court has a discretionary power to order the repayment of any deposit paid by a buyer. This power is only used in exceptional circumstances where the "justice of the case" requires it.

The whole purpose of the deposit is to guard against failure to complete pursuant to a legal agreement and it is therefore unlikely that this power will be utilised unless the seller has acted

fraudulently or where in the circumstances it is unfair for the buyer to lose its deposit (but these situations are rare).

*Tennaro v Majorach* [2003] involved the sale and purchase of three flats. The buyer paid a large deposit. The sale of two of the flats was completed but due to financial difficulties the buyer was unable to complete the third purchase. The seller relied on the contract to retain the deposit. In response the buyer offered to buy the third property at a price higher than the property's market value. The seller refused. The court exercised its discretion under section 49(2) of the LPA deciding the retention of the deposit was a cynical move on the part of the seller to take advantage of the buyer's short-term financial difficulties. The fact the buyer had offered to buy the third property at a higher price meant that the retention of the deposit would be unjust.

The case of *Midill Limited and Park Lane Estates Limited & Anor* [2008] showed that even where the seller was able to resell the property at a higher price than the price agreed with the defaulting buyer, the courts still held that there were no exceptional circumstances to justify returning the deposit to the defaulting buyer. The buyer sought to rely upon the decision in *Tennaro* however the court refused to accept there were any special circumstances arguing that if "liability to repay the deposit depended upon some future sale price there would be considerable uncertainty possibly for a lengthy period. That would create precisely the uncertainty which a fixed deposit is intended to avoid".

### **Protected Deposits**

House builders and Housing Associations often enter into development agreements where the Housing Association will pay a substantial amount of the purchase price (sometimes up to 100%) on exchange of contracts.

As the Housing Association does not have a legal interest on exchange of contracts the deposit is usually protected by a bond and/or a parent company guarantee pending grant of a lease or transfer of the land.

If the Housing Association units are transferred in phases the bond will be released on a pro rata basis until all of the units have been transferred.

If the house builder is unable to transfer all or part of the contracted Housing Association units there is frequently a contractual obligation on the house builder to return all or part of the deposit.

Where the house builder fails to return the deposit (or part thereof) to the Housing Association the bond company or guarantor will be obliged to repay the deposit (or part thereof) on behalf of the house builder.

The treatment of the deposit in these circumstances is different to the conventional transaction and thus unlikely to be caught by the provisions of section 49(2) of the LPA as the development agreement contains provisions setting out in what circumstances the deposit will be returned to the Housing Association.

### **Deposit Guarantee Companies**

There are new companies coming to the fore which offer property deposit guarantees to prospective buyers.

The guarantee is often secured by a bank with a strong financial rating.

The buyer purchases the guarantee from the bank. The seller (often a housebuilder) agrees to accept the guarantee in place of a cash deposit. The housebuilder is given the guarantee on exchange and is able to claim the deposit amount from the bank, should the buyer fail to pay the deposit at completion. The buyer is liable for the deposit amount to the deposit guarantee

company.

The seller should be aware that the property deposit guarantee company may have a right to buy included within the terms of the guarantee permitting the deposit guarantee company to purchase the property at the amount that the defaulting buyer contracted to pay pursuant to its contract (including any additional items offered as incentives, less any discounts that are available to the buyer).

### **Concluding Remarks**

The law largely supports the seller where a buyer defaults on the sale/purchase of a property/land. The buyer will, in the majority of cases, lose its deposit however sellers should be careful to avoid negotiating deals that may fall within the remit of section 49(2) of the LPA requiring the seller to return the deposit to the buyer.

Sellers should consider alternatives to the traditional cash deposit. In the current economic climate, deposit guarantee companies offer an opportunity to buyers to get back into the property market.