DEPOSITS IN SALE/PURCHASE AGREEMENTS OF SERVICED APARTMENTS IN NEW ZEALAND: A MULTI-MILLION DOLLAR GAMBLE

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I INTRODUCTION

New Zealand's building boom of the last five years has led to at least one significant new trend—the growth of serviced apartments. According to one source, there has been an 800 per cent increase in the number of such units in Auckland since 1990.[1] These buildings are very often expensive, prestigious, made of high quality materials and located on prime inner-city land. Although prices start as low as $150,000 NZD, a premier penthouse apartment could be worth well over a million dollars, with a median around $350,000 NZD.[2] Costs of construction are immense, but the size of the building allows a developer to sell a large number of apartments.

Serviced apartments have some interesting features. Purchasers of such apartments receive a unit title under the *Unit Titles Act 1972* (NZ), and rights to use any common areas contained within the development. They may also separately purchase accessory units, such as car parks or storage units. A Body Corporate is formed to administer such things as building maintenance and services, and the costs incurred are apportioned between the dwelling owners according to the pre-established unit entitlement formula contained under the *Unit Titles Act*. Instead of purchasers actually using their apartments, however, they usually buy them on the basis that

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[1] Margo White, 'Auckland's Building Boom' *New Zealand Listener* (Auckland, New Zealand) 12 January 1998, 23.
[2] Ron Taylor, 'Apartment Buyer Beware, Say Experts' *New Zealand Herald* (Auckland, New Zealand) 20 December 1997, A20.

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the vendor will arrange to have them leased to some third party. Essentially, it is an ingenious way for a vendor to finance a very expensive project.

The novel nature of the projects is often mirrored in their legal arrangements. Because of the high costs of construction, and the fact that the apartments are usually sold before the building is complete, vendors are anxious to ensure that purchasers do not default under the agreement for sale and purchase. Therefore, deposits are demanded that are substantially in excess of the customary 10 per cent in New Zealand. Fifteen per cent is a common amount, and even 25 per cent has become less rare. In the event of default, contracts invariably provide for retention of those monies by the vendor.

While there are sound commercial reasons behind such deposits, the complex and novel legal arrangements in the contracts have in many ways outstripped the law. Even though large sums of money are at stake and the rewards of litigation could be substantial, the legal validity of such forfeiture provisions is unclear and has apparently never been considered in New Zealand courts, nor has there been any serious academic discussion. Not only that, but there is dearth of information about serviced apartments, and the state of the market in general. Perhaps as a consequence, it seems that few participants in the market nor their professional advisers have considered the legality of such arrangements.

There are two ways that a vendor may retain a sum of money paid by the purchaser in the event of default. First, if the amount is a genuine deposit pursuant to a contract for the sale and purchase of land. Second, if the monies are liquidated damages.[3] This paper examines both of these legal bases, and then looks at the commercial wisdom of such deposits.

II DEPOSITS PURSUANT TO CONTRACTS FOR LAND

A *The Origins of the Principle*

1 *The Right of Forfeiture*

Since the leading decision of *Howe v Smith*,[4] it is now accepted that purchasers may be required to forfeit a deposit pursuant to a contract for the sale and purchase of land should they default. But before this 19th century UK Court of Appeal decision, the relevant authorities had been contradictory. In *Palmer v Temple*,[5] Lord Denman CJ had argued that a vendor could not retain a deposit, for it should be considered as part payment. Because the notion of payment became irrelevant upon cancellation of the contract, all advances already made were held on trust for the purchaser

[3] See *Simanke v Liu* (1994) 2 New Zealand Conveyancing Cases 191,888.
[4] (1884) 27 Ch D 89.
[5] (1839) 9 Ad & El 508.

from the termination of the contract.[6] This position was affirmed in *Ockenden v Henly*.[7] However, an entirely contrary view had also been expressed in *Collins v Stimson*.[8] In that case Pollock B considered a deposit for land to be a guarantee for the performance of the contract, with default entitling the vendor to retain the monies.[9]

Fry LJ in *Howe v Smith* held that the treatment of a deposit upon default was determined by the implied terms of the contract in question. Those implied terms were shaped by the customs of commerce and the law. In his view it was traditional to give something, whether a sum of money or a piece of jewellery or other object, to mark the inception of a contract. The custom came from Phoenician, Greek, French, and most significantly Roman law, where anything given as an earnest to bind the bargain was subject to forfeiture upon termination of the contract. The Roman principle of *arra* had been adopted into English law, and noted by Bracton in the early days of the common law.[10] By the 17th century, the concept of an earnest to bind the bargain was sufficiently well established for the *Statute of Frauds 1677* (UK) to deal with it separately from part payment.[11]

The decision is perhaps an illustration of the old common law jurisprudence that the law was not created, only discovered—for on Fry LJ's view, the common law had always been, as he put it, descending in a clear line from the Romans. So the Court determined that despite authority to the contrary, a deposit could be retained by the vendor should the purchaser default.

2 *The Right of Relief from Forfeiture*

While the decision in *Howe v Smith* made it clear that in principle a deposit pursuant to an agreement to purchase land could be forfeited if the purchaser breaches the contract, it is also clear that in certain circumstances a purchaser may apply to the court for relief from such forfeiture. In essence, a deposit pursuant to a contract for the sale and purchase of land is not subject to forfeiture if that would be unconscionable.

For many years, the courts would not treat forfeiture clauses as analogous to penalty clauses. Courts were more reluctant to allow the recovery of money already paid than to deny the enforcement of a sum agreed to be payable upon breach of contract.[12] In other words, it was much harder to get affirmative relief than negative relief. The first modification of that position was to allow an extension of time to

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[6] Ibid 520.
[7] (1858) El Bl & El 485.
[8] (1883) 11 QBD 142.
[9] Ibid 143-4.
[10] See Sir Travers Twiss (ed), *Henrici de Bracton de Legibus et Consuetudinibus Angliae* (1990) vol 1, 490.
[11] See *Statute of Frauds 1677* (UK), s 17.
[12] See Anthony Guest (ed), *Chitty on Contracts* (27th ed, 1994) vol 1, [26-070].

make a payment in cases where forfeiture of previous advances would follow breach.[13]

However, following the decision in *Stockloser v Johnson,*[14] it became possible to recover a deposit under certain circumstances. In that case Denning[15] and Somervell[16] LLJ held that the court retained an equitable discretion to relieve buyers from the forfeiture of their deposit, because a sum that might otherwise be a penalty could not be validated by calling it a deposit. Denning LJ cited the Privy Council case of *Steedman v Drinkle*[17] in support, while acknowledging that the instant case turned on its own facts.

His Lordship's principle was somewhat imprecise, however. He conceded that 'the difficulty is to know what are the circumstances which give rise to this equity'.[18] He suggested that a deposit might be subject to equitable relief if the forfeiture clause was penal in nature (defined as being out of all proportion to the damage), and if it was also unconscionable for the seller to retain the money. This decision was accepted in New Zealand by Chief Justice Wild in *Codot Developments Ltd v Potter.*[19] Wild CJ stressed the equitable nature of relief, and the importance of the discretion of the Court. This use of the court's equitable jurisdiction was later confirmed in *Simanke v Liu.*[20]

So the doctrine was established on equitable principles of fairness and unconscionability. The contractual rights of the vendor were subject to the equitable jurisdiction of the court, despite the fact that a purchaser had voluntarily entered into the contract accepting the terms regarding forfeiture of deposit in the event of breach.

3 *The Grounds for Relief*

Being an equitable doctrine, relief from forfeiture of deposit is not governed by clearly established immutable rules. The facts of the case in question are paramount.[21] However, more certainty as to how the courts will approach the issue does exist now than when the doctrine was born. In essence, there are two modern requirements for a deposit to be validly forfeited. It must be reasonable, and it must be a genuine earnest to bind the bargain.

In practice these criteria are not distinct, for if a deposit is not reasonable it is unlikely to be considered by the court to truly be an earnest, and correspondingly if a sum is not objectively an earnest it is unlikely to be a reasonable deposit. *Linggi*

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[13] See *Re Dagenham (Thames) Dock Company Ex parte Hulse* (1873) 8 LR Ch App 1022.
[14] [1954] 1 All ER 630 ('*Stockloser*').
[15] Ibid 638.
[16] Ibid 634.
[17] [1916] 1 AC 275.
[18] *Stockloser* [1954] 1 All ER 630, 637.
[19] [1981] 1 NZLR 729.
[20] (1994) 2 New Zealand Conveyancing Cases 191,888.
[21] See Donald McMorland, 'Sale of Land: Deposits and Relief Against Forfeiture' (1993) 6(6) *Butterworths Conveyancing Bulletin* 191.

Plantations Ltd v Jagatheesan[22] illustrates how the two requirements can blur. Lord Hailsham referred on a number of occasions to a requirement that the amount of the deposit be 'reasonable'. But reasonableness, he said, related to the function of the deposit as a guarantee of performance. So the sum must be objectively reasonable as an earnest for the contract.[23] The best way to determine this question is to examine the following four elements: proportionality, unconscionability, the nature of the sum and special circumstances surrounding excessive deposits.

(a) Proportionality

First, if the sum forfeited is out of all proportion to the damage suffered by the vendor, then forfeiture is likely to be penal and unreasonable.[24] In the serviced apartment situation, if an apartment developer is able to quickly resell the unit which is the subject of the default, then loss may be minimal and any attempt to retain a high deposit unacceptable. Alternatively, however, if the entire development is put at risk by the default of a major purchaser, then forfeiture may not be penal. It is not uncommon in these new developments for a number of buyers to purchase a large number of units each, and were one of these individuals to default the subsequent loss of settlement monies for a significant proportion of the units could threaten the ability of the purchaser to meet construction and development costs. In these circumstances the forfeiture of deposit might not be penal. However, while that may be arguable in relation to those who buy many units, the practical reality is that all purchasers are signatories to a standard form contract specifying the same deposit. For buyers who have not made large investments such a justification would not be relevant.

(b) Unconscionable Behaviour

While relief from forfeiture of deposit does not require unconscionable behaviour by the purchaser, there is no doubt that such behaviour is relevant if it exists. This principle focuses not on the nature of the deposit, but the conduct of the vendor. The views of Somervell and Denning LJJ in *Stockloser* was that unconscionability is essential to relief, but that has not been affirmed by more modern courts.[25] Nevertheless, regardless of whether such a requirement is mandatory this consideration will surely go to the reasonableness of forfeiture.

The original authority on point is the somewhat vague decision in *Steedman v Drinkle*.[26] The judgment is very brief, and some of the facts of the case not entirely clear, but what is certain is that the purchase price of the land was payable in six

[22] [1972] 1 *Modern Law Journal* 89.
[23] See, for example, *Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370.
[24] See *Stockloser* [1954] 1 All ER 630, 638-9 (Denning LJ).
[25] See *Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370 and *Simanke v Liu* (1994) 2 NZ CONVC 191,888.
[26] [1916] 1 AC 275 ('*Steedman*').

annual instalments. The second instalment was not made by the due date, and as the land had greatly risen in value the vendor seized the opportunity to cancel the contract, refusing the purchaser's attempts to pay the instalment late. The Privy Council held that the contract was validly cancelled, but that the money already paid should be returned. The reason for the decision in *Steedman* appears to be sharp practice on the part of the vendors, although this is not explicit in the case as reported. The vendor's decision to cancel seems to have been prompted by a desire to profit from default by invoking the penalty clause. Most significantly, Denning LJ in *Steedman* explained and approved the *Stockloser* judgment in this way.

It may be, however, that *Steedman* can be best explained as a case involving a hire-purchase agreement, and that the monies paid were not really a deposit but an instalment on the purchase price. On that analysis, the money is recoverable on purely orthodox principles. Significantly, serviced apartment contracts differ from a *Steedman* situation in that they generally involve only two payments: an initial deposit followed by settlement. But regardless of how analogous on the facts *Steedman* is to such contracts, it is clear from the case itself, and perhaps just as significantly its interpretation in *Stockloser*, that in principle unconscionable behaviour by a vendor is not necessary, but will be relevant.

So if vendors act unconscionably, perhaps in such a way that it is clear that they are merely interested in claiming the deposit and not performing the contract, then the court may be inclined towards ordering relief. For example, it could be that a buyer defaults in the purchase of units in a building that is heavily oversubscribed, and the vendor takes the opportunity to cancel the contract immediately in an attempt to make a windfall profit from retaining the forfeited deposit and reselling the unit at a higher price. In this case, allowing the vendor the deposit should be unconscionable, for cancellation of the contract had as much to do with the vendor's desire for extra profit as the purchaser's inability to settle. Unconscionability, however, will always rest very much on the facts of the particular case, and such conduct will not be easily found.[27]

(c) The Nature of the Sum

As already noted, an earnest is designed as a tangible affirmation of the birth of a contract. It is not a part payment, for traditionally it was not necessarily of the same nature as the consideration for a contract. Moreover, an earnest was not always applied to the purchase price of the contract, because it was not money—a ring, for example was often given. Because deposits are today monetary and applied towards the purchase price, the feature which provides the distinction between a deposit and a part-payment is quantity. Historically an earnest was a symbol or token, and therefore small. Five to 10 per cent is not a significant payment in the context of the contract overall, even if the absolute sum is large. However 25 per cent (for exam-

[27] See *Stockloser* [1954] 1 All ER 630.

ple) is a discharge of a significant proportion of the purchaser's total obligation to the vendor, and a substantial deposit may therefore be better seen as an instalment.

Support for such a view may be found in the decision of Henry J in *Simanke v Liu.* In that case, the contract for the sale and purchase of a property for $650,000 provided for a deposit of $300,000. That sum could not be retained as a deposit, for its size meant that it was a part-payment. Of course, a deposit of over 45 per cent is clearly unacceptable, so the value of the case as a precedent for the serviced apartments situation where the maximum deposit is approximately half that amount, is limited.

Thus, a deposit must objectively be an earnest, and not a part-payment. The distinction between the two may well be a fine one, for both are advances designed to mitigate the effects and likelihood of default by the purchaser. As the particular customs surrounding deposits (such as their being non-monetary and not applied to the purchase price) have fallen into disuse, size is perhaps now the only difference between the two. However, the distinction is the foundation of the exception allowing forfeiture, and therefore by their very size large sums may be best seen not as genuine deposits but as instalments on the purchase price.

Furthermore, if a sum is to be supplemented with further payments until the contract price is met, then it is even more likely that that amount may not be a deposit but the first instalment for the property, and therefore a part payment.[28]

(d) Special Circumstances Justifying Large Deposits

In order for a deposit of greater than 10 per cent to be objectively reasonable as earnest money, and therefore subject to forfeiture, courts require some special circumstances. This condition was established by the Privy Council decision in the Jamaican case of *Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd.*[29] In that case Workers Trust sought to enforce a clause of the contract which provided for forfeiture of the deposit of 25 per cent if the purchaser failed to observe or comply with any of the contractual provisions. This occurred after a property transfer tax had caused the customary deposit amount in such transactions to be increased from 10 per cent to 17.5 per cent. In the event of default, that tax would not be payable.

Their Lordships held that it was customary to demand a deposit of 10 per cent in both the United Kingdom and in Jamaica prior to the introduction of the special tax. Again, the anomaly of allowing forfeiture of deposit was explained in terms of history and tradition. As custom was the justification for allowing forfeiture, however, the principle could not easily be extended in a way inconsistent with common practice. Any unusual provisions had to be justified by special circumstances.

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[28] See Hugh Beale, 'Unreasonable Deposits' (1993) 109 *Law Quarterly Review* 524.

[29] [1993] 2 All ER 370 ('*Dojap*').

It was decided that 25 per cent was far from a reasonable deposit. First, the increase to cover Jamaica's property transfer tax was not acceptable. In the ordinary course of events settlement would occur before the tax was due, and in any case default would nullify any obligation to pay the tax, even if payment of it had already been made. Secondly, the costs of sale (in this case by auction) did not justify the extra 15 per cent, for they were minute in comparison to the sum forfeited. Finally, while it was accepted that part of the reason for the unusually large sum was (in the words of counsel for the bank) 'to ensure that persons do not bid frivolously at the auction',[30] such evidence was not sufficient to discharge the onus on the vendor to prove special circumstances.

Clearly then, the normal desire to ensure settlement is by itself not enough reason for a high deposit. There must be some objective exceptional circumstances to justify that desire. For example, a wish to ensure performance because default would lead to more severe results than normal might be sufficient, but some specific and tangible consequence is also necessary.

Would an agreement for the sale and purchase of serviced apartments meet such a requirement? A number of reasons make these developments unique. Firstly, there is no doubt that such a development requires a greater level of commitment from purchasers. A developer must be confident that purchasers will not default before embarking on a significant construction project. Secondly, each purchaser frequently buys a large number of apartments. Were even one substantial purchaser to withdraw, the financial viability of the development could be threatened. Moreover, while default is serious enough in the context of any property transaction, a development where the building is very expensive and not complete upon sale is extremely vulnerable. If the project ceases to be viable, then completion is obviously threatened. If a developer goes into liquidation the bona fide purchasers may wait years before they can take possession of their units, if at all. Further, the security of the lender of construction funds depends on the building being completed and upon the purchasers completing settlement in order that such funds be repaid. Finally, agreements for the sale and purchase of serviced apartments have a much longer period than usual between signing and settlement, because the buildings are normally incomplete upon purchase and require a long time to build. So there is greater potential for market changes to lead to defaults. Construction may take over two years, in which time the value of the unit might have greatly altered. If there is a significant fall in the market during that period a purchaser will be less inclined to settle.

So serviced apartment contracts are unusually sensitive to default by purchasers. While any overriding special circumstances will always turn on the particular facts of the case in question, clearly some general characteristics do exist to justify an increased deposit. However, the size of the amount in question will be vital in determining its enforceability. A premium of five per cent may well be acceptable

[30] Ibid 375.

to courts; any more is unlikely to be. Moreover, there must be proportionality between the size of the amount and the seriousness of the special circumstances: in *Dojap* a deposit of 25 per cent was considered to be much too great. It is similarly difficult to envisage circumstances where that same amount would be justifiable in serviced apartment cases, for it is improbable that a vendor would face consequences or likelihood of default any more severe than normal.

Lastly, the more common deposit for serviced apartments is 15 per cent. Because the law regarding deposits has always been justified in terms of accepted custom,[31] it may well be that the spread of the practice in demanding an additional five per cent in these contracts has simply changed what is customary, and therefore, acceptable. This, however, would also preclude the forfeiture of greater sums.

4 *The Consequences of Relief From Forfeiture*

If a sum is not a genuine deposit, its entirety must be returned to the purchaser. The vendor can not seek to retain part of it, even a normally acceptable 10 per cent of the purchase price.[32] So a successful court challenge to the retention of a deposit following default will have serious consequences for the vendor—they will be unable to retain any monies at all from the deposit. They will, however, be allowed to deduct the amount of damages sustained as a consequence of breach.[33] It is perhaps this feature of the law that provides the most useful characteristic of large deposits: they effectively provide the vendor with a security from which they may recover a particularly substantial loss following breach.

III Liquidated Damages

A *The Nature of the Doctrine*

If the parties to a contract agree that in the event of breach a specified sum will be payable by the contract-breaker to the other, it will be enforceable if it equates to liquidated damages or a genuine pre-estimate of loss between the parties. Such provisions may be included to facilitate the recovery of damages without the difficulty and expense of proving actual damage,[34] to avoid the risk of under-compensation where the legal rules as to what damage may be claimed would be inadequate[35] or to operate as a limit on liability.[36]

[31] See *Dojap* [1993] 2 All ER 370.
[32] Ibid. See also *Simanke* v *Liu* (1994) 2 NZ CONVC 191,888.
[33] *Dojap* [1993] 2 All ER 370.
[34] See *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6 (‘*Clydebank*’).
[35] See *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447-9.
[36] See *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827.

If the sum is a penalty, however, it is not enforceable, for the clause cannot be an attempt to guarantee performance. So the central issue in the application of this branch of the law is always which category the sum in question falls into. While such a distinction has existed at least since the decision in *Sloman v Walter*,[37] the law in this area is still best summarised by Lord Dunedin in the landmark case of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*.[38]

Lord Dunedin's decision contained four propositions. Firstly, the words penalty or liquidated damages in the contract are not conclusive, although they may be relevant to who has the onus to prove their case.[39] Regardless of the language of the contract, the courts still have the power to decide whether the sum was a genuine forecast of probable loss. Secondly, the essence of liquidated damages is that they are a genuine pre-estimate of the damage that would follow breach, whereas the essence of a penalty is a sum stipulated *in terrorem* of the offending party.[40] The word 'genuine' has not been the subject of judicial definition. It is likely that it means a serious attempt to estimate loss, made in good faith.[41] But the crucial point is that again, for a sum to be enforceable, it cannot merely be an attempt to ensure performance.

Thirdly, distinguishing between the two is a question of construction to be decided on the terms and inherent circumstances of each particular contract, judged as at the time of making the contract, not as at the time of breach.[42] So a genuine pre-estimate of damage may take into account a possible worst-case scenario, and still be payable even if the actual loss is less. The facts of the case in question will be determinative, and general rules difficult to apply. Certain factors, however, will aid in construction. A sum is a penalty if it is extravagant and unconscionable in amount in comparison with the greatest loss that could possibly follow from the breach.[43] Further, if the breach consists only of not paying a sum of money, a stipulated sum greater than that amount will be a penalty.[44] There is also a presumption that the sum is a penalty if it is stipulated as a single amount of compensation on the occurrence of one or more of several events, some of which may cause serious and others minor damage.[45] However, if the consequences of breach are such as to make a precise pre-estimation almost an impossibility, that does not mean that the amount is automatically a penalty—indeed, the court may consider this to be the sort of case where a pre-estimate is appropriate.[46]

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[37] (1783) 1 Bro CC 418.
[38] [1915] AC 79 ('*Dunlop*').
[39] See *Wilson v Love* [1896] 1 QB 626.
[40] See *Clydebank* [1905] AC 6.
[41] See Guest, above n 12, [26-061].
[42] See *Webster v Bosanquet* [1912] AC 394.
[43] See *Dunlop* [1915] AC 79.
[44] Ibid.
[45] Ibid.
[46] Ibid.

B *An Equitable Approach?* Dunlop *and its Aftermath*

While Lord Dunedin's view of the law has survived intact, there has been some suggestion that a broad discretionary equitable approach is more appropriate. Lord Denning in *Bridge v Campbell Discount Co Ltd*[47] first articulated this idea. In that case, he attempted to formulate a general equitable power to relieve those who wished to exit their contract from the imposition of an unjust burden. The case involved the hire-purchase of a car. The contract in question provided for the payment of a sum equal to two-thirds of the hire-purchase price, less any monies already paid under the agreement upon termination of the contract (as opposed to default). The compensation was agreed to be for the depreciation of the vehicle.

Lord Denning stressed that a rigid application of the common law would lead to an 'absurd paradox'.[48] If the hirer had simply defaulted under the agreement, the sum would have been a penalty and unenforceable. But where he exercised a right under the contract (termination) which involved a certain cost as a consequence, the sum was not a penalty for there was no breach of contract. As the hirer was therefore better off to break the contract than give notice of termination, there was a need for equitable intervention.

The other members of the House of Lords were content to decide the matter on orthodox principles. Lord Morton examined the issue in the light of the guidelines laid down in *Dunlop*, and concluded that the amount payable could not have been a genuine pre-estimate of damage, because it declined as the car got older and its value fell.[49] Depreciation cover was not the intention of the provision—indeed this was conceded by counsel for the respondent, who admitted that it was to ensure that at least two-thirds of the purchase price was paid.[50] Because the sum was not a genuine pre-estimate of damage, it must be a penalty. Viscount Simonds argued that the clause simply provided a right to terminate the contract, for which the hirer paid a price to use. The provision was not a penalty, for the hirer could choose whether to exercise it.[51]

It is easy to overemphasise the anomalous nature of *Bridge*. Only Lord Denning's approach is other than conservative. Lord Morton's analysis of the sum being unable to operate as proper compensation and therefore not being genuine fits easily within the ambit of *Dunlop*. Viscount Symonds, moreover, explicitly disagreed with Lord Denning. Even Lord Denning's judgment is easily explained in terms of the injustice evident in the case,[52] and the 'absurd paradox' in *Bridge* is likely to be a

[47] [1962] AC 600 ('*Bridge*').
[48] Ibid 629.
[49] Ibid 616.
[50] Ibid.
[51] Ibid 613.
[52] See *Phillips Hong Kong Limited v Hong Kong (AG)* (1993) 151 National Reporter 219.

rare one. So *Bridge* does not significantly undermine the principles espoused in *Dunlop*, and indeed has not been followed in subsequent cases.

The High Court of Australia has stressed that the equitable basis of the doctrine must not be allowed to excessively interfere with freedom of contract. In *AMEV UDC Finance Ltd v Austin*[53] the court noted that equity has a supervisory jurisdiction to relieve against provisions that are so unconscionable or oppressive that their nature is penal rather than compensatory. It was held that while oppression was the basis for intervention, the courts must be careful not to impinge unreasonably on the parties' freedom to settle for themselves the rights and liabilities following a breach of contract. For this reason, the court affirmed the importance of the *Dunlop* approach, and suggested that it was necessary to defend it against the erosion of recent decisions. This view was confirmed in *Esanda Finance Corporation Ltd v Plessnig*.[54]

Most significantly, the Privy Council affirmed *Dunlop* in *Phillips Hong Kong Limited v Hong Kong (AG)*.[55] The court rejected the previous suggestion (contrary to *Dunlop*) that a 'mechanical'[56] approach could be taken to the question: if the amount specified was greater than the actual damage suffered, was it a penalty?[57] It stressed that oppression was the basis of relief, and that it would normally be insufficient to establish that a provision could result in a larger sum being recovered by the injured party than the actual loss suffered. To avoid undesirable uncertainty, the court had to bear in mind that what the parties agreed to normally had to be upheld.

So *Dunlop* remains the mainstay for determining whether a sum is a genuine pre-estimate of loss or a penalty. Instead of a broad discretionary decision, the courts should make a determination on the basis of certain specific factors, which go to proving the oppression of one party to the contract. Oppression, not general equitable principles, provides the basis for intervention.

C Other Considerations

Firstly, the provision for a specific sum makes a genuine pre-estimate of loss more likely. If the amount fluctuates greatly depending on events not connected with the contract, then it is likely to be a penalty. In *Public Works Commissioner v Hills*,[58] the contract in question involved the construction of a South African railway. There, the amount to be retained as liquidated damages amounted to 10 per cent of the

[53] (1986) 162 CLR 170.
[54] [1989] ALJR 238. In Canada too, there has been a concern not to stray too far from the approach laid down in *Dunlop*. In *Elsley v JG Collins Insurance Agencies Ltd* (1978) 83 DLR (3rd) 1 the Supreme Court of Canada emphasised that a cautious approach to declaring sums as penal was necessary.
[55] (1993) 151 National Reporter 219 ('*Phillips*').
[56] See Hoick-Lai Ho, 'The Privy Council on Liquidated Damages' (1995) 8(3) *Journal of Contract Law* 280, 281.
[57] See *Robophone Facilities v Blank* [1966] 1 WLR 1428.
[58] [1906] AC 369.

progress payments made under the contract. Because the amount was not a fixed sum, it could not be a genuine pre-estimate of loss.

In addition, a contract cannot stipulate a sum as liquidated damages and also make provision for recovery of actual losses upon breach. In simple terms, vendors cannot have it both ways. They can either provide for liquidated damages or actual damages, not both. In *Turner v Superannuation & Mutual Savings Ltd*,[59] retention of a deposit of just five and a half per cent as liquidated damages was unconscionable when the agreement for sale and purchase also included a clause making the purchaser liable for any actual damages suffered by the vendor as a consequence of breach. The retention clause was construed as a penalty because such an arrangement inherently means that any retention is in reality a recovery beyond any loss suffered.

Thirdly, the cases indicate that a sum fixed as a pre-estimate is appropriate when the loss consequent on breach would be difficult to quantify. This was suggested in *Dunlop* and developed further in *Phillips*. In that case, the contract in question was for the construction of a highway in Hong Kong. It provided for liquidated damages for failure to meet certain key dates and the timely completion of the contract. The Privy Council upheld the forfeiture of the amounts, noting that 'it would be obvious that substantial loss would be suffered in the event of delay but virtually impossible to calculate precisely in advance.'[60] So liquidated damages were acceptable because of the nature of the transaction.

D Applying the Doctrine to Serviced Apartments

In general, liquidated damages provisions are not found in agreements for the sale and purchase of real property, so the vast majority of case law regarding these provisions is not factually similar. How a court would interpret such a provision in the context of serviced apartments is therefore unclear. But many of the requirements for a genuine pre-estimate are in fact met. In most contracts the clauses are not invoked for a range of breaches but instead they relate only to default, the most serious breach of all. Additionally, they do not involve the payment of a larger sum of money than the amount that was the subject of the default. Lastly, they provide for a fixed sum.

The best chance that a large deposit has of surviving a court challenge as liquidated damages is that there was no oppression involved in the formation of the contract. The courts have emphasised the desirability of allowing freedom of contract and only interfering if substantial inequality of bargaining power exists. A number of purchasers of serviced apartments are property developers, experienced in such dealings and able to afford experienced legal advice before they commit themselves to the contract. Therefore, it may be equitable to hold them to their bargain, for they

[59] [1987] 1 NZLR 218.
[60] *Phillips* (1993) 151 National Reporter 219, 229.

should be aware of the ramifications of the contract before they choose to sign. When litigation inevitably commences on such an issue, this argument may well be the one most strongly relied on by the vendors of such developments.

But could a clause be a penalty for one purchaser but not another? *Dunlop* indicates that oppression is not just founded on the plain words of the contract, but also the surrounding circumstances.[61] It is likely that the degree of knowledge and experience that a purchaser has, and their ability to bargain, is part of that. In other areas of the law (such as that relating to guarantees) the commercial expertise of a party is relevant to the exercise of an equitable discretion to relieve them from their obligations under a contract, but the court is wary of setting aside a bargain on these grounds.[62] However, it may be that need for certainty and consistency in the law is such that all purchasers should be treated alike. Ultimately, it is difficult to predict whether professional investors will be treated differently to owner-occupiers, as the matter is one that will depend very much on the courts' discretion.

Another argument developers may mount is that some of the deposit is an earnest and the remainder is a pre-estimate of loss. So for example, a 20 per cent deposit may be comprised of one half as an earnest to bind the bargain, and the other half as liquidated damages. The difficulty with this argument is that it is quite clear that relief from forfeiture considers the actual nature of a payment in the circumstances which surround it, not the nature which the contract may purport to give it.[63] Therefore, if in all the circumstances a retention is in fact oppressive, or not in the nature of a genuine earnest, how it is characterised by the agreement is not relevant. Even if the court accepts that an amount of liquidated damages is appropriate in a serviced apartment contract, it is likely that coupling such a retention to a further forfeiture (that of the earnest money) would be too much for a court to allow.

As certain key features of a genuine pre-estimate of loss are likely to be missing in a property transaction, it is improbable that a large sum would be enforceable. Firstly, the implicit but inherent purpose of large deposits in contracts for serviced apartments is to prevent default by the vendor, because of the unusually serious consequences of such an act. Therefore, despite being carefully worded in an attempt to qualify either as deposits or liquidated damages, they are in reality designed to act *in terrorem*. Moreover, the agreements are commonly signed by purchasers new to such transactions and with little opportunity to negotiate over the terms of what is a standard form contract. So in this way the provisions do not satisfy the most fundamental principle of *Dunlop*.

Unlike the law regarding deposits, unusually serious consequences as a result of default are not relevant. The likelihood of loss being difficult to quantify, on the other hand, is. It may well be that losses following default by the purchaser under an agreement for sale and purchase are not abnormally difficult to measure. They

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[61] *Dunlop* [1915] AC 79.
[62] See, for example, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.
[63] See *Dunlop* [1915] AC 79, 84.

would likely include costs of resale, any amount following resale at a loss and possibly increased costs of construction. All these amounts are both adequately compensated in monetary terms and easily measured.

Moreover, it is unlikely that any intangible or immeasurable loss would follow. In *Phillips* the consequences of default were unquantifiable losses—the effect on the Hong Kong economy and subsequent lost tax revenue resulting from any delay in the completion of the highway. Political damage to the government's reputation may have ensued too. The nature of real property transactions, however, is such that damage is readily gauged following default, as the developer loses nothing but money and in precisely ascertainable amounts. So contracts for the purchase of serviced apartments are unlikely to fit into the categories indicated by the courts as appropriate for the contractual provision for liquidated damages.

Whether a high deposit for a serviced apartment is extravagant and unconscionable in relation to the largest loss that could possibly be suffered as a result of breach is somewhat less clear. While in most cases an amount such as 25 per cent will be far in excess of the losses suffered by the vendor, it is possible to conceive of instances where it may not be. The most obvious example relates to loss on resale. If there is a slump in the market during construction, a vendor may be unable to resell the unit for the same price. While a 25 per cent fall in prices seems unlikely it is always possible, particularly given New Zealand's present oversupply of serviced apartments, and the threat of recession and even a collapse in property prices. Indeed, in Auckland, the CBD property market (where most serviced apartments are situated) is the most depressed it has been for a long time.[64] So while in ordinary times a loss of more than 10 per cent on resale would be very unlikely, it is possible. A sum does not have to be extravagant or unconscionable with regard to probable losses, merely possible ones.

The question is an extremely difficult one, made harder by a lack of reliable empirical data. Historically, the property market in New Zealand has been defined by the consistent appreciation of all types of urban land. Declining property values are rare, and in the vast majority of cases prices have risen significantly and often spectacularly. Of course, there is always a possibility of a slump. In particular the combination of factors noted above have recently fuelled speculation that property's reputation as a fail-safe investment may be about to end.[65] Some apartments recently sold have changed hands for less than the original purchase price.[66] A pre-estimate of damages may be designed to cover losses that are not likely but merely possible, and a crash in the value of serviced apartments may fall into this latter category. Practically, though, it is unlikely that the court would accept a 25 per cent deposit justified on the basis of speculation at the time of signing that the property market

[64] CBD properties generally gave a return of just 3.5 per cent in the year to June 1999, the lowest of any form of property—see the Consumers' Institute, 'Are Property Investments all Huff and Puff?' (1999) 387 *Consumer* 18.

[65] See Taylor, above n 2.

[66] Ibid.

was about to collapse—unless of course it actually does. Such an event seems too remote and too exceptional to be the real purpose of such a deposit.

Thirdly, the judgment of Smellie J in *Turner v Superannuation and Mutual Savings Ltd*[67] may prove fatal in a large proportion of cases involving serviced apartments. As well as specifying a large deposit, most contracts also reserve the right to claim for specific losses. For example, a purchaser is commonly liable for such things as interest on the unpaid portion of the purchase price from the settlement date to the date of resale; all costs and expenses incurred on any resale or attempted resale; and all outgoings, Body Corporate levies and maintenance expenses in respect of the unit from the settlement date until the date of resale. Agreements also commonly state that all contractual remedies are without prejudice to any at common law or equity.

Thus, serviced apartment contracts leave nothing to chance. They allow for claims through the court in addition to forfeiture of deposit. In theory, a vendor could stand to make a handsome profit from default. A resale for a profit could be coupled with liability for the expenses relating to the unit, interest payments (at a high rate), and retention of a sizeable deposit. This kind of windfall profit at the expense of a purchaser in default is unlikely to be acceptable to the courts. Just as in *Turner* where it was decided that a deposit cannot be retained if that would involve compensation in addition to recovery of actual loss, since most contracts stipulating high deposits also include the right to full recovery of actual loss, the same principle would indicate that the deposits will not be able to be legally retained.

IV COMMERCIAL ISSUES

Clearly, if an unusually large deposit is enforceable, then it makes excellent commercial sense. In the event of default the vendor may make a windfall profit, and the sum should easily cover any losses that may have been suffered. In the unlikely event that it does not, the vendor can sue for additional actual damage. If a deposit cannot legally be retained, however, the commercial wisdom of such a contractual provision becomes much less certain. Therefore, this discussion rests on the presumption that legal challenge would result in relief from forfeiture.

A *Advantages*

Firstly, an increased deposit reduces the likelihood of a default. It ensures that only serious purchasers enter into the contract, and may have the effect of focusing the mind of a prospective purchaser as to whether they are likely to default before they sign. Put simply, 25 per cent of the total price is a lot of money, and a prospective purchaser will give serious thought to entering into the contract. As a mid-range

[67] [1987] 1 NZLR 218 ('*Turner*').

apartment could be worth $400,000 NZD, a typical purchaser might be required to commit $100,000 NZD when they sign. This should serve to filter out less committed purchasers. So a developer may well be able to achieve the practical objective of such a deposit without it being legally enforceable.

In addition, the prospect of litigation following default may serve to deter purchasers inclined to do so. Prospective purchasers know that even if their deposit is returned, they will likely incur substantial legal costs in the process. In general, business people are averse to litigation, and with good reason—it is slow and wastes resources, with no guarantees as to outcome. In this case, with few clear precedents and a lot of money at stake, an attempt to retain a high deposit could, in New Zealand, conceivably go all the way to the Privy Council. The prospect of having their deposits tied up pending litigation for a long period of time should deter prospective purchasers who entertain thoughts of breaking their bargain if it becomes convenient to do so.

Further to this, purchasers with limited resources may recognise that they would be unable to afford to challenge a vendor's forfeiture of deposit. If they do not have the resources to launch legal action, then their deposit is effectively lost. So even if the law is on their side, the incentives not to breach the contract may be high.

Such provisions also put the onus on the purchaser to move. Possession is not nine-tenths of the law, but it does determine who must initiate and maintain legal proceedings following default. A vendor could have the use of the deposit for years, until litigation was concluded. Also, in the happy event (for a vendor) that a purchaser chooses not to litigate for the return of its deposit, the developer's legal weakness will not matter.

Finally, such a deposit may secure the vendor's short-term financial position. In the event of default, it will have the use of a significant amount of money with which to complete the development or fight legal action for recovery of the deposit. If legal action is protracted, as is likely, the vendor may have possession for a considerable length of time. So even if the money is eventually returned to the purchaser, it may well be of real benefit to the vendor in the interim. But most significantly, such a deposit will ensure that actual losses suffered as a result of breach can be quickly and efficiently recompensed, because even if a deposit is too great for a vendor to successfully retain, he or she is entitled to deduct actual losses from it. A large deposit may ensure that such claims by the vendor can be met without the need to actually pursue the debt through the courts, and it gives the vendor the luxury of not being required to initiate legal proceedings in order to recover any expenses incurred in resale.

B *Disadvantages*

As shown, there are sound commercial reasons for unusually high deposits, even if they are not legally enforceable. That is why such contractual provisions exist. However, developers do take a gamble. If litigation does ensue, forfeiture of a large

deposit may well be unacceptable to a court. If this is so, developers will be unable to retain any proportion of the deposit, for they cannot seek to keep such amount as is equivalent to 10 per cent of the purchase price, and return the rest. A developer will be left in a very undesirable position, faced with the costs of legal action and unable to retain any deposit monies. Moreover, even though such a deposit does provide a greater fund from which to deduct the actual expenses occurred in resale, it is unlikely that such costs will be greater than 10 per cent, as has already been noted. So in most situations a standard 10 per cent deposit is likely to be more desirable, because it not only allows a developer to cover actual losses incurred as a result of default, but may also give a windfall profit.

Once a clear precedent is set, subsequent claims will be much cheaper for other purchasers of serviced apartments who made similar deposits and the floodgates may open. A successful claim for the return of a deposit will become a far more affordable and attractive proposition, and the publicity that may surround such a decision could serve to promote default as an option in the minds of purchasers.

The door is also open for smart and well advised purchasers to gain advantage. If they are prepared to gamble that the courts would reject attempted forfeiture of a very high deposit, then incentives exist to sign in haste and repent at leisure. In other words, speculative purchasers could try their luck on a development and see how the market subsequently shifted. So the nature of the deposit may hinder, not help, its purpose.

Finally, the likelihood of legal action following any default under a contract with provision for an unusually large deposit will put certain financial pressures on the vendor. Not only is legal action probable, the rarity of such an action and the lack of clear law on point may make the action particularly expensive, as has been noted. So litigation may put considerable strain on a developer's resources.

V CONCLUSION

The developers of serviced apartments have good reason for attempting to ensure that purchasers do not default under their contracts. Were a purchaser to do so the result could be very serious, significantly more so than in other types of developments. Because of this, some premium in excess of the standard deposit of 10 per cent might well be acceptable to courts. However, while a deposit of 15 per cent may well be successfully retained, there are no guarantees that even this amount would survive legal challenge. And any sum in excess of 15 per cent is very unlikely to survive court action seeking relief from forfeiture.

So vendors take a gamble when they demand a large deposit. A high deposit may well serve a worthwhile commercial purpose, for defaults are surely less likely if less committed purchasers are filtered out. It also guarantees a fund from which to claim actual expenses. But there are severe risks associated with this strategy. Such deposits will attract legal action in the event of default, which is likely to be expen-

sive. An action of this type has an excellent chance of success, and will have very serious repercussions. If a deposit is found to be unacceptable by a court, a purchaser is not entitled to retain a lesser proportion of the deposit. The vendor will be left with no retained funds, and considerable legal bills. One successful action could increase the possibility of other claims, as purchasers realise that they can withdraw from the contract without losing their deposits and pay only for the actual damage suffered by the vendor. So the likelihood of default may be reduced, but the consequence of one becomes much greater. Ultimately, which of these conflicting concerns wins out is a practical and commercial decision that can only be taken by each individual vendor with regard to the circumstances of the particular development.

What seems like an obscure point of law may have serious ramifications in the years to come. With hundreds of millions of dollars invested in serviced apartment agreements in New Zealand, the potential for litigation is immense. The greatest irony, of course, is that while both property developers and investors will suffer, their lawyers will benefit. Lawyers were responsible for the introduction of such onerous deposit provisions; when they unravel, they may well be the only ones to profit from the mess.