Commercial Real Estate

Why Do We Have Deposits?

When buying real property, purchasers typically submit a deposit with their offer to purchase. The deposit is considered part of the purchase price and is ultimately credited towards the purchase price on closing. In this way, a deposit is a down payment, but it is also a sign of good faith, acting as an incentive for the purchaser to complete the agreement of purchase and sale. Without a deposit, the buyer will not feel the immediate pain of improperly failing to comply with its obligations under the contract. While it is true that a vendor could sue on the agreement of purchase and sale for damages even in the absence of a deposit, this typically involves a long, drawn-out and costly litigation process and, depending on what assets the purchaser has, the vendor may never be able to collect. Accordingly, a vendor should be satisfied that the amount of a deposit covers possible damages such as subsequent sale at a lower sale price. On the other hand, a prudent purchaser's solicitor will include a clause in the agreement of purchase and sale limiting the buyer's liability to the amount of the deposit.

How Do Deposits Work?

When an agreement of purchase and sale is entered into, the purchaser generally gives the deposit to a real estate agent or real estate lawyer to hold in trust until the agreement is completed. Deposits made payable directly to the seller should be avoided. A deposit made payable to a listing brokerage, or to a lawyer's trust account is not immediately available to either the purchaser or the vendor and brokerages and lawyers are less likely to improperly release a deposit. Also, deposits held in trust by a broker or lawyer are protected by an insurance fund.

Deposits will typically be returned in situations where the seller is in default of the agreement or if the contract cannot be completed through no fault of either party. Where an agreement cannot be completed due to a default of the buyer, the deposit will be forfeited. Deposits in Ontario are released when a sale goes through, when the parties mutually agree or a mutual release is signed by the parties, or when a court order directs the release. If two parties cannot agree that a deposit can be released, the deposit must remain in a trust account (or be paid into court) until a court order is obtained.

What If There Are No Damages?

What happens if a buyer repudiates a contract, but the seller is then able to sell the property at a higher price and therefore does not suffer any damages? The British Columbia Court of Appeal answered this question in *Tang v. Zhang*, 2013, BCCA 52, which has since been cited with approval by the Ontario Court of Appeal in *Redstone Enterprises Ltd. v. Simple Technology Inc.*, 2017 ONCA 282. When the buyer in *Redstone* failed to complete the purchase, the seller brought an application for a declaration that it was entitled to retain the deposit. The Ontario Court of Appeal held that even if no damages were suffered, a deposit is to be forfeited to the seller if a buyer wrongfully fails to complete a purchase.

One of the fundamental principles of contract law is that damages are based on the actual loss suffered by the innocent party when there is a breach of contract. Damages are intended to restore the innocent party to the position that it would have been in had the contract been fulfilled. However, the position with regard to real estate deposits is that they are non-refundable except in situations where its forfeiture would be unconscionable. The reason for this can be traced back to the English Court of Appeal decision of *Howe v. Smith* (1884) 27 CH. D. 89 where Lord Justice Fry stated that a deposit was "not merely a part payment, but is then also an earnest to bind the bargain so entered into, and creates by the fear of its forfeiture a motive in the payer to perform the rest of the contract."

A defaulting purchaser may be successful in getting all or part of a deposit returned where the deposit is disproportionate to the damages suffered and it would be unconscionable for the seller to retain the deposit. Factors that help determine unconscionability were set out in Redstone, and include an inequality in bargaining power, a substantially unfair bargain, the relative sophistication of the parties, the existence of *bona fide* negotiations, the nature of the relationship between the parties, and the gravity of the breach and the conduct of the parties, though this is not a complete list. Still, the court in *Redstone* emphasized that a finding of unconscionability is not an easy one to prove, rather it, "must be an exceptional one, strongly compelled on the facts of the case."

While there is no hard and fast rule about how large a deposit must be in order for it to be unconscionable, deposits comprising over 20% of the purchase price have been deemed acceptable in some cases. In *Redstone*, the purchase price of the property was $10,225,000.00, and the Ontario Court of Appeal found that a deposit of $750,000 was not unconscionable. In *Nawara v. Riverstone*, 2019 ONSC 111, deposits totaling $82,498.50 on a purchase price of $359,999 were not found to be unconscionable even though the seller ended up selling the unit for $11,000 more, and the deposit comprised 28% of the purchase price.

How Much Should a Deposit Be?

The answer will largely depend on where the property is located. Deposits for residential homes, for example, are typically larger in Toronto where demand has been outpacing supply. There are many variables depending on the type of transaction, the motivation of the parties and the state of the real estate market.

Purchasers of new homes or condominiums should also be mindful of the deposit protection provided by the Tarion Warranty Corporation. Deposits paid on new condominium units are protected by Tarion up to a maximum of $20,000.00 and deposits paid for all other new homes signed on or after January 1, 2018 are protected by Tarion up to $60,000.00 for homes sold for $600,000.00 or less, and 10% of the purchase price, up to a maximum of $100,000.00, for homes over $600,000.00. This deposit protection includes other payments made by the purchaser, such as for upgrades and extras. Buyers who are asked to give deposits greater than these amounts should ensure that builders have excess deposit insurance. Excess deposit insurance can protect purchasers and can enable builders to use purchasers' deposits as a low-cost and easily-accessible source of financing for their projects.

The consequence of a deposit that is too small (in the case of the seller) or too large (in the case of the buyer) can be serious. Very often, a purchaser may be an assetless entity, so the deposit constitutes the only tangible means for the vendor to enforce a transaction or to obtain compensation for damages where the purchaser fails to comply with its contractual obligations. The size of the deposit, how/by whom it is held pending the closing of the transaction, and its role in the event of a default, are all matters that should be considered carefully by lawyers and their purchaser and vendor clients **before** an Agreement of Purchase and Sale is entered into.

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Pallett Valo LLP Commercial Real Estate Practice

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