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Against the Current: Acting for Preconstruction Buyers in a Downward Market

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The preconstruction condominium and newly built home markets have had a tough go of it for the past year or so and we're not out of the woods yet. Most of the transactions closing now were signed in 2021 and 2022 during the real estate boom fuelled by extremely low-interest rates and the fear of missing out ("FOMO") that was felt because of COVID-19 lockdowns, seemingly unstoppable stock and cryptocurrency markets and the desire to do something productive instead of watching another episode of Tiger King. Unfortunately, all the above, plus global supply chain issues, a resilient labour market, volatile energy prices, and other not-so-fun things led to hot inflation and a swift move upwards in interest rates and downwards for valuations of most assets, including the price of newly built homes that many people are now contractually obligated to purchase. In many cases, new build appraisals are coming in 20% lower than purchase prices, so financing, especially at these rates, has become hard to come by. This does not appear to be a "crash" (so far), but more of "deep correction" reminiscent of the real estate market in 2017 when the Office of the Superintendent of Financial Institutions announced changes to the mortgage stress test[1] and the announcement of the Non-Resident Speculation Tax.[2]

Although the resale home market has been under pressure too, for the same reasons, it is more nimble and able to adapt to these changes in market conditions. Buyers can test the waters of the resale market and wait on the sidelines as things play out, whereas purchasers of new builds are locked in both contractually and financially. In my own practice, I'm quickly approaching $1,000,000.00 in deposits forfeited by purchaser clients who either managed to settle with the builder to obtain a mutual release, have walked away from their deposit, and are waiting to see if they get served with a Statement of Claim or have been served and are now defending an action for damages.

One of the more challenging aspects of managing these situations has been setting and tempering client expectations. I will use a scenario I'm currently working on as an example. The clients failed to close on a newly built home due to a low appraisal and difficulties securing financing. They and their real estate lawyer (I was not on the transaction for this one) tried many different options with the builder to close, but they could not and walked away from a deposit well over $100,000.00. The builder served them with an action for damages and costs north of $500,000.00, and they are now defending it. These clients are younger individuals who would have been first-time home buyers. They are not real estate investors who could stomach this loss and move on to the next one. The deposit represents their life savings, and they are now being sued for more. It goes without saying it is a difficult and emotional situation for

[1] Final Revised Guideline B-20: Residential Mortgage Underwriting Practices and Procedures.
[2] Ontario - Non-Resident Speculation Tax.

them. Our first few discussions were challenging because they thought they could get their deposit back or at least a portion of it. Although there are loss mitigation and other factors at play that we are using to discuss a settlement, the fact is they are going to forfeit their deposit and pay more due to the numbers. Playing the sympathy or going public cards will not work. It is a harsh reality that needs to be set as the expectation early on.

Interestingly, it has been my discussions with counsel for builders that got me interested in writing on this topic. In the same scenario noted above, counsel for the builder explained to me during one of our discussions that her biggest challenge has been dealing with counsel for buyers/defendants who are demanding the deposit be returned in full while threatening counterclaims and the addition of real estate agents, lawyers, and others as defendants to the action. Admittedly, I mentioned Section 98 of the *Courts of Justice Act* and unconscionability in correspondence on files I was working on last summer and fall. In hindsight, doing so was not productive and likely moved discussions a step backwards instead of forwards. In the example I've referenced, counsel and I have had a few settlement discussions now, and we're inching closer to a number that makes sense based on the facts and economics of our scenario and the law.

Without further ado, that leads me to introduce this article, where we will examine the applicable test used by the court in determining whether to grant relief from forfeiture and the guidance to be found in recent case law. We will conclude that while relief from forfeiture may be available in narrow circumstances, it would likely take a serious case of unconscionability for the court to grant it.

Presumption in Favour of Forfeiture

In *Redstone Enterprises Ltd. v. Simple Technology Inc.,*[3] the Ontario Court of Appeal described the legal nature of deposits with the following quote from *Tang v. Zhang*:[4]

> A true deposit is an ancient invention of the law designed to motivate contracting parties to carry through with their bargains. Consistent with its purpose, a deposit is generally forfeited by a buyer who repudiates the contract, and this is not dependent on proof of damages by the other party. If the contract is performed, the deposit is applied to the purchase price.

As explained by the Court in *Benedetto v. 2453912 Ontario Inc.,*[5] a deposit is given by the buyer to the seller in order to secure the buyer's future performance of the contract and incentivizes the purchaser to complete the purchase for fear of the deposit's forfeiture. Therefore, if the buyer fails to close the transaction, forfeiture of the deposit is typically intended.

Furthermore, courts have stressed that a seller's entitlement to retain a deposit does not depend on any proof of damages. Even where the seller incurs no loss, it is entitled to a deposit.

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[3] 2017 ONCA 282 at 20.
[4] 2013 BCCA 52 at 30.
[5] 2019 ONCA 149 at 5-7.

As the Court of Appeal remarked in *Rahbar v. Parvizi:*[6] "if purchasers were allowed to reclaim their deposits in a rising real estate market simply because vendors resold their property at a higher price it would eviscerate the very purpose of deposits."

Relief from Forfeiture

However, all forfeiture under the law is subject to the equitable remedy of relief from forfeiture, codified under Section 98 of the *Courts of Justice Act,*[7] which provides that: "[a] court may grant relief against penalties and forfeitures, on such terms as to compensation or otherwise as are considered just." When considering the forfeitures of deposits, Section 98 has been applied according to the test set out in the English case *Stockloser v. Johnson*[8] and later adopted by the Ontario Court of Appeal in *Varajao v. Azish,*[9] which requires the party seeking relief to establish both of the following:

(1) that the deposit is "out of all proportion" to the damages suffered by the seller; and

(2) that it would be "unconscionable" for the seller to retain the deposit.

Step 1: Disproportionate to the Damages

The first branch of the test considers whether the deposit to be forfeited is disproportionately large as compared to the damages suffered by the seller as a result of the buyer's failure to close the transaction. Most often, these damages will result from the home being sold to a different buyer on a later date, but at a lower price than was originally bargained for.

If there is no evidence of damages provided, or the seller in reality suffered no damages, then this condition is easily met. However, this alone will not grant relief; the purchaser must show that allowing the seller to retain the deposit would be "unconscionable".

Step 2: Unconscionability

In determining whether the forfeiture of the deposit would be unconscionable, the court must "step back and consider the full commercial context" of the failed real estate transaction.[10] While the most relevant facts concerning unconscionability will be context-specific, the Court has set out a non-exhaustive list of factors, including:

- a grossly disproportionate deposit, as compared to the purchase price,
- inequality of bargaining power,
- a substantially unfair bargain,
- the relative sophistication of the parties,

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[6] 2023 ONCA 522 at 59.
[7] R.S.O. 1990, c. C.43, s. 98.
[8] [1954] 1 Q.B. 476 (Eng. C. A.)
[9] 2015 ONCA 218
[10] *Supra* note 3 at 18

- the existence of bona fide negotiations,
- the nature of the relationship between the parties,
- the gravity of the breach, and
- the conduct of the parties.[11]

The Ontario Court of Appeal has held that "the finding of unconscionability must be an exceptional one, strongly compelled on the facts of the case".[12] Consequently, the courts rarely find that unconscionability will result if the seller retains the deposit. As Chown J. reflected in *Gagliardi v. Al-Karawi*:[13]

> The reason it is so difficult to establish unconscionability in a deposit case is that the buyer has always agreed to pay the deposit. In addition, real estate deals rarely involve vulnerable parties or significant unequal bargaining power. If the deposit is for a reasonable amount in relation to the purchase price, and if the contract does not proceed due to the breach of the buyer, it is difficult to see how it could be unconscionable to make the buyer pay what it agreed and expected to pay.

Of the many deposit cases reviewed for the aforementioned case, Chown J. had yet to find a single one in which it was considered unconscionable for the seller to keep the deposit.[14] Unsuccessful arguments have included the raising a vulnerable mental state[15], the need to back out due to a falling market[16], or the inability to secure financing.[17]

Conclusion

In conclusion, while the doctrine of relief from forfeiture remains available for buyers seeking to reclaim their deposits after breaching a purchase agreement, the threshold for a court to exercise such discretion is exceedingly high. It is important to note there is a clear presumption in favour of forfeiture, emphasizing that the intention behind deposits as security for performance cannot be lightly set aside. It remains evident from recent rulings that only under extraordinary and truly unconscionable circumstances might the courts intervene to grant relief. In the interplay of contractual obligations and equitable remedies, the courts strive to uphold a careful balance of justice and predictability in transactions. It is a bitter pill to swallow, but this is the starting point for any failed transaction. Knowing and accepting this allows for the uphill journey towards a resolution to begin.

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[11] *Ibid*, at 30.
[12] *Ibid*, at 25.
[13] 2023 ONSC 6853 at 72.
[14] *Ibid*, at 65.
[15] *Mouralian v. Grouleau*, 2022 ONSC 2925, at 17.
[16] *Grandfield Homes (Kenton) Ltd. v. Li*, 2021 ONSC 2670, at 57.
[17] *Sinha v. Shabestari*, 2018 ONSC 298, at para. 2.