

# EARNEST MONEY

## THE OHIO ASSOCIATION OF REALTORS

JUNE, 1990

### I. Introduction

Earnest money deposits are involved in almost every real estate transaction. Although not essential to the creation of a valid and binding purchase agreement, it is the rare residential real estate transaction that does not require the Buyer to make an earnest money deposit. The earnest money is almost always turned over to the real estate broker who holds the money in trust for the parties to the transaction. Since the Ohio real estate licensing laws place some very definite obligations on the broker with respect to the earnest money deposit, it is the purpose of this paper to discuss generally the law of earnest money and, more specifically, the manner in which the broker should handle the earnest money deposit to comply with the state licensing laws.

### II. The Law of Earnest Money

"Earnest money" is nothing more than a deposit of part payment of the purchase price on a sale to be consummated in the future. In the context of a real estate transaction, several courts have defined earnest money as a comparatively small sum of money paid down as an assurance that the party making the offer is acting in earnest and good faith and that ". . . if his being in earnest and good faith fails, it will be forfeited." While the terms of the earnest money deposit should be defined in the purchase agreement, generally the deposit is delivered to the real estate broker at the time the offer is made, and the broker deposits the earnest money in his trust account either upon receipt or upon acceptance of the offer by the Seller, depending upon the terms of the purchase agreement. When the real estate transaction is closed, the earnest money is either returned to the Buyer or the Buyer is given a credit against the purchase price.

There is almost never a problem with an earnest money deposit when the real estate transaction actually closes. However, problems do arise when the real estate transaction fails, for whatever reason, and there is no closing. This situation invokes not only the general law with respect to earnest money but should also cause the broker to examine his obligations with respect to the licensing laws.

The general rule with respect to earnest money deposits is that the Buyer is entitled to a return of the deposit if the contract is not closed through no fault of the Buyer. Conversely, the Seller is entitled to the earnest money deposit if the Buyer breaches the purchase agreement. The purchase agreement should specify that the retention of the earnest money by the Seller should not be the Seller's exclusive remedy, but he should also be permitted to pursue an action for specific performance or damages. Most purchase contracts contain contingencies (most commonly relating to financing and inspection), which excuse the parties from performance if the contingencies are not satisfied or removed. If the contingencies are not satisfied, notwithstanding good faith efforts by the parties, then the contract is null and void, and the Buyer is entitled to a return of the earnest money deposit. However, if the Buyer does not act in good faith in attempting to satisfy the contingency, then a court may rule that the Seller is entitled to the earnest money even though the contingency has not been satisfied or removed.

When a real estate transaction fails, the broker who is holding the earnest money deposit in his trust account is placed in the position of having to decide which party is entitled to the earnest money. This is a position in which a broker should never place himself because the decision as to the proper recipient of the earnest money is a legal decision which should be made by a lawyer or the courts. The difficulty of this decision is compounded by the fact that, in most cases, the broker owes fiduciary duties to the Seller, and naturally those duties include obeying the lawful instructions of the Seller. In this situation, the broker's duties to the Seller would compete with the broker's duty to determine which party, if any, breached the purchase agreement, if he were to attempt to dispose of the earnest money on his own.

To avoid placing the broker in this difficult position, the Ohio Real Estate Commission and the Division of Real Estate have specified that a broker shall not disburse earnest money to any party unless the other party to the transaction has provided him with a release or authorization to do so. If the parties refuse to give the broker

appropriate authorization to disburse the funds, then the broker is required to keep the funds in his trust account until the parties provide him with an appropriate authorization or until a court of law orders him to disburse the funds. A copy of the Superintendent of the Division of Real Estate's comments on this subject is attached hereto as Exhibit A. These comments appeared in the March-April, 1987 Division of Real Estate Newsletter.

### **III. Purchase Agreement**

It is important that both the Buyer and Seller understand what the broker's legal obligations are with respect to an earnest money deposit. Therefore, there should be some discussion of these legal obligations in the purchase agreement that the parties execute. Many form purchase agreements recite only that the broker has received a specified sum of money as an earnest money deposit, and then when the transaction fails, the parties are surprised that the broker cannot simply return the deposit to the Buyer or turn it over to the Seller. It is recommended that there be included in the purchase agreement a provision that specifies that if the parties are unable to agree as to the proper party to receive the earnest money deposit, the broker must keep the deposit in his account until a final court order specifies which party is to receive the deposit. Attached hereto as Exhibit B is a form Real Estate Purchase Contract that has been adopted by the Columbus Board of REALTORS and the Columbus Bar Association. Paragraph 11 of this form serves to advise the parties of the broker's obligations with respect to the earnest money deposit. It is recommended that language similar to this be included in all purchase agreements where the broker receives an earnest money deposit.

### **IV. Authorization to Release the Earnest Money Deposit**

As stated above, the Division of Real Estate and the Ohio Real Estate Commission have specified that a broker should not release an earnest money deposit to any party unless the other party to the transaction so authorizes him. This is true even in the situation where it is obvious to the broker as to which party should receive the deposit. For example, the Division of Real Estate suggests that a broker not return the earnest money deposit to the Buyer without the Seller's approval even in those situations in which there is a financing contingency, and the lending institution has denied financing because the Buyer did not qualify. Attached hereto as Exhibits C and D are suggested release forms that can be used for purposes of securing the authorization of the Seller or Buyer to release the earnest money deposit. There is no particular language that needs to be used, but it is prudent to secure a written authorization such as those attached. It would not be unlawful to distribute the earnest money pursuant to an oral authorization but this would not be a good business practice and may provide problems down the road if the broker is placed in a position of having to prove that he received appropriate authorization.

### **V. Legal Action**

In those situations where both the Buyer and the Seller claim a right to the earnest money deposit, and neither will authorize the broker to distribute the earnest money to the other, then the broker has two possible courses of action. First, he should advise the parties that he is unable to release the earnest money deposit to either party without a court order or their agreement. He may then choose to leave the earnest money in his trust account and advise the Buyer and Seller that they must bring a court action and obtain a court determination as to who is the proper recipient of the earnest money deposit. If either the Buyer or Seller commences an action, it is likely that the real estate agent will be included as a party defendant in the case, and the broker should merely advise the court that he will pay the earnest money deposit to whichever party the court specifies. Until a court order is obtained, the money must remain in the broker's trust account.

Alternatively, the broker may commence a legal action himself. He would be the plaintiff in the case and would name as defendants both the Buyer and the Seller. In his complaint he would ask the court to determine whether the earnest money deposit should be paid to either the Buyer or the Seller. In this kind of "interpleader" action, the broker would be the "stake holder," and the Buyer and Seller would be required to set up their claims to the funds and convince the court that one or the other is entitled to the money.

Procedurally, it would probably be easiest for the broker to wait for the Buyer and Seller to commence an action, rather than commencing the action himself. Nevertheless, there may be situations in which the broker may want to commence the action himself so as to clear his trust account of the earnest money deposit. Attached hereto as Exhibit E is a form complaint that can be used in these situations. This complaint complies with the local rules of the Franklin County Municipal Court, Small Claims Division, and we have been advised that the Franklin County

Small Claims Court would indeed handle cases such as this. In fact, the Franklin County Small Claims Court has advised that the broker could pay the money into court at the time he filed the complaint, or could keep the money in his trust account pending an order of the court.

The Small Claims Courts in the State of Ohio have jurisdiction over disputes up to \$1000. They are "informal" courts, and are convenient since parties are typically not represented by counsel in Small Claims proceedings. The cost (filing fees) are also substantially less than filing fees for the regular Municipal Court or the Common Pleas Court. In Franklin County, the filing fee is \$15.00. There are some other limitations on the use of the Small Claims Court, and therefore, it is important that the attached Exhibit E be reviewed with legal counsel in the particular county in which the action is to be brought or that the broker at least discuss the complaint form with his local Small Claims Court. Small Claims Court Administrators are typically very helpful and will advise the broker of any changes that must be made to the form to comply with the law in that particular jurisdiction. Many Small Claims Courts have particular forms that can be used for handwritten complaints, and therefore, it is very easy to commence an action in these courts. Attached as Exhibit F is a blank form that is used by the Franklin County Small Claims Court.

If the amount of the earnest money deposit exceeds \$1000, then it will be necessary to file the action in the regular Municipal Court. The Same complaint language as found in Exhibit E can be used, but the reference to the Small Claims Court should be deleted. Furthermore, there will be a different filing fee depending upon the county, and the broker should check with the Clerk of the Municipal Court in his jurisdiction to determine the amount of the filing fee. If the amount of the earnest money deposit exceeds \$10,000, then in most counties it will be necessary to file the case in the Common Pleas Court. Once again, the same form language as in Exhibit E can be used, but the broker should check with the Clerk of the Court of Common Pleas to determine the filing fee and any other peculiarities associated with these kinds of "interpleader" actions in the local jurisdiction.

## **VI. CONCLUSION**

In summary, when both the Buyer and Seller claim a right to the earnest money deposit, the broker must keep the earnest money in his trust account until the parties reach an agreement or a court issues an order. Many times when parties are initially unable to agree, a compromise can be struck when a broker advises the parties of his legal obligations with respect to the deposit. It is not necessary that the entire deposit be paid to either the Buyer or the Seller. To avoid a court action, the Buyer and Seller may wish to agree that one-half of the deposit should go to the Seller and one-half should go to the Buyer, or any other form of compromise. The broker would be authorized to distribute the earnest money in accordance with any compromise reached by the Buyer and the Seller, but he should be certain to receive a written authorization which describes the specific terms of the compromise.

## **EXHIBIT A**

### **REPRINT OF ARTICLE FROM MARCH/APRIL 1987 DIVISION OF REAL ESTATE NEWSLETTER**

"Handling of Earnest Money Deposits Discussed"

By Margaret J. Ritenour, Superintendent

In each issue of the Division of Real Estate Newsletter, the disciplinary actions levied against licensees by the Ohio Real Estate Commission are reported. The purpose of doing so is not only to comply with the Commission's statutory obligation to report its decision, but also to educate our licensees as to the types of conduct that constitute violations of Ohio's license law. Through these examples it is hoped that licensees may avoid engaging in similar conduct.

A review of the Commission's decision reveals that a large percentage involve the handling of earnest money deposits. Discussed below are the most common violations committed with respect to earnest money and recommended practices to avoid problems in these areas:

## **1) Misrepresenting the Receipt of Earnest Money**

On most purchase contracts, an earnest money deposit is recited in the body of the contract as part of the purchase price. At the bottom of the contract there is usually a line for the licensee to sign acknowledging the receipt of such earnest money. Frequently, licensees sign this acknowledgement when they do not have the earnest money in their possession at that time. Such a knowing misrepresentation of the receipt of earnest money constitutes a violation of Ohio Revised Code Section 4735.18(A).

To avoid problems in this area, licensees should be careful to indicate the amount of the earnest money they have received and whether they have received cash, a check, or a note from the prospective buyer. If a note is accepted, a specific date for redemption should be included in the note. If the buyer does not give the licensee an earnest money deposit at the time the offer is made, the acknowledgement section of the contract should clearly not be signed. Further, to avoid confusion, if the licensee has not received the earnest money but his/her name is typed below the signature line acknowledging receipt, his/her name should be crossed out. In such cases it is always recommended that upon presentation of the offer the fact that no earnest money has been received should be pointed out to the listing agent, or if there is none, directly to the seller.

## **2) Failing to Deposit Earnest Money into the Broker's Trust Account**

It should go without saying that earnest money must be deposited in the broker's trust account as soon as possible after receipt. What will be considered a reasonable time will be determined from the circumstances involved (e.g., whether the check is received on a weekend, or holiday.) However, it is generally recommended that earnest money be deposited within 24-48 hours of receipt unless such a deposit is not possible.

Licensees often clip earnest money checks to their copy of an offer and only deposit it if the offer is accepted. This practice is acceptable if the delay in depositing the earnest money is provided for in the purchase contract. For example, if the contract states "Earnest money to be deposited in broker's trust account upon acceptance of offer," such a practice would be in accord with the purchase contract and would not violate license law. But, if the contract merely states that the earnest money is to be deposited "upon receipt," the broker is required to deposit the money as soon as possible after it is given to him/her. The important point to remember here is that the contractual language controls whether the earnest money is to be deposited when it is received by the broker or when the offer is accepted. It is suggested that brokers review this language in their contracts to remove any ambiguity that may exist regarding when the earnest money will actually be deposited.

## **3) Failing to keep the Seller Apprised of Problems that Arise Concerning an Earnest Money Deposit**

Recently, the Commission has heard many cases in which licensees have failed to notify sellers of the fact that the prospective buyer has stopped payment on an earnest money check or that the check has "bounced". Such a failure to notify the sellers of this type of development has been found to constitute misconduct in violation of Ohio Revised Code Section 4735.18(F). Similar violations could occur where the licensee fails to notify the seller that the buyer has failed to pay a note that was tendered for an earnest money deposit. These are material facts and should be immediately conveyed to the seller or his agent. As always, to cover ones self it is recommended that the licensee give this notice in writing as soon as possible.

## **4) Remitting Earnest Money without a Release Signed by the Parties**

Except at the closing of a transaction, a broker should only disburse earnest money from his/her trust account when authorized in writing by the parties to the purchase contract or when ordered by a court of law. Disbursing earnest money without such a signed release or court order has been found to constitute misconduct in violation of Ohio Revised Code Section 4735.18(F).

When earnest money is released without the authorization of the buyer and seller or a court order, a licensee is unilaterally determining which party to the contract is entitled to the earnest money. Such a decision requires either an interpretation of the terms of the contract or a legal determination as to whether a party breached the contract. Clearly, this is not a decision a licensee is qualified to make. To avoid a violation of license law in this area, a licensee should not release earnest money to a party unless the other party to the transaction has provided him/her with a release or authorization to do so. This should be done even in simple cases where it

appears clear that the prospective buyer was unable to get the necessary financing. Again, it is highly recommended that this authorization be in the form of a written release so as to avoid later claims that permission was not given.

In the event that one of the parties refuses to sign a release, the earnest money must remain in the broker's trust account until the parties resolve their dispute and instruct the broker of the fact in writing. The only other alternative is for the parties to take their dispute to court. In the event the court orders the licensee to disburse the funds, such a disbursement pursuant to the court's order is required.

#### **5) Failure to Remit Earnest Money within a Reasonable Time**

Brokers have been found to violate Ohio Revised Code Section 4735.18(E) for failing to remit earnest money to a party within a reasonable time, where such a disbursement is clearly appropriate. Examples of situations requiring a timely remittance would be where a party's offer was not accepted, where the parties have provided the broker with a signed release, or where a court has ordered that a disbursement be made. In these instances, the earnest money should be returned to the appropriate party within a reasonable time. Again, what is reasonable must be determined from all of the circumstances.

It is hoped that this article has served as an overview of how to properly handle earnest money deposits, so licensees can comply with Ohio's licensing laws. As always, it is urged that brokers share the information in this article with their salespersons so they too can avoid violations of these laws and the risk of a suspension or revocation of their license. Any questions regarding the matters discussed herein can be directed to our Legal or Enforcement Section.