

# Legal Questions, Practical Solutions

## How Do You Handle Non-Refundable Earnest Money?



by Jeff Pitcher, Esq., Fennemore Craig as interviewed by Gayle Henderson, CRS, GRI, ABR, RE/MAX Excalibur Realty

Jeff, our question this month comes from one of our readers, Sue Shapiro, from Coldwell Banker. The whole issue of non-refundable earnest money is more prevalent in the luxury market and the very term “non-refundable” brings forth a myriad of issues.

**Q:** Will you start with a brief synopsis of the value of “strong” earnest money?

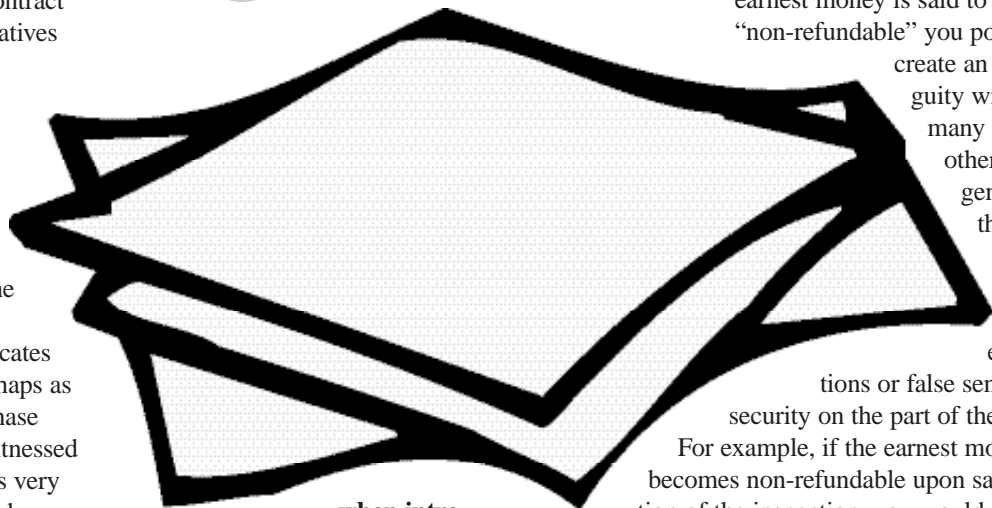
**A:** Earnest money, as you remember from your contract law class, represents “consideration” as one of the required elements of contract formation. Many buyer representatives feel that the smaller the amount of the earnest money deposit, the less financial exposure to the buyer and, in concept, the better representation of the buyer’s interests. However, a “strong” earnest money deposit can also be thought of as equally having the buyer’s best interests in mind. A strong earnest money deposit indicates a larger-than-average deposit, perhaps as much as 5-10 percent of the purchase price. This is more commonly witnessed in the luxury market. The value is very simply that strong earnest money demonstrates seriousness of intent on the part of the buyer and the ability of the buyer to have sufficient funds to close the transaction. In theory, this may lead to a buyer getting a home at a lower price than the

seller might have anticipated selling.

**Q:** If I may pursue this for a moment, why could it result in a lower price for the home?

**A:** When the seller and his/her agent are reviewing the elements of the offer, they are most concerned about two issues: What are the levels of risks? And how likely is this contract going to close? Strong earnest money answers both of those questions. Strong earnest money inhibits buyers from capriciously walking away from a contract in escrow should they suddenly find another property that they might like better or decide, for whatever arbitrary reason, that they don’t want to close on this contract. In addition, strong earnest money deposits demonstrate enough liquidity to close the loan, a critical element in the contract process.

**Q:** Let’s move on to this more complicated issue of “non-refundable” earnest money and its meaning



**A:** when introduced into the contract language. How do I, as an agent, handle this issue when raised during negotiations? Non-refundable earnest money should be addressed very carefully. Many issues

**A:** arise with “non-refundable” earnest money deposits. At what stage in the contract does the deposit become non-refundable (i.e., upon deposit or after the inspection period)? What happens to the deposit when it becomes non-refundable (i.e., does it get released to the seller or is it held in escrow)? What are the exact conditions that lead to “non-refundability” (i.e., failure to terminate after inspection or default)? Why is it necessary and how can it be counter-productive? As an agent electing to add this language to your contract, you must be absolutely precise and articulate and make certain that you are not creating a false set of conditions.

**Q:** It sounds as if you feel that the use of the word “non-refundable” is something you should try to avoid in contract language. Is that true?

**A:** Yes. I believe that you raise the possibility of unnecessary problems by adding that language. If the earnest money is said to be “non-refundable” you possibly create an ambiguity with many of the other contingencies in the contract and false expectations or false sense of security on the part of the seller. For example, if the earnest money becomes non-refundable upon satisfaction of the inspection, you would also have to address and modify the buyer’s rights to review and approve the Homeowner’s Association documents and the preliminary title report.

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Another contingency that would need to be modified is loan qualification. In reality this doesn't occur until several days before closing when the buyer is signing the documents and the lender "funds" the loan. Up until that moment, the loan contingency is still a factor. The contract language handles numerous ways that a buyer's actions can lead to a "breach" in the contract and subsequently put his earnest money subject to forfeiture. Let the contract do its work in the printed language.

**Q:** How do lines 306-311 affect this issue of earnest money?

**A:** Prior to recent contract revisions, the escrow company, as a neutral third party, would

rarely release earnest money without a "mutual cancellation" from both parties. Regardless of how blatant the breach might have appeared, in order to get the earnest money released, the parties usually ended up splitting the earnest money. That situation has changed, and agents should make certain that the escrow company is complying with these five critical lines in the contract. In essence these five lines are specific instructions, from both the buyer and the seller, that should there be a dispute regarding the release of the earnest money, the escrow company in its sole discretion, through interpretation of the language of the contract, may release the earnest money.

**Q:** In summary, what would you suggest to agents regarding earnest money?

**A:** Don't create a false sense of security to the seller through your use of "non-refundable deposits." Encourage buyers to make

strong earnest money deposits. Remember, sellers are most interested in making sure there is a better-than-average probability that the contract will close and that the buyers will not capriciously walk away from a situation where they have financially little to lose. Strong earnest money is your best bet. And from a buyer's perspective, strong earnest money may result in the buyer getting his price, because the seller sees fewer risks than with a buyer with weak earnest money. ★

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