QUERIN LAW LLC

Making Earnest Money Deposits "Non-Refundable"

Earnest Money Deposits Generally. The term "earnest money" has historically been used to refer to the "deposit" paid by buyers that accompanies an offer to purchase real property. Metaphorically, it is intended to show the buyer's "good faith" intent to complete the transaction. Most written sale agreements provide that the earnest money deposit will be forfeited to the seller should the buyer fail to perform, i.e. "default". But if the transaction fails for reasons unrelated to the buyer's nonperformance, the earnest money deposit is normally refunded. In Oregon this is the "standard of practice" or "custom".

OREF Sale Agreement. The OREF Sale Agreement ("Sale Agreement") is no different. There are several buyer contingencies in the Sale Agreement, e.g. for bank financing, appraisal, inspection, and if applicable, for inspection and approval of the private well and septic/drain field.[1] If the contingent event fails to occur, e.g. satisfactory professional inspection, and the buyer so elects within the agreed-upon contingency period, the transaction may be terminated, and the earnest money deposit refunded.

The OREF Sale Agreement provides that when escrow opens a transaction, the earnest money is to be deposited into its trust account, and not released before closing, except upon written instructions of the seller and buyer.

Lastly, it is important to know that under the Sale Agreement, forfeiture of the deposit is the seller's *only* remedy upon a buyer's default. This means that sellers must be prudent in setting the amount of the earnest money, since a small deposit that could be easily forfeited right before closing may have little effect in keeping a buyer committed to a transaction if he or she wanted out. Walking away from $5,000 is far easier than walking away from $25,000.

Making Earnest Money Deposits Non-Refundable. Notwithstanding the terms of the OREF Sale Agreement, sellers occasionally insist that the earnest money deposit be "non-refundable" and released to the seller prior to closing. Since there is no standard provision in the Sale Agreement form for early release of the deposit, it falls to the parties or their brokers to write something for escrow to follow; and even then, escrow will normally supplement the parties' instruction with a printed form for them to also sign.[2]

[1] I say "buyer contingencies" because they may only be used by buyers to terminate the transaction. If, for example, the well water report showed contamination, the buyer – not the seller – could terminate. Alternatively, the buyer could elect not to terminate or waive the contingency. In such event, it should only be done in writing so the buyer's decision is clear and irrevocable.

[2] The form provided by escrow releases the title company from any liability for the early disbursement of the deposit, since the terms of the Sale Agreement provide that it is to remain in trust until closing.

Why would a seller insist on making the earnest money deposit non-refundable? In new construction, this is not uncommon, especially where custom changes may be made to the plans at a buyer's request. In the view of many builders, the larger the deposit, the greater the buyer's commitment is to remain in the transaction.

In the sale of existing homes, if it is a "seller's market" (i.e. there are more buyers vying for a smaller inventory of homes) some sellers demand the deposit be made "non-refundable" simply because they can. And in some instances, sellers may require it because they believe they will be significantly damaged should their buyer default – say because the seller has already committed to purchase another home.

Poor Drafting. Unfortunately, when parties agree to make the deposit non-refundable, it is not uncommon for the broker to simply write an Addendum to the Sale Agreement saying:

> ***"Buyer and Seller agree that the earnest money deposit shall become non-refundable and immediately released to Seller."***

However, simply calling the deposit "non-refundable" may not make it so. Why? Because there are several other sections of the Sale Agreement expressly providing that if certain events occur, *the deposit "shall" be refunded to the buyer*. For example:

> **5.2 FAILURE OF FINANCING CONTINGENCIES:** If Buyer receives actual notification from Lender that any Financing Contingencies identified above have failed or otherwise cannot occur, Buyer shall promptly notify Seller, and the parties shall have _ business days (two [2] if not filled in) following the date of Buyer's notification to Seller to either (a) Terminate this transaction by signing an OREF 057 Termination Agreement and/or such other similar form as may be provided by Escrow; or (b) Reach a written mutual agreement upon such price and terms that will permit this transaction to continue. Neither Seller nor Buyer are required under the preceding provision (b) to reach such agreement. If (a) or (b) fail to occur within the time period identified in this Section 5.2 (Failure of Financing Contingencies), *this transaction shall be automatically terminated, and all earnest money shall be promptly refunded to Buyer.* Buyer understands, upon termination of this transaction, Seller shall have the right to place the Property back on the market for sale upon any price and terms as Seller determines, in Seller's sole discretion. (Italics and underscore mine.)

Here is another example:

> **27.2 EARNEST MONEY REFUND TO BUYER:** If (1) Seller does not approve this

> Agreement; or (2) Seller signs and accepts this Agreement but fails to furnish marketable title; or (3) Seller fails to complete this transaction in accordance with the material terms of this Agreement; or (4) any condition which Buyer has made an express contingency in this Agreement (and has not been otherwise waived) fails through no fault of Buyer, *then all earnest money deposits shall be promptly refunded to Buyer*. However, acceptance by Buyer of the refund shall not constitute a waiver of other legal remedies available to Buyer.

The Legal Issue. So the question is: Does calling the deposit "non-refundable" in an Addendum, have the effect of amending the clear language in Sections 5.2 and 27.2 of the Sale Agreement providing a contrary result? After all, the Addendum is a part of the Sale Agreement. And to make this more confusing, does the addition of certain language change the result? Such as: ***"Except as otherwise amended, all other terms of the Sale Agreement shall remain the same."***

At the risk of being accused of hair-splitting, in my opinion, brokers should be careful about "amending" a Sale Agreement through the use of an Addendum – or at least they should be aware of the difference between the two documents.

The term "Addendum" means "something to be added" *Black's Law Dictionary* 31 (7th ed. abridged 2000). Thus, use of an Addendum, by its own terms, is intended to *"add"* a certain provision to the Sale Agreement. Typical examples might be moving a closing date; increasing the deposit; correcting an error in the address, etc.

Amending a Sale Agreement is entirely different because the underlying document, i.e. the Sale Agreement, is changed in a substantive way that affects the rights of the parties. One way to look at the difference[3] might be to use the Addendum for those discretionary items that the parties complete by inserting text into the Sale Agreement, such as the amount of earnest money, the closing date, etc.

Changes to the printed text of the Sale Agreement, such as making the earnest money non-refundable, are more in the nature of an "amendment". For example, reserving to the seller the right to bring a specific performance claim against the buyer; adding a seller contingency to the Sale Agreement; making the transaction subject to the seller's ability to locate another home,[4] etc.

Now, back to the use of the Addendum to make the deposit non-refundable. If the Addendum does not say the Sale Agreement is "amended", wouldn't that mean Sections 5.2 and

[3] This as an example, not a "rule".

[4] Caveat: This can be a very complicated provision. My use of the words "locate another home" is not intended to be used as a seller contingency. Actually, this is where the complications arise: Is the transaction going to be subject to seller's offer of purchase being accepted? Seller's removal of inspection contingencies in the new home purchase? Removal of the seller's finance contingency? Etc., etc.

27.2 *remain in effect*? Especially where the Addendum says, "Except as otherwise amended, all other terms of the Sale Agreement shall remain in full force and effect."

To put a fine point on the issue, without *also* expressly amending Section 5.2 and 27.2 in the Addendum would mean that the earnest money is *both* refundable (under the Sale Agreement) and nonrefundable (under the Addendum). This is the classic definition of an ambiguity, i.e. a writing that is susceptible of at least two alternative constructions.

To interpret the Addendum as making the deposit nonrefundable *for all purposes* – without saying so, would mean the buyer would lose their deposit, even though:

- Their bank did not approve the loan – something over which the buyer had no control;
- The property did not appraise at least for the sale price of the home – something over which the buyer had no control;
- Seller could not deliver marketable title – something over which the buyer had no control;
- Seller refused to close the transaction – something over which the buyer had no control.

Clearly, these harsh consequences were not something contemplated by the parties at the time the Addendum was drafted and signed.

Typically, when amending a written contract, good draftsmanship requires that the amendment expressly state: (a) What part of the Sale Agreement is to be changed, added, or deleted, and (b) What part is to remain unchanged. If that is so, using an Addendum stating simply that the deposit is to become "nonrefundable" without more, is woefully inadequate and does not serve the parties' best interest, since it sets them up for a dispute, which usually means attorneys and attorney fees.

How Courts Deal With Ambiguity. Once a document is determined to be ambiguous, the court will permit the introduction of "extrinsic evidence", i.e. evidence outside the four corners of the written agreement, to explain the circumstances of the change.

From a lawyer's point of view, when this happens, the drafter of the document has failed, since the goal in all contracts is to create a document that is clear on its face; black and white. Opening the door to extrinsic evidence to interpret the document can become a free-for-all, where all parties can point to outside events and statements, supporting their own preferred interpretation.

The Take-Away. Use of the word "non-refundable" standing alone, is capable of multiple interpretations – most of which encompass events that were likely never considered by the parties when the Addendum was drafted.

- It could mean non-refundable for all purposes, *except* seller's default. Thus, if the buyer's lender did not approve the loan, the deposit will not be refunded;
- It could mean non-refundable for all purposes, *including* seller's default, which seems unreasonable, although there is nothing to clarify it;
- It could mean non-refundable *except* where a buyer contingency occurs, in which case the deposit *will be* refunded.

Had any of these circumstances been considered, they would have likely been addressed at the time. Accordingly, proactive drafting is encouraged. This means the following:

- Don't add an Addendum or Amendment to the Sale Agreement without making sure it will not contradict, or make ambiguous, other provisions – this means being familiar with what the *entire* Sale Agreement says.
- Even if it doesn't affect the terms of the Sale Agreement, is the change clear on its face?
- Does it require further explanation (by the drafter) to be understood? If that occurs, the drafter has failed, since his/her explanation is not a part of the written terms.
- Are there alternative provisions that are shorter and more succinct?
- Would a third party (who is unfamiliar with the transaction) interpret the change the same way as you? This is a good litmus test for whether a stranger to the transaction can read the amendment and understand what the parties intended.

Conclusion. In Oregon, it is not customary for sellers and buyers to retain legal counsel in residential transactions. The corollary to this is that the parties more often rely upon their real estate agent throughout the transaction. It is this client reliance that imposes upon agents the duty to know whether they should undertake the drafting of amendments to the Sale Agreement. The first place to go for an answer is the company's managing principal broker. And if the managing broker is unsure, the next step is for the parties to check with their own legal counsel.