

Questions and Answers on: EARNEST MONEY DEPOSITS

This brochure in the Commission's *Questions & Answers* series examines issues arising from the payment of earnest money deposits prior to closing a residential real estate sales transaction. Since payments made before closing are not treated the same in all transactions, it is important to understand the purpose of earnest money and how it will be handled during the transaction. This is usually spelled out in the offer to purchase or sales contract. Therefore, you should always read the contract or offer to purchase before paying any money and **CONSULT YOUR OWN ATTORNEY IF YOU DO NOT UNDERSTAND THE PURPOSES AND DISPOSITION OF ANY PAYMENT OR ANY OTHER TERMS IN THE CONTRACT OR OFFER.** The questions raised in this publication are of special concern to real estate purchasers. Consequently, they are posed from the standpoint of the purchaser.

Q: What is "earnest money?"

A: It is money you give to the seller (or the seller's agent) to show your good faith when making an offer to purchase the seller's property.

Q: Do I have to pay an earnest money deposit to have a valid contract?

A: Although no law requires it, sellers typically do require it. If you agree to pay earnest money but do not make the required payment or your earnest money check "bounces," you will probably be considered in breach of the contract.

Q: How much earnest money should I pay?

A: The amount is negotiated between you and the seller. It is typically a small percentage of the purchase price and can vary depending upon local market conditions, the price of the property, the type of property (e.g. vacant land, existing housing, or new construction), whether cash advances to a builder or seller are involved, and other factors.

Q: What happens to the earnest money before closing?

A: The purchase contract governs where earnest money will go. It should also specify the amount(s) to be paid, when the payments are to be made, whether the money will be held in a trust (escrow) account, who will hold it, whether it will be credited against the purchase price at closing, and what may happen to it if the transaction does not close.

Q: Will my earnest money earn interest between contract and closing?

A: Probably not. Most earnest money is held by real estate brokers in non-interest-bearing trust or escrow accounts. In order for the money to earn interest, the buyer and seller must agree, and they also must determine who will earn the interest. Such an agreement should be included in the purchase contract and may require the assistance of an attorney to prepare.

Q: Who can hold earnest money?

A: Any person (or entity) agreeable to you and the seller, but usually a licensed attorney. As a buyer, be aware that if you allow earnest money to be held and deposited by a seller or by a builder or developer for use in construction, you risk that they will not be able to return it to you in the event the transaction does not close (due to the seller's death, divorce, bankruptcy, judgment liens, receivership, fraud, tax liens, title problems, etc.). Consequently, most buyers prefer to have real estate agents or attorneys hold the earnest money deposit. Since they are licensed by the state and required to deposit the money in a trust or escrow account, this reduces the risk that the monies will be improperly used.

Q: Under the standard Offer to Purchase and Contract form*, who holds the earnest money?

A: The form permits the parties to select who will hold the money - typically, the listing firm. Whenever a licensed real estate firm or agent holds any earnest money, it must be deposited in a trust or escrow account until closing. However, if any addenda are used with the form, check to see whether they conflict with any provisions in the form concerning who will hold the earnest money or other pre-closing deposits.

*The Standard Form No. 2-T, Offer to Purchase and Contract is a well-known and widely used form jointly adopted by the North Carolina Bar Association (a voluntary professional association of attorneys) and the NC REALTORS® (a voluntary professional organization of real estate agents).

Q: Is earnest money the same as a due diligence fee?

A: No. The "due diligence fee" is a separate, non-refundable fee a buyer may pay for a negotiated period of time (the "due diligence period") during which the buyer may perform inspections, obtain loan approval, schedule a property survey or appraisal, review restrictive covenants, and determine whether or not to proceed with the purchase. The due diligence fee is paid directly to the seller under the standard Offer to Purchase and Contract.

Before the end of the due diligence period, the buyer has the right to terminate the contract for any reason or no reason at all, while the seller remains bound by the terms of the contract. Buyers typically want to negotiate the lowest due diligence fee for the longest due diligence period, while sellers want to negotiate the highest fee for the shortest period. Regardless, just like the earnest money deposit, no due diligence fee is required by law.

If a buyer wants the seller to make repairs, the buyer should have the parties enter into a signed, written agreement before the expiration of the due diligence period to have the specific repairs completed. While the due diligence fee is non-refundable, except in the event a seller breaches the contract, the due diligence fee is typically credited to the buyer at closing.

For more information about due diligence, please refer to the Commission's Q & A on: Due Diligence for Residential Buyers.

Q: What if the standard contract form is not used?

A: Many developers, builders, employee relocation services and lenders' asset managers use their own sales contract forms. Generic contract forms are also commonly available and can now be found on the Internet. Many will require you to make an earnest money deposit or similar deposit, but they may differ from the standard form in how it is to be handled. For

example, unlike the standard *Offer to Purchase and Contract* form which contains inspection and repair provisions, title requirements and other protections, there may be no provision allowing you to obtain a refund of the earnest money under any circumstances. Therefore, you must read every contract form carefully and consult with your attorney if you have questions.

Q: If a contract contains a rescission (“cooling off”) period, can I get my earnest money back if I cancel the contract during that time?

A: Probably; however, most purchase contracts do **not** have a rescission period. Only in certain kinds of transactions will you be allowed (for a limited time) to cancel the contract. These transactions include developer offerings of condominiums, timeshares, and interstate land sales; and where a seller fails to give you certain disclosures in a timely manner, including the *Residential Property Disclosure Statement*, *Mineral and Oil and Gas Rights Mandatory Disclosure Statement*, and, (for properties built before 1978) the lead-based paint disclosure. These rescission rights are usually created by state or federal law. The amount of time varies but is typically only a few days. You should consult your own attorney about rescission rights in such transactions.

Q: Isn't there a federal law that allows me to rescind my home loan and get my earnest money back?

A: No. Although there is a federal law that gives you three days to cancel a home loan commitment, it does not give you the right to cancel a purchase contract and get a refund of your earnest money. Your obligation to purchase as set forth in the sales contract is unrelated to your right to obtain the best possible loan or avoid a loan that has hidden conditions. However, the standard *Offer to Purchase and Contract* form has a provision allowing you to cancel the contract for any reason or no reason prior to the expiration of the “due diligence period” agreed to by the parties. If you cancel the contract during the due diligence period, you will get a refund of your earnest money deposit, although you would lose any fee you paid for the right to terminate during the due diligence period, and any fees paid to third party vendors for items such as inspections.

Q: Under the standard Offer to Purchase and Contract, do I get my earnest money back if the transaction does not close?

A: It depends on why the contract isn't consummated. If the transaction does not close due to your inability to fulfill your contractual obligations (such as your failure to obtain necessary financing), the seller would be entitled to retain the earnest money deposit plus any due diligence fee, but would not be entitled to any other damages. Conversely, if the transaction does not close due to the seller's material breach (such as the inability to deliver marketable and insurable title), the buyer would be entitled to recover the earnest money deposit and due diligence fee, together with reasonable costs actually incurred by you during the due diligence process (for example costs incurred for a survey and property inspection) in addition to other remedies available at law.

Q: What if the contract fails and the seller and I cannot agree on who is entitled to the earnest money?

A: According to the terms of the standard *Offer to Purchase and Contract* and the rules governing real estate brokers, if there is a dispute between you and the seller over the return or forfeiture of an earnest money deposit, the escrow agent holding the money must continue to hold the funds in trust until you and the seller resolve the dispute in writing or until a court decides the matter (less than \$10,000, Small Claims Court; more than \$10,000, usually District or Superior Court although some cases may go to federal court). The parties may also resolve disputes through voluntary or court-ordered mediation. Alternatively, the escrow agent may choose to pay the disputed funds to the Clerk of Court in the county where the property is located after first providing 90 days written notice to you and the seller. If the disputed funds are deposited with the Clerk of Court, you would have to initiate a special proceeding with the Clerk to recover the funds. If no one institutes a special proceeding within a year of the funds being deposited with the Clerk, it will be deemed unclaimed and delivered to the State Treasurer's Office as escheated funds. When a form other than the standard *Offer to Purchase and Contract* is used, it may allow the seller access to the money whether or not the closing occurs as scheduled. In any event, while a broker is not allowed to pursue a claim for earnest money for you, the broker may appear as a witness in court.

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