

A Reprint from *Tierra Grande*



In Earnest

by Judon Fambrough

Earnest money contracts form the backbone of the real estate industry. Practically every real estate transaction starts with the parties negotiating and signing this type of contract.

The agreement serves two purposes. First, it indicates the purchaser's good faith intention to fulfill the contract. Second, the earnest money represents a potential remedy for the seller. If the buyer defaults, the seller has the option of taking the earnest money as liquidated damages.

The exact amount is negotiable. As a general rule, it averages 5 to 10 percent of the purchase price. The amount should be sufficient to discourage the buyer from defaulting, compensate the seller for taking the property off the market and cover any expenses the seller incurs during the interim.

The amount must be a reasonable estimate of the actual damages even though the exact amount may

be difficult or impractical to forecast. If it is too much, the deposit could be viewed as a penalty and be deemed unenforceable.

Earnest Money Failure

Earnest money contracts work smoothly as long as all parties perform accordingly. But what happens when the check for the earnest money bounces for insufficient funds? Does this invalidate the contract and free the vendor to sell the property elsewhere? Are there other legal consequences?

The answers lie within the wording of the contract and the interpretation of that language by the Texas appellate courts.

One of the first cases to address the consequences of a failed earnest money deposit was *Hudson v. Wakefield*. It reached the Texas Supreme Court twice, once in 1981 and again in 1986. The issue was whether the failure of the earnest money terminated the contract.

On March 18, 1981, the sellers (Wakefield) entered into an earnest money contract with the purchasers (Hudson) for the sale of 186 acres in Freestone County. The contract required the purchasers to deposit \$5,000 in earnest money. On March 30, 1981, the escrow check was returned for insufficient funds.

Wakefield then contracted to sell the property to a third party. Hudson's attorney wrote a letter to the sellers demanding specific performance of the contract even though the earnest money failed. Wakefield refused, and the buyers sued.

The trial court found the failure of the deposit of the earnest money was a *condition* for the formation of a binding contract. The purchasers argued, on appeal, that the earnest money was a *covenant*, not a condition.

The Texas Supreme Court agreed with the purchasers that the deposit of the earnest money was a covenant and remanded the case. In the ensuing trial, the trier of facts (the jury or the judge in a bench trial) had to decide whether the failure of the earnest money amounted to a *material breach*. If so, the sellers were free to repudiate the contract and sell to another party.

The difference between a condition and a covenant varies drastically. The breach of a condition terminates the contract or keeps a future obligation from becoming enforceable. A breach of a covenant may or may not terminate the contract depending on how material it is.

The intent of the parties determines whether a condition or a covenant exists. This is accomplished by examining the entire contract. While no particular words are required, the use of "when," "after," "as soon as," "subject to," "if," "provided that," "on condition that" or similar phrases indicates the creation of a condition. The absence of these words generally indicates a covenant.

Is Failure a Material Breach?

Following the Hudson decision, the legal question became whether the failure of all or a part of the earnest money amounted to a material breach. A fundamental principle of contract law holds that a material breach discharges or excuses the other party from further performance.

As a general rule, the materiality of a breach is a question of fact for a jury. However, sometimes it is a question of law for the courts when the terms of the contract are clear, unambiguous and conclusively established. The case of *Crandall Medical Consulting Services Inc. v. Harrell* is a good example. Here the court ruled the issue of materiality was a question of law.

The purchasers (Harrell) agreed to buy property located in New Braunfels for \$253,000. The terms required Harrell to deposit \$2,000 in earnest money at the commencement of the contract and an additional \$100 at the conclusion of the feasibility period. Harrell deposited the first amount, but failed to deposit the second.

For that reason, on Jan. 3, 2007, days before the scheduled closing, the sellers sent "Notice of Termination of Contract" to the title company. The notice was relayed to Harrell the next day. On Jan. 9, 2007, Harrell's attorney notified the sellers that they did not have the right to terminate the contract and that his clients would proceed to closing and seek specific performance.

On Jan. 26, 2007, the buyers closed their side of the contract by tendering the full amount of the purchase price by cashier's check to the title company, and then sued for specific performance.

At trial, the issue boiled down to whether the failure to deposit the additional \$100 constituted a material breach of the contract. The trial

court ruled that the failure was immaterial and ordered specific performance. The sellers appealed.

The appellate court reviewed the six factors formulated by the Texas Supreme Court as guidelines for determining whether a breach is material or not. The courts must consider the extent to which:

- the injured party would be deprived of the benefit he or she reasonably anticipated,
- the injured party would be adequately compensated for the benefit to which he or she was deprived,
- the failing party would suffer forfeiture if the contract is declared void,
- the failing party would cure the failure if the contract is not declared void, taking into account the circumstance of any reasonable assurances and
- the failing party failed to conform to the standards of good faith and fair dealing.

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After examining and applying these factors to the present case, the appellate court concluded that the sellers were not harmed by the buyers' failure to deposit the additional \$100 and ordered specific performance. The buyers had tendered the full purchase price as agreed on the scheduled date. The sellers suffered no loss of benefits.

The appellate court offered another reason for the decision. "The plain language in this sentence (in the contract) refers to 'the earnest money' singularly. . . and allows the seller to terminate only if Harrell failed to deposit the *initial* \$2,000," the court ruled.

This interpretation shows a good-faith intention on the buyers' part to complete the transaction. This is consistent with the purpose of an earnest money contract. The breach was immaterial even though time was of the essence. However, had Harrell *not tendered* the full amount of the purchase price at the scheduled closing, the outcome may have been different.

Likewise, the court may have ruled differently had the two deposits been switched with the first being \$100 and the second \$2,000.

The case needs to be compared with *Limestone Group Inc. v. Sai Thong*. According to the contract, the purchasers were to deposit \$75,000 in earnest money. The purchasers deposited only \$25,000. Later, the purchasers, like Harrell, sued for specific performance.



They argued (1) the failure of the earnest money was not a condition for the formation of the contract, and (2) it was an immaterial breach. The trial court disagreed. The buyers appealed.

The appellate court denied specific performance based on the language used in the contract. The contract allowed specific performance *only if* the purchasers were not in *default*. The contract did not define *default*.

The court followed prior case law in which the term was defined as an omission, a failure to act, or simply a breach. But, as pointed out by the court, none of these definitions gauge the severity of the breach. An omission is an omission. Thus,

a failure or omission to any degree or magnitude constitutes a default. The materiality of the breach is no longer relevant.

Consequently, the failure to deposit the *full amount* of the earnest money constituted a default and prevented the buyers from pursuing specific performance. The deposit of the *entire amount* of the earnest money becomes a contractual condition whenever the word "default" is used.

Promulgated Forms

These cases are relevant to understanding the Texas Real Estate Commission's (TREC) promulgated contracts for several reasons. First, the promulgated forms use, but do not define, *default*. Thus, the definition of the term found in the Limestone case becomes relevant. The promulgated forms place the buyer in default for failing to deposit the earnest money regardless of the amount. In effect, this makes the deposit of the entire amount of the earnest money a contractual condition as it did in the Limestone case, with one possible exception discussed next.

Second, the promulgated forms discuss the possibility of the buyer having to make two deposits of earnest money similar to the Harrell case. The first is required upon execution of the contract by all parties and the second on an agreed number of days after the effective date of the contract. The language in the TREC forms then states, "If Buyer fails to deposit the earnest money (singular), as required by this contract, Buyer will be in default." The Harrell decision, with similar contractual language, held that the default refers to the failure of the first deposit and not the second.

Third, the promulgated forms impose deadlines for the deposits. However, time is *not* of the essence in the promulgated forms unless made so in the special provisions. Consequently, buyers have a reasonable time to comply with each deadline.

Election of Remedies

The promulgated forms describe the following remedies when the buyer defaults. The seller may (1) enforce specific performance, seek such other relief as may be provided by law, or both, or (2) terminate the contract and receive the earnest money as liquidated damages, thereby releasing both parties from the contract.

In January 2010, an unpublished Texas appellate decision dealt with the interpretation of this language. The buyer defaulted. The sellers did not seek specific performance but sought damages under "other relief as provided by law." When the trial began, the court released the \$3,000 held in escrow to the sellers.

The buyer immediately sought termination of the lawsuit because the sellers opted to receive the earnest money as liquidated damages. In other words, the sellers must choose between alternatives (1) and (2). They cannot pursue both at the same time. This is known as an election of remedies.

When the sellers received the funds, however, they refused to sign a form that would have given them the earnest money and released the buyer from damages. Instead, the sellers deposited the money with the registry of the court. They never intended to retain the funds.

The court ruled that the sellers “temporary receipt of the earnest money stemming from the district court’s order is not inconsistent with their election to seek monetary damages under the contractual remedies clause and does not support limiting their recovery of the earnest money based on the election of remedies defense.”

Specific Performance

The promulgated forms do not mention that specific performance does not arise automatically. Case law requires the party seeking specific performance to substantially comply with the terms of the contract at the agreed time.

This means the seller must tender the deed as required by the contract. The buyer, on the other hand, must tender the full purchase price at the appointed time. Remember, the buyers in the Harrell decision tendered the full purchase price on the scheduled closing date even though the sellers had purportedly terminated the contract.

Timing is important. The performance or tender of full performance must occur at the time prescribed in the contract when time is of the essence. When it is not, as is the case in the promulgated forms, the performance or tender of performance must occur within a reasonable time as determined by the circumstances of each case.

The appellate courts’ interpretation of the language currently used in the promulgated forms, suggest the following conclusions. However, this does not represent an exhaustive search of the case law.

- Deposit of the *entire* amount of the required earnest money is a contractual condition whenever the word default is employed. The issue of materiality becomes irrelevant.
- When the contract requires more than one deposit, case law indicates that a default occurs only when the first deposit is missed. This rule applies when the contract uses the singular term *earnest money* and not earnest moneys.
- Promulgated forms contain deadlines for making the deposit, but time is not of the essence unless specifically made so in the special provisions. Consequently, buyers have a reasonable time to make the deposit without being in default.
- If the buyer defaults, the seller must choose between alternatives (a) and (b) contained in the promulgated forms. This is known as an election of remedies.
- Finally, if either party wishes to pursue specific performance, he or she must perform or tender full performance within the time specified when time is of the essence. Otherwise, the buyer or seller has a reasonable time to do so. 📌

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THE TAKEAWAY

Practically every real estate transaction begins with negotiating and signing an earnest money contract. Real estate licensees need to understand the legal consequences of the failure of the earnest money. What effect does this have on the contract, especially when time is not of the essence? Likewise, what remedies are available to the seller in such circumstances?

Key Questions and Answers

Real estate practitioners might be asked or should ask these questions on behalf of their clients.

- ***Would the sales contract be enforceable even if no earnest money were required?***

Yes. A contract without earnest money is still enforceable. It is known as a bilateral contract. The buyer promises to purchase, and the seller promises to sell based on the terms and conditions of the contract. The only difference is that there are no available funds to serve as liquidated damages if the buyer defaults.

- ***If the buyer defaults on an earnest money deposit, will the title company require a written release from the buyer before the title company releases the funds to the seller?***

Yes. Even though the earnest money serves as liquidated damages, the title company will not release the funds without the defaulting buyer’s consent.

- ***If the buyer defaults, will the title company deduct a “service fee” for handling the earnest money?***

Yes. Generally, title companies deduct a handling charge before releasing the funds to the seller. This is an issue the seller or the seller’s agent should raise with the title company before the funds are deposited to see if the deduction is negotiable.



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