

Earnest Money Disputes: An Unfortunate Reality

Course No.: 38468
Credit Hours: 1
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Introduction

- An unfortunate reality in the real estate business is a dispute over earnest money.
- The disposition of earnest money is expressly governed by the TREC One to Four Family Contract and its addenda.

Earnest Money Contract Provision

- 5. EARNEST MONEY: Within 3 days after the Effective Date , Buyer must deliver \$ _____ as earnest money to , as escrow agent, at _____ (address). Buyer shall deliver additional earnest money of \$ _____ to escrow agent within _____ days after the Effective Date of this contract. If Buyer fails to deliver the earnest money within the time required, Seller may terminate this contract or exercise Seller's remedies under Paragraph 15, or both, by providing notice to Buyer before Buyer delivers the earnest money. If the last day to deliver the earnest money falls on a Saturday, Sunday, or legal holiday, the time to deliver the earnest money is extended until the end of the next day that is not a Saturday, Sunday, or legal holiday. **Time is of the essence for this paragraph.**

What is Earnest Money?

- Earnest Money is a deposit made by the buyer into a trust or escrow account.
- Earnest Money is used to show the seller that the buyer has entered into the transaction in good faith.
- Earnest money is not required to make a contract binding.

The TREC One to Four Contract Provisions

- Paragraphs 18.A and B address the title company's role and expenses relating to earnest money:
 - A. **ESCROW:** The escrow agent is not (i) a party to this contract and does not have liability for the performance or nonperformance of any party to this contract, (ii) liable for interest on the earnest money and (iii) liable for the loss of any earnest money caused by the failure of any financial institution in which the earnest money has been deposited unless the financial institution is acting as escrow agent.
 - B. **EXPENSES:** At closing, the earnest money must be applied first to any cash down payment, then to Buyer's Expenses and any excess refunded to Buyer. If no closing occurs, escrow agent may: (i) require a written release of liability of the escrow agent from all parties, (ii) require payment of unpaid expenses incurred on behalf of a party, and (iii) only deduct from the earnest money the amount of unpaid expenses incurred on behalf of the party receiving the earnest money.

The Contract Provisions

- Paragraphs 18.C through E address the procedure for release of earnest money:
 - C. DEMAND: Upon termination of this contract, either party or the escrow agent may send a release of earnest money to each party and the parties shall execute counterparts of the release and deliver same to the escrow agent. If either party fails to execute the release, either party may make a written demand to the escrow agent for the earnest money. If only one party makes written demand for the earnest money, escrow agent shall promptly provide a copy of the demand to the other party. If escrow agent does not receive written objection to the demand from the other party within 15 days, escrow agent may disburse the earnest money to the party making demand reduced by the amount of unpaid expenses incurred on behalf of the party receiving the earnest money and escrow agent may pay the same to the creditors. If escrow agent complies with the provisions of this paragraph, each party hereby releases escrow agent from all adverse claims related to the disbursement of the earnest money.
 - D. DAMAGES: Any party who wrongfully fails or refuses to sign a release acceptable to the escrow agent within 7 days of receipt of the request will be liable to the other party for damages in an amount equal to the sum of: (i) the earnest money; (ii) reasonable attorney's fees; and (iii) all costs of suit.
 - E. NOTICES: Escrow agent's notices will be effective when sent in compliance with Paragraph 21. Notice of objection to the demand will be deemed effective upon receipt by escrow agent.

The Title Company's Role as a Third Party Fiduciary

- Third Party Fiduciary – Impartial Third Party
- Title company can't arbitrarily make decisions about earnest money.
- Charged with holding the earnest money and applying the funds as instructed, in writing, by the parties to the contract. *Trevino v. Brookhill Capital Resources*, 782 S.W.2d 279, 281 (Tex. App. – Houston [1st Dist.] 1989, writ denied).
- 3 Elements of this fiduciary duty: (1) a duty of loyalty; (2) a duty to make full disclosure; and (3) a duty to exercise a high degree of care to conserve the money and pay it only to those persons entitled to receive it. *Fort Worth v. Pippen*, 439 S.W.2d 660, 665 (Tex. 1969).

The Title Company's Role as a Third Party Fiduciary

- High degree of care required = title company walks a fine line when trying to interpret provisions of the contract and make the determination of entitlement to the earnest money based on who may or may not have complied with the terms of the contract.
- Each title company must make their own internal decisions on handling earnest money disputes.
- Title company can't play judge or jury.
- Most title companies require either (1) written agreement between the parties (release of earnest money form) or (2) court order.

Earnest Money Demand

- Upon failure of the contract for any reason, the party wanting the earnest money must send written demand to the title company.
- A copy of the demand should be sent to the other party.

What Happens After the Earnest Money Demand is Made?

- The written demand triggers a 15-day period during which the other party may make written objection to the title company.
- A phone call will not meet the requirements of the contract.
- Email or fax would be sufficient, but certified mail to both the title company and the other party is best, particularly if litigation is a possibility.

What Happens After the Earnest Money Demand is Made?

- If the title company receives releases from both parties, in other words, a proposed release of earnest money to the buyer and a proposed release of earnest money to the seller, this would suffice as a written objection.
- The language of the contract is vague about which demand—demand from the party wanting the earnest money versus demand from the title company—triggers the 15- and 7-day periods, but it is prudent to be conservative and assume that these periods begin when the first party makes written demand.

What Happens After the Earnest Money Demand is Made?

- The title company will follow up with a notice of its own that written demand has been made and enclose a release form for signature.
- The release must be signed by all parties and their brokers.
- Remember, title companies are impartial third parties and are not, generally, to decide the merits of an earnest money dispute.

What Happens After the Earnest Money Demand is Made?

- Although fifteen days are permitted in order to make written objection, paragraph 18.D imposes damages in the amount of the earnest money if a party “wrongfully” refuses to sign a release within seven days.
- Prior Contract imposed “Treble damages”, which are a multiple of, and not an addition to, actual damages. Thus, where a person received an award of \$1,000 for an injury, a court applying treble damages would raise the award to \$3,000.
- Attorney’s fees and costs could be added to this amount as articulated in paragraph 17.

Mediation

- If the release is not signed by both parties and the earnest money is not released, mediation must precede the filing of litigation to recover earnest money.
- Prior TREC One to Four Contract – mediation was optional.
- Most courts will abate the lawsuit until mediation occurs.

Mediation

- Abatement is the interruption of a legal proceeding upon the pleading by a defendant of a matter that prevents the plaintiff from going forward with the suit at that time or in that form.
- Dispute submitted to mutually acceptable mediation service and provider.
- Parties shall bear mediation costs equally.

The Filing of a Lawsuit

- Mediation must precede the filing of litigation to recover earnest money.
- Lawsuits may be filed in Justice Court, providing the total amount claimed (including attorney's fees) does not exceed \$10,000.
- If total damages exceed that amount, then suit may be filed in the County Court at Law.
- Named defendants should include the party refusing to sign the release and the title company holding the earnest money.

The Filing of a Lawsuit

- Title companies will usually respond by interpleading the earnest money (depositing it into the court's account).
- Before filing a legal action concerning earnest money, it is important to consider the practical reality that attorney's fees and costs, once added up, can easily exceed the amount of earnest money in dispute.
- As a consequence, many earnest money disputes are resolved by the parties' splitting the funds and going their separate ways.

Interpleader Action

- Title company may ask the court to decide the issue by placing the funds into the registry of the court by an interpleader action.
- Interpleader is the procedure when two parties are involved in a lawsuit over the right to collect a debt from a third party, who admits the money is owed but does not know which person to pay.
- The debtor deposits the funds with the court (“interpleads”), asks the court to dismiss it from the lawsuit and lets the claimants (Buyer and Seller) settle their dispute in court.
- Title company is often entitled to have its attorney’s fees paid out of the funds deposited with the court.
- Only used as a last resort in situations when the parties or the whole situation have become intolerable.

Buyer Withdrawal Because of Failure to Obtain Financing

- A common area of dispute is failure by the buyer to obtain financing.
- Although paragraph 4.A(1) makes the TREC 1-4 contract contingent upon financing, the TREC Third-Party Financing Condition Addendum contains a blank for a specific time during which the buyer must notify the seller of his inability to obtain financing.
- If this notice is not timely given, the contingency is waived.
- Buyers often miss this detail and insist on their continuing right to get their earnest money back if their loan application is denied, even after the specified time has run.

Buyer Withdrawal Because of Failure to Obtain Financing

- Sellers, on the other hand, may believe that the buyer did not make “every reasonable effort to obtain credit approval” (as required by the TREC addendum) and therefore should not be entitled to return of earnest money even if notice is given within the prescribed period.
- Unfortunately for this point of view, the addendum does not go into detail about what “every reasonable effort” means.

Backup Contracts

- Not uncommon to see the sellers hold out and refuse to release earnest money until they are ready to close with another buyer.
- Title companies are not supposed to accept “back up” contracts and produce title commitments until the previous contract is formally terminated and the earnest money is released.

The End!

Please call and/or email us if you ever have any questions. We would love to help!