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# Earnest money: More may be less, and vice versa

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(This is the third in a series of articles about issues involved in a purchase-offer contract for property.)

We buy and sell property in an odd and awkward way. Among the puzzling steps in the process we use is the packaging of earnest money with our purchase-offer contract. Earnest money is a buyer's deposit that's held in trust, pending ultimate acceptance or rejection of the offer. It is parked in a trust account where it's not used for any purpose before or during escrow, which is the time when the purchase contract is in effect.

Few other types of purchases involve buyers depositing earnest money.

Real-estate brokers, representing either buyer or seller (but usually the latter), hold these deposits in trust. Real-estate lawyers also have trust accounts. I've always felt most comfortable as a buyer putting my earnest money in my lawyer's trust account, and I've never had a seller complain.

A buyer dealing with For-Sale-By-Owner sellers should use his own lawyer's trust account. Buyers should never give earnest money directly to sellers. I have seen FSBO sellers pocket such deposits when the sale fell apart.

Earnest money is applied to the agreed-on purchase price when buyer and seller close the sale. If no sale agreement is reached, earnest money is returned to the buyer in full. Interest may or may not accrue to the buyer, depending on the state.

If a buyer defaults on a signed purchase contract, the common remedy is forfeiture of the earnest money to the seller. This forfeiture payment is the usual reason given for sellers wanting large deposits from buyers. The bigger the deposit, the reasoning goes, the less likely a buyer will back out and the greater the compensation to the seller if it happens.

But this remedy comes into play only when the buyer has language in the contract that says words to the effect that in the event of buyer default, the seller's sole and exclusive remedy is to receive the forfeited deposit held in trust. Absent such language, the seller can sue the defaulting buyer for full performance on the terms of their contract.

Forfeiture is, in other words, a liability-limiting provision.

Some sellers prefer the right to sue for performance instead of a limited remedy like forfeiture. The threat of suing for full performance may get more money out of a defaulting buyer than the forfeiture of earnest money. Some sellers use contracts that give them the choice of either taking the deposit or suing.

A contract reflects a meeting of the minds between buyer and seller. And one element of a buy-sell contract is that the seller should receive some agreed "consideration" from the buyer in return for whatever he has sold. Consideration is usually money, but it could be property, the promise of future payment or a combination of things.

Buyer and seller can have a legally valid contract for a real-estate sale without having any earnest money deposited as part of their agreement. The consideration in such a case is the buyer's promise to pay the seller the agreed-on price and fulfill other contract terms

in the future. If the buyer defaults, the seller will sue for performance with all costs paid by the buyer. I've seen very large deals structured this way.

What purpose, then, is served by earnest money?

The conventional answer is that the buyer shows the seller his degree of seriousness by the size of his deposit.

Several questions might be raised about this answer.

First, the size of the deposit may or may not indicate buyer seriousness. It depends on the wording and types of contingencies attached to the buyer's offer, among other items. Generally speaking, a contingency should be worded in a way that allows the buyer to judge whether or not its results are acceptable to him. If the results of a contingency investigation are not acceptable, the buyer's earnest money should be returned in full and without penalty whereupon the buyer and seller have no further obligation to each other. The buyer's earnest money is not at risk until the parties reach an agreement on terms. No agreement, no risk of loss to the buyer. The buyer's money is not at risk during the time the seller is considering his offer after it is first proposed or when they are trying to hammer out an agreement.

For that reason, I have proposed contracts to sellers that are packaged with $100 in earnest money and a sizeable increase once I have removed all contingencies. The seller is not shorted in this arrangement, since he cannot get his hands on the earnest money as a remedy until all contingencies are removed and I then default. Before default, the money is locked away from the seller in the trust account. From the buyer's point of view, a two-step deposit is a better arrangement than having to come up with a bunch of cash that sits unproductively in escrow and is then applied to the sale.

A small earnest-money deposit can also be coupled with the buyer's promise to pay some defined sum in the event of a default after contingencies are removed and a contract is in effect. That sum should be set up as the seller's sole remedy for default. If the buyer is short of cash, he might pledge personal property or equities as sole compensation for default rather than cash.

A highly motivated buyer who has done all of his due diligence before submitting an offer might show his earnestness by not using any results-acceptable-to-the-buyer contingencies. In that case, the buyer may be able to bring about a contract with a very small deposit, or none at all. This is a high-risk maneuver, however, because it assumes that the buyer has or can get the money to buy the property and that he has thoroughly scoped its assets and liabilities. The upside is that a contract proposed with no contingencies can often bring the seller to a lower price because the offer is seen as a sure sale.

I've found it useful to explain in writing to a seller why I'm offering the amount of earnest money and the reason behind the two-step structure if I'm using that.

Second, earnest money is often mainly about psychology. Sellers think a "real" buyer is one who ponies up a big deposit. Often, a buyer uses that belief against a seller.

I've seen buyers put in big deposits that are combined with a three- to six-month "research period" for due diligence. This gives the buyer a very long look. It keeps the seller psychologically invested with this buyer. If the buyer exercises a back-out contingency, the buyer's loses interest on his cash deposit plus his research expenses—but neither may amount to much. The seller, however, may lose his best season for

selling or the market may have turned against him. I've seen buyers extract a lower price after a large deposit hypnotized their sellers into agreeing to an extra-long study period.

The size of a deposit may or may not indicate a buyer's ability to perform on a contract. Many of us have run into buyers who appear to be wealthy but aren't. I've seen buyers play this role, stretch out a seller with a long research period and threaten to exercise a blow-up-the-deal contingency—all in order to beat down the eventual selling price.

Sellers need to remember that buyers often use information developed as part of their contingency-related due diligence to reduce the final selling price. The seller agrees, because he figures he's better off lowering the price than to start the selling process from scratch.

A third point to consider is that sellers can propose lower earnest-money deposits in return for concessions on other buyer-proposed terms. As a seller, I'd take a $1 deposit and a short escrow in return for zero back-out contingencies any day of any week. A low deposit can be coupled with a fixed-fee penalty for a buyer's failure to perform.

Buyers, of course, can raise their deposit in return for seller concessions as part of pre-contract bargaining. A buyer who knows that he's able and willing to make the purchase may be able to negotiate better terms by starting with a low deposit and then raising it in return for better terms from the seller.

Sellers who dismiss a low deposit out of hand may be "reading" a buyer's intentions and capabilities incorrectly. Were I a seller facing a low-deposit proposal, I would ask the buyer for a written explanation.

And I might propose a double-down alternative: $1 deposit with either a huge penalty in the event of a default as the sole remedy or an agreement that the buyer pays all costs of enforcing performance on himself.

An earnest-money deposit -- its size and structure -- is a tactic in buyer-seller negotiations. Theoretically, a deposit could range from $1 (or even no dollars) to one dollar less than the proposed purchase price. Deposit language may or may not put the buyer's money at risk—and risk comes in degrees. I've seen a contract where the parties agreed that the buyer's deposit would be returned in full in the event of default. And for that Get-Out-Of-Jail-Free card, the buyer willingly agreed to and paid a higher price.

Like other tactics, the size, structure and wording of a deposit should be thought through in relation to the set of objectives that buyers and sellers want to reach.