

**BEFORE THE STATE OF ALASKA OFFICE OF ADMINISTRATIVE HEARINGS
ON REFERRAL BY THE ALASKA REAL ESTATE COMMISSION**

STEPHEN D. HENRY and)
CHERYL M. HENRY,)
Claimants,)
v.)
JOEL JOHNSON and)
JOEL JOHNSON REALTY,)
Respondents.)
_____)

OAH No. 07-0267-RES
REC No. S-27-011

DECISION

I. Introduction

Stephen and Cheryl Henry executed an agreement to sell their house to Fred Opper and Birte Horn-Hansen. Opper and Horn-Hansen deposited \$6,540 with their real estate licensee, Joel Johnson, as earnest money. When the sale failed to close as scheduled, the Henrys demanded that Johnson tender the earnest money to them. Instead, Johnson refunded the earnest money to his clients. The Henrys filed this claim against the Real Estate Surety Fund, seeking compensation for Johnson's failure to tender the earnest money to them.

A hearing on the claim was conducted at which Mr. Henry, Mr. Johnson and other witnesses testified. The administrative law judge issued a proposed decision which was considered by the Real Estate Commission at its meeting on March 13, 2008. Following an executive session, the commission directed the administrative law judge to revise the proposed decision. Based on the testimony at the hearing and the evidence in the record, and in conformity with the commission's directive and its oral order on June 19, 2008, the administrative law judge issued this amended revised proposed decision. The claim is denied.

II. Facts

Stephen and Cheryl Henry owned a house located at 1512 Ithaca Road in Fairbanks. On August 31, 2006, they listed the house for sale through their licensee, Cynthia Lee O'Hare. Joel Johnson, a licensed real estate broker, brought the house to the attention of his clients, Fred Opper and Birte Horn-Hansen, who were looking for a house to buy.

On October 2, 2006, the parties entered into a purchase and sale agreement for the house. The purchase price was \$332,000, and closing was set for November 8, 2006. Opper and Horn-

Hansen tendered an earnest money payment of \$6,540, which Mr. Johnson retained in his trust account.¹

On November 1, 2006, at the request of Ms. O'Hare,² a well inspection was conducted by Jim Ringstad of 3-Tier of Alaska. At that time, the water flow from the well was 80 gallons in a 30 minute period, when the well ceased producing, and then 30 gallons in a 15 minute period, when the well again ceased producing. The well production and flow rate was less than recommended for a three bedroom house and was insufficient to perform a test of the septic system. Mr. Ringstad deemed the water well supply unsatisfactory.³

On November 3, 2006, the closing company informed the brokers that the transaction was ready to close, contingent upon the well and septic inspection. Ms. O'Hare spoke with Mr. Ringstad, who explained that the well flow was insufficient, but that an adequate supply of household water could be provided through a supplemental holding tank, which could be installed in the garage. Ms. O'Hare contacted the Henrys, who agreed to install the holding tank. Ms. O'Hare then contacted Mr. Johnson and informed him of their plan.

Mr. Johnson contacted the buyers. Mr. Johnson also checked with Mr. Ringstad, who informed him that the well flow had been inadequate to complete a septic test, and that he was planning to return to the house to conduct a test using trucked-in water.⁴ Mr. Johnson called Ms. O'Hare on November 6, 2006, and informed her that the buyers were no longer interested in the house. Ms. O'Hare indicated that her clients were prepared to install the supplemental holding tank and that they still wanted to close the transaction. That same day, Mr. Johnson contacted the closing company and let it know that the transaction might not close due to well and septic issues.⁵ Later that day, Mr. Ringstad returned to the house, at which time he conducted an inspection of the septic system using the trucked-in water. The inspection report, issued on November 14, revealed that the septic system was satisfactory.⁶

¹ Exhibit A, page 11.

² The well and septic inspection were paid for by the seller, pursuant to Paragraph 3 of the purchase and sale agreement. Paragraph 3 does not allocate the cost of a well flow test to either party; Mr. Johnson testified that because a well flow test is not required for closing, he had not included it in the standard well inspection.

³ Mr. Ringstad issued a written report describing the inspection and his conclusions on November 14, 2006. The report indicates that the recommended production for a three bedroom house is 720 gallons in 4 hours (equivalent to a well flow rate of 3 gallons per minute). Exhibit B. The well flow rate at the property, during the time the well produced, was 2.44 gallons per minute (110 gallons in 45 minutes). Mr. Henry testified that in a subsequent 24-hour test, the well produced at a rate of 2.5 gallons per minute.

⁴ Johnson Narrative of Events.

⁵ Exhibit H, page 4.

⁶ Exhibit B.

At 8:00 a.m. on the morning of November 8, 2006, the scheduled closing date, Ms. O'Hare made a written request to Mr. Johnson for transfer of the earnest money into her trust account.⁷ Mr. Johnson called Mr. Ringstad to ask about the results of the septic test. According to Mr. Johnson, Mr. Ringstad indicated that based on his preliminary review of the test results, he anticipated failing the system.⁸ That evening, Mr. Johnson submitted a proposed rescission agreement to Ms. O'Hare, citing as grounds an alleged failed septic system.⁹ The Henrys refused to sign the agreement, and Mr. Johnson did not transfer the earnest money to Ms. O'Hare's account. On November 9, 2006, Mr. Johnson refunded the entire earnest money to his clients.¹⁰ The Henrys installed a supplemental tank in the garage, but on November 24, 2006, Mr. Johnson's clients entered into a purchase and sales agreement on a different property.¹¹

III. Discussion

A. Applicable Legal Principles

Alaska law provides that the commission may award reimbursement from the surety fund for a loss resulting from fraud, misrepresentation or deceit by a licensee in connection with a real estate transaction, or for conversion of trust funds.¹² To be eligible for an award based on fraud, misrepresentation or deceit, the claimant must show an intentional or fraudulent misrepresentation, rather than merely an innocent or negligent misrepresentation.¹³ The Henrys' claim for reimbursement is not based on a loss arising from any intentional or fraudulent misrepresentation to them,¹⁴ but rather on an alleged conversion of trust funds.

Conversion is "an intentional exercise of dominion or control over [property] which so seriously interferes with the right of another to control it that the actor may justly be required to

⁷ Exhibit C, Exhibit J.

⁸ Mr. Johnson testified to this effect; Ms. O'Hare testified that Mr. Johnson had told her that Mr. Ringstad had found the septic system inadequate. Mr. Ringstad testified that nothing in his preliminary observations suggested that the septic system would fail, but he recalled telling Mr. Johnson at some point that as an older system, there was a good chance it would fail the test [Recording at 46:25-48:30]. As previously noted, the written inspection report is dated November 14. Exhibit B.

⁹ Exhibit D, Exhibit M; Exhibit R (O'Hare email dated 11/15/2006).

¹⁰ Johnson Narrative of Events; Exhibit N

¹¹ Exhibit T. Mr. Henry testified that he installed the supplemental tank, but the date on which this was done was not established.

¹² AS 08.08.470.

¹³ State, Real Estate Commission v. Johnson, 682 P.2d 383 (Alaska 1984).

¹⁴ The Henrys allege that Mr. Johnson misrepresented Mr. Ringstad's description of the outcome of the septic test, but they have not alleged that they took any action or changed their position in detrimental reliance on such a misrepresentation. Accordingly, it is not necessary to determine whether Mr. Johnson misrepresented Mr. Ringstad's statements to him, or, if so, whether he did so intentionally or fraudulently.

pay the other the full value of the [property].”¹⁵ A claim for damages arising from a breach of contract generally does not give rise to a claim for damages for conversion.¹⁶ As between contracting parties, “[o]nly where the duty breached is one imposed by law, such as a traditional tort law duty furthering social policy, may an action between contracting parties sound in tort.”¹⁷

B. Applicable Contract Terms

In this case, Mr. Johnson held his clients’ funds in trust under AS 08.88.351(a)(3). By law, Mr. Johnson was obliged to retain the money in trust “until it [was] appropriate for [him] to distribute the money to the proper persons.”¹⁸ To the extent consistent with law, the trust under which Mr. Johnson held the earnest money is controlled by the terms of the purchase and sale agreement. Paragraph 15 of that contract governs disposition of earnest money. It states, in relevant part:

(a) Earnest Money will be deposited in trust by the SELLING OFFICE and transferred to the LISTING OFFICE upon written request. Earnest Money is partial payment for the subject property. [capitals in original]

(b) Earnest Money will be refunded only if one or more of the following occur:

...

7. Rescission by Buyer in accordance with Paragraph 14(e).

...

...Buyer agrees that, if this transaction does not close for any reason other than those cited above [*i.e.*, subparagraphs (b)(1)-(7)], Seller may retain Earnest Money.... If recording does not occur for any reason, the broker holding Earnest Money shall request the parties to sign a Rescission Agreement for release of Earnest Money. If Buyer and Seller cannot agree on who is entitled to Earnest Money, the broker may..., at his/her sole discretion, determine disposition of Earnest Money. Broker may transfer Earnest Money to a conflict resolution center, other agency, or the court and the broker may file action to interplead the money for determination of the appropriate person to receive the Earnest Money. The real estate firm shall then be released from any further liability.

These provisions are directly applicable to the circumstances of this case. Paragraph 15(a) provides the seller’s licensee with the right to make a written request for transfer of the trust funds to the seller’s licensee’s trust account at any time after the agreement is executed.

¹⁵ McKibben v. Mohawk Oil Company, 667 P.2d 1223, 1228 (Alaska 1983) (quoting RESTATEMENT OF TORTS 2D §222A). The term used in the Restatement is “chattel”, which may be understood, in some contexts, as not including money.

¹⁶ See, e.g., K&K Recycling, Inc. v. Alaska Gold Company, 80 P.3d 702, 717 (Alaska 2003).

¹⁷ Alaska Pacific Assurance Company v. Collins, 794 P.2d 936, 946 (Alaska 1990).

¹⁸ AS 08.88.531(a)(3).

Paragraph 15(b) provides that the seller may retain the earnest money unless the sale fails to close for one of the reasons designated in Paragraph 15(b)(1)-(7). Paragraph 15(b) also provides that regardless of the reason why a sale does not close, the broker holding the earnest money may “at his/her sole discretion, determine disposition of Earnest Money.”

Relevant to the buyer’s right of rescission is the following language in Paragraph 14:

14. Buyer’s Right and Duty of Inspection

....

(b) Not later than fifteen (15) calendar days following Seller’s acceptance, Buyer shall have the right and duty, at Buyer’s expense, to have a licensed contractor(s) or other qualified professional(s) inspect and investigate the subject property for possible defects.... Sewer/septic and well shall be exempt from the fifteen-day discovery period and can be tested anytime prior to closing. Sewer/septic and well inspections, as defined in Paragraph 11(b), are not subject to conditions in Paragraph 14(e).

....

(e) If Buyer is not satisfied with the results of the inspection(s), as specified in Paragraph 14(b), Buyer reserves the right to rescind this Purchase Agreement by notifying the seller’s broker, in writing, within two (2) business days of receipt of the inspection report, and Earnest Money shall be refunded in full.

C. Analysis

In this case, the Henrys argue that they were entitled to possession of the earnest money once their licensee, Ms. O’Hare, made a written demand for its transfer, and that Mr. Johnson is liable to them pursuant to Paragraph 15(a) for his failure to transfer the earnest money upon demand. Mr. Johnson argues that the Henrys were not entitled to retain the earnest money, and that his clients were entitled to a refund, because the sale failed to close for the reason stated in Paragraph 15(b)(7): rescission by the buyer in accordance with Paragraph 14(e). The Henrys respond that there was no rescission in accordance with Paragraph 14(e), because neither the well nor the septic failed the inspection described in Paragraph 11(b) of the contract, which states that “standard” well and septic inspections include well and septic compliance with construction standards, and septic compliance with performance standards, but notes that “[t]here is not a minimum accepted ADEC regulation or recommendation for well flow.”

Which of these opposing views of the parties’ respective rights under the real estate contract is correct need not be decided in this case, which is a claim against the surety fund for conversion of trust funds, not a claim against the buyers or their licensee for breach of contract. The buyers exercised an asserted right to unilateral rescission under a reasonable construction of

the contract.¹⁹ The sale did not close, and under Paragraph 15(b) the broker holding the earnest money had “sole discretion” to dispose of the earnest money. Under these circumstances, the broker’s disposition of the earnest money is not a ground for a claim against the surety fund, regardless of whether the buyers or the sellers were actually entitled to the money. Similarly, Mr. Johnson’s failure to transfer the earnest money upon written request may have been contrary to the terms of the contract, but when the sale did not close Mr. Johnson retained the right to dispose of the earnest money in his “sole discretion.” While a licensee who disposes of the earnest money to the wrong party may be liable for breach of contract, a breach of contract is generally not sufficient to establish a claim for conversion. The Henrys have not shown that the general rule should not be applied under the circumstances of this case.

IV. Conclusion

The buyers exercised an alleged contractual right of unilateral rescission. Even if the buyers did not have a right to rescind under the contract, their licensee had the right to dispose of the earnest money after the sale did not close. Assuming the licensee made payment to the wrong party and is liable for breach of contract, the licensee’s conduct was not a conversion of trust funds for purposes of a claim against the Real Estate Surety Fund.

V. Order

The claim is DENIED.

DATED June 19, 2008.

By: _____
Andrew M. Hemenway
Administrative Law Judge

¹⁹ The written notice of rescission specifies an unsatisfactory septic inspection, rather than the well inspection, as the ground for rescission. However, Mr. Johnson had verbally identified the well flow issue prior to the written notice. In any event, Paragraph 14(e) requires only that notice of rescission be provided; it does not limit the buyer to the grounds specified in the notice of rescission.

Adoption

On behalf of the Alaska Real Estate Commission, the undersigned adopts this decision as final under the authority of AS 44.64.060(e)(1). Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with AS 44.62.560 and Alaska R. App. P. 602(a)(2) within 30 days after the date of this decision.

DATED this 19 day of June, 2008.

By: _____
Signature Gene DuVal
Name Chair person
Title _____

The undersigned certifies that this is a true and correct copy of the original and that on this date an exact copy of the foregoing was provided to the following individuals:

John Connors
Joel Johnson
Sharon Walsh, Real Estate Comm

Signature

Date

6/25/08