

Proper use of an escalation clause

Escalation clauses, when properly used, are an advantageous negotiating tactic that benefit the buyer and the seller. As you will see, the problems with escalation clauses are numerous and could create issues for the buyer, the seller and REALTORS®. In order to fully dissect and analyze an escalation clause, we must first ask “What does an escalation clause do?” and “How does an escalation clause work?”

When the sales of residential real estate are extremely active, this creates a seller’s market. The resulting increased competition can create the need for an additional ‘edge’ for aggressive buyers. Often, potential purchasers have been outbid on numerous properties even when making initial and subsequent offers at, or above, the asking price. Discouraged at losing one or more properties to better offers, buyers and their respective agents have been insisting that purchase offers submitted to the seller include an escalation clause.

An escalation clause is a pre-established term in a purchase offer that increases the buyer’s original offer by a certain sum. In other words, Buyer X puts in an offer for a property with an escalation clause. After all offers are submitted, Buyer X does not have the highest offer. Normally, the seller would accept the highest offer, however, in this situation, Buyer X included an escalation clause that offers the seller \$1,000 above the next best offer. By operation of the escalation clause, Buyer X just submitted an offer that is \$1,000 above the seller’s best offer. As you can see, the inclusion of an escalation clause in a purchase offer affords the buyer the greatest chance of success in submitting an offer that a seller is most likely to accept. However, a poorly worded escalation clause can hurt your client more than help them.

An example of a simple unconditional escalation clause is as follows: “Purchaser will increase the best offer received by \$1,000” (of course, the dollar amount can vary, but for the sake of simplicity, I will use the figure of \$1,000 throughout this article). The simple example set forth above, by itself, is poorly-worded and should not be included in any purchase offer without additional language protecting and limiting the exposure of the buyer and their respective agent.

Licenseses that use escalation clauses should check with their MLS and broker to inquire if there are any available escalation forms available. If no form is available, the licensee should carefully discuss the components of an escalation clause with the purchaser. After the purchaser is fully informed as to the use of an escalation clause, the licensee can then put the offer down on paper through a pre-printed purchase offer, binder, etc.

One issue that immediately enters my mind is when a REALTOR® is acting as a seller’s agent or broker’s agent working with a buyer who wishes to have an escalation clause in the purchase offer. The buyer will inform the seller’s agent the maximum purchase price the buyer is willing to pay for the property (the ceiling). Pursuant to the law of agency and one’s fiduciary duties, the seller’s agent must then disclose this amount to the seller. In this situation, the seller’s agent must disclose this fact to the buyer and make the buyer

aware that the seller will know the buyer's ceiling. For properties where multiple offers are made, this may not be an issue, but for properties where there are not multiple offers made or the buyer that includes an escalation clause submits the highest purchase offer, the seller holds a significant advantage.

Suppose Buyer X submits a purchase offer with an escalation clause that contains a ceiling of \$400,000. The buyer's initial offer is for \$375,000. The seller has the opportunity to reject the buyer's offer and make a counter offer for an amount up to the buyers ceiling. Since the seller already knows how much the buyer is willing to spend and the buyer is obviously interested in purchasing the property, the seller has a strategic negotiating advantage. This is why it is important to only include an escalation clause in a purchase offer when it is more than likely that a property will get multiple competitive offers. It is also important when not acting as a buyer's agent to fully inform the buyer that you are not acting in their best interest and nothing they tell you, including their 'ceiling', is confidential and you must disclose such information to the seller.

Along the same lines, the buyer must be fully aware that it is entirely possible that the monetary limit set for the ceiling may turn out to be the buyer's offer. It is foreseeable that a buyer will set a ceiling well above what is financially feasible down the road. Knowing the buyer's finances upfront will help you to set a realistic ceiling with the buyer. So now that you have the offer completed with an escalation clause, you must wait to see if the escalation clause is triggered.

For a listing agent, the best course of action when an escalation clause is triggered is to treat it the same as a counter offer from the seller (unless the form you are using provides otherwise). The seller should present the counter offer to the buyer for the new purchase price based on the escalation clause. The buyer would then accept the counter offer and re-execute the purchase offer with the new purchase price dated and initialed. However, all this could be avoided with the inclusion of an escalation clause addendum that takes all these items into consideration. Therefore, if a properly-drafted escalation clause is attached to the purchase offer as an addendum, signature lines should be included for the seller to execute the counter offer pursuant to the escalated purchase price and for the buyer to accept the counter offer pursuant to the escalation clause.

One issue that occurs from time to time is when buyers are overpaying for property. While this appears to be a windfall for the seller, the buyer may in fact be left out in the cold for many reasons. First and foremost, if the buyer is planning on financing the property, an appraisal will most likely need to be completed for the lender. Many properties have been appraised for less than the amount listed in the purchase offer. In certain instances, it is nearly impossible for the buyer to get the proper amount of financing because the lender is basing the loan on the appraised value of the property, not the actual purchase price. Sometimes, the only way around this issue is that the buyers have to make a down payment of more than they originally planned. Furthermore, since the increased down payment is being credited towards the amount between the appraised value and the purchase price, the buyer may now be required to pay Private Mortgage Insurance (PMI) on the loan, another added monthly expense.

Another issue with escalation clauses is that a buyer is sometimes under the impression they are “guaranteed” to submit the highest purchase price and therefore the seller will accept their offer. This is not always the case. Numerous factors come into consideration when a seller accepts a purchase offer. For instance, a buyer with an escalation clause could have one or more contingencies included in their purchase offer and another buyer who is offering a lower purchase offer could have no contingencies or paying cash. In some instances, a seller does not want to address contingencies if there is a higher probability that a closing will occur with little or no difficulty.

Now that we have the do’s and don’ts of dealing with escalation clauses addressed, we must go forward and discuss how a proper escalation clause should be drafted. An escalation clause is not as easy to draft as one would imagine. The original example that was utilized in the onset of this article, “Purchaser will increase the best offer received by the seller by \$1,000”, is not the proper way to draft an escalation clause. There are many factors to take into consideration when including an escalation clause in a purchase offer. The most important rule of drafting a proper escalation clause is to include a ceiling. Imagine the following scenario: Buyer X submits a purchase offer for 123 Maple Lane with an escalation clause of \$1,000 above the next best offer. Buyer Z does the same. Without a ceiling included in the purchase offer, the two competing escalation clauses would continue to “one up” the other increasing the purchase price into perpetuity. While that scenario would be great for the seller, the buyers would not be so happy. If this were to occur, the seller would most likely instruct the listing agent to go back to Buyer X and Buyer Z and ask them to submit a new purchase offer under whatever multiple offer scenario the seller chooses. This is not the most efficient use of time for any party in the transaction and may frustrate the seller. If the purchase offers were submitted with a ceiling, this issue would not have occurred. A ceiling would put a cap on the amount of the offer once the escalation clause was triggered. Normally the amount of the ceiling is only disclosed to the buyer’s agent and not made available to the listing agent until the escalation clause is triggered. Then, the buyer’s agent will tell the listing agent whether the triggered escalation is below the ceiling. The following is an example of an escalation clause scenario with a ceiling: Buyer X has a ceiling of \$325,000 and Buyer Z has a ceiling of \$330,000, Buyer Z would have the highest offer of \$326,000 (Buyer X had the next highest bid at \$325,000 and Buyer Z’s escalation clause was for \$1,000 increments, therefore, \$326,000). Of course, there are downfalls to the inclusion of a ceiling.

A properly-drafted escalation clause should contain language specifically addressing the following: an incremental monetary amount used to increase the purchase offer; a ceiling on the amount of the escalated offer; as well as a requirement that if the escalation clause is triggered, the seller must disclose the amounts of the other offers to the buyer, or at least the next best offer. It is suggested that the escalation clause be included as an addendum to the purchase offer in clear concise language rather than being added into a space in that is intentionally left blank for other items and/or contingencies. However, the most important thing to remember when drafting the escalation clause is whether the seller and purchaser can actually settle under the terms of the purchase offer.

In closing, the use of an escalation clause is not always appropriate. If an escalation clause is to be used in a purchase offer, the licensee must fully disclose to the buyer how the escalation clause operates. Furthermore, the buyer should discuss the use of the escalation with their attorney and the addendum should include or be subject to an attorney approval clause since it will be treated as a counter offer. There are numerous factors to take into consideration when determining if an escalation clause is appropriate. Issues such as previous trends in the market, how “hot” the market currently is, how desirable the particular property/location is and whether the asking price is higher or lower than other comparable properties should all be considered. If it is determined that an escalation clause is warranted when presenting a purchase offer, please remember the basic framework set forth in this article.