

ESCALATION CLAUSES – DO’S & DON’TS

Buying a house can be stressful in today’s market of scarce inventory and competing buyers. The National Association of REALTORS® reports that in February 2021 nearly four offers were made for every house sold. To bring their offer to the top, buyers use various strategies, including leaving off the inspection contingency, cash offers, or no closing costs. Escalation clauses are yet another tool used by prospective buyers. But before using an escalation clause, it is important a buyer understands the risks and ensures certain liabilities are avoided.

What is an escalation clause?

An escalation clause is a provision attached to a purchase agreement, providing that the prospective buyer’s offer increases (or escalates) automatically if the seller receives a higher offer on the property. Here is an example of an escalation clause: Win Adalkost makes an offer on Ima Seller’s house for \$240,000 and adds a clause to his purchase agreement escalating Win’s offer to \$100 more than any offer over \$240,000, up to \$275,000. Joe Bihous then offers \$250,000 for the house, which would escalate Win’s offer to \$250,100.

Pros and Cons of Using

Before discussing legal issues with escalation clauses and best practices, let’s look at the strategical reasons behind using and not using an escalation clause.

To Use - Ultimately, an escalation clause is meant to help a buyer buy a house. A buyer may include an escalation clause if multiple offers are expected on a house, the buyer is short on time, the buyer simply loathes the negotiation process, or all the above. When a seller asks multiple prospective buyers for their best offer, an escalation clause can increase the chances of a buyer having the highest offer without paying the highest amount a buyer is willing to pay.

Not To Use - That being said, escalation clauses do have strategic drawbacks buyers should consider.

One, including an escalation clause may cause the buyer to pay more. After all, by using an escalation clause, a buyer is telling a seller how high the buyer is willing to go. A seller can use this to negotiate a higher amount, regardless of whether other offers are submitted. In the example above, Win has signaled that he is willing to pay up to \$275,000 for the house. Ima is free to counter-offer at \$275,000, or at least more than \$250,100. What does Win do if Ima refuses to come down? Ima has little incentive to lower her demand when Ima knows Win is willing to pay \$275,000.

Two, an escalation clause does not guarantee a better offer. Offers from other buyers may be more competitive even if they contain a lower purchase price. Examples may include a lower seller’s contribution to closing costs, fewer contingencies (i.e., inspection), or a cash offer. Adding

an escalation clause decreases the buyer's need (opportunity) to negotiate, which is the point after all, but that can inhibit the buyer from competing against other, negotiated offers.

Three, some sellers (and their agents) simply do not appreciate an escalation clause, whether they prefer negotiating, view it as an overaggressive strategy, or believe it carries too much risk.

Issues to Avoid or Address

If drafted poorly, escalation clauses can create significant risk for the buyer, the buyer's agent, and sometimes the seller's agent. A few issues to avoid and make sure are addressed in the clause are bona fide offers, offerors related to the seller, and ceiling amounts. We will take each in turn.

Verifiable Offers - Competing offers that trigger an escalation clause must be verifiable and bona fide. In other words, the clause must state that the escalation clause can only be triggered if the competing offer is shown to the buyer and is a bona fide, rather than bogus, offer. Without providing this clause, a seller can simply state a higher offer was received, and without requiring verification, the buyer has no way to know if this is the truth. The second part of this is that by requiring the seller to provide the competing offer, the buyer can determine if the offer is legitimately from another potential buyer.

Unrelated Competing Buyer – Additional language to include in the clause is to disqualify competing offers from relatives. This prevents the seller from asking a cousin to make an offer simply to drive up the price.

Ceiling Amount – An escalation clause should also include a ceiling amount. In the example above, the ceiling amount is \$275,000. Offers well over asking price are to be expected in markets where an escalation clause is utilized. Without a ceiling amount, the buyer risks an expensive surprise, and the agent risks an unhappy client.

Seller's Agents Beware – If and when tabulating the highest offer between multiple offers with one or more escalation clauses, do so carefully and with help from a broker. A miscalculation will end poorly for the agent. After all, comparing a lot of offers is complicated enough. Throw in an escalation clause or two, and you may feel like you're back in trigonometry learning SOHCAHTOA for the first time.