

ESCALATION CLAUSES

In many areas in Michigan, shrinking inventories have caused some buyers to resort to something called an escalation clause. These buyers have lost out on too many bidding wars for their dream home and do not intend to lose again. Despite its increasing popularity, the use of escalation clauses creates numerous potential pitfalls for buyers. Even the most carefully drafted escalation clause cannot eliminate all risks. The purpose of today's legal primer is not to encourage the use of escalation clauses but to discuss many of the potential issues that can arise from their use.

Let's start with the following hypothetical. Buyer A makes an offer on 123 Elm Street for its list price, \$150,000. Buyer A's offer goes on to provide:

Buyer A will increase his offer by \$2,000 more than any competing offer made for 123 Elm Street (the "Escalation Clause").

Does the use of this Escalation Clause pose risks to Buyer A? Most certainly. First, this Escalation Clause subject's Buyer A to limitless financial exposure. If Buyer A offers \$150,000 on 123 Elm Street, a competing offer could be received for \$300,000, making Buyer A contractually liable to \$302,000. This risk can be addressed by adding the following language:

Buyer A will increase his offer by \$2,000 more than any competing offer made for 123 Elm Street **in an amount not to exceed \$160,000.**

Even as revised, the Escalation Clause could subject Buyer A to a "fake" competing offer. Suppose the Seller's cousin submits an offer for \$158,000. Buyer A could be on the hook for \$160,000. Buyer A can attempt to reduce this risk by adding the words "bona fide" or "good faith" into the Escalation Clause as follows:

Buyer A will increase his offer by \$2,000 more than **any bona fide or good faith** competing offer made for 123 Elm Street, in an amount not to exceed \$160,000.

While the meaning of the terms "good faith" or "bona fide" may be subject to debate, the addition of this language at least provides the buyer a standard to argue about.

Buyer A could further try to protect himself by indicating he will only pay \$2,000 more than any competing offer only if the competing offer is supported by a bank pre-qualification or pre-approval letter indicating the second buyer is qualified to purchase 123 Elm Street at the price offered by that buyer. The Escalation Clause could include the following language [read only bold portion]:

Buyer A will increase his offer by \$2,000 more than any bona fide or good faith competing offer made for 123 Elm Street, in an amount not to exceed \$160,000. **Buyer A must be provided with a copy of the competing offer together with a bank pre-qualification or pre-approval letter demonstrating, to Buyer A's sole satisfaction, that the second buyer is qualified to purchase 123 Elm Street at the price set forth in the competing offer.**

Of course, as most Realtors® are aware, many lenders freely offer various forms of pre-qualification or pre-approval letters; thus, the effectiveness of this requirement as proof of ability to pay may be limited.

Buyer A could also try to protect himself by inserting other contingencies in the contract to provide himself with an out in the event the contingencies in the Escalation Clause fail. For example, Buyer A could insert a contingency which permits him to elect to terminate the purchase agreement if the property does not appraise at an amount equal to the purchase price. Alternatively, Buyer A could include an extremely broad inspection clause. Further, if Buyer A's contract is contingent on financing, he may well be protected if the property will not appraise to support the higher purchase price. The tradeoff, of course, is the insertion of any or all of these additional contingencies may make a buyer's offer less desirable to the seller.

Buyer A must also determine how long he wishes to be at risk through the Escalation Clause. He can address this risk by adding an end date to the Escalation Clause which would provide as follows [read only bold portion]:

Buyer A will increase his offer by \$2,000 more than any bona fide or good faith competing offer made for 123 Elm Street in an amount not to exceed \$160,000. Buyer A must be provided with a copy of the competing offer together with a bank pre-qualification or pre-approval letter demonstrating, to Buyer A's sole satisfaction, that the second buyer is qualified to purchase 123 Elm Street at the price set forth in the competing offer. **This offer shall remain effective until five days after the date of this offer.**

Buyer A also needs to try to make sure that his contract with the Escalation Clause and the competing offer are compared as apples to apples. Assume that the competing offer is for \$158,000 but with \$8,000 of seller's concessions and \$2,000 for personal property. Would Buyer A be bound to pay \$160,000 or would the competing offer be treated as having an equivalent value of \$148,000? There is no Michigan case law or statute on this issue. In an effort to address this potential problem, an escalation clause may include language which attempts to define how the amount of any competing offer will be determined. For example, an escalation clause could include the following language [read only bold portion]:

Buyer A will increase his offer by \$2,000 more than any bona fide or good faith competing offer made for 123 Elm Street in an amount not to exceed \$160,000. Buyer A must be provided with a copy of the competing offer together with a bank pre-qualification or pre-approval letter demonstrating, to Buyer A's sole satisfaction, that the second buyer is qualified to purchase 123 Elm Street at the price set forth in the competing offer. This offer shall remain effective until five days after the date of this offer. **Prior to increasing the purchase price pursuant to this paragraph, the total of all seller concessions and any separate consideration for personal property provided for in the competing offer shall be deducted from the purchase price contained in said offer.**

Finally, the potential for problems increases substantially if more than one competing offer has an Escalation Clause. What happens if Buyer A submits his Escalation Clause without a cap and another buyer submits a substantially similar Escalation Clause, *i.e.*, \$1,500 more than any competing offer? Obviously, the price cannot continue to increase into infinity. Can the

seller accept either of the competing Escalation Clause offers, or would the unsuccessful buyer have standing to object? Do the two competing Escalation Clauses cancel each other out? There is no clear answer to any of these questions. If both buyers are motivated, the seller may find himself an unwilling participant in a lengthy legal battle.

As can be seen, it is not possible to eliminate all risks in the use of an Escalation Clause. Moreover, there is always the risk that, a court may decide that a purchase agreement containing an Escalation Clause is too vague to be enforceable. The risk of lengthy and expensive litigation must be taken into consideration when considering the use of an Escalation Clause.