

Use of Escalator Clause Can Spell Trouble

Hot real estate markets tend to make buyers a little crazy. One of the places this craziness can manifest itself is in the use of what is called an "escalator clause." The clause, which works by "offering" the seller \$500 or a \$1000 more than the "highest bid" the seller receives from other buyers, is inserted into the buyer's offer or counter offer with the hope that the seller will accept the offer. Typically, the escalator will contain a cap to limit the buyer's price exposure.

A typical escalator clause with a cap might look something like this: "if this is not the highest qualified bid for this property, the buyer offers \$1000 dollars more than the highest bid to a maximum of (X dollars), with proof that there was a qualified bid for more than the buyer's original bid of (X dollars)." It is easy to see why buyers, and their agents, might like escalator clauses. They think they can trick the seller into accepting an offer that will allow them to beat out the competition and still pay less than the maximum price the property might actually bring in a bidding war.

Real estate doesn't normally work on "bids." Real estate forms contemplate offers that, if accepted, will form an enforceable contract. To be enforceable, the offer must propose definite terms. The "escalator clause with cap" term may not be definite enough to form the basis for an enforceable offer. If that is the case, the buyer using the clause might be able to claim no enforceable contract was formed if they later change their mind about the deal.

Even if an enforceable contract can result from acceptance of an offer with an escalator clause, such clauses still aren't good for sellers. An escalator clause invites the seller to engage in a bidding war where the other contestants are unaware that they are bidding. It is an attempt by a buyer to transfer control of negotiations from the seller to this buyer. The buyer's hope is that their "\$1000 more" offer will not be disclosed to other buyers. That way the other buyers will not compete against this buyer. Good for the buyer with the clause, bad for the seller.

Actually, most escalator clauses aren't even good for the buyer. If the escalator clause contains a cap, the offer tells the seller the top price this buyer is willing to pay. A smart seller will reject the escalator clause offer (and all others) and counter all offers with a request for new offers not less than the cap. The "smart" buyer with the escalator with a cap clause will find that his maximum price has just become the minimum. If it was the buyer's agent who came up with the clause and cap, the buyer may feel they have not been well served.

Even without a cap, an escalator clause tells the seller this buyer will go at least \$1000 above the listed price. Armed with this information, the seller can then see what the competing buyers are really willing to pay by requesting offers of not less than \$1000 above the listed price (or the best offer now on the table if already above the listed price). That way, the seller can see who will offer what once they know they are competing with other buyers.

Escalator clauses, especially escalator clauses with a cap, are tricks that, if accepted, undermine the enforceability of the contract. It is hard to imagine a situation in which it would be in the seller's interest to accept an offer with such a clause. If something goes wrong, use of such clauses invite claims of negligence against the buyer's agent for suggesting an offer with an indefinite price term and telegraphing their client's maximum price. There is also the potential for negligence claims against the listing agent if they allow the seller to accept such an offer without explanation.

There can also be problems with the trigger mechanism when escalator clauses are used. To make the clause work, the seller must disclose the terms of another buyer's offer. That is legal in Oregon (not so in all states), but can cause serious problems if the listing firm also represents the buyer whose offer is used as the trigger. Escalator clauses make the extremely dangerous situation that exists when multiple offers are "in-house" completely untenable.