EDITORIAL & OPINION

Contingencies are in a real estate deal for a reason

In a hot market, waiving buyer safeguards proves troublesome

By PHIL DIAMOND AND JEFF LERMAN
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With high demand, low inventory, and unprecedented appreciation, the hot California residential real estate market we've experienced for the last several years has resulted in a fact pattern that we've now seen on many occasions: Homebuyers, eager to get into the market, have been outbid on several other properties.

They then find another potential "dream home" and receive from the seller's agent a disclosure package with a short fuse for offers to be received and for escrow to close.

Not wanting to lose out again, the buyers make an over-asking offer with a short close. And, relying entirely on a visit to the property and the disclosure package (sometimes without fully understanding the package or even reviewing it in detail), and against the written advice of their agent, they waive all contingencies with their offer.

The offer is accepted, the buyers put a 3% initial deposit into escrow, and the buyers and sellers are now in contract.

After the parties are in contract, however, something happens that causes the buyers to want to renegotiate or cancel the deal.

In the past, that "something" has typically been that the buyers discovered something about the property that wasn't disclosed.

Even with a contingency waiver, the seller still has a legal duty to disclose all facts that might materially affect the value or desirability of the property. Buyers in that situation therefore could take the position that they would not have entered into the deal if they had known the true facts.

At that point the typical result was that the parties would renegotiate the price, or agree to cancel the contract and return some or all of the deposit. The sellers would then re-list the property, with supplemented disclosures, and in a rising market they would typically be able to sell the property for more than the price of the canceled contract.


Jeff Lerman


Phil Diamond

More recently, however, the "something" that has changed for the parties after entering into the contract is related to rapidly-changing financing and market conditions.

With interest rate hikes beyond what we've seen in recent history and more on the way, buyers are now finding themselves either unable to get the financing they were counting on to close the deal, or fearful that they will be able to sell their current homes at the price they were counting on to close on the new one.

And sellers, fearful that they may not be able to sell their property at the same price to someone else, are less motivated to let their buyers out of the deal, or to release their deposit.

If the buyers have waived all their contingencies, there isn't much that can be done to help them from a legal standpoint.

To understand why, and why the contingencies are there in the first place, it's important to understand: 1) What are the contingencies and why are they there? 2) What are the bases for a buyer to cancel a purchase contract? And 3) What happens if a buyer wants to cancel but the seller won't agree?

WHAT ARE THE CONTINGENCIES?

Assuming the parties are using the standard California Association of Realtors ("CAR") form Residential Purchase Agreement (rev. 12/21; "Agreement"), the contingencies spelled out in Par. 8 are: Loan; Appraisal; Investigation of Property; Review of Seller Documents; Preliminary Title Report; Common Interest Disclosures (if applicable); Review of leased or liened items (if applicable); and (if both sides agree), Sale of Buyer's Property. In rare cases, there may also be a Seller's Contingency for the acquisition of a replacement property.

From the buyer's standpoint, these contingencies are there for a simple but important reason: To make sure the buyer knows what he or she is getting into, and to have a contractual way to end the deal if things change after the parties go into contract.

If a buyer is for some reason (such as a change in job status, or a change in available interest rates) unable to obtain appropriate financing, or if the property doesn't appraise high enough to support the needed financing, the Loan and Appraisal contingencies give the buyer a way out.

If something that wasn't known going into the deal is discovered about the title to the property, or about its physical condition, the contingencies for Title, Investigation, and Review of Seller Documents allow the buyer to call the deal off. In short – the contingencies are there to protect the buyer from having to complete a deal that turns out to be different from what was expected going into it.

WHAT ARE THE BASES FOR A BUYER TO CANCEL THE PURCHASE CONTRACT?

Depending on the circumstances, and if the buyer hasn't waived the contingencies, there are potentially both contractual and non-contractual bases for a buyer to cancel the purchase contract.

Under Par. 14.D. of the agreement, the contractual bases fall into 2 categories: 1) The seller hasn't removed its contingencies or performed its contractual obligations; or 2) the buyer in good faith hasn't removed all of the buyer's contingencies.

But here's the problem: The first category typically won't help a buyer cancel the contract because there usually aren't any seller contingencies – and even if there were, under the agreement, the seller must first be given 3 days notice to perform (either by lifting the seller contingency or fulfilling a contractual obligation such as providing disclosure documents).

That means that, as a practical matter, the only contractual basis for a buyer to cancel is by way of the buyer's contingencies – which in turn means that, if the buyer has waived all contingencies, there typically is no contractual basis to cancel the contract.

The only other way a buyer might be able to cancel the contract is, as mentioned above, if he or she is able to prove that there was a material misrepresentation in the disclosure documents, and that they never would have entered into the deal in the first place had the true facts been known.

But going down that road can be expensive, with an uncertain outcome.

What happens if the buyer wants to cancel and get its deposit back, but the seller refuses?

Under the agreement, the deposit cannot be released by the escrow officer without

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the written consent of both the buyer and seller, or by order of an arbitrator or court.

That means that the only way to change the status quo is for the parties to reach an agreement on their own, or, failing that, to resolve the dispute through mediation (which is required by Par. 20 of the agreement), or through binding arbitration (if both parties have initialed Par. 31 of the agreement) or court trial.

These processes can be expensive, and depending on the amount of the deposit, can sometimes exceed the amount at stake. Importantly, the agreement (Par. 22) also provides that whoever wins in arbitration or court trial is entitled to recover their attorney's fees from the other side (if the prevailing party had previously agreed to participate in the required mediation process).

WHY WAIVING CONTINGENCIES ISN'T A GOOD IDEA

Conclusion and take-away message. The agreement is a legal contract, with important terms that may direct the outcome of a dispute, depending on the circumstances. It's important that buyers – and sellers – know and understand those terms before signing on the bottom line. That's especially true as to the buyer's contingencies. It was never a good idea from a legal standpoint to for buyers to waive their contingencies – and that is especially true now, with rising interest rates, an uncertain economy, and the potential for a changing real estate market.

Phil Diamond (philipdiamond@comcast.net) is a real estate attorney, Of Counsel to Lerman Law Partners LLP in San Rafael. Diamond is also a licensed real estate broker, commercial landlord and developer. Jeff Lerman (jeff@lermanlaw.com), co-founder of Lerman Law Partners LLP. . He is past president of Marin County Bar Association and included in the list of Super Lawyers.

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crash like in 2005 to 2012, when the Great Recession had a wave of foreclosures, Margreiter said.

Patricia Oxman, a 30-year real estate veteran and top producer for Golden Gate Sotheby's International Realty, said the Marin County market data she tracks suggests local entry-level buyers have already pulled back so far this year, but higher-priced homes continue to be selling.

Sales of single-family homes in Marin County are down 17%, with 1,120 changing hands so far this year, compared with 1,346 in the same time frame last year. Home sales under $1 million have dropped to 72 from 145 a year ago. Sales of mid-range homes ($2 million to $4 million) moved down to 48% of all sales from 54% last year, while top-end homes (over $4 million) now make up 46% of sales, up from 34% a year ago.

"The luxury market is still strong because buyers pulled money out in anticipation of the purchase and 28% of our sales are all cash," Oxman said.

Gerrett Snedaker, broker and partner with Better Homes and Gardens Real Estate-Wine Country Group, said he's seen "a decrease in multiple offers and homes selling in excess of asking prices." The firm has multiple offices in Napa, Sonoma and Mendocino counties.

In May, 16% of homes in the three counties sold at reduced prices, and by late June that proportion is 19%, in line with the level from a year before, according to Snedaker. And the share of homes selling for over the asking price was 55% in May, 44% through late June and 52% a year before.

MARKET INFLUENCES

The changing market conditions have already started to reduce prices on listings.

Just over 9% of Sonoma County listings experienced a price cut in May, compared with 6.9% in April and 4.9% in March, Zillow reported. About the same percentage of sellers lowered their prices in neighboring Napa County, in contrast to reductions in April at 7.1% and 6.3% in March. To the west in Marin County, 6.8% of listings were lowered, versus 5.1% in April and 4.9% in March.

Much of this trend is due to "rising interest rates on the back of the incredible price appreciation in recent years," Kreamer pointed out, adding: "People are being priced out."

FROM THE GROUND LEVEL

Jeff Kram, president of the North Bay Association of Realtors, said he's already started to see evidence of the slowing.

"It's still a seller's market, but we're not seeing 20 offers on (one) property anymore," said, the Mendocino County broker, who works for Luxe Places International Realty.

In Sonoma County, Carol Lexa, a broker at Compass Realty in Healdsburg, has seen the same tendency.

"We're seeing a slowdown of both the low end and the high end (buyers). They're seeing limitations on their buying power. People are still buying, just not at the frenzied rate," said Lexa, who is also the past president of the North Bay association. "A lot of them are cash buyers, but they had the cash because they had high stock values."

That's not so much anymore, with the U.S. stock market plummeting in the past month.

GENERATIONAL DIFFERENCES

In recent years, the real estate market may have also been influenced by attitudes from different demographics. With baby boomers becoming seniors and more reluctant to downsize because of the higher interest rates, that leaves much of the movement in the real estate market on the backs of the next generations.

"Millennials still have a lot of funds. But the issue with millennials is fatigue," she said.

Millennials starting to buy in plentiful numbers recently offered a cash cow to the real estate world, if they didn't come into the picture with huge student loan debt from college. But they grew tired of bidding wars on what homes were available, Lexa explained.

"If there's one thing we learned during the pandemic, is that we need to make sure homes are listed in a competitive way," she said, referring to price and presentation.

Staff writer Cheryl Sarfaty contributed to this report.