



# Tight Market Tips

By MNR'S Risk Management Team

## **A guide to keeping transactions legal, ethical, and fair in a heated real estate market**

With competition for scarce housing stock at an all-time high, many buyers are taking on big risks to seal the deal on a property. By skipping the financing contingency, dropping the inspection contingency, making offers on multiple properties simultaneously, and other questionable actions, they create hardships for themselves, the sellers, and the brokerages that represent them. Fortunately, Realtors® are in a prime position to help their buyer-clients make choices that are ethically and legally sound, and serve the greater interests of the community, and the real estate industry.

### **When buyers skip the financing contingency**

In pursuit of making their bid look like an attractive cash deal, some buyers want to make offers without a financing contingency—even though they need financing to purchase the property. Sellers who accept such offers find themselves locked into purchase agreements that can crash and burn when the buyer's financing fails to come through. Without the Mortgage Financing Contingency in the MNR residential purchase agreement (PA), there is no specificity of what financing the buyer needs to obtain, nor is there a requirement for buyer to apply for financing within five business days of final acceptance or provide a written statement before closing. That means that right up to the closing date, the seller won't know if the buyer is able to perform on the PA. For the buyer, it means they will lose their earnest money if they can't obtain financing by the closing. Without the financing contingency language, there is no cancellation language specifying what happens if the buyer is unable to obtain financing. The parties are then left with the default provision in the PA when the buyer fails to close because they couldn't obtain financing.

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When the deal melts down, the seller is left with few options:

1. Seller has the right to cancel the PA and retain the earnest money. Ideally, the buyer and seller will sign a cancellation of the PA directing the earnest money to the seller.
2. If the buyer refuses to sign a cancellation, the seller may initiate a statutory cancellation. However, without a declaratory cancellation provision for this default, the seller will need to wait for the 15-day cure period to lapse.
3. Or alternatively, the seller can pursue the buyer for actual damages for breach of the PA or specific performance.

In short, with no financing contingency that includes a declaratory cancellation in the PA, the property owner might be unable to sell their property for a while if the buyer can't get financing by date of closing and puts up a fight over the earnest money.

### **Headaches multiply when buyers make offers on multiple properties**

Frustrated by watching their offers sink without a ripple, some buyers are fielding multiple offers on properties at the same time. Of course, most buyers are only approved for a loan on one property. So, if more than one offer is accepted the fallout can be costly. As a Realtor®, you have an ethical obligation to be truthful to all parties. That means if you know your buyer never intends to fulfill their obligations on multiple agreements to buy multiple homes, you are very likely in violation of Article 1 of the Code of Ethics. At the core of this is the legal principle of good faith and fair dealing. All contracts are structured around the implicit understanding that everyone participating in the agreement will make their best efforts to deliver on their end of the bargain and will not impede the other party from being able to perform. Not only is this the bedrock of the real estate industry, but the entire economy. As a licensee, it is your responsibility to help your clients understand the seriousness of entering into a purchase agreement for the purchase and sale of real property. In this type of contract, the seller is giving the buyer a legal equitable interest in the seller's property. So, the buyer must act in good faith and fair dealing in meeting their contractual terms to purchase.

### **Dropping the inspection contingency**

Desperate to get a home in a competitive market, many buyers are waiving the seller's obligation to disclose material facts about the property and choosing not to obtain an inspection—potentially buying a property full of problems. In fact, most disputes are about material fact disclosures. What material facts did the seller or Realtor® know and fail to disclose? These issues can come back to haunt you long after closing day. Most material facts disputes arise about one year after closing.

Encourage your buyer clients to consider obtaining an inspection of the property—even in this tight market. The MNR Purchase Agreement allows for two options:

1. Buyer can opt to get an inspection, but cannot cancel the PA based on the inspection findings.
2. Buyer can obtain an inspection and may cancel the PA based upon the inspection.

If the buyer does not want to obtain an inspection, or make the purchase agreement contingent upon inspection, they should at least consider asking for a material fact disclosure from the seller. If the seller is not providing a material fact disclosure, the buyer should at least view the property to ascertain its condition at the time of entering the purchase agreement.

Additionally, the MNR PA gives a buyer the right to perform a walk-through review of the property before closing to determine if the property is in substantially the same condition it was in at time the PA. The buyer's agent should ensure their client takes advantage of this important opportunity.

The Code of Ethics and license laws obligate Realtors® to disclose material facts of which they are aware irrespective of whether the buyer agrees to waive the seller's disclosure obligations. So, you must disclose any known material facts about the property to the prospective buyer prior to entering into a purchase agreement. Remember, it is not uncommon for buyers to blame Realtors® for property issues they discover after closing. Although Realtors® must follow their buyer's lawful instructions if a buyer chooses to move forward with such a transaction, you can help them understand, long before making the offer, the potential risks. Also help buyers understand that with no inspection contingency, they will purchase the property in the condition it is in at the time of entering into the PA with all its known and unknown problems. This knowledge and understanding of the risks up front will help alleviate conflict later.

### **Bridging the appraisal gap**

When the market accelerates and every property receives multiple offers, the cycle of up-bidding gets underway. This creates gaps between the value a house appraises for versus the prices generated in a hot market. In this high-demand environment, buyers try to make their offers as enticing to the sellers as possible. Sellers are expecting buyers to perform even if the appraisal comes back lower than the purchase price.

It is important to note that the MNR PA does not have an "appraisal contingency" except for FHA and DVA escape clauses as required by federal law. A buyer seeking an FHA or DVA loan can cancel the purchase agreement without penalty if the appraisal does not come in at the purchase price. On a conventional loan, if the PA is subject to a financing

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contingency and the lender denies the loan based on the low appraisal, the PA may be canceled based on the financing contingency language. However, if the property is being purchased with cash, no financing contingency is applicable. And if the buyer's appraisal came back lower than the purchase price, there is no appraisal contingency that would allow cancellation of the purchase agreement, nor is there any language that would require the seller to renegotiate the purchase price.

In this seller's market, some agents are drafting an "appraisal gap" clause into the PA requiring the buyer to come up with the difference between the appraised value and the purchase price. If you do so, remember to cover all the details in the drafted terms. For example, is there a cap on the amount the buyer will cover? Is this to be paid at closing as part of the purchase price? Proof of buyer's funds? What happens if the buyer can't come up with the funds?, etc.

#### **Are "signing bonuses" legal and ethical?**

In today's competitive market, some buyers are adopting unorthodox approaches to make their offers stand out and clinch the deal. One tactic that is surfacing is the so-called "signing bonus." From conversations MNR's legal team has had with brokers, we hear that it works like this:

Eager to get the home of their dreams, a buyer offers a lump of cash directly to a seller who agrees to sign their purchase agreement i.e., a "signing bonus." Although the structure of these deals is not fully understood and is still being explored by the MNR Risk Management team, as the facts are presented to them on the Legal Hotline, they do raise numerous red flags on potential legal and ethical issues.

**Trust Funds:** Under the licensing statute, any funds received by a broker or salesperson on behalf of any person as part of a real estate transaction must be deposited in a trust account maintained by the broker. It is not clear how the signing bonus is being delivered but it certainly raises questions as to the brokers' responsibility and accountability of such funds for the parties if they are not moving through the broker's trust account.

**Non-refundable Earnest Money:** It is unclear whether these funds are intended to be part of the purchase price or even subject to a successful closing on the transaction. In short, if it is meant to be non-refundable earnest money, this should be addressed in writing in the purchase agreement. Buyers' agents should make sure their clients understand the non-refundable terms.

**Mortgage Financing:** If the buyer is seeking a federally backed mortgage loan, is the lender or mortgage originator aware of this "signing bonus?" Remember, when the buyers sign a statement to obtain the loan, they agree that there are no side agreements between the parties. So, the lender will need to be made aware of such monetary exchange.

**Option to Purchase:** If this is intended to be an "option" to purchase or "right of first refusal" instead of part of a purchase agreement, then it should be structured as such, in writing, accordingly.

Again, the MNR Risk Management team is only beginning to explore the legal and ethical implications of this new phenomenon of "signing bonuses." Until we know more, Realtors® should consider signing bonuses from the perspective of their obligations under the Code of Ethics and their fiduciary duties. Is this in the best interest of my buyer-client? Is this properly documented in writing in the purchase agreement and does the buyer understand these funds are being provided to the seller irrespective of whether there is a successful transaction?

#### **Always serve your clients' best interests**

A tight market can drive buyers to do risky—even irrational—things in pursuit of a new home. Realtors® have a legal and ethical responsibility to make sure they follow their client's lawful instructions and keep the best interest of their clients at the forefront of their transactions while remaining truthful to all parties. Holding to these expectations will benefit both you and your clients in both the long and short term.