

2009-2010 UPDATE COURSE

SECTION THREE

“DUE DILIGENCE” IN RESIDENTIAL TRANSACTIONS

EDITOR’S NOTE: While the current version of Standard Form 2-T no longer has “alternatives,” the discussion as to due diligence under former Alternative 2 remains germane under the present Offer to Purchase and Contract Form. Licensees are also referred to the 2010-2011 Real Estate Update course materials which covered in depth the new Standard Form 2-T released in January 2011.

OUTLINE:
Introduction
Alternative Two of the Offer to Purchase
Due Diligence
Conclusion

LEARNING OBJECTIVE: Upon completing this section, licensees should have a better understanding of the scope and application of Alternative Two of the standard Offer to Purchase and Contract form, and hopefully a greater appreciation of the benefits afforded both the parties and the brokers in a transaction involving Alternative Two.

INTRODUCTION

The standard Offer to Purchase and Contract form (Form 2-T) utilized by most real estate brokers and consumers in residential sales transactions has contained two alternatives for addressing “Property Inspection/Investigation” issues since 2004. Yet word is that the second alternative in Paragraph 16, known as “Alt 2,” is rarely used. Why is that? Are agents adequately explaining to buyers, in particular, the two options a buyer has in deciding how to handle inspection and investigation issues when submitting an offer? Do an agent’s duties or obligations or services differ that much depending on which alternative in Paragraph 16 is chosen? When one thinks about it, no, not really.

Under **Alternative 1**, there are multiple dates and deadlines to meet in order for the buyer to retain his/her right to conduct investigations, inspections and negotiate repair requests. Also, the buyer may request repairs only as to property conditions which meet the standards specified in the contract for “Necessary Repairs.” The seller must timely respond to the buyer’s request for repairs, and failure to do so, or failure to agree to make all requested Necessary Repairs, allows the buyer to terminate the contract and receive a refund of his/her earnest money deposit

if the buyer timely notifies the seller in writing that s/he is exercising the right to terminate the contract. Additionally, a buyer agent may be tracking two different timetables under Alt 1 if the buyer makes his/her written request for repairs prior to the Repair Notice Date, as the seller's response period begins to run from the date notice is actually given, while the seven day period within which the buyer may terminate under the Cost of Repair Contingency in Paragraph 16(e) runs from the Repair Notice Date stated in Alt 1(b). For most, if not all, of these deadlines, the contract states that "time is of the essence," which is a very unforgiving standard.

Have any brokers ever encountered the following issues when dealing with Alternative 1? Disputes concerning:

- whether an item is a "covered" or eligible repair?
- whether an item is performing its intended function or in need of *immediate* repair?
- whether the repair requests are timely?
- whether the estimated cost of repairs submitted by the buyer is reasonable?
- whether the contract has actually been terminated, allowing the seller to accept other offers?

Obviously disputes may arise in any sales transaction, but Alternative 1 does not necessarily dispose of these disputes any more effectively than Alternative 2. Actually, Alternative 2 may be more effective in dealing with various property inspection and repair issues than Alternative 1. Why?

- First, *there is only one date to remember — the option termination date — that's it*. If the buyer hasn't exercised his/her right to terminate the contract by delivering written notice to the seller or seller's agent by 5:00pm on the option termination date, then s/he loses that right and is now bound to perform the contract, subject to fulfillment of other conditions, such as any loan or appraisal contingencies.
- Second, *there are no parameters or limits on what the buyer may ask the seller to remedy if the buyer has discovered unsatisfactory conditions* as a result of any inspections or investigations the buyer chose to have performed, so long as the buyer makes the requests and negotiates a resolution prior to the expiration of his/her option termination date as thereafter, s/he loses the ability to terminate the contract.

The balance of this section will briefly review the provisions of Alternative 2 and then explore the opportunities it affords the buyer to conduct any desired inspections or investigations and a buyer agent's duty in advising and assisting his/her buyer client in arranging such inspections.

ALTERNATIVE TWO OF THE OFFER TO PURCHASE

How It Works

Under **Alternative 2**:

- The buyer pays an option fee to the seller in exchange for the buyer having a stated period of time (the option period) within which to decide whether the buyer wishes to consummate the transaction.
- The seller retains the option fee, the amount of which is negotiable, regardless of whether the transaction closes. If the transaction does close, the option fee is applied to the purchase price.
- During the option period, the buyer is free to conduct any and all inspections and investigations s/he wishes. If such inspections reveal property conditions unacceptable to the buyer, the buyer either may terminate the contract outright, or may request that the seller fix the conditions. *The buyer may request any repair s/he wishes, even if the repair is outside the scope of the repairs enumerated in Alternative 1.*

EXAMPLE: The property has drainage issues, but the excessive moisture does not impact any of the structures. The buyer nonetheless may request that the seller correct the drainage problem. The seller may agree or not, or the parties could agree to split the expense or whatever. If they can not agree, then the buyer must deliver written notice of termination by 5:00pm on the option termination date or s/he will be obligated to purchase the property in its then existing physical condition.

Understand, however, that under Alternative 2 the buyer does not need to specify any reason as to why s/he is terminating the contract. *So long as the buyer notifies the seller in writing prior to the option termination date, the buyer may terminate the contract for any or no reason, including that s/he just changed his/her mind.*

Option Fee and Option Period

Option Fee

Both the amount of the option fee and the length of the option period are negotiable. Generally, the initial proposal will come from the buyer, but the seller is free to alter either the amount of the fee or the option period in a counteroffer. The amount of the option fee may be influenced by factors such as the value of the property, the likelihood of other offers, the length of the option period, or perhaps the amount of the seller's mortgage payment. *The option fee is paid directly to the seller and is his/hers to keep regardless of the outcome of the transaction.* Prior to contract formation, licensees may hold and safeguard a *check made payable to the seller* for the option fee without depositing it into the broker's trust account. *The broker must deliver the option fee check to the seller or his/her agent within three business days of contract*

formation; however, so long as the check remains in the possession of any broker, whether listing agent or buyer agent, the broker is to obey the *buyer's instructions* as to delivery. (See Rule A.0107(a).)

The option fee should be a separate check from any earnest money deposit paid in the transaction. Licensees are *strongly discouraged* from accepting checks for option fees made payable to the real estate company or broker, because it then must be deposited in the broker's trust account. Once in the account, it will be subject to the disputed funds rule [Rule A.0107(g)] in the event of a disagreement. Thus, unlike the earnest money deposit which is held by a broker or escrow agent, the general advice is to make the option fee check payable to the seller and do not deposit it into a broker's trust account. If the buyer agent gives the option fee check to the listing agent to hold prior to contract acceptance, the buyer agent might also wish to instruct the listing agent that s/he is not at liberty to convey the check to the seller until the parties have successfully created a contract.

As previously mentioned, the option fee belongs to the seller regardless of whether the transaction closes. A buyer only gets credit for the amount of the option fee if the transaction does close, in which event the option fee is credited to the purchase price. If the buyer timely gives written notice that s/he is terminating the contract prior to the expiration of the option period, then the buyer is entitled to a refund of the earnest money deposit. If the buyer does not timely notify the seller that the buyer is terminating the contract, then the seller generally will be entitled to retain the earnest money deposit if the buyer fails to close *unless* the failure is due to the seller's inability to convey marketable and insurable title, or the property is found to be in a previously undisclosed flood zone, or the property fails to appraise for the sales price. In the latter three instances, buyer would be entitled to a refund of the earnest money deposit under the terms of the contract.

Option Period

How long should the option period be? It is negotiable and, like the amount of the fee, may be influenced by a variety of factors such as:

- the type of inspections the buyer wishes to conduct;
- the time needed to conduct all desired inspections and any follow up;
- the amount of the option fee the buyer paid.

Another factor might be the "cost" to the seller of keeping the property off the market, although listing agents should attempt to make sellers understand that they are not compelled to remove the property from the market. The property may continue to be advertised and shown, though the advertising must indicate "under contract" or "contract pending" or something similar, but the seller is free to consider any other offers which may be submitted and may accept a second offer in a back-up contract position.

Buyers should be careful to allow themselves adequate time in their option period within which to conduct any and all desired inspections and negotiate any issues arising therefrom, being mindful too of the availability of third parties needed to conduct such inspections, such as home inspectors, pest inspectors, etc.

DUE DILIGENCE

What should the parties be doing during the option period? In most sales transactions, the greater burden is on the purchaser to exercise due diligence in conducting any desired inspections and investigations in a timely, expeditious manner, whether Alternative 1 or Alternative 2 governs.

Seller's Preparation

Typically, *the seller should have conducted his/her due diligence before marketing the property*. Minimally, the seller should be sure that s/he can convey clear and insurable title. If there are any property encroachments or survey issues or clouds on the title then these should be corrected and eliminated prior to offering the property for sale. A seller also may wish to have a home inspection so s/he is aware of possible issues and can decide whether to remedy certain conditions prior to marketing the property. A listing agent should also inquire about the existence of any liens on the property, whether arising by deed of trust or judgment lien or unpaid taxes or assessments, to determine what sales list price will be necessary to satisfy all outstanding liens and encumbrances. *If the total of all liens exceeds the reasonable fair market value of the property, then the seller may be unable to convey clear and insurable title*. A listing broker should inquire to learn whether the owner may be in a short sale situation, because if s/he is, then that is a material fact that must be disclosed to potential purchasers. A seller also should be encouraged to gather in advance the documents s/he is to provide the buyer under the contract. Such documents include "... title insurance policies, attorney's opinions on title, surveys, covenants, deeds, notes and deeds of trust and easements relating to the Property" [See Par. 13, Offer to Purchase] as well as the Residential Property Disclosure Statement.

Buyer's Preparation

"Due diligence" from a buyer's perspective may relate to numerous issues including the condition of the property itself, surrounding property uses, special needs of the buyer and general aesthetics. What types of inspections or investigations or inquiries might a buyer undertake during his/her option period? The following are examples of inquiries a buyer may initiate in the exercise of due diligence.

- home inspections, not only of the principal residence, but of any other structures on the property
- inspections for wood-destroying insects
- survey issues: boundaries, encroachments, easements, etc.

- square footage and acreage/lot size
- lead based paint, radon, underground storage tanks and other environmental issues
- well and water issues
- septic and soil suitability issues
- compliance with applicable building codes
- swimming pool inspections
- required permits for any room additions or renovations
- flood-related issues, including flood insurance
- zoning and/or other land use issues
- restrictions imposed by protective covenants and/or owner association rules or bylaws
- pending or confirmed assessments
- amount of any owners' association dues
- city/county lines, jurisdiction and provision of services
- school districts
- surrounding traffic, congestion, road construction or availability of public transportation
- property taxes
- presence of sex offenders living in the area
- ability to insure the buyer and the property and cost thereof
- neighboring property uses
 - noise considerations, such as airports, flight paths or regular warning sirens from nuclear power plants
 - smelly uses, such as hog or poultry farms
 - waste dumps or landfills
- anything else that is important to the buyer

The point of this lengthy list is to illustrate that any buyer may conduct any investigations or inquiries s/he wishes during some stated period of time specified in the contract. If the results of *any* of the foregoing matters is unsatisfactory to the buyer, then a buyer under Alternative 2 may choose to terminate the contract (so long as the option termination date has not passed), whereas a buyer under Alternative 1 may still be obligated to purchase the property even though s/he is not happy about what s/he has learned.

EXAMPLE 1: Buyer learns that the property is in an area that is soon to be annexed by the City, which will result in higher property taxes. A buyer under Alternative 2 may attempt to negotiate a price reduction with the seller and if the parties can not achieve a satisfactory resolution, the buyer can terminate the contract until the end of the option period. A buyer under Alternative 1 could attempt to negotiate a price reduction with the seller, but if unsuccessful, would still be bound by the contract to purchase. [NOTE: Even if the seller's agent and/or buyer's agent should have known about the pending annexation and disclosed it to the buyer up-front, the buyer would still be bound by the contract to purchase.]

EXAMPLE 2: When viewing a property initially, the buyer noticed that there was a hog farm approximately one-half mile down the road, but didn't give it much thought. A few days after entering into a contract to purchase the property, the buyer is visiting the property for one of several inspections s/he has ordered. The winds that day are blowing downwind from the hog farm and the smell is significant, more than the buyer cares to tolerate on warm summer days while attempting to enjoy the screened-in porch. A buyer under Alternative 2 could terminate the contract, whereas an Alternative 1 buyer could not terminate based on the hog farm.

EXAMPLE 3: The seller and buyer are under a contract to sell/purchase. During the inspection period, the buyer is visiting the property one afternoon when he is startled by a thunderous noise. It turns out that the adjacent property owner is in the habit of scaring crows out of his cornfield by firing a cannon. Upon inquiry, the buyer learns that this may occur several times each day, but only while the corn is in the field. A buyer under Alternative 2 could terminate the contract; most likely a buyer under Alternative 1 could not.

Virtually *anything* may be renegotiated between a seller and buyer under an Alternative 2 contract up until the expiration of the option period. A buyer utilizing Alternative 1 does not have this latitude and generally may terminate the contract only if the seller refuses to repair or correct a situation which qualifies as a "Necessary Repair" under the contract. The buyer is still under a time constraint and must notify the seller in writing of buyer's election to terminate by the deadline stated in the contract. *Any agreement reached between the buyer and the seller during the option period as to repairs or other matters should be reduced to writing and signed by both parties prior to the expiration of the option period.*

Can the option termination date be extended? As with any other provision in a contract, the option termination date may only be extended *by mutual agreement of the parties*. If the seller refuses to allow the buyer additional time, then the buyer remains bound by the original date. If the seller is willing to grant an extension, then the parties could evidence their agreement in an amendment to the contract. Alternately, the original date in the contract could be stricken and the new option termination date inserted and the change initialed and dated by each party. To be safe, the buyer probably should pay some additional amount as consideration for the extended time period and the additional option fee may be applied to the purchase price if the transaction closes.

Buyer's Exercise of Option to Terminate

If the buyer decides to terminate the contract, then s/he **must *deliver written notice of termination to the seller or the seller's agent no later than 5:00pm on the option termination date. Time is of the essence as to this date.*** If the buyer, or his/her agent, fails to deliver written notice to the seller by 5:00pm on the option termination date, then the buyer is "... deemed to have accepted the property in its physical condition existing as of the Option Termination Date." Buyers should not wait until the final hour to decide to terminate, because if they miss the deadline, then they are bound under the contract. NCAR has various forms which REALTOR® members may use to give this notice, but any written notification that the buyer is electing to terminate the contract as permitted under Alternative 2 which is timely delivered to the seller or his/her agent will suffice.

Can a buyer email the seller or listing agent notifying them that s/he is terminating the contract? Paragraph 27 of the contract states that any written notice required to be given under the contract may be communicated to a party or the party's agent "...by sending or transmitting it to any mailing address, e-mail address or fax number set forth in the "Notice Address" section below." Thus, if the seller or listing agent has provided his/her email address in the Notice Information section, communication by email would be valid, as long as it is timely sent, even if the seller or listing agent do not actually read it until after the deadline. Recall too that under the contract terms, notice to a party's agent is notice to the party.

What if five days prior to the option termination date, the buyer requests that the seller remedy certain conditions, but the buyer has not received any response from the seller? Failure of the seller to respond does not extend the termination date nor excuse buyer's performance; thus, the buyer needs to decide whether to exercise his/her right to terminate and, if yes, then deliver written notice of that decision to the seller or listing agent prior to 5:00pm on the option termination date regardless of whether s/he has heard from the seller; otherwise, buyer will be obligated to purchase the property in its then existing condition (unless other contract conditions are not satisfied) and the seller can refuse to remedy anything.

If the buyer does not exercise the right to terminate, does that mean the transaction will close? Not necessarily, because there are other conditions in the contract, such as the loan contingency and the appraisal condition, which if not satisfied, will excuse the buyer's performance, although if the date has passed for the buyer to terminate based on the loan

contingency, then the seller should receive any earnest money deposit paid. All the conditions set forth in Paragraph 7 also survive the expiration of the buyer's option period, including the requirement that the property be in substantially the same or better condition at closing as it was on the option termination date.

CONCLUSION

Licensees should shed their fear of Alternative 2 and suggest that buyers and sellers consider its use. The seller receives some consideration for the option period, as opposed to none under Alternative 1, and the option period may not be any longer than the inspection period requested by an Alternative 1 buyer. There are far fewer dates and deadlines to remember and the issues which may be negotiated are wide open – there literally are no limitations. While humans often are creatures of habit and resist change, agents are encouraged to expand their horizons and may just find they are simplifying their brokerage practice simultaneously.