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Rethinking contingencies: Disclosure, warranty and make-good

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(This is the thirteenth in a series of articles about issues that sellers and buyers face when negotiating a purchase-offer contract.)

Buyers use contingencies in a purchase-offer contract for several different purposes—to gain bargaining leverage, extract information from the seller and give themselves the opportunity to research the property and/or arrange financing, among others. In this column, I'll discuss using a contingency to gather information and assurances from the seller, an approach that I've found to be extremely useful but not widely used.

Properly conceived and worded contingencies in a purchase-offer contract become one of the conditions of the sale. The concern spelled out in the contingency must be met for the sale to proceed. When a contingency is not met, the buyer's offer should be voided and his deposit returned without penalty.

In most cases, I advise clients to use "results-acceptable-to-buyer" contingencies. Rather than make the condition of sale a strait-jacket of specificity -- "obtaining financing for $200,000 at no more than a fixed rate of six percent for a 30-year term with no more than two points" -- broader language -- "This purchase is contingent on obtaining financing whose terms are acceptable to the buyer." – provides the flexibility that is often needed to get a deal done and better protects the buyer's interests.

Sellers, however, may be suspicious of "results-acceptable-to-buyer" contingencies. Some buyers will use them as a tactic to stretch out a seller and get him invested in making a sale to the buyer in front of him. I've seen contingencies used to manipulate the seller, and I've seen them used fairly to protect the buyer.

Sellers usually know more about the property being sold than potential buyers. This is particularly true with buyers who don't research a target property before submitting a contract and count on a "study contingency" (or its equivalent) to provide them with sufficient due-diligence opportunity during escrow.

Why not make a purchase contingent on a seller disclosing "any condition -- manifest or latent -- in the property or its title of which the seller is aware that would negatively affect the buyer's possession, use or enjoyment of the property"? This language would include matters that may not be covered in a title search or by title insurance, such as an unrecorded sale of an interest in the property, an easement or life estate; boundary disputes or boundary encroachments (either extending or diminishing the seller's property); chronic trespass; and a well routinely going dry in August, among many other items.

States differ in their seller disclosure requirements. My impression is that the majority limit disclosure to "latent defects"— conditions that are not observable, such as a deteriorating water-well casing.

State disclosure requirements do not, as a rule, cover "manifest defects" in the property, that is, conditions that are observable, but whose significance a buyer may not understand. A buyer can see a fence line, but he will know that it's not on the boundary line only with a survey. A four-inch-diameter chimney flue is not hidden from a buyer, but its heating limits and use restrictions may not be comprehended. Most state disclosure rules would not be construed to require the seller to tell the buyer about either the off-fence line or the small flue.

Further, disclosure requirements are generally limited to the house and its support systems; they don't typically apply to the surrounding property. A seller would not be required to disclose the presence of soil toxicity or insect infestation that limits a farm field's utility for agriculture.

Many states, moreover, have an opt-out feature in their disclosure procedures that allow sellers to choose to reveal nothing at all. In that case, the buyer can insert his own disclosure provision in his contract…and see what happens.

A buyer should also consider adding a warranty provision to disclosure, as in "The seller warrants that the property is free of any material or latent defect of which he is aware that would negatively affect the buyer's possession, use and enjoyment of the property." The buyer's contract should also include the sentence: "Warranties survive the contract." Otherwise, they won't.

The buyer's local lawyer should be involved in drafting this language and possibly packaging it with a "make-good" provision that requires the seller to fix defect that turns up within, say, six months of closing.

Many sellers, of course, will object to disclosure, warranty and make-good provisions. It's important for a buyer to have a face-to-face discussion with such sellers, to find out the basis for the objection. Why, a buyer should ask a seller, are you refusing to disclose something wrong with what you want to sell to me? The parties can always agree that the seller is not required to do anything about defects he discloses.

Sellers have a post-sale defense, namely, that they didn't know about a defect, which is why they didn't disclose it. Most courts, I hope, would apply a standard of what a seller should be reasonably expected to know about his own property. Lack of knowledge is not a credible defense for a seller who has lived on a farm for 20 years, yet claims he did not know that the house spring went dry during droughts.

Seller advocates often argue that it's outrageous to ask a seller to disclose, warrant and make good. But isn't that what we expect of most things we buy these days? Why should sellers be permitted to hide defects from buyer and profit from being dishonest?

If I were approached by a buyer, I would initiate full disclosure, warranty and make-good as a means of justifying and getting my price. I might tell the buyer that I'm not willing to fix defect A and explain why. I would say that my price is discounted to reflect that condition.

"Caveat emptor" is a doctrine that should be retired when it comes to real estate.