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Negotiating with contingencies

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

In earlier columns, I discussed how a buyer might use a contingency to get a seller to disclose information, and provide a warranty about some aspect of the property. In this column, I'll discuss several ways for a buyer to use contingencies as part of his approach to negotiating a purchase.

Most sellers and agents representing sellers encourage buyers to submit "clean" contracts. Generally speaking, this means the fewer contingencies the better—none being best; a large deposit; no language that requires the seller to do anything; a very short escrow, full-price offer and all cash. From the seller's perspective, contingencies are potential deal-breakers.

From the buyer's perspective, contingencies can have intrinsic worth as well as negotiating worth. The former are genuine questions and issues that the buyer must address and resolve satisfactorily during escrow before buying. A vanilla financing contingency -- making the sale depend on the buyer arranging financing at acceptable terms -- is commonly used to protect the buyer's offer; it has intrinsic worth.

Contingencies can also be bargaining chips for buyers who have scoped the property sufficiently prior to submitting an offer and are, therefore, confident that they know enough to buy.

Take, for example, an investor who wants to buy 400 acres of undeveloped land -- part open, part woods -- that's within a two-hour drive of Charlotte. Before submitting his contract, this investor has performed the following due-diligence investigations related to his idea of dividing the property into eight 50-acre parcels:

1. Researched the current market value of the property through one or more means, including appraisal, tax-assessed value, Competitive Market Analysis and asking around;
2. Researched division potential, costs, regulatory (zoning) guidelines, building codes, etc.;
3. Hired a consulting forester to do a walk-through to get an approximate idea of the immediate sale value of the timber. The investor has decided that he might do a "residential cut," which takes out only the highest-value trees, and chip the tops to minimize the aesthetic downside of a freshly logged property.
4. Researched the deed enough to know that no defects are obvious. The investor

has also had a surveyor run the deed's calls through a deed-mapper program and walked the boundaries to make sure the calls in the deed match the boundaries in the field.

5. Looked into the environmental issues that might limit the investor's plans, such as the presence of endangered species, wetlands, floodplain, sub-surface minerals, archeological sites and so on;

6. Discussed financing with three lenders, provided each with his financials and gotten informal green lights to go forward.

In discussions with the seller, the buyer indicates that he is considering using a number of separate contingencies, including ones related to seller disclosure, rezoning for division, buyer-paid appraisal, timber evaluation, surveyor inspection, environmental study and financing. The buyer's offer is strong for the market, but the seller is afraid that one or more of the buyer's contingencies will turn up a deal-breaker. He objects to all the contingencies, except for financing..

So the buyer negotiates away those contingencies that he doesn't need, because he has already done the due-diligence necessary to allow him to waive further investigation. In return, of course, the buyer asks the seller to give up something for something given. In this example, the buyer should not give up a contingency that makes the sale rest on the seller obtaining the rezoning necessary for an eight-parcel division, because that is essential to the buyer's plans and the one issue that can't be resolved through pre-offer buyer research.

A quid pro quo might be a price reduction given the buyer's argument that he is assuming greater risk by waiving the protection of one or more contingencies. Or the buyer might insist that the seller fix something, do something or include something the seller would not have done otherwise. If the buyer has not been thorough in his pre-offer research, he is, in fact, taking on risk that might bite him after the sale by foregoing contingencies.

If a seller agrees to all the proposed contingencies save one, the buyer should refocus his attention on the sticking point. Maybe the buyer knows what the problem is, but maybe he doesn't know what the seller fears he will find out. If the buyer knows the problem and can manage it, he should get something significant for giving up the contingency the seller objects to. More opportunities for negotiation arise when the buyer knows the extent of a problem beforehand.

Buyers should not bargain away intrinsically valuable contingencies that they need to protect their interests.