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What Is An Escalation Clause and How Is It Used In Real Estate?

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If you have recently tried to buy a home in Pacific Palisades, you know how competitive the market is. To give yourself an advantage over the competition, your real estate agent or a friend may have suggested using an escalation clause in your purchase contract.

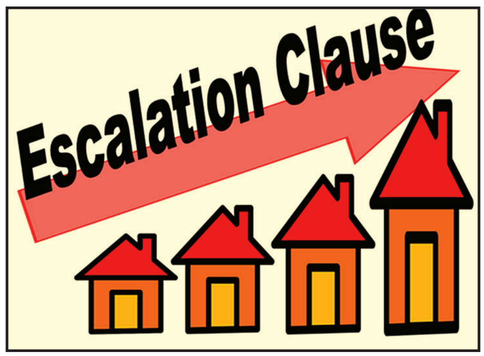
Well, you may ask yourself, "What is an escalation clause?"

A buyer will put in their purchase contract that they will offer a certain amount above the highest other offer once the seller provides a copy of the front page of the other offer. For example, if there is a property asking $2 million, the buyer may write they will offer $5,000 more than the highest offer.

The proper way to do escalation clause is to put a cap on how high you (the buyer) are willing to go. As you can imagine, if two buyers both put escalation clauses in their offers without putting a cap, then not only is the buyer committing themselves to an unlimited price, there is also no way to ultimately pick the highest price.

Escalation clauses tend to be more common in very active sellers' markets. The definition of a sellers' market is when inventory levels (i.e the Unsold Inventory Index) are very low.

To calculate the Unsold Inventory Index, you take the existing number of homes on the market and divide that by the number of homes that sold the previous month. For example, if there are 60 homes on the market in the Palisades and 20 homes sold in June, the Unsold Inventory Index would be three, which is indicative of a strong sellers' market.



Marguleas takes a look at escalation clauses.
Photo courtesy of Amalfi Estates

A buyers' market is if there is more than six months of homes available on the market. A sellers' market is if there is less than six months.

In the Palisades, we have seen the Unsold Inventory Index as low as one month and as high as 20 months.

Regarding escalation clauses, they are more complex than one would think. When a buyer writes an offer on a property with multiple offers, one of the things the seller typically counters with is "highest and best price."

We usually see escalation clauses used by less experienced agents. When a seller counters asking for "highest and best price," and a buyer counters with an escalation clause that says they will come $5,000 above the highest offer, the seller then does not know what the buyers' highest and best price really is.

Also if one buyer comes in $300,000 over asking without an escalation clause, while the escalation-clause buyer comes in at asking price, but puts a $5,000 escalation clause, many sellers get turned off by this approach, as it can come off as game playing.

Other issues that can arise are if there are only two offers on a property and one buyer decides to do an escalation clause, but unbeknown to them, the other offer happens to be a low offer. Or if the other offer decides to back out during the negotiations, the seller is stuck with how to properly respond to the buyer, since they cannot show the buyer that the offer is lower than the escalation clause initial offer.

There is also the issue of showing the escalation clause buyer, the written competitor's offer, which some sellers are not comfortable doing.

So, if a buyer still chooses to use an escalation clause, we recommend that you put a cap on the amount and only use if there are at least four or five other offers on the property to avoid at least two of the pitfalls mentioned above.

Anthony Marguleas runs the Marguleas Team of Amalfi Estates that has sold over $1 billion in properties and was selected by the WSJ *as one of the top 60 agents in the country out of one million agents. Marguleas can be reached on his cell at 310-293-9280 or anthony@amalfi-estates.com.*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