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Topic: The "New" Due Diligence Procedure – Part 1

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The "new" contract going into common use on June 13th is actually the same contract Horry County agents have been using, except the "repair procedure" and "as-is" options in paragraph 8 are gone. The "newness" is that "due diligence" is brought into the mainstream. Therefore, it will be a good idea to closely examine the meaning of the due diligence provision and the new responsibilities imposed on agents. Part 2 of this article (being published in a couple days), will present sensible alternatives to the due diligence procedure, but here in Part 1, we examine the due diligence procedure exactly as it is written.

The core elements of due diligence are:

a. The parties agree the buyer has a certain amount of time to inspect the property and consider whether or not to purchase;

b. The buyer can terminate the contract for any reason or no reason within the due diligence period; and

c. A buyer who decides to terminate will probably have to pay a termination fee (the parties can agree there will not be a termination fee).

Paragraph 8 presents a rather obvious list of the opportunities the buyer can avail himself of during due diligence:

1. Conduct/obtain inspections [e.g. on site conditions, off site conditions]

2. Deliver Repair Requests Notice to Seller [e.g. SCR525 with all repair requests, all portions of reports]

3. Proceed under amended Contract [e.g. SCR310 and SCR525, SCR390, SCR391]

4. Proceed under As Is Contract [e.g. Buyer desires to buy anyway, Buyer wants Property without repair]

5. Terminate Contract by timely/properly Delivering "Notice of Termination" and "Termination Fee" to Seller within the Due Diligence Period.

The preceding list might be thought of as buyer options, but in deciding how long of a due diligence period he will require, the buyer must first understand what actually needs to be accomplished during the due diligence period. At the least, the due diligence essentials are as follows:

- Obtain a Home Inspection Report
- Conduct a meaningful review of the Report
- Consider what demands he will make on the seller
- Attempt to negotiate those demands
- If the buyer is not satisfied with the seller's response or if the seller doesn't respond at all, terminate the contract

As a convenient example, we will presume the parties agree to:

- 10-day due diligence period
- $500 Termination Fee

The buyer's situation might not be as simple as this example might make them seem. It will be helpful to pause to examine the termination clause -- this is where the ball curves. The clause [Contract – within para 8] is as follows:

> **TERMINATION: During the Due Diligence Period, Buyer may unilaterally terminate this Contract only by Delivering to the Seller both Notice of Termination and a Termination Fee of $______ USD Good Funds.**

Clearly both the Notice of Termination <u>and</u> the Termination Fee must be delivered before due diligence expires. This requires familiarity with at least two other contract provisions:

> <u>Good Funds</u> – is the transfer of the required amount of United States Dollars (USD) within any required timeframe. [Contract - para 1]
>
> > Note: The term "good funds" as used in the legal and financial industries means a payment that cannot be cancelled or reversed by the person making the payment. Wires and cashier's checks are "good funds." Obviously, a personal check is not good funds because the payor can issue a "stop payment" or the check can be returned NSF. The contract definition of "good funds" is muddy. This definition (as opposed to the industry meaning) is the meaning of the term in the contract and it is an imprecise definition -- "transfer …" feels unnecessarily vague.
>
> <u>Notice and Delivery</u> - … All notices … will only be effective as of delivery to the Notice address/email/fax written below and awareness of receipt by Broker ("Delivered") unless Parties agree otherwise in writing. [Contract - para 28]
>
> > Note: The delivery is to be made to the address appearing under the seller signature lines. In prior contracts, the absence of this address mattered little. Now, though, it is of paramount importance because this is where the Notice of Termination and the Termination Fee are to be delivered. If the buyer wishes to terminate and that

address line is blank, a difficulty is presented. Many brokerages are actual offices with cheerful receptionists ready to greet all comers. Others, though, are virtual offices or the address on Google is an old address or the Google address is current, but the office isn't staffed or it's someone's house.

If the contract calls for a termination fee, a buyer's agent should:

- Make sure the "delivery" address is in the contract before it is signed;

- Construe "good funds" in the strictest sense by having a terminating buyer send a cashier's check (it is to be made payable to the seller – not to the listing agent's brokerage)

- Allow plenty of time for the buyer to transmit the Termination Fee to him (the buyer's agent) so it can be delivered before due diligence expires. In the example above, we used a 10-day due diligence. Even if the Home Inspection Report is done on Day 7, there are now only 3 days to review it, decide what to demand, negotiate those demands and, if negotiation is unsuccessful, terminate.

The unfortunate reality of the due diligence provision (at least one that has a Termination Fee) is that, at the very time the buyer's agent knows he won't be making a commission, he is saddled with the rather inconvenient responsibility of procuring the Termination Fee from his client and delivering it before due diligence expires.

Practical Notes and Recommendations:

a. **Educate the Client**: Educate your clients (buyer and sellers) on how due diligence works. It might be helpful to furnish them with a list of "Frequently Asked Questions." A few brokerages have asked me to furnish them with a prepared list of questions and I will gladly do so.

b. **Broaden the Use of the Due Diligence Period**: Though the due diligence period seems primarily intended to allow time for a home inspection, use the due diligence period to explore anything the buyer wishes to explore. If the buyer needs to know he can build a fence and/or have a dog, this is a great time to find out. You can avail yourself of a "document stipulation" at the same time the contract is signed. If the seller claims the roof was re-shingled last year, the HVAC was just installed, he has a dock permit (etc.), you can present a document stipulation along with the contract in which the seller is required to produce proof of those things within 5 days of contract execution ("5 days" is an example). If the property is leased you should require a copy of the lease, a copy of any management agreement and a rent history. While a seller might not appreciate an overly long list of things to produce (and therefore might reject the offer), a reasonable seller won't mind rounding up copies of a few items.

c. **Be Aware of Expiration of the Due Diligence Period**: Realize the due diligence provision has only one deadline: the date/time it expires. This means planning and awareness are required. Under the former "repair procedure," the buyer had until "Day X" to make repair requests and the seller then had until "Day Y" to respond, etc. The due diligence clause doesn't have progression dates – it simply ends – so the buyer and the buyer's agent must stay keenly aware of that date in their planning and in conducting due diligence, negotiating a repair request and, in addition, must allow sufficient time to effect a termination [the buyer will need to transmit a Termination Fee to the buyer's agent and the buyer's agent must then deliver it and the Notice of Termination to the "delivery address shown in the contract (presumably the listing brokerage)].

d. **<u>Termination Fee Should Be a "Cashier's Check" or Wire</u>**: If the buyer is terminating, make sure the buyer sends you a cashier's check as opposed to a personal check. The buyer might want to only send a personal check because it's more convenient, but this risks the seller taking the position that termination has not been properly effected because a personal check isn't "good funds." In other words, to avoid unnecessary quarrels, don't try to decide what the contract definition of "good funds" means – instead, err on the side of a strict interpretation of "good funds."

e. **<u>Require Delivery Address When Contract is Signed</u>**: Make sure the "delivery address" is in the contract when signed and make sure it's a "real" address.

f. **<u>Require Signature when Termination Fee is Delivered</u>**: When you deliver the Notice of Termination and Termination Fee, have the recipient sign for it and have them place the date/time beside their signature.

g. **<u>Make Buyer Aware He Must Be Available</u>**: As the contract is being prepared and signed, make sure your buyer understands he must be prepared to procure and send a Termination Fee by a date that makes it comfortable for you as the agent to receive it and deliver it. A buyer who is on a cruise ship, in the hospital or otherwise unavailable might not be able to get a check to you (especially a cashier's check) in time.

h. **<u>Extend Due Diligence if More Time is Needed</u>**: If the due diligence period is close to expiration and more time is needed, ask the listing agent for an extension. If the seller agrees to extend, create a due diligence extension agreement and have it signed by both parties before due diligence expires. If the seller will not agree to extend, make sure your buyer understands he is faced with either terminating now or purchasing the property "as-is."

i. **<u>Extend Closing Date</u>**: If the due diligence period is extended, you may need to also extend the closing date. You might have timed the closing date based upon when due diligence expires because that's when the title work and the core of the loan process begin. If the due diligence deadline is extended and the buyer eventually decides to move forward with his purchase, there might not be enough time for the preparatory work to be done – this, of course, would place the buyer in default and would expose him to liability. Therefore, when the due diligence period is extended, think about also extending the closing date (do it in the same document).

j. **<u>Due Diligence Should Expire on Workday</u>**: Make sure due diligence expires on a workday. If you accidentally have it end on a weekend or federal holiday, you may find yourself trying to deliver the Notice of Termination and Termination Fee when the listing brokerage isn't open.

Here are some questions your clients might ask you:

1. What happens if the due diligence period expires without a repair/credit agreement between the parties and the buyer hasn't terminated?

   Answer: The contract converts to an as-is purchase.

2. Once the due diligence period ends and the contract isn't terminated (whether there's a new repair/credit agreement or the contract converts to as-is), what happens to the contract contingencies?

   Answer: The contract contingencies survive the due diligence period. In other words, even after due diligence expires, the buyer's purchase obligation is still contingent on any stated contingencies (ex. financing, appraisal, termite report, sale of buyer's current home).

3. If due diligence ends and the buyer then gets turned down for financing, does the buyer have to pay a termination fee? (obviously, this question presumes there <u>is</u> a financing contingency).

   Answer: No. The failure of a contingency allows the buyer to terminate without paying a Termination Fee.

4. Once the due diligence period ends, what requirements must the seller meet?

   Answer: The seller must make any agreed-upon repairs, "maintain the property in operable condition …" [Contract - para 3], present marketable title at closing, present the property as vacant (unless the parties agree an existing tenant will remain).

5. What if the Notice of Termination and Termination Fee are delivered late?

   Answer: The contract states "time is of the essence" in all obligations. Therefore, if the termination is late, it's as if it didn't happen at all. The buyer is now obligated to purchase the property as-is (subject to any contingencies) -- if the buyer does not move forward, he will be in breach of contract. Obviously, the seller can waive the tardiness.

6. Can the buyer instruct that the Termination Fee be paid from the earnest money?

   Answer: No. The parties can <u>agree</u> up front to the Termination Fee being paid from the earnest money, but absent such an agreement, the buyer cannot instruct that the Termination Fee be paid from the earnest money.

7. What if the Termination Fee bounces?

   Answer: The termination in not effective and the buyer is now obligated to purchase the property as-is and, if he does not, he is in breach. Remember the meaning of "good funds" – if the contract is being terminated, the buyer should present a cashier's check and the seller should probably insist on it.

8. If the buyer presents a repair request with only 2 days left in due diligence, is the seller required to respond within the due diligence period?

   Answer: No. The seller is not contractually required to respond. Unless the parties agree to extend the due diligence period, the buyer will have to either terminate within the due diligence period or purchase the property as-is.

9. Should the buyer instruct his attorney to order title work during due diligence?

   Answer: This is optional. Even after due diligence ends, the seller is required to present marketable title, so there isn't a legal need to order title work during the due diligence period.

10. What if I want to make my offer as-is?

    Answer: You can definitely do this. Simply strike through the due diligence paragraph and use an as-is addendum.

11. If the buyer terminates, do the parties still have to sign a release in order for the earnest money to be refunded to the buyer?

    Answer: Yes, that is what paragraph 5 of the contract requires. The alternative suggested in Part 2 of this article does away with the "release" requirement, but if that alternative isn't used, a signed release is required.

Part 2 of this article will present alternatives to the due diligence provision as it is written.