What is ''Up'' Will Sometimes Crash Down: The Side Effects of ''Up-Markets''

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To those interested in real estate—the real estate professionals, sellers, home buyers, investors, mortgage brokers—''up-markets'' are both exciting and challenging, and to many very profitable. It may be a surprise to many that ''up-markets'' are also direct corollaries to real estate disputes and litigation.

As a mediator, arbitrator and special master for over 20 years, emphasizing for many of those years the resolution of real estate non-disclosure cases, commission disputes, multiple offer claims, and related construction issues, hand on experience has permitted re-examination of the common thought that real estate disputes are *driven* by down markets. What is clear to those in the alternative dispute resolution industry who deal with such disputes as mediator, arbitrator, referee, special master, early neutral evaluator (''ADR neutrals''), the disputes are truly driven most often by ''up-markets.''

From the view of this ADR neutral (and others in both the ADR and real estate professional arenas who have shared their views on the issue), claims and lawsuits spring from the variety of rushed decisions made in conjunction with competing for property in frenzied buying situations. In direct contrast to the attitudes of buyers who in up-markets have to line up to make offers to purchase at very high prices, become involved in multiple offer situations, or deal with owners who often believe the market is so good they can sell their home themselves without marketing or attention to legal detail, when buyers are scarce (buyer markets) they have the time to spare to shop around, look for faults, make inspections and basically get what they want at a price which is not hyped by either the seller or the market itself. In down markets, buyers are more cautious and afraid to spend money so they are more selective and more careful, but this does not always make the deal problem free.

However, it is born out by the internal statistics of the hundreds of mediated, arbitrated or special master cases of this ADR neutral (and others) that while the claims, potential lawsuits, or arbitrated actions of the hot market deals usually rear their ugly heads at the time real estate markets are bad, those claims/lawsuits are not *caused* by the down markets.

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Mandatory Disclosures

A majority of the U.S. states and District of Columbia require a mandatory property condition disclosure. Sellers must reveal known factors which can affect the value or desirability of a property. Amid the boom, detail hardly matters. As the saying goes, when the river runs full one does not see all the jagged rocks that lie below the surface. Buyers, in the drive to get the ''perfect home'' in a ''have to have'' neighborhood are often seen later by a mediator, arbitrator, or court to have overlooked their own obligations of due diligence in the transaction, and to have relied only on the best offer to get the deal done. It is also seen in these ADR or litigation settings that some real estate professionals, especially in dual agency situations, in a drive to ''close the deal,'' fail to appropriately provide buyers time to understand ''as is'' clauses, time to do inspections, or even to document the file in a manner which verifies the fault lies not with them, but with the seller, or as is often the case, with the buyer's own need for speed.

In times of exuberance, the odds of obtaining a sale which does not later result in second thoughts or a claim or action against the seller or selling/listing agents is very low indeed. Bring on a drought (down market) and all the rocks previously hidden by the full flow of the tide of exuberance begin to surface. In analyzing a claim after a boom sale, when the buyers have had a chance to see the rocks, ADR neutrals and

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claims/risk managers (involved often when claims are made against insured real estate professionals or other insured parties to the dispute) deal with a variety of claims. Assertions of fraud and non-disclosure against sellers, as well as similar claims and additional fiduciary duty breach issues against real estate professionals, are heard together with the presentation of fact scenarios which provide evidence of very close shaving by sellers of what is a material and relevant fact about the condition of the property required to be disclosed.

As a specific instance, what often happens when markets are hot, there are multiple offers. People are so anxious to get ''the'' perfect property they move too quickly, overlook inspections because they do not want to miss out on the deal, and then regret it later when problems arise. A prime problem in real estate non-disclosure cases is the buyer disputing repair or construction related problems after moving in which could have been discovered during the pre-closing inspection time frame provided for in their contracts. In hot markets, buyers are so panicky about missing out on the purchase and sale of their lifetime they shorten these time frames, accept inspection reports done for and provided by sellers prior to and unrelated to the instant transaction, and sometimes waive inspections altogether.

Similarly, believing they have enough experience to make their own decisions about the condition of the property, investors reject the right to make inspections. In one recent case, an investor actually saw evidence of mold in a rental property on two occasions, rejected the opportunity to get a mold assessment, and did not even have his personal property maintenance personnel look at the situation because he was afraid to lose out on obtaining the multi-unit property for a price he could not pass up.

Litigation Ensues

However, after the deal closes (and, in the case of home buyers, after they move in) and the warts appear, buyers want to sue the seller for not disclosing prior repairs or defects, even ones clearly disclosed or open and obvious to even the unsophisticated buyer. The listing broker gets dragged into the fight over not disclosing, and eventually the buyer's own real estate professional becomes the target on a claim the broker/agent breached their fiduciary duty by allegedly failing to adequately advise the buyer to get the appropriate inspections, or by not insisting that new inspection reports.

Because of the frantic pace of these up-market sales, oftentimes the selling broker/agent has been so busy handling the pace of the market factors that keeping good notes and documentation becomes a nonpriority, or in some cases just falls by the wayside in the rush not to lose the deal. Even if the buyer has told their own broker/agent they do not want inspections, or they want to shorten or waive the inspection window, after the closing it is normally seen by the ADR neutral that files are lacking documentation in writing to show these buyer-to-broker/agent conversations took place.

Writing it Down

One would be amazed at the large number of such disputes which would never ripen to the claim/mediation/lawsuit level at all if there were detailed or even short notes in the real estate professional's file, or if an email or facsimile of confirmation of the buyer's desires and directions existed. Even a written contemporaneous telephone log reflecting a buyer's decision not to inspect or to waive inspections altogether would help resolve the matter without ADR intervention. Counsel for real estate professionals have confirmed, when this topic of missing backup comes up at mediation, the cases which the ADR neutral does not see are the ones where the documentation is actually in the file. In those instances, the dispute dies of its own accord when proof of what transpired is presented to the complaining party.

Another area that fertilizes the need for ADR intervention in up-market sales disputes involves ''as is'' clauses in contracts executed during the boom. These clauses later turn into fraud and non-disclosure claims as the market dies down and buyers realize they had little or no understanding of what the ''as is'' clause meant to the deal they closed. Here again, an amazingly high number of matters brought to ADR neutrals arise from disputes between buyers and their real estate professionals over what they were told about the ''as is'' provisions. Buyers claim they were not adequately advised about what the "as is" clause means; sellers, who have now had a claim made against them, believe the "as is" clause is their protector. Sellers, similarly, project claims against real estate professionals over what took place during the disclosure process: what to disclose, what is material (or why is it not ''material''), why the ''as is'' clause does not protect them when they have suppressed information which should have been on the disclosure form. The battle waged in ADR processes or lawsuits over who did or did not explain the ''as is'' provision on the selling side can be just as difficult when, because the market was hot and there were multiple offers being made, sellers and their real estate professionals disagree on who said not to disclose something material or who did not.

The Significance of Mortgage Rates

Added to all of the direct forces involved in purchasing and selling in a hot market, are the indirect effects of mortgage rates, new and untested mortgage products, loosening of credit requirements, and a fast moving mortgage industry trying to keep up with refinances and sales. In many instances, real estate professionals and/or mortgage brokers may not be paying detailed

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attention to the borrower's ability to repay loans on inflated home prices, nor the potential for increased payments when ''teaser'' loan rates rise a year or two (and in some cases six months) following the closing. If mortgage rates are low at closing and are on the rise thereafter, the potential claims become more serious, and claims escalate into foreclosures and the potential for bankruptcy filings.

Education for borrowers in up-markets seems to hit a low point. At this point of rapidly moving activity, add new mortgage brokers who have moved into the industry from totally unrelated fields (to reap the profits of the boom times), real estate professionals facing demands from buyers to help them obtain 100 percent financing or mortgage products to fund an over-list-price-multiple-offer sale, buyers with weak credit whom are scrambling for subprime loans so they can get into a deal, and future claims are gestating. Any other additives, such as excessive investor speculation in new homes or condominiums they can ''flip'' as the market continues to drive upwards, appraisals obtained on the fly for prices agreed upon that are over the list or market price, or a buyer/borrower who is so anxious to get the deal done they fail to read the papers placed before them delineating their rights and what they are getting into, and the end result is buyer/borrower ''Monday morning quarterbacking'' in the form of claims and litigation.

The news today is full of stories quoting borrowers involved in sales and refinances of the last up-market complaining they ''did not understand they had an interest-only loan,'' they ''were not told about negative amortization,'' they ''received no explanation about what would happen when their ARM loans 'exploded' and they could not make the payments.'' In these instances, ADR neutrals often seen claims against real estate professionals, lenders, and mortgage brokers which are difficult to settle when such buyers/borrowers are faced with the presentation of forms provided by lenders which were in fact signed for by borrowers in the heat of the closing on their must-have home. Unfortunately, such forms are finally read or explained to them by attorneys at the tail end of the frenzied purchase and move-in experience, in most cases after the market has softened and their loan interest has risen. In one matter, this ADR neutral helped resolve in the last year, not only was there a claim the buyer/borrower did not understand the ARM adjustment provisions, but there also was no disclosure of a large prepayment penalty in the loan terms which negatively affected the borrower's ability to refinance to a lower rate mortgage product in order to ameliorate the exploding loan payment situation.

The Market

In the seller market when buyers compete for a home in the best area, or with the best schools, with little time to obtain financing for a home which is at the apex of price and scarcity, the end result is that ADR neutrals and adjusters get to witness, in pre-litigation mediation, at arbitration, or during litigation, less than stellar decision making, skipping or waiving entirely of inspections, immediate turnarounds on contract formation documentation, all leading to the result that buyers ultimately end up later questioning the deal and blaming everyone except themselves.

As an ADR neutral in this specific field, the conclusion is easily drawn—whether you are in a hot real estate market or a down-market arena, the vast majority of complaints and legal action can be avoided if:

(1) buyers would exercise appropriate caution in their decision making process;

(2) buyers/borrowers would read documents which they are asked to execute before actually signing them, not succumbing to the rush-to-finish atmosphere in which they are often placed by real estate professionals, mortgage brokers, or title officers;

(3) sellers would fully disclose the true nature of the material facts regarding the home they are selling, erring on the side of disclosure in as many instances as possible; and

(4) the actions and decisions of the participants in the transactions are clearly documented in some written form for all, at some later time when the claim of damage or wrongdoing is made, to be able to access.

Conclusion

Alternative dispute resolution processes do derive business from the natural side-effects of up-market purchases and sales, this is true. This is not to say other real property transactions do not have similar downsides. Such has been the case historically for many, many years. To be true, however, to the goals of an ADR professional, one should encourage resolution, with or without neutral intervention, by encouraging the adoption in practice of the simple rules mentioned above, and by following the writings of Abraham Lincoln in 1850: ''Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser—in fees, expenses, and waste of time. As a peacemaker the lawyer has a superior opportunity of being a good man. There will still be business enough.''[1]

[1] Abraham Lincoln, 1850, Notes for a Law Lecture. Abraham Lincoln Online, Speeches & Writings. www.showcase.netins.net/speeches/writings Source: The Collected Works of Abraham Lincoln, edited by Roy P. Basler.