

BROKER RISK MANAGEMENT WEEKLY PRACTICE TIP

The Risks of Working with Wholesalers

Broker Risk Management (“BRM”) has noted that a number of clients are working with wholesalers in the purchase and resale of property. A “wholesaler” is a client who purchases properties, generally at a discount from market value, with a view to re-selling it at a profit. There are risks of liability associated with these transactions.

While there are many variations of working with wholesalers, the four most common are as follows:

SCENARIO NO. 1. A wholesaler (investor/buyer) executes a purchase agreement for real property with contingencies. The wholesaler then locates a buyer who is willing to purchase the property for more than the sales price. The wholesaler assigns the contract to that buyer.

SCENARIO NO. 2. Same as Scenario No. 1, but the wholesaler will close on the escrow and immediately resell the property to the new buyer.

SCENARIO NO. 3. The wholesaler purchases the property, undertakes some improvements and repairs, and resells the property for a profit.

SCENARIO NO. 4. The wholesaler purchases the property but does the improvements while it is still owned by the seller and then looks for a buyer to resell the property at a profit.

The following discusses these scenarios and the risks to agents.

In each scenario, one general risk of liability to the listing agent is an accusation by the seller that the property was underpriced (i.e., the agent provided poor advice as to the recommended sales price). If a wholesaler is able to identify a buyer who is willing to pay more money than the wholesaler, a seller may be able to support that allegation.

Another risk is that the seller’s disclosures are not being properly transmitted to the end buyer who is purchasing the property from the wholesaler. In many instances, the wholesaler will insist that its buyer purchase the property without inspections or contingencies, particularly if the wholesaler intends to close the escrow and then resell the property to the buyer. (The wholesaler does not want the seller to find out that the wholesaler has identified the buyer who is willing to pay a higher price.) Other risks include a seller refusing to sign the assignment of contract to the new buyer/assignee. A further risk is a seller asserting a claim that the seller was defrauded by the parties, if the situation with the resale was not fully disclosed to the seller.

A further risk to the seller is that the wholesale does not close using the contingencies as a guise. The wholesaler’s reasons for cancellation may be specious. This will cause delays for the seller in selling the property.

Many times, wholesalers operate through a limited liability company (“LLC”). Therefore, the wholesaler will close the purchase and resale escrows and, upon receipt of the proceeds, dissolve the LLC. In that instance, recovering against the wholesaler becomes challenging. While it is possible to pursue the LLC members, a buyer has the burden of showing that the LLC was a mere disguise for the individuals or a sham company, which can be difficult to prove in court. In addition, as indicated above, a seller may also argue that the seller was defrauded by the parties by failing to disclose that there was another buyer who was willing to pay more money.

The fourth scenario involves a wholesaler purchasing a property and making improvements before taking title then reselling it. There are the obvious risks associated with a flip (*i.e.*, detailed information regarding disclosures not being provided to a buyer). With regard to the disclosures, the most significant concern is the failure to disclose work performed without permits and/or by unqualified handymen. More importantly, there is significant risk if a wholesaler performs work while the seller still owns the property. Attached to this tip is a prior tip regarding risks associated with buyers doing work prior to the close of escrow.

PRACTICE TIPS:

1. If an agent is going to work with a wholesaler, the agent should involve the agent’s manager to ensure that the risks outlined herein are minimized.
2. Agents involved in wholesale purchases and sales of real property must ensure that any end buyer who purchases a property from a wholesaler receives all the disclosures from the original seller, as well as all updated disclosures by the wholesaler regarding any repairs or improvements performed at the property.
3. Agents representing sellers who agree to have wholesalers perform work at their property prior to the close of escrow should be advised of the risks and to consult a qualified California real estate attorney prior to permitting this work. The seller’s attorney should prepare an addendum to the purchase agreement addressing the risks associated with allowing the wholesaler to undertake work at a property prior to the close of escrow.
4. If an agent is aware that a wholesaler is reselling the property for more money, the agent should ensure the information is properly disclosed to the seller to avoid liability to the seller.

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