

How I learned to stop worrying and love the escalation clause

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OK, so I took y'all's advice and bought a house in Baltimore. Finding it was pretty easy: we went to Baltimore, called the number on the first 'for sale' sign we saw, and asked them for the addresses of all the houses in the neighborhoods we wanted for under USD400,000. Since all realtors have all listings, that went smoothly and easily. We looked at the cheaper four out of the six that they gave us, and picked one of those.

Once again, a buyer's broker is about 80% unnecessary here in the modern day. But if the buyer doesn't have a broker, then the selling agent gets to double-bill the seller, for six percent of the house instead of the usual three percent. The real estate industry gets its six percent cut no matter what.

The offer was basically dull. It seems like the only two variables are: what sort of home inspection clauses do you want, and do you want an escalation clause (see below)? You also get to call the agent on assorted other things, for example this one downplayed the fact that there's asbestos insulation on the pipes and my right to get that inspected. We had to write that one in. As often as he pointed out how he was sticking to the ethics rules, I kept having to ask him about things that he should have revealed.

The escalation clause

So the traditional method is a first-price sealed bid auction. You give a number, other buyers give a number, and one evening the buyer opens all the envelopes and finds the highest number. If you expect that there will be multiple bids, then you include an escalation clause that if somebody else's bid is higher than yours, you'll raise your bid to match theirs, plus a few bucks. Your escalation clause puts an upper limit on how far up you'll go.

Ebayers, you'll notice that this exactly matches ebay's bidding system. Herein I'm assuming you've already read my notes on second price auctions in the how to bid optimally on ebay entry.

Anyway, I give the escalation clause a whole separate entry because every last real estate type I met characterized the escalation clause as some sort of extortionary humiliation that buyers have to suffer because it's a seller's market. But no, it's just an alternative type of auction. You're still bidding against other

buyers, just like you were before, and you'll only pay an iota more than the next guy.

I think the real estate industry got this one right (except for the phraseology). A second price auction is, in my opinion, a much more together way of doing business, requiring less guesswork all around. But it doesn't work if there's only one serious bidder, so there's the backup of a first price auction, for those houses that only have interest from one or two buyers.

So the moral, dear house buyer, is: don't fear the escalation clause—run with it. Determine your true valuation for the house (not an easy task, I know), then make a too-low base bid and an escalation clause up to your true valuation. If you win, you'll then pay exactly what you need to get the house, and if you lose, then you would've had to pay more than the house was worth, so you're better off. If you do this, you're way ahead of the other bidders who fear the scarily-named escalation clause and thus place a high base bid and a too-low maximum bid.