

WHOLESALING: A RISKY BUSINESS MODEL

The basic business model for wholesaling is pretty straightforward. It usually involves distressed properties. It is perhaps most easily described through the use of a hypothetical. Assume that Sam Smith wishes to make money from real estate but has very little spare cash. He uses his funds to solicit the purchase of properties from persons who have a need to sell. He places signs in his area indicating that he will buy homes for cash. He also sends out letters to persons who may be highly motivated to sell, such as persons whose residences are in foreclosure. His efforts result in him being contacted by the owner of 123 Elm Street who needs to sell her property as soon as possible. Sam enters into a purchase agreement with the owner to purchase the property for \$30,000 cash within thirty days. The purchase agreement contains a clause which permits Sam to assign his position as buyer to a third party without the consent of the owner. Further, the purchase agreement contains a contingency which permits Sam to lawfully terminate the purchase agreement at any time during the 30-day period, typically by using an inspection period which runs for all 30 days.

Upon entering into the purchase agreement, Sam immediately begins marketing 123 Elm Street to third parties. He contacts known possible investors, advertises over the internet and places a sign in the yard of 123 Elm Street. His goal is to find a third party who will buy 123 Elm Street for \$35,000. If Sam can find such a person, he will assign his interest in his purchase agreement with the owner and pocket the \$5,000 difference. If he cannot find such a cash buyer within the 30-day period, he will exercise the contingency in the purchase agreement and terminate his transaction with the owner.

A number of Realtors® have asked whether wholesaling is lawful and if so, what are the rules? At the outset, Realtors® who are considering this business model should recognize the

optics. It is certainly true that as a general matter, contracts are enforced as written. On the other hand, many would argue that no property owner would ever enter into this type of transaction if they actually understood it. That is, no one would agree to sell their property if they understood that the only way their buyers will go through with the transaction is if they find someone willing to pay them more. Many persons looking at this transaction would assume that there must have been some type of deception that would cause a property owner to enter into such a one-sided contract. The fact that the property owner was facing foreclosure or otherwise in financial distress adds support to this view.

But, before we discuss possible challenges to the overall business model, there are a number of hard and fast rules. Realtors® involved in wholesale transactions must, at a minimum, strictly comply with the following rules:

1. Assuming Sam does more than 5 of these types of deals during a 12-month period, he must have a real estate license.

2. When Sam approaches the owner of 123 Elm Street, Sam must make very clear at the outset that Sam is not there as a potential agent for the seller, but on his own behalf. If an agency relationship is established, even for a brief period of time, it cannot later be “converted” into a wholesale transaction without full disclosure – “I am only going to buy this property from you if I find someone that will pay me more than I am paying you.”

3. Sam may not provide the owner with a market analysis or otherwise offer an opinion as to the value of the property.

4. Sam must disclose to the owner in writing that he is a real estate licensee before he enters into a purchase agreement to buy 123 Elm Street.

5. When advertising the home for resale, Sam must do that in the name of, and under the supervision of, his real estate broker. At all times, it must be clear that the broker's "client" in this transaction is Sam and not the current owner of 123 Elm Street.

Even assuming that Sam and his broker can successfully establish that they complied with all of the above requirements, the wholesale transaction is still subject to challenge. Again, while it is certainly true that one party to a contract has no duty to explain the contract or disclose their motives to the other side of the contract, a contract that has been "fraudulently induced" will not be enforced.

There are also additional issues raised by Sam's status as a real estate licensee. In our hypothetical, while Sam is a real estate licensee, he is not working as an agent for the owner of 123 Elm Street. Certainly, a court looking at this transaction would require that it have been made clear to the owner of 123 Elm Street from the outset that Sam was representing himself and was not looking out for her interests. Assuming that Sam can get past this hurdle, the question becomes whether a court would hold Sam to some higher standard as a result of his status as a real estate licensee.

The Occupational Code contains a number of provisions aimed at making certain that real estate licensees do not use their expertise to take advantage of buyers and sellers. Rule 333(1), for example, precludes a licensee from "directly or indirectly" misrepresenting material facts. Under the wholesaling business model, at the time Sam enters into the purchase agreement with the owner of 123 Elm Street, he has no intention of fulfilling the terms of the purchase agreement unless he successfully finds a third-party buyer within the 30-day period. If Sam does not disclose this fact to the owner of 123 Elm Street at the time he makes the offer, it could be

argued that he has at least indirectly misrepresented a material fact, *i.e.*, he will walk away if he cannot find a third-party buyer. It is also the case that someone could argue that this type of transaction – by which the owner agrees to a base price and the real estate licensee receives everything above and beyond that base amount – is nothing more than a disguised net listing arrangement which, of course, is prohibited by the Occupational Code.

Finally, Realtors® and their brokers should understand that because there is no agency relationship between the broker and the owner of 123 Elm Street, if she sues, it is unlikely that the broker's errors and omissions insurance policy will cover her claim. As a general matter, claims arising out of the purchase of property by an agent are excluded from coverage.

Conclusion

Absent some type of fraudulent inducement, contracts are enforceable as written even if extremely one-sided. Under this general rule of law, a buyer can enter into a real estate purchase contract that is terminable at will at any time prior to closing. But a person holding a real estate license who approaches a seller is in a different position. The Occupational Code imposes certain obligations on a real estate licensee designed to protect sellers. Compliance with these requirements arguably makes it harder for a real estate licensee to act as a wholesaler than it is for a non-licensee. And, of course, a person who engages in more than five real estate sales in a 12-month period must have a real estate license.

This article is intended to reach not only licensed salespersons who are engaging in wholesaling or thinking about doing so, but also the brokers with whom they are affiliated. Under Michigan law, brokers are generally required to supervise the salespersons affiliated with them and may be held responsible for a salesperson's failure to comply with the law. It is also

the case that a claim based upon an agent's wholesaling activities is likely not covered by the broker's insurance. For these reasons, brokers should concern themselves with the wholesaling activities of their salespersons.

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