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Fundamentals of Contract Law

Contract Validity and Enforceability

Contract Creation

Classifications of Contracts

Contract Termination

Real estate contracts are the legal agreements that underlie the transfer and financing of real estate, as well as the real estate brokerage business. Sale and lease contracts and option agreements are used to transfer real estate interests from one party to another. Mortgage contracts and promissory agreements are part of financing real estate. Listing and representation contracts establish client relationships and provide for compensation.

In order to work with real estate contracts, it is imperative first to grasp basic concepts that apply to all contracts in general. These concepts provide a foundation for understanding the specifics of particular types of real estate contract.

CONTRACT VALIDITY AND ENFORCEABILITY

Legal status of contracts

Criteria for validity

Validity of a conveyance contract

Enforcement limitations

Electronic contracting

A **contract** is an agreement between two or more parties who, in a "meeting of the minds," have pledged to perform or refrain from performing some act. A *valid* contract is one that is *legally enforceable* by virtue of meeting certain requirements of contract law. If a contract does not meet the requirements, it is not valid and the parties to it cannot resort to a court of law to enforce its provisions.

Note that a contract is not a legal form or a prescribed set of words in a document, but rather the intangible agreement that was made in "the meeting of the minds" of the parties to the contract.

Legal status of contracts

In terms of validity and enforceability, a court may construe the legal status of a contract in one of four ways:

- ▶ valid
- ▶ valid but unenforceable
- ▶ void
- ▶ voidable

Valid. A valid contract is one which meets the legal requirements for validity. These requirements are explained in the next section.

A valid contract that is in writing is enforceable within a statutory time period. A valid contract that is made orally is also generally enforceable within a statutory period, with the exceptions noted below.

Valid but unenforceable. State laws declare that some contracts are enforceable only if they are in writing. These laws apply in particular to the transfer of interests in real estate. Thus, while an oral contract may meet the tests for validity, if it falls under the laws requiring a written contract, the parties will not have legal recourse to enforce performance. An oral long-term lease and an oral real estate sales contract are examples of contracts that may be valid but not enforceable.

Note that such contracts, if valid, remain so even though not enforceable. This means that if the parties fully execute and perform the contract, the outcome may not be altered.

Void. A void contract is an agreement that does not meet the tests for validity, and therefore is no contract at all. If a contract is void, neither party can enforce it.

For example, a contract that does not include consideration is void. Likewise, a contract to extort money from a business is void. Void contracts and instruments are also described as "null and void."

Voidable. A voidable contract is one which initially appears to be valid, but is subject to rescission by a party to the contract who is deemed to have acted under some kind of disability. Only the party who claims the disability may rescind the legal effect of the contract.

For example, a party who was the victim of duress, coercion, or fraud in creation of a contract, and can prove it, may disaffirm the contract. However, the disaffirmation must occur within a legal time frame for the act of rescission to be valid. Similarly, if the party who has cause to disaffirm the contract elects instead to perform it, the contract is no longer voidable but valid.

A voidable contract differs from a void contract in that the latter does not require an act of disaffirmation to render it unenforceable.

Criteria for validity

A contract is valid only if it meets all of the following criteria.

Exhibit 10.1 Contract Validity Requirements



Competent parties. The parties to a contract must have the capacity to contract, and there must be at least two such parties. Thus, the owner of a tenancy for life cannot deed his interest to himself in the form of a fee simple, as this would involve only one party. Capacity to contract is determined by three factors:

- ▶ legal age
- ▶ mental competency
- ▶ legitimate authority

Depending on state law, a contract involving a minor as a party may be either void or voidable. If the law allows a minor to contract, the contract will generally be voidable and the minor can disaffirm the contract.

To be mentally competent, a party must have sufficient understanding of the import and consequences of a contract. Competency in this context is separate and distinct from sanity. Incompetent parties, or parties of "unsound mind," may not enter into enforceable contracts. The incompetency of a party may be ruled by a court of law or by other means. In some areas, convicted felons may be deemed incompetent, depending on the nature of the crime.

During the period of one's incompetency, a court may appoint a guardian who may act on the incompetent party's behalf with court approval.

If the contracting party is representing another person or business entity, the representative must have the *legal authority* to contract. If representing another person, the party must have a bona fide power of attorney. If the contracting party is representing a corporation, the person must have the appropriate power

and approval to act, such as would be conferred in a duly executed resolution of the Board of Directors. If the contracting entity is a general partnership, any partner may validly contract for the partnership. In a limited partnership, only general partners may be parties to a contract.

Mutual consent. Mutual consent, also known as *offer and acceptance* and *meeting of the minds*, requires that a contract involve a clear and definite offer and an intentional, unqualified acceptance of the offer. In effect, the parties must agree to the terms without equivocation. A court may nullify a contract where the acceptance of terms by either party was partial, accidental, or vague.

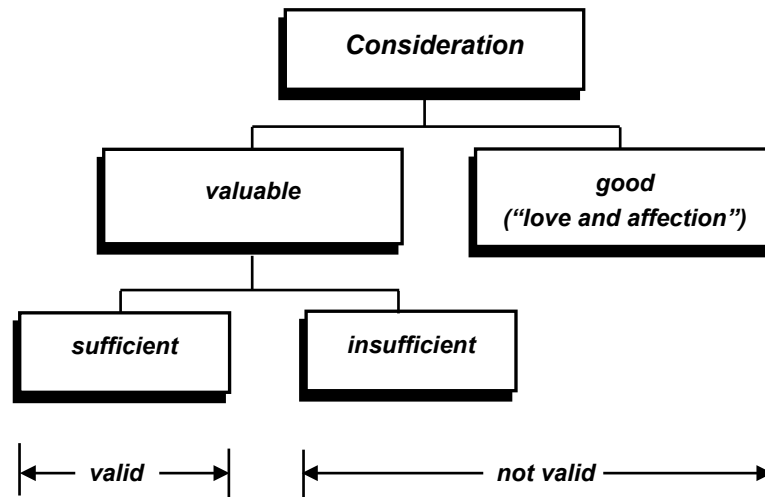
Valuable consideration. A contract must contain a two-way exchange of valuable consideration as compensation for performance by the other party. The exchange of considerations must be two-way. The contract is not valid or enforceable if just one party provides consideration.

Valuable consideration can be something of tangible value, such as money or something a party promises to do or not do. For example, a home builder may promise to build a house for a party as consideration for receiving money from the home buyer. Or, a landowner may agree not to sell a property as consideration for a developer's option money. Also, valuable consideration can be something intangible that a party must give up, such as a homeowner's occupancy of the house in exchange for rent. In effect, consideration is the price one party must pay to obtain performance from the other party.

Valuable consideration may be contrasted with good consideration, or "love and affection," which does not qualify as consideration in a valid contract. Good consideration is something of questionable value, such as a child's love for her mother. Good consideration disqualifies a contract because, while one's love or affection is certainly valuable to the other party, it is not something that is specifically offered in exchange for something else. Good consideration can, however, serve as a nominal consideration in transferring a real property interest as a gift.

In some cases, what is promised as valuable consideration must also be deemed to be *sufficient* consideration. Grossly insufficient consideration, such as \$50,000 for a \$2 million property, may invalidate a contract on the grounds that the agreement is a gift rather than a contract. In other cases where there is an extreme imbalance in the considerations exchanged, a contract may be invalidated as a violation of good faith bargaining.

Exhibit 10.2 Consideration



Legal purpose. The content, promise, or intent of a contract must be lawful. A contract that proposes an illegal act is void.

Voluntary, good faith act. The parties must create the contract in good faith as a free and voluntary act. A contract is thus voidable if one party acted under duress, coercion, fraud, or misrepresentation.

For example, if a property seller induces a buyer to purchase a house based on assurances that the roof is new, the buyer may rescind the agreement if the roof turns out to be twenty years old and leaky.

Validity of a conveyance contract

In addition to satisfying the foregoing requirements, a contract that conveys an interest in real estate must:

- ▶ be in writing
- ▶ contain a legal description of the property
- ▶ be signed by one or more of the parties

A lease contract that has a term of one year or less is an exception. Such leases do not have to be in writing to be enforceable.

Enforcement limitations

Certain contracts that fail to meet the validity requirements are voidable if a damaged party takes appropriate action. The enforcement of voidable contracts, however, is limited by **statutes of limitation**. Certain other contracts which are valid may not be enforceable due to the **statute of frauds**.

Statute of limitations. The statute of limitations restricts the time period for which an injured party in a contract has the right to rescind or disaffirm the contract. A party to a voidable contract must act within the statutory period.

Statute of frauds. The statute of frauds requires that certain contracts *must be in writing* to be enforceable. Real estate contracts that convey an interest in

real property fall in this category, with the exception that a lease of one year's duration or less may be oral. All other contracts to buy, sell, exchange, or lease interests in real property must be in writing to be enforceable. In addition, *listing agreements* in most states must be in writing.

The statute of frauds concerns the enforceability of a contract, not its validity. Once the parties to a valid oral contract have executed and performed it, even if the contract was unenforceable, a party cannot use the Statute of Frauds to rescind the contract.

For example, a broker and a seller have an oral agreement. Following the terms of the agreement, the broker finds a buyer, and the seller pays the commission. They have now executed the contract, and the seller cannot later force the broker to return the commission based on the statute of frauds.

Electronic contracting

Contracting electronically through email and fax greatly facilitates the completion of transactions. Clients, lenders, title agents, inspectors, brokers, and other participants in a transaction can quickly share documentation and information. Electronic contracting is made possible by the Uniform Electronic Transactions Act (UETA) and the Electronic Signatures in Global and National Commerce Act (E-Sign), which are federal laws. UETA, which has been accepted in most states, provides that electronic records and signatures are legal and must be accepted. E-Sign makes contracts, records, and signatures legally enforceable, regardless of medium, even where UETA is not accepted.

CONTRACT CREATION

Offer and acceptance
Counteroffer
Revocation of an offer
Termination of an offer
Assignment of a contract
Contract preparation

Offer and acceptance

The mutual consent required for a valid contract is reached through the process of offer and acceptance: The **offeror** proposes contract terms in an **offer** to the **offeree**. If the offeree accepts all terms without amendment, the offer becomes a contract. The exact point at which the offer becomes a contract is when the offeree gives the offeror notice of the acceptance.

Exhibit 10.3 Offer, Counter Offer and Acceptance



Offer. An offer expresses the offeror's intention to enter into a contract with an offeree to perform the terms of the agreement in exchange for the offeree's performance. In a real estate sale or lease contract, the offer must clearly contain all intended terms of the contract in writing and be communicated to the offeree.

If an offer contains an expiration date and the phrase "time is of the essence," the offer expires at exactly the time specified. In the absence of a stated time period, the offeree has a "reasonable" time to accept an offer.

Acceptance. An offer gives the offeree the power of accepting. For an acceptance to be valid, the offeree must manifestly and unequivocally accept all terms of the offer without change, and so indicate by signing the offer, preferably with a date of signing. The acceptance must then be communicated to the offeror. If the communication of acceptance is by mail, the offer is considered to be communicated as soon as it is placed in the mail.

Counteroffer

By changing any of the terms of an offer, the offeree creates a counteroffer, and the original offer is void. At this point, the offeree becomes the offeror, and the new offeree gains the right of acceptance. If accepted, the counteroffer becomes a valid contract provided all other requirements are met.

For example, a seller changes the expiration date of a buyer's offer by one day, signs the offer and returns it to the buyer. The single amendment extinguishes the buyer's offer, and the buyer is no longer bound by any agreement. The seller's amended offer is a counteroffer which now gives the buyer the right of

acceptance. If the buyer accepts the counteroffer, the counteroffer becomes a binding contract.

Revocation of an offer

An offer may be revoked, or withdrawn, at any time before the offeree has communicated acceptance. The revocation extinguishes the offer and the offeree's right to accept it.

For example, a buyer has offered to purchase a house for the listed price. Three hours later, a family death radically changes the buyer's plans. She immediately calls the seller and revokes the offer, stating she is no longer interested in the house. Since the seller had not communicated acceptance of the offer to the buyer, the offer is legally cancelled.

If the offeree has paid consideration to the offeror to leave an offer open, and the offeror accepts, an option has been created which cancels the offeror's right to revoke the offer over the period of the option.

Termination of an offer

Any of the following actions or circumstances can terminate an offer:

- ▶ acceptance: the offeree accepts the offer, converting it to a contract
- ▶ rejection: the offeree rejects the offer
- ▶ revocation: the offeror withdraws the offer before acceptance
- ▶ lapse of time: the offer expires
- ▶ counteroffer: the offeree changes the offer
- ▶ death or insanity of either party

Assignment of a contract

A real estate contract that is not a personal contract for services can be assigned to another party unless the terms of the agreement specifically prohibit assignment.

Listing agreements, for example, are not assignable, since they are personal service agreements between agent and principal. Sales contracts, however, are assignable, because they involve the purchase of real property rather than a personal service.

Contract preparation

State laws define the extent to which real estate brokers and agents may legally prepare real estate contracts. Such laws, referred to as "broker-lawyer accords," also define what types of contracts brokers and agents may prepare. In some states, brokers and agents may not draft contracts, but they may use standard promulgated forms and complete the blanks in the form.

As a rule, a broker or agent who completes real estate contracts is engaging in the unauthorized practice of law unless the broker is a party to the agreement, such as in a listing agreement or sales contract. Brokers and agents may not complete leases, mortgages, contracts for deed, or promissory notes to which they are not a party.

Agents must be fully aware of what they are legally allowed to do and not do in preparing and interpreting contracts for clients. In addition to practicing law without a license, agents expose themselves to lawsuits from clients who relied on a contract as being legally acceptable.

CLASSIFICATIONS OF CONTRACTS

Oral vs. written
Express vs. implied
Unilateral vs. bilateral
Executed vs. executory

Oral vs. written A contract may be in writing or it may be an oral, or **parol**, contract. Certain oral contracts are valid and enforceable, others are not enforceable, even if valid. For example, most states require listing agreements, sales contracts, and leases exceeding one year to be in writing to be enforceable.

Express vs. implied An **express contract** is one in which all the terms and covenants of the agreement have been manifestly stated and agreed to by all parties, whether verbally or in writing.

An **implied contract** is an unstated or unintentional agreement that may be deemed to exist when the *actions of any of the parties* suggest the existence of an agreement.

A common example of an implied contract is an implied agency agreement. In implied agency, an agent who does not have a contract with a buyer performs acts on the buyer's behalf, such as negotiating a price that is less than the listing price. In so doing, the agent has possibly created an implied contract with the buyer, albeit unintended. If the buyer compensates the agent for the negotiating efforts, the existence of an implied agency agreement becomes even less disputable.

Bilateral vs. unilateral

A **bilateral contract** is one in which both parties promise to perform their respective parts of an agreement in exchange for performance by the other party.

An example of a bilateral contract is an exclusive listing: the broker promises to exercise due diligence in the efforts to sell a property, and the seller promises to compensate the broker when and if the property sells.

In a **unilateral contract**, only one party promises to do something, provided the other party does something. The latter party is not obligated to perform any act, but the promising party must fulfill the promise if the other party chooses to perform.

An option is an example of a unilateral contract: in an option-to-buy, the party offering the option (optionor) promises to sell a property if the optionee decides to exercise the option. While the potential buyer does not have to buy, the owner must sell if the option is exercised.

Executed vs. executory

An **executed contract** is one that has been fully performed and fulfilled: neither party bears any further obligation. A completed and expired lease contract is an executed contract: the landlord may re-possess the premises and the tenant has no further obligation to pay rent.

An **executory contract** is one in which performance is yet to be completed. A sales contract prior to closing is executory: while the parties have agreed to buy and sell, the buyer has yet to pay the seller and the seller has yet to deed the property to the buyer.

CONTRACT TERMINATION

Forms of contract termination Breach of contract

Forms of contract termination

Termination of a contract, also called **cancellation** and **discharge**, may occur for any of the following causes.

Performance. A contract terminates when fully performed by the parties. It may also terminate for:

- ▶ partial performance, if the parties agree
- ▶ sufficient performance, if a court determines a party has sufficiently performed the contract, even though not to the full extent of every provision

Infeasibility. An otherwise valid contract can be canceled if it is not possible to perform. Certain personal services contracts, for example, depend on the unique capabilities of one person which cannot be substituted by someone else. If such a person dies or is sufficiently disabled, the contract is cancelable.

Mutual agreement. Parties to a contract can agree to terminate, or renounce, the contract. If the parties wish to create a new contract to replace the cancelled contract, they must comply with the validity requirements for the new contract. Such substitution is called **novation**.

Cooling-period rescission. Rescission is the act of nullifying a contract. In many states, parties to certain contracts are allowed a statutory amount of time after entering into a contract, or "cooling period", to rescind the contract without cause. No reason need be stated for the cancellation, and the cancelling party incurs no liability for performance.

For example, consider the unsuspecting buyer of a lot in a new resort development. Such buyers are often the targets of hard-sell tactics which lead to a completed sales contract and a deposit. The statutory cooling period gives the buyer an opportunity to reconsider the investment in the absence of the persistent salesperson.

Revocation. Revocation is cancellation of the contract by one party without the consent of the other. For example, a seller may revoke a listing to take the property off the market. While all parties have the *power* to revoke, they may not have a defensible *right*. In the absence of justifiable grounds, a revocation may not relieve the revoking party of contract obligations.

For example, a seller who revokes a listing without grounds may be required to pay a commission if the broker found a buyer, or reimburse the broker's marketing expenses if no buyer was found.

Abandonment. Abandonment occurs when parties fail to perform contract obligations. This situation may allow the parties to cancel the contract.

Lapse of time. If a contract contains an expiration provision and date, the contract automatically expires on the deadline.

Invalidity of contract. If a contract is void, it terminates without the need for disaffirmation. A voidable contract can be cancelled by operation of law or by rescission.

Breach of contract

A breach of contract is a failure to perform according to the terms of the agreement. Also called **default**, a breach of contract gives the damaged party the right to take legal action.

The damaged party may elect the following legal remedies:

- ▶ rescission
- ▶ forfeiture
- ▶ suit for damages
- ▶ suit for specific performance

Rescission. A damaged party may rescind the contract. This cancels the contract and returns the parties to their pre-contract condition, including the refunding of any monies already transferred.

Forfeiture. A forfeiture requires the breaching party to give up something, according to the terms of the contract. For example, a buyer who defaults on a sales contract may have to forfeit the earnest money deposit.

Suit for damages. A damaged party may sue for money damages in civil court. The suit must be initiated within the time period allowed by the statute of limitations. When a contract states the total amount due to a damaged party in the event of a breach, the compensation is known as **liquidated damages**. If the contract does not specify the amount, the damaged party may sue in court for **unliquidated damages**.

Suit for specific performance. A suit for specific performance is an attempt to force the defaulting party to comply with the terms of the contract. Specific performance suits occur when it is difficult to identify damages because of the unique circumstances of the real property in question. The most common instance is a defaulted sale or lease contract where the buyer or seller wants the court to compel the defaulting party to go through with the transaction, even when the defaulter would prefer to pay a damage award.

10 Fundamentals of Contract Law Snapshot Review

CONTRACT VALIDITY AND ENFORCEABILITY

Legal status of contracts

- contract: mutual promises based on "meeting of the minds" to do or refrain from doing something; potentially enforceable if created validly
- valid: meets criteria
- void: does not meet criteria
- voidable: invalid if disaffirmed
- valid yet unenforceable: certain oral contracts

Criteria for validity

- competent parties; mutual consent; valuable consideration; legal purpose; voluntary, good faith act

Validity of a conveyance contract

- must be in writing; contain a legal description; be signed by one or more parties

Enforcement limitations

- statute of frauds: must be written to be enforceable
- statute of limitations: must act within time frame

Electronic contracting

- federal law: electronic records and signatures are legal and must be accepted; enforceable regardless of medium

CONTRACT CREATION

Offer and acceptance

- valid offer and valid acceptance creates contract
- offer becomes contract on communication of acceptance by offeree to offeror

Counteroffer

- any offer in response to an offer or any altered original offer; nullifies original offer

Revocation of an offer

- offeror may revoke offer prior to communication of acceptance by offeree

Termination of an offer

- acceptance; rejection; revocation; expiration; counteroffer; death or insanity

Assignment of a contract

- assignable unless expressly prohibited or a personal service

Contract preparation

- restricted unless licensed as attorney or a party to the contract

CLASSIFICATIONS OF CONTRACTS

- oral or written; express or implied; unilateral or bilateral; executed or executory

CONTRACT TERMINATION

Forms of contract termination

- performance; infeasibility; mutual agreement; cooling-period rescission; revocation; abandonment; lapse of time; invalidity of contract; breach of contract

Breach of contract

- default without cause
- legal remedies: rescission; forfeiture; suit for damages; specific performance