Introduction

Every time you are involved in a real estate transaction, you will use a contract that transfers or indicates an interest in the property. It is important that you understand the nature of legal agreements, so you are able to explain them to your clients and customers as part of your role as a real estate licensee. This unit explains what a contract is and how contracts are used to assure the understanding and approval of all parties to an agreement.

Learning Objectives

After reading this unit, you should be able to:

• define contract.
• discuss the legal requirements for an enforceable contract.
• describe performance of contracts and give two examples.
• explain statute of frauds.
• identify the remedies for breach of contract.
Contracts in General

A **contract** is a legally enforceable agreement made by competent parties, to perform or not perform a certain act. It may be an **express contract**, in which the parties declare the terms and put their intentions in words, either oral or written. A lease or rental agreement, for example, is an express contract. The landlord agrees to allow the tenant to live in the apartment and the tenant agrees to pay rent in return.

A contract may be an **implied contract** in which agreement is shown by act and conduct rather than words. We create a contract when we go into a restaurant and order food, go to a movie, or have a daily newspaper delivered. By showing a desire to use a service, we imply that we will pay for it.

Contracts may be bilateral or unilateral. A **bilateral contract** is an agreement in which each person promises to perform an act in exchange for another person’s promise to perform. In other words, both parties must keep their agreement for the contract to be completed. An example might be a promise from a would-be pilot to pay $2,500 for flying lessons, and a return promise from the instructor to teach him or her to fly.

A **unilateral contract** is a contract in which a party promises to perform without expectation of performance by the other party. The second party is not bound to act, but if he or she does, the first party is obligated to keep the promise. An example might be a radio station offering $1,000 to the 100th caller. Some lucky person makes the call and the station pays the money. An option is another example of a unilateral contract.

A contract may be executory or executed. In an **executory contract**, something remains to be performed by one or both parties. An escrow that is not yet closed, or a contract not signed by the parties are examples of executory contracts. In an **executed contract**, all parties have performed completely. One of the meanings of execute is to sign, or complete in some way. An executed contract may be a sales agreement signed by all parties.

Contracts may be void, voidable, unenforceable, or valid. A **void contract** is no contract at all or no legal effect (to lack of capacity, illegal subject matter). A **voidable contract** is valid and enforceable on its face, but may be rejected by one or more of the parties (induced by fraud, menace, duress). An **unenforceable contract** is valid, but for some reason cannot be proved by one or both of the parties (an oral agreement should be in writing because of the statute of frauds). A **valid contract** that is binding and enforceable has all the basic elements required by law.
Basic Elements of All Contracts

In order for a contract to be legally binding and enforceable, there are four requirements: (1) legally competent parties, (2) mutual consent between the parties, (3) lawful objective, and (4) sufficient consideration.

Legally Competent Parties

Parties entering into a contract must have legal capacity to do so. Almost anyone is capable, with a few exceptions. A person must be at least 18 years of age unless married, in the military, or declared emancipated by the court.

A minor is not capable of appointing an agent, or entering into an agency agreement with a broker to buy or sell. Brokers dealing with minors should proceed cautiously and should seek an attorney’s advice. A contract with a minor is considered voidable by the minor.

When it has been determined judicially that a person is not legally competent, the contract made by that person is terminated. If it is obvious that a person is not legally competent there can be no contract. In the case of a person who is not legally competent, a court-appointed guardian would have legal capacity to contract. Both minors and people who are not legally competent may acquire title to real property by gift or inheritance. However, any transfer of acquired property must be court approved.

A contract made by a person who is intoxicated or under the influence of legal or illegal drugs can be cancelled when the individual sobers up. Or the contract may be ratified (approved after the fact) depending on the parties.

Any person may give another the authority to act on his or her behalf. The legal document that does this is called a power of attorney. The person holding the power of attorney is an attorney-in-fact. When dealing with real property, a power of attorney must be recorded to be valid, and is good for as long as the principal is competent. A power of attorney can be cancelled by the principal at any time by recording a revocation. A power of attorney is useful, for example, when a buyer or seller is out of town and has full trust in that agent to operate on his or her behalf.

Mutual Consent Between the Parties

In a valid contract, all parties must mutually agree. Mutual consent (or mutual assent), is sometimes called a meeting of the minds. It is an offer by one party and acceptance by the other party.
Offer

An offer shows the contractual intent of the offeror, or the person making the offer, to enter into a contract. That offer must be communicated to the offeree, or the person to whom the offer is being made. Unconditional acceptance of the offer is necessary for all parties to be legally bound. The offer must be definite and certain in its terms, and the agreement must be genuine or the contract may be voidable by one or both parties.

Acceptance

One party must offer and another must accept, without condition. An acceptance is an unqualified agreement to the terms of an offer. The offeree must agree to every item of the offer for the acceptance to be complete. If the original terms change in any way in the acceptance, the offer becomes a counteroffer, and the first offer terminates. The person making the original offer is no longer bound by that offer, and may accept the counteroffer or not. The counteroffer becomes a new offer, made by the original offeree. Acceptance of an offer must be communicated to the offeror, in the manner specified, before a contract becomes binding between the parties. The seller may rescind an offer prior to acceptance. Silence is not considered to be acceptance.

Termination

An offeror expects that his or her offer will be accepted in a timely manner and a contract created. An offer is specific, and an offeror does not have to wait indefinitely for an answer.

Review - Termination of an Offer

- Lapse of time: an offer is revoked if the offeree fails to accept it within a prescribed period
- Communication of notice of revocation: notice is filed by the offeror anytime before the other party has communicated acceptance
- Failure of offeree to fulfill a condition of acceptance prescribed by the offeror
- A qualified acceptance, or counteroffer by the offeree
- Rejection by the offeree
- Death or insanity of the offeror or offeree
- Unlawful object of the proposed contract
Genuine Assent

A final requirement for mutual consent is that the offer and acceptance be genuine and freely made by all parties. **Genuine assent** does not exist if there is fraud, misrepresentation, mistake, duress, menace, or undue influence involved in reaching an agreement.

**Fraud**

An act meant to deceive in order to get someone to part with something of value is called **fraud**. An outright lie, or making a promise with no intention of carrying it out, can be fraud. Lack of disclosure—causing someone to make or accept an offer—is also fraud. For example, failure to tell a prospective buyer that the roof leaks when he or she makes an offer to purchase on a sunny day is fraud. It can make the contract voidable.

**Innocent Misrepresentation**

When the person unknowingly provides wrong information, **innocent misrepresentation** occurs. Even though no dishonesty is involved, a contract may be rescinded or revoked by the party who feels misled. The **hold harmless clause** protects the broker from incorrect information.

**Mistake**

In contract law, **mistake** means an agreement was unclear or there was a misunderstanding in the facts. Mistake does not include ignorance, incompetence, or poor judgment. For example, you accepted an offer to purchase a home on what you thought was an all cash offer. Later you found that you had agreed to carry a second trust deed. Even though you made a mistake in reading the sales contract, you now have a binding agreement.

There are times when ambiguity creates a misunderstanding, and ultimately you void the contract. For instance, you were given directions to a friend’s beach house, went there on your own, and fell in love with the home. You immediately made an offer, which was accepted, only to discover you had gone to the wrong house. Because you thought you were purchasing a different property than the one the seller was selling, this mistake is a major misunderstanding of a material fact, and therefore would void any signed contract.

**Duress**

Use of force, known as **duress** or **menace**, which is the threat of violence, cannot be used to get agreement.
**Undue Influence**

Undue influence or using unfair advantage is also unacceptable. All can result in a contract to be voidable by the injured party.

**Review - No Genuine Assent If The Contract Involves:**
- fraud
- misrepresentation
- mistake
- duress or menace
- undue influence

**Lawful Objective**

Even though the parties are capable, and mutually agreeable, the object of the contract must be lawful. A contract requiring the performance of an illegal act would not be valid, nor would one in which the consideration was stolen.

The contract also must be legal in its formation and operation. For example, a note bearing an interest rate in excess of that allowed by law would be void. Contracts contrary to good morals and general public policy are also unenforceable.

**Sufficient Consideration**

There are several types of consideration one can use in a contract. Generally, consideration is something of value, such as a promise of future payment, money, property, or personal services. For example, there can be an exchange of a promise for a promise, money for a promise, money for property, or goods for services. Legally, all contracts require acceptable consideration. Terms that denote acceptable consideration include valuable, adequate, good, or sufficient consideration.

Forbearance, or forgiving a debt or obligation, or giving up an interest or a right, qualifies as valuable consideration. Gifts, such as real property based solely on love and affection are good consideration. They meet the legal requirement that consideration be present in a contract.

In an option, the promise of the offeror is the consideration for the forbearance desired from the offeree. In other words, the person wanting the option promises to give something of value in return for being able to exercise the option to purchase at some specifically named time in the future.
In a bilateral contract, a promise of one party is consideration for the promise of another. For example, in the sale of real property, the buyer promises to pay a certain amount and the seller promises to transfer title.

Note: The earnest money given at the time of an offer is not the consideration for the sale. It is simply an indication of the buyer’s intent to perform the contract, and may be used for damages, even if the buyer backs out of the sale.

## Contracts That Must Be In Writing

In California, the statute of frauds requires that certain contracts be in writing to prevent fraud in the sale of land or an interest in land. Included in this are offers, acceptances, loan assumptions, land contracts, deeds, escrows, and options to purchase. Trust deeds, promissory notes, and leases for more than one year also must be in writing to be enforceable.

### Statute of Frauds

Most contracts required by law to be in writing are under the **statute of frauds**. The statute adopted in England in 1677 became part of English common law. Later, it was introduced to this country and is now part of California’s law. The statute’s primary purpose is to prevent forgery, perjury, and dishonest conduct on the part of unethical people against citizens. Thus, it improves the existence and terms of certain important types of contracts.

The law provides that certain contracts are invalid unless they are in writing and signed by either the parties involved or their agents. The California Civil Code lists the contracts that must be in writing to be enforceable.

### Contracts That Must Be In Writing

- Any agreement in which the terms are not to be performed within a year from making the contract
- A special promise to answer for the debt, default or no performance of another, except in cases covered by the Civil Code
- An agreement made upon the consideration of marriage, other than a mutual promise to marry
- An agreement to lease real property for a period longer than one year, or to sell real property or an interest therein; also, any agreement authorizing an agent to perform the above acts
- An agreement employing an agent, broker or any other person to purchase, sell or lease real estate for one year; or find a buyer, seller, lessee or lessor for more than one year in return for compensation
The statute of frauds also affects personal property. Personal property valued at more than $500 must be accompanied by a written bill of sale.

**Parol Evidence Rule**

When two parties make verbal promises to each other, and then write and sign a contract promising something different, the written contract will be considered the valid one. Parol means oral, or by word of mouth. The *parol evidence rule* extends this meaning and prohibits introducing any kind of outside evidence to vary or add to the terms of deeds, contracts or other writings once executed. Under the parol evidence rule, when a contract is intended to be the parties’ complete and final agreement, no further outside promises, oral or written, are allowed. Occasionally a contract is ambiguous or vague. Then the courts will allow use of prior agreements to clarify an existing disputed contract.

One of a real estate licensee’s main duties is to make sure all contract language conveys the parties’ wishes and agreements. Oral agreements have caused much confusion and bad feelings over the years, particularly in real estate. Even a lease for less than one year should be in writing, though the statute of frauds does not require it. *(A lease for one or more years must be in writing).* It is easy to forget verbal agreements. A written contract is the most reasonable way to ensure mutual assent.

**Preprinted Forms**

What about using and changing preprinted real estate forms? If the parties involved want to make handwritten changes and initial them, those changes control the document.

**Precedence When Using Preprinted Forms**

- Specific information takes precedence over general information.
- Typed clauses and insertions take precedence over the preprinted material.
- Handwritten clauses and insertions take precedence over the typed and preprinted material.
Discharge of Contracts

Discharge of contract refers to the cancellation or termination of a contract. Contracts are discharged by performance, release, assignment, novation, and breach.

Performance

Commonly the discharge of a contract occurs when the contract has been fully performed.

Tender of Performance

A tender of performance is an offer by one of the parties to carry out his or her part of the contract. Usually, a tender is made at the time to close escrow. The person to whom the tender is made must state any objections at that time or they are waived. A waiver is the relinquishment or refusal to accept a right. A person must take advantage of his or her rights at the proper time. If they do not, they give up (waive) their rights. A tender of performance by the buyer, for example, by depositing the purchase money into escrow, places the seller in default, if the seller refuses to accept it and deliver a deed. The buyer could rescind the transaction, or sue for breach of contract or for specific performance. Specific performance is a court action brought about by one party to force the other (breaching) party to fulfill the conditions of the contract.

Release

The person in the contract to whom an obligation is owed may release the other party from the obligation to perform the contract.

Mutual Rescission

A mutual rescission occurs when all parties to a contract agree to cancel the agreement.

Assignment

An assignment will transfer all the interests of the assignor (principal) to the assignee. The assignee takes over the assignor’s rights, remedies, benefits, and duties in the contract. In this situation, the assignor is not completely released from the obligations for the contract and remains secondarily liable.

Novation

If the assignor wants to be released entirely from any obligation for the contract, it may be done by novation. That is the substitution, by agreement, of a
new obligation for an existing one, with the intent to extinguish the original contract. For example, novation occurs when a buyer assumes a seller’s loan, and the lender releases the seller from the loan contract by substituting the buyer’s name on the loan.

**Breach**

Occasionally the result is a breach of contract, in which someone does not fulfill the agreement. A breach of contract is a failure to perform on part or all of the terms and conditions of a contract. A person harmed by non-performance can accept the failure to perform or has a choice of three remedies: unilateral rescission, lawsuit for money damages, or lawsuit for specific performance.

**Unilateral Rescission**

Unilateral rescission is available to a person who enters a contract without genuine assent because of fraud, mistake, duress, menace, undue influence, or faulty consideration. Rescission may be used as a means of discharging a contract by agreement, as we have mentioned.

If one of the parties has been wronged by a breach of contract that innocent party can stop performing all obligations as well, therefore unilaterally rescinding the contract. It must be done promptly, restoring to the other party everything of value received as a result of the breached contract, on condition that the other party shall do the same.

**Lawsuit for Money Damages**

When a party is a breach-of-contract victim, a second remedy is a lawsuit for money damages. If damages to an injured party are expressed in a dollar amount, the innocent party could sue for money damage. This includes the price paid by the buyer, the difference between the contract price, and the value of the property, title and document expenses, consequential damages, and interest.

**Lawsuit for Specific Performance**

A third remedy for breach of contract is a lawsuit for specific performance. This is an action in court by the injured party to
force the breaching party to carry out the remainder of the contract according to the agreed-upon terms, price, and conditions. Generally, this remedy occurs when money cannot restore an injured party’s position. This is often the case in real estate because of the difficulty in finding a similar property.

**Review - Discharge of Contracts**

- Full performance
- Release by one or all of the parties
- Assignment
- Novation
- Breach of contract

**Statute of Limitations**

Under California law, any person seeking relief for a breach of contract must do so within the guidelines of the **statute of limitations**. This set of laws determines that civil actions start only within the time periods prescribed by law. Filing lawsuits within the allowed time prevents this right from expiring. Here are some actions of special interest to real estate agents, with the time frames required.

**Time Limits for Filing Civil Actions**

| 90 Days | Civil actions to recover personal property, such as suitcases, clothing, or jewelry alleged to have been left at a hotel or in an apartment; must begin within 90 days after the owners depart from the personal property. |
| 6 Months | Action against an officer to recover property seized in an official capacity—such as by a tax collector. |
| 1 Year | Libel or slander, injury or death caused by wrongful act, or loss to depositor against a bank for the payment of a forged check. |
| 2 Years | Action on a contract, not in writing; action based on a policy of title insurance. |
### Summary

A **contract** is a legally enforceable agreement to perform or not perform a certain act. There are five types of contracts: (1) **express contracts**, (2) **implied contracts**, (3) **bilateral contracts**, (4) **unilateral contracts**, and (5) **executory contracts**. A contract may be executory or executed. Contracts are void, voidable, unenforceable, or valid.

There are four requirements for a contract to be legally binding and enforceable: (1) legally competent parties, (2) mutual consent between the parties, a (3) lawful objective, and (4) sufficient consideration.

In a valid contract, all parties must mutually agree (meeting of the minds). One party must offer and another must accept unconditionally. An **acceptance** is an unqualified agreement to the terms of an offer. The offer must be definite and certain in its terms, and the agreement must be genuine or the contract may be voidable by one or both parties. A **counteroffer** becomes a new offer, made by the original party (offeree).

Parties must take advantage of their rights at the proper time. For example, a person must state any objections at the time of contract performance. Parties can terminate a contract by performance, release, assignment, novation, and breach.

All contracts require acceptable consideration. Types of **acceptable consideration** are valuable, adequate, good, or sufficient consideration. **Forbearance** (forgiving a debt) also qualifies as consideration.

The **California Statute of Frauds** requires that certain contracts be in writing to prevent fraud in the sale of land or an interest in land. Seven contracts are...
under the umbrella of the statute of frauds. Written contracts are valid and enforceable.

When using preprinted forms, make sure the document focuses on specific information. Typed or handwritten clauses and insertions take priority over the preprinted material.
Matching Exercise

Instructions: Write the letter of the matching term on the blank line before its definition. Answers are in Appendix B.

Terms

A. abrogation  H. express contract  O. revocation
B. addendum  I. forbearance  P. specific performance
C. assignee  J. novation  Q. statute of frauds
D. assignor  K. offer  R. statute of limitations
E. consideration  L. offeree  S. tender
F. counteroffer  M. offeror  T. waiver
G. executory contract  N. rescission

Definitions

1. _______ The rejection of an original offer that becomes a new offer.
2. _______ A presentation or proposal for acceptance to form a contract.
3. _______ Something of value—such as money, a promise, property, or personal services.
4. _______ An offer by one of the parties to carry out his or her part of the contract.
5. _______ The law that requires contracts to be in writing.
6. _______ The relinquishment or refusal to accept a right.
7. _______ The person transferring a claim, benefit, or right in property to another.
8. _______ A court action brought to compel a party to carry out the terms of a contract.
9. _______ A contract in which obligation to perform exists on one or both sides.
10. _______ The canceling of an offer to contract by the person making the original offer.
11. _______ Party to whom a lease is assigned or transferred.
12. _______ Legal action taken to repeal a contract either by mutual consent of the parties or by one party when the other party has breached a contract.

13. _______ The party making an offer.

14. _______ The substitution by agreement of a new obligation for an existing one.

15. _______ Parties declare the terms and put their intentions in oral or written words.

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**Multiple Choice Questions**

Instructions: Circle your response and go to Appendix B to read the complete explanation for each question.

1. An agreement to do or not to do a certain thing is called:
   a. a contract.
   b. forbearance.
   c. mutual consent.
   d. negotiation.

2. When a promise is given by both parties with the expectation of performance by the other party, it is known as a(n) _______ contract.
   a. unilateral
   b. bilateral
   c. implied
   d. express

3. A minor cannot hire a real estate broker using a listing agreement because a minor:
   a. can disaffirm the contract.
   b. is legally incapable.
   c. is incapable of making an adult decision.
   d. cannot do so without parental approval.

4. All of the following are necessary for a valid contract, except:
   a. sufficient writing.
   b. genuine consent.
   c. lawful object.
   d. capable parties.
5. All of the following are necessary for a valid contract, except:
   a. payment of money.
   b. genuine consent.
   c. lawful object.
   d. adequate mental capacity of the contracting parties.

6. The following are necessary elements to create a valid contract, except:
   a. consideration.
   b. acceptance.
   c. offer.
   d. performance.

7. Another name for mutual assent is:
   a. unilateral agreement.
   b. meeting of the minds.
   c. implied agreement.
   d. executory agreement.

8. A contract signed under duress is:
   a. void.
   b. voidable.
   c. illicit.
   d. enforceable.

9. Consideration is one of the necessary elements of a valid contract. Which of the following is consideration?
   a. A promise to perform an act
   b. An exchange of money
   c. A service rendered
   d. All of the above

10. An oral agreement for the sale of a business is:
    a. valid.
    b. void.
    c. voidable.
    d. unenforceable.
11. The essential element needed to create a binding employment contract for the sale of any right, title, or interest in real property is a(n):
   a. written instrument.
   b. written authorization to accept offers on the property.
   c. written agreement as to the amount of commission.
   d. authorization to accept a deposit.

12. A written contract takes precedence over oral agreements. This principle is expressed by the:
   a. statute of limitations.
   b. statute of frauds.
   c. parol evidence rule.
   d. rule of previous evidence.

13. The relinquishment or refusal to accept a right is known as:
   a. tender.
   b. waiver.
   c. novation.
   d. forbearance.

14. A synonym for rescind is:
   a. abate.
   b. annul.
   c. abolish.
   d. abrogate.

15. The substitution of an obligation or contract with a new one is called a:
   a. rescission.
   b. subordination.
   c. novation.
   d. conversion.