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Big Picture Thinking About Real Estate Contracts

Real estate licensees face two challenges when it comes to real estate contracts. The first is that state law provides that real estate licensees can only fill out preprinted form contracts prepared by legal counsel. In passing this law, the Georgia Legislature was trying to draw a line between the practice of real estate brokerage and the practice of law. Preparing a contract from scratch is the practice of law. Filling out a preprinted contract prepared by an attorney is the practice of real estate brokerage. Unfortunately, the line between the two practice areas is often blurred because it is unclear whether drafting special stipulations for inclusion in a form contract falls into the category of filling in a preprinted contract or instead crosses over into the practice of law. A good argument can be made that drafting special stipulations is a part of filling in a preprinted contract because state law provides that the contract filled out by real estate licensees shall include, among other things, "stipulations or addenda". However, there is no case law on this point.

The second challenge is that with the role of real estate licensees largely being limited to filling in the blanks in preprinted contracts, the understandable orientation of real estate licensees is often on what to put in the blanks rather than on whether the contract, taken as a whole, protects the REALTOR'S® client. However, with more licensees now using non-GAR Forms, REALTORS® need to have a better understanding of the big picture issues in real estate contracts so that they can evaluate the differences between forms and explain why a GAR Form offers better protection to the client than a non-GAR Form. This article will try to provide REALTORS®, with that framework.

WHAT SHOULD THE GOALS BE OF A WELL-WRITTEN REAL ESTATE CONTRACT?

A well-written real estate contract should accomplish three important goals. These include:

1. Identifying areas of risk in the transaction (both before and after closing) and allocating those risks in the contract in a manner acceptable to the buyer and seller;

2. Setting forth the entire business agreement of the parties; and

3. Meeting legal and license law requirements to create an enforceable contract.

IDENTIFYING AND ALLOCATING RISKS

There is an exercise I do with new lawyers in my firm that would benefit REALTORS®. Specifically, when the new lawyer is reviewing a real estate contract that has not yet been signed by the client, I have the lawyer first make a list of all of the risks in the contract. The improvements on the property being destroyed prior to closing is an example of one such risk. I then ask the lawyer to identify how the contract allocates that risk between the buyer and seller. So, for example, in the GAR contract, this risk is allocated to the seller because the buyer can terminate the contract if the improvements are destroyed. I then ask the lawyer to identify if there are other risks which have not been addressed in the contract. This is normally the hardest part of the exercise for new

lawyers because they simply do not have the experience to know everything that can go wrong in a real estate transaction. I then have the lawyer discuss the various risks with the client so that the client can decide how best to proceed in negotiating changes to the contract.

The benefits of this exercise are numerous. First, the lawyer quickly realizes that real estate transactions are full of risks and that the risks can be allocated in different ways. Going back to our example of the improvements on the property being destroyed prior to closing, there are some contracts which allocate the risk to the buyer by requiring the buyer to purchase the property even if the property is destroyed (and receive an assignment of the insurance proceeds). There are other contracts where the risk of the improvements being destroyed is shared in some way between the buyer and the seller. So, for example, the buyer might be obligated to purchase the property if the damage is less than $50,000 to repair but not have to purchase the property if the cost of repairs exceed that amount.

Understanding how risks are allocated in a real estate purchase and sale agreement is the key to being able to understand whether the contract is one which a buyer or seller client should be comfortable in using. For example, the GAR Purchase and Sale Agreement tries to generally balance the risks being assumed by the buyer and seller so that it is fair to all parties. Other contracts are written in a one sided manner to protect the buyer or seller. For example, in most REO, lender and builder contracts, risk is shifted as much as possible to the buyer's side of the ledger. In many cases, there is direct relationship between risk and reward and risk and negotiating power. For example, while the buyer may assume more risk in a REO contract, for many buyers the risk is worth taking because of the reward of a low price. Looking at it another way because the lender is offering such a low price, the lender wants to be protected against the risk of the deal either not closing or claims being asserted against the lender after the property has been sold. In other cases, negotiating power determines risk. For example, in good economic times when new homes are being sold as fast as they can be built, if a buyer wants a particular new home, he or she may be given no choice but to use the builder's contract. In more difficult economic times, the builder may be willing to use any form contract if it will help get a sale closed.

Four important goals are accomplished when contracts are explained to clients in risk allocation terms. First, it helps the client understand that risk is inherent in real estate transactions and that there is never a guarantee that any particular real estate transaction will close. Second, when the client sees that both parties are assuming risk in the transaction, it makes some clients more reasonable in agreeing to changes in how those risks are to be allocated in the contract. Third, viewing a contract in risk allocation terms helps clients prioritize which risks are ones they can accept and which ones are deal breakers. For example, with REO contracts, the one risk most buyers usually want to be protected against is the risk of the seller deciding to sell the property to someone else. Therefore, if the seller tries to limit the seller's remedies in the event of a breach of contract to the return of the buyer's earnest money plus some small amount, the buyer will usually insist on being given the remedy of specific performance of the contract. Finally, discussing contracts in risk allocation terms helps the REALTOR® representing the client understand the client's tolerance for risk. Some clients are risk averse. Other clients thrive on risk. Knowing how the client thinks about risk helps the REALTOR® better serve the client's interests.

Some form contracts do a better job than others in identifying and allocating the various risks that can arise in a real estate transaction. Contrary to popular belief, shorter is not always better when it comes to Purchase and Sale Agreements. The best form contracts are the ones that anticipate all of the issues which can go awry in a real estate transaction and provide guidance or solutions to the parties in the event that issue arises. The GAR Form contracts reflect the experiences, good and bad, of REALTORS® over more than a 20 year period. As a result, our forms do a much better job than most in providing guidance on the myriad of little problems which can arise in real estate transactions. For example, most form contracts are silent on what happens if the buyer is unable to close on the purchase of the property due to no fault of the buyer. The GAR Purchase and Sale Agreement anticipates that this issue might arise and includes a 7 day right to unilaterally extend the contract in certain circumstances. Without such a provision, the parties would be left to their common law rights to either terminate the contract for breach or amend the contract to extend the closing date. Providing a solution to the issue in the contract creates a much lower risk that the transaction will fall apart.

THE CONTRACT SHOULD REFLECT THE ENTIRE AGREEMENT.

Making sure that the entire agreement of the parties is reflected in the purchase and sale agreement is mostly a matter of paying attention to the details of the transaction and including them in the contract. In addition to asking whether every aspect of the business deal is accurately reflected in a form contract, REALTORS® can protect their clients by asking two key questions:

1. Is there any issue normally addressed in a GAR Form contract that is not addressed in this contract?

So, for example, in comparing the GAR Purchase and Sale Agreement with a competing form contract, the author discovered that the non-GAR contract failed to include a title section. This created a risk of the contract being struck down as unenforceable due to the failure of the parties to agree to a material term in the contract. Comparing the headings in a form contract to the headings in a GAR Purchase and Sale Agreement is a quick and dirty way to confirm that the major issues have been addressed. A better way to ensure that issues are not missed is to create a comprehensive issues checklist and compare any non-GAR Form against that checklist.

2. Has the seller or buyer made specific representations or promises that have not been reflected in the purchase and sale agreement?

In drafting a contract, the drafter should ideally try to include every statement or promise that a party is relying upon as an affirmative representation in the contract and have such representations survive the closing. So, for example, let's say that a seller states that the property is 2 acres in size and the buyer is not planning on having a new survey done. If the seller misrepresents the acreage, the buyer will not be able to sue the seller for fraud. This is because in Georgia, a fraud claim will not stand as a matter of law if the buyer could have protected himself or herself against the fraud by having a survey done of the property. However, by writing the acreage into the contract as an affirmative seller misrepresentation, the buyer may be able to assert a claim against the seller for breach of contract. An example of such a provision is as follows:

> "Seller warrants that the Property is 2 acres in size. In the event the size of the Property is less than 2 acres, Buyer shall have the right to pursue the seller for damages between the values of the Property had it been 2 acres in size versus the actual size of the Property. This provision shall survive the closing."

Not only does this provision give the buyer a claim where there would not otherwise have been one, it also helps ensure that the seller accurately reflects the size of the property in the first instance.

MEETING THE LEGAL AND LICENSE LAW REQUIREMENTS TO CREATE AN ENFORCEABLE CONTRACT

The same law which allows real estate licensees to fill in preprinted form contracts prepared by legal counsel also specifies what must be included in those contracts. Specifically, O.C.G.A. § 43-40-25.1 requires the contract to include a description of the real property, a method of payment, any stipulations or addenda the offer requires and such dates as may be necessary to determine whether the parties have acted timely in meeting their responsibilities under the contract. Examples of required dates include a closing date, a offer date, time limit of the offer, a date for the transfer of possession of the property and a date when contingencies such as an appraisal or financing contingency or due diligence periods lapses. My list of additional items to create an enforceable contract include:

1) a price for the purchase and sale of the property;

2) the names and signatures of the buyers and sellers as well as proof that the accepted offer has been timely returned to the party making the offer;

3) a recital of consideration for the contract; and

4) a section describing the type of deed the seller is using to convey the property.

Some sections of a contract while recommended, will not render a contract unenforceable if they are not included. For example, while it is a good idea to spell out in detail those items which remain with the property, the lack of such a section will not render the contract unenforceable. This is because in the absence of such a section, common law provides that all fixtures remain with the property while all personal property that is not a fixture can be removed from the property.

Similarly, while federal law requires the use of a lead-based paint exhibit for houses built prior to 1978 may be required under state law, the lack of such a provision will not render the contract unenforceable.

There are two additional issues I focus on in determining whether a contract is at risk of being declared unenforceable. The first is whether there is a present agreement on all of the material terms in a contract or whether there are terms that remain open to be negotiated in the future with reference to any objective standard.

So, for example, let's imagine that instead of filling in the sales price in the contract, the phrase "to be determined" is written instead. There is agreement on every other term in the contract. Do we have an enforceable agreement? The answer is clearly "no" since there is not a present agreement on all material terms in the contract. Instead, we have an agreement to agree at some point in the future on price, the most important term in the contract. Agreements to agree without any reference point on how an agreement will be reached almost always render a contract unenforceable.

When there is a missing term, the key to whether the contract is enforceable or unenforceable depends on whether the missing term can be determined by some objective directions set forth in the contract. So for example, let's say that the purchase price in the contract is left blank, but the contract provides that the buyer will pay $50,000 per acre and includes a method for determining the exact acreage of the property. In that instance, the contract should be enforceable because there is a method within the contract itself for determining the exact purchase price.

REALTORS® and their clients sometimes get into trouble by rushing to get a contract signed prematurely before all of the deal points are capable of being finalized. For example, some sellers who are selling a portion of a larger tract of real property, enter into a purchase and sale agreement before they have identified the exact boundary lines of the parcel to be sold. This will almost always render a contract unenforceable because of an insufficient property description. Rather than focusing on getting a contract signed, it would have been better to first concentrate on getting a survey done of the parcel of land to be sold.

The other question to ask in trying to ensure that the contract is enforceable is whether there are any provisions which give a party the unbridled discretion to terminate the contract. So, for example, let's say that a contract includes the following provision: "The buyer agrees to purchase the property unless prior to closing the buyer changes his or her mind and decides not to purchase the property". This type of provision arguably creates an illusory contract because there is nothing in the contract which obligates the buyer to purchase the property in at all. While the above provision may be an extreme example, a provision that often appears in contracts that may be equally unenforceable is "Buyer may terminate this Agreement if for any reason Buyer is dissatisfied with the inspection of the Property". To be clear, courts will normally enforce discretionary terms provided that the exercise of the discretion is based upon the objective judgment of a third party. As a result, a provision such as "Buyer may terminate this Agreement if Buyer's home inspector determines that the Property has construction defects" will not render the contract unenforceable because the contract cannot be terminated unless a third party finds a construction defect.

CONCLUSION

The new era of competing form contracts requires REALTORS® to be more knowledgeable of the big picture issues in contracts than ever before. As with most things, those REALTORS® who take the time to broaden their perspective of real estate contracts will be in the best position to serve their clients and capture new business.

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