

# 14 Contracts for the Sale of Real Estate

Contract for Sale  
Sale Contract Provisions  
Option-To-Buy Contract  
Contract for Deed

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## CONTRACT FOR SALE

Legal characteristics  
Contract creation  
Earnest money escrow  
Contract contingencies  
Default

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A real estate sale contract is a binding and enforceable agreement wherein a buyer, the **vendee**, agrees to buy an identified parcel of real estate, and a seller, the **vendor**, agrees to sell it under certain terms and conditions. It is the document that is at the center of the transaction.

The conventional transfer of real estate ownership takes place in three stages. First, there is the negotiating period where buyers and sellers exchange offers in an effort to agree to all transfer terms that will appear in the sale contract. Second, when both parties have accepted all terms, the offer becomes a binding sale contract and the transaction enters the pre-closing stage, during which each party makes arrangements to complete the sale according to the sale contract's terms. Third is the closing of the transaction, when the seller deeds title to the buyer, the buyer pays the purchase price, and all necessary documents are completed. At this stage, the sale contract has served its purpose and terminates.

Other names for the sale contract are *agreement of sale*, *contract for purchase*, *contract of purchase and sale*, and *earnest money contract*.

**Legal characteristics** **Executory contract.** A sale contract is *executory*: the signatories have yet to perform their respective obligations and promises. Upon closing, the sale contract is fully performed and no longer exists as a binding agreement.

**Signatures.** All owners of the property should sign the sale contract. If the sellers are married, both spouses should sign to ensure that both spouses release homestead, dower, and curtesy rights to the buyer at closing. Failure to do so does not invalidate the contract but can lead to encumbered title and legal disputes.

**Enforceability criteria.** To be enforceable, a sale contract must:

- ▶ be validly created (mutual consent, consideration, legal purpose, competent parties, voluntary act)
- ▶ be in writing
- ▶ identify the principal parties
- ▶ clearly identify the property, preferably by legal description
- ▶ contain a purchase price
- ▶ be signed by the principal parties

**Written vs. oral form.** A contract for the sale of real estate is enforceable only if it is in writing. A buyer or seller cannot sue to force the other to comply with an oral contract for sale, even if the contract is valid.

**Assignment.** Either party to a sale transaction can assign the sale contract to another party, subject to the provisions and conditions contained in the agreement.

**Who may complete.** A broker or agent may assist buyer and seller in completing an offer to purchase, provided the broker represents the client faithfully and does not charge a separate fee for the assistance. It is advisable, and legally required in most states, for a broker to use a standard contract form promulgated by state agencies or real estate boards, as such forms contain generally accepted language. This relieves the broker of the dangers of creating new contract language, which can be construed as a practice of law for which the broker is not licensed.

## Contract creation

**Offer and acceptance.** A contract of sale is created by full and unequivocal acceptance of an offer. Offer and acceptance may come from either buyer or seller. The offeree must accept the offer without making any changes whatsoever. A change terminates the offer and creates a new offer, or counteroffer. An offeror may revoke an offer for any reason prior to communication of acceptance by the offeree.

**Equitable title.** A sale contract gives the buyer an interest in the property that is called equitable title, or *ownership in equity*. If the seller defaults and the buyer can show good faith performance, the buyer can sue for specific performance, that is, to compel the seller to transfer legal title upon payment of the contract price.

## Earnest money escrow

The buyer's earnest money deposit fulfills the consideration requirements for a valid sale contract. In addition, it provides potential compensation for damages to the seller if the buyer fails to perform. The amount of the deposit varies according to local custom. It should be noted that the earnest money deposit is not the only form of consideration that satisfies the requirement.

The sale contract provides the *escrow instructions* for handling and disbursing escrow funds. The earnest money is placed in a third party trust account or escrow. A licensed escrow agent employed by a title company, financial institution, or brokerage company usually manages the escrow. An individual broker may also serve as the escrow agent.

The escrow holder acts as an impartial fiduciary for buyer and seller. If the buyer performs under the sale contract, the deposit is applied to the purchase price.

## Contract contingencies

Strict rules govern the handling of earnest money deposits, particularly if a broker is the escrow agent. For example, state laws direct the broker when to deposit the funds, how to account for them, and how to keep them separate from the broker's own funds.

A sale contract often contains contingencies. A contingency is a condition that must be met before the contract is enforceable.

The most common contingency concerns financing. A buyer makes an offer contingent upon securing financing for the property under certain terms on or before a certain date. If unable to secure the specified loan commitment by the deadline, the buyer may cancel the contract and recover the deposit. An appropriate and timely loan commitment eliminates the contingency, and the buyer must proceed with the purchase.

It is possible for both buyers and sellers to abuse contingencies in order to leave themselves a convenient way to cancel without defaulting. To avoid problems, the statement of a contingency should:

- ▶ be explicit and clear
- ▶ have an expiration date
- ▶ expressly require diligence in the effort to fulfill the requirement

A contingency that is too broad, vague, or excessive in duration may invalidate the entire contract on the grounds of insufficiency of mutual agreement.

## Default

A sale contract is bilateral, since both parties promise to perform. As a result, either party may default by failing to perform. Note that a party's failure to meet a contingency does not constitute default, but rather entitles the parties to cancel the contract.

**Buyer default.** If a buyer fails to perform under the terms of a sale contract, the breach entitles the seller to legal recourse for damages. In most cases, the contract itself stipulates the seller's remedies. The usual remedy is forfeiture of the buyer's deposit as **liquidated damages**, provided the deposit is not grossly in excess of the seller's actual damages. It is also customary to provide for the seller and broker to share the liquidated damages. The broker may not, however, receive liquidated damages in excess of what the commission would have been on the full listing price.

If the contract does not provide for liquidated damages, the seller may sue for damages, cancellation, or specific performance.

**Seller default.** If a seller defaults, the buyer may sue for specific performance, damages, or cancellation.

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## SALE CONTRACT PROVISIONS

### Primary provisions

### Secondary provisions

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Sale contracts can vary significantly in length and thoroughness. They also vary according to the type of sale transaction they describe. Some of the varieties are:

- ▶ Residential Contract of Sale
- ▶ Commercial Contract of Sale
- ▶ Foreclosure Contract of Sale
- ▶ Contract of Sale for New Construction
- ▶ Contract of Sale for Land
- ▶ Exchange Agreement

As the most common sale transaction is a residential sale, a Residential Contract of Sale is the type with which a licensee should first become familiar.

**Primary provisions** A typical residential sale contract contains provisions of the following kind.

**Parties, consideration, and property.** One or more clauses will identify the parties, the property, and the basic consideration, which is the sale of the property in return for a purchase price.

There must be at least two parties to a sale contract: one cannot convey property to oneself. All parties must be identified, be of legal age, and have the capacity to contract.

The property clause also identifies fixtures and personal property included in the sale. Unless expressly excluded, items commonly construed as fixtures are *included* in the sale. Similarly, items commonly considered personal property are *not included* unless expressly included.

**Legal description.** A legal description must be sufficient for a competent surveyor to identify the property.

**Price and terms.** A clause states the final price and details how the purchase will occur. Of particular interest to the seller is the buyer's down payment, since the greater the buyer's equity, the more likely the buyer will be able to secure financing. In addition, a large deposit represents a buyer's commitment to complete the sale.

If seller financing is involved, the sale contract sets forth the terms of the arrangement: the amount and type of loan, the rate and term, and how the loan will be paid off.

It is important for all parties to verify that the buyer's earnest money deposit, down payment, loan proceeds, and other promised funds together equal the purchase price stated in the contract.

**Loan approval.** A financing contingency clause states under what conditions the buyer can cancel the contract without default and receive a refund of the earnest money. If the buyer cannot secure the stated financing by the deadline, the parties may agree to extend the contingency by signing next to the changed dates.

**Earnest money deposit.** A clause specifies how the buyer will pay the earnest money. It may allow the buyer to pay it in installments. Such an option enables a buyer to hold on to the property briefly while obtaining the additional deposit funds. For example, a buyer who wants to buy a house makes an initial deposit of \$200, to be followed in twenty-four hours with an additional \$2,000. The sale contract includes the seller's acknowledgment of receipt of the deposit.

**Escrow.** An escrow clause provides for the custody and disbursement of the earnest money deposit, and releases the escrow agent from certain liabilities in the performance of escrow duties.

**Closing and possession dates.** The contract states when title will transfer, as well as when the buyer will take physical possession. Customarily, possession occurs on the date when the deed is recorded, unless the buyer has agreed to other arrangements.

The closing clause generally describes what must take place at closing to avoid default. A seller must provide clear and marketable title. A buyer must produce purchase funds. Failure to complete any pre-closing requirements stated in the sale contract is default and grounds for the aggrieved party to seek recourse.

**Conveyed interest; type of deed.** One or more provisions will state what type of deed the seller will use to convey the property, and what conditions the deed will be subject to. Among common "subject to" conditions are easements, association memberships, encumbrances, mortgages, liens, and special assessments. Typically, the seller conveys a fee simple interest by means of a general warranty deed.

**Title evidence.** The seller covenants to produce the best possible evidence of property ownership. This is commonly in the form of title insurance.

**Closing costs.** The contract identifies which closing costs each party will pay. Customarily, the seller pays title and property-related costs, and the buyer pays financing-related costs. Annual costs such as taxes and insurance are prorated between the parties. Note that who pays any particular closing cost is an item for negotiation.

**Damage and destruction.** A clause stipulates the obligations of the parties in case the property is damaged or destroyed. The parties may negotiate alternatives, including seller's obligation to repair, buyer's obligation to buy if repairs are made, and the option for either party to cancel.

**Default.** A default clause identifies remedies for default. Generally, a buyer may sue for damages, specific performance, or cancellation. A seller may do likewise or claim the earnest money as liquidated damages.

## Secondary provisions

**Broker's representation and commission.** The broker discloses the applicable agency relationships in the transaction and names the party who must pay the brokerage commission.

**Seller's representations.** The seller warrants that there will be no liens on the property that cannot be settled and extinguished at closing. In addition, the seller warrants that all representations are true, and if found otherwise, the buyer may cancel the contract and reclaim the deposit.

A sale contract may contain numerous additional clauses, depending on the complexity of the transaction. The following are some of the common provisions.

**Inspections.** The parties agree to inspections and remedial action based on findings.

**Owner's association disclosure.** The seller discloses existence of an association and the obligations it imposes.

**Survey.** The parties agree to a survey to satisfy financing requirements.

**Environmental hazards.** The seller notifies the buyer that there may be hazards that could affect the use and value of the property.

**Compliance with laws.** The seller warrants that there are no undisclosed building code or zoning violations.

**Due-on-sale clause.** The parties state their understanding that loans that survive the closing may be called due by the lender. Both parties agree to hold the other party harmless for the consequences of an acceleration.

**Seller financing disclosure.** The parties agree to comply with applicable state and local disclosure laws concerning seller financing.

**Rental property; tenants rights.** The buyer acknowledges the rights of tenants following closing.

**FHA or VA financing condition.** A contingency allows the buyer to cancel the contract if the price exceeds FHA or VA estimates of the property's value.

**Flood plain; flood insurance.** Seller discloses that the property is in a flood plain and that it must carry flood insurance if the buyer uses certain lenders for financing.

**Condominium assessments.** Seller discloses assessments the owner must pay.

**Foreign seller withholding.** The seller acknowledges that the buyer must withhold 15% of the purchase price at closing if the seller is a foreign person or entity and forward the withheld amount to the Internal Revenue Service. Certain limitations and exemptions apply.

**Tax deferred exchange.** For income properties only, buyer and seller disclose their intentions to participate in an exchange and agree to cooperate in completing necessary procedures.

**Merger of agreements.** Buyer and seller state that there are no other agreements between the parties that are not expressed in the contract.

**Notices.** The parties agree on how they will give notice to each other and what they will consider to be delivery of notice.

**Time is of the essence.** The parties agree that they can amend dates and deadlines only if they both give written approval.

**Fax transmission.** The parties agree to accept facsimile transmission of the offer, provided receipt is acknowledged and original copies of the contract are subsequently delivered.

**Survival.** The parties continue to be liable for the truthfulness of representations and warranties after the closing.

**Dispute resolution.** The parties agree to resolve disputes through arbitration as opposed to court proceedings.

**C.L.U.E. Report.** CLUE (Comprehensive Loss Underwriting Exchange) is a claims history database used by insurance companies in underwriting or rating insurance policies. A CLUE Home Seller's Disclosure Report shows a five-year insurance loss history for a specific property. Among other things, it describes the types of any losses and the amounts paid. Many home buyers now require sellers to provide a CLUE Report (which only the property owner or an insurer can order) as a contingency appended to the purchase offer. A report showing a loss due to water damage and mold, for instance, might lead a buyer to decide against making an offer because of the potential difficulty of getting insurance. A report showing no insurance loss within the previous five years, on the other hand, is an indication that the availability and pricing of homeowner's insurance will not present an obstacle to the purchase transaction, and also that the property has not experienced significant damage or repair during that time period.

**Addenda.** Addenda to the sale contract become binding components of the overall agreement. The most common addendum is the seller's property condition disclosure. Examples of other addenda are:

agency disclosure	asbestos / hazardous materials
liquidated damages	radon disclosure
flood plain disclosure	tenant's lease

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## OPTION-TO-BUY CONTRACT

### Contract requirements

### Common provisions

### Legal aspects

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An option-to-buy is an enforceable contract in which a potential seller, the **optionor**, grants a potential buyer, the **optionee**, the right to purchase a property before a stated time for a stated price and terms. In exchange for the right of option, the optionee pays the optionor valuable consideration.

For example, a buyer wants to purchase a property for \$150,000, but needs to sell a boat to raise the down payment. The boat will take two or three months to sell. To accommodate the buyer, the seller offers the buyer an option to purchase the property at any time before midnight on the day that is ninety days from the date of signing the option. The buyer pays the seller \$1,000 for the option. If buyer exercises the option, the seller will apply the \$1,000 toward the earnest money deposit and subsequent down payment. If the optionee lets the option expire, the seller keeps the \$1,000. Both parties agree to the arrangement by completing a sale contract as an addendum to the option, then executing the option agreement itself.

An option-to-buy places the optionee *under no obligation* to purchase the property. However, the seller must perform under the terms of the contract if the buyer exercises the option. An option is thus a *unilateral* agreement. Exercise of the option creates a bilateral sale contract where both parties are bound to perform. An unused option terminates at the expiration date.

An optionee can use an option to prevent the sale of a property to another party while seeking to raise funds for the purchase. A renter with a **lease option-to-buy** can accumulate down payment funds while paying rent to the landlord. For example, an owner may lease a condominium to a tenant with an option to buy. If the tenant takes the option, the landlord agrees to apply \$100 of the monthly rent paid prior to the option date toward the purchase price. The tenant pays the landlord the nominal sum of \$200 for the option.

Options can also facilitate commercial property acquisition. The option period gives a buyer time to investigate zoning, space planning, building permits, environmental impacts, and other feasibility issues prior to the purchase without losing the property to another party in the meantime.

### Contract requirements

To be valid and enforceable, an option-to-buy must:

- ▶ include actual, non-refundable consideration

The option must require the optionee to pay a specific consideration *that is separate from the purchase price*. The consideration cannot be refunded if the option is not exercised. If the option is exercised, the consideration may be applied to the



purchase price. If the option is a lease option, portions of the rent may qualify as separate consideration.

- ▶ include price and terms of the sale

The price and terms of the potential transaction must be clearly expressed and cannot change over the option period. It is customary practice for the parties to complete and attach a sale contract to the option as satisfaction of this requirement.

- ▶ have an expiration date

The option must automatically expire at the end of a specific period.

- ▶ be in writing

Since a potential transfer of real estate is involved, most state statutes of fraud require an option to be in writing.

- ▶ include a legal description

- ▶ meet general contract validity requirements

The basics include competent parties, the optionor's promise to perform, and the optionor's signature. Note that it is not necessary for the optionee to sign the option.

**Common provisions** Beyond the required elements, it is common for an option to include provisions covering:

- ▶ how to deliver notice of election

A clause clarifies how to make the option election, exactly when the election must be completed, and any additional terms required such as an earnest money deposit.

- ▶ forfeiture terms

A clause provides that the optionor is entitled to the consideration if the option term expires.

- ▶ property and title condition warranties

The optionor warrants that the property will be maintained in a certain condition, and that title will be marketable and insurable.

- ▶ how option consideration will be credited

A clause states how the optionor will apply the option consideration toward the purchase price.

## Legal aspects

**Equitable interest.** The optionee enjoys an equitable interest in the property because the option creates the right to obtain legal title. However, the option does not in itself convey an interest in real property, only a right to do something governed by contract law.

**Recording.** An option should be recorded, because the equitable interest it creates can affect the marketability of title.

**Assignment.** An option-to-buy is assignable unless the contract expressly prohibits assignment.

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## CONTRACT FOR DEED

### Interests and rights

#### Legal form

#### Default and recourse

#### Usage guidelines

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A contract for deed is also called a *land contract*, an *installment sale*, a *conditional sales contract*, and an *agreement for deed*. It is a bilateral agreement between a seller, the **vendor**, and a buyer, the **vendee**, in which the vendor defers receipt of some or all of the purchase price of a property over a specified period of time. During the period, the *vendor retains legal title* and the vendee acquires equitable title. The vendee takes possession of the property, makes stipulated payments of principal and interest to the vendor, and otherwise fulfills obligations as the contract requires. At the end of the period, the buyer pays the vendor the full purchase price and the vendor deeds legal title to the vendee.

Like an option, a contract for deed offers a means for a marginally qualified buyer to acquire property. In essence, the seller acts as lender, allowing the buyer to take possession and pay off the purchase price over time. A buyer may thus avoid conventional down payment and income requirements imposed by institutional lenders. During the contract period, the buyer can work to raise the necessary cash to complete the purchase or to qualify for a conventional mortgage.

A contract for deed serves two primary purposes for a seller. First, it facilitates a sale that might otherwise be impossible. Second, it may give the seller certain tax benefits. Since the seller is not liable for capital gains tax until the purchase price is received, the installment sale lowers the seller's tax liability in the year of the sale.

**Interests and rights**    **Vendor's rights and obligations.** During the contract period, the seller may:

- ▶ mortgage the property
- ▶ sell or assign whatever interests he or she owns in the property to another party
- ▶ incur judgment liens against the property

The vendor, however, is bound to the obligations imposed by the contract for deed. In particular, the vendor may not breach the obligation to convey legal title to the vendee upon receipt of the total purchase price. In addition, the vendor remains liable for underlying mortgage loans.

**Vendee's rights and obligations.** During the contract period, the buyer may occupy, use, enjoy, and profit from the property, subject to the provisions of the written agreement. The vendee must make periodic payments of principal and interest and maintain the property. In addition, a vendee may have to pay property taxes and hazard insurance.

**Legal form**    Like other conveyance contracts, a contract for deed instrument identifies:

- ▶ the principal parties
- ▶ the property's legal description
- ▶ consideration: specifically what the parties promise to do
- ▶ the terms of the sale
- ▶ obligations for property maintenance
- ▶ default and remedies
- ▶ signatures and acknowledgment

The contract specifies the vendee's payments, payment deadlines, when the balance of the purchase price is due, and how the property may be used.

**Default and recourse**    **Seller default.** If the seller defaults, such as by failing to deliver the deed, the buyer may sue for specific performance, or for cancellation of the agreement and damages.

**Buyer default.** States differ in the remedies they prescribe for the seller in case of buyer default. Some states consider the default a breach of contract that may be remedied by cancellation, retention of monies received, and eviction. Others provide foreclosure proceedings as a remedy.

**Usage guidelines**    Many areas have no standardized contract for deed or any form sanctioned by associations and agencies. Therefore, this kind of conveyance presents certain pitfalls for buyer and seller.

In some states, a breach of the contract for deed is remedied under *local contract law* rather than foreclosure law. The buyer may not have the protections of a redemption period or other buyer-protection laws which accompany formal foreclosure proceedings. The vendor might sue the vendee for breach of contract for the slightest infraction of the contract terms.

A second danger for the vendee is that the vendor has the power and the right to encumber the property in ways that may not be desirable for the buyer. For

example, the seller could place a home equity loan on the property, then fail to make periodic payments. The bank could then foreclose on the vendor, thus jeopardizing the vendee's eventual purchase.

For the seller, the principal danger is that the buyer acquires possession in exchange for a minimal down payment. A buyer might damage or even vacate the property, leaving the seller to make repairs and retake possession. Further, since the contract is recorded, the seller must also bear the time and expense of clearing the title.

To minimize risk, principal parties in a contract for deed should observe the following guidelines:

- ▶ use an attorney to draft the agreement
- ▶ adopt the standard forms, if available
- ▶ become familiar with how the contract will be enforced
- ▶ utilize professional escrow and title services
- ▶ record the transaction properly
- ▶ be prepared for the possible effect on existing financing

# 14

## Contracts for the Sale of Real Estate Snapshot Review

### CONTRACT FOR SALE

- Legal characteristics**
  - binding, bilateral contract for purchase and sale; enforceable; executory, or to be fulfilled; expires upon closing; must be in writing; contain valuable consideration; identify property; be signed by all; be a valid contract
- Contract creation**
  - by unqualified acceptance of an offer; gives buyer equitable title, power to force specific performance
- Earnest money escrow**
  - secures contract validity and buyer's equitable interest; varies in amount; deposit controlled by disinterested party who must act according to escrow instructions
- Contract contingencies**
  - conditions that must be met for the contract to be enforceable
- Default**
  - buyer may sue for cancellation and damages or for specific performance; seller may claim deposit as liquidated damages, or may sue for cancellation, other damages, or for specific performance

### SALE CONTRACT PROVISIONS

- Primary provisions**
  - parties, consideration, legal description, price and terms, loan approval, earnest money, escrow, closing and possession dates, conveyed interest, type of deed, title evidence, property condition warranty, closing costs, damage and destruction, default, broker's representation, commission, seller's representations
- Secondary provisions**
  - inspections, owner's association disclosure, survey, environmental hazards, compliance with laws, due-on-sale, seller financing disclosure, rental property tenant's rights, FHA or VA financing condition, flood plain and flood insurance, condominium assessments, foreign seller withholding, tax-deferred exchange, merger of agreements, notices, time of the essence, fax transmission, survival, dispute resolution, addenda

### THE OPTION-TO-BUY CONTRACT

- optionor gives option to optionee; unilateral contract: seller must perform; buyer need not; if option exercised, option becomes bilateral sale contract
- Contract requirements**
  - must include: non-refundable consideration for the option right; price and terms of the sale; option period expiration date; legal description; must be in writing and meet contract validity requirements
- Common clause provisions**
  - special provisions: how to exercise option; terms of option money forfeiture; how option money will be applied to purchase price
- Legal aspects**
  - creates equitable interest; is assignable; should be recorded

### CONTRACT FOR DEED

- purchase price is paid over time in installments; seller retains title; buyer takes possession; at end of period, buyer pays balance of price, gets legal title
- Interests and rights**
  - seller may encumber or assign interest; remains liable for underlying mortgage
  - buyer may use, possess, profit; must make periodic payments, maintain the property, and purchase at end of term
- Default and recourse**
  - if seller defaults, buyer may sue for cancellation and damages or specific performance; seller's default remedies vary by area; may sue for specific performance or damages, or may need to foreclose