Contract Law

Contracts are a significant part of the real estate business. Almost everyone has a basic understanding of what a contract is, but real estate agents need more than that. This chapter explains the requirements that must be met in order for a contract to be valid and binding; how a contract can be terminated; what is considered a breach of contract; and what remedies are available when a breach occurs.

Introduction

Real estate licensees deal with contracts on a daily basis: listing agreements, purchase and sale agreements, option agreements, and leases are all contracts. Thus, it is essential for a licensee to understand the basic legal requirements and effects of contracts.

Keep in mind, however, that a real estate licensee may not draft the original language for a contract. Anyone other than a lawyer who drafts a contract for someone else may be charged with the unauthorized practice of law.

Here is a general definition of a contract: an agreement between two or more competent persons to do or not do certain things in exchange for consideration. An agreement to sell a car, deliver lumber, or rent an apartment is a contract. And if it meets minimum legal requirements, it can be enforced in court.

Legal Classifications of Contracts

There are certain basic classifications that apply to any contract, no matter what type it is. Every contract is either express or implied, either unilateral or bilateral, and either executory or executed.
Express vs. Implied

An **express** contract is one that has been put into words. It may be written or oral. Each party to the contract has stated what he is willing to do and has been told what to expect from the other party. Most contracts are express. On the other hand, an **implied** contract, or contract by implication, is created by the actions of the parties, not by express agreement.

**Example:** A written lease agreement expires, but the tenant continues to make payments and the landlord continues to accept them. Both parties have implied their consent to a new lease contract.

Unilateral vs. Bilateral

A contract is **unilateral** if only one of the contracting parties is legally obligated to perform. That party has promised to do a particular thing if the other party does something else. The other party has not promised to do anything and is not legally obligated to do anything.

**Example:** In an open listing agreement, a seller promises to pay a real estate broker a commission if the broker finds a buyer for the property. The broker does not promise to try to find a buyer, but if
she does, the seller is obligated to pay. An open listing agreement is a unilateral contract.

A **bilateral** contract is formed when each party promises to do something, so that both parties are legally obligated to perform. Most contracts are bilateral.

**Example:** In a purchase agreement, the seller promises to transfer title to the buyer, and the buyer promises to pay the agreed price to the seller. This is a bilateral contract. Each party has made a promise, and both are obligated to perform.

**Executory vs. Executed**

An **executory** contract is one that has not yet been performed, or is in the process of being performed. An **executed** contract has been fully performed; the parties have fulfilled the terms of their agreement. With respect to contracts, the terms “executed” and “performed” mean the same thing. (Note that sometimes “executed” can mean “signed”: when a contract is executed by the parties, it is signed by the parties. The context surrounding the term will indicate which meaning is intended.)

**Elements of a Valid Contract**

Four elements are needed for a valid and binding contract that will be enforced by a court:

1. legal capacity to contract,
2. mutual consent,
3. a lawful objective, and
4. consideration.

**Capacity**

The first requirement for a valid contract is that the parties have the legal capacity to enter into a contract. A person must be the age of majority or
legally emancipated to enter into a valid contract, and he must also be competent.

**Age of Majority.** In most states, eighteen years of age is considered the age of majority. Minors (those under the age of majority) do not have capacity to appoint agents or to enter into contracts. If a minor signs a contract, it is voidable by the minor; that is, it cannot be enforced against him.

**Example:** A 16-year-old signs a contract to purchase a car. The car dealer cannot enforce the contract against the minor, although the minor could compel the dealer to honor the terms of the agreement.

The purpose of this rule is to prevent people from entering into legally binding agreements when they may be too young to understand the consequences.

In some states, real estate contracts entered into by minors are void. This means a purchase agreement signed by a minor cannot be enforced by either party.

A minor who has been legally emancipated may enter into any type of contract. For example, a 17-year-old who is married is usually considered emancipated and thus may enter into a contract to buy a home. A minor can be emancipated in three ways: by marrying, by serving in the military, or by court order. When a minor who has been emancipated by court order enters into a sales transaction, copies of the emancipation documents should be given to the escrow company so it will know that the minor has the capacity to carry out the transaction.

**Competent.** A person must also be mentally competent to have capacity to contract. If a person has been declared incompetent by a court, any contract she signs is void. If the party was probably incompetent when the contract was signed, but a court declares her incompetent only after the signing of the contract, the contract may be voidable at the discretion of the court-appointed guardian.
A contract entered into by a person who is temporarily incompetent (for example, under the influence of alcohol or drugs) may be voidable if he takes legal action within a reasonable time after regaining mental competency. Similarly, a court will usually find that a contract entered into by a mentally ill person is voidable at any point during the mental illness and for a reasonable period after the illness ends. Note that the fact that a person is receiving psychiatric treatment does not necessarily mean that she is incompetent.

**Necessities Exception.** There’s an exception to these capacity rules. If a minor or an incompetent person contracts to buy necessities (such as food or medicine), he is required to pay the reasonable value of those items. Housing is not generally considered a necessity for a minor, unless the minor is legally emancipated.

**Representing Another.** Often, one person has the capacity to represent another person or entity in a contract negotiation. For instance, the affairs of minors and incompetent persons are handled by parents or court-appointed guardians; corporations are represented by properly authorized officers; partnerships are represented by individual partners; deceased persons are represented by executors or administrators; and a competent adult (but not a minor) can appoint another competent adult to act on his behalf through a power of attorney. In each of these cases, the authorized representative can enter into a contract on behalf of the person represented.

**Corporations and Partnerships.** A corporation may enter into contracts through an individual authorized by the board of directors. In some states, a contract must also have a corporate seal to be valid.

A general partner of a partnership has legal capacity to contract on behalf of the partnership in her name, or in the name of the partnership.

**Aliens.** An alien has essentially the same property rights as a citizen and may acquire and convey property freely. However, aliens are subject to certain property transfer reporting requirements.
**Convicts.** Those convicted of crimes and serving time in prison are not automatically deprived of all of their civil rights. Generally, they do not forfeit their property, nor are they prevented from obtaining or transferring real property. In some states, however, an imprisoned felon may not be legally competent to enter into a contract.

**Mutual Consent**

Mutual consent is the second requirement for a valid contract. Each party must consent to the agreement. Once someone has signed a contract, consent is presumed, so no contract should be signed until its contents are fully understood. A person can’t use failure or inability to read an agreement as an excuse for nonperformance. An illiterate person should have a contract explained thoroughly by someone who is concerned with his welfare.

Mutual consent is sometimes called mutual assent, mutuality, or “a meeting of the minds.” It is achieved through the process of **offer and acceptance.**

**Offer.** A contract offer shows the willingness of the person making it (the offeror) to enter into a contract under the stated terms. To be valid, an offer must meet two requirements.

1. It must express a willingness to contract. Whatever words make up the offer, they must clearly indicate that the offeror intends to enter into a contract.
2. It must be definite and certain in its terms. A vague offer that does not clearly state what the offeror is proposing is unenforceable.

Note that an advertisement that lists a property’s price is not considered a contract offer; it is merely an invitation to negotiate.
**Terminating an Offer.** Sometimes circumstances change after an offer has been made, or perhaps the offeror has had a change of heart. If an offer terminates before it is accepted, no contract is formed. There are many things that can terminate an offer before it is accepted, including:

- revocation by the offeror,
- lapse of time,
- death or incompetence of the offeror,
- rejection of the offer, or
- a counteroffer.

The offeror can **revoke** the offer at any time until she is notified that the offer has been accepted. To effect a proper “offer and acceptance,” the accepting party must not only accept the offer, but must also communicate that acceptance to the offeror before the offer is revoked. (See the discussion of acceptance, below.)

Many offers include a deadline for acceptance. If a deadline is set and acceptance is not communicated within the time allotted, the offer terminates automatically. If a time limit is not stated in the offer, a reasonable amount of time is allowed. What is reasonable is determined by the court if a dispute arises.

If the offeror dies or is declared incompetent before the offer is accepted, it is terminated.

A **rejection** also terminates an offer. Once the **offeree** (the person to whom the offer was made) rejects the offer, he cannot go back later and create a contract by accepting the offer.

**Example:** Valdez offers to purchase Carter’s house for $385,000. Carter rejects the offer the next day. The following week, Carter changes her mind and decides to accept Valdez’s offer. But her acceptance at this point does not create a contract, because the offer terminated with her rejection.
A counteroffer is sometimes called a qualified acceptance. It is actually a rejection of the offer and a tender of a new offer. Instead of either accepting or rejecting the offer outright, the offeree “accepts” with certain modifications. This happens when some, but not all, of the original terms are unacceptable to the offeree. When there is a counteroffer, the roles of the parties are reversed: the original offeror becomes the offeree and can accept or reject the revised offer. If she chooses to accept the counteroffer, there is a binding contract. If the counteroffer is rejected, the party making the counteroffer cannot go back and accept the original offer. The original offer was terminated by the counteroffer.

Example: Palmer offers to buy Harrison’s property under the following conditions: the purchase price is $250,000, the closing date is January 15, and the down payment is $25,000. Harrison agrees to all the terms but the closing date, which he wants to be February 15. By changing one of the terms, Harrison has rejected Palmer’s initial offer and made a counteroffer. Now it is up to Palmer to either accept or reject Harrison’s counteroffer.
Acceptance. An offer can be revoked at any time until acceptance has been communicated to the offeror. To create a binding contract, the offeree must communicate acceptance to the offeror in the manner and within the time limit stated in the offer (or before the offer is revoked). If no time or manner of acceptance is stated in the offer, a reasonable time and manner is implied.

Negative Influences. The offeree’s acceptance must also be free of any negative influences, such as fraud, mistake, undue influence, or duress. If an offer or acceptance is influenced by any of these negative forces, the contract is voidable by the injured party.

Fraud is misrepresentation of a material fact to another person who relies on the misrepresentation as the truth in deciding to enter into a transaction.

- Actual fraud occurs when the person making the statement either knows the statement is false and makes it with an intent to deceive, or doesn’t know whether or not the statement is true but makes it anyway. For example, a seller who conceals cracks in the basement and then tells the buyer that the foundation is completely sound is committing actual fraud. A promise that is made without any intent to keep it can also be considered actual fraud.

- Constructive fraud occurs when a person who occupies a position of confidence and trust, or who has superior knowledge of the subject matter, makes a false statement with no intent to deceive. For example, if a seller innocently points out incorrect lot boundaries, it may be constructive fraud. Constructive fraud is also called innocent misrepresentation.

A mistake occurs when the parties are mistaken as to a material fact or the terms of the contract. If there is an ambiguity in negotiations, any contract that is signed may be void for lack of mutual agreement.
Example: Beth offers to buy a barren cow from Carl for $400. The day before Carl is to deliver the cow to Beth, he discovers that the cow is pregnant. This is an example of a mistake of fact. Both Carl and Beth mistakenly believed the cow to be barren. Thus, the contract is voidable.

Mistake does not include failing to read the terms of the contract, bad judgment, or entering into a disadvantageous contract.

Undue influence is using one’s influence to pressure a person into making a contract, or taking advantage of another’s distress or weakness of mind to induce him to enter into a contract.

Duress is compelling someone to do something—such as enter into a contract—against her will, with the use of force or constraint or the threat of force or constraint.

Lawful Objective

The third requirement for a valid contract is a lawful objective. Both the purpose of the contract and the consideration for the contract (discussed below) must be lawful. Examples of contracts with unlawful objectives are a contract requiring payment of an interest rate in excess of the state’s usury limit, or a contract relating to unlawful gambling. If a contract does not have a lawful objective, it is void.

Sometimes contracts contain some lawful provisions and some unlawful provisions. In these situations, it may be possible to sever the unlawful portions of the contract and enforce the lawful portions.
**Example:** Callahan and Baker enter into a contract for the sale of an apartment house. A clause in the contract prohibits the buyer from renting the apartments to persons of a certain race. The contract concerning the sale of the property would probably be enforceable, but the racially restrictive clause would be void because it is unlawful.

**Consideration**

The fourth element of a valid contract is **consideration**. Consideration is something of value exchanged by the contracting parties. It might be money, goods, or services, or a promise to provide money, goods, or services. Whatever form it takes, the consideration must be either a benefit to the party receiving it or a detriment to the party offering it. The typical real estate purchase agreement involves a promise by the purchaser to pay a certain amount of money to the seller at a certain time, and a promise by the seller to convey title to the purchaser when the price has been paid. Both parties have given and received consideration.

While consideration is usually the promise to do a particular act, it can also be a promise to not do a particular act; this is called **forbearance**. For example, Aunt Martha might promise to pay her nephew Charles $1,000 if he promises to stop smoking.

As a general rule, a contract is enforceable as long as the consideration has value, even though the value of the consideration exchanged is unequal. A contract to sell a piece of property worth $220,000 for $190,000 is enforceable. However, in cases where the disparity in value is quite large (for example, a contract to sell a piece of property worth $300,000 for $95,000), a court may refuse to enforce the contract. This is particularly likely to happen if the parties have unequal bargaining power (for example, if the buyer is a real estate developer and the seller is elderly, uneducated, and inexperienced in business).
The Writing Requirement

The requirements we’ve covered so far—capacity, mutual consent, lawful objective, and consideration—apply to any kind of contract. For most contracts used in real estate transactions, there is a fifth requirement: they must be put into writing, as required by the statute of frauds.

The **statute of frauds** is a state law that requires certain types of contracts to be in writing and signed. Only the types of contracts covered by the statute of frauds have to be in writing; other contracts may be oral.

Each state has its own statute of frauds, and the requirements vary slightly from state to state. As a general rule, however, almost all of the contracts typically used in a real estate transaction are covered by the statute of frauds. In many states, the statute of frauds applies to:

1. an agreement that is not to be performed within a year of its making;
2. any agreement for the sale or exchange of real property or an interest in real property;
3. a lease of real property that will expire more than one year after it was agreed to;
4. an agency agreement authorizing an agent to purchase or sell real property, or lease it for more than one year;
5. an agency agreement authorizing an agent to find a buyer or seller for real property, if the agent will receive compensation (a listing agreement); and
6. an assumption of a mortgage or deed of trust.

The “writing” required by the statute of frauds does not have to be in any particular form, nor does it have to be contained entirely in one document. A note or memorandum about the agreement or a series of letters will suffice, as long as the writing:

1. identifies the subject matter of the contract,
2. indicates an agreement between the parties and its essential terms,
3. is signed by the parties to be bound.

If the parties fail to put a contract that falls under the statute of frauds in writing, the contract is usually unenforceable. However, occasionally a court will enforce an unwritten agreement. This might occur if there is both evidence that the contract exists and evidence of its terms, and if the party trying to enforce it has completely or substantially performed his contractual obligations. This is rare; the safest course is to put a contract in writing.

If a contract is partly printed and partly handwritten (like a filled-out contract form) and there’s a conflict between the handwritten and printed portions, the handwritten portion takes precedence. It’s presumed to be a more reliable indication of the parties’ intent than the printed portion.

**Parol Evidence Rule.** In the event of a dispute between parties to a contract, a written agreement provides the best evidence of the terms agreed upon. When a written agreement is considered complete and unambiguous, the parol evidence rule prevents the parties from introducing oral statements or other extraneous evidence (parol evidence) to prove the contents of the contract.

**Example:** McKinney and Francisco signed a listing agreement in which McKinney promised to pay Francisco a 6% commission upon the sale of McKinney’s home. After the home sold, McKinney paid Francisco a commission amount equal to 5% of the sale price. Francisco sued McKinney for breach of contract. Because the listing agreement is clear and complete, McKinney cannot introduce evidence that the parties had orally agreed to lower Francisco’s commission to 5%.

However, parol evidence will be allowed where the contents of the contract are incomplete or ambiguous, or where it is necessary to prove that the writing was induced by undue influence, duress, or some other negative influence.
Legal Status of Contracts

Four terms are used to describe the legal status of a contract: a contract is void, voidable, unenforceable, or valid. These terms have already been used in our discussion, and now we'll look more closely at what each one means.

<table>
<thead>
<tr>
<th>Type of Contract</th>
<th>Legal Effect</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Void</td>
<td>No contract at all</td>
<td>An agreement for which there is no consideration</td>
</tr>
<tr>
<td>Voidable</td>
<td>Valid until rescinded by one party</td>
<td>A contract entered into as a result of fraud</td>
</tr>
<tr>
<td>Unenforceable</td>
<td>One or both parties cannot sue to enforce</td>
<td>A contract after the limitations period expires</td>
</tr>
<tr>
<td>Valid</td>
<td>Binding and enforceable</td>
<td>An agreement that meets all the legal requirements</td>
</tr>
</tbody>
</table>

**Void**

A void contract is no contract at all; it has no legal effect. This most often occurs because one of the essential elements, such as mutual consent or consideration, is completely lacking.

**Example:** Talbot signed a contract promising to deed some property to Worth, but Worth did not offer any consideration in exchange for Talbot’s promise. Since the contract is not supported by consideration, it is void.

A void contract may be disregarded. Neither party is required to take legal action to withdraw from the agreement.
Voidable

A voidable contract appears to be valid, but has some defect giving one or both of the parties the power to withdraw from the agreement. For instance, a contract entered into as a result of fraud is voidable by the defrauded party.

Unlike a contract that is void from the outset, a voidable contract can’t simply be ignored. Failure to take legal action within a reasonable time may result in a court declaring that the contract was ratified. (If the injured party decides to continue with the agreement, he may expressly ratify it.)

Unenforceable

An unenforceable contract is one that can’t be enforced in court for one of the following reasons:

1. its contents cannot be proved,
2. it is voidable by the other party, or
3. the statute of limitations has expired.

Contents Cannot Be Proved. This is most often a problem associated with oral agreements. Even if the law does not require a certain kind of contract to be written, it is a good idea to put it in writing because it avoids confusion and misunderstanding.

Contract Voidable by Other Party. If a contract is voidable by one of the parties, it is unenforceable by the other party. (Note that the party who has the option of voiding the contract can choose instead to enforce the contract against the other party.)

Statute of Limitations Expired. A statute of limitations is a law that sets a deadline for filing a lawsuit. Unless an injured party files suit before the deadline set by the applicable statute of limitations, her legal claim is lost forever. The purpose of a statute of limitations is to prevent lawsuits long after an event, when memories have faded and evidence has been lost.
Every state has a statute of limitations for contracts. If one of the parties to a contract fails to perform his obligations (breaches the contract), the other party must sue within a certain number of years after the breach. Otherwise, the limitations period will run out and the contract will become unenforceable.

The doctrine of laches is related to the concept of statutes of limitations. Laches is an equitable principle that courts can use to prevent someone from asserting a claim after an unreasonable delay. For instance, suppose a property owner knowingly stands by while a neighbor builds a house that encroaches a few feet onto his property. He then sues, demanding that it be torn down. Because the property owner’s unreasonable delay caused the neighbor harm, the court may use the doctrine of laches to deny the requested remedy.

Valid

If an agreement has all the essential elements, can be proved in court, and is free of negative influences, it’s a valid contract and a judge will enforce it.

Discharging a Contract

Once there is a valid, enforceable contract, it may be discharged by:

1. full performance,
2. agreement between the parties, or
3. termination of the contract.

Full Performance

Full performance means that the parties have performed all of their obligations; the contract has been executed. For example, once the deed to the property has been transferred to the buyer, and the seller has received the purchase price, the purchase and sale agreement has been discharged by full performance.
Agreement Between the Parties

The parties to a contract can agree to discharge the contract in any of the following ways:

- rescission,
- cancellation,
- assignment,
- novation, or
- partial performance.

**Rescission.** Sometimes the parties to a contract agree that they would be better off if the contract had never been signed. In such a case, they may decide to rescind the contract.

The buyer and seller sign an agreement that terminates their previous agreement and puts them as nearly as possible back in the positions they were in before entering into the initial agreement. If any money or other consideration has changed hands, it will be returned.

In certain circumstances, a contract can be rescinded by court order (rather than by agreement between the parties). Court-ordered rescission is discussed later in this chapter.

**Cancellation.** A cancellation does not go as far as a rescission. The parties agree to terminate the contract, but previous acts are unaffected. For example, money that was paid prior to the cancellation is not returned.

When contracting to purchase real property, a buyer generally gives the seller a deposit to show that she is acting in good faith and intends to fulfill the terms of their agreement. This is called a **good faith deposit** (or earnest money deposit), and the seller is entitled to keep it if the buyer defaults on the contract. If the buyer and seller agree to terminate the contract and the seller refunds the good faith deposit to the buyer, the contract has been rescinded. If the seller keeps the deposit, the contract has been canceled.
**Assignment.** Sometimes one of the parties to a contract wants to withdraw by assigning her interest in the contract to another person. As a general rule, a contract can be assigned to another unless a clause in the contract prohibits assignment. Technically, assignment does not discharge the contract. The new party (the assignee) assumes primary liability for the contractual obligations, but the withdrawing party (the assignor) is still secondarily liable.

**Example:** A buyer is purchasing a home on a land contract over a 15-year period. In the absence of any prohibitive language, she can sell the home, accept a cash down payment, and assign her contract rights and liabilities to the new buyer. The new buyer would assume primary liability for the contract debt, but the original buyer would retain secondary liability.

One exception to the rule that a contract can be assigned unless otherwise agreed: a personal services contract can’t be assigned without the other party’s consent.

**Example:** A nightclub has a contract with a singer for several performances. The singer cannot assign her contract to another singer, because it is a personal services contract. The nightclub management has a right to choose who will be singing in their establishment.

**Novation.** The term “novation” has two generally accepted meanings. One type of novation is the substitution of a new party into an existing obligation. If a buyer under a real estate contract is released by the seller in favor of a new buyer under the same contract, there has been a novation. The first buyer is relieved of all liability connected with the contract.

Novation may also be the substitution of a new obligation for an old one. If a landlord and tenant agree to tear up a three-year lease in favor of a new ten-year lease, it is a novation.
**Assignment vs. Novation.** The difference between assignment and novation concerns the withdrawing party’s liability. When a contract is assigned, there is continuing liability for the assignor. In a novation, on the other hand, the withdrawing party is released from liability, because he was replaced with an individual who was approved by the other party. Novation, unlike assignment, always requires the other party’s consent.

**Partial Performance.** In some instances, the parties to a contract may agree to discharge a contract after one of the parties has partially performed under the terms of the contract. The parties execute a written agreement stating that the work performed is sufficient to discharge the contract. Partial performance should not be confused with substantial performance, which is discussed below.

**Termination**

Not all contract disputes can be resolved by the parties. A court may terminate a contract on the basis of substantial performance, impossibility of performance, and through operation of law.

**Substantial Performance.** The doctrine of substantial performance is most often applied to construction contracts. Where one party has performed under the contract, but did not precisely follow the terms, a court may find that the performance is sufficient to discharge the contract.

**Example:** The Michaelsons contract with Happy Day Construction to build their dream house. After construction is completed, the Michaelsons notice that Happy Day installed kitchen cabinets that are a shade darker than they had originally selected. Under the doctrine of substantial performance, the Michaelsons will be required to pay the contractor for the work performed, less any damage suffered as a result of the contractor’s error.

**Impossibility.** A contract may be terminated when an unforeseen event prevents a party from performing under the contract; in other words, performance becomes legally impossible. For example, you sign an
agreement to have Acme Painters paint your house. The day before they are to begin work, the house burns down. The contract is terminated due to impossibility of performance.

**Operation of Law.** A court may terminate a contract through operation of law, as in voiding a contract signed by a mentally incompetent person. A contract may also be terminated for fraud, undue influence, mistake, or duress.

**Breach of Contract**

A breach of contract occurs when one of the parties fails, without legal excuse, to perform any of the promises contained in the agreement. The injured party can seek a remedy in court only if the breach is a **material breach.** A breach is material when the promise that has not been fulfilled is an important part of the contract.

Many standard contract forms state that “**time is of the essence.**” That phrase is used to warn the parties that timely performance is crucial and failure to meet a deadline would be a material breach. If one party misses a deadline, the other party may choose whether to proceed with the contract or use the time is of the essence clause as the basis for ending it.

When a breach occurs, there are four possible remedies available to the injured party:

- rescission,
- compensatory damages,
- liquidated damages, or
- specific performance.

**Rescission**

As previously explained, a rescission is a termination of the contract in which the parties are returned to their original positions. In the case of a purchase agreement, the seller refunds the buyer’s good faith deposit and
the buyer gives up his equitable interest in the property. The rescission can be by agreement, or it can be ordered by a court at the request of one party when the other party has breached the contract.

Compensatory Damages

Financial losses that a party suffers as a result of a breach of contract are referred to as damages.

Example: Able, a manufacturer, contracts to buy 50,000 hinges from Baker for $12,000, and Baker promises to deliver the hinges by April 22. As it turns out, Baker fails to deliver the hinges on time, and Able (in order to fulfill commitments to her customers) must quickly purchase the hinges from another supplier. This other supplier charges Able $17,000—$5,000 more than Baker was charging. Able has suffered $5,000 in damages as a result of Baker’s breach of contract.

The most common remedy for a breach of contract is an award of compensatory damages. This is a sum of money that a court orders the breaching party to pay to the other party, to compensate the other party for losses suffered as a result of the breach of contract. Compensatory damages are generally intended to put the nonbreaching party in the financial position she would have been in if the breaching party had fulfilled the terms of the contract.

Example: Continuing with the previous example, suppose Able sues Baker for breach of contract. The court orders Baker to pay Able $5,000 in damages. When Baker pays Able the $5,000, that puts Able in the financial position she would have been in if Baker had delivered the hinges on time.
Liquidated Damages

The parties to a contract sometimes agree in advance to an amount that will serve as full compensation to be paid in the event that one of the parties defaults. This sum is called liquidated damages.

Example: Let’s return to the previous example. Now suppose that Able and Baker included a liquidated damages provision in their contract. The provision states that if Baker breaches the agreement, he will pay Able $3,000, and that will serve as full compensation for the breach.

Baker fails to deliver the hinges to Able on time, Able must purchase them from another supplier, and that costs her an extra $5,000. But because of the liquidated damages provision in the contract, Able is only entitled to receive $3,000 from Baker. She can’t sue for any additional amount, even though her actual damages were greater than $3,000.

Although a liquidated damages provision limits the amount of compensation the nonbreaching party will receive, it benefits both parties by making it easier to settle their dispute without going to court. It’s sometimes
difficult for the nonbreaching party to prove the extent of the actual damages she suffered; a liquidated damages provision makes that unnecessary.

In a real estate transaction, the buyer’s good faith deposit is often treated as liquidated damages. If the buyer breaches the purchase and sale agreement, the seller is entitled to keep the deposit as liquidated damages. The seller usually can’t sue the buyer for an additional amount.

On the other hand, a typical purchase and sale agreement doesn’t have a liquidated damages provision that applies if it’s the seller who breaches instead of the buyer. If the seller breaches the contract, the buyer can sue for compensatory damages.

**Specific Performance**

Specific performance is a legal action designed to compel a defaulting party to perform under the terms of the contract. For example, a court can order a seller to sign and deliver a deed to a buyer to complete a purchase.

Specific performance is usually available as a remedy only when monetary damages are not sufficient compensation. For example, when the purchase of real property is involved, the court might order specific performance because there is no other property that is just like the one the seller agreed to sell. Payment of damages would not enable the buyer to purchase another property exactly like it.

Note that if the consideration promised for the property is unreasonable, a court may refuse to order specific performance in the event of a breach.

**Tender**

A tender is an unconditional offer by one of the contract parties to perform her part of the agreement. It is sometimes referred to as “an offer to make an offer good.” A tender is usually made when it appears that the other party is going to default; it is necessary before legal action can be taken to remedy the breach of contract.
Example: A seller suspects that the buyer does not plan to complete the purchase, and he intends to sue the buyer if this happens. The seller must attempt to deliver the deed to the buyer as promised in the purchase and sale agreement. When the tender is made, if the buyer refuses to pay the agreed price and accept the deed, the buyer is placed in default and the seller may then file a lawsuit.

If a buyer has reason to believe the seller does not plan to complete the sale, the buyer tenders by attempting to deliver the full amount promised in the purchase agreement to the seller. When the seller refuses to accept the money and deliver the deed, she is in default.

Sometimes there is an **anticipatory repudiation** by one of the parties. An anticipatory repudiation is a positive statement by the defaulting party indicating that he will not or cannot perform according to the terms of the agreement. When this happens, no tender is necessary as a basis for a legal action. (Rockwell, 144-159)

Cited Material: