

A real estate contract: At what point and to what extent does it become binding?^{1, 2}

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ABSTRACT

The purchasing process in the real estate world can be very complex for both the buyer and the seller of the property. Both can be reluctant to signing the contract in regards to the level to which it is binding, so it is important to be informed about the different steps of the process and the level to which they are binding to one or both parties.

We will here review all eleven steps of the real estate purchasing process and determine what contingencies can be found at which step. We will then deduct from this analysis the level to which each step is binding and create a ranking of the steps.

This will lead to the resolution of our problem which is to determine at what point and to which extend a real estate contract becomes legally binding.

Keywords: Contract; real estate; legal; binding; offer; seller; buyer; contingency; dispute

INTRODUCTION

When individuals are asked about their life goals, a very common response is to “buy a house”. Nearly everyone will be concerned by this situation at one point in their life and will have to look into the procedure of doing so. On the other hand, if you own a property and wish to sell it you will also have to inform yourself about those procedures to conclude a deal with a potential buyer. The real estate market is enormous and concerns everyone; in the United States, in 2015, 5,250,000 existing homes were sold as well as 510,000 newly constructed ones.

Once a buyer and a seller have come together to conclude a deal, buyers can agree verbally with the sellers on their decision to purchase or not. They will then proceed to sign a real estate contract.

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But can they change their mind after the contract is signed? How binding is the signed contract and at what stage of the buying procedure does the action of the house being sold from the seller to the buyer become official? Can the buyer retract from the contract and until what stage? What about the seller?

It can be interesting to look into this situation to try and determine exactly at what point a real estate contract becomes binding and to which level. We will examine the contingencies decided by the attorneys and the contract's details that can prevent a party to be unable to retract from the contract, and we will reflect on the reasons a buyer and a seller each have to make the contract more or less easy to cancel.

This will bring us to the resolution of our problem which is to **determine at what point and to which extent does a real estate contract become legally binding?**

METHODOLOGY

1. Feasible alternatives; Identification of the steps in the real estate purchasing process

In order to resolve our problem which is to understand and determine at what point a real estate contract becomes binding and to what level, it is first necessary to have a look at the real estate purchasing process.

There are a number of necessary steps that have to occur before a property can be purchased. We will go throughout the steps one by one in order to gain more clarity on the chronology of the process. It is necessary to mention that these steps are not fixed and may differ according to the place where the real estate contract is being decided.

The feasible alternatives will be the different steps of the purchasing contract, described below in an order going from 1 to 11.

2. Development of the outcomes for each alternative

To keep our analysis relevant, we will only concentrate on the steps that involve both the seller and the buyer and leave out for example the steps where the buyer proceeds to getting a loan for the payment.

1. The first step once the property is chosen by the buyer is making an offer. A letter of intent has to be addressed by the buyer to the seller. This offer being in writing will permit both the buyer and the seller to reach a signed agreement before any attorneys are involved.

During this step, negotiations concerning the total purchase price, the terms of sale and the conditions of sale will occur. This negotiated and accepted deal will be the first step to having a legally formalized agreement.

2. Finding an attorney is the second step to the process as both the buyer and the seller will need to be legally represented in order to close the real estate deal.
3. An escrow will then be opened, which means an account will be held by someone who is neither the buyer nor the seller in the transaction. This account owned by a third party will hold the money and the documents that are related to the transaction until everything is decided. They will be important throughout the process.
4. An earnest money deposit can be made to the escrow. This will show the buyer is committed to the transaction, but this deposit is refundable depending on the contingencies.
5. Obtaining an appraisal on the property is the next step.
6. The seller must then provide the buyer with documents that will disclose the person buying the property of any flaws that would affect its value.
7. The buyer will then conduct an inspection to uncover eventual defects and can ask for reasonable reparations.
8. All contingencies of the contract then need to be removed to proceed.
9. A final walk through of the property can then be done by the buyer to check the property is in the state in which he or she has agreed to buy it.
10. The step of signing the loan and the escrow documents comes next.
11. Finally, the buyer will deposit the rest of the down payment and closing costs to the escrow. The real estate purchasing process will be completed once the escrow is closed.

Each step of the real estate purchasing process is important to both the buyer and the seller. We could think that the contract becomes binding in step one when a contract is signed by both parties, or only in step 10 and 11 when the loan is signed and the money handed over but in reality, the contract is binding from step one but with many contingencies that will allow both parties to retract during each step.

Our analysis will consist of finding out what the contingencies can be at each step of the process and to explain for which step to what extend the contract is binding to both parties.

The attributes will be the level to which the contract is binding at this particular step. If a contract is considered binding in this case, we will consider that there are no contingencies to permit one or the other party to retract from the deal.

There will then be three possible outcomes for our analysis; not binding, somewhat binding which we will explain with the development of the contingencies, or binding to the point where there are no more contingencies.

The above explanation of the feasible alternatives and attributes can be resumed in the following table that will be explained and completed with our findings:

Alternative/Attribute	Step 1	Step 2	Step 3	Step 4	Step 5	Step 6	Step 7	Step 8	Step 9	Step 10	Step 11
Not binding		Yes			Yes	Yes	Yes				
Binding with contingencies	Yes		Yes	Yes							
Binding without contingencies								Yes	Yes	Yes	Yes

3. Selection of criteria

This table will be completed according to an analysis of each step of the process. If the step is found to not be binding or to be binding without contingencies the table will simply show this is the case. However, if the step is found to be binding with contingencies the step will be developed with examples of possible contingencies and their importance.

To identify if a step is binding or not we will mainly try to see if once the step is finished there are legal ways that allow the buyer or the seller to change their mind and retract themselves if they wish to.

None of the 11 steps can be abandoned and rejected at this step because they are all part of the process and will all need to be analyzed as you cannot have one before completing the precedent.

4. Problem definition

This will be able to resolve the following problem; at what point and to which extent does a real estate contract become legally binding?

FINDINGS

5. Analysis and comparison of the alternatives

To resolve our problem and review the real estate purchasing process, it is necessary to issue a rank ordering to determine which steps are the best, or which ones are better than others in the event where one party would like to withdraw from a real estate contract.

In order to do so we will analyse each process more in depth, as in the methodology, only the basic description of what happens during the step was given.

1. A letter of intent is addressed from the buyer to the seller and a signed agreement is reached, but no attorneys are involved. As this is only the first step of the whole process, there are many contingencies that will allow one of the parties to retract from the contract at this point;

a) Appraisal contingency

The buyer has negotiated a price that he is willing to pay for the property and this is the price indicated on the signed document. As the appraisal has not been done yet and will only occur in step 5 of our process, if the price decided at this step is not the same as the one on the signed agreement both parties will be able to withdraw. If the appraisal price is lower than the negotiated purchase price, the seller will want to renegotiate and will be able to end the deal if no agreement is reached. On the other hand if the appraisal price is higher than the purchase price the buyer will be required to pay the difference and may not be able to for many reasons (for example if he has taken a loan for a certain amount) and will then retract from the deal.

b) Financing contingency

If the buyer is not able to provide the expected amount of money in time the contract will be abandoned, this is a financing contingency. At this step, as no financial transactions have been made this contingency is valid.

c) Home inspection contingency

At step 7 of our purchasing process the property is inspected and if it is not up to the buying standards, the buyer is able to retract. This contingency ensures the protection of the buyer who will not be trapped in a deal that does not match his expectations. It is valid in the step as the inspection has not been done yet.

The signed document makes this first step of the process binding but as there are many contingencies that able both parties to have a way out of the contract, we will consider this step *binding with contingencies*.

2. Finding an attorney. Attorneys will be necessary to legally close the real estate contract. However, in this step the three contingencies seen in step one are still valid (appraisal, financing and home inspection contingency) so we will not consider this step to be more binding than the previous one.

Having paid an attorney might influence the parties into being less inclined to withdraw from the deal as money has been involved but this is more of a personal factor than as legal one so we will not consider it. As of the purchasing process, this step adds nothing that will legally change the contract's validity so we will consider it to be *not binding*.

3. An escrow held by a third party will then be opened in the third step. The contingencies that were valid in the two previous steps are still valid and no financial transaction occurs at this step, the escrow is only opened. We will consider this to be like the previous step and choose to refer to it as *not binding*.
4. An earnest money deposit can be made to the escrow. This will show the buyer is committed to the transaction, but this deposit is refundable depending on the contingencies. Money is finally officially involved and this makes this step more binding than the previous ones for the buyer. He has the possibility to be refunded according to the three contingencies that are still valid. This step is *binding with contingencies*, but when we will choose to rank the steps from more to less binding, we will place it before step 1 (making it more binding) as there is a financial transaction involved.
5. Obtaining an appraisal on the property is step 5. This is the last step where the appraisal contingency is considered. Once we move on to step 6, the purchase price will not have the possibility to be renegotiated. This step is *binding with contingencies* and is more binding than step 1 and 4 that were previously analyzed, as a contingency is here removed. If a buyer backs out of the deal at this point, the earnest deposit will be returned to him.
6. The seller must then provide the buyer with documents that will disclose the person buying the property of any flaws that would affect its value. In this step, two contingencies are still valid (financing and home inspection). We can link this step to home inspection as the flaws that may be disclosed here may be related to the state in which the property is sold and the buyer may wish to retract because of this.

However, it is step 7 where the home inspection will be conducted and the contingency will be removed. In step 6, the buyer will be provided with the disclosure documents, but this will not make the contract any more binding to him. Therefore, this step is *not binding*.

7. The buyer will then conduct an inspection to uncover eventual defects and can ask for reasonable reparations. This step is *binding with contingencies* and can be considered more binding than step 5 because as said before, the home inspection contingency will

be removed at this point and if the buyer accepts the property at this point he will not have the possibility to retract because of defects later on.

8. All contingencies of the contract then need to be removed to proceed. Only one contingency remains at this point of the real estate purchasing process and it is the financial contingency one. As it requires that the buyer provides the seller with the required money at a certain time we can determine that at this step the correct amount needs to be available to end the transaction in the three remaining steps. This step is *binding with contingencies* but once it has passed there are no remaining contingencies that enable the parties to withdraw.
9. A final walk through of the property can then be done by the buyer to check the property is in the state in which he or she has agreed to buy it.
10. The step of signing the loan and the escrow documents comes next.
11. Finally, the buyer will deposit the rest of the down payment and closing costs to the escrow. The real estate purchasing process will be completed once the escrow is closed.

As step 8 is binding with only the last contingency which is the financial one, we can consider that the three steps that come after it to be *binding without contingencies* as, if the process is followed normally, no further contingencies should appear making the contract not valid anymore.

In other words, if a real estate purchasing process has reached steps 9, 10 or 11 it is completely binding and will be able to be closed without the parties having the possibility to withdraw anymore.

6. Selection of the preferred alternative

The table we have made to help with the methodology can now be modified according to our findings:

We are now able to show the number of contingencies that can be found at each step and indicate them accordingly. From there we can see which steps are more binding (ranked 1) and with this logic which are the less binding (ranked 7). There are not 7 levels because we can regroup some steps as some have an equivalent level.

Alternative/Attribute	Step 1	Step 2	Step 3	Step 4	Step 5	Step 6	Step 7	Step 8	Step 9	Step 10	Step 11
Not binding		3	3			2					
Binding with contingencies / how many	3			3	2		1	0			
Binding without contingencies									0	0	0
Summary for the ranking	6	7	7	5	4	7	3	2	1	1	1

We can then issue a rank ordering of the steps of the purchasing process, depending on if they are more or less binding. To avoid any confusion with the steps that are numbered 1 to 11, we will rank in an alphabetical order, A being the most binding step.

Ranking of the steps in the real estate purchasing process

- A) Steps 9, 10 and 11
- B) Step 8
- C) Step 7
- D) Step 5
- E) Step 4
- F) Step 1
- G) Steps 2, 3, and 6

7. Performance Monitoring and post-evaluation of results

According to our results, not all steps of the real estate purchasing process are binding but for those who are, they become more and more important and as the process advances it becomes harder for both parties to withdraw.

We now have a better understanding of which steps of the process are more or less binding and therefore can seem more or less important.

CONCLUSIONS

Our main problem was to find out at what point, and to which extend a real estate contract becomes legally binding. With the analysis of each step of the 11 ones that form the real estate purchasing process and the decision of which contingencies were valid at which step we were able to issue a ranking that clearly shows which steps are more or less binding.

The three contingencies that will allow a party to withdraw from a real estate contract are the appraisal contingency, the home inspection contingency and the financing contingency. Once those three contingencies have been removed, the contract becomes completely binding and this is why the three final steps are the most important ones; once they have been reached a withdrawal is not possible.

This gives us a better understanding of the real estate purchasing process and allows us to clearly see which steps it is necessary to be focused on as they are more important and result in making the contract more binding to both parties. It is necessary to have basic understanding of the impact of the contingencies and of the level to which steps are binding before starting the process of buying or selling a property in order to get exactly what you want out of it and to not become trapped in a contract that does not match your expectations.

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Alix Sion is a MSc student studying Project and Programme Management and Business Development in the Paris campus of SKEMA business school. Born in France, she lived three years in Chester, England and three years in Manila in The Philippines during her childhood, before moving back to France at age 11. Once she obtained her baccalauréat, she then went on to study a double degree in Global Business. After two years of studies in Dublin City University and two years in NEOMA Reims in France she graduated with first class honours in 2017.

During her two years in NEOMA, she was vice president of the student union and contributed to the organization of a business weekend reuniting more than 500 students from many different countries. She was very passionate about it and this has contributed to her desire to spend her life engaging in temporary projects.

Once she has obtained her masters degree, she will go on to start her career abroad, possibly in Ireland or Switzerland where her family currently lives.