

The Perils of Conditions in Sale and Purchase Agreements

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Recently, we were presented with a situation where a client had identified issues with a property he was proposing to purchase, but assured us that he was able to get out of the agreement and would instruct his conveyancing solicitor accordingly. On our review of the agreement, his purported get out of jail free card was not quite what it appeared to be.

Unfortunately, we have dealt with a number of matters over the years where we have been required to provide advice to clients where advice as to non-fulfilment of a condition has not been accepted by the vendor as bringing the contract to an end. As a specialist litigation practice, we are generally only involved in matters when things go wrong. As a result, we have the benefit of having a greater understanding of interpretation issues, and consequently how potential issues could be avoided with specific drafting techniques at the time the agreement is entered into.

The purpose of this article is to explore the legal position surrounding special conditions, including some standard special conditions, that are drafted at the end of the ADLS Sale and Purchase Agreement.

Conditions Precedent and Conditions Subsequent

Historically, conditions were classified as either conditions precedent (an event that was required to take place before an agreement becomes contractually binding) or conditions subsequent (an event following which a concluded contract is discharged).

The relevance of the distinction is that conditions precedent have the effect of providing that an agreement reached will have no contractual effect until the condition is fulfilled, and if not fulfilled by the required date, the agreement is automatically voided (or strictly speaking, never came into existence). Alternatively, conditions subsequent have the effect of simply suspending the parties' contractual obligations pending the event provided for in the condition.

Because of the automatic results of conditions precedent there was later a move to categorise conditions in standard agreements and in judicial construction as conditions subsequent. Clause 8.7 of the standard REINZ/ADLS Agreement for Sale and Purchase of Real Estate (Eighth Edition) (ADLS Agreement) provides that any conditions are to be conditions subsequent.

However, whilst the Court will take such provision into account, it is not necessarily determinative of the issue as the ultimate determination is the intention of the parties as gathered from the contract as a whole and the surrounding circumstances at the time it was made.

If acting for parties to an agreement, it will be important to consider the drafting of the condition to ensure that it accurately reflects the parties' intentions.

Subject to solicitor approval

One of the most often used special conditions is a subject to solicitor approval clause. Whilst we have seen a number of drafting techniques, the effect is generally the same. The agreement is conditional on approval from the purchaser's solicitor, such approval to be provided within a certain period.

In New Zealand, it is generally accepted that solicitor approval clauses operate such that a contract exists but the principal obligations of the parties are suspended pending solicitor approval.

In determining the interpretation of a solicitor's approval clause, the leading case in New Zealand is *Provost Developments Ltd v Collingwood Towers Ltd*¹. In that case, there was a basic solicitor approval clause and the vendor sought to avoid the agreement on the basis that the vendor was offered a higher price for the property.

In the Court of Appeal it was determined that the agreement could only be avoided through non-compliance of the solicitor approval clause in circumstances where the solicitor had genuine concerns about the conveyancing aspects of the transaction. A summary of the legal principles emerging from the decision in *Provost Developments Ltd v Collingwood Towers Ltd* is found in *Dashwood Vineyards Ltd v F M and C M Hammond*². These are as follows:

- (a) A solicitor's approval clause is a condition subsequent: it attaches to the parties' binding agreement and may operate to bring an agreement to an end.
- (b) The wording of the particular clause (since solicitor's approval clauses vary) needs to be interpreted, in the context of the particular agreement. What might be expected of a conveyancing solicitor will vary according to the kind of parties involved and/or the type of property being sold. The interpretation principles adopted by the Court of Appeal in *Boat Park v Hutchinson*³ will apply, i.e. the agreement is to be given the meaning it would have to a reasonable person having all the background knowledge which would reasonably have been available to the parties at the time of the contract.
- (c) The solicitor's approval function is limited to the "conveyancing aspects" or "legal implications" of the agreement. Although those phrases are to be liberally construed, they are still restricted to considerations peculiarly within the solicitor's sphere. The solicitor may not act as a general or financial/business advisor. The solicitor may not review the "wisdom" or "appropriateness" of the bargain as a whole, or its commercial advantages/disadvantages. Nor may the solicitor be the "alter ego" of the client in a commercial sense. In short, the solicitor is only entitled to refuse approval if there are genuine legal objections or impediments to the bargain the parties have made.
- (d) Although obviously obliged to act in the client's interest, the solicitor must exercise honest, genuine professional judgment, with the objectivity and reasonableness that entails, and may not simply do what the client instructs.
- (e) It is the reasons given by the solicitor for declining approval which the Court must look at. Reasons subsequently added should be treated with circumspection, if not ignored, as ex post facto justification is irrelevant to the timely exercise of a solicitor's approval function.

¹ [1980] 2 NZLR 205

² High Court Blenheim, CP 15/99, 21 July 2000, Wilde J.

³ [1999] 2 NZLR 74

It may be possible to draft a solicitor's approval clause more broadly with an example as set out below:

"This Agreement is conditional upon the approval of the Purchasers' solicitors, who may take into account any aspects of the contract and/or the Property (including any commercial, conveyancing or any other aspect relating to the desirability of the contract and/or the Property) and the wishes of the Purchaser, such approval to be given in writing within 10 working days of the date of this Agreement. If no such approval has been given this Agreement shall be void and all monies (if any) paid under it shall be refunded and neither party shall have any right or claim against the other. This clause is inserted for the sole benefit of the Purchaser."

For the reasons that are set out below, the Court would likely interpret such a condition as providing an option for purchase exercisable by the purchaser until the end of the due diligence period, and not a concluded agreement for sale and purchase.

Subject to finance

Clause 8.7 of the ADLS Agreement provides that the party for whose benefit the condition has been inserted *"shall do all things which may be reasonably necessary to enable the condition to be fulfilled by the date for fulfilment."*

If the ADLS Agreement was not used, then the Court would imply a term that required reasonable efforts be made.

In *Connor v Pukerau Store Limited*⁴ there was a contractual obligation to *"arrange suitable finance"*. The Court held that reasonable efforts had not been made by the defendant to achieve finance after he made only one unsuccessful enquiry with a potential lender.

In the recent Court of Appeal decision of *Purewal BS & JK Ltd v Connell Street Limited*⁵ the finance condition was expressed as *"conditional upon the purchaser arranging finance in terms of those particulars on or before the finance date."*

The purchaser had two properties under contract for sale that required titles to be issued before it would be in a position to settle with the vendor. The purchaser sought and obtained finance shortly after entry into the agreement. However, settlement (which was 12 working days after issue of the purchaser's titles) was delayed significantly because of the delay in obtaining titles. When titles were eventually issued, the National Bank's original offer of finance had lapsed and the lending criteria had changed as a result of the global recession. The purchaser was unable to obtain finance from other lenders.

The Court held that clause 8.1 of the ADLS Agreement refers to finance being arranged on or before the finance date: it does not say that the finance must be available on the settlement date. Accordingly, it was for the purchaser to ensure that it enters into suitable arrangements so that the finance will be available at settlement. Once finance is arranged, the purchaser, by virtue of clause 8.7(2), is bound to notify the vendor that finance is arranged.

⁴ [1981] 1 NZLR 384

⁵ [2012] NZCA 42

In considering the obligation under clause 8(4) of the ADLS Agreement, which requires notification before the condition is deemed fulfilled, the Court held that the act of notification is one of the things which must be done ~~to~~ enable the condition to be fulfilled by the date of fulfilment.⁶ Accordingly, if a party does not notify of the fulfilment of the condition inserted for that party's benefit, that party has not done all things which may be reasonably necessary to enable the condition to be fulfilled, and, accordingly, the agreement is voidable only at the election of the other party.

Subject to Building Report

Again, another typical condition is that requiring purchaser satisfaction of a building report to be obtained.

In *Lerner v Schiehallion Nominees Ltd*⁷ the relevant provision in the contract was expressed as follows:

"This agreement is conditional on a building report satisfactory to the purchaser within seven days of the signing of this agreement by both parties."

In this case, the purchaser obtained a ~~short~~ form+ or brief report from a building surveyor/expert after the building surveyor/expert had undertaken a normal inspection of the property. The vendor argued that a full building report based on a full and proper inspection had not been obtained as was required pursuant to the agreement.

In considering whether a subjective or objective test ought to apply to the phrase ~~satisfactory to the purchaser~~+ the Court found that the parties must have intended an objective test. The Court relied on the provision of clause 8.7(1) of the ADLS Agreement which provided that the condition was a condition subsequent. The Court stated⁸:

"A subjective interpretation of a conditional contract which provides for one party an unfettered route of escape is contrary to the intention expressed by the parties in entering into the contract in the first place. In effect it can convert what the parties intended should be a binding contract, subject to a condition subsequent, into an option in favour of one of the parties."

The Court also held that a building report must be prepared:

- (a) By a person qualified to give such a report; and
- (b) In good faith; and
- (c) In accordance with basic inspection and reporting principles and methods for building reports.

The Court found that basic inspection and reporting methods were followed, albeit that the report was in summary written form supplemented by verbal advice.

Accordingly, purchasers ought to be advised that if they agree to a condition requiring the preparation of a building report, the purchaser ought to ensure that it is undertaken by a

⁶ Clause 8.7(2) of the ADLS Agreement

⁷ [2003] 2 NZLR 671

⁸ At [33]

professional and in accordance with basic inspection and reporting principles. A brief inspection by a builder mateqand without any written report, may not be sufficient if the agreement is subsequently sought to be voided.

Due Diligence

In *Rosa and Litica v MacEnnovy Trust Limited*⁹ the following condition was inserted in the agreement:

“This agreement is subject to the purchaser being satisfied with a due diligence investigation to be carried out by the purchaser in respect of such aspects of the property that the purchaser deems relevant. In the event the Purchaser [sic] is not satisfied with any aspect of the due diligence investigation then the purchaser may cancel this agreement by notice in writing to the vendor and the purchaser shall not be obliged to give reasons for such cancellation and/or non-satisfaction of this condition. The date for the satisfaction of this condition shall be ... 4 September 2009. This condition is inserted for the sole benefit of the purchaser.”

The purchaser undertook a number of inquiries and made various visits to the property with tradespeople before advising that the due diligence condition was not satisfied and the agreement was at an end.

The vendor then argued that the clause did not give the purchasers an unrestricted option to cancel and submitted that the decision had to be reached fairly and reasonably (in other words it had to be objectively justifiable), and solely on matters arising out of the due diligence investigation. The vendor relied on the above decision in *Lerner v Schiehallion Nominees Ltd*.

However, the Court did not agree. It held that an agreement can be worded so as to make satisfaction of a condition entirely a matter for the subjective determination of a purchaser and this was the effect of the above clause.

A similar due diligence clause was at issue in *Prime Property Group Ltd v Amtrust Pacific Property Ltd*¹⁰ where the agreement was conditional on the purchaser completing an investigation ~~entirely to its satisfaction~~. The Court found that the combined effect of the due diligence clause and the standard clause in 8.7(2) of the ADLS Agreement was to give the purchaser an option subject to the vendor cancelling the contract in writing.

Referring to *Prime Property Group Ltd v Amtrust Pacific Property Ltd* in the later Court of Appeal decision of *B S Developments No 12 Ltd v P B & S F Properties*¹¹ it was observed that the difference between a real option and the effective option created by agreements of this kind is that an option typically has an exercise date, and if it is not exercised by that date it lapses. In the present case the effective option keeps running until one of the parties avoids the contract. The Court of Appeal suggested that the uncertainty could be avoided if

⁹ Unreported, High Court Auckland, CIV-2009-084-00053, 26 August 2010.

¹⁰ Unreported, High Court Wellington, CIV-2003-485-208, 25 March 2004.

¹¹ (2006) 7 NZCPR 603 (CA)

the arrangement were documented as an option, which would better reflect the commercial realities of the situation.

The Court of Appeal also noted that the agreement could only be avoided by giving notice under clause 8.7(5) of the ADLS Agreement and therefore only at the expiry of the due diligence period.

Conclusion

When drafting conditions to be inserted into agreements for clients, it will be necessary to take into account the parties' intentions. If the condition involves a third party (i.e. solicitor) pronouncing on the substance of the agreement, or there is a due diligence provision for the benefit of the purchaser, then such agreements are likely to be construed as options only, and therefore arguably only terminable pursuant to clause 8.7(5) of the ADLS Agreement.

A standard solicitor approval clause provides only limited avenues for approval to be withheld.

Finance clauses ought to be drafted such that finance must be available on settlement date, to avoid the pitfalls of finance lapsing prior to settlement.

Consideration ought to be given to the drafting of a clause conditional on a builder's report, with the extent and nature of the clause to be suggested depending on whether advice is being provided to a purchaser or vendor. It is possible to set the standard to which a builder's report is to be obtained by the purchaser.

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