

# A contract game

Use these tips to delve in

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Whether you're a public accountant helping guide a business client or a corporate CPA looking over your first contract, it's not a process that's inherently and easily understood. Combing through contracts is a learned skill, and one for which many CPAs are not initially prepped.

To this end, a working knowledge of contract law is useful to CPAs in a wide variety of contexts: negotiation of engagements and other relationships, communicating with clients about their businesses, and understanding their clients' obligations in performing a wide variety of tax and attest engagements.

This article provides some basics about contract law that all CPAs should know. A disclaimer: This article makes a series of generalizations. Exceptions and counterexamples could be found on many of these points.

## Basic contract elements

The "freedom to contract" is often thought of as a pillar of our economic system. At its most basic, a contract is simply an agreement, or exchange of promises, that is capable of being enforced by the courts. For an enforceable contract to exist, the following six elements must be present:

- An **offer**. The offer is a promise to act — or to refrain from acting — in exchange for a promise of return of some kind. The offer must clearly and totally specify the terms of the agreement. An offer that is vague or incomplete will not form the basis of an enforceable contract. And an offer can be withdrawn — without consequence — at any point before it is accepted.
- An **acceptance** of that offer. Acceptance can be explicit or implied from conduct of the target of the offer (or offeree). A response to an offer that proposes different terms (in whole or in part) is, generally speaking, a counteroffer (which then could be accepted by the party that made the original offer). In transactions for the sale of goods between commercial entities, the Uniform Commercial Code (UCC) broadens the requirements of offer and acceptance. The UCC allows a contract to be made in any manner sufficient to show agreement, including the conduct of the parties or electronic interaction.
- The **consideration**. Consideration is an exchange of value. Value can consist of a wide variety of things or conduct. A rich uncle could offer to transfer a car to his niece for money, or for her agreement to go to college and graduate with a certain GPA. In many circumstances, courts do not inquire into whether the consideration is sufficient or appropriate on the theory that parties to a contract should be free to set the terms of their exchange. But, in some circumstances, an unequal exchange (say, a transfer of a \$500,000 house to a relative or friend for \$5) likely would lead a court or other authority to conclude the transaction is a gift. But the consideration must have some value.

- The obligations must be **mutual**. For a contract to be enforceable, both sides must agree to give up something of value or to do something of value. As an example, a promise to do something that the promisor is already required to do is not legally sufficient consideration.
- The transaction must be **legal**. A court will not enforce an illicit transaction, such as an agreement to sell illegal drugs.
- The parties to the transaction must have the legal **capacity** to understand and perform the obligations set forth in the agreement. A court will not enforce an agreement to sell an automobile to a child, nor will a court uphold an agreement by a person suffering from dementia to sell her house.

A common misconception is that all contracts must be in writing. Many contracts may be enforced whether or not they are in writing. The primary advantage of putting a contract in writing, of course, is that a document is strong (if not conclusive) evidence that the agreement exists. Also, a written contract can go a long way toward preventing a claim that a contract is ambiguous. Bear in mind that many contracts can be reflected in more than a single document. As a basic example, an offeror proposes an agreement in one document, the offeree could respond with a second document that accepts most of the terms of the offer, and the offeree could accept the revised terms of agreement in a third document.

Nevertheless, under a law known as the statute of frauds, courts will not enforce certain agreements unless they are in writing. These include contracts that cannot be performed within one year, promises to answer for the debt or conduct of another person, real estate transactions (except leases of less than one year) and prenuptial agreements. Other law may also require agreements to be in writing. For instance, an agreement with a lawyer to pay a contingent fee, or a "restrictive covenant" with an employee, is not enforceable unless it is in a signed document.

## Applying the basics

These basic contract elements should inform a CPA's work. In many engagements, CPAs are not asked to judge the validity of the client's business arrangements, and are justified in taking their client's word regarding transactions. But that does not mean a CPA can suspend their common sense and blind themselves to certain realities. The following are examples of circumstances that might prompt further inquiry:

- A conveyance of valuable property in return for a nominal amount. Such a transaction would likely be considered a gift by courts or taxation authorities.
- Lack of writing. While many contracts do not need to be in writing to be valid, certain agreements (as noted before) will not be enforceable unless the agreement is made or reflected in a signed document.
- One-sided obligations. A promise to do or pay something, without any corresponding obligation by the other party, is nothing more than a promise, which courts will not enforce.
- Transactions with children or other persons whose ability to understand and act is questionable.

## Reading a contract

Given the preference for “freedom of contract,” a contract — even a written contract — can take an almost infinite variety of forms. Thus, if an engagement calls for you to read and understand a client’s contract, it can be challenging. To simplify your task, begin by considering the aforementioned points and the following questions:

- Do you have the full agreement? Has the agreement been modified in some way by later documents?
- What is each party’s obligation(s)?
- Are both parties giving up and/or committing to do something, or is this simply a one-sided promise?
- Is the contract reasonably clear, or is there some room for ambiguity or interpretation regarding those obligations?

Hopefully, the above serves to illuminate some basic points of contract law. When in doubt, communicate with your client (or even counsel) regarding questions and unusual situations. ■



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