

MORTGAGE CONTINGENCY CLAUSES: ESSENTIAL PROTECTION FOR PURCHASERS

By *Edward Farrell*



For many years, it has been standard in the real estate industry that contracts of sale for the purchase from the sponsor of newly constructed or newly renovated residential condominium units or cooperative apartments do not contain a mortgage contingency clause. Accordingly, purchasers would not have the right to terminate a contract of sale if an

application for financing were denied or, alternatively, if it was granted for an amount lower than the amount sought.

By 2003, in a seller's market, this standard had spread to traditional arm's-length transactions involving sellers of all kinds. At the time, "bidding wars" in residential real estate transactions were common. Many purchasers were willing to assume the risk of entering into a contract of sale without a mortgage contingency clause for two reasons:

- Purchasers wanted their bids to be more appealing to sellers, and
- Underwriting guidelines were not stringent and obtaining financing was not difficult.

Neither of these reasons for waiving a mortgage contingency clause is justified in today's real estate market. Currently, "bidding wars" for residential real estate occur only rarely. More importantly, an increasing number of loan applications are being denied because underwriting standards have dramatically changed and continue to change.

Many people mistakenly believe they will be able to obtain financing so long as their credit report, income and debt ratio justify the loan and meet a lender's guidelines. However, several other factors could result in the denial of a loan application. I have recently been involved in transactions where applications for financing have been denied for various reasons, including a low appraised value of the property and an insufficient reserve fund in a condominium building. Further, performing due diligence and research are insufficient to protect you in this ever-changing mortgage market. For example, a prospective purchaser who is not a citizen of the United States recently applied for financing from a bank that had customarily issued loans to non-citizens. After the application was submitted, the bank's lending policy to non-citizens changed and the

application for financing was denied. In this transaction, the prospective purchaser had been diligent and investigated to find an appropriate lender that would issue financing to a non-citizen, and yet was still unable to obtain financing.

It is impossible to predict how future underwriting changes will impact your ability to obtain financing. The only way to protect yourself is to insist on the inclusion of a mortgage contingency clause in the contract of sale. Failure to do so could result in a default under a contract of sale and the eventual forfeiture of your down payment.

In addition to insisting on a mortgage contingency clause, you should request a clause that grants you the right to terminate the contract of sale after the issuance of a mortgage commitment letter in the event the loan is not funded by the lender, unless the failure to fund the loan is due to your fault. I have seen and heard of lenders that have issued an authorization to close a loan and scheduled a closing, but still failed to issue the funds for the closing. On one such occasion, the lender had liquidity issues and the loan proceeds were not funded for several weeks after the loan documents had been signed. Moreover, there are some banks that have gone out of business or have had control of their business assumed by The Federal Deposit Insurance Company, commonly known as the FDIC, after issuing loan commitments. In today's market, for all of these reasons, it is reasonable to request this additional protection.

Many circumstances, some of which are unforeseen and not within the control of a purchaser, can result in the denial of a financing application. A financing contingency clause is a contract provision that every purchaser should insist be included in every contract of sale.

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