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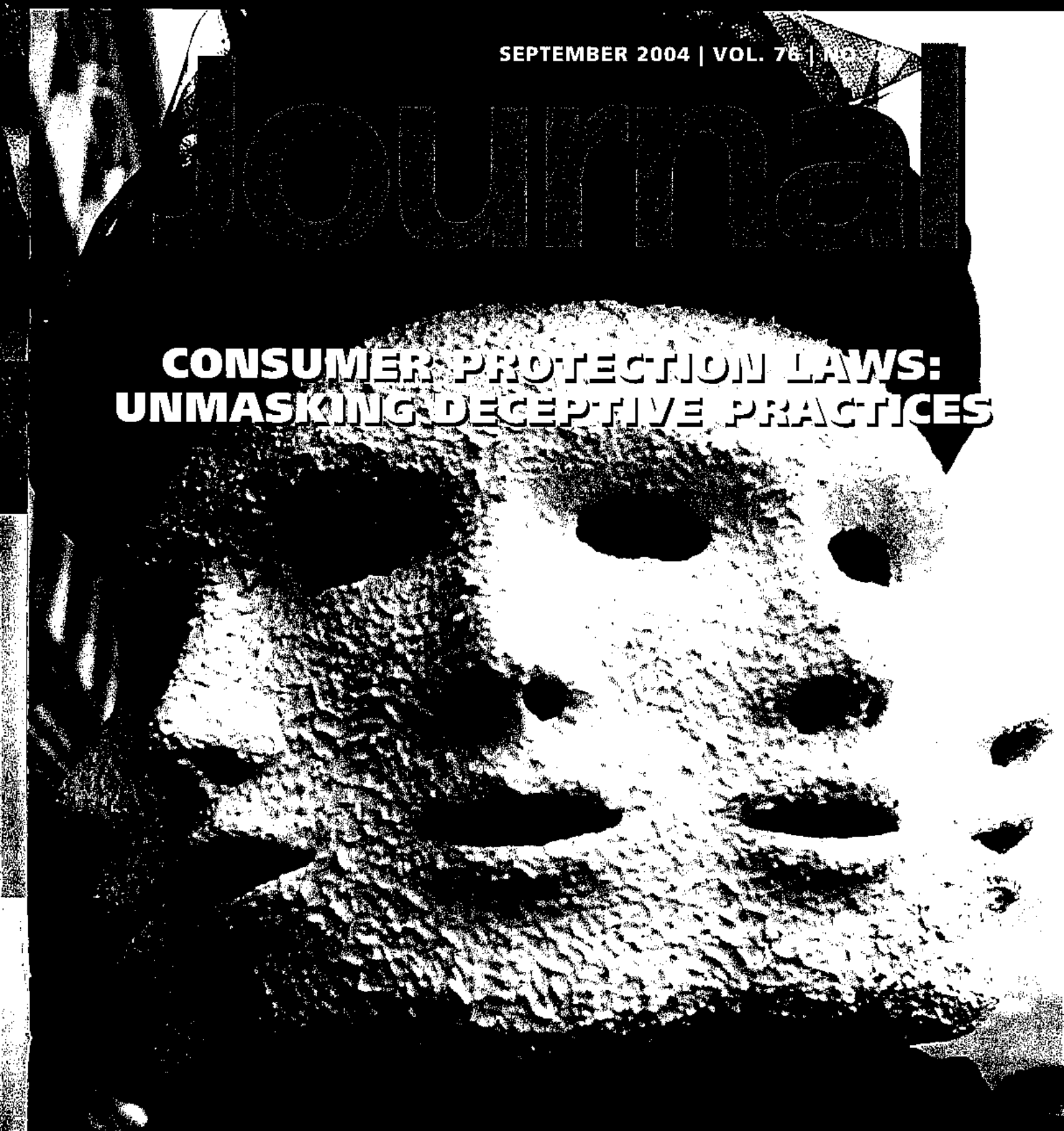

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When a Mortgage Commitment Is Issued But Later Revoked, Who Keeps the Down Payment?

By Eric W. Penzer

With interest rates at or near their 40-year lows,[1] and a corresponding increase in the number of mortgage loan applications,[2] lenders must remain competitive in the industry by processing loan applications and issuing commitments as rapidly as possible. When a mortgage commitment is issued but subsequently revoked, however, is the purchaser still required to complete the transaction? If the sales contract is contingent upon the purchaser obtaining a financing commitment, what happens if that commitment is later revoked?

A mortgage contingency clause in a contract for the sale of real property is designed to allocate risk. It "protects a contract vendee from being obligated to consummate the transaction in the event mortgage financing cannot be obtained in the exercise of good faith and through no fault of the purchaser."[3] Most contracts contain a "contingency period" limiting the time within which the purchaser is permitted to cancel the contract because of an inability to obtain financing.[4] The "standard" mortgage contingency clauses have evolved over time as the form contract has been revised. Notably, some versions of the clause do not address the situation where a mortgage commitment is issued but subsequently revoked after the contingency period expires. In that situation, does the seller keep the down payment as damages, or must it be returned to the purchaser? That question has been answered by several courts, with seemingly inconsistent results.

"Good Faith" Cases

The majority of cases on this issue stand for the proposition that the purchaser does not forfeit the down payment, at least where the purchaser acts in good faith and is not at fault for the mortgage commitment revocation. The Appellate Division, Second Department first addressed the issue in detail in *Lane v. Elwood Estates, Inc.*[5] That case, although more than three decades old, still reflects the current state of the law, at least in the Second Department.

In *Lane*, the purchase contract executed by the plaintiffs and the defendant provided that in the event "the lending institution . . . shall refuse to approve the application aforesaid for the amount set forth and upon the terms and conditions above described, the money deposited hereunder, shall be returned to [the plaintiffs], and upon such repayment both parties hereto shall be released from any further liabilities hereunder."[6] The plaintiffs obtained approval of their mortgage loan, and so informed the defendant. The defendant continued to work on the house to be sold and obtained a Certificate of Occupancy for the same. A closing of the title was scheduled for November 16, 1965. On October 25, 1965, however, the plaintiffs' attorney wrote to the bank, informing it that the plaintiff-husband's income had diminished significantly due to termination of his main employment. Accordingly, the bank withdrew approval of the mortgage. The plaintiffs then sought the return of their deposit.

After a bench trial, the lower court granted judgment in favor of the plaintiffs, reasoning that the contract provision permitted a recovery of the deposit because the mortgage application had not been approved.[7] The Second Department affirmed.

The appellate court noted the trial court's finding that the plaintiffs had acted in good faith in informing the lending institution of their change of circumstances, and further found that it was "apparent" from the testimony that the plaintiffs truly desired to purchase the house.[8] Further, the court found that the plaintiff-husband made genuine efforts to obtain new employment, and delayed in informing the lending institution of his loss of employment only because he was hopeful that he

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would be able to secure substitute employment. Moreover, the court noted that it seemed "incredible" under the circumstances that the plaintiff-husband, the father of five children, one of whom had a brain injury, would deliberately bring about his own unemployment.[9]

In *Bobrowsky v. Landes*,[10] the financial lender revoked its mortgage commitment after being advised by the plaintiffs prior to the closing that there was a substantial change in their financial circumstances. The trial court denied summary judgment in favor of the plaintiff-purchasers, but the Second Department reversed. The appellate court noted that there was no triable issue of fact concerning the plaintiffs' good faith, inasmuch as their loss of income resulted from circumstances beyond their control.[11]

The right to the down payment turned on whether the failure of the transaction was attributable to bad faith on the part of the purchaser.

Likewise, the court affirmed a grant of summary judgment to the prospective purchasers in *Byrne v. Collins*,[12] where a commitment was revoked due to one plaintiff's loss of employment. In so affirming, the court held that the plaintiff made a "genuine effort" to secure other employment in order to obtain reinstatement of the commitment and, thus, there was no willful breach of contract.[13]

Summary judgment for the purchaser was denied in *Morris v. Hochman*,[14] however, where the plaintiff's mortgage commitment was revoked because she could not occupy the home as her primary residence, having decided to relocate to another state for employment purposes. The court determined that summary judgment in her favor – for the return of her down payment – was inappropriate inasmuch as the motion was made prior to discovery and "essential" issues of fact existed within her exclusive knowledge, presumably regarding her good-faith efforts to obtain financing.

The Appellate Division, First Department has likewise held that in the situation of a commitment revocation, the provisions of the contract do not control if the contract is silent on the issue of commitment revocation. Under the rule set forth by the court, the purchaser is entitled to recover the down payment unless "the commitment revocation and consequent failure of the transaction was attributable to bad faith on [the purchaser's] part."[15]

Creighton v. Milbaur[16] was brought by the proposed purchaser of a condominium unit to compel the return of her down payment. The sale contract contained a mortgage contingency clause, permitting the plaintiff to cancel the contract in the event she was unable to obtain financing by a specified date. It further provided, however, that the contract was to remain in full force and effect if the purchaser failed to give notice of her inability to obtain financing on or before the third business day following the date specified. The plaintiff obtained a mortgage commitment, which was subsequently revoked after the expiration of the contingency period.[17]

The court began its analysis by rejecting the sellers' argument that they were entitled to retain the down payment by virtue of the fact that the contingency period had expired. This argument, the court noted, was "flawed" because the contract was "devoid of any procedures to be followed in the event a commitment is later withdrawn."[18] Accordingly, the court held that inasmuch as a mortgage contingency clause created a condition precedent to the contract of sale, the sellers' claim to retain the down payment must be "based upon the general rule that a party may not frustrate the performance of an agreement by bringing about the failure of a condition precedent."[19] The court also made clear that the burden of establishing that the condition was prevented rested upon the seller, *i.e.*, the party seeking to enforce the contract. The court ruled that the defendant was not entitled to summary judgment, compelling the return of the down payment because it failed to offer evidence that the plaintiff was denied financing because she did not pursue her application in good faith.[20]

The First Department applied this rule again in *Kapur v. Stiefel*.[21] There, the purchaser of a condominium unit obtained a mortgage commitment, but it was revoked due to the termination of the purchaser's employment. As in *Creighton*, the contract conditioned the plaintiff's right to the return of his down payment upon his cancellation of the contract within a specified time period. The revocation came after the expiration of the contingency period set forth in the contract of sale. The court held, however, that the mortgage contingency provision was inapplicable "[i]nasmuch as plaintiff's mortgage commitment letter was revoked by the lender after the contingency period."[22] Thus, the right to the down payment turned on whether the failure of the transaction was attributable to bad faith on the part of the purchaser.[23] The court held, however, that issues of fact existed concerning whether the termination of the plaintiff's employment "was a circumstance of plaintiff's making intended to bring about the failure of the subject real estate transaction."[24]

Notably, Justice Saxe dissented in *Kapur*. In his view, the purpose of the mortgage contingency clause was to allocate the risk of an unconsummated transaction. Specifically, the provision allocated the risk to the seller during the period prior to the purchaser's receipt of a mortgage commitment, and to the purchaser once that commitment was received.[25] According to Justice Saxe, the purchaser's receipt of the mortgage commitment, and the expiration of the cancellation period, were dispositive; no provision of the contract entitled the purchaser to cancel the contract and recover his down payment. Justice Saxe's view is consistent with Second and Third Department decisions discussed below.

Most recently, a Supreme Court justice applied the "good faith" rule in *Grillo v. Finch*.[26] There, the plaintiffs sued to recover their contract deposit. The contract contained a mortgage contingency provision permitting the purchasers to cancel the contract upon their failure to obtain a commitment prior to a specified date. The plaintiffs received a mortgage commitment, and advised the seller's attorney that they would be ready to close on a particular date. The closing did not occur, however, because the mortgage commitment was revoked based on, among other things, the plaintiffs' allegedly insufficient assets. Notwithstanding the scheduling of a "time of the essence" closing, the defendant's attorney subsequently faxed a proposed termination of the contract agreement to the plaintiffs' attorney for execution, and represented that upon execution he would return the deposit to the plaintiffs. Subsequently, however, the defendant retained new counsel and attempted to resurrect the "time of the essence" closing. The court noted that the purchasers' entitlement to the return of their deposit "turn[ed] upon whether the commitment revocation and consequent failure of the transaction was attributable to bad faith on [their] part."[27] The court also ruled that the plaintiffs' diligence and good faith were issues of fact for trial.

"Strict Construction" Cases

The Appellate Division, Third Department applied a seemingly "literal" construction of a contingency clause in *Tator v. Salem*.[28] There, the defendant entered into a contract to purchase realty from the plaintiff. The purchase offer was contingent upon the defendant's obtaining a mortgage loan, but the contingency was deemed waived unless the defendant provided written notice to the plaintiff of his inability to obtain the loan within 45 days after acceptance of the offer.

The defendant obtained a mortgage commitment, but it was revoked when the defendant's spouse was advised by the State Education Department that she could not practice public accountancy without qualifying as a certified public accountant.[29] The defendant's lending institution thereafter revoked its commitment, after expiration of the 45-day period. The plaintiff brought the action to recover direct and consequential damages for the defendant's breach of contract. The trial court ruled in the plaintiff's favor, and the appellate division affirmed.

The Third Department strictly construed the contingency clause, holding: "Although defendant's duty to purchase the property was admittedly contingent upon his obtaining a mortgage loan, this condition was plainly waived by defendant's failure to notify plaintiff within the contractually provided 45-day period of his inability to obtain a loan."[30] The defendant's inequitable conduct, however, no doubt contributed to the court's determination. The court noted that the defendant had applied for a loan substantially in excess of the purchase price for the property, and made no apparent attempt to make alternative financing arrangements despite the fact that he owned "a considerable amount of land in several states."[31] Moreover, he misled the lending institution by indicating that his wife would not have any earning power unless she qualified as a certified public accountant.

Likewise, in *Arnold v. Birnbaum*,[32] a Second Department case, the plaintiffs and the defendants had contracted for the sale of a residential condominium unit. The contract was conditioned upon the plaintiffs obtaining a mortgage commitment within a contingency period. In addition, the contract required that, in the event the plaintiffs failed to obtain such a commitment by the end of the contingency period, they were to notify the defendants within five business days. Absent such notice, the contract provided that "it shall be conclusively presumed that the [plaintiffs] obtained a satisfactory mortgage commitment."[33]

Although the plaintiffs in *Arnold* applied for and received a mortgage commitment, it was contingent upon the prior sale of their own apartment. Upon receipt of the commitment, the plaintiffs notified the defendants of the issuance of the mortgage commitment, but did not give notice that the commitment was conditional. After the contingency period expired, the plaintiffs notified the defendants that they were unable to sell the apartment and that, therefore, they could not obtain a mortgage.[34] The plaintiffs' request for a return of their down payment was refused, precipitating the litigation. The trial court granted summary judgment in favor of the plaintiffs, but the Appellate Division, Second Department reversed. According to the Appellate Division, the plaintiffs failed to avail themselves of the cancellation provision. Instead, they represented to the defendants that a mortgage commitment had been obtained, and by doing so satisfied the contingency clause, leaving no right of cancellation.[35]

In *Roga v. Westin*,[36] the plaintiff sued to recover a down payment in connection with a contract for the sale of real property. The trial court granted summary judgment for the defendant seller, and the Second Department affirmed. With respect to the mortgage contingency clause, the court stated:

> The plaintiff's right to cancel the contract for failure to obtain financing terminated prior to the prospective lender's revocation of its mortgage commitment. Pursuant to the mortgage contingency provision, the plaintiff's failure to give notice of cancellation within five business days after the commitment date resulted in a waiver of his right to cancel the contract.[37]

In *D'Agnese v. Spinelli*,[38] however, involving a claim brought by the seller for breach of contract, seeking to retain the defendant's down payment, the Second Department affirmed the denial of summary judgment for the plaintiff. According to the court, issues of fact existed regarding "whether the plaintiff waived strict compliance with the mortgage contingency clause, and whether the defendant exercised good faith to retain the mortgage commitment which was previously issued by her lender."[39] In so ruling, the court cited the First Department's decision in *Creighton*.

In *Cortesi v. R & D Construction Corp.*,[40] it appears that the Third Department relied upon a perceived ambiguity in the contract to relieve the plaintiffs from what it considered to be an unjust result. The plaintiffs had entered into a contract with the defendants in November 1983 for the construction and sale of a home. The contract contained a mortgage contingency clause, which provided the plaintiffs 45 days to notify the defendants of their inability to obtain financing and, upon such notice, the contract would be canceled and the plaintiffs would be entitled to the return of their down payment. The plaintiffs were unable to secure an appropriate commitment for financing, inasmuch as the commitment they received expired before the scheduled closing date, and the lender refused to extend it. Accordingly, in February 1984, the parties met and modified the contract in several respects, most notably adjourning the closing date. The parties made no written reference in their modification to the mortgage contingency clause. The plaintiffs thereafter sought financing from multiple lending institutions but were unable to secure the same.

The plaintiffs notified the defendants of their inability to secure financing and requested the return of their down payment. The defendants refused, citing the fact that the 45-day contingency period had long since expired and was not renewed in the modification. The plaintiffs brought suit seeking the return of their deposit, plus damages, and the defendants counterclaimed for damages for the plaintiffs' breach of contract. The trial court granted summary judgment in the plaintiffs' favor and dismissed the defendants' counterclaims. The Appellate Division affirmed.

According to the Appellate Division, although the modification resulted in a new contract, the unmodified terms of the original contract remained intact, including the 45-day contingency period. Moreover, the court noted, the contract contained no date on which the period started to run, resulting in an ambiguity. The court determined that the only reasonable interpretation of the provision was that the contingency period began to run on the date of the modification and, therefore, had not expired when the plaintiffs canceled the contract.[41]

Until the Court of Appeals clarifies this issue, or the Appellate Divisions reach an accord, there will continue to be uncertainty concerning the governing legal principles to be applied in resolving such disputes.

Justices Levine and Kane dissented in a memorandum by Justice Levine, in which they applied a "literal" interpretation of the contingency clause.[42] According to the dissenting justices, the conclusion was "inescapable" that the 45-day contingency period began to run upon the execution of the contract. Otherwise, "the time limit would be free-floating and essentially meaningless."[43] Therefore, the dissenting justices were of the view that by the "literal terms of the clause," the plaintiffs waived the mortgage contingency provision when they failed to cancel the contract within 45 days of its execution.

Conclusion

These cases may well be the last of a dying breed. The November 2000 revision of the Blumberg "standard form" residential contract of sale includes language making clear that once a commitment is issued, the purchaser is bound to perform the contract even if the lender fails or refuses to fund the loan for any reason. Although this revision may resolve the issue discussed above (and, of course, the parties are always free to specifically address that issue in additional detail in their contract), as long as "older" form agreements are in circulation, disputes will exist. And until the Court of Appeals clarifies this issue, or the Appellate Divisions reach an accord, there will continue to be uncertainty concerning the governing legal principles to be applied in resolving such disputes.

1. *See* Jim Carlton, *Home Investments (A Special Report)*, Wall St. J., June 14, 2004, at R8.

2. *See Mortgages: Applications Increase as Rates Drop Back Below 6%*, Chicago Trib., July 8, 2004, at 2; Gail Kalinoski, *Explaining the Skittish Stock Market*, Westchester County Bus. J., May 31, 2004, at 17; Julie Haviv, *Mortgage Purchase Applications, Refinancings Fall Again*, Dow Jones Capital Markets Rpt., May 19, 2004.
3. *Creighton v. Milbaur*, 191 A.D.2d 162, 166, 594 N.Y.S.2d 185 (1st Dep't 1993).
4. *See, e.g., Roga v. Westin*, 212 A.D.2d 685, 686, 622 N.Y.S.2d 777 (2d Dep't 1995).
5. 31 A.D.2d 949, 298 N.Y.S.2d 751 (2d Dep't 1969).
6. *Id.* at 950 (dissenting opinion).
7. *See id.*
8. *Id.* at 950.
9. *See id.* at 949.
10. 124 A.D.2d 618, 507 N.Y.S.2d 879 (2d Dep't 1986).
11. *See id.* at 619.
12. 142 A.D.2d 661, 531 N.Y.S.2d 17 (2d Dep't 1988).
13. *See id.* at 662.
14. 296 A.D.2d 481, 745 N.Y.S.2d 549 (2d Dep't 2002).
15. *Kapur v. Stiefel*, 264 A.D.2d 602, 603, 695 N.Y.S.2d 330 (1st Dep't 1999).
16. 191 A.D.2d 162, 594 N.Y.S.2d 185 (1st Dep't 1993).
17. *See id.* at 164.
18. *Id.*
19. *Id.* at 165.
20. *Id.*
21. 264 A.D.2d 602, 695 N.Y.S.2d 330 (1st Dep't 1999).
22. *Id.* at 603.
23. *See id.*
24. *Id.*
25. *See id.* at 606 (Saxe, J., dissenting).
26. N.Y.L.J., Apr. 21, 2004, p. 17, col. 1 (Sup. Ct., Nassau Co.).
27. *Id.* (citing *Kapur*, 264 A.D.2d 602).
28. 81 A.D.2d 727, 439 N.Y.S.2d 497 (3d Dep't 1981).
29. *See id.* at 727.
30. *Id.* at 727–28.
31. *Id.* at 728.
32. 193 A.D.2d 710, 598 N.Y.S.2d 68 (2d Dep't 1993).
33. *Id.* at 711.
34. *See id.*
35. *See id.*
36. 212 A.D.2d 685, 622 N.Y.S.2d 777 (2d Dep't 1995).
37. *Id.* at 686.
38. 290 A.D.2d 528, 737 N.Y.S.2d 301 (2d Dept 2002).
39. *Id.* at 528.
40. 137 A.D.2d 901, 524 N.Y.S.2d 874 (3d Dep't 1988).
41. *See id.* at 902–03.
42. *See id.* at 903 (Levine and Kane, JJ., dissenting).
43. *Id.*