The New York Times

July 18, 1999
YOUR HOME

YOUR HOME; Mortgage Contingency Clauses

By JAY ROMANO

MOST people know that a contract to buy a house or apartment usually contains a clause that allows the buyer to get out of the deal if he or she does not qualify for a mortgage.

But such clauses often provide less protection than people think, real estate specialists say, and no protection whatsoever when careless, overconfident buyers allow the clauses to expire prematurely or deliberately choose to waive them to impress sellers looking for the best deal possible.

"The so-called mortgage contingency clause is one of the hottest issues in real estate today," said Richard Nardi, general counsel to the Mortgage Bankers Association of New York. Mr. Nardi said that mortgage contingency clauses found in most standard real estate contracts are misleading in several respects.

For example, he said, while the term "mortgage contingency clause" is commonly used to describe the contract provision that addresses the buyer's obligation regarding his mortgage, the clause might more appropriately be called a "mortgage commitment contingency clause" because the contingency usually refers to the issuance of the mortgage commitment, not the mortgage itself.

So a buyer who satisfies a standard contingency clause by obtaining a mortgage commitment, Mr. Nardi said, can still lose her deposit if the deal falls through because the loan ultimately fails to close. And that can happen for various reasons.

If the buyer's circumstances change -- if, for example, money that was supposed to be set aside for closing costs is unavailable and must now be borrowed -- the lender could refuse to grant the mortgage even after issuing a commitment, Mr. Nardi said. The same thing could happen if a buyer or a spouse loses a job or incurs additional debt after the commitment is issued but before the day of closing.

Oded Ben-Ami, senior loan officer for Sterling National Mortgage, a mortgage banker based in Great Neck, N.Y., agreed that a change in financial circumstances could lead to the revocation of a loan commitment.

"A commitment is a contract between the lender and the borrower," Mr. Ben-Ami said, explaining that since the basis for the commitment is the financial and credit condition of the borrower at the time the application is made, those same conditions must exist at the time of closing.

"At the closing table, the borrower is usually required to sign his original application anew as an affirmation that there have been no material changes in his situation," Mr. Ben-Ami said. "Material changes can include things like loss of income or employment, dissipation of assets, or incurring new debt. And any material change in circumstances can easily result in a withdrawal of an otherwise valid commitment."

In fact, Mr. Nardi said, even commitments themselves are no longer what they used to be.

"Most people don't understand that when these boiler-plate clauses were drafted 10 or 15 years ago, lenders were doing all their homework before they agreed to make a loan," Mr. Nardi said. "Now, because of incredible competition in the industry, lenders issue commitments that are contingent on so many conditions that they are not really commitments at all."

For example, he said, lenders frequently issue mortgage commitments subject to an appraisal of the property. That is not a problem for a buyer if the mortgage contingency clause is still in effect at the time the appraisal is received. But if the contingency expires before the appraisal is received, and the buyer does not obtain an extension, he could have a problem if the appraisal ends up being for less than what is acceptable to the lender.

In such a case, Mr. Nardi said, the buyer would be in the unenviable position of either losing the deposit or being committed to buy a house that is worth less than he agreed to pay and for which he could not obtain financing even if he still wanted to buy it.

Seth Cohen, managing director of Home Mortgage Acceptance Corporation, a mortgage company based in Manhattan, said that while it might seem naive for a buyer to consider waiving the mortgage contingency clause or allowing it to expire, the practice is fairly common because of the increasing use of prequalification and preapproval letters issued by mortgage brokers and lenders.

Mr. Cohen said that such letters give buyers a false sense of security about their ability to obtain a mortgage, something that can be a serious problem for those who are buying co-op apartments.

"In most cases, when a bank preapproves a borrower, it's only qualifying the borrower," Mr. Cohen said. "But when a bank is making a loan on a co-op, it's not just the borrower who has to qualify for the loan, but the building as well."

He explained that borrowers who are so confident they will qualify for a share loan -- the counterpart to a mortgage in financing a co-op -- that they are comfortable waiving the

mortgage contingency clause may be in for a surprise if the building they are buying into doesn't pass the lender's muster.

And that can happen, Mr. Cohen said, if more than 50 percent of the units in a building are owned by the original sponsor or if any individual other than the sponsor owns more than 10 percent of the units.

In addition, he said, banks are typically hesitant to lend in buildings that have fewer than 10 units, in buildings in which the lender has already made loans to 25 percent or more of the shareholders, and in buildings that do not have a positive cash flow.

Accordingly, Mr. Cohen said, co-op buyers should check with their mortgage broker or lender to find out, if possible, whether the building they are buying into meets the lender's standards. That becomes even more important, he said, for buyers who may consider locking a seller into a deal by waiving the mortgage contingency clause.

Eric Gonchar, a Manhattan real estate lawyer, said that even buyers who do not voluntarily waive their mortgage commitment may do so inadvertently if they do not pay careful attention to the contract terms and dates.

"Contracts usually contain a clause that says that if you don't notify the seller that you have been declined for a loan within a specified time period, you will be deemed to have waived the contingency," Mr. Gonchar said.

William Selsberg, a Stamford, Conn., lawyer, said it is for that reason that he makes sure he knows exactly where the client is going to be on the day the mortgage contingency clause is to expire.

"I tell them, 'Act as if that's the most important day of your life,' " Mr. Selsberg said, adding that he also instructs clients to carefully follow other terms of the mortgage contingency clause. For example, he said, there are occasions in which a client has signed a contract with a mortgage contingency clause for an 80 percent mortgage who is then told that he or she can probably qualify for a 90 percent loan.

"I have to explain to them that if they apply for the bigger loan, and the loan is declined, they are at risk of losing their deposit because they'll be in default of the contract," he said. And the only thing more risky than that, he said, is to waive the contingency clause entirely.

"I've had clients who have been told that there are two or three other buyers waiting in the wings, and to separate themselves from the pack, they want to agree to a deal with no contingencies whatsoever," Mr. Selsberg said. "It seems that the biggest problem real estate lawyers have today is protecting clients from themselves."