Chapter 4

PURCHASE-AND-SALE AGREEMENTS: STATUTE OF FRAUDS AND PARTIES TO THE AGREEMENT

Scope of the Chapter

The next five chapters are about the decisions that realty buyers and sellers must make to reach a mutually binding and acceptable agreement of sale. The title to each of these chapters begins with the heading 'purchase-and-sale agreements' to mark their having been organized around the key provisions in a home purchase-and-sale contract: (1) the parties, (2) the sales price and financing terms, (3) the physical condition of the property, (4) the quality of the title, and (5) the time for performance.

We begin this chapter by addressing these pre-contract matters: (1) why the parties bother entering a formal written agreement instead of proceeding directly to closing, (2) whether they should ever bother repeating in their contracts the default rules that would apply in the absence of an explicit agreement to the contrary, and (3) why they sometimes enter letters of intent before signing formal contracts of purchase and sale.

Then, we review the Statute of Frauds provisions requiring realty buyers and sellers to sign formal written agreements, if they formulate a contract at all, and the many exceptions to the Statute of Frauds. In a final section on the parties to the contract, under the heading 'grantor,' we discuss the special challenges of purchasing realty from a trust, partnership or corporation or from a married seller, the difficulties to be overcome when not all of the owners want to sell, and why realty is sometimes sold indirectly through the transfer of the interests in the entity holding title to it.

Under the heading 'grantee,' we consider possible contract provisions governing the buyer's right to assign its interest in the contract. Sometimes, intermediaries acquire title for purchasers who don't want the seller to know their identity. We discuss the sellers' rights regarding undisclosed principals.

I. THREE QUESTIONS ANCILLARY TO DRAFTING A PURCHASE-AND-SALE CONTRACT

A. Why Bother Contracting?

Although there are significant advantages to having a written contract of sale, it is possible for buyer and seller to save the time and money by proceeding without a written contract directly to the execution of their deal. An owner of a much-desired site could manage to avoid the haggling and the risk of a lawsuit for specific performance by telling prospective buyers: "Investigate the property to your heart's content and if you want to buy, let me know. You'll bring a cashier's check for the full purchase price to a designated place at a convenient time, where I'll hand you a properly executed deed covered by a policy of title insurance. The property will be yours without a fuss." At the moment of paying the price and recording the deed, the buyer will have become the legitimate owner of record despite never having signed a contract to buy the property.

Yet, only an infinitesimal number of real estate sales are consummated without written contracts. Here are some possible explanations:

(1) A written contract of sale can help guard against the fogginess and inherent bias of memory, memorializes the results of the parties' negotiations and provides confirmation and evidence of the agreement;

(2) Written contracts are the universal custom and practice for realty sales, re-enforced by the Statute of Frauds;

(3) Real estate brokers insist upon written purchase-and-sale contracts as essential to the paper trails that will demonstrate their having earned their commissions by procuring 'ready, willing, and able' buyers;

(4) Until they are sure they have an enforceable deal, buyers are reluctant to invest time and money in a careful inspection of the soil, foundation, plumbing, electrical system, heating/air conditioning, structural integrity, roofing, and other parts of the property;

(5) Lenders are hesitant to make loan commitments except to buyers who can prove they have the right to buy on acceptable terms;

(6) Sellers want a sale they can count on before preparing to relocate, and maybe before committing to buy another house; and

(7) Most buyers and sellers don't want to pay for title insurance searches and title polices until they have a signed deal.

B. SHOULD CONTRACT PROVISIONS BE INCLUDED WHICH REITERATE THE DEFAULT RULES?

Few contracts anticipate every risk and contingency. 'Default' rules fill the gaps left open by contractual silence. As opposed to 'immutable' rules, parties can always contract around the default rules.

This chapter describes many default rules that would surprise most buyers and a few that would startle most sellers. No one has the time and imagination to draft and negotiate a contract covering all possible contingencies.[1] But some of the default rules described here may jump start even the most preoccupied buyers and sellers into modifying, deleting, or adding provisions in the standard form realty sales contract.

[1] Jules L. Coleman, Douglas X. Heckathorn & Steven M. Maser, *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J. L. & PUB. POL'Y 639 (1989).

Suppose the buyer makes an offer on a form purchase-and-sale contract that is silent on a deal point for which the default rule favors the seller. Should the seller bother adding the deal point to the contract anyway? Doing so wastes negotiating leverage, risks alerting the buyers to a point they may simply have overlooked, and could drag everyone into a readily avoidable, wordy brawl.

Still, a strong case can be made for specifying deal points even if they comport with the default rule. The default rule may turn out not to have been as clear as the favored party presumed, and courts and legislatures often modify even firmly established default rules. Besides, people are more likely to abide by explicit contract provisions than they are to acquiesce in the other party's self-serving pronouncement of the law. Then, too, litigators prefer written contract provisions supporting their positions because if a dispute reaches trial, being able to display the contract language eases counsel's burden of persuading a jury of the parties' mutually agreed intentions.

C. Should the Parties Use a Letter of Intent?

As the first step in formalizing a complex commercial transaction, buyers and sellers often begin by negotiating letters of intent. A letter of intent describes the parties' tentative resolution of the main deal points, leaving many details for a later formal agreement to follow. The crucial deal points would usually include the purchase price, contemplated financing arrangements, allowable contingencies, seller warranties and representations, and the closing date.[2] If they are able to work out the big deal points through a pre-contract letter of intent, or sign off on a term sheet embodying the main deal points, the parties take comfort in knowing that no insurmountable differences divide them. A letter of intent can also embody an agreement to negotiate in good faith and could include such details as whether and how often each party is obligated to meet with the other.

Crucially, the letter of intent needs to specify whether the parties mean for it to be binding or not. The parties may elect to characterize some items as binding and others as non-binding. For instance, real estate transactions attorneys prefer to label deal points mentioned in a term sheet (price, financing, etc.) provisional and not binding. But they are comfortable binding the parties to maintain the confidentiality of the negotiations or to negotiate in good faith. To avoid disputes over the meaning of the implied obligation to negotiate in good faith, if the parties reach an impasse and one believes continued negotiations could be fruitful while the other has had enough, they limit the obligation to negotiate to a date certain. After that, either party is free to end the chatter.

Attorneys drafting letters of intent worry about one of the parties trying to enforce a partial understanding against the other as if they had reached a complete meeting of the minds. To discourage such attempts, attorneys virtually always place a recitation in the letter that the parties intend a formal agreement to follow within a set time, and if it doesn't, the obligation and the letter itself are automatically deemed terminated.

---

[2] http://www.socrates.com/real-estate-forms/buying-selling-and-investing/Letter-of-Intent-to-Purchase-Real-Estate.aspx (Last visited 06/03/08).

Disclaimers like these, though helpful, cannot guarantee that one of the parties won't try to bind the reluctant other to a letter of intent. Such attempts rarely occur and seldom succeed. On those unusual occasions when they do, courts point to the familiar legal principal that intent to form a contract is a question of fact and the parties are deemed to have formed a contract once they agree on all material terms. The common law rule is that any provision in a contract may be waived by subsequent consent, express or implied. There is also an equitable basis for enforcement. A person who utters a spoken promise meant to induce another to rely on it may be estopped from repudiating the promise.[3]

Still, courts sometimes honor provisions called integration clauses almost invariably found in realty purchase and sale contracts specifying that they are the final and complete expression of the parties' understandings and supersede all prior oral and written agreements.[4]

Real estate entrepreneurs don't necessarily see their obligations in the same way as their attorneys or courts. Some entrepreneurs may feel no special compunctions about breaching obscure provisions buried in voluminous contracts–and paying the price–when breaching advances their business interests. Yet, they may feel bound to honor a spoken promise made to one of their business peers even though the promise couldn't be enforced. Attorneys sensitive to their client's perceptions and reputations avoid taking aggressive positions without prior client approval.

II. THE STATUTE OF FRAUDS AND ELECTRONIC CONTRACTING

A. WHAT IT TAKES FOR A REALTY CONTRACT TO SATISFY THE STATUTE OF FRAUDS

States have enacted Statutes of Frauds, based on the English original of 1677, that declare certain types of contracts invalid unless the contract, note, or memorandum of it is in writing. 'Invalid' doesn't mean such contracts are illegal or that they cannot be made or performed. It means they are unenforceable in court. The Statute is a defense that must be pleaded or is deemed to have been waived. On the list of affected transactions, the statutes invariably impose a writing requirement on all contracts to lease realty for a period longer than one year and agreements for the sale of real property, or of an interest therein.

Though details vary, Statutes of Frauds require certain minimal information to be written: (1) identify the parties to the agreement, (2) be signed by the party to be charged,[5] (3) specify the price, (4) describe the property, and (5) contain all

---

[3] *Rose v. Spa Realty Assocs.*, 366 N.E.2d 1279 (N.Y. 1977) (once purchaser relied on parties' oral modification, seller couldn't lawfully renege even though contract prohibited oral modification or termination, despite New York statute purporting to allow only written modification or termination of contracts so providing). *See generally* David V. Snyder, *The Law of Contract and the Concept of Change: Public and Private Attempts to Regulate Modification, Waiver, and Estoppel*, 1999 WIS. L. REV 607.

[4] *EPA Real Estate Partnership v. Kang*, 12 Cal.App.4th 171, 15 Cal.Rptr.2d 209 (Cal.App.,1992)..

[5] CAL. CIV. CODE § 1624 (West 1985). Some versions of the statute bar *evidence* of contracts for the creation or transfer of interests in land unless the contract is in writing and "*signed* by the party charged or his authorized agent." IOWA CODE § 622.32 (1987).

other essential terms of the agreement including financing terms and contingencies, if any.[6] Most purchase and sale contracts contain far more than these skeletal parts.

The Statute requires a "note or memorandum," not necessarily the contract itself, to be in writing. "An agreement for the purchase or sale of real property does not have to be evidenced by a formal contract drawn with technical exactness in order to be binding. A memorandum of the agreement is sufficient, and this may be found in one paper or in several documents, including an exchange of letters or telegrams or both, or in a letter from the vendor to the purchaser which is accepted and acted upon by the latter."[7]

The Statute's requirement of written documentation was meant to discourage fraud, perjury and spurious litigation. Sometimes, judges find compliance with the Statute of Frauds based on the flimsiest of written evidence, believing that not doing so would result in the court releasing a shirker on purely technical grounds from a firm agreement.[8] Other judges demand strict adherence to the legislated dictates of the Statute of Frauds, independent of whether the parties' intentions to enter a contract have been clearly proven, and summarily deny petitions seeking enforcement of realty contracts imperfectly evidenced by written notes or memoranda.[9]

Identification of Parties. The Statute of Frauds requires that all parties be identified in writing. If the seller had simply contracted to sell to herself or placed the word assignee where the name of the grantee should appear, the Statute of Frauds will bar enforcement of the contract because it lacks a designated assignee. But as long as the contract identifies some existing person or entity as the buyer, the Statute is no bar to later written substitutions of a new buyer for the original one. Following this same line of reasoning, as long as an undisclosed principal's agent is identified, the principal need not be.

---

[6] To be a valid contract, the parties have to reach accord on all essential terms. The Statute of Frauds requires that the essential terms be written.

[7] *Quan Shew Young v. Woods*, 218 Cal. App. 2d 506, 511 (1963).

[8] In doing so they are likely to quote Williston on Contracts: "[I]f after a consideration of the surrounding circumstances, the pertinent facts and all the evidence in a particular case, the court concludes that enforcement of the agreement will not subject the defendant to fraudulent claims, the purpose of the Statute will best be served by holding the note or memorandum sufficient even though it is ambiguous or incomplete." 10 WILLISTON ON CONTRACTS § 29:4, p. 438 (4th ed.1999).

[9] *See, e.g, Crosby v. Strahan's Estate*, 324 P.2d 492, 499 (Wyo. 1958). Although recognizing the existence of an oral contract by decedent to deed mineral rights to plaintiff, court refused to enforce the agreement because it didn't comply with the Statute of Frauds. Regarding the plaintiff's claim of estoppel, the court observed: "The courts have not attempted to define what extent or character of change in the situation induced by the oral agreement will be sufficient to estop the party inducing such change from questioning the validity of the oral promise. It must be a change of such character and to such an extent that the interposing of the defense of the statute would be a fraud. The mere denial of the right promised by the oral agreement, the loss of that which existed only by virtue of the oral promise, being deprived of the bargain, does not create an exceptional situation as to the statute, but the very situation the statute covers. To take a case out of the statute because of such resulting loss or injury annuls the statute. The injury or loss which would result from the enforcement of the statute must arise from the acts done in performance or in pursuance of the oral agreement, and such acts must so far alter the situation of the parties seeking to avoid the statute that it would be unjust and against conscience to allow the other party, who has permitted such change to take place in pursuance of his oral agreement, to thereafter refuse to perform on his part."

Subscription by Party to be Charged–Competing Definitions of Subscription. Some statutes require not just that the contract be signed but that it be 'subscribed.' "The purpose of such a requirement is to prevent fraud through additions to a writing subsequent to its execution."[10] Some courts claim to adhere to this interpretation, but we have been unable to find any decided case denying enforcement of an otherwise valid contract solely because a signature didn't appear at the bottom of the page. Other courts construe subscription as synonymous with 'attestation' and often interpret the word 'subscription' broadly to require only that the parties' signatures appear somewhere on the document.[11]

Who Must Sign? The signature must come from the 'party to be charged'–meaning the defendant. A buyer seeking enforcement needs the seller's signature. A seller seeking enforcement needs the buyer's signature. In a number of states, only the seller must sign on the theory that "the purpose of the statute . . . is to protect the vendor only."

Agent's Authority to Sign for Principal. Generally, if a party's signature is required by law to be affixed to a written contract in order to satisfy the Statute of Frauds, an agent's authority to sign the contract on behalf of that party must also be in writing. This is sometimes called the *equal dignities rule*: authority to sign on behalf of another must be in writing if the underlying contract being signed must by law be written. Thus, a client planning to be out of town during a scheduled real estate closing could execute a limited power of attorney authorizing someone else to sign documents on her behalf. That power of attorney would have to be in writing if the documents requiring the client's assent needed to be in writing. An exception: a party's signature is deemed valid if made by another person in the presence and at the direction of that party.[12] The signing agent is known as an *amanuensis* of the principal.[13] (Amaneunsis is an outdated term for an assistant or secretary.)

Price. Most recent court opinions hold that the agreed price must be recited in the purchase-and-sale agreement for the contract to satisfy the Statute of Frauds.[14] Unlike in the sale of goods, where the U.C.C. sometimes allows courts to determine the price if the parties have failed to do so,[15] courts will not infer the price in a real estate deal.[16]

---

[10] *Seidman v. Dean Witter & Co.*, 418 N.Y.S.2d 6, 8, 70 A.D.2d 845 (1979).

[11] California courts have taken this view, citing early legislation requiring wills to be "subscribed at the end," redundant if 'subscription' means 'at the end.' *Marks v. Walter G. McCarthy Corp.*, 205 P.2d 1025, 1028 (Cal. 1949) ("The Statute of Frauds does not demand that the signature of the party to be charged be placed at the end of the writing relied upon if a proper signature be found elsewhere on the instrument").

[12] *Lukey v. Lukey*, 365 P.2d 487, 488, 77 Nev. 402, 404 (1961) ("We find approval in virtually every jurisdiction of the United States of the rule stated as follows: 'Generally, a signature may be made for a person by the hand of another, acting in the presence of such person, and at his direction, or request, or with his acquiescence, unless a statute provides otherwise.'"); *Mutual Ben. Life Insur. Co. v. Brown*, 30 N.J. Eq. 193 (Ch. 1878).

[13] 3 Miller and Starr, CALIFORNIA REAL ESTATE LAW § 8:27 (Database updated September, 2004).

[14] Roger Cunningham, et al., THE LAW OF PROPERTY § 10.1, at 630, n.31 (1993).

[15] The court may determine the reasonable price for goods. U.C.C. § 2-305.

[16] *See* 72 AM. JUR. 2D, *Statute of Frauds* § 347 (1974).

Property Description. The Statute doesn't require the same precision of a land description in the purchase-and-sale contract as would be required in the instrument of conveyance, usually a deed. For instance, in purchase and sale contracts, street addresses usually suffice as a means or key to finding a proper legal description for the property. But street addresses aren't acceptable in deeds because they don't delineate the precise boundaries of the conveyed land.

All Other Material Terms. For the purpose of Statute of Frauds, contract terms are either material or incidental. To be valid, the writing must spell out the exact details of all material terms. For example, an agreement by the vendor to finance part of the purchase price must elucidate the interest rate, principal repayment provisions, payment schedule, and other loan details. All financing contingencies and arrangements are examples of material terms.[17] If the parties agreed for the buyer to 'assume' the existing loan, the parties must stipulate this in either the purchase contract or the instrument of conveyance, most commonly a deed.[18]

Two examples of incidental terms: (a) Where no contemplated closing date has been specified and no particular date is a material factor in the deal, most courts will infer a 'reasonable time' based on trade practice. (b) Where no arrangement has been made for a change in possession, most courts will presume possession changes on the date set for closing.

B. EXCEPTIONS TO THE STATUTE OF FRAUDS

There are many significant exceptions to the Statute of Frauds:

Reconciling Ambiguities in the Writing. The *parol evidence rule* provides a legal limitation on the admission of written or oral evidence in court. One of the most familiar precepts of black letter law is that parol evidence is admissible to reconcile the ambiguities or uncertainties of written provisions but not to supply essential terms omitted entirely. Statute of Frauds disputes often become contests over the application of this Delphic aspect of the parol evidence rule. [19]A puzzling word or phrase that one court interprets as sufficient to meet an essential term required by the Statute of Frauds or sufficiently ambiguous as to permit extrinsic evidence of what the parties meant by it, may strike another court as utterly too vague or incomplete to support the admission of oral extrinsic evidence to clarify its meaning.

Documents Lost or Destroyed. In cases where the final memorandum or contract required by the Statute once existed, and can be proven to have been

---

[17] *Lawrence v. Jones*, 864 P.2d 194 (Idaho 1993). The new English version requires *all* terms to be written.

[18] California has codified this requirement in CAL. CIV. CODE § 1624 (West 1985).

[19] *Sterling v. Taylor*, 40 Cal. 4th 757 (2007)(Contract specified a price of "approx. 10.1468 X gross income, estimated income $1,600,000, Price $16,750.00" (should have been $16,750,000). Purchaser introduced extrinsic evidence that multiplying actual gross income by10.1468 would yield a price of $14,404,841. The seller prevailed on a summary judgment motion, affirmed by the California Supreme Court because no written note or memo supported the buyer's claim that the parties had agreed to multiply the current rent role by 10.1468.

lost or destroyed, either party may testify to the existence and content of the lost document.[20]

Full Performance. The Statute of Frauds is only applicable to agreements which have yet to be fully performed. Once one of the parties completes his or her part of the transaction–i.e., money or deed have changed hands–the Statute of Frauds becomes irrelevant as a defense. In fact, the burden of proving fraud or undue influence shifts to the seller seeking to cancel a deed or the buyer attempting to obtain a refund of the purchase price.

Admission in Court or Pleadings. Except in a handful of states, a party to a realty sales agreement does not forfeit a Statute of Frauds defense by admitting the existence or essential terms of the contract in pleadings, affidavits, depositions or testimony.[21] The opposite is true under the Uniform Commercial Code which imposes a writing requirement on the sale of goods valued at over $500, but eliminates the requirement if the party against whom enforcement is sought admits the agreement.[22] However, most states have refused to allow an 'admission exception' to realty writing requirements because it could trap parties into inadvertently waiving their rights by demurrer, or in answers to interrogatories or depositions–even in another case.[23] Also, they want to avoid backing parties into perjury to squirm out of liability for their oral realty agreements.

Even after admitting in court the parties reached an oral agreement on all essential terms, a realty owner or purchaser would not necessarily mean to be bound before signing a written contract since real estate contracts aren't generally regarded as final until written and signed by both parties.[24]

Part Performance. The most prominent exception to the Statute of Frauds is for unwritten agreements for the purchase and sale of realty partly performed. Courts long ago created part performance exceptions to the Statute of Frauds,

---

[20] *Chakur v. Zena*, 233 S.W.2d 200 (Tex. 1950).

[21] Peter J. Shedd, *The Judicial Admissions Exception to the Statute of Frauds in Real Estate Transactions*, 19 REAL EST. L. J. 232 (1993) (Majority of states follow the English precedent of not enforcing oral contracts for realty just because the defendant admits the existence of the contract in court, because allowing such an exception would encourage defendants to commit perjury by denying the existence of the agreement).

[22] U.C.C. § 2-201(3)(b).

[23] *See, e.g., Key Design Inc. v. Moser*, 983 P.2d 653 (Wash. 1999), amended by 993 P.2d 900 (Wash. 1999). California has enacted the court admissions exception, but only for 'qualified financial contracts' which does not include contracts for the sale of real property or interests therein. CAL. CIV. CODE § 1624(b)(3)(C) (West 1985)). The Statute of Frauds exception for in-court admissions should be distinguished from the doctrine of judicial estoppel. This doctrine applies to prevent a party from denying a fact she benefitted in an earlier lawsuit from claiming was true.

[24] *Smith*, 553 A.2d at 134.

occasionally codified by statute,[25] but more often applied despite the clear language of the Statutes.[26]

What constitutes sufficient part performance varies from case to case–though usually the putative purchaser has taken possession and paid part of the purchase price or made valuable improvements.[27] Ideally, part performance makes clear which property was to be conveyed and at what price, along with "all the essential terms of the contract established by competent proof, and shown to be definite, certain, clear, and unambiguous."[28] Partial payment of the purchase price without a change in possession doesn't suffice. The putative buyer's possession of the claimed property is required as a substitute for a written legal description of it.

Equitable Estoppel. A related, but distinctly different, doctrine is equitable or promissory estoppel. Courts reserve estoppel "for that limited class of actions where the result of enforcing the contract would be so egregious as to render unconscionable the Statute of Frauds,"[29] and where the relying party "changed his position so that injustice can be avoided only by specific enforcement."[30] Although courts often blend the elements of part performance and estoppel, part performance focuses mainly on the acts of the purchaser. Conversely, estoppel focuses on the misleading acts of the seller on which the buyer detrimentally but reasonably relied, with the seller's continuing assent.

---

[25] *See, e.g.*, MONT. CODE ANN. § 70-20-102 (The Statute of Frauds must not be construed to "abridge the power of any court to compel the specific performance of an agreement in case of part performance thereof"). *See also* The Uniform Land Title Act, which defines and endorses the partial performance exception to the Statute of Frauds. U.L.T.A. § 2-201.

[26] "Judges apply doctrines of their own creation, such as part performance or estoppel, to 'take' certain situations 'out of' the statute of frauds. Do not courts contradict the legislatures when they create and utilize doctrines to enforce contracts for the sale of land absent a writing? In most states, these doctrines are not mentioned in the statute, which pretty clearly speaks in terms of 'no action' and 'every contract.'" Barbara Taylor Mattis, *ULTA and USLTA in Coursebooks and Classrooms*, 20 NOVA L. REV. 1095, 1099 (1996). A few state courts, Mississippi's among them, strictly adhere to the language of the Statute of Frauds and reject the part performance doctrine. *See Wells v. Brooks*, 24 So. 2d 533 (Miss. 1946) ("In Mississippi part performance does not take the case from under [the Statute of Frauds]").

[27] Michelle L. Evans, *The Part Performance Exception to the Statute of Frauds in Real Estate Transactions*, 55 AM. JUR. 3D., *Proof of Facts* 441. *See Hunte v. Blake*, 476 So. 2d 75 (Ala. 1985) (holding that the part performance exception requires the purchaser to be in possession and have paid all or part of the purchase price for the property). *Sutton v. Warner*, 15 Cal. Rptr. 2d 632, 636 (Ct. App. 1993) (Purchaser took possession under a lease. Seller then granted purchaser an oral option for which purchaser paid $15,000 to be credited to the purchase price. Purchaser also made minor improvements. Trial court found evidence of the existence of the oral contract based on purchaser's occupancy, payments, improvements, and reliance on the oral contract.).

[28] *Fowler v. Fowler*, 933 P.2d 502, 504 (Wyo. 1997) (Supreme Court reversed trial court's finding that father promised son $2,000 a month in equity or salary plus ownership of the ranch upon parents' deaths if son became resident ranch manager. Son moved there in 1974. Father sought to eject son in 1990. The appellate court found the son's claim of equity build-up inconsistent with his claim he would be entitled to inherit property at parents' deaths and inconsistent with his testimony in a divorce proceeding that he had no ownership interest in the ranch.).

[29] *Carvel Corp. v. Nicolini*, 535 N.Y.S.2d 379, 381 (App. Div. 1988). *See* Note, *Promissory Estoppel as a Means of Defeating the Statute of Frauds*, 44 FORDHAM L. REV. 114 (1975).

[30] RESTATEMENT (SECOND) OF CONTRACTS § 120 (1981).

A typical estoppel case, brought by a would-be grantee, might arise when an elderly, seriously ill person promises to convey her home to a care giver for looking after the homeowner until her death. After the homeowner passes away, having made no provision to fulfill the promise, the disappointed care giver sues the heirs for specific performance of the unkept promise. The estate's defense will be based on the invalidity of an oral promise to convey real estate or devise property by will.[31]

On occasion, sellers may be able to enforce a contract against reluctant purchasers based on estoppel. This could happen when the seller rejects other good offers, vulnerably relying on the buyer's oral promise to buy.[32]

To avoid having to decide claims unsupported by convincing evidence, some courts only recognize the part performance exception, not the estoppel exception.[33] Don't expect consistency in part performance and equitable estoppel cases. Like all suits in equity for specific performance, judges are given wide discretion and outcomes depend on the court's sense of justice.

Exceptions to Counter Inequity or Fraud. Sometimes judges are not presented with enough evidence to justify granting specific performance, but they are nonetheless persuaded that the seller promised the buyer something. So to prevent the inequity of an unkept promise, they award restitution–a refund of deposit money or reimbursement based on the reasonable value of services rendered.[34]

Consider this example: an unscrupulous homebuilder routinely collects deposits from eager but naive buyers, always manages to avoid signing written purchase-and-sale contracts beforehand, squanders the buyers' deposit money, and never builds the promised houses. When dragged into court by buyers demanding refunds, the homebuilder pleads the Statute of Frauds as a defense. What result? The buyers should win because even though they have no signed promise by the homebuilder to sell, and hence no valid claim to specific performance, they may still be granted rescission and restitution to redress fraud and inequity.

---

[31] *See Housley v. Haywood*, 56 Cal. App. 4th 342 (1997) (court enforced decedent's oral promise to leave son all his property in exchange for what turned out to be 35 years of care-giving despite Statute of Frauds).

[32] *Kipperman v. Dixson (In re Diego's Inc.)*, 88 F.3d 775 (9th Cir. 1996) (The seller was a bankruptcy trustee. The property included a restaurant. The buyer sought to rescind upon learning the liquor license would take a long time to transfer during which the buyer couldn't sell alcohol.).

[33] *See McGinn v. Willey*, 141 P. 49, 52 (Cal. 1914). The Montana Supreme Court overruled a trial court's finding of estoppel and upheld the seller's Statute of Frauds defense in *Austin v. Cash*, 906 P.2d 669 (Mont. 1995). The listing broker had added new terms to an earlier counteroffer that had been signed by all parties. The broker faxed the revision to the buyers who signed it but the seller never did. Believing they had a done deal, the buyers sold some out-of-state property at a big price reduction so they could complete their part of the deal. On learning the seller never signed the counteroffer, the buyers tried to force the sellers to accept the buyers' counteroffer by claiming estoppel based on their hurried sale of their other property. They won at trial but lost on appeal. The Montana Supreme Court rejected entirely the concept of equitable estoppel in Statute of Frauds cases, insisting that only part performance, unequivocally elucidating the contract terms, would do.

[34] *Compare Dougherty v. Dougherty*, 130 A. 833 (N.J. Ch. 1925) (care giver obtained specific performance), *with Standage v. Tarpey*, 446 P.2d 246 (Ariz. Ct. App. 1968) (care givers not allowed specific performance, but instead were awarded a judgment for services rendered).

C. Electronic Contracts and the Statute of Frauds

"Electronic documents will soon begin to replace paper documents in many if not all phases of residential real estate transactions. This transition from paper to electronic documents will occur for the same reasons that papyrus rolls replaced clay tablets several thousand years ago: as familiarity and acceptance builds and the technology improves, the advantages of the newly available medium will far outweigh the costs and disadvantages....Lenders are already using electronic documents extensively in originating loans. While still using paper documents for the required disclosures and the commitment letter, most lenders have made significant progress in replacing paper with electronic documents in the underwriting process."[35]

Institutional lenders, mortgage investors and title companies have found electronic documents cost effective.[36] How quickly eClosings become a universal reality depends on state legislatures empowering and funding local recording offices to accept eRecordings, and on public acceptance of paperless transactions. Buyers and sellers more comfortable with paper copies may be weaned off of them by lenders offering loan discounts to the eWilling.

To legitimize the use of documents "created, generated, sent, communicated, received, or stored by electronic means", Congress enacted the Federal Electronic Signatures in Global and National Commerce Act, known as E-Sign.[37] This law ordains that "a signature, contract, or other record . . . may not be denied legal effect, validity, or enforceability solely because it is in electronic form. . . ."[38] An explicit pre-requisite is that the contracting parties intend to contract electronically. Similarly, the Uniform Electronic Transactions Act (UETA), adopted or proposed in over the half the states, legitimizes the use of electronic writings and signatures to satisfy the requirements of state laws such as the Statute of Frauds.[39] Professor Patrick Randolph offers the example of this e-mailed offer: "I'll buy your property at 450 W. Meyer in Chicago for $50,000." Upon receiving the offer, the property owner types at the top of the message "OK" and hits the return button. This could suffice to create a binding realty

---

[35] Sam Stonefield, *Electronic Real Estate Documents: Context, Unresolved Cost-Benefit Issues and a Recommended Decisional Process*, 24 WESTERN NEW ENGLAND LAW REVIEW 205 (2002).

[36] James Bryce Clark and Maura B. O'Connor, *An Overview of Electronic Mortgage Origination and Recording Issues*, 489 PLI/Real 169 (2003).

[37] 15 U.S.C. §7006 (4)(2000).

[38] 15 U.S.C. § 7001. The statute (E-SIGN) defines an electronic signature as an electronic sound, symbol or process . . . adopted by a person with the intent to sign.
States may elect to supersede the federal statute by enacting, without modification, the UNIFORM ELECTRONIC TRANSMISSIONS ACT, which legitimizes contracts made by electronic means as long as the parties' intent to do so is evidenced by language, a course of dealing, or trade usage.

[39] The requirement of a written memorandum or signature under the Statute of Frauds may be satisfied by an electronic record pursuant to the Uniform Electronic Transactions Act. http://www.pdfforlawyers.com/UETARole.ppt#318,25,Time of Receipt UETA §15 (last visited 06/03/08). California was the first state to adopt the law. CA. CIV. CODE §1633.1.

purchase-and-sale agreement, but only if the owner were proved to have adopted the use of "OK" as an intended signature substitute.[40]

Besides the consent of the parties involved to transact business electronically, an electronic record satisfies legal requirements for a writing only if "capable of being retained and accurately reproduced for later reference."[41] In this way, E-sign respects the Statute of Frauds requirement for a preservable and reproducible record. Of course, this isn't a substantial barrier to the enforcement of electronic contracts since e-mail can be downloaded and even telephone conversations can be taped and transcribed.

III. THE PARTIES TO THE TRANSACTION

A. THE GRANTOR

1. Identifying the True Owner

Ordinarily, the seller is the current legal title holder, or holds a contract or option to buy from the title holder. Understandably, home buyers assume that anyone residing in a home and marketing the property for sale actually owns it. Usually, this assumption proves correct, though not always. Unfortunately, in the ordinary residential sale, sellers seldom recite that they have the authority to convey and the buyer won't be told much about the condition of the title until a number of days after she has signed a binding purchase-and-sale contract. Then, she will receive a preliminary report from a title company cryptically listing defects the insurer won't cover. True, the contract will allow the buyer to exit the deal with impunity upon disapproval of exclusions and exceptions to coverage contained in the preliminary title report. Yet, most buyers would have preferred knowledge of serious title problems before bothering to formulate their offers and negotiate the terms of their sales contracts.

Successful commercial developers often run title checks before making offers to verify that the person who purports to own the property really does. In this way, they don't waste time negotiating with someone who can only deliver partial title or no title at all. Also, early title searches usefully reveal recorded evidence of sellers in big financial trouble–recently incurred mortgage debt, liens for unpaid mortgage or property tax bills, and judgment creditors' liens.

2. Buying From a Married Grantor

With married couples, generally both spouses must sign the deed for a transfer of jointly owned property to be valid.[42] "[B]oth spouses, either personally or by duly authorized agent, must join in executing any instrument by which such community real property or any interest therein is leased for a longer

[40] Patrick A. Randolph, Jr., *Has E-sign Murdered the Statute of Frauds?*, 15 PROB. & PROP. 23 (July/August 2001).

[41] 15 U.S.C. § 7001(e).

[42] CAL. FAM. CODE § 1102(a) (West 1994).

Chapter 5
PURCHASE-AND-SALE AGREEMENTS: FOLLOWING THE MONEY

Scope of the Chapter

In this chapter we discuss how buyers decide upon the purchase price, and how much of an initial deposit they should make. We look at the mortgage loan features that determine the borrower's monthly payment level and the borrower's total cost of financing over the life of the loan. The chapter concludes with a discussion of financing contingencies in purchase and sale contracts.

I. THE PURCHASE PRICE

A. How Do Buyers Know What Price Is Right for Them?

Price is the one contract term home buyers can be counted on to have understood and the provision they are most likely to have spent time negotiating. Until the parties agree on a sales price, there is no binding contract.

Some home buyers treat the purchase of a home as they would the purchase of any other consumer good. If they like it and can afford it, they buy it at or close to the seller's asking price, no questions asked.

MIT behavioral economist Dan Ariely and his wife were house hunting, and noticed "how difficult it is to calculate the optimal amount of money we should spend on a house and how much of it should we take as a mortgage. To work this out, we need to take into account our current income, our expected future income, our predictions for the stock market and the housing market and the interest rate of mortgages today and in the future. On top of that, we need to consider the amount of happiness different houses will provide us and how will that level of happiness measure up against the lifetime costs of these homes.41 years of education between us does not seem to be enough to figure this out."[1]

Determining affordability is easier to calculate than deciding how much personal satisfaction any consumer good is likely to bring its owner. An *acquisition* budget starts with the sales price and takes into account the amount of the buyer's cash down payment and the buyer's likely share of closing costs including title, escrow, recording, and loan fees. To estimate the *ongoing costs of ownership*, the buyer adds up projected mortgage payments, casualty insurance premiums, property taxes, maintenance costs, and homeowner or coop/condo association dues.

Rationally, buyers could determine the right price to pay by using established appraisal methods, described at length in chapter 27: (1) the price

[1] http://marketplace.publicradio.org/display/web/2008/04/04/the_science_of_buying_a_home/ (Last visited 06/12/08).

at which comparable properties are trading; (2) capitalized net operating income (income less expenses); and (3) reproduction cost: what it would cost to acquire land and build an equivalent project.

Home buyers tend to be swayed by 'comps,' the prices at which similar properties have sold recently, or are currently listed. Investors looking for income producing property are keenly interested in the cash flow the property generates. They capitalize the income (convert an annual cash flow into present value) by applying a capitalization (cap rate, for short). Value=Income/cap rate. A property producing $100,000 of income after expenses capitalized at a rate of 5% is worth $2,000,000. At a cap rate of 10%, it would be worth $1,000,000.

Commercial buyers are usually more interested than residential ones in the question of whether property they are about to acquire could be reproduced for a sum lower than their contemplated acquisition price, because they know that if it can, competitors may sooner or later decide to do that. They must then factor into their buying equation the chance of future competition.

Buyers sometimes make choices irrationally. For instance, people pay more for housing when they first move from a more expensive place to a less expensive one. Apparently, they carry their notions with them of what housing should cost. On their second move in the new locale, they pay less, having become attuned to local housing price levels. The opposite is true of those moving from low cost areas to expensive ones. They tend to pay less (and get less) for their first dwellings in the new location, and on their next move, adjust to the higher price levels they encounter at the new more costly locale.[2]

B. CLOSING COSTS AND PRO RATIONS

1. Allocating the Cost of Settlement Services Between the Parties.

Until the buyer and seller accurately estimate the total costs of executing their transaction, and allocate those costs between themselves, neither of them will know their true 'bottom line' price. Closing a real estate sale means paying an escrow agent's or closing attorney's fee, title insurance premiums, and state and local transfer taxes.[3] The parties should make an itemized estimate of these costs before signing a purchase-and-sale contract and specify exactly how they prefer to allocate each of these unavoidable expenses. The parties can choose to pro-rate some of the charges between them and assign sole responsibility to one of them for other charges.

---

[2] Uri Simonsohn and George Loewenstein, *Mistake #37:The Effect of Previously Encountered Prices on Current Housing Demand*, 116 THE ECONOMIC JOURNAL 175 (2006).

[3] Transfer taxes may be levied by state, county or local governments, and often don't specify whether the buyer or seller is responsible for them. http://www.taxadmin.org/fta/rate/Realty transfer.html (Last visited 06/12/08).

Where the contract is silent on apportionment, local custom applies. Because local customs vary and aren't always clear, it is best for the parties to agree on a method of apportionment before closing.

2. Pro Rations of Property Taxes, Casualty Insurance and Mortgage Payments

Property taxes are customarily allocated between the parties according to one basic principle: each party is responsible for paying expenses which accrued (or will accrue) during their tenure.[4] The parties reimburse each other accordingly.

To see how this works, imagine a jurisdiction in which property taxes are levied twice a year, the first installment accruing January through June, the second July through December. If the closing takes place December 1, the seller owes all of the first installment and 5/6th of the second. The buyer owes only that portion which accrues after the closing–1/6th of the second payment. If the seller paid the second installment on or before the closing date, the buyer will owe the seller reimbursement for 1/6th of the second installment. If the seller failed to pay the second installment before closing, the seller owes the buyer a sum equal to 5/6th of the second installment.

If the buyer is retaining the seller's casualty insurance coverage or assuming the seller's existing mortgage, the insurance premiums and mortgage payments will be pro-rated in the same way as the property taxes.

C. FORMULA PRICING

The purchase price doesn't have to be a specific sum ('in gross'). It can be based on a formula as long as the formula is clear enough for a trial judge to apply confidently. A home-builder might purchase acreage for an agreed sum 'per buildable lot,'defining buildable as the number of lots the local government allows in approving the builder's subdivision map. The owner of income producing property could contract to sell for a specified multiplier of gross income, for instance, seven times gross income. A farmer could sell land priced per acre, contingent on how many acres a survey of the site reveals.

When the property turns out to be smaller than the buyer believed or larger than the seller thought it was, a buyer's refund or seller's rebate claim depends on the trial court's determination of whether the parties intended the sale price to be set 'in gross' or 'per acre.' No refund or rebate needs to be paid on contracts priced in gross. The opposite is the case for contracts priced per acre.

A buyer complaining that he overpaid for a house that contained 625 square feet less than promised would have to prove that his agreed purchase price was substantially, unconscionably higher than the fair market value of the house at

---

[4] I.R.C. § 164(d)(1) requires buyer and seller to apportion the property tax deduction based on the "real property tax year." John R. Becker, *Tax Consequences of the Financing and Purchase of a Residence after TAMRA*, 17 TAXATION FOR LAWYERS 340 (1989).

the time of purchase to recover compensatory damage for a sale 'in gross.' If the sale had been 'per square foot,' the buyer would be entitled to compensation based on the agreed price per square foot multiplied by 625.[5] (Of course, the discrepancy can't have resulted solely from buyer and seller having utilized different but equally valid methods of measuring square footage.) [6]

Reviewing courts, trying to discern whether the parties intended a sale to be in gross or by the acre, take into account local custom and practice. For instance, it is rare for home buyers and sellers to price by the square foot, but common for farmers to price per acre and subdividers to price per buildable lot.[7]

The exact contract language can matter. Predictably, contracts in which the parties had stipulated a precise sum 'per acre' or 'per square foot' are more likely to be construed as having been priced on the basis of size than contracts referencing only a lump sum purchase price.[8] Another drafting nuance courts often mention is the phrase 'more or less' following an indication of acreage ("containing 100 acres *more or less*"). Some courts interpret this phrase as strongly indicative of lump sum pricing.[9] Other courts give it less weight.[10]

---

[5] *Matheus v. Sasser*, 164 S.W.3d 453 (Tex. App. 2005). The buyer would also be entitled to specific performance with a price abatement if the seller had deliberately misrepresented the size of the parcel.71 Am. Jur. 2d Specific Performance § 151.

[6] Buyers had measured the square footage of their condo units "paint-to-paint," from inside wall to inside wall. Sellers had measured from the outside wall to half of the demising wall, also a commonly accepted way of calculating square footage. *Kirkpatrick v. Strosberg*, — N.E.2d —, 2008 WL 3317748 (Ill. App. 2008).

[7] *Hagenbuch v. Chapin*, 500 N.E.2d 987, 149 Ill. App. 3d 572 (1986) ("Where a farm is sold and described as containing any certain number of acres, a presumption arises that the sale is by the acre and not in gross").

[8] "[T]he rule is that, where it clearly appears that the sale was made in gross, and not by the acre, and the purchaser not only had every opportunity afforded him to ascertain and satisfy himself definitely as to the extent and location and quantity and boundaries of the lands purchased, but actually did so, going personally upon the property and viewing it from every angle, he has no right to recover for a deficiency, unless actual fraud is proven, or the circumstances and the deficiency are such as to raise a presumption of fraud. The expression frequently used in this connection, 'so great as to shock the conscience of the court,' occurs always in direct association with the suggestion of a presumption of fraud. In other words, relief will be granted where a deficiency is so great as to shock the conscience of the court because a presumption of fraud must thereupon arise. Under the facts of this case, a deficiency of 17.5 percent is not so great as to shock the conscience of the Court." *Tamco Supply v. Pollard*, 37 S.W.3d 905, 910-11 (Tenn. Ct. App. 2000).

[9] *Wyatt v. Ark. Game & Fish Comm'n*, 202 S.W.3d 513, 518 (Ark. 2005).("Where land is sold 'in gross' or where the legal description is qualified by the words 'more or less,' the buyer takes the risk of the quantity, in the absence of fraud").

[10] *Perfect v. McAndrew*, 798 N.E.2d 470, 477 (Ind. Ct. App. 2003) ("The terms 'by estimation,' 'more or less,' or other expressions of similar import, added to a statement of quantity, can only be considered as covering inconsiderable or small differences, one way or the other, and do not, in themselves, determine the character of the sale").

II. THE INITIAL DEPOSIT

The purchase and sale contract should specify how and when the deposit is to be paid, how it should be paid (cashiers' check or wire transfer, typically, sometimes personal check), whether interest is to be paid on the deposit and who is entitled to the accrued interest, and liability for real estate commissions. Trade practice dictates that a 'good faith' or 'earnest money' deposit accompany the buyer's offer. The parties need to decide who should hold the deposit–the seller, the seller's or buyer's attorney, an escrow agent, or a real estate broker.

Contracts usually specify when the purchaser is required to advance additional payments, typically, once or twice during home sales. After the initial deposit, some contracts call for a second sum to be paid either when the seller accepts the offer or all the buyer's 'contingency' periods expire. The balance is due at closing.

The *amount* of the initial deposit is negotiable, though strongly influenced by local custom and practice.[11] The seller and listing broker prefer to lock the buyer into the deal by pushing for a deposit large enough to discourage the buyer from backing out for fear of losing the money deposited.

The Case for the Smallest Possible Initial Deposit. Buyers should think hard before plunking down big initial deposits. Buyers who change their minds about going through with the purchase will usually forfeit their initial advance as liquidated damages because most purchase contracts are written that way.

Once the deposit leaves the buyer's control, few escrow agents, brokers or sellers' attorneys will refund the money without the seller's consent or a court order, even if the seller breaches. Opportunistic sellers won't agree to release those funds without bargaining to grab some of the money for themselves, however unjustifiably, knowing full well that the buyer would probably acquiesce to avoid the costs and delay of suing the seller for a release. On the other hand, breaching buyer's aren't necessarily saints either, and could attempt to reclaim some of the deposit by refusing to sign a release for escrowed funds even though by contract those monies were to become the seller's as liquidated damages for the buyer's breach.

The Case for a Big Initial Deposit. In some situations it is a good idea for buyers to advance hefty down payments as liquidated damages. One of those situations is when the buyer is vying against other bidders in buoyant markets; a generous initial deposit attracts the seller's attention because it signals the buyer's commitment to close. Sometimes, sellers trade a lower sales price for a huge down payment because they would prefer a quick and definite closing date even if they leave some money on the table.

---

[11] For example, California home buyers seldom deposit more than 3% of the purchase price before closing because that is the maximum liquidated damage sum prescribed by statute, unless the seller can prove a larger sum is justified in the particular transaction. In New York, a 10% deposit is customary, which sellers are entitled to retain as liquidated damage.

Should Deposits Be Fully Refundable If the Buyer Decides to Rescind? Typically, purchase contracts call for the initial deposit to be credited to the purchase price if the buyer goes forward with the sale. Should these deposits also be made fully refundable if the buyer rescinds based on discretionary contingencies during the due diligence period?

In commercial realty transactions potential buyers sometimes deploy the tactic of making their offers attractive to sellers by declaring their deposits non refundable. Potential buyers are willing to do this when many bidders are vying for the same property and the sellers have made available before accepting offers complete information about the realty, virtually everything that would be of interest to potential bidders performing their due diligence work–consultant reports about the condition of the building, environmental hazards, entitlement issues, and the status of the title, along with copies of leases, management and labor agreements and accounting records.

By contrast, under many standard residential contracts, sellers must fully refund the buyer's initial deposit if the buyer decides to exercise a virtually unbridled right not to go forward with the acquisition after the expiration of the due diligence period. This gives the buyer, in effect, a free option.

Under just such a 'free option' purchase and sale agreement for ten 'unentitled' acres of land, when the seller refused the buyer's demand to perform, the buyer sued for specific performance. The contract imposed no obligation upon the buyer to seek approval of a subdivision map although the buyer intended to do that. Quite possibly, the seller refused to perform in order to capture the increased land value resulting from the buyer's imminent subdivision map approval. A California appellate court sided with the seller. The court concluded that the contract was nothing but a thinly disguised option without consideration, hence unenforceable against the seller. The California Supreme Court granted a petition for review.[12] Regardless of the outcome, California lawyers are likely to caution buyers to include at least some non refundable consideration ($500 to $1000) in all their purchase and sale contracts unless they are giving sellers another type of consideration for entering the contract, such as obligating themselves to apply for zoning or subdivision approvals for previously unentitled land.

III. THE COMPONENTS OF MORTGAGE DEBT

A. THE DETERMINANTS OF THE MORTGAGE BORROWER'S COST OF MORTGAGE FUNDS

A borrower's cost of funds depends on: (1) the lender, (2) the borrower's creditworthiness, persistence in shopping for the most favorable loan, and ability to grasp the nuances of loan terms, (3) the amount borrowed, (4) the ratio of the

---

[12] *Steiner v. Thexton*, 163 Cal. App. 4th 359, 77 Cal. Rptr. 3d 632 (Cal. App. 2008), review granted, 193 P.3d 281, 84 Cal. Rptr.3d 36 (Cal. 2008).

amount borrowed to the value of the property (the loan to value ratio), (5) the interest rate and other loan related fees, (6) the timing and amount of the borrower's repayment of principal (amortization), (7) the loan term(duration to maturity), and (8) whether the borrower pays interest on the loan as it accrues, or defers interest payments.

A good mortgage broker is capable of presenting borrowers with comparisons of the total costs of financing for various loan options though, unfortunately, few of them bother to do this unless the borrower insists.

B. INTEREST

Interest is the price borrowers pay for the use of money and lenders receive as their rate of return for extending cash. To lawyers, interest is "compensation for the use, forbearance, or detention of money."[13]

Mortgage Interest Rates Equal Treasury Yields Plus Basis Points. Residential and commercial mortgage loans are priced according to the risks of inflation, default, and liquidity. In making this calculation mortgage investors start with the going rate on 10-year U.S. Treasury bonds because of their liquidity (they are easily bought and sold in thick, active markets) and safety (investors are confident that the U.S. government will not default on its obligations). Mortgage investors assume that inflation will impact 10-year Treasuries and mortgages to virtually the same extent.

The mortgage investor takes the current rate paid on a 10-year U.S. Treasury obligation and adds basis points to account for the riskier mortgage loan. A basis point is one-one hundredth (1/100 or. 01) of one percent. The difference between the Treasury rate and other mortgage or bond rates is called the 'spread.'

The spread between the 10-year Treasury and mortgage rates increases when investors are jittery about the economy and diminishes with increased investor confidence. For instance, on December 31, 2001, the spread between mortgage and 10-year Treasury rates was 150 basis points, or 1.5%. On December 31, 2006, following five years of economic growth and no domestic terrorist attack after 9/11/2001, the spread had narrowed to 1.0% or 100 basis points.[14] By March 28, 2008, mortgage markets were in turmoil as home mortgage foreclosures climbed upward, and the spread grew to 2.52%.[15]

The margin or spread compensates the lender for the default or credit risk it assumes. Other factors impact the spread as well. On long term loans lenders weigh political risks such as unfavorable tax law changes or restrictive foreclosure policies. Currency risk, too, could concern intermediaries making dollar denominated loans with funds obtained from investors expecting to repaid in

[13] TEX. FIN. CODE ANN. § 301.002(a) (Vernon 1998).

[14] http://www.uli.org/AM/Template.cfm?Section=Home&CONTENTFILEID=23697&TEMPLATE=/CM/ContentDisplay.cfm (last visited 06/12/08).

[15] Luke Mullins, *Why Mortgage Rates Aren't Lower*, U.S. NEWS & WORLD REPORT, September 17, 2008.

euros or yen. Finally, there is the loss of liquidity, the difficulty of the lender obtaining cash for a long term mortgage loan compared to the ease of selling a U.S. Treasury obligation.

Loan shoppers need to tally up the total cost of financing whether labeled as interest or not. Besides the interest rate, the borrower needs to consider loan closing costs,[16] 'points' or discounts which are subtle front-end charges that increase the lender's yield, and nonlender charges for such services as title insurance, surveys, and attorneys.

'Points' refers to interest paid on the amount borrowed at the outset. Generally, the more points the borrower pays, the lower the borrower's interest rate. One point typically lowers the interest rate by 1/8% to 1/4%. Paying points saves borrowers money if they keep their loans in place for five to seven years.

Points are calculated as a percentage of the amount loaned. One point equals one percent of the loan amount. Thus, a $100,000 loan with "one point" will cost the borrower $1,000. The lender could add the points to the loan principal or the borrower could pay the points up-front to avoid having to pay interest on the points over the life of the loan. The least expensive way for the borrower to pay for points is to write a check for $1,000. Alternately, the lender can "discount" the loan amount by disbursing only $99,000–and charge interest and obtain repayment on the full $100,000.

C. FIXED OR ADJUSTABLE RATE?

Borrowers may choose a loan with a fixed or an adjustable rate of interest. In a fixed rate loan, the rate of interest remains the same over the life of the loan–typically 5, 7, 10, 15 or 30 years. ARM rates are lower than fixed rate loans at the outset because ARM borrowers assume the risk of inflation. However, the amount of the difference fluctuates substantially.

Borrowers on fixed rate debt enjoy payment predictability; their monthly payments remain the same for the duration of the loan. ARM rates float with the index to which they are attached,[17] plus a fixed margin, typically an interest rate add of on two to five percent. The formula is index + margin = ARM interest rate. Loans tied to indices historically favorable to borrowers tend to come with higher margins. Low risk borrowers should be paying smaller margins. However, some lenders charge higher margins than others across the board.[18]

---

[16] Borrowers may be able to find a lender willing to guarantee a fixed-priced comprehensive package covering all loan closing costs. Kenneth R. Harney, *One-size-fits-all Closing Fees*, LOS ANGELES TIMES, February 16, 2003, p. K1, col. 3.

[17] FEDERAL RESERVE BOARD, CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES. The various indices all tend to move in the same direction with slight but financially significant differences.

[18] Some researchers have suggested that the margin depends on how tight the caps are on the loan, the length of the rate adjustment frequency, the type of index used, the contract rate, the loan size, the up-front fees, and the call for prepayment and other options (*e.g.*, "due-on-sale" features). *See, e.g.*, Sa-Aadu & Sirmans, *The Pricing of Adjustable Rate Mortgage Contracts*, 2 J. REAL EST. FIN. & ECON. 253 (1989).

The ARM borrower's obligation depends on payment and life of loan caps, and the frequency with which they are adjusted. For instance, an adjustable rate note could provide that: "The interest rate I am required to pay at the first Change Date will not be greater than _____ % or less than _____ %. Thereafter, my interest rate will never be increased or decreased on any single Change Date by more than two percentage points (2.0%) from the rate of interest I have been paying for the preceding 12 months. My interest rate will never be greater than _____ %." This last number is the life of loan cap–the borrower's 'worst case' situation. In this form, after the payment at the first Change Date, there is no minimum rate or floor below which the borrower will never pay less.

Historically, except for 2002-2007, home buyers and commercial borrowers alike have overwhelmingly preferred fixed rate loans. Most home buyers migrate to ARMs for reasons of affordability. By reducing their initial monthly payment obligations,[19] they can more easily qualify for the mortgage loan they need to swing the purchase of their dream home. Commercial borrowers prefer fixed rate loans unless they are quite confident the income from their mortgaged realty will rise and fall in tandem with periodic adjustments in ARM rates.[20]

To lure borrowers, some lenders offer ARM 'teaser' rates, rates below the actual rate of interest accruing. After a year or two, as accrued but unpaid interest is added to the loan principal, the borrower ends up owing more than the original loan amount. This is called negative amortization. Borrowers tend to underestimate how much their payment obligations will expand due to negative amortization once the 'teaser' period ends. Optimistic borrowers hope to refinance their loans beforehand but may not be able to, especially if their incomes won't support the higher interest rate, and the value of the security property has fallen.

ARMs may be adjusted daily (as it is in some large commercial loans), monthly, biannually, or yearly. Home mortgage lenders are trending towards monthly adjustment periods. Whether shorter intervals between adjustment periods advantage borrowers or lenders depends on whether rates are rising or falling.

Wharton professor emeritus Jack Guttentag recommends fixed rate loans for borrowers who can afford the higher starting rate, and who have a strong preference for predictability in their payment obligations, or for borrowers who plan to keep their mortgage for seven years or longer. Adjustable rate borrowers need to answer the question put by The Federal Reserve *Consumer Handbook on*

---

[19] As California home prices were more than doubling from 2001 to 2005, and the percentage of home buyers who could afford the average home declined from 30% to 16%, the percentage of home buyers using ARMs rose from 20% to 80%. By reducing their monthly mortgage payments, home buyers had the option of purchasing more expensive houses than they could have afforded with fixed rate debt. From 1986 to 2004, ARM borrowers on average purchased homes 31% more expensive than homes financed with fixed rate loans, and enjoyed much higher rates of home value appreciation–164% v. 114%.

[20] See John B. Corgel and Scott Gibson, *The Use of Fixed and Floating Rate Debt for Hotels*, 46 CORNELL HOTEL AND RESTAURANT ADMINISTRATION QUARTERLY 413-430 (November 2005).

Adjustable Rate Mortgages, a 'must' read for any first time home buyer unsure whether to go fixed or adjustable: "Is my income enough–or likely to rise enough–to cover higher mortgage payments if interest rates go up?"[21]

Professor Guttentag's web site has a calculator for estimating how changes in the interest rate will impact monthly payments. To use it, you must know the current value of the index, margin, rate adjustment cap, and maximum rate on the ARM you are considering. You input into the professor's calculator your assumptions about what will happen to interest rates, including a "worst case" based on the life of loan cap. "The worst case has a very low probability of occurrence, but it is nice to know you could manage it."[22]

D. HYBRIDS

By far the most popular type of adjustable rate loan currently is a hybrid that combines a short term fixed rate mortgage with a long term adjustable rate mortgage. "It might be quoted as a 5/1, meaning that for the first 5 years the note rate is fixed and thereafter it floats and is re-set once per year."[23] The amortization schedule for such loans is based on a 30-year term. But in year six the rate becomes adjustable. Interest rates on hybrids usually fall somewhere in between fixed and adjustable rates.[24]

For borrowers who want the security of a fixed rate but who anticipate selling or refinancing before the hybrid rate becomes adjustable, this is ideal. They avoid paying the built in premium for a longer fixed rate loan duration than they actually plan to use.[25] On the other hand, if a sale or refinancing becomes problematical because the value of the security property declines or borrowing becomes difficult due to adverse market conditions, the borrower will end up with an adjustable rate loan in year six.

Borrowers with 2/28 or 3/27 loans–loans with fixed rates of interest for two or three years that switch to adjustable rates afterward–may be in for quite a payment shock. Their loans were not underwritten to assure their ability to pay the highest interest rate to which they could become liable under their adjustable rate loan caps. Quite the contrary, as long as the borrower seems able to pay the sometimes artificially reduced fixed rate for a couple of years, the lender makes the loan.

---

[21] http://www.federalreserve.gov/pubs/arms/arms_english.htm (Last visted 06/12/08).

[22] Jack Guttentag, *Tutorial on Choosing Between ARMs and FRMs*, 18 April 2006. http://www.mtgprofessor.com/Tutorials%20on%20Mortgage%20Features/tutorial_on_choosing_between_ARMs_and%20FRMs.htm (last visited 06/12/08).

[23] Laurence G. Taff, INVESTING IN MORTGAGE SECURITIES (2002), p. 119.

[24] Peter E. Knight, *Convertible ARMs: A Loan for All Leasing?*, BOTTOMLINE, Jan. 1988, at 53.

[25] N. Noel Fahey, *The Pluses and Misses of Adjustable-Rate Mortgages*, 3 FannieMae Papers, Dec, 2004. http://www.certifiedscripts.com/pdf/fanniemae.pdf (Last visited 06/12/08). In Europe these hybrids are regarded as fixed rate loans.

Because the adjustable rate feature comes with many permutations, the federal Consumer Protection Act of 1968 ('Truth-in-Lending') imposes special disclosure obligations on lenders originating ARMs for home loans, on top of the usual loan disclosure requirements. Even so, borrowers have a harder time figuring out their liability on adjustable-rate loans than they do on fixed-rate loans. Lenders, too, seem to be having difficulty accurately computing borrower liability and have been accused of overcharging many holders of adjustable-rate mortgages.[26]

E. CHOOSING AMONG AMORTIZATION SCHEDULES

Amortization[27] refers to the repayment of principal. The opposite of no amortization (also called 'interest only') is full amortization.[28] Borrowers keep monthly payment to a minimum with no amortization and pay the largest monthly payments with full amortization. Full amortization means that the borrower will have repaid all of the principal by the end of the term without the borrower having to make a whopping final repayment of principal (called a balloon payment). Loans with no amortization are also referred to as bullet loans. The bullet is the final payment. Sometimes, lenders offer the 'interest only' borrower the option of refinancing the loan near the time it falls due to avoid immediate liability for the big final loan payoff, or agree to accept title to the property instead of foreclosing if the borrower can't refinance.

Pros and Cons of No Amortization. The advantages to the borrower of a 'no amortization', 'interest only' loan are:

(a) With no amortization, the borrower minimizes her monthly payments. For instance, on an interest only loan for $100,000, the borrower would pay $500 a month. On a $100,000 loan, 30-year term, fixed-rate at 6%, the borrower's monthly payment would be $599.55, nearly $100 a month going to principal reduction. The lower the monthly payments, the bigger the loan for which the borrower qualifies. Interest only loans also provide a measure of flexibility to borrowers with fluctuating incomes, enabling them to make larger-than-required payments in months when their incomes are high enough to support some amortization.[29]

(b) For 'qualified' home mortgage loans every dollar of interest paid is tax deductible. Interest on commercial loans is deductible as a business expense. Repayments of principal are never deductible. The point at which more than half of the borrower's monthly payments are allocable to repayment of principal and

---

[26] Paul Duke, *Adjustable-Rate Mortgage Errors Spark Concerns*, WALL ST. J., Oct. 26, 1990, at A16. The alleged over-charges in most cases aren't huge–in the range of $500 to $1,000 over the life of the loan.

[27] The word derives from Middle English, and means 'to kill.' It refers to the borrower killing the debt by repaying the loan principal.

[28] Axelrod et al., LAND TRANSFER AND FINANCE 135 (3d ed. 1986).

[29] Jack Guttentag, *Interest-only Loans: Make Sure the Benefits Are Right for You*, LOS ANGELES TIMES, January 18, 2004, p. K5, col. 1.

therefore non deductible depends on the duration of the loan and the interest rate. The longer the term, and the higher the interest rate, the longer it takes before the portion of each monthly payment allocable to principal equals and then exceeds interest payments on a fully amortized loan.[30]

The disadvantages of an 'interest only' loan to the borrower are:

(a) Lenders compensate for the delayed return of principal by charging a higher interest rate than they would on a fully amortizing loan.

(b) The borrower pays more interest over the life of the loan since interest is based on the loan balance and that sum never gets paid down during a no amortization loan.

(c) The borrower foregoes the forced savings plan built into a fully amortizing loan. Eventually, the loan principal must be repaid. The date and amount of payment are known at the outset. Typically, the borrower anticipates making the balloon payment by refinancing the loan or selling the security property at a high enough price to cover the payment. What the borrower cannot know for sure at the outset is whether realty market and lending conditions will make it feasible for the borrower to sell or refinance at the appointed time. Unlucky borrowers chance foreclosure unless they happen to possess a stash of funds out of which to repay the debt.

F. Selecting the Loan Term

Borrowers must also choose the length of the loan–the date by which all the loan proceeds will have been repaid. For home mortgage loans, 15 or 30 year, fully amortized loans were once the only loans available. They continue to be the most popular choices though loans of 20, 25 and 40 years are now available. Borrowers who can afford the higher monthly payments of a loan that amortizes in 25 years pay far less over the life of the loan than borrowers who elect 30 year loans.

To see the trade off between monthly payments and life of loan mortgage costs, consider the example of $180,000 financed either with a 30 or 15 year mortgage loan.[31] The interest rate on the 30 year loan will be 5.99% and on the 15 year loan, 5.72%. (The shorter term loan carries a reduced interest rate.)

Over the life of the loans, the 30 year borrower will make interest payments of $208,092.21. Interest payments on the 15 year loan would come to $88,532.66. Total payments on the 30 year loan equal $392,092.21. On the 15 year loan, $268,532.66.

By spreading out the payment obligation over 30 years, the borrower reduces monthly debt service considerably, from $1073.78 on the 30 year loan compared to a sum of $1,491.85 on the 15 year loan–a difference of $418.17 per month.

[30] The point at which principal and interest payments are about an equal par of each monthly payment occurs after 24% of the life of the loan on a 15-year 6% loan and 81% of the life of the loan on a 30-year 12% loan.

[31] The example comes from http://www.bestwayinvesting.com/ (Last visited 06/12/08).

Which would you choose if you could afford the extra $418 per month? Would you estimate the interest cost in after tax dollars? Would you anticipate investing the monthly savings or spending it, and if you plan on investing it, would you anticipate a rate of return above 5.72%?

Commercial mortgage loans usually amortize partially and, typically, are written to mature in five to ten years. For instance, a borrower might make payments as if the loan were to be fully amortized in 30 years but fall due at the end of year ten ("30 due in 10"). At the end of year ten the borrower would have to make a sizable balloon payment.

IV. FINANCING CONTINGENCIES

A. THE DEFAULT RULE REGARDING FINANCING CONTINGENCIES

The law of vendor and purchaser presumes–absent clear contrary language in the contract–that the seller will be receiving 100% cash at closing. The amount of cash the seller receives isn't necessarily the amount the buyer pays since most buyers are not 'all cash' purchasers and expect to borrow funds to complete the sale. Even if the seller knows this, the default rule places the risk squarely on the buyer of not being able to arrange financing.

Most home buyers are oblivious to the financing default rule and could benefit from a clear warning that the financing risk is theirs. A suitable recap of the default rule might read: "Buyer represents that buyer has sufficient funds available to close this sale in accordance with this agreement, and is not relying on any contingent source of funds. . . ." A properly worded affirmation of the default rule also serves to undermine any later claim by the buyer of a financing contingency when there was none.

In their purchase-and-sale contracts, home sellers should and usually do require a representation from the buyers that they possess access to sufficient funds to complete their purchase obligation. Contracts may call for early proof of the buyer's financing in a form acceptable to the seller, typically a loan commitment from an institutional lender. Sellers usually reserve the right to rescind if they come to have serious misgivings about the buyer's ability to pay.[32]

Buyers need a 'subject to financing' condition allowing them to rescind and get back a full refund of their deposit if they can't find suitable financing. "In a properly drafted sales contract, the buyer has a right to cancel the purchase obligation if the buyer both fails to obtain an acceptable loan commitment letter

---

[32] "If Buyer fails to obtain written notification from Lender of Loan approval within said thirty (30) day period, then Seller may at any time thereafter cancel the Agreement by providing three (3) business days' prior written notice to Buyer; provided, however, that if Buyer, through its Lender or otherwise, places all funds into escrow necessary to purchase the Property no later than three (3) business days after the delivery of Seller's notice to terminate the Agreement pursuant to this section, the loan approval condition shall be deemed satisfied and the Agreement shall not terminate."

within a specified time, and the buyer promptly notifies the seller of this failure."[33]

Most home sellers prefer offers not hedged with financing contingencies. Sellers are more likely to accept offers from buyers so confident of their ability to finance their acquisitions that they require no financing contingency. Consequently, a buyer willing to shoulder the financing risk is in a stronger negotiating position than a buyer who, by insisting on a financing contingency, hints that she isn't sure she will be able to finance the purchase.

Too much can be made of a financing contingency or its absence. A seller may be mistaken who infers from a buyer's willingness to risk her deposit as liquidated damages that she is more likely to complete the sale than a buyer who insists upon a financing contingency provision. Such a buyer may simply be less averse to taking risks or less aware of the risk she is taking, not necessarily more credit worthy or better capitalized than the buyer who insists upon a financing contingency. It would also be wrong to infer that a financing contingency greatly minimizes the buyer's incentive to obtain financing or reduces the chance that the buyer will ultimately default for lack of financing. A financing contingency provision adds little to the buyer's already powerful incentive to try to acquire the property she freely chose and went through the trouble of negotiating and signing a contract to acquire. And don't forget the lender. A financing contingency in a purchase and sale contract or its absence has no bearing on the lender's decision to grant or deny the buyer the funds needed to close.

Financing Contingencies in Commercial Realty Transactions. Though it isn't unheard of for commercial purchase and sale agreements to come with a financing contingency, more often sellers grant the buyers of commercial realty a period of due diligence to decide whether the property is right for them. The buyer can use the time as it wishes, pursuing financing opportunities if it needs financing to complete the contract. Sellers are willing to do this because in the highly specialized world of commercial real estate, the seller can usually learn quite a lot about prospective buyers from mutual acquaintances. Also, sellers know that the 'due diligence' period isn't a completely free look-over because astute buyers spend small fortunes checking out properties before the due diligence period ends. Sellers get wind of buyers in the habit of contracting for realty and letting their contracts expire without performing extensive due diligence, and won't enter contracts with them.

B. Drafting a Financing Contingency

1. Comparing Three Possible Financing Contingencies

Financing contingencies come with three variations. (1) Subject to 'available' financing. (2)'Subject to buyer obtaining satisfactory financing.' (3) Based on specific loan characteristics.

---

[33] Eric G. Menkes, *What You Need to Know About Commitment Letters in Residential Real Estate Transactions*, 12 PRAC. REAL EST. LAWYER 63, 63-64 (1996).

(1) Of the many ways to phrase a financing contingency, the one that buyers should always reject out of hand is 'available' financing. Buyers should avoid committing themselves to available financing because they may not like what is available. A perfect example is the case where the buyers wanted a fixed rate loan they could refinance without penalty but were only able to obtain an adjustable rate loan with a prepayment penalty–the exact opposite of what they were looking for.[34] The court found irrelevant the fact that the buyers didn't like the proffered financing; it was indisputably available.

(2) A contingency that financing must be satisfactory to buyer is the most buyer friendly provision imaginable. Sellers will see the provision as giving the buyer a free look at the property for the duration of the financing contingency period, a period usually set in the contract to be coterminous with the buyer's other contingencies such as those for title review and physical inspections.

The buyer's contract obligation appears so discretionary as to be vulnerable to judicial invalidation for being illusory. Many courts are able to justify upholding such provisions by interpreting them to require 'reasonable' satisfaction coupled with an implied obligation that the buyer will, in good faith, apply for and accept a reasonable loan.[35] Other courts strike down 'buyer satisfaction' contingency clauses as illusory promises. Commonly, courts take one of two postures when invalidating a financing clause as illusory: either no party can enforce the contract or the contract is enforceable–but with the 'all-cash-at-closing' default rule.

(3) Perhaps the most popular financing contingency format calls for detailing the mortgage terms the buyer wants, for instance: "a new 30-year fixed interest rate mortgage of at least $100,000 with interest not exceeding 8 percent, a loan fee of not more than 2 percent, and a monthly payment not exceeding $733.76."[36] Expect sellers and listing brokers to verify that the specified loan terms are realistic in the then current market. Only the most clueless buyers will specify loan terms that are unavailable or unaffordable to them. Since rates could rise during escrow, Los Angeles mortgage broker David Soleymani recommends pegging the rate at half a point higher than those prevailing on the date the contract is signed.

Buyers contemplating this type of financing contingency are best advised to seek a loan pre-approval to be sure they qualify for and can procure the loan specified. Of course, buyers will need to apply for the loan identified in the contract. If they can obtain a less costly loan, so much the better for them. But if

---

[34] *Gaynes v. Allen*, 362 A.2d 197 (N.H. 1976).

[35] *Giallanza Realty, Inc. v. Rosebud Props.*, 434 S.E.2d 130, 132 (Ga. 1993) (purchasers have an "implied duty to exercise due diligence and good faith in seeking to have the financing contingency take place"). For an excellent discussion of the legal issues raised by financing conditions and contingencies, *see* Raushenbush, *Problems and Practices With Financing Conditions in Real Estate Purchase Contracts*, 1963 WIS. L. REV. 566 (1963); Aiken, *Subject to Financing Clauses in Interim Contracts for the Sale of Realty*, 43 MARQ. L. REV. 265 (1960).

[36] http://www.homeprospect.com/article/article15a.html (Last visited 06/23/08).

they can't, they will have breached their contract if they refuse a loan offered on the same terms as were specified in the contract.

2. Contingencies Based on Application, Commitment, or Funding?

Buyers can make their obligations to purchase contingent on *applying for a loan*, *receiving a loan commitment*, or *actually obtaining a loan*. Buyers prefer the financing contingency to be based on the loan actually being funded. There is a world of difference between money promised and money delivered.[37] "So the purchaser, who satisfies a standard contingency clause by obtaining a mortgage commitment, can still lose his or her deposit if the deal falls through because the loan ultimately fails to close. And that can happen for a variety of reasons."[38]

Quite commonly, home loan commitments are contingent on a satisfactory property appraisal and credit check. If either proves disappointing and the lender declines to make the loan, the buyer may end up forfeiting the down payment as liquidated damages for breach of contract. Had the buyer's contract obligation been conditioned on the loan actually being funded, once the lender declined to fund, the buyer would have become entitled to rescission and a refund of its deposit.

The seller who accepts a loan contingent on financing won't know if she has a deal until the day before closing. Of course, the reality is that even under a loan commitment contingency, the seller has no assurance of the sale closing until the lender funds. Understandably, sellers could contract for the receipt of convincing indicators much earlier than that of their buyers' abilities to perform.

Lender's Breach. Occasionally lenders breach a loan commitment by wrongfully refusing to fund the loan, owing to bureaucratic snafues within the lending institution, a liquidity crisis, or a shift in the lender's loan preferences. Without the promised funds, the buyer may be left with no practical choice but to breach her purchase obligation. When that happens, sellers can suffer big losses. For example, the seller may have contracted to buy another house. While pursuing an impecunious breaching buyer may do the seller little good, going after the reneging lender might be quite promising. But the seller who seeks

---

[37] *Malus v. Hager*, 712 A.2d 238 (N.J. Super. Ct. App. Div. 1998) (Funding of loan commitment was contingent on no adverse change in borrower's financial condition or employment status. Borrower lost job just before closing. Lender refused to fund. Borrower held in breach of purchase-and-sale contract contingency which had been for a loan commitment, not actual funding.). *Compare Kapur v. Stiefel*, 695 N.Y.S.2d 330 (App. Div. 1999) (After lender refused to fund its loan commitment, court held that buyer could rescind contract conditioned on loan commitment if lender's refusal to fund was caused by the job loss, and the buyer hadn't effected the termination in order to shirk his real estate contract) and *Aubin* v. *Miller*, 781 A.2d 396, 403, 64 Conn. App. 781, 788 (2001) (Lender rejected purchaser's loan application after he was fired during the executory period. Neither he nor his wife had any obligation to make another loan application because "the law does not require the performance of a useless act . . . and common sense dictates that someone with no income would not be approved for a $400,000 mortgage.").

[38] Daniel M. Shlufman, *The Attorney and the Mortgage Loan*, 178 PLI/NY 327 (2008).

damages against the lender on third party beneficiary or estoppel theories will usually lose.[39] Sellers who want third party beneficiary status should be designated jointly with their buyers as among the parties to whom the lender made the loan commitment.[40]

C. IMPLEMENTING FINANCING CONTINGENCIES

1. Good Faith Effort to Procure Loan

A buyer who contracts for a 'subject to financing' clause does not gain an automatic free option for the duration of the loan contingency period. Buyers are legally obligated to make the effort of applying in good faith for a loan at a reasonable number of lenders and completing the required applications for financing. A buyer who fails to do so will be liable for the difference between the contract price and the fair market value at the date of breach.[41] To comply, the buyer must apply on or before the date specified in the contract[42] on terms essentially identical to those specified in the contingency provision.[43] Not only must buyers apply for a loan in good faith under a financing contingency provision, their applications must be complete and truthful. A buyer fails to perfect a good faith application by not furnishing all documents and information when and as required by the lender.[44]

Buyers who change their minds and decide they no longer wish to buy the property they promised to acquire, often consider invoking the financing contingency as an excuse to exit their contracts with impunity. To succeed, they will have to establish that, but for their inability to obtain a loan, they would have

---

[39] Carroll J. Miller, Annotation, *Vendor's Action Against Vendee's Prospective Lender for Misrepresentation Respecting or Failure to Complete Loan Commitment*, 30 A.L.R. 4TH 474 (1984).

[40] *Morrison v. Home Sav. & Loan Ass'n*, 346 P.2d 917 (Cal. Ct. App. 1959) (seller obtained appraisal and oral commitment from lender before selling and after contract was entered the commitment was issued by lender to both seller and buyer).

[41] *Binks v. Farooq*, 578 N.Y.S.2d 335 (App. Div. 1991) (Buyers who made no effort to obtain financing were held liable for $198,000–the difference between their contract price and the price the sellers received in a sale to a third party).

[42] In *Vafa v. Cramer*, 622 N.Y.S.2d 567 (App. Div. 2 Dept. , 1995), the purchase-and-sale agreement called for purchaser to apply for a mortgage loan from an institutional lender within ten days of signing the contract. The purchaser submitted a loan application to a mortgage broker. The broker did *not* pass the application forward to the lender within ten days. The lender ultimately denied the loan. The purchaser was held liable for breach of contract because the loan had not been submitted to an institutional lender within ten days, as required by the contract.

Ratner v. Elovitz, 604 N.Y.S.2d 82 (App. Div. 1 Dept. ,1993). The late Miles Davis, a renowned jazz musician, had applied for a loan shortly before he died, to buy a cooperative apartment on Central Park West in Manhattan. The loan was denied because of "temporary or irregular employment" and a "slow, delinquent payment record." His executor contended that Davis had applied to an institutional lender by applying to a mortgage banker. The sellers thought otherwise. The case was remanded to trial for a determination of whether the broker's loan application was in effect an application to an institutional lender.

[43] *Herbage v. Snoddy*, 864 S.W.2d 695, 699 (Tex. App. 1993).

[44] *Grimsley v. Lenox*, 643 So. 2d 203 (La. Ct. App. 1994) (breaching purchaser barred from invoking the financing contingency clause when loan was denied).

bought the property. If the buyer's real reason for not going through with the sale was that she couldn't scrape up enough cash for the down payment, she can't expect a refund of her deposit pledged as liquidated damages. Her entitlement to a refund depends on her proving that but for the lack of a loan, she would have bought the property.[45]

2. The Financing Contingency Time Period

The seller is better off if the buyer must waive the financing contingency or relinquish her rights under it expeditiously. The time it takes lenders to issue a commitment varies with market conditions, lender competence and the complexity of the loan request itself. Typically, contracts allow from ten days to two weeks for loan commitment approval. This may not be long enough for some lenders to review the buyer's loan application, appraise the property, and issue a firm mortgage loan commitment.

Sometimes, sellers will grant buyers a time extension if asked–unless they have lined up a better offer from a back up buyer. In asking for an extension of the financing contingency deadline, buyers should resist threatening to terminate the contract if the seller turns down the request. The seller can treat the buyer's demand to extend-or-terminate as an offer to terminate, and accept it, precluding the buyer from reinstating the contract without the seller's consent if the buyer's lender should eventually come through with financing in time to close on schedule.

Should the seller turn down the buyer's request for a financing contingency time extension, buyer's counsel may advance the claim that the seller's refusal was unreasonable, and file suit to extend the deadline. While some analysts believe the seller has an absolute right to rely on the financing contingency deadline in the contract–whether accompanied by a time of the essence provision or not, others take the position that the seller's refusing to grant an extension should be based on what a reasonable seller would have done under similar circumstances, not the subjective standard of whether the seller in the dispute acted in good faith or without malice in this instance.[46]

Once the financing contingency date actually arrives, the seller may be able to compel the buyer to choose between (a) terminating the contract if the buyer has obtained no loan commitment, or (b) relinquishing the financing contingency, perhaps relying on informal indications from a mortgage broker or lender that the loan is likely to go through.

The enforceability of timing constraints in financing contingencies is iffy. Many courts will terminate the buyer's right to purchase for failure to meet the

---

[45] *La. Real Estate Comm'n v. Blakes*, 880 So. 2d 79, 82 (La. Ct. App. 2004) ("In order to decide who is entitled to the $25,000 deposit, it is necessary to determine whether the cause of the contract's failure was the Blakes' inability to obtain financing, which would allow the Blakes to receive the return of their deposit, or whether the cause was the Blakes' failure to have the down payment, which would result in the forfeiture of their deposit").

[46] *Jaramillov v. Case*, 100 Conn. App. 815 (2007).

time line in a contract financing contingency, perceiving contingencies as a free option for the buyer.[47] Other courts are lenient with buyers whose loan commitments run late, especially when the loan commitment, though tardy, comes through in time to close the contract on schedule.[48]

Can Buyer Waive the Financing Contingency? Financing contingency provisions should always and often do specify the buyer's remedies. Typically, buyers are explicitly entitled either to waive the financing contingency, and proceed to closing by assuming the financing risk on their own, or terminate the contract and receive a refund of any deposits (sometimes they share incidental costs such as escrow fees to date). Some courts have granted buyers the right to waive the financing contingency even without having reserved the right to do so.[49]

Though a buyer could be willing to take her chances and proceed without a firm loan commitment, a seller may not want to keep the property off the market for a buyer with no guaranteed source of funding. Sellers could reserve the right to terminate the contract and refund the buyer's deposit; of course, the seller could also waive this right unless the buyer convincingly explains how she plans to finance the acquisition.

QUESTIONS

Question 1. *Factors to Consider in Deciding How Much to Pay and How to Finance Realty.* In shopping for a home, Professor Dan Ariely considers his "predictions for the stock market and the housing market and the interest rate of mortgages today and in the future." How could comparative stock and housing market trends and predictions about interest rate movements impact a rational home buyer's decisions about (a) how much to spend for a home, (b) the optimal debt/equity ratio, and (c) whether to select a fixed or adjustable rate mortgage loan?

Question 2. *Down Payment.* A first time home buyer isn't sure how much of an initial 'good faith' deposit to include with the offer she is about to make on the house of her dreams. The broker recommends a 10% deposit while explaining that most deposits range from 1-10% of the offer price. What factors should the buyer

---

[47] *Churgin v. Hobbie*, 655 N.E.2d 1280, 1283-84 (Mass. App. Ct. 1995): "A mortgage financing condition . . . has characteristics of an option in that one party has a unilateral right to proceed or not proceed with the transaction. The selling party is obliged to keep the property off the market while the buying party explores its ability to finance. For the same reasons that optionees are required to turn their corners squarely in exercising option rights, it is not too much to ask that a party adhere closely to the notice of cancellation provision of a financing condition clause. Of course it is open to the parties to establish a new financing condition or to extend a financing condition, but such an extension should be express and not left to implication from extension of the date of performance of the contract."

[48] *Keliher v. Cure*, 534 N.E.2d 1133 (Ind. Ct. App. 1989).

[49] *Dygert v. Crouch*, 36 S.W.3d 1 (Mo. Ct. App. 2001).