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# TIGHT MONEY AND POSSIBLE SUBSTANTIVE DEFENSES TO ENFORCEMENT OF FUTURE MORTGAGE COMMITMENTS

*Daniel C. Draper\**

## I. Introduction

No western economy has solved the problem of full employment and stable prices. Despite the efforts of central bankers and economic planners, the economy has oscillated between inflation and unemployment and today is plagued by both.

Although the mechanics of achieving optimum employment with minimum impact on price levels have taken many forms, they have all emphasized credit restrictions during times of inflation. These restrictions have manifested themselves in increasingly wide fluctuations in interest rates<sup>1</sup> as government demands have preempted credit previously available to the private sector and the intermediaries which serve it. The current money crisis, the fourth in nine years, particularly affects the construction industry—dependent as it is on long-term credit. The economy has been plagued by tight money crises in 1966, 1969, and again in the fall of 1973. The current crisis, however, portends a more severe<sup>2</sup> shortage of mortgage credit than ever.

Against this setting, some imaginative mortgage bankers and lending institutions lacking current funds have issued future commitments at fixed rates to purchase or make mortgages.<sup>3</sup> By agreeing to furnish dollars tomorrow at today's prices,<sup>4</sup> long-term lenders have to some extent cushioned the impact of stop-start mortgage credit and have thereby produced more orderly money markets. Additionally, a sponsor-builder with a long-term mortgage loan commitment can use it to secure construction financing<sup>5</sup> at presumably lower costs in the continuing inflationary spiral, provided that prospective rental income can sustain the currently high interim and long-term interest rates. The builder or promoter, moreover, knows before he starts construction that his price for

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1 *Quarterly Economic Report*, 32 THE MORTGAGE BANKER 24B (1972); see 58 FED. RESERVE BULL. A-9-10, A-34-35, A-53 (1974) (detailed summary of recent fluctuations in lending rates).

2 Jones, *Persistent Inflation Calls for New Economic Game Plan*, 34 THE MORTGAGE BANKER 10 (1974); New York Times, August 31, 1974, at 19, col. 6, citing Professor Hyman Minsky, Professor of Economics at Washington University.

3 Sometimes the lender will protect itself against the possibility that it will not have funds immediately available at the closing date by including a provision permitting delay at the lender's option. For example: "The loan shall be closed not later than \_\_\_\_\_. You agree to give us 30 days' prior written notice of the closing and upon receipt of such notice we may, by notice to you in writing, delay such closing for a period of not more than six months."

4 Jacobs & Kozuch, *Is There a Future for a Mortgage Futures Market?*, 34 THE MORTGAGE BANKER 5 (1974).

5 Particularly in this market, construction lenders require long-term "takeouts" which assure that the construction loan will be paid (refinanced) on maturity.

long-term money is fixed. Likewise, the lender can reduce its vulnerability to downside interest rate fluctuations by entering into future commitments to lend anticipated incoming funds from mortgage principal payments. Future trading in commodities has produced similar beneficial results by permitting hedging against prospective price changes;<sup>6</sup> the future commitment in effect treats money as a commodity.<sup>7</sup> A sponsor-builder can hedge its position against a further rise in the price of money by transferring the risk, often for a fee,<sup>8</sup> to the long-term lender who is better able to bear it. The long-term lender, on the other hand, can assure itself of a future loan inventory at a point in the business cycle when a previous tight money period has reduced construction by restricting the availability of mortgages. The long-term lender can assume this risk because it has a steady cash flow from amortization payments on its mortgage portfolio.<sup>9</sup>

Through this mechanism, the construction industry can better compete for the limited available credit when the central banking authorities constrict credit to reduce total consumption. To the extent the device is effective, it reduces the inefficiencies created by the cyclical nature of the construction industry.<sup>10</sup>

The enforceability of mortgage and loan commitments, therefore, serves

6 Kroll, *Commodity Hedging for Insurance and Profit*, C.P.A.J., April, 1972, at 303; Yamey, *Short Hedging and Long Hedging in Futures Markets: Symmetry and Asymmetry*, 14 J. LAW & ECON. 413 (1971); H. GOSS, *THE THEORY OF FUTURE TRADING* (1972).

7 "But the defendant was not building a shopping center; it was providing money as a commodity." [Emphasis supplied.] Boston Rd. Shopping Center, Inc. v. Teachers Ins. Annuity Ass'n of America, 13 App. Div. 2d 106, 109, 213 N.Y.S.2d 522, 526 (1961), *aff'd*, 11 N.Y.2d 831, 182 N.E.2d 116, 227 N.Y.S.2d 443 (1962).

8 In theory, such commitment fees should not constitute interest for usury purposes because they represent payments for the lender's assumption of the risk that rates will be higher at the time the loan closes than the so-called "spot" rate in effect at the time the commitment issues. *Cf.* Chambers & Co. v. Equitable Life Assurance Soc'y, 224 F.2d 338 (5th Cir. 1955); Goldman v. Connecticut Gen. Life Ins. Co., 251 Md. 575, 248 A.2d 154 (1968); Continental Assurance Co. v. Van Cleve Bldg. & Constr. Co., 260 S.W.2d 319 (Mo. Ct. App. 1953). But the New York State Banking Department, after first adopting this rationale, now has issued novel regulations that in effect have rejected it for one- and two-family-dwelling mortgages. See Draper, *Highlights of Usury for the Thrift Industry in BUSINESS AND LEGAL PROBLEMS OF THE THRIFT INDUSTRY* 122 (2d ed. 1970); Sintenis, *Current Treatment of Non-Refundable Commitment Fee and Related Problems*, 86 BANKING L.J. 590 (1969).

9 The usual technique is to meet commitment requirements out of cash-flow from prior investments and maturing obligations. If necessary, short-term paper can be sold or, if further necessary money can actually be borrowed by the lender at a prime rate for a brief period until the lender has funds to repay the loan. Wolf, *The Refundable Commitment Fee*, 23 BUS. LAWYER 1065, 1069 (1968). See also note 3 *supra*.

10 Compared to the Gross National Product, the transactions affected by the future commitment device may well not have more than a minimal effect on the national price structure. The limited number of projects that can sustain current high interest costs, and the unwillingness of lending institutions to take future positions not covered by amortization runoffs probably would assure that the device will not adversely affect central bank restrictive monetary policies. With respect to residential construction, BUSINESS WEEK, Aug. 17, 1974, at 50 states:

Arnold Packer of the Committee for Economic Development (CED) has emphasized that housing is not a good sector to absorb the variability of the economy because it accounts for only 4% of the total gross national product. Therefore, even small fluctuations of the total will show up as massive ups and downs in housing. Policies that even out and spread around the total variability are thus less disruptive and more equitable, particularly in light of the CED's own 1973 policy statement on housing, which calculated that as many as one out of seven households in the U. S. has inadequate housing. Possible procedural or conceptual impediments to remedies available to mortgage lenders are discussed in Draper, *The Broken Commitment: A Modern View of the Mortgage Lender's Remedy*, 59 CORNELL L. Q. 418 (1974) [hereinafter cited as *Broken Commitment*].

borrowers and lenders alike. At the same time, wide interest rate fluctuations have caused borrowers (when rates fall) and lenders (when rates rise) to attack the substantive validity of mortgage commitments where performance or non-performance often involves hundreds of thousands of dollars even after discounting to present-day values.<sup>11</sup>

Despite the fact that future commitments have long been used, almost all litigation<sup>12</sup> involving them has occurred in the last twenty years<sup>13</sup> since the advent of a money-managed economy. The attacks on this system have generally centered on commitment provisions which require certain matters, such as leases or the state of title, to be in form and/or in substance "satisfactory"<sup>14</sup> to the lender, its counsel, or both.<sup>15</sup>

Lenders impose these "satisfaction clauses" principally because the sponsor-builder usually cannot fulfill all the prerequisites which the lender requires before making the commitment. For example, a shopping center developer normally wants to be able to begin construction before he has procured all of the tenants, although a diligent lender would make the loan only when assured that the leases adequately provide for protection of its security. Of course, with respect to leases involving major tenants, the careful developer often resolves potentially difficult problems with the lender prior to signing the commitment, thus rendering a satisfaction clause unnecessary. Frequently, however, this cannot be done.

Although the typical commitment indicates an intent by the parties to be bound,<sup>16</sup> critics of the commitment device nevertheless question whether satisfaction provisions limit the options of the lender and fill the gaps in order to make the agreement binding. This article will consider and respond to the arguments

11 *Broken Commitment*, *supra* note 10, at 428.

12 Where, of course, the "so-called" commitment is not obligatory, at least in form, no problems of enforcement or defense to enforcement would arise; see Sintenis, *supra* note 8, at 597-603 (examples given of careless practice which render written commitments unenforceable through omission of mutual terms). See note 21 *infra*.

13 There is considerable case law of more ancient vintage with respect to "instant delivery" loan commitments. See, e.g., *Jay v. Wilson*, 91 Hun. 391, 36 N.Y.S. 186 (1895), *aff'd*, 158 N.Y. 693, 53 N.E. 1126 (1899).

14 On the subject of "satisfaction" clauses generally, see 3A A. CORBIN, CONTRACTS §§ 644-48 (rev. ed. 1963); 5 S. WILLISTON, CONTRACTS §§ 675A, 675B (3d ed. 1961); RESTATEMENT OF CONTRACTS § 265 (1932); 17 AM. JUR. 2D *Contracts* §§ 366-69 (1964); Annot., 6 A.L.R. 1497 (1920) (employment contract conditional upon the services rendered being satisfactory); Annot., 81 A.L.R. 1058 (1932) (option for renewal of lease conditional upon the lease having been satisfactory to lessor); Annot., 167 A.L.R. 411 (1947) (contract for sale of land which makes performance conditional upon purchaser's or third person's satisfaction with condition of property); Annot., 44 A.L.R.2d 1114 (1955) (private work must be done to satisfaction of owner); Annot., 47 A.L.R.2d (1956) (contract for sale of land provision that title must be satisfactory purchaser); Annot., 86 A.L.R.2d 200 (1962) (sale of goods subject to satisfaction of buyer).

15 For an example of a loan commitment see Draper, *Permanent Mortgage Financing — The Shopping Center* in REAL ESTATE FINANCING 2D 117 (1972) [hereinafter cited as *Shopping Center*].

16 Melody, *Protecting Loan Commitments*, 33 THE MORTGAGE BANKER 28 (1973):

There is probably no legal document so carelessly drafted as a loan commitment. A study conducted by the Mortgage Bankers Association Income Property Finance Subcommittee showed that many lender commitments are almost impossible—short of litigation—to interpret concerning precisely what is supposed to happen if the borrower defaults.

An example of an obligatory clause is "The Loan, which by your acceptance of this commitment you agree to accept from us [ ] shall be in the amount of . . ." *Shopping Center*, *supra* note 15, at 119.

that future commitments containing satisfaction clauses are illusory, vague and indefinite, or violative of the Statute of Frauds.

## II. Illusory Consideration

Professor Corbin defines an illusory promise as "words in promissory form that promise nothing; they do not purport to put any limitation on the freedom of the alleged promisor but leave his future action subject to his own future will, just as would have happened had he said no words at all."<sup>17</sup> If a contract imposes no definite obligation on one party to perform, it lacks mutuality of obligation and no enforceable obligation exists.<sup>18</sup> One who promises to do a thing only if it pleases him is not bound to perform.<sup>19</sup> Williston noted that it "is only where the option reserved the promisor is unlimited that his promise becomes illusory,"<sup>20</sup> and Corbin concluded that a court should not frustrate the parties' intent to be bound where it can fill in the gaps so as to limit choices.<sup>21</sup>

In *Lawrence Block Co. v. Palston*,<sup>22</sup> the court examined a satisfaction clause similar to those found in loan commitments and apparently determined that the gaps could not be filled. There, a contract for the sale of land was made subject to three conditions: (1) Buyer's obtaining sufficient financing secured by a deed of trust, (2) buyer's approval of OPA Rent Statements, and (3) buyer's inspection and approval of all apartments. Immediately after the agreement was signed, the purchaser tried but was unable to procure the required deed of trust and the transaction was cancelled. Thereupon, the broker who had arranged the transaction sued for his commission, maintaining that a valid contract of sale had been made. At least with respect to the last two conditions,<sup>23</sup> the court held that since the buyer's discretion to approve and be bound or disapprove and not be bound was unrestricted, the contract was illusory:

No standard or basis for these "approvals" is established. No hint is given as to what criteria, if any, are to determine whether the OPA rent statements and all the apartments will be approved by the buyer. What are the rent statements to contain or show for the offeror's approval to be forthcoming? What are the apartments to have and consist of in order to be "approved"? Are they to satisfy him as to size, furnishings, decor? Who

17 1 A. CORBIN, CONTRACTS § 145 (rev. ed. 1963).

18 *Patty v. Berryman*, 95 Cal. App. 2d 159, 212 P.2d 937 (1949).

19 *Central Oil Co. v. Southern Ref. Co.*, 154 Cal. 165, 97 P. 177 (1908).

20 1 S. WILLISTON, CONTRACTS § 43 at 143 (3d ed. 1957).

21 1 A. CORBIN, CONTRACTS § 95 at 400 (rev. ed. 1963), cited with approval in *Paley v. Barton Sav. & Loan Ass'n*, 82 N.J. Super. 75, 196 A.2d 682 (1964) and *Sonnenblick-Goldman Corp. v. Murphy*, 420 F.2d 1169 (7th Cir. 1970); RESTATEMENT OF CONTRACTS § 265, comment *a* (1932). In *White Lakes Shopping Center, Inc. v. Jefferson Standard Life Ins. Co.*, 208 Kan. 121, 490 P.2d 609 (1971), the Kansas Supreme Court held:

It is suggested that . . . the rules for determination set forth herein should not apply to loan commitment agreements. The rules set forth in [citation omitted] are applicable under the general law relating to contracts. We see no reason for applying different rules to loan commitment agreements.

*Id.* at 127, 490 P.2d 614.

22 123 Cal. App. 2d 300, 266 P.2d 856 (1954).

23 Relating to the first condition, that purchaser secure an adequate deed of trust, the court held that since this condition had been handwritten upon the contract of sale after the vendor had signed it, it constituted a counteroffer. Since the seller did not subsequently accept this counteroffer, no enforceable contract was formed.

is to judge whether he is satisfied with the statements and apartments? Only the buyer himself. It is entirely a subjective matter.<sup>24</sup>

The holding of *Lawrence Block* that the "subject to" provisions rendered the contract illusory was specifically overruled only four years later in *Mattei v. Hopper*.<sup>25</sup>

In *Mattei*, a written agreement for the sale of land to be developed into a shopping center contained the following familiar provision: "Subject to Coldwell Banker & Company obtaining leases satisfactory to the purchaser."<sup>26</sup> In order to give the purchaser time to find satisfactory tenants, final consummation by payment and conveyance was not required until after a period of 120 days. Before the end of that period, the seller repudiated. Thereafter, the purchaser informed him that he had found satisfactory tenants, demanded conveyance, and sued for damages for breach. The trial court found the purchaser's promise illusory and held the contract unenforceable. The District Court of Appeal reversed the decision. The California Supreme Court vacated the decision of the Court of Appeals but nevertheless reversed the trial court. It held that the purchaser's promise was not illusory, even though conditioned on finding satisfactory tenants. The court stated that satisfaction clauses have been divided into two primary categories which have been accorded different treatment.<sup>27</sup> First, where the contract condition calls for satisfaction as to "commercial value or quality, operative fitness, or mechanical utility," dissatisfaction cannot be arbitrary. The standard of a "reasonable person" has been used to determine whether satisfaction has been received and the gap filled. However, the *Mattei* court stated that the variables involved in ascertaining whether a lease is satisfactory to the lessor are too numerous to permit application of the "reasonable man" standard:

Illustrative of some of the factors . . . are the duration of the leases, their provisions for renewal options, if any, their covenants and restrictions, the amounts of the rentals, the financial responsibility of the lessees, and the character of the lessees' businesses.<sup>28</sup>

This multiplicity of factors led the court to conclude that the evaluation of leases more appropriately falls within the second category of satisfaction clauses—those involving fancy, taste, or judgment. "Where the question is one of judgment, the promisor's determination that he is not satisfied, when made in good faith, has been held to be a defense to an action on the contract."<sup>29</sup> The promised duty to act in good faith<sup>30</sup> was sufficient consideration to support the contract,

24 123 Cal. App. 2d 309, 266 P.2d 861-62.

25 51 Cal. 2d 119, 330 P.2d 625 (1958).

26 *Id.* at 121, 330 P.2d 626.

27 *Id.* at 122-23, 330 P.2d 626-27. *Furmsmidt v. Hotel Abbey Holding Corp.*, 10 App. Div. 2d 447, 200 N.Y.S.2d 256 (1960), also distinguishes between the two types of "satisfaction" clauses. See also 3 S. WILLISTON, CONTRACTS § 675A at 1946 (rev. ed. 1936).

28 51 Cal. 2d 123, 330 P.2d 627.

29 *Id.*

30 In a related context, the New York Supreme Court, First Department, applied the "good faith test" even though one of the parties was given "absolute discretion" to cancel the contract by its terms. The contract involved was an underwriting agreement and the underwriter was given the privilege of terminating the agreement if in its "absolute discretion" it determined that market conditions and prospects for the public offering were such as to

notwithstanding the argument that the promises involved were illusory and lacked mutuality of obligation.<sup>31</sup>

*Mattei* was followed by another case interpreting a similar satisfaction clause. In *Lyon v. Giannoni*,<sup>32</sup> the court, citing *Mattei*, held that a clause in a contract for the sale of realty conditioning the purchaser's obligations upon "satisfactory tests for water available" on the property did not render the contract illusory.<sup>33</sup> The court however, still citing *Mattei*, went on to impose the "reasonable man" standard, stating that the determination of whether satisfactory water was available fell within the category of "commercial value or quality, operative fitness, or mechanical utility." The court did not even consider the possibility that the good faith standard might have been more appropriate. Rather, it cited a series of California cases applying the reasonable man test,<sup>34</sup> without even mentioning the good faith standard which was the basis of the *Mattei* decision. Did this represent a departure from *Mattei*, or is the holding merely that what constitutes satisfactory water is more readily ascertainable than what constitutes satisfactory leases?<sup>35</sup>

*Mattei* and subsequent cases, although rejecting the argument that a satisfaction clause renders a contract illusory, still leave many unanswered questions. As to loan commitments, is it sufficient that the lender be genuinely dissatisfied or must he additionally decide whether his decision is reasonable? If the test is subjective, what are the criteria for determining "good faith"? If it is objective, what are the operable variables? More critically, if the test varies from issue to issue, how do you determine which standard applies?

A subsequent New York case involving loan commitments perhaps puts these issues in some perspective. In *Boston Road Shopping Center, Inc. v. Teachers Insurance & Annuity Association of America*,<sup>36</sup> the defendant promised to lend and the plaintiff promised to borrow \$1,100,000 on stated terms to finance a shopping center. The plaintiff made a "stand-by deposit" of \$22,000 which was to be returned on full performance by plaintiff or retained by defendant as liquidated damages in case of breach. The original commitment provided that the plaintiff would "deliver for the examination of defendant's counsel" the original leases described in the attached Schedule of Leases which leases were to "be in form satisfactory to defendants." The transaction was ter-

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make it inadvisable to go forward. The court held that the "discretion" was not in fact absolute but had to be exercised in good faith. *Richard Bruce & Co. v. J. Simpson & Co.*, 40 Misc. 2d 501, 243 N.Y.S.2d 503 Sup. Ct. (1963).

31 In *Continental Assurance Co. v. Van Cleve Bldg. & Constr. Co.*, 260 S.W.2d 319 (Mo. Ct. App. 1953), the court rejected the argument that a loan commitment containing a "satisfaction" clause lacked mutuality.

32 168 Cal. App. 2d 336, 335 P.2d 690 (1959).

33 *Id.* at 339, 335 P.2d 692.

34 *Thomas Haverty Co. v. Jones*, 185 Cal. 285, 296, 197 P. 105, 110 (1921); *Collins v. Vickter Manor, Inc.*, 47 Cal. 2d 875, 882, 306 P.2d 783, 788 (1957); *Tiffany v. Pacific Sewer Pipe Co.*, 180 Cal. 700, 702-04, 182 P. 428, 429-30 (1919).

35 In *Uhlman v. North Whittier Highlands, Inc.*, 167 Cal. App. 2d 758, 334 P.2d 1022, (1959), decided by a different District Court of Appeals one month prior to *Lyon v. Giannoni*, the Court applied the good faith test to a clause conditioning a broker's commission upon his obtaining a major tenant for a proposed shopping center on terms and conditions satisfactory to the corporate landowner.

36 13 App. Div. 2d 106, 213 N.Y.S.2d 522 (1961), *aff'd*, 11 N.Y.2d 831, 182 N.E.2d 116, 227 N.Y.S.2d 944 (1962).

minated after the plaintiff was unable to acquire satisfactory leases and the plaintiff sued for the return of its deposit. The trial court held that since the plaintiff acted in "good faith" in its effort to get satisfactory leases, it was entitled to the return of its deposit.<sup>37</sup> The New York First Department reversed, holding that the defendant was legally entitled to keep the deposit:

The requirement that the defendant must be satisfied with the "leases" did not render the agreement illusory. It seems reasonable to believe that if defendant had rejected the leases as unsatisfactory, it would have been required to do so on reasonable grounds resting on the form of the leases themselves, since it had accepted the tenants and the terms stated in the schedule. But even if the test of defendant's rejection of the leases be good faith, rather than reasonableness, the contract is enforceable according to its terms and is not illusory.<sup>38</sup>

Since the New York Appellate Division was only called upon to decide the validity of the contract, its decision regarding the standard must be considered dictum; in any event it certainly lacks definitiveness.<sup>39</sup>

In *Commercial Mortgage & Finance Corp. v. Greenwich Savings Bank*,<sup>40</sup> the Supreme Court of Georgia was called upon to rule on the effect of a satisfaction clause in a loan purchase commitment agreement. The plaintiff bank committed itself to purchase home mortgage loans of a specified aggregate amount subject to plaintiff's approval of certain conditions.<sup>41</sup> When the defendant refused

37 *Id.* at 109, 213 N.Y.S.2d 526.

38 *Id.*

39 "The New York Appellate Division held that the agreement was not illusory because it was understood that such decisions would have to be reasonable or at least made in good faith." Paley v. Barton Sav. & Loan Ass'n, 82 N.J. Super. 75, 84, 196 A.2d 682, 686 (1964), interpreting the *Boston Road Shopping Center* case. In *Jay v. Wilson*, *supra* note 13, the court did not directly confront the issue as to whether a loan agreement which made the lender's duty contingent upon title being satisfactory to his counsel was enforceable. The court apparently bypassed this issue by presuming it was, and applied what seems to be a good faith standard by stating that the lenders did not have the right "arbitrarily and capriciously to refuse to be satisfied with the title which was tendered, but that there must be some reason upon which the satisfaction is founded." 36 N.Y.S. at 187. In another old case, *Fagen v. Davidson*, 2 Duer 153 (1853), the court rejected the middle ground of the good faith test relating to a contract for the exchange of real property which provided that "the title to be good and satisfactory to the party to receive the same." The court stated that to give the agreement such a construction would be to rob it fully of its obligatory character, and held that a title satisfactory to the party to whom it is given meant a title to which there is no reasonable objection, and with which the party to whom it is tendered ought to be satisfied. *Ivor B. Clark, Inc. v. Boston Road Shopping Center, Inc.*, 24 Misc. 2d 84, 207 N.Y.S.2d 582 (Sup. Ct. 1960), takes a similar approach to a loan commitment agreement.

40 112 Ga. App. 388, 145 S.E.2d 249 (1965).

41 The agreement read, in part, as follows:

Terms and Conditions of Commitment for Purchase of FHA 203 Loans. 1. Plans and specifications or any changes therein to be subject to the approval of The Greenwich Savings Bank and the Federal Housing Administration . . . 3. Sale of premises to owner-occupants whose credit rating shall be satisfactory to the Federal Housing Administration and The Greenwich Savings Bank. . . . 6. It is understood and agreed that policies of title insurance in favor of The Greenwich Savings Bank and written by title companies acceptable to us will be furnished dated as of the date of the assignment of the mortgages to this institution. . . . 7. All documents to be in form and contents satisfactory to our counsel. 8. All fire insurance policies together with extended coverage are to be in an amount and in companies acceptable to us.

Similar conditions were provided for plaintiff's commitments with respect to purchase of VA loans. *Id.* at 389, 145 S.E.2d 250.



fully to perform the contract, plaintiff sued for liquidated damages. In dismissing the defendant's argument that the contract was illusory, the court applied the good faith standard without differentiating between the various conditions that were subject to the plaintiff's satisfaction:

The contract here is not lacking in mutuality, for the plaintiff had a positive obligation to purchase those loan agreements which were submitted by defendant and were satisfactory to plaintiff in the stipulated respects in the exercise of plaintiff's honest judgment. If plaintiff had refused to purchase any loans submitted by defendant, defendant had the means of enforcing the contract by seeking a jury determination as to whether plaintiff acted in good faith in rejecting the loans.<sup>42</sup>

This decision represents a significant step forward in interpreting satisfaction clauses in loan commitments since it recognizes, at least implicitly, that it is impossible to establish an objective standard where conditions relate to the lender's satisfaction with the security. A number of conditions in a single commitment cannot be considered individually but rather must be taken as a whole in determining whether the lender's security is sufficiently protected. Thus, paraphrasing the test of *Mattei*,<sup>43</sup> the multiplicity of factors involved in evaluating a lender's security indicates that this class of cases falls within the second category of satisfaction clauses—those requiring merely good faith.

Such an analysis recognizes that modern real estate financing involves a complex series of business judgments. The decision whether and upon what terms to lend rests upon complicated formulas involving a series of interrelated questions. Frequently the terms of the loan, including the interest rate, will vary according to the degree of security the borrower can provide. The determination of adequate security for a particular loan is highly subjective. Each lender will evaluate differently the chances that it will be able to realize upon the security if the borrower defaults on the loan. A multitude of factors and their interrelationship must be evaluated in determining whether the risk is one which the lender is willing to take. This is especially true where interests in realty are involved, since these in fact, and in law, have always been deemed unique.

The good faith requirement thus appears to be more appropriate when dealing with loan commitments since it is all but impossible to judge reasonable satisfaction.<sup>44</sup> What is required is that the lender use his business judgment in

<sup>42</sup> *Id.* at 391-92, 145 S.E.2d 252.

<sup>43</sup> 51 Cal. 2d, 119, 330 P.2d 625 (1958).

<sup>44</sup> Of course, it is also possible to come to the "good faith" standard through the "plain meaning" rule of construction. In *Anderson v. Franklin Soc. Federal Sav. & Loan Assn.*, 39 Misc. 2d 7, 239 N.Y.S.2d 765 (Sup. Ct. 1963), the court, in interpreting a mortgage which required that the mortgagor carry insurance with companies satisfactory to the mortgagee, stated that the satisfaction clause meant exactly what it purported to say, and was therefore enforceable:

The phrase "satisfactory to" has been interpreted "not as a stipulation for what court or jury would pronounce satisfactory to a reasonable man, but literally as meaning actually satisfactory to [the party] personally." [Citations omitted.] When such literal construction is rejected, the reason is usually some consideration of hardship or of unjust enrichment.

*Id.* at 10, 239 N.Y.S.2d 768.

good faith<sup>45</sup> in determining whether the specific conditions<sup>46</sup> have been satisfactorily met so as to provide adequate security.

The good faith requirement applies not merely to the party which is to be satisfied, usually the lender in the case of a commitment. The party which is to satisfy, the borrower, also has a good faith obligation to meet the conditions of the agreement. In *Mezzanotte v. Freeland*,<sup>47</sup> the court, in interpreting a contract for the sale of land which was contingent upon the purchaser obtaining satisfactory financing, stated that the purchaser had an obligation to make a good faith effort to seek proper financing.<sup>48</sup> Accordingly, where a loan commitment, for example, called for leases in form and substance satisfactory to the lender, the borrower would have a duty to make a good faith effort to acquire such leases. *Mezzanotte* and other cases<sup>49</sup> have thus rejected the illusoriness argument based in part upon the obligation of the one who must satisfy. The obligations of the parties to a loan commitment are mutual, and the commitment agreement withstands the contentions of borrowers and lenders alike that it is illusory.

### III. Vagueness and Indefiniteness

A second possible impediment to enforcing loan commitments is the argument that they are vague and indefinite. This view was accepted by the court in *Ivor B. Clark, Inc. v. Boston Road Shopping Center*,<sup>50</sup> an action by a broker against a shopping center promoter for commissions allegedly earned in procuring a lending institution's acceptance of a first mortgage loan application. The commitment agreement between the defendant and the institution was the same one discussed in *Boston Road Shopping Center, Inc. v. Teachers Insurance & Annuity Association of America*<sup>51</sup> which required the leases to "be in form satisfactory to the lender." In *Ivor B. Clark*, the New York Supreme Court held:

It is well known that loan instruments such as mortgages, bonds, notes, etc., insurance policies and long term leases contain many complicated

45 He should fairly and candidly investigate and consider the matter, reach a genuine conclusion, and express the true state of his mind. He cannot act arbitrarily or capriciously, or merely feign dissatisfaction. . . . It is of no consequence that a court or jury might believe that he ought to have been satisfied, or that a reasonably prudent purchaser would have been satisfied. *Hollingsworth v. Colthurst*, 78 Kan. 455, 456-57, 96 P. 851 (1908).

46 The dissatisfaction "must be not only bona fide and in good faith, but also must relate to the specific subject matter of the condition. General dissatisfaction with the bargain will not suffice." *Western Hills, Oregon, Ltd. v. Pfau*, 508 P.2d 201, 204 (Ore. 1973).

47 20 N.C. App. 11, 200 S.E.2d 410 (1973), *cert. denied*, 284 N.C. 616, 201 S.E.2d 689 (1974).

48 "The contract implies that plaintiffs would in good faith seek proper financing . . . and that such financing in keeping with reasonable business standards could not be rejected at the personal whim of plaintiffs but only for a satisfactory cause." *Id.* at 17, 200 S.E.2d 414. Note how the court skirts the good faith or reasonable man issue. The court continues: "Where a contract confers on one party a discretionary power affecting the rights of the other, this discretion must be exercised in a reasonable manner based upon good faith and fair play." *Id.*

49 *E.g.*, *Kays v. Brack*, 350 F. Supp. 1243 (D. Idaho 1972); *Sheldon Simms Co. v. Wilder*, 108 Ga. App. 4, 131 S.E.2d 854 (1963). *Cf.* 3A A. CORBIN, CONTRACTS § 767 (rev. ed. 1963).

50 24 Misc. 2d 84, 207 N.Y.S.2d 582 (Sup. Ct. 1960).

51 13 App. Div. 2d 106, 213 N.Y.S.2d 522 (1961), *aff'd*, 11 N.Y.2d 831, 182 N.E.2d 116, 227 N.Y.S.2d 944 (1962).

provisions with respect to which there is often strenuous and protracted negotiation, frequently followed by disagreement and no meeting of the minds. Insofar as the last mentioned letters required defendant and the lending institution to agree in the future as to the open, essential elements of the transaction, they were too indefinite to be enforced, and therefore did not constitute a binding commitment.<sup>52</sup>

This decision, however, cannot be reconciled with *Teachers Insurance* where the court held the contract enforceable, although it did not directly consider whether the provision was vague and indefinite. The holding in *Teachers Insurance*, while nominally based on the determination that the contract was not illusory, impliedly rejects the vagueness argument.<sup>53</sup> Later cases have been more explicit.

In *Paley v. Barton Savings & Loan Association*,<sup>54</sup> after analyzing the commitment agreement, the court held:

[W]e do not find this agreement to be so vague as to require a determination that it is unenforceable. The mere fact that certain items of an agreement may require construction by a court does not establish that either of the parties to that agreement is without any obligation thereunder. If it is at all possible, a court will attach a sufficiently definite meaning to the terms of a bargain to make it enforceable . . . and ambiguous words would be interpreted most strongly against the party who used them in cases of fair doubt as to their scope. . . . The significant consideration here is whether or not the parties intended to enter into a binding agreement. It is manifest that such an intention was present on the part of both parties.<sup>55</sup>

In *Sonnenblick-Goldman Corp. v. George J. Murphy*,<sup>56</sup> the plaintiff sought recovery of the balance due on a commission for procuring an interim loan commitment for the defendant. The commitment provided that the amount of reserves and holdbacks was within the lender's reasonable discretion. In affirming the district court's directed verdict for the plaintiff, the Court of Appeals for the Seventh Circuit reasoned:

Defendant argues that the contract [commitment] was too vague and indefinite to be enforceable, and was merely an "agreement to agree." We disagree. The fact that some of the terms contained in the commitment . . . were inherently flexible does not render the contract unenforceable. Where the parties themselves have manifested an intent to make a contract and to bind themselves to render future performance, the courts should not frustrate

52 24 Misc. 2d 89, 207 N.Y.S.2d 58-59.

53 Of course, the results reached in *Lawrence Block*, *supra* note 22, and *Ivor B. Clark*, *supra* note 50, may hinge on the fact that both cases were suits by brokers to collect commissions. Cases involving brokers have often produced inconsistent applications of legal principles, since the courts frequently focus on the justice and equity of the broker collecting his fee, and not on the substantive legal issue of whether an enforceable contract, which is a precondition to the broker collecting his fee, was actually formed. Courts have generally been reluctant to apply legal principles in a strict and neutral fashion where they feel technical arguments are being used either to deprive a broker of his justly earned commission, or to collect a brokerage commission where the parties have not actually come to an agreement.

54 82 N.J. Super. 75, 196 A.2d 682 (1964).

55 *Id.* at 82-83, 196 A.2d 686.

56 420 F.2d 1169 (7th Cir. 1970).

this intention by holding that a gap in one of the terms of the otherwise binding agreement renders the contract too vague and indefinite to enforce.<sup>57</sup>

The commentators are unanimous in their agreement with this rationale. As stated by Professor Corbin:

If the parties have concluded a transaction in which it appears that they intend to make a contract, the court should not frustrate their intention if it is possible to reach a fair and just result, even though this requires a choice among conflicting meanings and the filling of some gaps that the parties have left.<sup>58</sup>

As with the closely related "illusory" defense, the courts have upheld the enforceability of satisfaction clauses in commitment agreements against the contention that they are vague and indefinite.

#### IV. The Statute of Frauds

An agreement to make a loan requiring the execution and delivery of a mortgage lien on real property must meet the requirements of the Statute of Frauds.<sup>59</sup> Accordingly, the material elements of the mortgage loan and the acceptance must be clearly and unambiguously set forth in writing in the commitment letter;<sup>60</sup> this requirement would apply to the satisfaction provisions. Stated in another way, the commitment must clearly indicate that the parties intend it to be binding and not merely a step in the process toward an agreement on the loan terms.<sup>61</sup> The obligatory language<sup>62</sup> is important in this regard but certainly would not be enough if too many gaps were left open for future determination.

In *Bowery Savings Bank v. Retail Realty, Inc.*,<sup>63</sup> the plaintiff brought suit

57 *Id.* at 1173.

58 1 A. CORBIN, CONTRACTS § 95 at 400 (rev. ed. 1963). *Accord*, 1 S. WILLISTON, CONTRACTS § 37 at 110-11 (1957).

59 *Brizick v. Manners*, 88 Eng. Rep. 454 (Ch. 1743); *Driver v. Broad*, 1 Q.B. 744 (1893). In *Sleeth v. Sampson*, 237 N.Y. 69, 142 N.E. 355 (1923), Judge Cardozo stated:

One who promises to make another the owner of a lien or charge upon land, promises to make him the owner of an interest in land, and this is equivalent in effect to a promise to sell him such an interest.

*Id.* at 72, 142 N.E. 356. C. BROWNE, STATUTE OF FRAUDS § 267 (1880); 5 H. TIFFANY, THE LAW OF REAL PROPERTY § 1384 (B. Jones ed. 1939); Note, *The Statute of Frauds and Oral Agreements to Mortgage Land*, 44 HARV. L. REV. 269 (1931). The pertinent language of the original Statute of Frauds, 29 CAR. 2, c. 3, § 4 (1677) reads: "No action shall be brought . . . upon any contract or sale of lands, tenements or hereditaments or any interest in or concerning them. . . ." For a modern example of this provision see N.Y. GEN. OBLIG. LAW § 5-703 (McKinney 1964). See also RESTATEMENT OF CONTRACTS § 195 (1932), where "interest in land" is defined for purposes of the Statute of Frauds as "any right, privilege, power or immunity, or combination thereof, relating to realty which under the rules of law governing that subject, (a) is property in realty, and (b) does not fall within the definition of goods in § 200.

60 "To be sufficient, the required writing must be one 'which states with reasonable certainty . . . the terms and conditions of all the promises constituting the contract and by whom and to whom the promises are made.'" *Ellis v. Klaff*, 96 Cal. App. 2d 471, 476, 216 P.2d 15, 19 (1950).

61 *Cf. Kris v. Pattison*, 159 Minn. 213, 198 N.W. 541 (1924); 2 A. CORBIN, CONTRACTS § 498 at 680 (1950).

62 See note 16 *supra*.

63 19 Misc. 2d 752, 191 N.Y.S.2d 904 (Sup. Ct. 1959).

upon a surety completion bond in his favor when the proposed mortgagor refused to go through with the loan on the ground that the commitment failed to satisfy the Statute of Frauds.<sup>64</sup> Defendant argued that the commitment was not a binding and enforceable contract because it was conditioned upon the execution of a building loan agreement, the terms of which were left to future negotiation. The trial court held for the defendant and noted that "since the terms of the building loan agreement as to what amounts would be advanced at what stages of construction were of vital importance to said defendant and have never been agreed upon, there was never a binding contract between it and plaintiff."<sup>65</sup> However, the intermediate appellate court unanimously reversed the decision,<sup>66</sup> holding that "the payment schedule was not left open—but the parties agreed that it was to be determined to the satisfaction of the bank."<sup>67</sup> Motion for leave to appeal was denied.<sup>68</sup>

Although the *Retail Realty* case upholds a commitment agreement against a Statute of Frauds attack,<sup>69</sup> commitment agreement draftsmen should not minimize the Statute of Frauds problem when they use satisfaction clauses to leave as many terms as possible open for determination in the future.<sup>70</sup>

Nevertheless, where the written commitment evidences a clear intent on the part of both lender and borrower to be bound and only conditions not presently ascertainable are left for future determination, the purposes of the Statute of Frauds would not be furthered by refusing to enforce the agreement.<sup>71</sup> In the usual commitment, gaps are left not for future negotiation but rather for future resolution by one of the parties who is under a duty to act in good faith.<sup>72</sup>

64 Plaintiff relied upon *Willmott v. Giarraputo*, 5 N.Y.2d 250, 157 N.E.2d 282, 184 N.Y.S.2d 97 (1952), wherein Judge Fuld stated "Few principles are better settled in the law of contract than the proposition that, 'If a material element of a contemplated contract is left for future negotiations, there is no contract enforceable under the Statute of Frauds or otherwise.'" *Id.* at 253, 157 N.E.2d 283, 184 N.Y.S.2d 98.

65 19 Misc. 2d at 753, 191 N.Y.S.2d 905.

66 *Bowery Savings Bank v. Retail Realty, Inc.*, 10 App. Div. 2d 924 (1960).

67 *Id.*

68 11 App. Div. 2d 649 (1960).

69 *Cf. Biothermal Process Corp. v. Cohn & Co.*, 119 N.Y.S.2d 158, (Sup. Ct.) *aff'd in part, rev'd in part*, 283 App. Div. 60, 126 N.Y.S.2d 1 (1953), *aff'd*, 308 N.Y. 689, 124 N.E.2d 323 (1954), involving an underwriting commitment, which was held unenforceable because of excessive "gaps."

70 In this regard, *Sintenis, supra* note 8, at 598 n.13 argues that a commitment would be legally enforceable under the Statute of Frauds even though subject to the following conditions: (a) satisfactory completion of specific work items or the erections of a building; (b) certificates of occupancy and electrical inspection and other needed municipal certificates of compliance; (c) evidence of satisfaction of an existing personal loan; (d) good and marketable title to the subject premises; and (e) approval of leases of the subject premises.

71 *Cardozo's* statement in *N.E.D. Holding Co. v. McKinley*, 246 N.Y. 40, 157 N.E. 923 (1927) relating to a contract for the sale of realty in which certain terms were left blank, is equally applicable to a future commitment:

We cannot say as an inference of law from the mere inspection of the writing that anything of substance was left open to be agreed upon thereafter. The parties evidently thought they were bound, for they described the writing as a binder. [Citations omitted.] We are not to strain for a construction that will defeat their expectation.

Details [not going to the substance of the transaction] may be left open for future specification without destruction of the contract and of every remedy thereunder. [Citations omitted.] Seller and buyer accept by implication as to such matters the test of the reasonable or the customary if no other is available. It is all a question of degree.

*Id.* at 44-45, 157 N.E. 924-25.

72 "[W]here the contract, instrument or agreement gives either party the unqualified

## V. Practical Considerations and Conclusions

The good faith requirement can arise in two distinct contexts in a legal proceeding involving a future loan commitment. If the commitment is attacked as illusory, vague and indefinite, or violative of the Statute of Frauds, the courts have at least inferred an obligation to act in good faith to fill the gaps and render the commitment enforceable. Neither party need prove good faith or the lack of it. The mere requirement, implied by law, that the parties act in good faith defeats these challenges to the commitment device. This must be distinguished from the situation where one party to the commitment asserts that the other did not act in good faith. Good faith thus becomes an issue of fact and the burdens of proof must be assessed not only from a legal but also, as we shall see, from a practical standpoint.

This distinction may be the basis for much of the confusion in the decisions<sup>73</sup> as to whether the good faith or reasonable man standard applies. Either one sufficiently fills the gaps; where the validity of the commitment itself is under attack, the courts need not choose between them. However, where one party asserts that the other failed to meet a specific standard of conduct, the courts must then articulate that standard. For reasons already indicated,<sup>74</sup> the good faith standard is most suited to the future commitment device.

As a general rule, the burden of proof as to good faith rests upon the party asserting a lack of good faith. In a loan commitment context, this burden may fall upon either the borrower or the lender depending upon which party raises the issue. If the borrower sues to enforce the commitment and asserts the lender's lack of good faith in stating that the conditions were not satisfactorily met, he would have the burden of proving satisfactory performance of the agreement. He would have to show that all conditions precedent have been satisfied and, consequently, that the lender acted in bad faith in rejecting his performance.<sup>75</sup> Additionally, for a promisee to recover for breach of contract, he must initially prove himself ready, willing, and able to perform.<sup>76</sup> This doctrine would apply even if the lender has repudiated the contract:

An anticipatory breach, in a proper case, may excuse one from performing a useless act, but it does not excuse one from the obligation of proving readiness, willingness, and ability to have performed the conditions precedent.<sup>77</sup>

On the other hand, if the lender sues to enforce the commitment or to recover damages relating to the borrower's breach, it must prove its readiness to go

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right or power to make a selectional determination of the details without necessity of further agreement or approval of other party," the requirement of the Statute of Frauds is met. *Skeeters v. Granger*, 314 S.W. 2d 364, 367 (Tex. Civ. App. 1958).

<sup>73</sup> *Boston Rd. Shopping Center, Inc. v. Teachers Ins. & Annuity Ass'n of America*, 13 App. Div. 2d 106, 213 N.Y.S.2d 522 (1961), *aff'd*, 11 N.Y.2d 831, 182 N.E.2d 116, 227 N.Y.S.2d 944 (1962); *Mezzanotte v. Freeland*, 20 N.C. App. 11, 200 S.E.2d 410 (1973), *cert. denied*, 201 S.E.2d 689 (1974).

<sup>74</sup> See text accompanying note 44 *supra*.

<sup>75</sup> *Sollows v. McCann Erickson, Inc.*, 27 F. Supp. 491, 492-93 (S.D.N.Y. 1939).

<sup>76</sup> *Oltarsh v. Bratter*, 48 F.2d 567 (2d Cir. 1931).

<sup>77</sup> *Ufitec v. Trade Bank and Trust Co.*, 21 App. Div. 2d 187, 190, 249 N.Y.S.2d 557, 560 (1964), *aff'd*, 16 N.Y.2d 698, 209 N.E.2d 551, 261 N.Y.S.2d 893 (1965).

forward with the transaction and produce the funds. The lender would have the burden of proving any assertion that the borrower did not act in good faith in attempting to satisfy the conditions of the commitment. However, if the borrower answers by asserting the lender's lack of good faith in stating dissatisfaction, the burden would then be placed upon the borrower with respect to this issue.

As a practical matter, however, a jury might disregard a proper charge regarding the burden of proof if the party accused of bad faith has benefited from a radical change in interest rates. In *Regional Enterprises v. Teachers Insurance & Annuity Association*,<sup>78</sup> the Court of Appeals for the Ninth Circuit upheld the trial court's judgment notwithstanding the verdict against the borrower claiming anticipatory repudiation based in large measure upon the fact that the borrower obtained a loan elsewhere at a substantially lower interest rate. The case, in effect, held that a jury may properly consider fluctuations in the interest rate in deliberating upon the enforceability of a loan commitment.

The *Regional Enterprises* case is helpful to the practicing lawyer for another reason. In *Regional Enterprises*, a shopping center developer had paid a deposit of \$40,000 upon entering into a loan commitment agreement. The commitment agreement was made subject to the lender's approval of all tenant leases and, in addition, to the developer obtaining, prior to the closing date of the loan, parking rights on adjacent property. After some time had passed, these parking rights had still not been obtained and the lender sent the developer a letter containing a 19-page interoffice memorandum stressing the importance of the parking rights. The letter invited the developer to remedy the situation and concluded with the sentence: "After you have had an opportunity to consider the foregoing, please call the undersigned at any time."<sup>79</sup> The court held that this was not an anticipatory repudiation of the agreement and that the lender was therefore entitled to retain the deposit as liquidated damages. Counsel for the lender had been careful not to repudiate the commitment inadvertently based on the developer's noncompliance with its terms. If it had not been so cautious, the court implies that it might have lost its security deposit.

Lender's counsel was not so wise in *Zelazny v. Pilgrim Funding Corp.*<sup>80</sup> The lender entered into a commitment agreement which was made subject to "approval by our attorneys of all closing papers." Subsequently, the lender, taking note of rising interest rates and the danger of the borrower losing his job due to a labor dispute, sent the borrower a letter stating in part:

On this commitment we indicated an interest rate of 5-1/2%; however, due to the fact that existing conditions to the Republic Aviation Corporation may necessitate a possible layoff, we are obliged to change subject commitment to 5-3/4% interest rate.

Kindly indicate your acceptance by signing the enclosed copy.<sup>81</sup>

The court held that this attempt to change the interest rate constituted a repudiation of the commitment agreement and granted the borrower special dam-

78 352 F.2d 768 (9th Cir. 1965).

79 *Id.* at 771.

80 41 Misc. 2d 176, 244 N.Y.S.2d 810 (Dist. Ct. 1963).

81 *Id.* at 179, 244 N.Y.S.2d 814.

ages.<sup>82</sup> The borrower eventually lost his job and could not have gone through with the loan anyway; the lender apparently lost because his repudiation was premature.

*Zelazny* makes it clear that a lender who attempts to exercise good faith in evaluating a borrower's fulfillment of the commitment agreement conditions should be careful to not anticipatorily repudiate the agreement where it suspects that the borrower will fail to satisfy the conditions. An invitation for discussion suggests a better approach, especially where the lender is open to the criticism that its actions were motivated by a favorable shift in interest rates. If one party suspects that the other may be attempting to avoid the commitment, it could request a reassurance of performance.<sup>83</sup> This would to some extent force the other party to commit itself; silence could even be taken as implicit repudiation.<sup>84</sup>

In order to establish good faith as to issues left to the lender's satisfaction, counsel for each party should stand ready to prove the consistency of its client's position on the particular matter at issue. For example, a lender fearing an accusation of bad faith in rejecting a particular loan provision could show that it has rejected similar provisions in the past; likewise, a borrower would benefit if it could show the lender had previously accepted such provisions.

To recapitulate, in addition to facilitating interim construction financing, an enforceable future commitment serves the legitimate economic function of cushioning the impact of increasingly severe interest rate fluctuations upon the construction and housing industries. In response to defenses of illusory promises, vagueness, and the Statute of Frauds, the courts have expressly or impliedly recognized the utility of future commitments by requiring lenders to act in good faith in approving borrower compliance with commitment conditions and borrowers to act in good faith in meeting the conditions.

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<sup>82</sup> Plaintiff's damages included the increased rental, gas and electric charges on a new rental apartment, since he had terminated the lease on his old apartment in reliance upon the commitment.

<sup>83</sup> *Cf.* UNIFORM COMMERCIAL CODE § 2-609 relating to the use of a request for reassurance of performance with respect to the sale of goods. Although this provision technically would not apply to contracts to lend money, a court could certainly find the reasoning behind it applicable to the loan commitment area.

<sup>84</sup> UNIFORM COMMERCIAL CODE § 2-609(4): "After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract."