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## The Shared Appreciation Mortgage: A Clog on the Equity of Redemption, 15 J. Marshall L. Rev. 131 (1982)

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## COMMENTS

### THE SHARED APPRECIATION MORTGAGE: A CLOG ON THE EQUITY OF REDEMPTION?

The conventional real estate mortgage<sup>1</sup> predominantly employed in the field of residential financing since the 1930s is obsolete.<sup>2</sup> We have entered a new era of innovative mortgage alternatives labeled with unfamiliar acronyms.<sup>3</sup> This shift

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1. The standard fixed payment mortgage is the primary instrument in use in the United States since the 1930s. It provides for a full amortization over an extended period of time and for equal monthly payments. The payments consist of both principal and interest, therefore, the proportion of interest and principal changes with each payment. The interest component declines and the principal component increases until the entire balance is repaid. The interest rate is fixed at the inception of the loan and remains constant over the loan's life. FEDERAL HOME LOAN BANK BOARD, II ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY, *Simulation Analysis of AMIs VIII-3* (Nov. 1977) [hereinafter cited as AMIRS]; BLACK'S LAW DICTIONARY 911 (5th ed. 1979). For a more detailed description of the standard mortgage, see, e.g., Bartke, *The Organized Bar in Housing and Urban Development*, 4 URB. LAW. 206, 212 (1972); Coan, *The Housing and Urban Development Act of 1968: Landmark Legislation for the Urban Crisis*, 1 URB. LAW. 1, 2 (1969).

2. The Federal Home Loan Bank Board initiated a major research project in 1976 known as the ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY or AMIRS. The AMIRS was designed to provide a comprehensive analysis of several proposed mortgage instruments. The need for alternative mortgage instruments stemmed from the inadequacies of the standard fixed-rate, level-payment mortgage widely in use. The three volume AMIRS was published in November, 1977.

3. They include *inter alia* the following: FLIP mortgage (flexible loan insurance program), the GPM (graduated payment mortgage), the ROM (roll-over mortgage), the VRM (variable rate mortgage), the DIM (deferred interest mortgage), and the RAM (reverse annuity mortgage). *Alternative Mortgage Instruments are Building*, SAVINGS & LOAN NEWS 51 (Aug. 1977). The reluctance of savings and loan associations to offer RAMs is discussed in Chicago Tribune, Aug. 2, 1981, § 14, at 1, col. 1. See also, II AMIRS, *supra* note 1, *Simulation Analysis of AMIs* at VIII-3. As a result of the AMIRS, the Federal Home Loan Bank Board authorized several new forms of mortgage instruments for federally chartered savings and loan associations. In December of 1978, the graduated payment mortgage (GPM) and the reverse annuity mortgage (RAM) were authorized for use in federal associations. In May of 1979 and April of 1980, respectively, the Federal Home Loan Bank Board authorized variable rate mortgages (VRM) and renegotiable rate mortgages (RRM) for use in federal associations. The Chicago Sun-Times, July 16, 1981, at 73, col. 3, reported that the graduated payment adjustable mortgage (GPAM), which combines a graduated monthly payment feature with an adjustable interest rate was authorized on July 15, 1981 for use in federally chartered savings and loan associations beginning July 22, 1981.

evolved from consumer demand, generated by the inadequacies of the traditional mortgage, for more flexible mortgage instruments.

Designed to operate in a relatively stable economy, the standard long-term mortgage features a fixed interest rate and level monthly payments. In periods of continued high inflation,<sup>4</sup> however, most residential lenders are reluctant to invest in long-term, fixed-rate mortgages because their earnings will not reflect increases in interest rates which they must offer to depositors to attract funds. In addition, sharp rises in interest rates adversely affect borrowers. Many people who otherwise could have become homeowners cannot afford the necessarily high monthly payments of the conventional mortgage caused, in part, by high interest rates. These people must continue renting.

The alternative mortgage instruments recently introduced attempted to ameliorate the inflexibility of the standard mortgage by accommodating diverse borrower financial needs and by permitting lenders to adjust earnings to prevailing economic conditions. However, these innovations have been unsuccessful in striking a balance which provides affordable financing for borrowers and also assures lenders a profitable yield. As a result, the shared appreciation mortgage<sup>5</sup> was proposed by the Federal Home Loan Bank Board<sup>6</sup> on September 30, 1980, for use by federally chartered savings and loan associations.<sup>7</sup> The shared appreciation mortgage bears an interest rate below that prevailing for a conventional mortgage and allows the lender to share in the anticipated increase in the property's market value. Consequently, the shared appreciation mortgage could eliminate the problems inherent in the standard mortgage which other alternative mortgage instruments have failed to overcome.

This article explores the impact of the economy on home financing,<sup>8</sup> focusing on the need for innovative mortgage instru-

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4. One of the early analyses of the inadequacies of the conventional mortgage in an inflationary economy is BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WAYS TO MODERATE FLUCTUATIONS IN HOUSING CONSTRUCTION, HOUSING FINANCE UNDER INFLATIONARY HOUSING CONDITIONS 355 (Washington D.C., 1972). For a more recent treatment, see, FEDERAL RESERVE BANK OF BOSTON, NEW MORTGAGE DESIGNS FOR STABLE HOUSING IN AN INFLATIONARY ENVIRONMENT, Conference Series No. 14 (Jan. 1975).

5. The shared appreciation mortgage is commonly referred to as SAM.

6. The Federal Home Loan Bank Board is an agency of the federal government that regulates federally chartered savings and loan associations.

7. The proposed regulation, presently in draft form captioned 12 C.F.R. § 545.6-4b [hereinafter cited as 12 C.F.R. § 545.6-4b Draft], is available from: Information Services of the Office of General Counsel, 1700 G. Street, N.W., Washington D.C. 20552.

8. See text accompanying notes 12-23 *infra*.

ments<sup>9</sup> from the perspective of both lenders and borrowers. Finally, the equitable doctrine against clogging the equity of redemption<sup>10</sup> is examined as a potential obstacle to implementation of the shared appreciation mortgage.<sup>11</sup>

#### THE NATION'S CHANGING ECONOMIC CLIMATE

The first few years following the end of World War II were characterized by an attempt to artificially maintain stable interest rates.<sup>12</sup> Unfortunately, the effort proved unsuccessful and was abandoned. Mortgage interest rates rose sharply, fueled by the demand for financing of the returning veterans. During the remainder of the 1950s, the country experienced a slower, but steady, increase in housing interest rates.<sup>13</sup>

This trend continued into the 1960s and was followed by a period of unprecedented stability which began in 1961 and continued through 1965 with interest rates for real estate transactions hovering at six percent.<sup>14</sup> At the same time, the interest rates offered depositors attracted a surplus of funds, enabling savings institutions to provide the financing necessary to support the rapid growth of housing in the United States.<sup>15</sup> Due to this stability in interest rates, lenders were not concerned with the imbalance of their financial position created by using short-term deposits to fund long-term loans.<sup>16</sup>

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9. See text accompanying notes 24-37 *infra*.

10. See text accompanying notes 72-94 *infra*.

11. See text accompanying notes 95-113 *infra*.

12. The Federal Reserve, in an effort to maintain low interest rates, bought government bonds at par in the market and let them float to achieve their own level. After proving unsuccessful, this experiment was terminated by the Federal Reserve Treaty Accord. See, e.g., KLAMAN, *THE POST-WAR RESIDENTIAL MORTGAGE MARKET* 84 (1961); SUBCOMM. ON HOUSING OF THE SENATE COMM. ON BANKING & CURRENCY, *A STUDY OF MORTGAGE CREDIT*, 86th Cong., 2d Sess. 197, 283-84 (1960).

13. See REPORT OF THE COMMISSION ON MORTGAGE INTEREST RATES 21, Fig. 3 (1969), for a chart showing selected bond and mortgage yields and FHA-VA interest ceilings for the period of 1950-1969. For a graph showing the average interest rates on conventional mortgages on existing houses during the period of 1960-1975, see Vidger, *Moderating Interest Rate Obsolescence and Mortgage Credit Scarcity in Housing Finance*, 45 APPRAISAL J. 405, 408 Fig. 1 (1977).

14. See, e.g., *A DECENT HOME, THE REPORT OF THE PRESIDENT'S COMMITTEE ON URBAN HOUSING* 128 (1968).

15. Kratovil, *A New Dilemma for Thrift Institutions: Judicial Emasculation of the Due-on-Sale Clause*, 12 J. MAR. J. PRAC. & PROC. 299, 311 (1979). For a comparison of the percentage of disposable income saved by Americans with savings in West Germany and Japan, see MORTGAGE BANKER, Feb. 1981, at 33.

16. This imbalance, referred to as the borrowing short, lending long syndrome, has been repeatedly documented. See, e.g., Bartke, *Home Financing at the Crossroads - A Study of the Federal Home Loan Mortgage Corpora-*

### The Plight of the Mortgage Lenders

The economic climate changed abruptly in 1966 when interest rates offered by federal government securities rose dramatically to attract funds to finance the mushrooming federal debt.<sup>17</sup> Disintermediation,<sup>18</sup> which occurs when depositors withdraw their money from savings institutions to take advantage of the higher interest rates offered by other forms of investment, caused a major drain on lenders' accounts, thereby preventing them from making new mortgage loans. This situation precipitated the first "credit crisis."<sup>19</sup> Although interest rates declined substantially in 1967, they rose again in 1968 and have been gyrating ever since.<sup>20</sup> Consequently, the imbalance in the mortgage lenders' financial position became a principal concern.<sup>21</sup>

Traditional mortgage lenders, particularly the savings and loan associations, depend upon short-term demand deposits and certificates as their primary source of funds, which they invest

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*tion*, 48 IND. L.J. 1, 7-9 (1972); Klamon, *Public/Private Approaches to Urban Mortgage and Housing Problems*, 32 LAW & CONTEMP. PROB. 250 (1967).

17. For a discussion of the experiences of 1966, see, e.g., 53 FED. RES. BULL. 728 (1967); Cagan, *Monetary Policy*, ECONOMIC POLICY AND INFLATION IN THE SIXTIES 89, 117-25 (1972).

18. When free market interest rates exceed the regulated interest ceiling for time deposits, some depositors withdraw their funds and invest them elsewhere at a higher interest rate. This process is known as "disintermediation."

BLACK'S LAW DICTIONARY 421 (5th ed. 1979).

19. A review of the "credit crises" of the recent past, including those that occurred in 1966, 1969-70, and 1974-75 when credit in general and mortgage credit in particular was simply not available at any reasonable price to many qualified borrowers, amply demonstrates the nature and severity of the cyclical instability of the conventional mortgage finance mechanism. I AMIRS, *supra* note 1, AMIRS: *An Overview and Summary* at 3. A more detailed discussion is provided in Dall, *The Conventional Mortgage-Backed Security*, in FNMA-FHLMC General Counsels' Conference 159-60 (1978).

20. For interest rate figures through 1975, see UNITED STATES SAVINGS & LOAN LEAGUE, 1976 SAVINGS & LOAN FACT BOOK 35 (1976). Figures for 1976 and 1977, respectively, may be found in 63 FED. RES. BULL. A3 (Jan. 1977); 63 FED. RES. BULL. A3 (July 1977). For long-term trends, see BUREAU OF THE CENSUS, U.S. DEPT. OF COMMERCE, 2 HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970, Series X474-486, at 1003 (1975).

21. The savings and loan industry has been hurt in two ways: first, many of its home mortgages return interest at below-market rates, and second, depositors have been withdrawing savings in favor of higher interest elsewhere. This situation threatens the stability of over one-third of the nation's federal savings and loan associations. Chicago Tribune, July 15, 1981, § 2, at 2, col. 3. A contrary view is expressed in Chicago Sun-Times, May 8, 1981, at 57, col. 3. For charts showing lender behavior in the last several years, see 63 FED. RES. BULL. 189, 192-94 (1977). Inflation and high interest rates have also affected real estate investors. For an analysis, see Wendt, *Inflation and the Real Estate Investor*, 45 APPRAISAL J. 343 (1977); Chicago Sun-Times, May 8, 1981, at 57, col. 1.

in long-term, fixed-rate real estate loans.<sup>22</sup> In periods of rising interest rates, this practice, known as the borrowing short, lending long syndrome, puts these lenders in a precarious position. Every time interest rates increase sharply, the savings and loan associations experience massive withdrawals, creating liquidity problems which impair their ability to continue making mortgage loans.<sup>23</sup>

In order to prevent disintermediation and thereby maintain a supply of funds to support the housing market, lenders must be able to offer depositors a return greater than that available from government and other securities. In addition, to keep mortgage lending institutions solvent, a profitable margin between the rate offered depositors and that of the lenders' loan portfolio must be maintained.<sup>24</sup> In short, a financing method must be found to allow lenders' long-term loans to respond to increases in interest rates. In an inflationary economy, financial institutions cannot survive by borrowing short-term and lending long-term.<sup>25</sup> The inefficiency of the standard fixed-rate mortgage in periods of fluctuating, rising interest rates induced by rapid inflation adversely affects borrowers as well as lenders.<sup>26</sup>

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22. See, e.g., Bartke, *Home Financing at the Crossroads - A Study of the Federal Home Loan Mortgage Corporation*, 48 IND. L.J. 1, 6-9 (1972); 63 FED. RES. BULL. A29, A40 (July 1977).

23. For the fluctuations in the net inflow or outflow of savings see, e.g., UNITED STATES SAVINGS & LOAN LEAGUE, 1976 SAVINGS & LOAN FACT BOOK (1976). The net operating margins of savings and loan associations in times of sharply rising interest rates are discussed in Advisory Opinion of the Federal Home Loan Bank Board, Resolution No. 75-647, at 21 (1975), submitted at the request of the court in *Schott v. Mission Fed. Sav. & Loan Ass'n.*, Cause No. Civ. 75-366 (C.D. Cal 1975). For a discussion of yield spreads between conventional mortgages and corporate bonds for the period 1971-76, see 63 FED. RES. BULL. 189, 192-93 (1977).

24. 63 FED. RES. BULL. 189, 192-93 (1977); Kratovil, *A New Dilemma for Thrift Institutions: Judicial Emasculation of the Due-on-Sale Clause*, 12 J. MAR. J. PRAC. & PROC. 299, 311 (1979). On August 20, the Federal Reserve Board offered to lend money to savings and loan associations at rates as low as 14 percent in an attempt to help financially pressed lending institutions. Sixty percent of the mortgages held by savings and loan associations were yielding less than 10 percent, yet savings and loans had to pay considerably more to attract depositors. *Chicago Sun-Times*, Aug. 21, 1981, at 79, col. 2; *Chicago Tribune*, Aug. 21, 1981, § 4, at 11, col. 5.

25. *Chicago Tribune*, Aug. 21, 1981, § 4, at 11, col. 5. Regulation permitting savings and loan associations to offer higher interest rates on six-month certificates and yields slightly above the rate on twenty-six month Treasury bills offer no solution. "Any bank that took that expensive new money and invested in a 30-year mortgage . . . had to be stupid or crazy." Vincent J. Quinn, president of Brooklyn Savings Bank, as quoted in *Wall St. J.*, Jan. 2, 1979, at 28, col. 2.

26. I AMIRS, *supra* note 1, AMIRS: *An Overview and Summary*, at 2.

### The Borrower's Dilemma

Many people cannot afford the necessarily high monthly payments of the conventional mortgage, caused in part by high interest rates, and must, therefore, postpone their housing purchases.<sup>27</sup> Those individuals fortunate enough to become homeowners may be "house poor" during the initial years of ownership because of the staggering monthly mortgage obligation and comparatively low income. Other families find that, because of prevailing interest rates, they are unable to afford the type of home that meets their long term income expectations.<sup>28</sup> These problems are manifestations of the "financing gap"<sup>29</sup> caused by the inadequacies of conventional mortgage financing during inflationary periods.<sup>30</sup>

The standard mortgage offers no flexibility for adaptation to diverse borrower financial requirements, thereby compounding the housing affordability problem. Specifically, traditional financing is unable to accommodate changing patterns of family income<sup>31</sup> and ignores the probable increase in the market value of the security property.<sup>32</sup> Because the conventional mortgage

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27. As home prices and interest rates spiral upward, many potential homeowners are priced out of the housing market. Only about one in four American families can afford a new home. BUILDER, May 21, 1979, at 100. The percentage of first-time home buyers in the United States declined from 36 percent in 1977 to 18 percent in 1979. MORTGAGE BANKER, Feb. 1981, at 37. For a comparison of monthly homeownership costs in major metropolitan areas, including Illinois, see Chicago Sun-Times, Aug. 21, 1981, (Homelife) at 4, col. 3. An example illustrating the reduction in the percentage of families that can afford a home as the interest rate increases is included in MORTGAGE BANKING, July 1981, at 38, table 1.

28. I AMIRS, *supra* note 1, AMIRS: *An Overview and Summary* at 2.

29. *Id.*

30. *Id.* In August, 1979, a borrower obtaining a conventional \$60,000 mortgage for 29 years at the 11 percent prevailing rate could look forward to a fixed monthly payment of \$573.98 for principal and interest. Borrowing the same amount at today's 17.5 percent rate requires initial monthly payments of \$880.72 which may be subject to change if the interest rate is adjustable. Chicago Sun-Times, Aug. 7, 1981 (Homelife) at 3, col. 1.

31. Conventional mortgages disregard most buyers' rise in earnings during their early working years, the more level income pattern of middle-aged families, and the often declining income of retired or soon to be retired individuals.

32. The value of the American home went up 113 percent between 1967 and 1977. The average price of unimproved land rose 150 percent in the same period. Meanwhile, overall inflation was 83 percent. READER'S DIGEST, Mar. 1981, at 140. The median price of a new home purchased in 1965 was \$20,000. BUREAU OF THE CENSUS, U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 792, No. 1398 (100th ed. 1979). In August of 1977, the average price of a new home was \$54,600. Wall St. J., Sept. 9, 1977, at 4, col. 3. The median cost of a new home in 1980 was \$64,600, while the median cost of a previously owned home stood at \$63,000. MORTGAGE BANKING, July 1981, at 33. The median sales price of a new home in January, 1981, was \$67,200. Chicago Tribune, Mar. 4, 1981, § 4, at 1, col. 1.

does not operate effectively in today's inflationary economy, consumers are demanding innovative mortgage instruments designed to close the "financing gap" by accommodating expected appreciation of the property and anticipated income increases of the consumers.<sup>33</sup> One viable mortgage alternative is the shared appreciation mortgage.

#### THE SHARED APPRECIATION MORTGAGE

Since 1974, several alternative mortgage instruments have been introduced by the federal government in an attempt to ameliorate the inflexibility of the standard mortgage.<sup>34</sup> These alternatives are comprised of variations on the conventional mortgage which benefit either the lender or the borrower, but not both. The variable rate mortgage includes a provision permitting the lender to adjust the interest rate in response to economic conditions.<sup>35</sup> The graduated payment mortgage, offered primarily to first-time homebuyers, has scheduled monthly payments that are initially less than those of a standard mortgage but which increase annually to reflect anticipated increases in the borrower's income.<sup>36</sup> These mortgages, however, have been unsuccessful in incorporating into a single instrument an affordable financing program for borrowers which also assures lenders a hedge against inflation.<sup>37</sup> Accordingly, the Federal Home Loan Bank Board, which regulates many of the nation's largest volume mortgage lenders, has recently proposed a regulation authorizing all federally chartered savings and loan associations to

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33. For a brief description of several of the alternative mortgage instruments presently available, see, e.g., I AMIRS, *supra* note 1, *Recommendations on Alternative Mortgage Instruments* at I-1; *Alternative Mortgage Instruments are Building*, SAVINGS & LOAN NEWS 51 (Aug. 1977); II AMIRS, *supra* note 1, *Simulation Analysis of AMIs* at VIII-3; McKenzie, *A Comprehensive Look at Shared-Appreciation Mortgages*, 13 FED. HOME LOAN BANK BOARD J. 11, 14 (Nov. 1980) [hereinafter cited as 13 F.H.L.B.B.J.].

34. 13 F.H.L.B.B.J., *supra* note 33, at 14. The graduated payment mortgage was authorized on an experimental basis by the Housing and Community Development Act of 1974. I AMIRS, *supra* note 1, *The HUD-FHA GPM Experiment* at V offers an analysis of the results of the experiment. The federal government pursues several goals in housing. Principal among these are the expansion of homeownership opportunities, the assurance of decent shelter for low and moderate income people, and the encouragement of a strong housing and mortgage finance industry. BUILDER, May 21, 1979, at 100.

35. BLACK'S LAW DICTIONARY 911 (5th ed. 1979); 13 F.H.L.B.B.J., *supra* note 33, at 14.

36. 13 F.H.L.B.B.J., *supra* note 33, at 14.

37. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 2. See also 13 F.H.L.B.B.J., *supra* note 33, at 14. Variable rate mortgages are basically for the protection of the lender. Graduated payment mortgages lower the monthly cost of homeownership in the early years but will eventually cost the homeowner more than a conventional mortgage. MORTGAGE BANKING, July 1981, at 33.



participate in marketing shared appreciation mortgages.<sup>38</sup> A shared appreciation mortgage is a residential housing loan in which the borrower agrees to share the property's appreciation with the lender in return for the lender's agreement to provide the financing at an interest rate below that prevailing for a conventional mortgage.<sup>39</sup>

The Federal Home Loan Bank Board's version of the shared appreciation mortgage<sup>40</sup> bears two distinct elements of interest. The first element is a below-market interest rate which is fixed at the loan's inception and is paid over the term of the loan as a portion of the level monthly payment. The principal and interest are amortized over a period of up to forty years. However, the shared appreciation mortgage, as proposed, would mature in a maximum of ten years.<sup>41</sup> Thus, the borrower must repay the outstanding indebtedness not later than the end of the tenth year after the origination of the loan.<sup>42</sup>

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38. 12 C.F.R. § 545.6-4b Draft, *supra* note 7. For a general discussion of the shared appreciation mortgage and several variations, *see, e.g.*, 13 F.H.L.B.B.J., *supra* note 33; Homeowner's Moneyletter, Nov. 1980, at 1-6; HOUSING, Sept. 1980, at 11; MONEY, Jan. 1981, at 82.

39. CHANGING TIMES, Dec. 1980, at 8; HOUSING, Sept. 1980, at 11. Lenders discuss the shared appreciation mortgage in MORTGAGE BANKER, April 1981, at 38. The major criticisms advanced by lenders against the shared appreciation mortgage are set forth in MORTGAGE BANKING, July 1981, at 39.

40. The shared appreciation mortgage that the Federal Home Loan Bank Board is proposing differs from shared appreciation mortgages presently in use. Advance Mortgage Corp., the mortgage banking subsidiary of Oppenheimer & Co., started packaging shared appreciation mortgages in 1980. Under the Advance Mortgage plan, known as the appreciation participation mortgage, the fixed interest rate will be approximately two-thirds of the current market rate. The stated interest rate will remain constant for the full 30 year term of the loan. Additional interest, equaling one-third of the appreciation in value of the property, is payable when the property is sold or transferred. If the property is not sold or transferred prior to maturity of the loan, the additional interest becomes due whenever the loan becomes due or is paid off. Unlike the Federal Home Loan Bank Board's proposed shared appreciation mortgage which requires the borrower to pay the contingent interest not later than 10 years after the loan's inception, the appreciation participation mortgage does not require the borrower to pay the additional interest until the loan becomes due, 30 years after its inception, unless the property is sold or transferred prior to maturity of the mortgage. CHANGING TIMES, Dec. 1980, at 8. Another instrument currently in use, the equity participation mortgage, (EPM), differs from a shared appreciation mortgage in that the lender can share in a portion of the entire equity on an EPM, including the down payment, while the lender will only share in the appreciation above the original purchase price in a SAM. The procedure used to calculate the lender yield on an EPM is discussed in MORTGAGE BANKER, Feb. 1981, at 37.

41. Ten years is the maximum permissible term of the shared appreciation mortgage. According to the proposed regulation, a shorter term is allowable. "The term of the loan shall not exceed 10 years. . . ." 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 11.

42. *Id.* 13 F.H.L.B.B.J., *supra* note 33, at 11.

The second element of interest is "contingent" in nature, based upon the sharing ratio between the borrower and the lender<sup>43</sup> of the property's "net appreciated value."<sup>44</sup> The percentage of the appreciation to be paid to the lender as contingent interest is determined at the loan's inception by negotiation between the lender and borrower. However, the actual dollar amount would remain indefinite until the contingent interest becomes due and payable on the maturity of the loan or the sale or transfer of the property, whichever is earlier.<sup>45</sup> If the borrower has not sold or transferred the property prior to maturity of the shared appreciation mortgage, the proposal requires the lender to provide refinancing of the outstanding principal indebtedness plus the full amount of contingent interest.<sup>46</sup> Although the proposed regulation limits the contingent interest to a maximum of forty percent of the net appreciated value, it does not establish a formula for relating the below-market fixed interest rate to the percentage of contingent interest.

Thus, a shared appreciation mortgage differs from a conventional mortgage in three significant respects. First, although both the shared appreciation mortgage and the standard mortgage have equal monthly payments based on a long-term amortization schedule, the entire outstanding indebtedness of the shared appreciation mortgage becomes due and payable no later than the end of the tenth year. Second, the shared appreciation mortgage bears a fixed interest rate below that of a conventional mortgage. Third, unlike standard mortgages, shared apprecia-

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43. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 11. See text accompanying notes 102-09 *infra*.

44. The term "net appreciated value" means the amount equal to the difference of (i) the market value of the security property, and (ii) the sum of (a) the cost of the security property, (b) any expenditure properly chargeable to capital account (including the cost of improvements made to the property) under the Code, and (c) the cost of any appraisal performed pursuant to subparagraph (c) (3) of this section.

12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 12.

45. For purposes of this section, a sale or transfer shall not include (i) the creation of a lien or encumbrance subordinate to the shared appreciation mortgage; (ii) the creation of a purchase money security interest for household appliances; (iii) a transfer by devise, descent or operation of law, upon the death of a joint tenant; or (iv) the grant of any leasehold interest of three years or less not containing an option to purchase.

12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 11.

46. In the event of the maturity of the loan prior to the sale or transfer of the security property, the association shall offer, without regard to the forecast of borrower's income, to refinance the outstanding indebtedness on the loan, including any contingent interest, . . . under the terms, conditions and interest rates prevailing for new loans on the security of homes at the time of such refinancing.

12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 13.

tion mortgages have a contingent interest feature. At either the maturity of the loan or the sale or transfer of the property, the borrower must pay the lender a share of the property's appreciation.<sup>47</sup>

### *Benefits to Lenders*

Since the mid-1960s, the savings and loan industry has been the largest provider of construction and permanent financing for residential real estate in America.<sup>48</sup> This same period has been characterized by volatile interest rate fluctuations accompanied by rampant inflation. Lenders' ability to continue making fixed-rate mortgage loans was thus impaired.<sup>49</sup> The shared appreciation mortgage provides savings and loan associations with a partial hedge against unanticipated inflation. If actual inflation exceeds expected inflation, the contingent interest yield on a shared appreciation mortgage will exceed the yield expected when the loan was originated.<sup>50</sup> In this respect, the shared appreciation mortgage has an inflation adjustment feature which allows lenders' earnings to reflect economic conditions.

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47. For purposes of this section, a shared appreciation mortgage loan is a loan bearing . . . contingent interest not to exceed 40 percent of the net appreciated value of the security property payable upon the earlier of maturity or payment in full of the loan or sale or transfer of the security property.

12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 11. See also 13 F.H.L.B.B.J., *supra* note 33, at 11.

48. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 3.

49. Since life insurance companies and other discretionary lenders have shown a preference for commercial mortgage investments that share in the appreciation of the security property, introduction of the shared appreciation mortgage has the potential of inducing the discretionary lenders to return to the residential mortgage finance market through the purchase of interests in pools of mortgages. Increased participation in the market by discretionary lenders would increase the availability of funds for housing. See Annot., 16 A.L.R.3d 475 (1967) (validity of agreements to share in the earnings or income from property in lieu of, or in addition to, interest). Although savings and loan associations would be involved in originating the shared appreciation mortgages, they may not develop an interest in SAMs as an investment because of their need for current earnings. Pension funds, life insurance companies, and other essentially inflation hedging investors may, however, provide a market for SAMs.

50. The converse is also true, however. If actual inflation is less than expected inflation, the actual yield on the shared appreciation mortgage will be less than the expected yield. 13 F.H.L.B.B.J., *supra* note 33, at 12. The computation of lender's yield on a shared appreciation mortgage considering the time value of money is set forth in MORTGAGE BANKING, July 1981, at 39, Table 6. For a table showing the value multiplier that would equate the desired return with the stated mortgage interest rate as well as the annual compound rate of appreciation required to achieve the desired rate of return on a shared appreciation mortgage, see MORTGAGE BANKER, April 1981, at 33, Table 2.

The shared appreciation mortgage reduces the interest rate risk to lenders in another way. If the contingent interest due and the outstanding indebtedness are refinanced upon maturity, rather than paid upon the sale or transfer of the property, the lender may "bring the loan to market" by charging the prevailing interest rate. The maximum ten year term of the shared appreciation mortgage has the effect of shortening the average maturity of the lender's mortgage portfolio while preventing loans from bearing long-term interest rates not commensurate with that of new mortgage loans.<sup>51</sup> The shared appreciation mortgage's contingent interest feature which directly benefits lenders is balanced by the benefits which the below-market interest rate offers to borrowers.

### *Benefits to Borrowers*

In periods of high interest rates, the shared appreciation mortgage's interest rate discount feature and the corresponding lower monthly payments may allow low and moderate income households to afford a home.<sup>52</sup> For example, a standard mortgage of \$50,000 at 13 percent interest amortized over thirty years involves a monthly payment of \$553.10. The monthly payment on a corresponding shared appreciation mortgage at 9 1/2 percent is only \$420.43. Assuming annual property taxes and insurance of \$1,000 and a 25 percent payment-to-income requirement, the household would need an annual income of \$30,549 to qualify for the 13 percent standard mortgage. In contrast, a yearly income of only \$24,181 is necessary to be eligible for the 9 1/2 percent shared appreciation mortgage, a reduction of 21 percent.<sup>53</sup>

Accordingly, a substantial number of additional households, now primarily renters, could qualify for homeownership with a shared appreciation mortgage. In effect, the shared appreciation mortgage offers renters an opportunity to get a "foot in the door." Although the potential homeowner pays the lender with a share of the property's appreciation, the borrower can own a home and reap some of the financial rewards and income tax benefits associated with homeownership.<sup>54</sup> The shared appreci-

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51. If the borrower refinances the contingent interest in addition to the outstanding indebtedness, the lender will earn interest at the prevailing rate on the contingent interest.

52. 13 F.H.L.B.B.J., *supra* note 33, at 11; HOUSING, Sept. 1980, at 11.

53. 13 F.H.L.B.B.J., *supra* note 33, at 11.

54. *Id.* Home ownership is one of the few forms of investment in America today that: (1) is helped by inflation; (2) is readily marketable; (3) can be purchased with 20:1 leverage; and (4) has maintained an almost yearly increase in value for the last quarter century. Another reason for buying a home is the tax incentive provided by government to promote homeownership. Approximately two-thirds of all the long form 1040 returns

ation mortgage is particularly attractive to first-time homebuyers because it enables them to purchase a home sooner than would otherwise be possible.

### *Potential Obstacles to Success*

Despite the significant benefits the shared appreciation mortgage offers lenders and borrowers, the Federal Home Loan Bank Board's proposed regulation presents several potential problems. First, the proposal allows the borrower and lender to negotiate the amount of the interest rate discount, the term of the loan for amortization and maturity purposes, as well as the lender's share of the net appreciated value.<sup>55</sup> Although the vast majority of lenders are ethical and problems involving dishonesty seldom occur, the borrower is, nevertheless, likely to be at a serious bargaining disadvantage. Moreover, negotiations between financial professionals and amateurs rarely produce results favorable to the consumer.<sup>56</sup>

Second, the proposed regulation does not prescribe any relationship between the fixed interest and the percentage of contingent interest; nor does it set a maximum limit on the lender's overall return on its investment.<sup>57</sup> Consequently, the monthly subsidy inherent in the shared appreciation mortgage's discounted interest rate may produce staggering gains for the lender. Although the contingent interest is limited to 40 percent of the property's appreciation, the actual dollar amount of contingent interest is unlimited. If the purchaser selected a home

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are filed because of the deductions for interest and taxes on the taxpayer's home. This tax benefit reduces the average home payment from 38 percent of gross income to 25 percent or less. MORTGAGE BANKING, July 1981, at 31. See note 109 *infra*.

The Internal Revenue Service has not decided how it will regard the portion of the appreciation that the borrower must pay the lender. If that share is considered profit to the borrower, he may owe capital gains on money that he is not entitled to keep. However, if the contingent interest is considered interest paid to the lender, the borrower could get an annual tax deduction that might exceed his income for the year. Regardless of the determination concerning contingent interest, the borrower would be entitled to an annual income tax deduction for fixed interest and real estate taxes paid during the year. Homeowner's Moneyletter, Nov. 1980, at 6.

55. "The contingent interest on the shared appreciation mortgage is equal to a percentage of the appreciation of the property not to exceed 40%, as agreed to by the borrower and lender." 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 15.

56. Chicago Tribune, Oct. 12, 1980, § 14, at 4, col. 1.

57. "Although the proposal does not establish a formula for relating the below-market rate of fixed interest to the sharing ratio for net appreciated value, the Board anticipates that associations will balance fixed interest and contingent interest to produce an overall competitive rate of return." 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 4.

in a rapidly appreciating neighborhood, the return on the shared appreciation mortgage could be substantially in excess of the yield which the lender would have realized on a variable rate mortgage adjusted semi-annually to reflect the prevailing interest rate.<sup>58</sup>

Finally, if the contingent interest payable to the lender upon maturity of the shared appreciation mortgage is refinanced, the borrower's monthly payment could increase dramatically. Adding contingent interest to the outstanding indebtedness would result in a new principal balance considerably in excess of that of the original loan. The discounted interest rate would no longer be available and the new mortgage would bear the prevailing interest rate.<sup>59</sup> Unless the consumer's income had increased substantially, refinancing both the contingent interest and the outstanding indebtedness could push the borrower into default.<sup>60</sup>

These potential problems present serious legal obstacles to successful implementation of the shared appreciation mortgage. Pursuant to the proposed regulation, a consumer may choose to contest the validity of an agreement entitling the lender to receive an unlimited dollar amount of contingent interest. A pro-debtor court<sup>61</sup> might be convinced that the overall result of the

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58. Under the new rules approved by the comptroller of the currency on March 24, 1981, national banks will be able to write home mortgages with interest rates that can be increased as much as one percent every six months. There is no overall limit on how much the rate can be increased over the life of the mortgage. The new rules do not apply to savings and loan associations however. Roland Barstow, chairman of Bell Federal Savings and Loan Association, said "If we (federal savings and loan associations) had that type of loan we'd be back in the mortgage market. We are afraid of the fixed rate mortgage." *Chicago Sun-Times*, Mar. 25, 1981, at 80, col. 2.

On April 23, 1981, the Federal Home Loan Bank Board approved the adjustable rate mortgage (ARM) for use in federally chartered savings and loan associations effective April 30, 1981. Changes in the interest rate, which may be adjusted as frequently as every month according to a federal index, can be reflected in any of three ways: (1) the monthly payment may be increased or decreased; (2) the term of the loan may be lengthened or reduced; or (3) the loan principal may be increased or decreased. *Chicago Sun-Times*, April 24, 1981, (*Homelife*) at 5, col. 2; *Chicago Tribune*, April 24, 1981, § 4, at 1, col. 1.

59. "Refinancing may be effected using any mortgage instrument other than the SAM authorized for owner-occupied homes to be made at prevailing market rates for new residential mortgages at the time of refinancing." 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 7. See text accompanying notes 102-09 *infra*.

60. See notes 102-09 *infra* and accompanying text.

61. The courts have played an active role in development of consumer protection. Recent literature on the subject is voluminous. See, e.g., Symposium, *The Developing Law of Consumer Protection*, 10 GONZ. L. REV. 319 (1975).

transaction is fundamentally unfair to the borrower or that the lender's return on its investment is exorbitant. Various legal and equitable doctrines may be employed to justify a consumer-oriented court's refusal to enforce the mortgage contract or its offensive provisions.<sup>62</sup> The protection that the courts of equity have historically afforded the mortgagor's right of redemption presents the principal impediment to the operation of the shared appreciation mortgage.

#### THE EQUITY OF REDEMPTION

The modern mortgage originated in England during the fourteenth century.<sup>63</sup> The transaction consisted of a deed from the borrower conveying fee simple ownership in the land to the lender, subject to a condition subsequent which would vest title in the borrower upon repayment of the debt.<sup>64</sup> Thus, the mortgagee became the owner of the land just as though a sale had occurred, subject to two qualifications. First, although the mortgagee, as owner, was entitled to immediate possession of the property, any rents collected by the mortgagee while in possession were to be applied in reduction of the mortgage debt. Hence, it became common practice for the mortgagee to permit the mortgagor to remain in possession until default.<sup>65</sup> Second, the deed described the mortgage debt and stated a payment date, known as the law day. The mortgagor had the right to pay the debt on the law day, thereby defeating the deed and returning ownership to the mortgagor. This provision became known as the defeasance clause.<sup>66</sup>

The common law courts enforced the mortgage as written. Consequently, if the mortgage debt was not paid promptly on the law day, the mortgagor's default automatically extinguished his interest in the land. The mortgagee became the absolute owner of the fee.<sup>67</sup> Generally, failure to pay the mortgage debt

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62. See generally Kratovil, *Mortgage Law Today*, 13 J. MAR. L. REV. 251, 257 (1980) (unconscionability); Fratcher, *Restraints on Alienation of Equitable Interests in Michigan Property*, 51 MICH. L. REV. 509, 538 (1953); Comment, *Oppressive Bargains: Equity and the Credit Market*, 19 VA. L. REV. 594 (1933) (relief from forfeitures); Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646 (1922); Annot., 16 A.L.R.3d 475 (1967).

63. KRATOVIL, *MODERN MORTGAGE LAW AND PRACTICE* 23 (1972).

64. *Id.* See, TURNER, *THE EQUITY OF REDEMPTION* 18 (1931); Fratcher, *Restraints on Alienation of Equitable Interests in Michigan Property*, 51 MICH. L. REV. 509, 539 (1953).

65. *Id.* KRATOVIL, *MODERN MORTGAGE LAW AND PRACTICE* 24 (1972). See *Christophers v. Sparke*, 37 Eng. Rep. 612 (1820).

66. KRATOVIL, *MODERN MORTGAGE LAW AND PRACTICE* 24 (1972).

67. *Id.* 1 COKE, *INSTITUTES* 205a and Butler's Note 96 to the 13th ed. (1787).

on the law day resulted in the mortgagor losing his land for inadequate consideration since the indebtedness was usually considerably less than the value of the property.

Borrowers who had forfeited their land through default, but who were subsequently capable of paying the mortgagee, began to petition the king for assistance. Typically, the petition would set forth the borrowing of the money, the making of the mortgage, the unintentional default in payment, and the resulting loss of the land. These petitions, which the king referred to the chancellor to be disposed of equitably and in good conscience, requested that the mortgagee be ordered to accept the proffered payment and convey the land to the mortgagor.<sup>68</sup>

In the course of the seventeenth century, the court of chancery began to regularly grant relief from these forfeitures, reasoning that the return of the outstanding indebtedness with interest was adequate to compensate the mortgagee from delayed payment.<sup>69</sup> The mortgagor who had defaulted, thereby losing all his legal rights in the land, was permitted to sue in equity for redemption. Upon payment of the debt with interest, the chancellor would compel the mortgagee to convey the land to the mortgagor.<sup>70</sup> Thus an important new right, the equity of redemption, was born.<sup>71</sup> However, ingenious mortgagees soon devised various schemes to evade the operation of this devastating development.

#### CLOGGING THE EQUITY OF REDEMPTION

The courts of equity ignored the explicit intention of the parties when they created the equity of redemption. Technically, legal title vested absolutely in the mortgagee upon default, but practically, the mortgagor remained the owner even after default since he could reacquire the property by exercising his

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68. KRATOVIL, *MODERN MORTGAGE LAW AND PRACTICE* 24 (1972).

69. Fratcher, *Restraints on Alienation of Equitable Interests in Michigan Property*, 51 MICH. L. REV. 538, 541 (1953).

70. *Id.* TURNER, *THE EQUITY OF REDEMPTION* 17-42 (1931); *Master and Fellows of Emanuel College, Cambridge, v. Evans*, 1 Chan. Rep. 18, 21 Eng. Rep. 494 (1625). A correlative remedy for the mortgagee who wanted his money was developed by the court of chancery as a necessary corollary to the creation of the equity of redemption without definite duration. The mortgagee could sue in equity for foreclosure of the equity of redemption. The court would enter a decree requiring the debtor to pay by a fixed date or lose his equity of redemption through sale of the land to satisfy the debt. *How v. Vignes*, 1 Chan. Rep. 32, 21 Eng. Rep. 499 (1628).

71. Various theories have been proposed as to the origin and historical development of the equity of redemption. Williams, *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31, 33 (1933); Coughlin, *Clogging Redemption Rights in Illinois*, 3 J. MAR. L.Q. 11 (1938).



right of redemption.<sup>72</sup> In response to this development, the mortgagees merely inserted a clause in the mortgage waiving the mortgagor's redemptive right.<sup>73</sup> The courts of equity, concerned with substance rather than form, countered this movement by establishing the doctrine against clogging<sup>74</sup> the equity of redemption. This doctrine voided any agreement contained in or contemporaneous with the mortgage which purported to terminate the mortgagor's right to redeem without resort to foreclosure by the mortgagee.<sup>75</sup>

Although the prohibition against clogging has been characterized in various ways,<sup>76</sup> the most common reference to the doctrine in the United States is "once a mortgage, always a mortgage."<sup>77</sup> The essence of the rule is that the parties cannot by stipulations, however express and positive, render the mortgage irredeemable.<sup>78</sup> The clogging doctrine was developed to prevent ingenious mortgagees from using their superior bar-

72. KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE 25 (1972); OSBORNE, NELSON, & WHITMAN, REAL ESTATE FINANCE LAW 28 (1979).

73. KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE 25 (1972); Wyman, *The Clog on the Equity of Redemption*, 21 HARV. L. REV. 459, 469 (1908).

74. The first use of the term clog may be found in *Bacon v. Bacon*, 21 Eng. Rep. 146 (1639) "[W]here the mortgagee will suddenly bestow unnecessary costs upon the mortgaged lands, of purposes to clogg the lands, to prevent the mortgagor's redemption. . . ."

75. The court of chancery would not countenance any provision in a mortgage which would defeat, clog or fetter the equity of redemption. *Lord Northingham in Vernon v. Bethell*, 2 Eden 110, 113, 28 Eng. Rep. 838, 839 (1762). The doctrine against clogging the equity of redemption has been extensively documented. *See, e.g.*, OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES 227-238 (1951); TURNER, THE EQUITY OF REDEMPTION 175-183 (1931); Annot., 24 A.L.R. 822 (1923); Coughlin, *Clogging Redemption Right in Illinois*, 3 J. MAR. L.Q. 11 (1938); Fratcher, *Restraints on Alienation of Equitable Interests in Michigan Property*, 51 MICH. L. REV. 509 (1953); Williams, *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31 (1933); Wyman, *The Clog on the Equity of Redemption*, 21 HARV. L. REV. 459 (1908); Note, *Clog on the Right to Redeem*, 12 COLUM. L. REV. 627 (1912); Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646 (1922); Note, *"Once a Mortgage, Always a Mortgage,"* 24 MOD. L. REV. 385 (1961).

76. *See* Lord Haldane in *Kreglinger v. New Patagonia Meat Co.*, (1914) A.C. 25 and Lord Davey in *Noakes v. Rice*, (1902) A.C. 24, 32 for excellent statements of the various aspects of the clogging doctrine.

77. *Bonham v. Newcomb*, 23 Eng. Rep. 422 (1683); *Newcomb v. Bonham*, 22 Eng. Rep. 845 (1681); *Newcomb v. Bonham*, 23 Eng. Rep. 266 (1681). For a discussion of the status of the clogging doctrine in the United States, *see, e.g.*, *MacArthur v. North Palm Beach Utilities, Inc.*, 187 So. 2d 681 (Fla. App. 1966); *Humble Oil & Refining Co. v. Doerr*, 123 N.J. Super. 530, 303 A.2d 898 (1973); Comment, *Due-On-Sale Clauses and Clogging the Equity of Redemption*, 36 WASH. & LEE L. REV. 1121 (1979); 59 C.J.S. *Mortgages* §§ 817-818 (1949); 55 AM. JUR. 2d, *Mortgages, Right or Equity of Redemption* §§ 510-524 (1971).

78. Lord Davey in *Noakes v. Rice*, (1902) A.C. 24, 32. *See* Fogelman, *The Deed Absolute as a Mortgage in New York*, 32 FORDHAM L. REV. 299, 301 (1963); Note, *Mortgages-Improvements-Absolute Deed in Lieu of Foreclosure*, 31 MO. L. REV. 312 (1966).

gaining position to insert clauses in the mortgage which would effectively nullify or restrict the operation of the equity of redemption.<sup>79</sup> Thus, the focus was on the position of the parties at the creation of the borrower-lender relationship. Any provision intended to waive the right of redemption was void and the mortgagor might redeem as though the clause did not exist.<sup>80</sup>

Determined mortgagees, seeking to escape the effects of the clogging doctrine, attempted to disguise restrictions on the right to redeem. The crudest attempts included clauses limiting redemption to a certain time after law day and restrictions as to who could exercise the right to redeem.<sup>81</sup> Courts of equity struck down these provisions automatically. Agreements allowing the mortgagee to keep part of the mortgaged property, redemption being limited to the balance, were also held invalid.<sup>82</sup> Similarly, courts have employed the clogging doctrine to deny a mortgagee's request for specific performance of an option to purchase the mortgaged premises entered into at the time of the loan.<sup>83</sup> As mortgagees became more sophisticated, however, attempts to waive the right of redemption became less obvious.

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79. 27 HALSBURY'S LAWS OF ENGLAND § 243 (3d ed. 1959); MEGARRY & WADE, THE LAW OF REAL PROPERTY 938 (4th ed. 1975); OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES 146 (2d ed. 1970).

80. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES 146 (2d ed. 1970); OSBORNE, NELSON, & WHITMAN, REAL ESTATE FINANCE LAW 29 (1979).

81. 27 HALSBURY'S LAWS OF ENGLAND, § 586 (limitation of right to redeem), and § 573 (persons who may redeem) (4th ed. 1980). For decisions concerning restrictions on the time to redeem, *see, e.g.*, Bradbury v. Davenport, 114 Cal. 593, 46 P. 1062 (1896) (four months); Frazer v. Couthy Land Co., 17 Del. Ch. 68, 149 A. 428 (1929) (three years); Heirs of Stover v. Heirs of Bounds, 1 Ohio St. 107 (1853) (before a fixed date); Floyer v. Lavington, 24 Eng. Rep. 384 (1714) (life of mortgagor); Price v. Perrie, 22 Eng. Rep. 1195 (1707). Provisions that only the mortgagor himself, as distinct from his executor or heirs, or that only the mortgagor and the heirs male of his body may redeem were held invalid. *See, e.g.*, Howard v. Harris, 23 Eng. Rep. 288 (1681); Newcomb v. Bonham, 23 Eng. Rep. 266 (1681). The mortgagor could sell his equitable right of redemption or dispose of it by will. If he died intestate, the right could be exercised by his heirs.

82. Salt v. Marquess of Northampton, (1892) A.C. 1.

83. Humble Oil & Refining Co., v. Doerr, 123 N.J. Super. 530, 303 A.2d 898 (1973). In *Humble Oil*, the court addressed the specific issue of whether the doctrine against clogging the equity of redemption bars a mortgagor's guarantor from enforcing an option to purchase the property taken from the mortgagor as part of the original mortgage transactions. *Id.* at 540, 303 A.2d at 906. Relying on the clogging doctrine, not specifically pleaded, the court concluded that the equity of redemption was clogged and denied specific performance of the option provision to the guarantor. *Id.* at 540-44, 303 A.2d at 906-08. *See, e.g.*, MacArthur v. North Palm Beach Utilities, Inc., 187 So. 2d 681 (Fla. App. 1966); Wilson v. Fisher, 148 N.C. 535, 62 S.E. 622 (1908); Note, 20 COLUM. L. REV. 920 (1920); Annot., 10 A.L.R.2d 231 (1950) (option executed simultaneously with mortgage for purchase of mortgaged property by mortgagee as subject of specific performance).

Stipulations providing for an increase in the interest rate upon default presented a more subtle clog of the equity of redemption. If the higher rate was fixed at the inception of the mortgage with a reduction for punctual payment, the agreement was valid.<sup>84</sup> However, if the rate was not specified at the outset, the agreement failed since the jump in the interest rate upon default could be so enormous that, as a practical matter, the mortgagor would be unable to pay it. A provision which does not specify the higher rate would be recognized as merely a device to render the mortgage irredeemable and therefore a violation of the clogging doctrine.<sup>85</sup> The same rationale applies to a clause entitling the mortgagee to a bonus upon redemption. Further, a stipulation that unpaid interest will be capitalized and interest paid on it has also been held void.<sup>86</sup>

These decisions are predicated upon a principle which underlies relief from penalties and forfeitures.<sup>87</sup> The gist of the principle is that relief will be granted where there has been reliance upon a "mirage of hope." The courts have interceded because of solicitude for the "impecunious landowner"<sup>88</sup> or "necessitous men [who] are not, truly speaking, free men."<sup>89</sup> Another significant influence on the court's decision to grant relief is the mortgagee's tendency to take advantage of the mortgagor's optimism - the "overconfidence in one's own capacities and faith in a special providence . . . [that] leads us to over-sanguine commitments."<sup>90</sup> Accordingly, where the agreement in-

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84. *Strode v. Parker*, 23 Eng. Rep. 804 (1694); *Holles v. Wyse*, 23 Eng. Rep. 787 (1693). See *Salt v. Marquess of Northampton*, (1892) A.C. 1, 19; *Firth, Freedom of Contract in Mortgages*, 11 L.Q. REV. 144, 153 (1895). See also *Goodyear Shoe Mach. Co. v. Selz, Schwab & Co.*, 157 Ill. 186, 41 N.E. 625 (1894).

85. OSBORNE, NELSON, & WHITMAN, REAL ESTATE FINANCE LAW 30 (1979).

86. HALSBURY'S LAWS OF ENGLAND, § 590 (4th ed. 1980) (bonus upon redemption); *Chambers v. Goldwin*, 32 Eng. Rep. 600 (1804) (capitalization of interest).

87. Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646 (1922). *Finger v. McCaughey*, 114 Cal. 64, 45 P. 1004 (1896) (increase from ten to twelve percent in the mortgage interest rate valid if not paid).

88. "[I]mpecunious landowner in the toils of a crafty money lender." *Samuel v. Jarrah Timber & W. P. Corp.*, (1904) A.C. 323, 327.

89. [A] mortgagee can never provide at the time of making the loan for any event or condition on which the equity of redemption shall be discharged, and the conveyance absolute. And there is great reason and justice in this rule, for necessitous men are not, truly speaking, free men, but, to answer a present exigency, will submit to any terms that the crafty may impose upon them.

Lord Northington in *Vernon v. Bethell*, 2 Eden 110, 113, 28 Eng. Rep. 838, 839 (1762).

90. Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646, 647 (1922).

cludes a future increase in the amount due for which the mortgagor never expects to become liable, the transaction is invalid.<sup>91</sup> Conversely, an initial firm commitment to a higher rate which the mortgagor knows he has bound himself to pay, but which may be reduced by future effort, would not violate the clogging doctrine.

Two other concepts have occasionally been used to explain the rule against clogging the equity of redemption. The first concept provides that the mortgagee shall not exact a "collateral advantage" from the mortgagor. This approach derives from the phraseology that a mortgagee "shall not have interest for his money and a collateral advantage besides for the loan of it, or clog the redemption with any by-agreement."<sup>92</sup> The second concept states that there must be no stipulation in the mortgage which will "fetter" the property on redemption. In sum, this theory means that "the mortgagee shall not make any stipulation which will prevent a mortgagor, who has paid principal, interest, and cost, from getting his mortgaged property in the condition in which he parted with it."<sup>93</sup>

Although the "collateral advantage" and "fettering" aspects of the clogging doctrine have played a significant role in English law, they have never flourished in the United States. Some commentators have expressed concern that these concepts might be adopted from the English decisions.<sup>94</sup> Nevertheless, the maxim "once a mortgage, always a mortgage," commonly associated with the clogging doctrine in America, encompasses most attempts to defeat the right of redemption. It may also be applied to the potential clog in the shared appreciation mortgage.

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91. OSBORNE, NELSON, & WHITMAN, *REAL ESTATE FINANCE LAW* 30 (1979).

92. This aspect of the clogging doctrine can be traced to a statement in *Jennings v. Ward*, 23 Eng. Rep. 935 (1705). Relief from a collateral advantage will only be granted in cases of oppression and unconscionable advantage. *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, (1914) A.C. 25. See 27 HALSBURY'S LAWS OF ENGLAND, § 587 (4th ed. 1980) (collateral benefits as clogs); Williams, *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31, 49 (1933) (instances when the courts have upheld collateral advantages).

93. Opinion of Lord Davey in *Noakes & Co. v. Rice*, (1902) A.C. 24, 33. The fettering aspect of the clogging doctrine originally invalidated any bargain binding the mortgaged property beyond the redemption period. However, relief will no longer be granted if the provision is reasonable and is part of an independent legitimate business agreement, even though the agreement is conditioned upon the giving of a mortgage at the same time the agreement is entered into. *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, (1914) A.C. 25.

94. OSBORNE, *HANDBOOK OF THE LAW OF MORTGAGES* 145 (2d ed. 1970); Williams, *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31, 52 (1933).

## THE SUSPECTED CLOG IN THE SHARED APPRECIATION MORTGAGE

Certain aspects of the clogging doctrine can be dismissed as inapplicable to the shared appreciation mortgage. The Federal Home Loan Bank Board's proposed regulation does not purport to waive the mortgagor's equity of redemption<sup>95</sup> or limit the right to redeem to a certain time after default.<sup>96</sup> Nor does the proposal impose restrictions as to who may exercise redemptive rights<sup>97</sup> or grant the mortgagee an option to purchase the property securing the loan.<sup>98</sup> However, the guaranteed refinancing provision,<sup>99</sup> which may result in future increases in the mortgagor's financial burden, could cause the shared appreciation mortgage to run afoul of the clogging doctrine.

The proposed regulation provides for guaranteed refinancing by the savings and loan association that originated the shared appreciation mortgage if the property securing the loan is not sold or transferred prior to maturity.<sup>100</sup> The outstanding principal indebtedness plus the full amount of contingent interest may be refinanced without regard to the forecast of the borrower's income. The new mortgage would be financed at the prevailing interest rate over a minimum of thirty years.<sup>101</sup>

The clog inherent in the guaranteed refinancing provision is best illustrated by an example of the possible result of the shared appreciation mortgage upon maturity. Suppose that the borrower obtained a \$50,000 shared appreciation mortgage to finance the purchase of a \$62,500 home, agreeing to share one-third<sup>102</sup> of the property's appreciation with the lender in return

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95. See text accompanying notes 72-75 *supra*.

96. See text accompanying notes 81-82 *supra*.

97. *Id.*

98. See text accompanying note 83 *supra*.

99. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 13.

100. In the event of the maturity of the loan prior to the sale or transfer of the security property, the association shall offer, without regard to the forecast of borrower's income, to refinance the outstanding indebtedness on the loan, including any contingent interest, . . . under the terms, conditions and interest rates prevailing for new loans on the security of homes at the time of such refinancing. Any refinancing offered pursuant to this paragraph shall be for a term of not less than 30 years. . . . The association may require as a condition of refinancing that any intervening lien or encumbrance arising between the origination of the shared appreciation mortgage and the time of refinancing be released of record of subordinated to the mortgage or deed of trust securing the refinancing.

101. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 13.

102. *Id.*

102. Although the lender in the example is entitled to only one-third of the property's appreciation, the proposed regulation allows the lender to receive up to forty percent of the net appreciated value of the security property. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 11.

for a 9 1/2 percent interest rate rather than the prevailing rate of 13 percent.<sup>103</sup> After ten years,<sup>104</sup> assuming annual appreciation of 10 percent,<sup>105</sup> the property would be worth \$162,109. The lender's share of the \$99,609 in appreciation, i.e., contingent interest, would equal \$33,203.<sup>106</sup> If the outstanding principal indebtedness of the original loan plus the contingent interest are refinanced over thirty years<sup>107</sup> at 13 percent interest,<sup>108</sup> the borrower's monthly payment would increase from \$420.43 to \$866.22.<sup>109</sup>

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103. Although the interest rate used in the example is thirteen percent, that figure is conservative in comparison to the rates presently prevailing. As of March 20, 1981, interest rates for residential financing in the Chicago, Illinois market ranged from 15 1/4 percent to 18 percent. Chicago Sun-Times, Mar. 20, 1981, at 68, col. 3. On August 21, 1981, interest rates charged by major lenders for home loans in the Chicago market ranged from 17 to 18 1/2 percent. Chicago Sun-Times, Aug. 21, 1981, [Homelife] at 4, col. 4.

104. The appreciation is calculated as of the tenth year because that is the maximum permissible term of the shared appreciation mortgage. Contingent interest becomes due and payable upon maturity of the loan unless the property has been sold or transferred prior to that time. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 11. See text accompanying notes 40-46 *supra*.

105. According to the National Association of Realtors, the national increase in home prices in 1980 was 11.7 percent. Chicago Tribune, April 3, 1981, at 1, col. 5. The value of the average American home went up 113 percent between 1967 and 1977. READER'S DIGEST, Mar. 1981, at 140.

106. The calculations of the property's appreciated value, the net appreciation, and contingent interest were rounded to the nearest dollar in the example. The actual figures are: appreciated value-\$162,108.87; net appreciation-\$99,608.87; and contingent interest-\$33,202.95. Although the amount of contingent interest the lender is entitled to receive may initially appear to be unreasonable, it must be balanced against the deferred interest the lender is entitled to; i.e., the difference between the below-market rate and the rate prevailing at the loan's inception, and the risk the lender assumed; i.e., the possibility of the property depreciating in value or failing to keep pace with inflation.

107. The minimum period for refinancing offered pursuant to the guaranteed refinancing provisions of the proposed regulation is thirty years. 12 C.F.R. § 545.6-4b Draft, *supra* note 7, at 13. Lenders will undoubtedly be hesitant to exceed the minimum requirement.

108. Based on present long term interest trends, the possibility that the interest rate prevailing upon maturity of the shared appreciation mortgage will be the same as that prevailing when the loan was originated is remote. For long term trends, see BUREAU OF THE CENSUS, U.S. DEPT. OF COMMERCE, 2 HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970, Series X474-86, at 1003 (1975).

109. 13 F.H.L.B.B.J., *supra* note 33, at 13. The increase in the borrower's monthly mortgage payment upon refinancing is in excess of 106 percent. George W. DeFranceaux, chairman of the National Housing Partnership predicts that by 1990 it will be commonplace for American households to pay 40 percent of their annual income for housing costs. Chicago Tribune, Mar. 27, 1981, § 3, at 13, col. 2. A Chicago area resident considering the purchase of an average-priced home should expect to pay over \$1000 a month for 1981 homeownership costs as compared to \$594 per month in 1978. Chicago Sun-Times, Aug. 21, 1981, [Homelife] at 4, col. 3. Three years ago the average housing cost took approximately 22 percent of a family's gross

Thus, many of the households with shared appreciation mortgages may experience financial difficulty when the loan is refinanced. When housing prices increase dramatically most homeowners may realize only nominal income growth; the low and moderate income households that qualified for a shared appreciation mortgage are not likely to experience the substantial increase in earnings necessary to afford the new payment burden. This failure of income to increase in proportion to the increase in monthly payments upon refinancing could push the homeowner into default.<sup>110</sup>

Mortgage terms which suggest that the mortgagee has taken advantage of the mortgagor's tendency to overestimate his future financial capabilities have been interpreted by courts of equity as clogs on the equity of redemption.<sup>111</sup> The guaranteed refinancing provision of the shared appreciation mortgage appears designed to exploit this human failing.<sup>112</sup> The amount of contingent interest could be so enormous or the prevailing interest rate upon maturity so burdensome that, as a practical matter, the mortgagor would be unable to afford the property. Thus, because the guaranteed refinancing provision is expressed in terms of an undeterminable future increase in the amount of contingent interest due, the agreement may be merely a device to render the mortgage irredeemable and, therefore, in violation of the clogging doctrine.

The refinancing provision also allows the lender to include the entire amount of contingent interest in the amount of the new mortgage together with the outstanding principal balance of the original loan. Similar provisions, where accrued unpaid interest has been added to principal, have been held void by the courts of equity as a clog on the equity of redemption.<sup>113</sup> Consequently, a borrower who chooses to contest the validity of the shared appreciation mortgage may persuade the court that the guaranteed refinancing provision was designed to lure an im-

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income; shelter currently consumes 38 percent of a family's income. MORTGAGE BANKING, July 1981, at 31.

110. Real family income declined 5.5 percent in 1980 according to a Census Bureau report issued August 20, 1981; double-digit inflation and the 1980 economic slump were responsible for the drop in median income, the largest plunge ever recorded. Chicago Tribune, Aug. 21, 1981, at 1, col. 4; Chicago Sun-Times, Aug. 21, 1981, at 1, col. 2. The effects of the current recession on the rate of mortgage delinquencies is discussed in Chicago Tribune, June 8, 1981, § 4, at 9, col. 2.

111. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES 147 (2d ed. 1970); Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646, 647 (1922).

112. See text accompanying notes 84-91 *supra*.

113. Chambers v. Goldwin, 32 Eng. Rep. 600 (1804).

provident mortgagor into a commitment which would inevitably lead to the loss of the mortgaged property.

Despite the similarity between the guaranteed refinancing provision and mortgage clauses that are held to clog the equity of redemption, ". . . Courts must not lose sight of the dominating principle underlying the reasons which originally influenced the terms of the rule, reasons which have, in certain cases, become modified as public policy has changed."<sup>114</sup> To allow an ancient interpretation of the clogging doctrine to impede the success of the modern shared appreciation mortgage would twist the equitable principle of avoidance of oppressive, unconscionable, or sharp bargains beyond recognition. The solution to overcoming the suspected clog in the guaranteed refinancing provision must, like the shared appreciation mortgage itself, balance the interests of lenders and borrowers. Federal preemption of state laws against clogging the equity of redemption might protect lenders but would not alleviate the financial difficulty many borrowers will experience upon maturity of the shared appreciation mortgage.<sup>115</sup> Conversely, limiting the dollar amount of contingent interest that the lender is entitled to receive may resolve the borrowers' problems but would return lenders to the same economic treadmill that they attempted to escape by avoiding fixed-rate loans.<sup>116</sup>

The violation of the clogging doctrine inherent in the shared appreciation mortgage stems primarily from the uncertainty of the dollar amount of contingent interest which will be due upon maturity. This lack of specificity, though necessary to the operation of the mortgage, involves risk to the lender as well as to the borrower. If the property's value has not increased substantially, the borrower will probably not experience financial problems upon refinancing. The lender, however, will not realize the earning expected and may incur a loss due to the below-market interest of the original loan. The consumer will be in jeopardy only when the property has considerably appreciated. At worst, upon default, the property would be sold pursuant to

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114. *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, (1914) A.C. 25, 44.

115. Federal law plays a significant role in mortgage financing. For example, interest rate ceilings set by state usury laws were preempted under section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132. The new rules approved March 24, 1981 by the comptroller of the currency allow national banks to write home mortgages with interest rates that can be increased as much as one percent every six months. These federal rules preempt state laws which prohibit or limit adjustable rate home loans. *Chicago Sun-Times*, Mar. 25, 1981, at 80, col. 2.

116. See text accompanying notes 17-26 *supra*.



foreclosure and the borrower would receive the proceeds in excess of the outstanding indebtedness and the contingent interest due.<sup>117</sup>

However, since default is unlikely unless the property's value has risen significantly, the amount of the proceeds that the borrower could receive from a foreclosure sale might be sufficient to enable him to purchase another home. Consequently, the problems arising upon refinancing would be alleviated by allowing the borrower, who could no longer afford the property, a grace period after maturity to sell the property. Alternatively, the property could be appraised at regular intervals prior to maturity. The borrower would be informed of the new financial burden based upon the appraised value and given an opportunity to refinance the property at each interval. Finally, lenders could be required to provide applicants with a detailed disclosure of the differences between the shared appreciation mortgage and other available forms of financing, including an estimate of the borrower's monthly payments upon refinancing. Armed with this information, the borrower would be in a position to make an intelligent decision on the merits of using a shared appreciation mortgage to finance his home purchase.

#### CONCLUSION

"Events shape the law."<sup>118</sup> Although the conventional mortgage operated effectively when the nation's financial climate was stable, in today's inflationary economy it has been unable to provide prospective homeowners with affordable financing while assuring lenders a hedge against unanticipated inflation. Innovative mortgage instruments designed to accommodate diverse financial requirements of borrowers and lenders are desperately needed to provide the funds necessary to revitalize the housing industry. The shared appreciation mortgage offers borrowers and lenders alike an opportunity to participate in the realization of the American dream of home ownership.<sup>119</sup>

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117. The lender's interest in the foreclosure sale would not be adverse to the borrower since the dollar amount of contingent interest the lender would receive would increase as the bidding on the property increased. The borrower would thus have some assurance that the property would be sold at market value.

118. Kratovil, *Mortgage Law Today*, 13 J. MAR. L. REV. 251, 271 (1980).

119. There is a presumption that once a person owns a home, quality of life will dramatically improve and children, raised in a home with grass and trees, will have a better life. In essence, a home is a place to call one's own—the proverbial castle, the refuge from turmoil. MORTGAGE BANKING, July 1981, at 31.

There is no question that mortgagors originally needed more protection than they received.<sup>120</sup> However, early decisions on clogging the equity of redemption were handed down under circumstances markedly different from those of the present. Responsible, honest, and skillful lenders provide certainty in modern mortgage transactions which was not present when the majority of mortgage lenders were individuals rather than financial institutions.

The doctrine against clogging the equity of redemption evolved in the courts in response to the litigated problems of the times. Like other rules proceeding from equitable principles, where the reason for the rule ceases, the principle fails of application.<sup>121</sup> Thus, as times change, the rules must yield to the reality of present conditions.

As a result of today's inflationary economy, many prospective buyers are prohibited from purchasing homes. However, inflation, when harnessed by the shared appreciation mortgage,<sup>122</sup> can be a strong ally in assisting the American public to achieve homeownership. Accordingly, absent precedent addressing today's novel issues, a borrower should not be protected to the point that he or she can no longer afford to own a home and must continue renting under the guise of consumer protection.<sup>123</sup>

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120. For a discussion of the law of consumer protection, *see, e.g.*, Symposium, *The Developing Law of Consumer Protection*, 10 GONZ. L. REV. 319 (1975).

121. Annot., 24 A.L.R. 822, 823 (1923).

122. MORTGAGE BANKING, July 1981, at 41.

123. Kripe, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 COLUM. L. REV. 445, 468-69 (1968).

