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A NEW DILEMMA FOR THRIFT INSTITUTIONS: JUDICIAL EMASCULATION OF THE DUE-ON-SALE CLAUSE

BY ROBERT KRATOVIL*

INTRODUCTION

The emergence of the due-on-sale clause[1] can be traced to the financial collapse accompanying the Great Depression. The country's banks, caught with heavy investments in illiquid real estate mortgages, could not produce the funds to pay off the panicked depositors lined up outside their doors. Many banks, ordered closed by President Roosevelt when he took office in 1933, never reopened. Those that did simply made no mortgage loans. The state building and loan associations that survived the period also discontinued further mortgage financing. To overcome this lenders' reluctance, the Federal Housing Administration was created. The mortgage insurance it provided induced some institutions to resume cautious mortgage lending; however, lending without government insurance was virtually nonexistent. Then a system of federal savings and loan associations was created and attracted depositors whose accounts were insured by federal institutions. This insurance was also extended to deposits in state savings and loan associations. Gradually these institutions resumed mortgage lending, but on a prudent basis. Ultimately these thrift institutions financed the subsequent phenomenal growth of housing in America, and today they represent the major source of mortgage funds available to the country's home buyers.

As mortgage financing again became available, mortgage documentation began to improve. Among the improvements was the appearance of the due-on-sale clause in mortgage contracts. In its early, unsophisticated form, the clause contained a

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1. A due-on-sale clause allows the lender to accelerate the due date if the mortgaged premises are sold without his consent.

covenant giving the lender a right to accelerate the remainder of the mortgage debt. The philosophy was simple and practical: the lender, who had made a loan to one credit-worthy individual, was assured that the home would only be sold to another credit-worthy individual.

All went well until interest rates began to rise. In 1966, and again in 1970 and 1974, disintermediation caused a major drain on thrift institutions.[2] Disintermediation occurs when depositors in thrift institutions withdraw their money to take advantage of the higher interest rates offered by other forms of investment. Finding themselves with many outstanding loans at rates below the prevailing interest rates, the thrift institutions began to search for alternative methods of increasing portfolio yield.[3] The due-on-sale clause became a means toward this end. When the original borrower attempted to sell his home subject to the existing mortgage, the lender refused to consent to the sale unless the purchaser would agree to pay a higher interest rate on the mortgage loan. Many borrowers and their purchasers resisted this requirement. Early attacks tended to focus on the proposition that the lender's use of the clause to force an increase in the interest rate constituted an illegal restraint on alienation. Early decisions sided with the lender, finding either that the restraint imposed was reasonable, or that there was in fact no restraint at all.[4] Later decisions, expressing a diversity

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2. Prior to the first credit crunch in 1966, which was followed by one in 1970, [and] one in 1974 . . . thrift institutions were able to bear the burden of providing the financing to support the growth of housing in America. There was little or no need for the movement of housing instruments from one institution to another because there existed a fairly well-developed brokerage system. This mortgage brokerage system operated in a manner which enabled mortgages to be moved from capital surplus to capital short areas and vice versa without any great difficulty. The real problems occurred beginning in 1966 when disintermediation started to take money out of the thrift system. Let us define disintermediation . . . . Disintermediation is simply that point in time when interest rates, particularly interest rates on government securities, rise to a point where money flows out of savings institutions [and into government securities] thereby preventing such institutions from making mortgage loans. Disintermediation and reintermediation—which is a reversal of that process—are words that were probably in our language a long time ago but became important beginning in 1966.

Dall, The Conventional Mortgage-Backed Security, *in* FNMA-FHLMC General Counsels' Conference 159-60 (1978).

3. *See* text accompanying note 54 *infra*.

4. Malouf v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973); Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975); Chapman v. Ford, 246 Md. 26, 227 A.2d 26 (1967); First Com. Title Inc. v. Holmes, 92 Nev. 363, 550 P.2d 1271 (1976); Century Fed. Sav. & Loan Ass'n v. Van Glahn, 144 N.J. Super. 48, 364 A.2d 558 (1976); Paydan Inc. v. Kiriaki, 130 N.J. Super. 141, 325 A.2d 838 (1974); Mutual Real Estate Inv. Trust v. Buf-

of legal philosophies, held against the lender when the purchaser was adjudged to be credit-worthy.[5] The battle having been joined, legal periodicals leaped into the fray.[6]

FORM AND RECOGNITION OF THE CLAUSE

In its early form the due-on-sale clause was simply one of many covenants in a broad acceleration clause covering breach of covenant in general.[7] After courts began to accord separate

falo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (App. Term 1977); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976), *noted in* 55 N.C. L. REV. 310 (1977); Peoples Sav. Ass'n v. Standard Indus. Inc., 22 Ohio App. 2d 30, 257 N.E.2d 406 (1970); Walker Bank & Trust Co. v. Neilson, 26 Utah 2d 383, 490 P.2d 328 (1971).

5. First Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 306 (Ala. 1977); Patton v. First Fed. Sav. & Loan Ass'n, 118 Ariz. 473, 578 P.2d 152 (1978); Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 481 S.W.2d 725 (Ark. 1972); Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 625, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); Clark v. Lackenmeier, 237 So. 2d 583 (Fla. 1970); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 250 N.W.2d 804 (Mich. 1977); Sanders v. Hicks, 317 So. 2d 67 (Miss. 1975); Continental Fed. Sav. & Loan Ass'n v. Felter, 564 P.2d 1013 (Okla. 1977).

6. Bartke & Tagaropulos, *Michigan's Looking Glass World of Due on Sale Clauses*, 24 WAYNE L. REV. 971 (1978); Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F. L. REV. 267 (1972); Cunningham & Tischler, *Transfer of the Real Estate Mortgagor's Interest*, 27 RUTGERS L. REV. 24 (1973); Humphrey, *Tucker v. Lassen—The Demise of the Due-on-Sale Clause in California?*, 10 U.S.F. L. REV. 665 (1976); Jacoway, *Mortgages—A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485 (1973); Koerselman, *Half-Way Mark Reached in the Demise of the Inequitable Application of the "Due-on-Sale" Clause*, 3 PEPPERDINE L. REV. 111 (1975); Short, *Applying the Brakes to Acceleration Clauses: Controlling Their Misuse in Real Property Secured Transactions*, 9 CAL. W. L. REV. 514 (1973); Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747 (1973); Warren, *Is the Practice of Raising the Interest Rate in Return for not Exercising an Acceleration Clause on Assumption of a Mortgage Illegal in Texas as a Restraint on Alienation?*, S. TEX. L.J. 296 (1972); Wilner, *Due on Sale and Due on Encumbrance Clauses in California*, 7 LOYOLA L.A. L. REV. 306 (1974); Comment, *Tucker v. Lassen: Due-on-Sale Clauses in Land Sale Contracts—a Victory for the Consumer-Buyer*, 11 CAL. W. L. REV. 578 (1975); Comment, *Beyond Tucker v. Lassen: The Future of the Due-on-Sale Clause in California*, 27 HASTINGS L.J. 475 (1975); Comment, *Mortgage Consent to Sale Clause: a Reasonable Restraint on Alienation?*, 8 J. MAR. J. 513 (1975); Comment, *Deeds of Trust—Restraints Against Alienation—Due-on Clause is an Unreasonable Restraint on Alienation Absent a Showing of Protection of Mortgagee's Legitimate Interests*, 47 MISS. L.J. 331 (1976); Comment, *Mortgages: Restrictions on Transfer of the Fee—Effect of Due-on-Sale Clauses*, 28 OKLA. L. REV. 418 (1975); Comment, *Use of "Due-on-Sale" Clauses to Gain Collateral Benefits: A Common-Sense Defense*, 10 TULSA L.J. 590 (1975). *See also* Subcommittee on "Due-on" Clauses, *Report*, 13 REAL PROP., PROB. & TR. J. 891 (1978) [hereinafter cited as *Due-on Clause Report*].

7. As is evident, early versions of the clause were unsophisticated. The clause contained a covenant not to convey without the lender's consent. The clause, in this form, is the form considered in Baker v. Loves Park

consideration to the due-on-sale aspects of the clause, in effect splitting the clause,[8] lenders' draftsmen segregated the due-on-sale provision into a separate article. Sophisticated versions of the clause appeared.[9] A sophisticated clause will expressly in-

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Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975). Such a form gratuitously invites an attack based on the restraints on alienation rule. This could have been avoided by use of the early FHA form:

> If there shall be any change in the ownership of the premises covered hereby without the consent of the Grantee, the entire principal and all accrued interest shall become due and payable at the election of the Grantee, and foreclosure proceedings may be instituted thereon.

HOAGLAND, STONE & BRUEGGEMAN, REAL ESTATE FINANCE, 14 (6th ed. 1977).

The FHA version of the due-on-sale clause originated in the FHA mortgage forms of Georgia, Puerto Rico and Ohio in the 1930's and Oregon's form in 1940. Louisiana vendors' lien form included such a provision in its 1938 form. These clauses were deleted between 1958 and 1962. Letter from Robert F. Hollister, Assistant General Counsel, HUD, to author (Nov. 20, 1978). *See also* Hood & Kushner, *Real Estate Finance: The Discount Point System and Its Effect on Federally Insured Home Loans*, 40 U.M.K.C. L. REV. 1 (1971).

8. *See* Annot., 31 A.L.R. 733 (1924).

9. *See* Comment, *Debt Acceleration on Transfer of Mortgaged Property*, 29 U. MIAMI L. REV. 584 (1975). The FHLMC mortgage form, as revised, contains a form of due-on-sale clause, which incidentally, specifically provides for an increase in interest:

> **19. TRANSFERS OF THE PROPERTY OR BENEFICIAL INTERESTS IN BORROWER; ASSUMPTION.** On sale or transfer of (i) all or any part of the Property, or any interest therein, or (ii) beneficial interests in Borrower (if Borrower is not a natural person or persons but is a corporation, partnership, trust or other legal entity), Lender may, at Lender's option, declare all of the sums secured by this Instrument to be immediately due and payable, and Lender may invoke any remedies permitted by paragraph 27 of this Instrument. This option shall not apply in case of
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> (a) transfers by devise or descent or by operation of law upon the death of a joint tenant or a partner;
>
> (b) sales or transfers when the transferee's creditworthiness and management ability are satisfactory to Lender and the transferee has executed, prior to the sale or transfer, a written assumption agreement containing such terms as Lender may require, including, if required by Lender, an increase in the rate of interest payable under the Note;
>
> (c) the grant of a leasehold interest in a part of the Property of three years or less (or such longer lease term as Lender may permit by prior written approval) not containing an option to purchase (except any interest in the ground lease, if this Instrument is on a leasehold);
>
> (d) sales or transfers of beneficial interests in Borrower provided that such sales or transfers, together with any prior sales or transfers of beneficial interests in Borrower, but excluding sales or transfers under subparagraphs (a) and (b) above, do not result in more than 49% of the beneficial interests in Borrower having been sold or transferred since commencement of amortization of the Note; and
>
> (e) sales or transfers of fixtures or any personal property pursuant to the first paragraph of paragraph 6 hereof.

FNMA-FHLMC General Counsels' Conference 148-49 (1977).

clude, as an event triggering acceleration, the placing of a junior encumbrance on the property,[10] or selling the property by means of an installment contract.[11] The exact language of the clause may be crucial in determining whether it is the original borrower or his purchaser who has the burden of obtaining the lender's consent to the sale.[12]

CURRENT JUDICIAL AND STATUTORY APPROACHES: CONSUMERISM VERSUS PORTFOLIO PROTECTION

Courts have long seen fit to grant equitable relief to borrowers attempting to escape the enforcement of acceleration clauses. Especially appealing to equity has been the protection of a mortgagor against his inadvertent default.[13]

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10. This is a common provision in corporate mortgages, which is beyond the scope of this article.

11. Whether the installment contract is a "sale" that triggers the due-on-sale clause is a topic that has recently engendered considerable discussion. Comment, *Beyond Tucker v. Lassen: The Future of the Due-on-Sale Clause in California*, 27 HASTINGS L.J. 475 (1975). Newer versions of this clause deal specifically with this problem.

12. It may reveal an intention that the seller was obligated to obtain a consent or waiver by the mortgagee. Or it may allow this burden to fall on the buyer. Stewart Title & Trust Co. of Phoenix v. Ordean, 528 F.2d 894 (9th Cir. 1976). It has been held, quite reasonably, that the burden of proof rests on the borrower to show that his buyer is credit-worthy and the lender's security is not impaired. First Com. Title Inc. v. Holmes, 92 Nev. 363, 550 P.2d 1271 (1976).

13. Justice Cardozo stated the classic case for equitable relief from acceleration:

> There is no undeviating principle that equity shall enforce the covenants of a mortgage, unremoved by an appeal ad misericordiam, however urgent or affecting. The development of the jurisdiction of the chancery is lined with historic monuments that point another course . . . . Equity declines to give effect to a covenant . . . if it is so *unconscionable* . . . as to be equivalent in its substance to a provision for a penalty . . . .
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> . . . [A]cceleration clauses in mortgages do not constitute an exception. They are not a class, removed from interference by force of something peculiar in their internal constitution. . . . The distinction lies in this only, that the punctual *payment of interest has an importance to the lender as affecting his way of life*, perhaps the very means of his support, . . . [I]t is a difference merely of degree, . . . a test wherewith to gauge the measure of the hardships, the extent of the oppression.
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> . . . [T]here may be conditions in which the enforcement of such a clause according to the letter of the covenant will be disloyalty to the basic principles for which equity exists . . . .
>
> . . . [F]or always the gravity of the fault must be compared with the gravity of the hardship. (citations omitted) Let the hardship be strong enough, and equity will find a way . . . . Graf v. Hope Bldg. Corp., 254 N.Y. 1, 8-13, 171 N.E. 884, 886-89 (1930) (Cardozo, J., dissenting) (emphasis added).

A generation later, it was clear that Cardozo's dissent had become the law. Bisno v. Sax, 175 Cal. App. 2d 714, 728, 346 P.2d 814, 823 (1959) (citing other jurisdictions which also adopted the *Graf* dissent). Unconscionabil-

As the language of due-on-sale clauses became more sophisticated, some courts allowed the lender to exercise his contractual right according to the terms of the agreement.[14] Others, however, provided varying degrees of protection to the mortgagor.[15] One court attempted to synthesize the various decisions by providing the following classifications:

> No jurisdiction has held 'call clauses' to be invalid per se, and they have been enforced and found unenforceable by the various state courts in a rather patchwork application of equitable principles based on essentially five basic rationales: (1) a doctrine of strict construction requiring all conditions for acceleration to be met before acceleration is permitted; (2) a requirement that the mortgagee justify his refusal to consent to the purchase before acceleration is permitted; (3) acceleration permitted based on the premise the mortgagee has the right to protect the security unless it would be inequitable under the circumstances; (4) refusal to permit acceleration if no harm to the mortgagee would result from the transfer; (5) approval of acceleration clauses as a reasonable business practice and not as an unreasonable restraint on alienation, unless inequitable under the circumstances.[16]

As the court indicates, a survey of decisional law provides ready support for either the mortgagor's or mortgagee's position.

California's Statutory Approach

Several states have enacted statutes aimed at the provisions of mortgage contracts, and others can be expected to do so. As

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ity has become the key word in the court's adjudication of the validity of foreclosure based on acceleration clauses. *See, e.g.*, Delgado v. Strong, 360 So. 2d 73, 75 (Fla. 1978); Streets v. M.G.I.C. Mortgage Corp., 378 N.E.2d 915, 919 (Ind. App. 1978); Gunther v. White, 489 S.W.2d 529, 531 (Tenn. 1973); State Bank of Lehi v. Woolsey, 565 P.2d 413, 417 (Utah 1977); Miller v. Pacific First Fed. Sav. & Loan Ass'n, 545 P.2d 546, 549 (Wash. 1976). *See also* 55 AM. JUR. 2d *Mortgages* § 371 (1971).

The majority in *Graf* had allowed foreclosure where the default occurred after an arithmetical error by the mortgagor's clerk resulted in an underpayment of less than 10% of the interest on a payment for which payment had been tendered immediately upon discovery of the mistake. Protecting against inadvertent default is particularly appealing to modern courts of equity. *See* Rosenthal, *Role of Equity in Preventing Acceleration Predicated upon a Mortgagor's Inadvertent Defaults*, 22 SYRACUSE L. REV. 897 (1971).

Though Cardozo would have held for the mortgagor in *Graf*, his opinion stresses the importance of interest to a lender, and the need to balance hardships. That dissent was written during the great depression. Query for whom the great judge might hold in a "due-on-sale clause" case in a period of soaring interest rates? "In equity as in mechanics, action and reaction are equal and opposite. The equity that one asks one must be ready to concede." 254 N.Y. at 13, 171 N.E. at 889.

14. *See* note 4 *supra*.

15. *See* note 5 *supra*.

16. Continental Fed. Sav. & Loan Ass'n v. Filter, 564 P.2d 1013, 1017 n.4 (Okla. 1977). *See also Due-on Clause Report*, *supra* note 6.

might be expected, California is in the vanguard of states legislating in this area.

One statutory provision requires that, with four or fewer residential units, any acceleration clause must appear in both the mortgage and the note.[17] Evidently the legislature felt this additional consumer disclosure would be helpful, since California's use of the master mortgage[18] recording procedure might cause the clause to be overlooked on the short form master mortgage unless it also appeared on the mortgage note. In another section, acceleration is forbidden because of the mortgagor's placing a junior encumbrance on the property *only* where four or fewer housing units are involved.[19] This was a legislative reaction to a state supreme court decision[20] which had limited enforcement to cases where the placing of a junior encumbrance endangered the lender's security; the court apparently overlooked the fact that all corporate mortgages contain an elaborate clause forbidding junior financing. The difficulty with this provision is that it cannot be reconciled easily with the previous provision, also amended after the court decision, which implicitly validates such acceleration.[21]

The California statutes also forbid the use of the lock-in clause prohibiting prepayment.[22] In addition, there are limitations on allowable penalties for prepayment within five years, and a prohibition on penalties for prepayment after five years.[23]

In another section, California has authorized the use of a variable rate mortgage, with limitations placed on the mode, timing and extent of allowable changes in interest rates.[24]

This patchwork of provisions reveals the California legislature's conception of the equities of the mortgagor-mortgagee relationship. Simply put, whatever bears harshly on the mortgagor is inequitable. Should interest rates decline, the mortgagor is protected by being given the right to prepayment.

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17. CAL. [CIV.] CODE § 2924.5 (West 1974). *See also* VA. CODE § 6.1-330.34 (Supp. 1978) (requiring that a due-on-sale clause be "in capital letters or underlined").

18. *See* KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE § 58 (1972).

19. CAL. [CIV.] CODE § 2924.6(a)(5)(C) (West Supp. 1979). *Accord*, VA. CODE § 6.1-2.5 (Supp. 1978).

20. La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

21. Requiring that such a clause be embodied in both the mortgage and the note implies that such a clause is valid. *See* Marantz, *Consumerism Reaches the Sacrosanct Trust Deed*, 52 CALIF. S.B.J. 203 (1977).

22. CAL. [CIV.] CODE § 2954.5(a)(1) (West Supp. 1979) which applies to obligations of $100,000 or less.

23. CAL. [CIV.] CODE § 2954.5(b) (West Supp. 1979).

24. CAL. [CIV.] CODE § 1916.5 (West Supp. 1979).

Yet should interest rates increase, the mortgagee is afforded no protection except being allowed to implement highly unmarketable variable interest rate schemes.[25] The only alternative for the mortgagee is to resort to the due-on-sale clause upon the mortgagor's sale of the home to upgrade the interest rate paid by the next borrower. Under a straightforward reading of the California statutes, this would appear to be permissible.[26] However, the California Supreme Court has effectively precluded use of the clause for this purpose.

Wellenkamp v. Bank of America

A recent California Supreme Court decision appears destined to become a leading case limiting the applicability of the due-on-sale clause. In *Wellenkamp v. Bank of America*,[27] a borrower sold property subject to a mortgage deed of trust, and the lender threatened to accelerate the debt unless the buyer agreed to a higher interest rate. In an action by the buyer for injunctive and declaratory relief, the court held that the lender could only exercise the clause upon a showing that it was necessary to protect against impairment of the property or default by the buyer who assumed the debt.[28]

Declining to examine authority in other jurisdictions, the court framed the issue as whether, under California law, the "automatic" exercise of the clause constituted an unreasonable restraint on alienation.[29] The court's test of reasonableness involved balancing the "*quantum of restraint*, the actual practical effect upon alienation" against the justification for enforcement of the clause.[30] In prior dicta, the court had suggested that the restraint imposed by the clause in the case of an outright sale would be *de minimis*.[31] The court qualified these earlier statements, stating that it was then referring to the situation where the seller received full payment from the buyer and thus was

25. *See* note 55 and accompanying text *infra*.

26. This is not so in all states. *E.g.*, COLO. REV. STAT. § 38-30-165 (Supp. 1976) (bars the use of the clause unless the buyer is uncreditworthy and limits the increase in interest or fees upon the assumption of the mortgage).

Due-on Clause Report, *supra* note 6, finds that legislation on the exercise of the clause "has not prohibited, but has permitted such use within far more clearly defined limitations than the case law has provided." *Id.* at 935.

27. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

28. *Id.* at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86.

29. *Id.* at 948-49, 582 P.2d at 973-74, 148 Cal. Rptr. at 382-83.

30. *Id.*

31. *Id.* at 949, 582 P.2d at 974, 148 Cal. Rptr. at 383, referring to the court's previous decisions in Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1133, 97 Cal. Rptr. 849 (1971).

able to pay off the mortgage. In the usual case, the seller was able to obtain full payment because the buyer had obtained independent mortgage financing. The court noted that in times of tight money, new financing may become unavailable and the buyer may not be able to produce the cash to pay the full purchase price. Like the present plaintiff, the buyer would want to pay the seller only the amount of his equity and assume the debt remaining on the deed of trust. However, if the lender insists on exercising the clause in this situation, the buyer will be unable to provide the necessary funds and the sale will not be completed. If the buyer is compelled to refinance at a higher interest rate, he may insist on a lowering of the purchase price to have the seller absorb some or all of the increased cost. In either case, the court concluded, a significant restraint on alienation may occur.[32]

Against this potential restraint the court balanced the interests of the lender. The court found unpersuasive the lender's argument that the transfer of the property to an unapproved buyer increased the possibility of waste or default. Because the buyer may have made a relatively large down payment by giving the seller his equity, he would have sufficient incentive to protect the property. In addition, he may in fact be more creditworthy than the seller to whom the lender originally extended credit.[33]

The court also expressly found the lender's interest in maintaining its loan portfolio at current interest rates to be an improper motive for exercising the clause. Though it recognized the need for thrift institutions to provide their depositors with a competitive return, it stated that the due-on-sale clause could not be used to achieve that result. The sole purpose of the clause was to protect the lender's security against impairment. It is up to the lender to take into account factors of economic uncertainty and inflation in fixing the duration and interest rates on long-term loans. If the lender's forecasts fail to predict the actual increase in interest rates, the court stated, "it would be unjust to place the burden of the lender's mistaken economic projections on property owners."[34] The court concluded that "a due-on clause contained in a promissory note or deed of trust cannot be enforced upon the occurrence of an outright sale unless the lender can demonstrate that enforcement is reasonably necessary to protect against impairment to its security or the

32. *Id.* at 950-51, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.
33. *Id.* at 951-52, 582 P.2d at 975-76, 148 Cal. Rptr. at 384-85.
34. *Id.* at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385.

risk of default."[35]

The court expressly limited its decision to institutional lenders.[36] This reflects the fact that, when a private party sells his home and takes back a purchase money mortgage with a due-on-sale clause, he may conceivably have a different motivation than an institutional lender. When a home owner is forced by circumstances to sell during a period when no mortgage money is available to the potential buyer, he may execute a purchase money mortgage with a due-on-sale clause, intending that it be discharged as soon as conventional financing becomes available. The court expressed no opinion whether this type of mortgage could be accelerated upon the resale of the home.

Of course, the great majority of home sales involve a discharge of the existing first mortgage at closing. Technically, a brief breach of the clause may occur when an executory cash contract for sale is entered into. By no stretch of the imagination can this situation be deemed to fall within the intent of the due-on-sale clause, and *Wellenkamp* does not change the law in this regard.[37]

Restraints on Alienation—What Public Policy?

Little will be gained by rehashing the venerable property rules governing ancient restraints on alienation, or by struggling with the general formulations of the Restatement of Property that grapple with these traditional law school problems. It is also unnecessary to consider arguments attacking the clause as a clog on the equity. Clogging exists where the lender exacts a *collateral* advantage, such as the option to purchase other land owned by the borrower.[38] This well-understood doctrine is inappropriate in concept for dealing with the problems presented by the due-on-sale clause.[39]

The fact is that the rules of restraints on alienation have not had a logical or consistent development.[40] For any given form of restraint, its utility today tends to be measured against the inju-

35. *Id.*, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86.

36. *Id.* at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 385 n.9.

37. The technical breach occurs because the doctrine of equitable conversion makes the buyer the equitable owner upon the execution of the contract for the sale of land. At all events the existing mortgage is paid at closing.

38. *See generally* OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 96 (2d ed. 1970).

39. *But see* Koerselman, *Half-Way Mark Reached in the Demise of the Inequitable Application of the "Due-on-Sale" Clause*, 3 PEPPERDINE L. REV. 111 (1975).

40. *See* Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 123, 333 N.E.2d 1, 3 (1975) (citing authorities).

rious consequences flowing from its enforcement, and thus the decision will turn on the court's conception of sound public policy.[41]

Today there are strong reasons militating in favor of finding the due-on-sale clause a reasonable restraint on alienation without embarking upon a case-by-case inquiry into the motivation of the lender or the possible impairment of his security, subject always to the court's inherent obligation to probe for instances of unconscionable conduct. Policy considerations must go beyond protecting lenders from the transfer of the mortgaged premises to one deemed lacking in financial substance. Protection of one party to the transaction seems a biased approach. Surely sound public policy must take account of the need for the continued existence of financial institutions willing and able to finance the purchase of homes.

The Modern Purpose of the Clause

Wellenkamp states that the sole purpose of the due-on-sale clause is to protect against impairment of the lender's security.[42] The purpose of the clause, of course, is derived from the intentions of the parties agreeing to it. It is perhaps speculative to ascribe any intention to the *borrower*, since he probably first became aware of the clause when confronted with the lender's requirement of higher interest upon a sale subject to the mortgage. With regard to the *lender's* intention, there is little doubt that in its early history the clause was used simply to prevent the sale to a poor credit risk. However, the intention of lenders in the 1930's is not necessarily the same as in the modern era of rising interest rates and universally recognized inflation. At least in part, the due-on-sale clause in recent times owes its existence to the fact that thrift institutions are keenly interested in improving their yield by upgrading their loan portfolios.[43] These institutions know that the average home is sold

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41. It should be noted at the outset that the rule has not had a logical and consistent development. . . . This seems to be due to the fact that such restraints vary greatly in form, and the application of the rule has turned largely on such considerations as the kind of property involved, the quality of the interest, and the form of the restraint. It has been stated that 'probably nowhere in the law does one find more resort to dogma than here.' Carey and Schuyler, Illinois Law of Future Interests, p. 542.

While other reasons are sometimes given for the rule, it seems to call for no other than that of sound public policy. . . . (citations omitted).

Gale v. York Center Com. Coop., 21 Ill. 2d 86, 91, 171 N.E.2d 30, 32-33 (1960).

42. 21 Cal. 3d at 952, 582 P.2d at 977, 148 Cal. Rptr. at 385.

43. *See* Flaherty, *Illinois Land Trusts and The Due-on-Sale Clause*, 65 ILL. B.J. 376, 377 (1977).

every five to seven years, depending on the area of the country. With escalator clauses fettered by usury laws,[44] and alternative mortgage instruments largely untested,[45] it is clear that the due-on-sale clause is, in a period of apparently uncontrollable inflation, a useful weapon in compelling replacement of old mortgages with new ones bearing market interest rates. It is myopic for a court to overlook the inflationary forces made evident by the very price of the property sold.

The judicial interpretation of the no-assignment provisions of commercial and residential leases offers some analogy to the due-on-sale clause. By the great weight of authority, a no-assignment clause requiring landlord consent gives the landlord the right to refuse permission for any or for no reason.[46] At the same time, the landlord is not allowed to exercise the clause under certain conditions, such as the involuntary transfer of the lease by bankruptcy or execution sale.[47] An equivalent construction could be given the due-on-sale clause. In a typical home sale, the clause should be enforced according to its express terms without examining the lender's reasons, yet enforcement can still be denied when special circumstances would make acceleration unconscionable.

The Federal Home Loan Bank Board has taken a position consistent with this interpretation. It has promulgated a regulation giving across-the-board, retrospective and prospective recognition to the clause with respect to its use by federal savings and loan associations.[48] Thus, this highly responsible and well-informed agency has signalled its belief that the clause is essential to the financial health of the thrift institutions. This apparent conflict with the *Wellenkamp* decision and California statutes has given rise to a preemption controversy of major significance to the entire mortgage lending industry. Numerous cases pending in federal court raise the issue whether the enforceability of due-on-sale clauses contained in loan instruments executed between federal savings and loan associations and California residents should be governed by federal or state law. One federal district court has ruled that state regulation of the validity and enforceability of the due-on-sale clause in mortgage instruments of federal associations executed on or after June 8, 1976 has been rendered inapplicable because FHLBB

44. *See* note 53 and accompanying text *infra*.
45. *See* note 54 and accompanying text *infra*.
46. 1 M. FRIEDMAN, FRIEDMAN ON LEASES § 7.304a (1974).
47. KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE § 345 (1972).
48. 12 C.F.R. § 545.6—11 (1978).

regulations have preempted the field.[49]

THE DILEMMA OF THE THRIFT INSTITUTIONS

Prior to the credit crunch of 1966, thrift institutions were successfully bearing the burden of financing sales of housing in the United States. The interest rates offered depositers attracted sufficient funds to enable thrift institutions to provide fixed interest, long-term mortgages. A fairly well developed brokerage system allowed mortgage money to move from capital surplus to capital short areas without a corresponding movement of mortgage instruments.[50]

In 1966, interest rates rose and disintermediation began to occur. Most significantly, the interest rates offered by federal government securities resulted in massive withdrawals from the thrift system. Funds available for mortgages shrank, as did the spread between the interest rates offered depositors and the average interest rate of the thrift institutions' loan portfolios. The situation has repeated itself twice since then, and the specter looms today of another crunch caused by greater government participation in the money market. The need to finance a mushrooming federal debt is an unwelcome but obvious fact of life.

In contrast with the plight of the thrift institutions is the situation of commercial banks, which deal mainly in short-term loans tied to current interest rates and sweetened by compensating balances. Under present practices, the thrift institutions make long-term loans at interest rates which quickly become obsolete.[51] In order to keep funds in the thrift institutions, and hence in the home financing market, these institutions must be able to offer their depositors a return greater than that available from government securities. In addition, to keep these institutions solvent, they must be able to maintain a spread between the rate they offer depositors and that of their loan portfolio. In short, a method must be found to allow their long-term loans to respond to increases in interest rates. In an inflationary economy no lender can borrow short-term and lend long-term and survive.

49. Glendale Fed. Sav. & Loan Ass'n v. Fox, 459 F. Supp. 903 (C.D. Cal. 1978).

See Comment, *The Due-On Clause: A Preemption Controversy*, 10 LOY. L.A. L. REV. 629-30 n.2 (1977), for some thirty cases then pending.

50. *See* note 2 *supra*.

51. Ashley, *Use of "Due On" Clauses to Gain Collateral Benefits: A Common Sense Defense*, 10 TULSA L.J. 590, 592 (1975) [hereinafter cited as Ashley].

Current regulations permitting thrift institutions to offer higher interest rates on six-month certificate at yields slightly above the rate on twenty-six month Treasury bills, offer no solution. That rate jumped from 7 1/2% in June, 1978, to nearly 10% at the end of the year. "Any bank that took that expensive new money and invested it in a 30-year mortgage at 8 1/2% had to be stupid or crazy."[52]

Perhaps the least subtle approach to the problem has been attempts to index the principal of the loan to the consumer price index or another inflation barometer. However, the additional "principal" has been held to be interest, and thus this arrangement runs afoul of the usury laws.[53]

Alternative Mortgage Instruments

A still open question is whether any of the alternative mortgage instruments[54] currently being developed can withstand legal challenges and obtain marketplace acceptance. The principal forms being considered are: (1) the graduated payment mortgage (GPM), a fixed interest rate mortgage with a modified payment schedule, where the monthly payments start low and increase over the years, presumably in step with the increased income of the borrower; (2) the deferred interest mortgage loan (DIM), where principal payments are made according to a fixed schedule, but interest payments are deferred; (3) the reverse annuity mortgage (RAM), designed for the older borrower, who receives monthly or annual disbursements of the loan over his lifetime, with the home being sold after his death to discharge the debt; (4) the roll-over mortgage (ROM), similar to the present amortized mortgage except that at periodic intervals the interest rate is renegotiated; and (5) the variable rate mortgage (VRM), again similar to the present mortgage except that the interest rate varies within limits to reflect changes in the market rate of interest.

After extensive examination by Congress, the Federal Reserve Bank of Boston, and the Federal Home Loan Bank Board, serious objections to these instruments have emerged. Of threshhold importance is whether any of these arrangements

52. Vincent J. Quinn, president of Brooklyn Savings Bank, as quoted in Wall St. J., Jan. 2, 1979, at 28, col. 2.

53. Aztec Prop. v. Union Planters Nat'l Bank, 530 S.W.2d 756 (Tenn. 1975) *noted in* 7 MEMPHIS ST. L.J. 450 (1976) & 11 TULSA L.J. 450 (1976); Olwine v. Torrens, No. 861 (Pa. Sup. Ct., Sept. 22, 1975) *noted in* 93 BANKING L.J. 223 (1976).

54. *See generally* ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY (Federal Home Loan Bank Board) (D. Kaplan dir. 1977) [hereinafter cited as AMIR STUDY].

will be acceptable to mortgagors. In one survey, for example, when the VRM was explained fully to prospective home buyers, eighty-two percent opposed it. This is not surprising when it is realized that if two home purchasers in 1950 signed a conventional mortgage and a VRM respectively, the purchaser who opted for the VRM would be paying two and one-half times as much interest today.[55]

In addition, there are unresolved legal difficulties with the alternative mortgage instruments.[56] To touch upon the myriad problems buried in the RAM, for example, a borrower may be unaware that his mortgage income could destroy his eligibility for medicaid.[57] Alternative mortgage instruments bristle with complex legal and financial problems.[58] It is small wonder that the thrift institutions have been extremely reluctant to embrace these instruments. No statute or regulation attempts to deal with the host of problems these instruments present.[59]

It is totally unrealistic to conclude that untried alternative mortgage instruments provide a ready solution to the thrift institutions' dilemma. This, today is a question, not an answer. This makes the logic of enforcing the due-on-sale clause, as written, even more compelling. The mortgagor can still be given a

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55. H.R. REP. No. 95-1383, 95th Cong., 2d Sess., *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 9451; AMIR STUDY, *supra* note 54; NEW MORTGAGE DESIGNS FOR STABLE HOUSING IN AN INFLATIONARY ENVIRONMENT (Federal Reserve Bank of Boston) (F. MODIGLIANI & D. LESSARD eds. 1975).

56. Another factor that must be considered is the fact that the low or no reduction of principal in the early years of a GPM mortgage increases lender risk. This is accentuated by the fact that such loans may be ineligible for PMI insurance. The Model Private Mortgage Insurance Act, in force in 20 states, requires the mortgage to have regular equal monthly payments. AMIR STUDY, *supra* note 54, at Vol. III, xx-7.

57. *See* Ege, *Legal Implications of the Alternative Mortgage Instrument*, in AMIR STUDY, *supra* note 54, at Vol. III, xx-30 (1977).

58. Barnett, *Alternative Mortgage Instruments: How to Maintain Lender Status*, 96 BANKING L.J. 6 (1979).

59. The *Wellenkamp* court suggested the AMIs were preferable to "due-on-sale" clauses as a means of protecting the lender's portfolio yield. 21 Cal. 3d at 952 n.10, 582 P.2d at 976 n.10, 148 Cal. Rptr. at 385 n.10.

The FHLBB has authorized the use of AMIs in California as of Jan. 1, 1979. Wall St. J., Dec. 15, 1978, at 5, col. 1. At the same time, the Board adopted permanent regulations for GPM, VRM and RAM AMIs. 43 Fed. Reg. 59336 (1978) (to be codified in 12 C.F.R. § 545.6-2). The regulations limit associations to no more than a 50% investment in VRMs and the program will be reevaluated in four years. *See* FHLBB Fact Sheet, December 13, 1978. *See also* Goldman, *Disintermediation Under the Microscope*, 75 F.H.L.B.B.J. 13 (1975); Cassidy & McElhone, *The Flexible Payment Mortgage*, 74 F.H.L.B.B. J. 7 (1974).

On January 25, 1979, Senator William Proxmire introduced legislation which would codify the FHLBB's action. Variable Rate Mortgage Act of 1979, S.218, 96th Cong., 1st Sess., 125 CONG. REC. 647-48 (1979). The preamble to this Bill reveals an intensely negative attitude toward the AMI.

fixed interest, long-term loan. But when the home is sold before the mortgage is paid off according to its terms, the thrift institution is always allowed to bring the interest into line with current market rates. If the courts refuse to allow the thrift institutions this opportunity over an extended period of rising interest rates, one questions whether the present form of fixed interest mortgage can survive.[60] And at present it has no viable replacement.

Tunnel Vision Consumerism

Restraint of alienation decisions have always been founded on the tenets of public policy, and the pronounced trend of policy today is in favor of consumerism. However, *Wellenkamp* and the other pro-borrowers decisions, while ostensibly consumer oriented, tend to examine the consumer's interest rather narrowly.

While no statistics are available, the decisions make it clear that the institution seeking to enforce the due-on-sale clause is almost invariably a savings and loan association. Of these, the great majority of these associations are mutual as opposed to stockholder associations. A mutual savings and loan association is hardly a grasping financial monster sucking the life blood of the downtrodden. It is an entity that makes home purchases possible and distributes its earnings to its depositors, most of whom are home owners.

On the other hand, the parties obtaining the benefits of nonenforcement of the clause under the *Wellenkamp* approach are the mortgagor and the new buyer of the home. The buyer is in a class of consumers least in need of a low interest rate. He is the rare purchaser who is able to come up with the large down payment needed to buy a home subject to a mortgage. His savings, no doubt, were invested up to the moment of home purchase in high-yield investments. Moreover, in actual practice, if he bargains with the lender for consent to the sale he will often be able to negotiate refinancing at below the current interest rate. The argument that the purchaser needs protection from the possibility of having his sale opportunities limited is palpably fallacious. There is nothing unconscionable about a buyer paying current market rates. But all home purchasers need protection from having the source of new mortgage funds dry up.[61]

60. Bartke & Tagaropulos, *Michigan's Looking Glass World of Due-on-Sale Clauses*, 24 WAYNE L. REV. 971 (1978).
61. *See generally* Ashley, *supra* note 51.

POSSIBLE SOLUTIONS

Redrafting the Clause

The controversy over the clause in its present form gives rise to the question of whether it can be modified to increase the probability of its enforcement. An obvious improvement would be to have the clause state that, to obtain a waiver of acceleration, the new buyer must be personally satisfactory to the lender, and criteria for satisfying the lender would include the buyer's willingness to pay the current interest rate. The mortgage document could also state that an express intention of the clause is to allow the lender to refinance the loan at current rates in the event of the mortgagor selling the home. This language would serve to explicitly identify the purposes of the clause to include portfolio upgrading. It would also anticipate an argument by the mortgagor that the lender unfairly failed to disclose his motivation at the time the contract was entered into. This drafting approach might assist a lender before a court considering the propriety of the clause as a novel question. However, it is not suggested that this language would lead to a reversal of position in those jurisdictions that have rejected the portfolio argument.[62] Nor would it be helpful as to mortgages constituting a lender's present portfolio.

The Uniform Land Transactions Act

It has been suggested here that the reasoning behind *Wellenkamp* and other pro-borrower decisions is unsound. A statute may be necessary to permit enforcement of the due-on-sale clause according to its terms. The Uniform Land Transactions Act, approved by the Uniform Commissioners and approved by the American Bar Association in February, 1978, advocates such enforcement. In commenting on the Act's adoption of a due-on-sale clause, one commentator states:

> This provision[63] rejects a recent trend of some courts to hold that the lender may not accelerate the debt under a due-on-sale clause unless he can show a reasonable basis to believe that the sale would impair the security. Apparently, the drafters believed that because of a justifiable business interest of lenders to adjust interest rates upward periodically in accordance with economic conditions, acceleration under a due-on-sale clause is always

62. *Cf.* Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 173-74, 250 N.W.2d 804, 809 (1977) ("We need not decide here whether disclosure . . . of the . . . clause's function as protection for the mortgagee's portfolio would make more cogent the argument that enforcement . . . is reasonable"). *See also* Crockett v. First Fed. Sav. & Loan Ass'n. of Charlotte, 289 N.C. 620, 633-34, 224 S.E.2d 580, 589 (1976) (Lake, J., dissenting).

63. ULTA § 3-208(a).

reasonable.[64]

Adoption of this Act would thus permit use of the clause by thrift institutions to upgrade their portfolios and would give effect to the views of the great body of American real property scholarship. The Uniform Act, in short, offers a genuine long-term solution to the problem.

Federal Relief

The very comprehensiveness of the Federal Home Loan Bank Board study of alternative mortgage instruments[65] is evidence of the strong interest of the federal government in providing new tools that will allow thrift institutions to continue mortgage financing. Possibly, alternative mortgage instruments can be made both fair and workable. Congressional movement, however, is glacial in tempo. The FHLBB's recent action, in light of Congressional inaction and possible disapproval, can only stress how seriously the Board viewed the dilemma of the thrift institutions.[66]

CONCLUSION

Despite the fact that it originally had a more narrow purpose, the due-on-sale clause has assumed the additional role of allowing thrift institutions to replace mortgage loans at obsolete rates with loans at current market rates. In this era of rising interest rates, with no viable alternatives near at hand, it is imperative that these institutions be allowed to do this if they are to continue mortgage financing. The courts that have rejected the portfolio argument seem to disregard current social and economic reality.[67] If this judicial trend continues, the conse-

64. Bruce, *Mortgage Law Reform Under the Uniform Land Transactions Act*, 64 GEO. L.J. 1245, 1272 (1976).

65. AMIR STUDY, *supra* note 54.

66. *See* note 59 *supra*. In introducing his bill, Senator Proxmire recognized the controversy and doubts about VRMs and termed the Board's action as "unfortunate," but thought it "essential that the Congress *act swiftly* to reassert its authority and control of public policy on this issue." 125 CONG. REC. 647 (1979) (emphasis added).

Finally, it has been recently reported that the Carter administration is considering fundamental changes in banking regulations that could lead to higher interest for savers and put thrift institutions in more direct competition with banks. Wall St. J., Feb. 22, 1979, at 2, col. 3.

67. *See Due-on Clause Report*, *supra* note 6, at 936:

> The determination of public policy as so propounded by the California Supreme Court [in *Wellenkamp*] is a province of the legislature, and not of the courts. A trend emerging from courts in placing burdens merely on the basis of who can best afford to pay the risk is alarming, especially when this determination is made on speculative and theoretical reactions, and not on intellectual inquiry.

quences could be devastating. It is time for members of the bar to seek a statutory solution to the dilemma of the thrift institutions.

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