Due-on-Sale in the Secondary Mortgage Market

Alan J. Blocher
DUE-ON-SALE IN THE SECONDARY MORTGAGE MARKET

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During the seventies, the mortgage finance industry witnessed the growth of two developments that threaten to collide during the eighties. These developments were the maturation of the secondary market\(^1\) for conventional mortgages\(^2\) and a disparity of treatment of "due-on-sale" clauses\(^3\) by the states. As recently as a few years ago, these subjects would have been of interest only to real estate professionals and a handful of legal scholars. Today, however, they have assumed greater importance because of the state of the home mortgage business. This article will discuss both of these developments and suggest an approach to avoid the harmful effects of the threatened collision.

I. SECONDARY MARKET DEVELOPMENT

Prior to 1970 there was an active secondary market for mortgages insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). In 1970, for example, $12.6 billion in FHA/VA loans were originated on one to four family properties, and an amount equal to 90% of these loans were placed in the secondary market. On the other hand, of the $23 billion in conventional mortgages that were originated on the same type of properties, sales in the secondary market

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1. "The secondary mortgage market is the aggregate buying, selling, and trading of existing mortgage loans and mortgage related securities." UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS, SAVINGS AND LOAN FACT BOOK '80, at 35 (1980).

2. 12 U.S.C. § 1451(i) (1976) defines a conventional mortgage for the purposes of the Federal Home Loan Mortgage Corporation as "a mortgage other than a mortgage as to which the Corporation has the benefit of any guaranty, insurance or other obligation by the United States or a State or an agency or instrumentality of either."

3. "Due-on-sale" clauses vary in scope and language. Normally, they are provisions within a mortgage or deed of trust (these terms are used interchangeably throughout, unless indicated otherwise) which enable the mortgagor to accelerate the debt upon the transfer of specified interests by the mortgagor.
amounted to only 12% of that year's originations.\(^4\)

There were three main reasons for the high degree of activity in FHA/VA loans and the relatively low secondary market activity in conventional mortgages, despite the almost two to one preponderance of conventional mortgage originations. First, FHA/VA mortgages carry the benefits of insurance or guaranty by the United States; therefore, purchasers of such loans are assured of the ultimate collection of the mortgage, regardless of what happens to the paying ability of the borrower.

Second, by requiring the use of approved document forms, the FHA and VA imposed fungibility on the mortgages they insured or guaranteed. The twin advantages of government guaranty and uniformity of documents were lacking in the conventional mortgage market. An observer has noted:

>[A] necessary precondition to a viable secondary market in mortgages is the existence of a relatively fungible product. There are probably over 2,000 mortgage deed of trust and related forms in common use in the 55-odd jurisdictions in the United States. An association in Florida, for example, is not very willing to purchase a deed of trust from California if it is used to a mortgage, and the instrument is not guaranteed by the Federal Government.\(^5\)

The third reason for the higher degree of activity in mortgages was the existence of a federally-sponsored secondary market for FHA/VA mortgages. In 1948, the Federal National Mortgage Association (FNMA) was created to provide a market for FHA loans.\(^6\) In 1968, activities of FNMA were divided between two separate structures. Support of subsidized housing programs was kept within the Department of Housing and Urban Development (HUD) in the Government National Mortgage Association (GNMA).\(^7\) A new FNMA,\(^8\) part governmental and part private, was established for the nonsubsidized FHA/VA programs. In 1970, FNMA purchased $5.1 billion of FHA/VA loans and retained a portfolio of $15.5

\(^4\) Dept of Housing and Urban Development, Supply of Mortgage Credit 70-79 (May 21, 1980).


\(^8\) Id. § 1716b. Although FNMA is owned by private stockholders, the President of the United States appoints 5 of its 15 directors. Id. § 1723(b). The approval of the Secretary of HUD is required for certain FNMA initiatives. See, e.g., id §§ 1717(b)(3), 1718(c), 1719(b). In addition, FNMA has a line of credit with the United States Treasury (currently $2.25 billion) which it may call upon, although it has not done so in the past.
billion,\(^9\) thus providing a significant outlet for sellers of government-backed mortgages.

Recognizing the need for an organized secondary market for the more numerous conventional mortgages, Congress enacted the Emergency Home Finance Act of 1970.\(^{10}\) Title II of the Act granted FNMA the authority to deal in conventional mortgages.\(^{11}\) Title III created a new entity, the Federal Home Loan Mortgage Corporation (FHLMC), "authorized to purchase, and make commitments to purchase, residential mortgages . . ."\(^{12}\)

Previously, although savings and loans as a group represented the largest holder of mortgages, the bulk of FNMA's dealings were with mortgage banking firms that originated FHA/VA mortgages for immediate sale to permanent investors.\(^{13}\) Because savings and loan associations were primarily conventional mortgage lenders and were the largest holders of mortgages, the success of a secondary market for conventional mortgages required their participation. FHLMC, therefore, was structured in a way to promote participation by savings and loan associations. For example, its Board of Directors includes the same three people who serve as the members of the Federal Home Loan Bank Board,\(^{14}\) which regulates the federally-chartered savings and loan associations. Its capital stock may be issued only to the Federal Home Loan Banks,\(^{15}\) which serve the savings and loan associations in much the same way that the Federal Reserve Banks serve the commercial banking industry. Thus, by the creation of FHLMC and the expansion of FNMA's authority to include the purchase of conventional mortgages, the means were provided for the development of a government-sponsored secondary market for conventional mortgages.

The difficulties inherent in the task of developing such a market were identified by an observer:

Unfortunately, the home mortgage market lacks several prerequisites of a smoothly operating market and therefore finds it

\(^9\) United States League of Savings Associations, Savings and Loan Fact Book '80, at 115 (1980).
\(^{12}\) Id. § 1454(a)(1).
\(^{13}\) In 1970 savings and loan associations held 47% of the total holdings of mortgages on one to four family dwellings in the United States ($310.7 billion of the total $656.6 billion). In 1979 savings and loan associations held 54% of the total ($479.1 billion of the total $890.2 billion). 66 Fed. Res. Bull. A41 (July 1980).
\(^{15}\) Id. § 1453 (1976).
difficult to compete with other money markets for the available amount of savings. First, the trading units are usually too large to attract modest investors. Secondly, the units lack homogeneity and fungibility. Thirdly, there are servicing problems to consider. Lastly, mortgages lack liquidity or marketability and therefore, once again, are at a disadvantage when compared to competing instruments.16

Notwithstanding these difficulties, giant steps were made in less than ten years following the creation of the FHLMC and the expansion of the FNMA's authority. Perhaps the best measure of the success of FNMA and FHLMC is the realization that, having started without any conventional loans in the beginning of 1971, by the end of 1979 FNMA had a conventional mortgage portfolio of $16.1 billion,17 and FHLMC was supervising a conventional portfolio of $18.2 billion.18 In addition, several large financial institutions, such as the Bank of America and the California Federal Savings and Loan Association, had issued mortgage-backed securities collateralized by conventional home mortgages, thereby directly accessing capital available from investors who were not previously interested in mortgage investments.

II. UNIFORM DOCUMENTS

The marketability of conventional mortgages depended, as mentioned above, on the development of uniform mortgage documents. The staffs of FNMA and FHLMC prepared notes, mortgages, and deeds of trust for each jurisdiction. Although some tailoring was necessary to accommodate state law, there was an attempt to make covenant clauses as uniform as possible. The due-on-sale clause has always been one of these uniform covenants.

In the first exposure draft of the mortgage forms, dated November 18, 1970, covenant 9, the due-on-sale clause, read as follows:

**Acceleration.** Upon the occurrence of any of the following, all of the sums secured by this Deed of Trust shall be immediately due and payable at the option of Lender, without notice or demand, which Borrower hereby expressly waives: (e) the sale or transfer of the Property, or any part thereof or interest therein, by Borrower without Lender's written consent...

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19. Senate Comm. on Banking, Housing and Urban Affairs, *Federal Na-
A second exposure draft, dated February 3, 1971, restricted the lender's rights in what was then covenant 17:

Acceleration. Upon the occurrence of any of the following events of default, Lender may during the continuance of such event, by notice to Borrower, declare the sums secured by this Deed of Trust to be immediately due and payable without demand: . . . (c) without Lender's prior written consent, the sale or transfer by Borrower of the Property, or any part thereof or interest therein, not, however, including the creation of any lien or encumbrance subordinate to this Deed of Trust, a transfer by devise or descent, or the grant of any leasehold interest of three years or less not containing an option to purchase.20

There were two significant differences between the two exposure drafts. First, the second draft provided greater protection to borrowers than did the first draft as the second draft required that notice of acceleration be given to borrowers. Second, in the first exposure draft the default was triggered by the transfer of any interest in the property, whereas the second exposure draft eliminated three significant interest transfers from the definition of default (i.e., junior liens, transfer by will or intestate inheritance, and short term rental).

FNMA and FHLMC sponsored a two day public meeting on April 5 and 6, 1971 in Washington, D.C. to hear the views of lenders, consumers and legislators regarding the proposed forms. The purpose of the meeting was identified in the opening remarks of Chairman Albert Rains, a former Congressman who had been Chairman of the Housing Subcommittee of the House Banking and Currency Committee. Chairman Rains stated:

Those familiar with the legislative history of the secondary market for conventional loans . . . will agree one of the major considerations that led Congress to authorize the program was the need to develop so far as possible some kind of uniformity in mortgage documents.

In developing this uniformity, however, it's imperative that to the extent possible an evenhandedness in the rights and duties between the borrower and the lender be achieved.21

Many of the forty-three individuals who presented their views at the meetings discussed the acceleration clause. Lenders asked for at least a retention of the rights expressed in the first exposure draft, while consumer

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20. Id. at 18.
21. Id. at 1.
representatives attacked the draft as overreaching. Legislators sided with the consumers.

Typical of the lenders' views was the statement of Lewis S. Eaton, president of the Fresno Guarantee Savings and Loan Association of Fresno, California, who was then president of the United States Savings and Loan League. Mr. Eaton stated: "[P]ermitting the lender to call the loan if he so desires in the event of a change of ownership is in the public interest."\(^{22}\)

John A. Spanogle, Jr., of the Public Interest Research Group, viewed the issue somewhat differently:

Covenant 17(c) of the FNMA form permits acceleration of the debt if borrowers sells [sic] the property, whether the lender's security interest is impaired or not. In recent times lenders have refused to allow transfer of the property and have also refused to make new loans. This effectively prohibits the homeowner from selling his house during periods of tight money, making him immobile in a mobile society.\(^{23}\)

As a result of the opposition to the acceleration clause, the two corporations issued separate document forms. The FHLMC form contained a new expanded covenant 17:

Transfer of the Property; Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or an encumbrance subordinate to this Deed of Trust, (b) the creation of a purchase money security interest for household appliances, (c) a transfer by devise, descent or by operation of law upon the death of a joint tenant or (d) the grant of any leasehold interest of three years or less not containing an option to purchase, Lender may, at Lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable. Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the Property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender and that the interest payable on the sums secured by this Deed of Trust shall be at such rate as Lender shall request. If Lender has waived the option to accelerate provided in this paragraph 17 and if Borrower's successor in interest has executed a written assumption agreement accepted in writing by Lender, Lender shall release Borrower from all obligations under this Deed of Trust and the

\(^{22}\) Id. at 45.

\(^{23}\) Id. at 116.
Due-On-Sale Clause

Note.24 This provision differed from the provision in the second exposure draft by the addition of two exclusions. A purchase money security interest for household appliances would no longer trigger default, thus eliminating the possibility that the purchase of a new stove on credit could constitute a default of the first mortgage. The new language also clarified that a transfer to a joint tenant by operation of law would not be considered a default.

In addition, the language of the expanded covenant 17 put the borrower on notice that the lender could require an increase of the interest rate as a condition to the consent to a transfer. The provision further provided that the lender became obligated to release the original borrower from any personal liability if the purchaser signed an assumption agreement.

Mortgage forms containing the above language were distributed by FHLMC in December 1971. The FNMA issued forms identical to those issued by the FHLMC with two exceptions. Whether because the FNMA was more sensitive to the public criticism voiced at the hearings, or because it read the prevailing political pressures differently, the FNMA issued mortgage forms that did not include the expanded covenant 17 language and note forms that did not contain a prepayment penalty provision.25

The two corporations had separate documents until June 1975.26 At that time joint documents were released which contained the covenant 17 language of the FHLMC form. That language remains unchanged to date.

III. STATE COURT DECISIONS DISFAVORING ENFORCEMENT

While the secondary market was developing, the state courts were coming to grips with due-on-sale provisions. Typically cases arose in one of two ways: either the issue of enforceability of the clause would be raised by a borrower seeking a declaratory judgment to prohibit enforcement of the clause in the face of a transfer rejected by the lender, or the issue would be raised as a defense by a borrower who ignored the lender's refusal to consent and was subjected to a foreclosure action. Although one goal in the secondary market development process was uniformity, there was no

24. FHLMC Deed of Trust for California 12/71, Covenant 17.
25. For a complete discussion of the development of the FNMA/FHLMC Uniform Instruments, see Jensen, Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure, 7 REAL PROP. PROB. & TR. J. 397 (1972).
26. FNMA would accept FHLMC forms provided the servicing lender agreed not to enforce the due-on-sale provision or the prepayment penalty. FHLMC would not accept the FNMA form in lieu of its own form.
similar concern among the courts interpreting the various clauses before them.

Any review of state court action in this area must of necessity start with California. That state was one of the earliest to speak to the issue and is looked to most frequently by other courts considering whether a due-on-sale provision is a restraint on alienation. In *Coast Bank v. Minderhout* 27, Justice Traynor, speaking for the California Supreme Court, stated: “The view that the common-law rule against restraints on alienation prohibits all such restraints has been forcefully criticized on the ground that it loses sight of the purposes of the rule and needlessly invalidates reasonable restraints designed to protect justifiable interests of the parties.” 28 The court concluded: “In the present case it was not unreasonable for [the lender] to condition its continued extension of credit to the [borrowers] on their retaining their interest in the property that stood as security for the debt.” 29

The California Court of Appeals, relying on *Coast Bank* in *Hellbaum v. Lytton Savings and Loan Association*, 30 stated: “It is settled that an agreement not to encumber or transfer property, exacted by a lender to protect his security interest, is not an invalid restraint on alienation.” 31 In *Hellbaum*, the lender had not expressed dissatisfaction with the proposed transferee, but had insisted on an assumption fee equal to 5% of the $274,000 loan. The court concluded: “[T]he terms complained of do not necessarily constitute an unreasonable restraint on alienation. The complaint does not allege that the fees proposed to be exacted were so large as to have no reasonable relation to the justifiable interests of the lender...” 32

The high watermark (or low watermark, depending on one’s perspective) was reached in *Cherry v. Home Savings and Loan Association*. 33 The mortgage in question had a due-on-sale provision which gave the lender the option to call the loan upon transfer, but made no reference to waiving that right upon payment of a fee or higher rate. The savings and loan association refused to consent to a transfer unless Cherry agreed to pay an assumption fee and to accept an increased interest rate.

The court of appeals acknowledged and accepted the economic arguments made by the lender in the following often-cited language:

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27. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).
28. *Id.* at 316, 392 P.2d at 268, 38 Cal. Rptr. at 510.
29. *Id.*
31. *Id.* at 458, 79 Cal. Rptr. at 11.
32. *Id.* at 459, 79 Cal. Rptr. at 11.
[T]he lender places some value on his belief that the person who takes out the loan is reliable and responsible. A lender may, indeed, be willing to loan money to some persons or entities at one rate of interest but to other, less desirable risks only at an increased rate.

Secondly, loan agreements frequently permit a borrower to pay off a loan before it is due. When interest rates are high, a lender runs the risk they will drop and that the borrower will refinance his debt elsewhere at a lower rate and pay off the loan, leaving the lender with money to loan but at a less favorable interest rate. On the other hand, when money is loaned at low interest, the lender risks losing the benefit of a later increase in rates. As one protection against the foregoing contingency, a due-on-sale clause is employed permitting acceleration of the due date by the lender so that he may take advantage of rising interest rates in the event his borrower transfers the security. This is merely one example of ways taken to minimize risks by sensible lenders.\(^3\)

That the court of appeals in Cherry considered the due-on-sale clause reasonable per se and entitled to automatic enforcement became evident when the court stated: "[Home Savings and Loan Association] had the power of free decision regarding use of its money by others, the right to determine in its own discretion whether it would exercise its option, and it had no obligation to act only in a manner which others might term reasonable."\(^3\)

Two years later, in 1971, the California Supreme Court had the opportunity to review the Hellbaum and Cherry rationales in La Sala v. American Savings and Loan Association.\(^3\) That case involved a due-on-encumbrance clause which was triggered when the borrowers took out a second mortgage. The lender then attempted to obtain an increase of the interest rate on the first mortgage as the price for waiving its right to accelerate the loan.

The court distinguished the rationale behind a due-on-sale clause and a due-on-encumbrance clause in a footnote quoting the Cherry economic rationale permitting lenders to increase rates. The court stated that, while

34. \textit{Id.} at 579, 81 Cal. Rptr. at 138.
35. \textit{Id.} at 579-80, 81 Cal. Rptr. at 139.
36. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).
37. A due-on-encumbrance clause provides for acceleration upon the sale, conveyance, transfer, disposition or any such encumbrance of the property. In contrast, a due-on-sale clause provides for acceleration only upon the sale of property. \textit{Id.} at 869, 489 P.2d at 1115, 97 Cal. Rptr. at 851.
the *Cherry* argument might be valid for the sale of a home, it was not valid in a case such as this where a homeowner obtains a second mortgage:

Acceleration upon sale of the property, in other words, does not seriously restrict alienation because the sale terms can, and usually will, provide for payment of the prior trust deed.

A junior encumbrance, on the other hand, often represents only a small fraction of the borrower's equity in the property; it does not often provide the borrower with the means to discharge the balance secured by the trust deed. Thus under a due-on-en-cumbrance clause the borrower is exposed to a detriment quite different than that involved in a sale.\(^{38}\)

The distinction between the due-on-sale situation and the due-on-en-cumbrance scenario described above does not appear helpful since, for the most part, the courts could anticipate having to decide due-on-sale cases only where the sale terms do not provide for payment in full for the trust deed. The distinction between *Cherry* and *La Sala* became more confusing when the court continued: "In any event, a restraint on alienation cannot be found reasonable merely because it is commercially beneficial to the restrainor."\(^{39}\)

Thus, the *La Sala* court appeared ready to disfavor *Cherry*, or at least to apply some limitations on the application of lenders' rights. Nevertheless, in summary the court stated:

[W]e have concluded that the lender may insist upon the automatic performance of the due-on-sale clause because such a provision is necessary to the lender's security. We have decided, however, that the power lodged in the lender by the due-on-en-cumbrance clause can claim no such mechanical justification. We sustain it only in the case of a trial court's finding that it is reasonably necessary to the protection of the lender's security . . . . \(^{40}\)

At least one commentator noted the inconsistency of the court's reasoning in reconciling *Cherry* and *La Sala* and suggested: "For the reasons enunciated in *La Sala* regarding due-on-encumbrance clauses, the due-on-sale clause should likewise be enforced only when reasonably necessary to protect a justifiable interest in the lender's security."\(^{41}\)

The next step in the line of cases disfavoring due-on-sale clauses oc-

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38. *Id.* at 880 n.17, 489 P.2d at 1123 n.17, 97 Cal. Rptr. at 859 n.17.
39. *Id.* at 880-81 n.17, 489 P.2d at 1123-24 n.17, 97 Cal. Rptr. at 860 n.17.
40. *Id.* at 883-84, 489 P.2d at 1126, 97 Cal. Rptr. at 862.
curred in 1974 when the California Supreme Court ruled, in *Tucker v. Lassen Savings and Loan Association*,42 that acceleration because of the execution of a land sales contract "would result in a restraint on alienation of very considerable proportions."43 The facts of the case made it easy for the court to focus on the economic arguments involved. Shortly after the Tuckers purchased property with the proceeds of a loan granted by Lassen Savings and Loan Association, the property was rented with the bank’s knowledge and apparent lack of objection. The Tuckers then attempted to sell the property to the tenants under a land sales contract. The bank refused to consent unless the tenants assumed the existing loan and the parties agreed to pay an increased interest rate. When the purchasers balked, the sales price was reduced to the outstanding balance of the mortgage at the increased rate. Thus, the Tuckers lost the difference between the original contract price and the amount of the mortgage.

For the first time, the court looked at the degree of restraint involved and suggested a weighing of factors:

[I]t is not only the justification for enforcing a particular restraint which is relevant to the determination of whether such a restraint is ‘reasonable’ within the meaning of *Coast Bank*; we must also consider the quantum of restraint—that is the actual practical effect upon alienation which would result from enforcement of the restraint. . . . To the degree that enforcement of the clause would result in an increased quantum of actual restraint on alienation in the particular case, a greater justification for such enforcement from the standpoint of the lender’s legitimate interests will be required in order to warrant enforcement.44

In a footnote, the court suggested that it might be willing to examine the economic justification for exercise of a due-on-sale clause in an outright sale situation, as set forth in *Cherry*, but that it would extend the *La Sala* reasoning to land contract situations:

We reject the suggestion that a lender’s interest in maintaining its portfolio at current interest rates justifies the restraint imposed by the exercise of a ‘due-on’ clause upon the execution of an installment land contract. Whatever cogency this argument may retain concerning the relatively mild restraint involved in the case of an outright sale (a matter to which we do not now address ourselves) it lacks all force in the case of the serious and extreme restraint which would result from the automatic enforcement of

43. *Id.* at 637, 526 P.2d at 1174, 116 Cal. Rptr. 639.
44. *Id.* at 637, 526 P.2d at 1173, 116 Cal. Rptr. 638 (emphasis in original).
'due-on' clauses in the context of installment land contracts.\textsuperscript{45}

A commentator has suggested that the distinction between the apparently unrestrained rights of the lender in outright sales situations, as in \textit{Coast Bank} and \textit{Cherry}, and the restrictions placed on junior liens and land contracts in \textit{La Sala} and \textit{Lassen} is unnecessary. All "due on" clause cases should be subject to the \textit{La Sala} and \textit{Lassen} reasoning, with the lender bearing the burden of showing a threat to its security interest before the clause would be enforced.\textsuperscript{46} However, the lower California courts were unwilling to pick up the clues laid down in \textit{La Sala} and \textit{Lassen}. In \textit{Medovoi v. American Savings and Loan Association},\textsuperscript{47} the court of appeals reviewed \textit{Cherry}, \textit{La Sala} and \textit{Lassen} and concluded that the \textit{La Sala} and \textit{Lassen} restrictions were not intended to cover outright sales.\textsuperscript{48}

In 1978, the California Supreme Court addressed the outright sale situation head-on, reexamining \textit{Coast Bank} and \textit{Cherry} in \textit{Wellenkamp v. Bank of America}.\textsuperscript{49} In a fact pattern similar to \textit{Cherry}, a deed transferring title to Ms. Wellenkamp was recorded and the Bank of America was notified. The Bank of America responded by offering to waive its right to accelerate in return for Ms. Wellenkamp's agreement to assume the loan with an increase of interest from 8\% to 9 1/4\%. When Ms. Wellenkamp refused to consent to the increased rate, the Bank filed a notice of default, and Ms. Wellenkamp sought an injunction against the enforcement of the due-on-sale provision. The lower court sustained the Bank's demurrer to the complaint on the ground that it failed to state facts sufficient to constitute a cause of action since automatic enforcement of a due-on-sale clause was valid under California law.\textsuperscript{50}

The California Supreme Court reversed, holding 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 \textit{reasonably necessary to protect against impairment to its security or the risk of default}.'\textsuperscript{51}

The court specifically rejected the economic analysis of \textit{Cherry},\textsuperscript{52} on the assumption that due-on-sale clauses were intended solely to protect against

\textsuperscript{45} Id. at 638 n.10, 526 P.2d at 1175-76 n.10, 116 Cal. Rptr. 640 n.10 (citation omitted).
\textsuperscript{47} 62 Cal. App. 3d 317, 133 Cal. Rptr. 63 (1976).
\textsuperscript{48} 133 Cal. Rptr. at 71-72.
\textsuperscript{49} 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).
\textsuperscript{50} Id. at 947, 582 P.2d at 972, 148 Cal. Rptr. at 381.
\textsuperscript{51} Id. at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86 (emphasis added) (footnote omitted).
\textsuperscript{52} Id. at 952-53, 582 P.2d at 977, 748 Cal. Rptr. at 385.
“the risk to the lender that waste or default will occur.” The court concluded: “[W]e believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against impairment to the lender's security that is shown from a transfer of title.”

The court reached these conclusions by first examining Coast Bank, La Sala, and Lassen. The court found that Coast Bank stood for the proposition that due-on-sale clauses were reasonable restraints on alienation if the restraint was necessary to prevent impairment to the lender's security. La Sala not only required an examination of whether or not the restraint was necessary to prevent impairment of the lender's security but also the effect that enforcement would have on alienation. Lassen required an analysis of the practical effect upon alienation caused by enforcement, such that “the greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for that enforcement.”

The court then reviewed dicta in Lassen and La Sala which permitted exercise of due-on-sale clauses in “outright” sales and concluded that those cases dealt only with sales where the seller was receiving cash sufficient to pay off the existing loan either from new financing or directly from the buyer. The court was therefore not bound by the holding in La Sala and Lassen in a case where a loan balance remained unpaid.

Recognizing the realities of inflation and “tight” money, the court noted that if a lender was unwilling to permit the assumption of the loan, a purchaser who was unable to obtain replacement financing might be prevented from purchasing the property. The court then discussed the situation where the lender would be willing to allow assumption at a market rate:

Even when the lender is willing to waive its option to accelerate in return for the assumption of the existing loan at an increased interest rate, an inhibitory effect on transfer may still result. The buyer, faced with the lender's demand for increased interest, may insist that the seller lower the purchase price. The seller would then be forced to choose between lowering the

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53. Id. at 952, 582 P.2d at 975, 148 Cal. Rptr. at 384.
54. Id. at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385 (footnote omitted).
55. Id. at 948, 582 P.2d at 973, 148 Cal. Rptr. at 382.
56. Id.
57. Id. at 948-49, 582 P.2d at 973, 148 Cal. Rptr. at 382.
58. Id. at 949, 582 P.2d at 973, 148 Cal. Rptr. at 382.
59. Id. at 949-50, 582 P.2d at 974, 148 Cal. Rptr. at 382-83.
60. Id. at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383.
purchase price and absorbing the loss with the resulting reduction in his equity interest, or refusing to go through with the sale at all. In either event, the result in terms of a restraint on alienation is clear.61

A dissenting opinion by Justice Clark criticized the majority's reasoning and application of the doctrines of *Coast Bank, La Sala* and *Lassen*. The dissent was particularly critical of the economic analysis conducted by the majority: "What the majority opinion fails to recognize is that the 'restraint' in its hypothetical case results not from exercise of the contractual clause but rather from the bleak and unpredictable economic conditions it paints."62

Justice Clark concluded that the majority failed to apply its previous decisions accurately:

> The majority opinion errs first in concluding that a due-on-clause unreasonably restricts outright sale of property; errs again in concluding there is little or no justification for the clause, contrary to our earlier holdings. We err again in failing to recognize that lenders and borrowers, owners and prospective owners, should be allowed to run their own affairs with minimal governmental intrusion—particularly from this branch.63

Justice Clark received support from the California Court of Appeals in *Medovoi v. American Savings and Loan Association*.64 *Medovoi*, discussed above, was pending appeal in the California Supreme Court when *Wellenkamp* was decided and *Medovoi* was returned to the court of appeals for rehearing in light of the *Wellenkamp* ruling. The *Medovoi* court found *Wellenkamp* inapplicable based on an involved and unusual fact pattern. In the sole footnote to the opinion, the court chided the supreme court for its "short sighted" decision which failed to recognize that Californians compete in a national market for financing:

> I agree with Justice Clark in his dissenting opinion in the *Wellenkamp* case that a due-on-sale clause does not unreasonably restrict the outright sale of property and with his conclusion that the majority opinion errs in concluding there is little or no justification for the clause.

If the 'rules of the game' in respect to home financing are to be changed as they pertain to "due-on-sale" clauses, such changes
should certainly not come from the judiciary but should emanate
from the legislative branch of government.\textsuperscript{65}

A concurring opinion by Justice Thompson expressed the lower court's
frustration with the supreme court's decision and its failure to lay down
specific guidelines for borrowers, lenders, and lower courts.\textsuperscript{66}

One commentator, tracing the history of California due-on-sale litiga-
tion,\textsuperscript{67} basically supported the direction in which the court had moved, but
questioned the lack of guidance given by the \textit{Wellenkamp} court:

This point of the analysis \textit{discloses} a weakness in the \textit{Wel-
lenkamp} decision, for no guidelines are given as to what a 'rea-
sonable threat' to the lender's security would be. How similar
must the buyer's and seller's credit rating be? How can a lender
know that a buyer will commit waste on the property? By what
test would a buyer be a greater risk of default? Perhaps the court
thought that these questions could be best answered by a jury.
This would be consistent with the Minority Doctrine case by case
approach of determining the reasonableness of a restraint on
alienation. But without any guidelines to work from a jury will
be somewhat hampered.\textsuperscript{68}

In any event, it is clear after \textit{Wellenkamp} that an institutional lender in
California may not exercise a due-on-sale clause to increase interest rates,
but may use it only if it can "demonstrate that enforcement is reasonably
necessary to protect against impairment to its security or the risk of de-
fault."\textsuperscript{69} Whether a showing that the proposed transferee is a bankrupt, or
a convicted arsonist, or both, is required, or even sufficient, was left for
future determination. As a practical matter, a lender is unlikely to test the
outer limits of the due-on-sale clause. During the time it would take to
demonstrate the potential risk to its security to the satisfaction of the Cali-
fornia courts, a payment history with the transferee will develop. If that
history is unsatisfactory, foreclosure for the nonpayment will make the
due-on-sale issue moot. If that history is satisfactory, the lender's burden
would probably be insurmountable. Thus, under California law, due-on-
sale clause enforcement is for all practical purposes prohibited, except for
the clearly unqualified transferee.

Other states have effectively reached the same position as California, but
by different means. In Arizona, for example, the courts have viewed the

\begin{itemize}
  \item \textsuperscript{65} \textit{Id.} at 257, 152 Cal. Rptr. at 583.
  \item \textsuperscript{66} \textit{Id.}, 152 Cal. Rptr. at 583-84.
  \item \textsuperscript{67} Comment, \textit{Wellenkamp} v. Bank of America: California Adopts the "Due When Rea-
  \item \textsuperscript{68} \textit{Id.} at 183-84 (emphasis in original).
  \item \textsuperscript{69} 21 Cal. 3d 953, 582 P.2d at 977, 148 Cal. Rptr. at 386 (footnote omitted).
\end{itemize}
issue of enforcement of due-on-sale clauses as primarily an equitable matter. In 1971, the Arizona Court of Appeals in *Baltimore Life Insurance Co. v. Harn*70 endorsed the view that "the parties to a mortgage and note may enter into such agreements as they deem necessary to the transaction of their business."71 When ruling on the lender's ability to enforce the clause, however, the court said:

An action to accelerate and foreclose a mortgage being an equitable proceeding, it is not enough to allege merely that the acceleration clause has been violated. Absent an allegation that the purpose of the clause is in some respect being circumvented or that the mortgagee's security is jeopardized, a plaintiff cannot be entitled to equitable relief.72

In *Harn*, there had been no allegation that the purpose of the clause was being circumvented nor an indication of what the purpose was.73 The court clearly read the sole purpose of the clause as protection of the lender's security against increased risk of default or waste.

By 1978, the showing required of a lender had been codified,74 allowing the Arizona Supreme Court to "hold that the 'due on sale' clause cannot be enforced unless [the lender] can show that its security is jeopardized by the transfer of the subject property without [the lender's] consent . . . ."75

Arkansas has also relied on an equitable approach. In *Tucker v. Pulaski Federal Savings & Loan Association*,76 the court examined a situation where the lender had rejected a transferee, citing as reasons: late payments by the transferee on an existing loan with the lender, a credit report on the

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71. 15 Ariz. App. at 81, 486 P.2d at 192.
72. *Id.* at 82, 486 P.2d at 193 (citations omitted).
73. *Id.* at 80, 486 P.2d at 191-92. The clause itself did not identify its purpose, reading "All sums due and payable under this Note . . . . shall become due and payable without notice forthwith upon the conveyance of title to all or any portion of the mortgaged premises or property, or the vesting thereof in any other manner in, one other than to Mortgagor named herein."
74. ARIZ. REV. STAT. ANN. § 33-806.01 (West 1974). Paragraph A reads as follows: "Nothing in this article shall be construed to prevent or limit the right of a trustor to transfer his interest in the trust property, or authorize a beneficiary or trustee to arbitrarily withhold his consent to a transfer by the trustor of his interest in the trust property." Paragraph B limits the fee a lender may charge for a transfer to the greater of $100 or 1% of the balance due. Paragraph C restricts the lender's right to increase the interest rate to those situations in which the transferor is released from all liability and limits the amount of the increase to 1/2 of 1% over the existing rate.
76. 252 Ark. 849, 481 S.W.2d 725 (1972).
borrower which showed slow payments on other obligations, and repossession of an automobile. The court noted that the lender had not reviewed its own previous experience with the proposed transferee prior to disapproval and that the lender had the credit report with the derogatory information in its possession when the earlier loan to the transferee was made. The court concluded that "it would be extremely unfair to hold that the Belchers are a bad risk when they are not only current in the original loan, but have likewise tendered the monthly payments each month on the property purchased from Tucker." 

The court indicated "there must be legitimate grounds for refusal to accept a transfer to a particular individual or concern." A dissenting opinion by Justice Fogelman looked both at the circumstances, which included the existence of a guaranty agreement by a previous owner, and at the suggestion of a deterioration in the value of the property due to changes in the neighborhood. He concluded that the lender had acted reasonably:

[T]he courts should direct their inquiry toward a determination whether the option to accelerate was exercised in the good faith belief that the prospect of payment or performance was impaired and the burden of establishing lack of good faith was on the party against whom the power has been exercised.

In Michigan, the court of appeals refused to allow the use of a due-on-sale provision to permit the increase of the interest rate in Nichols v. Ann Arbor Federal Savings and Loan Association. While there was some discussion regarding the economic balances in cases such as Cherry, that argument was rejected because of the existence of a prepayment penalty. Without providing a detailed analysis of its reasoning, the court decided: "If the mortgage clause defendant seeks to enforce can be labeled a restraint on alienation only by expanding the restatement definition, we do not hesitate to stretch the term to include this 'due-on-sale' clause." The court went on to say that "Michigan has adopted a flexible approach in the area of restraints; a restraint on alienation will not be enforced unless it is found to be reasonable in a particular case."

77. Id. at 856-57, 481 S.W.2d at 729-30.
78. Id. at 858, 481 S.W.2d at 731.
79. Id. at 855, 481 S.W.2d at 729.
80. Id. at 861, 481 S.W.2d at 732 (Fogelman, J., dissenting).
82. 73 Mich. App. at 166, 250 N.W.2d at 806.
83. Id. at 168, 250 N.W.2d at 806.
IV. STATE COURT DECISIONS ALLOWING ENFORCEMENT

California, Arizona, Arkansas and Michigan courts, as indicated above, have placed severe burdens on lenders' exercise of due-on-sale provisions. In this respect, they are clearly in a minority among the states that have ruled on the issue. The following is a review of the state court decisions allowing enforcement. Since systematic categorization, even if possible, is not likely to be helpful, they will be discussed in chronological order. While a majority of the states have approved the "due on" clause, they have done so for a variety of reasons and with varying degrees of exploration of the issues. A Maryland court, for example, when dealing with a prepayment penalty provision in *Chapman v. Ford,* simply assumed the enforceability of the clause as the clear, unambiguous language of the mortgage contract.

The Ohio Court of Appeals upheld the right of a lender in *People's Savings Association v. Standard Industries, Inc.* It held that:

[A] significant element in the mortgage contract is the mortgagor himself, his financial responsibility and his personal attitudes. The right of the mortgagor to protect its security by maintaining control over the identity and financial responsibility of the purchaser is a legitimate business objective and is not illegal, inequitable or contrary to the public policy of the state of Ohio.

The Utah Supreme Court made short shrift of the argument that due-on-sale clauses were contrary to public policy in *Walker Bank and Trust Co. v. Neilson.* After citing *Cherry* with favor, it said, "One of the conclusions made by the trial judge was to the effect that the acceleration provision in the addendum to the trust deed is void as being against public policy. In this conclusion the court erred."

In Colorado, the due-on-sale clause was determined to be a reasonable restraint on alienation in *Malouf v. Midland Federal Savings and Loan Association.* In language reminiscent of *Cherry,* the court examined the economic rationale behind the enforcement of the clause:

We do not consider the motive of [the lender] in seeking to

84. 246 Md. 42, 227 A.2d 26 (1967).
85. *Id.* at 51-52, 227 A.2d at 31.
86. 22 Ohio App. 2d 35, 257 N.E.2d 406 (1970). The Ohio Supreme Court reserved judgment on the enforceability of the due-on-sale clause in *Great Northern Sav. Co. v. Ingarra,* 66 Ohio St. 2d 503, 423 N.E.2d 128 (1981), finding that the lender was estopped from enforcement because of delay and other conduct.
87. 22 Ohio App. 2d at 38, 257 N.E.2d at 407.
89. *Id.* at 385, 490 P.2d at 329.
Due-On-Sale Clause

Due-On-Sale Clause

protect itself and the borrower from the effects of inflationary or deflationary conditions in the money market to be improper or unlawful. Both parties have the benefit of their original bargain during their continued creditor-debtor relationship. However, when the property is sold to a purchaser who desires to assume the existing loan, economic consideration [sic] may reasonably justify the lender in raising the interest rate to or approaching one equal to the current market rate.\(^9\)

Limitations were placed on the lender's ability to exercise its rights under a due-on-sale clause by the Colorado legislature for loans executed on or after July 1, 1975.\(^{92}\) Lenders can accelerate the loan only if they reasonably determine the transferee is a poor credit risk based on standards used by mortgage lenders in similar circumstances. Fees charged are restricted to no more than 0.5% of the unpaid balance of the loan. Finally, and most significantly, interest rate increases are restricted to 1% above the existing rate of the loan.

A constitutional amendment\(^{93}\) regarding the due-on-sale provision was submitted to the Colorado voters in November 1980. This amendment would have prohibited lenders from accelerating a mortgage upon the transfer of the property, so long as the original borrower remained liable and there was no substantial impairment to the lender's security as a result of the transfer. This proposed amendment was overwhelmingly defeated, and the due-on-sale clause remains enforceable in Colorado, subject to the restrictions noted above.

Tennessee has clearly upheld the lender's right to increase interest rates upon the sale of the mortgaged property. In *Gunther v. White*,\(^ {94}\) the court said: "Equity should not depart from the law which requires it to enforce valid contracts and strike down the acceleration option simply because its exercise will let the appellees, not the appellants, make the profit on the

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91. *Id.* at 303, 509 P.2d at 1245.
93. Proposition 4—The question presented to the voters was as follows:
   Shall Article XVIII of the Constitution of the State of Colorado be amended to provide that in order that all persons shall have the right to sell or transfer their real estate or any interest herein subject to existing financing, no person or lending institution with a security interest in the real estate shall accelerate or mature the indebtedness secured by such real estate or alter the terms and conditions of the indebtedness or security interest because of such sale or transfer, so long as the original debtor remains directly responsible for the indebtedness and the security for the indebtedness is not substantially impaired by the sale or transfer?

   (Nov. 4, 1980).
94. 489 S.W.2d 529 (Tenn. 1973).
interest rate occasioned by the increased cost of money.”

In Illinois, the lender’s right to exercise the due-on-sale clause was upheld in *Baker v. Loves Park Savings and Loan Association*. The supreme court concluded that “the restraint contained in the mortgage in this case is permissible because it is a reasonable restraint, that is, one for which sound and convincing reason exists.” The court also enforced a provision in the note for an increase of the interest rate of 1% upon any default. A lender’s right to increase the rate is restricted in Illinois by the usury law.

The Wisconsin Supreme Court had held “that a due-on-sale clause. . . is not against public policy and is enforceable as a contractual condition of the note and mortgage.” However, the court has used its equitable powers to stay enforcement in cases when enforcement was inappropriate. Thus, in *Mutual Federal Savings and Loan Association v. American Medical Services*, the court allowed a transferee to raise a defense of laches to prevent acceleration under a due-on-sale provision.

The North Carolina decision in *Crockett v. First Federal Savings and Loan Association* provides a detailed analysis of the reasons for upholding the enforceability of due-on-sale clauses. The *Crockett* court noted that events that would trigger the clause were solely within the discretion of the borrower and that, in the absence of a prepayment penalty, the borrower was also free to refinance the loan if interest rates fell. Thus, even with a due-on-sale provision, the borrower was in a superior position. The court noted:

Plaintiff would not have to wait for an alienation of the property before being permitted to take advantage of changed interest rates. Thus, as between plaintiff-trustor-borrower and defendant-beneficiary-lender, plaintiff is in a more favorable position for taking advantage of fluctuations in interest rates assuming the due-on-sale clause is permissible. If the due-on-sale clause is not

95. Id. at 532.
96. 61 Ill. 2d 119, 333 N.E.2d 1 (1975).
97. Id. at 125, 333 N.E.2d at 4 (citing Volkmer, infra note 206, at 763).
98. ILL. REV. STAT. ch. 74, § 4(2)(d) (Supp. 1980). The impact of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980), is a question which is beyond the scope of this paper. Briefly, § 501 of the Act preempts state usury laws for first mortgages made by most mortgage lenders. States have until April 1, 1983, to explicitly reimpose usury limits or the preemption remains effective. A detailed study of both the Illinois and federal statute would be necessary to determine the status of this situation. To date, Illinois has not explicitly reimposed its usury statute.
100. 66 Wis. 2d 210, 223 N.W.2d 921 (1974).
Due-On-Sale Clause

Permissible, the plaintiff would have an even superior position.\(^{102}\)

Contrary to courts that viewed the sole purpose of the clause as providing protection to the lender against increased risk of default,\(^{103}\) the North Carolina court felt that, "under the circumstance of this case where there were no prepayment penalties, it was appropriate to exercise the due-on-sale clause even though the security of the lender was not threatened.\(^{104}\)

Although the language of the clause did not specifically put the borrower on notice that assumption might be permitted only at an increased rate, the court found the contract unambiguous, since there were no stated restrictions on the lender's exercise of its rights.\(^{105}\) The court placed minimal restrictions on the enforcement of a due-on-sale clause:

\[
\text{[I]n the absence of allegations and proof that the lender acted fraudulently, inequitably, oppressively or unconscionably in its demand for increased interest rates in return for the lender's consent to the sale, then the exercise of the due-on-sale clause is reasonable and not invalid as a restraint on alienation.}^{106}\]

As early as 1968, the New Jersey courts had assumed the enforceability of a due-on-sale provision in a construction loan agreement.\(^{107}\) In 1976, the issue was dealt with directly in *Century Federal Savings and Loan Association v. Van Glahn*.\(^{108}\) This case involved an acceleration of the mortgage upon the recordation of a land contract. When the borrower refused to pay an increased interest rate, the lender started foreclosure proceedings. The court concluded that the execution of the contract was sufficient to trigger the clause. The defendant's suggestion, that the reasoning of the California court in *Lassen*\(^{109}\) be applied, was rejected when the court noted that California had a statute forbidding unreasonable restraints on alienation and that "New Jersey has no such statutory authority nor, as recited above, does our case law prohibit this 'restraint' as unreasonable-

\(^{102}\) Id. at 626, 224 S.E.2d at 585.


\(^{104}\) 289 N.C. at 630, 224 S.E.2d at 587.

\(^{105}\) Id. at 631, 224 S.E.2d at 588.

\(^{106}\) Id. at 630-31, 224 S.E.2d at 587.

\(^{107}\) See Shalit v. Investors Sav. & Loan Ass'n, 101 N.J. Super. 283, 244 A.2d 151 (1968) (lender's right to charge $14,635 to assume $320,000 construction loan upheld). Parol evidence regarding a lending officer's assurances at the time of the original agreement was not admitted.

\(^{108}\) Id. at 626, 224 S.E.2d at 585.

Finally, the court suggested that not only did the lending association have a right to insist upon an increased interest rate, it might have an obligation to do so. The court explained:

By the enforcement of the acceleration clause in this case, [the lender] seeks only to protect itself and its members from the inflationary and deflationary conditions of the money market. Such a motive is neither unlawful nor improper. The officers and directors of a savings and loan association have a fiduciary obligation to their depositors to obtain the best lawful yield of their mortgage portfolio. This court will not interfere with the discretion of the officers and directors in these matters unless such discretion is grossly abused.111

In Fidelity Land Development Corp. v. Rieder & Sons Building & Development Co.,112 the court indicated that there were limitations on the discretion that a lender could exercise. In this case, title to vacant land awaiting development was transferred for nominal consideration from the owner corporation to its principal stockholder. The lender contended that this transfer accelerated the due date of the loan. Prior to this allegation, however, the shareholder had conveyed title back to the corporation.

After citing Van Glahn and another case113 in which seemingly automatic enforcement of similar provisions was allowed, the court noted, "[N]either of these two cases involved facts, such as those presented in this matter, precluding the existence of any threat to the lender's security."114 It should be noted, however, that the lender was not an institutional lender in this case. Whether taking advantage of the business opportunity presented here, despite the lack of any threat to the lender's security, would be considered an institutional lender's fiduciary obligation or abuse of discretion is not clear.

Nevada has permitted the automatic enforcement of the clause when there is an outright sale.115 The Nevada court viewed the enforceability of the clause as a basic contract question: "[W]e do not suggest that the clause is absolutely enforceable without regard to surrounding circumstances. We would merely attach the same reverence to the due-on-sale clause as is accorded to any other provision which may appear in a

110. 144 N.J. Super. at 54, 364 A.2d at 561.
111. Id. at 55, 364 A.2d at 562 (emphasis added).
114. 151 N.J. Super. at 510, 377 A.2d at 695.
Due-On-Sale Clause

In New York, however, the clause is presumptively enforceable, but the courts have not hesitated to employ their equitable powers to prevent abuses. The recent case of Silver v. Rochester Savings Bank may be read as both a continuation of the strict enforcement of the language of the contract favored in earlier cases and an exercise of the powers of a court to prevent an inequitable result. It is also possible, however, to read the case as questioning the lender's right to use a due-on-sale clause to protect its portfolio yield.

The fact pattern in this case was so specialized that general conclusions should be made very hesitantly. The bank approached Silver and arranged for the construction of a branch building, to its specifications, on land owned by Silver. Financing for the construction was provided to Silver by the bank, with principal and interest fixed for twenty years. The bank leased the building for twenty years at a fixed rental, with an option to renew for an additional twenty years and the right of first refusal to purchase the building in the event of a potential sale. When Silver attempted to sell the property to a financially sound purchaser, the bank chose to exercise its option to accelerate the loan, with the intention of increasing the interest rate to a level that would require a monthly principal and interest payment on the mortgage in excess of the monthly rent paid by the bank.

The court looked at the intent of the parties under the unusual facts recited above and concluded that the normal inference was that the lender was concerned solely with its security: "To construe it as granting to the lender an unlimited right to decline to accept a grantee for any reason, including the lender's refusal to consent to a change of the mortgage contract by increasing the rate of interest, is a giant step. . . ." 120

In language not clearly identified as being restricted to the special circumstances of the case, the court explained: "With much sympathy for the bank's position, we conclude that as a matter of law it cannot use the approval clause as a weapon to protect itself against the changed interest-

116. Id. at 365, 550 P.2d at 1272.
117. 73 A.D.2d 81, 424 N.Y.S.2d 945 (1980).
119. This case actually involved an approval clause which allows the lender to evaluate the potential buyer and to approve or disapprove a sale to that buyer. If the seller sells without the lender's approval, the lender may demand payment of the balance. For all practical purposes, the approval clause in this case was equivalent to a due-on-sale clause.
120. 73 A.D.2d at 84, 424 N.Y.S.2d at 947.
market conditions." In a footnote to the above language, the court suggested that, had the contract expressly provided for the bank's right to increase the rate, a different question would be presented: "Then, at least, the mortgagor would have had clear notice of the bank's asserted right, and there is authority that the provisions, exercised in good faith, would be valid."

A better interpretation of the case is probably to assume that the court intended to affirm the presumption of enforceability. The court referred to paragraph twelve of the mortgage which reads, "[W]here any of the terms . . . of the mortgage require the approval . . . or consent of Mortgagee . . . [it] shall not be unreasonably withheld . . . by Mortgagee." The court relied on this contractual agreement not to unreasonably withhold consent and indicated that under New York law such an agreement would not be implied. At least one lower New York court has interpreted Silver as limited to its unusual circumstances and not as an invalidation of the due-on-sale clause.

In the only reported Pennsylvania case dealing with the issue, the court assumed enforceability, stating:

[T]he validity and enforceability of 'acceleration' clauses are not here questioned. Generally, a provision in a mortgage agreement according the mortgagee the option to accelerate the maturity of the mortgage debt, under certain conditions or upon the happening of specified events, is regarded as a legitimate contractual stipulation.

Alabama is somewhat unique in that it represents the only state in which a court decision restricting the lender's right to increase interest rates has been overruled. Due-on-sale clauses had been favored in Alabama since 1907. However, in 1977, in First Federal Savings and Loan Association v. Britton, the Alabama Court of Civil Appeals ruled that, unless there is an explicit indication in the mortgage instrument that refusal to agree to an increase of the interest rate might be the sole reason for withholding consent to transfer, the lender could not withhold consent to the transfer.

In Tierce v. APS Co., the Alabama Supreme Court found the holding

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121. Id. at 83-84, 424 N.Y.S.2d at 947.
122. Id. at 84 n.2, 424 N.Y.S.2d at 947 n.2.
123. Id. at 83, 424 N.Y.S.2d at 946.
126. Tidewater v. Wittmeier, 150 Ala. 253, 43 So. 782 (1907).
128. 382 So. 2d 485 (Ala. 1979).
of the court of civil appeals in Britton to be in error. After discussing the suitable review that due-on-sale clauses would receive in any foreclosure proceeding, the court said, “We cannot, however, agree that the desire of a lender to terminate loans upon transfers, due to rising interest rates, is not a valid business purpose, thus rendering a ‘due-on-sale’ clause unconscionable and unenforceable when such desire is the primary purpose for acceleration.” 129

Nebraska is one of the most recent state supreme courts to address the issue in Occidental Savings and Loan Association v. Venco. 130 The court reviewed the actions taken in other jurisdictions and stated, “We believe that the error committed by most jurisdictions in deciding this matter is their willingness to assume that a ‘due on sale’ clause is a restraint on alienation and that the only issue is reasonableness.” 131

After reviewing the Restatement of Property definition of restraint on alienation and concluding that the clause is not a direct restraint, 132 the court took issue with other courts that have found an indirect restraint. The Wellenkamp 133 decision, in particular, came in for a large share of criticism:

Relatively few legal principles are relied upon as authority. The decision is based primarily on considerations of social need and the assumed effect of a ‘due-on-sale’ clause in the marketplace. The rights and needs of the seller, as seen by the court, are detailed and balanced against the rights and needs of the lender, as seen by the court. The court concludes that the rights and needs of the seller outweigh those of the lender, notwithstanding the fact that the parties have freely entered into a contract to the contrary. . . .

Decisions such as Wellenkamp place an unreasonable burden upon lenders and call upon courts to act as periodic arbitrators in the sale of real estate. 134

The court then reviewed the argument that the clause was contrary to public policy. After noting the importance of viable savings and loan associations to mortgage lending, it concluded:

Balancing portfolio return with cost of money is an important

129. 382 So. 2d at 487-88.
130. 206 Neb. 469, 293 N.W.2d 843 (1980).
131. Id. at 471, 293 N.W.2d at 845.
134. 206 Neb. at 476-77, 293 N.W.2d at 847.
factor in the survival of lending associations. The due on sale clause is an important device in maintaining that balance. . . .

We are cited to no authority, nor are we able to find any, which would legally justify declaring a contract provision such as the one in the instant case, generally referred to as a 'due on sale' clause, to be contrary to public policy and void.135

The Supreme Judicial Court of Massachusetts also has criticized the Wellenkamp court for its reasoning.136 The Massachusetts court determined that since the mortgage could have been payable on demand from the outset without being an unreasonable restraint on alienation, making the note payable on demand only upon sale of the property was not unreasonable. The court viewed the issue as between the borrower on the one hand and the depositors of the savings bank on the other and found the balance in favor of protecting the interests of depositors. There was also serious concern expressed about the ability of a Massachusetts-chartered institution to compete effectively with a federally-chartered savings and loan association.137

Finally, the Wyoming Supreme Court recently gave implied approval of due-on-sale clause enforcement when it ruled that acceleration upon transfer of title was not permitted in the absence of a due-on-sale provision.138

V. STATE COURT DECISIONS LEAVING DOUBT AS TO ENFORCEMENT

While there is great disparity among the states discussed so far, there is at least some degree of clarity within each of those states as to the enforceability of the due-on-sale clause on a "routine" basis. Thus, one could safely say that enforcement is not permitted in California, Arizona, Arkansas and Michigan, absent a showing of unusual circumstances. Among the other states discussed (with the exception of Colorado and Illinois where legislatively-imposed restrictions have limited the practice of increasing interest rates), the clause is presumptively enforceable, with the presumption subject to rebuttal on equitable grounds. There is, however, a third group of states where reasonable doubts exist as to whether the clause is considered valid and, if it is, whether there are any restrictions on the enforcement.

In Washington, an interest rate increase of 0.5% upon transfer was permitted in Miller v. Pacific First Federal Savings and Loan Association.139

135. Id. at 480-81, 293 N.W.2d at 849.
137. See discussion of federal preemption, notes 179-194 and accompanying text infra.
139. 86 Wash. 2d 401, 545 P.2d 546 (1976).
The due-on-sale provision in that case specifically provided for the lender to exercise an option to either accelerate the balance or increase the interest rate by no more than 2% if the title passed or the property was vacated.

The court held: "[A] loan agreement provision that permits the lender to increase the interest rate upon transfer of the mortgaged property, even without a showing of increased risk to the lender, is not invalid per se as an unreasonable restraint of the free alienation of property."¹⁴⁰

The court focused on the language of the clause providing for the interest rate increases when it said: "[A]ppellants and respondent both voluntarily agreed to all the terms of the note and mortgage. Nothing suggests that there was any duress, misrepresentation or overreaching on the part of the respondent."¹⁴¹

Shortly after deciding Miller, the Washington Supreme Court addressed the issue of the use of a due-on-sale clause where title was being transferred under a land contract. In Bellingham First Federal Savings and Loan Association v. Garrison,¹⁴² the court found the reasoning of the California Supreme Court in Lassen¹⁴³ persuasive. The court explained that "[w]e therefore hold the due-on-sale clause before us to be an unreasonable restraint on alienation unless the respondent can show that the enforcement of the clause is necessary to protect the lender's security."¹⁴⁴ After reviewing the facts, the court found the lender had made the necessary showing and allowed enforcement.

The court distinguished its Miller holding:

Our Miller decision concerned only a portion of the due-on-sale clause which permitted the lender to increase the mortgage interest on the loan when the mortgaged property was transferred. The clause in this case does not give respondent the right to increase the interest rate upon transfer of the property. It is an acceleration clause.¹⁴⁵

Taking Miller and Bellingham together, it is clear that a contract provision specifying an increase of the interest rate by a stated amount upon transfer of title is enforceable. It is almost as clear that a clause that provides for acceleration but is silent regarding an interest rate increase may be used to protect the lender's security, but may not be used solely to increase the interest rate. It is not clear whether a clause such as that con-

¹⁴⁰. Id. at 405, 545 P.2d at 549.
¹⁴¹. Id. at 406, 545 P.2d at 549.
¹⁴². 87 Wash. 2d 437, 553 P.2d 1090 (1976).
¹⁴⁴. 87 Wash. 2d at 441, 553 P.2d at 1092.
¹⁴⁵. Id. at 439, 553 P.2d at 1091.
tained in the FNMA/FHLMC Deed of Trust may be used to increase the rate because, while the borrower is placed on notice that an increase of rate is possible, the magnitude of that increase is not limited.

Although the Florida Supreme Court has not ruled on the matter, there were four Florida District Courts of Appeal decisions between 1970 and 1976. The first of these cases, Clark v. Lachenmeier, involved an inartfully-worded clause which attempted to permit the lender to review the credit of any transferee but did not provide for acceleration if the credit rating was unsatisfactory. The Second District Court noted that the lender had not demonstrated that the security had been impaired and upheld the trial court, saying: “We believe the Court was correct in denying foreclosure merely because the mortgage called for the consent of the mortgagee before property can be sold to a third party, where no harm has resulted to mortgagee from such a conveyance.”

The Fourth District Court made a very careful reading of the contract provision the following year in Home Federal Savings and Loan Association v. English. The court noted that the warranty deed by which the transfer was effectuated contained a provision that the grantee assumed the obligation of the mortgage. The court then noted that this clause required two conditions to allow the mortgagee to accelerate conveyance without written consent and without assumption. Since the transferee had assumed the obligation by the terms of the warranty deed, one of these conditions was lacking and acceleration was not permitted.

Another close reading of the instruments was made in Stockman v. Burke. The clause was actually contained in a purchase money mortgage, but the parties and the court agreed that it had become part of the terms of the note since the note and mortgage were executed contemporaneously and the instruments referred to each other. In allowing acceleration, the Second District Court made it clear that there were significant differences between the suit on the note before it and the alternative of a foreclosure of the mortgage:

In this suit at law upon a promissory note, there was no more reason for the court to nullify the provision for payment upon resale of the property than there would have been to otherwise

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147. The clause read, “It is hereby agreed that in the event of the transfer of ownership of the above described property that the Mortgagee has the right and privilege of accepting or rejecting, or passing on credit, etc., of such successor in ownership.” Id. at 584.
148. Id. at 585.
vary the time of payment which was agreed upon by the parties. . . . We leave open until another day the question of whether a mortgage with a similar provision can be accelerated and foreclosed upon the sale of the property without a showing that the mortgagee has been prejudiced by reason of the conveyance to the new owner.151

In Chopan v. Klinkman,152 the Fourth District Court found that a transfer made by means of a land contract did not trigger a provision which was dependent upon a sale. Perhaps it was summarizing the view of all the Florida courts that had ruled on the issue when it explained: “While an acceleration clause is a valid contractual provision, in enforcing such a clause, a court of equity should require the showing of a clear unequivocal right to forthwith call due the balance of the debt.”153

The sole Mississippi decision on the matter, Sanders v. Hicks,154 involved a loan, secured by a service station, which contained no provision for the payment of interest until default. The lender's attempt to prevent transfer of title and accelerate the debt was disfavored by the court:

[We] hold that such restraints are not per se invalid, and that such a restraint may be valid depending upon whether it is reasonable under the circumstances.

We hold that the restraint on alienation in the deed of trust involved in this case, which has no relation to any threat to the legitimate interests of the mortgagee, is invalid. As to what would constitute a threat to a mortgagee's legitimate interests is not before us; the development of the law in this respect must abide future cases.155

The court's failure to provide any guidance as to what constitutes a "mortgagee's legitimate interests" left borrowers and lenders uncertain as to their respective rights. One commentator has cautioned: "The courts have assumed the task of steering an uncertain course through an area where 'predictability of judicial result' is of paramount importance."156

The Oklahoma Supreme Court, in Continental Federal Savings and Loan Association v. Fetter,157 dealt with a somewhat different aspect of the usual

151. Id. at 90.
153. Id. at 156.
154. 317 So. 2d 61 (Miss. 1975).
155. Id. at 64.
156. Note, 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 (Sanders v. Hicks, Miss. 1975), 47 Miss. L.J. 331, 346 (1976).
fact pattern. There the challenge was to the lender's practice of charging a fee for the consent to transfer. The normal fee was $100, but, if the existing interest rate was below market, the lender charged a one time fee equal to 1% of the outstanding loan balance. The actual cost to the lender of making the necessary changes to its records was conceded to be approximately $100. The court was apparently impressed by both the lack of language in the mortgage agreement referring to such a fee and by what it apparently took to be the purpose of a due-on-sale clause:

Acceleration clauses are bargained-for elements of mortgages and notes to protect the mortgagee from risks connected with transfer of the mortgaged property. The underlying rationale for an acceleration clause is to insure that a responsible party is in possession, to protect the mortgagee from unanticipated risks, and to afford the lender the right to be assured of the safety of his security. However, an action to accelerate and foreclose a mortgage is an equitable proceeding and the equitable powers of the court will not be invoked to impose an extreme penalty on a mortgagor with no showing that he has violated the substance of the agreement.\textsuperscript{158}

It is not clear whether the Oklahoma court would look favorably upon a lender's right to protect itself from the risk of changed money market conditions by providing for an option to increase the interest rate upon transfer of title, or whether the sole rationale it would accept for allowing acceleration "is to insure that a responsible party is in possession."\textsuperscript{159}

The Oregon Supreme Court, while not dealing with the due-on-sale clause directly, was asked to analogize the reasoning of the California Court in \textit{Lassen} to hold that a restriction on prepayment for ten years was an unreasonable restraint on alienation. In \textit{Hartford Life Insurance Co. v. Randall},\textsuperscript{160} the court refused to adopt the \textit{Lassen} analogy, calling the restriction on the right to prepay for ten years "a trade off of commercially beneficial interests . . . ."\textsuperscript{162} The court's reasoning did not suggest how it might rule if the issue before it was actually a due-on-sale provision.

The final state court decision to be noted is a recent Louisiana Court of Appeals decision\textsuperscript{163} dealing with a provision similar to the FNMA/FHLMC uniform covenant \texttext{17} provision. The validity of the clause itself was not in question since Louisiana statutory law gives savings

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\textsuperscript{158} Id. at 1017.
\textsuperscript{159} Id.
\textsuperscript{160} 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).
\textsuperscript{161} 282 Or. 297, 583 P.2d 1126 (1978).
\textsuperscript{162} Id. at 298, 583 P.2d at 1127.
\textsuperscript{163} Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. Ct. of App. 1980).
Due-On-Sale Clause

and loan associations the right to enforce a due-on-sale provision. The lender, however, had attempted to impose a fee of 1% of the unpaid balance of a $700,000 nursing home mortgage to permit the transfer of title from three individual owners to one of the individuals. The court refused to allow the imposition of the fee, ruling that the clause and the statute anticipated the introduction of new parties and that, in effect, there was no transfer under the facts of the case.\textsuperscript{164}

VI. STATE STATUTES LIMITING ENFORCEMENT

As previously indicated, Arizona and Colorado statutes dealing with the transfer of real estate limit the amount a lender may increase the interest rate to 0.5% and 1% respectively.\textsuperscript{165} A New Mexico statute\textsuperscript{166} makes unenforceable any provision in a mortgage secured by a one to four family residence that provides for either acceleration of the indebtedness or an increase of the interest rate, upon the transfer of any interest by the mortgagor, unless the security interest is substantially impaired.

A subsequently changed Minnesota law eliminated a lender's right to exercise a due-on-sale provision if the original loan was a purchase money conventional mortgage on a one to four family dwelling used as the borrower's primary residence. The lender had to consent to the transfer so long as the original borrower remained liable for the repayment of the indebtedness. The lender had to release the original borrower and allow the transfer "if the transferee (1) meets the standards of credit worthiness normally used by persons in the business of making conventional loans . . . and (2) executes an agreement . . . assum[ing] the obligations of the existing borrower."\textsuperscript{167} At least in part due to pressure from FHLMC, FNMA and local lenders, the statute was amended in May 1981 to permit an interest rate increase to the current rate charged by the lender but no more than the most recently published FNMA monthly index of auction yields.\textsuperscript{168}

A Georgia statute\textsuperscript{169} is similar to the former Minnesota law. The statute limits a lender's right to accelerate because a transfer is limited to only those situations in which the transferee does not intend to occupy the property as a principal residence and where occupancy is required by a federal regulator of the lender. Increases of the interest rate are permitted only

\textsuperscript{164} Id. at 1237-39.
\textsuperscript{165} See notes 74 & 92 and accompanying text supra.
\textsuperscript{166} N.M. STAT. ANN. § 48-7-12 (1978).
\textsuperscript{168} Id. § 47.20(6a).
when the original borrower requests a release from all liability and the lender grants the release. Interest rate increases, moreover, are limited to no more than 1% above the existing rate and cannot be increased more frequently than once every two years. The lender, when asked to release the original borrower, may disapprove the credit worthiness of the transferee, but the lender is held to "standards normally used by persons in the business of making loans on real estate in the same or similar circumstance . . . ."\(^{170}\) If the transferee is unwilling to pay the increased rate, the loan may be prepaid without penalty within sixty days. Limitations are also placed on the amount of fees that the lender may charge. The law is applicable to all residential loans other than apartments, motels, hotels, and nursing homes for which the original amount is less than $100,000. A 1981 amendment permits lenders to accelerate the loan if they reasonably determine that the proposed transferee is financially incapable of meeting the payments, provided there is a due-on-sale provision in the controlling instruments.\(^{171}\)

The Minnesota and Georgia laws are unusual in that they provide the mortgagor an absolute right to transfer title, without regard for the credit worthiness of the transferee, so long as the original borrower remains liable. This can have a major impact on a lender forced to accept a borrower with unworthy credit which could severely impact the value of the secured property. In any event, the significance placed on personal liability by the Minnesota and Georgia legislatures seems out of proportion to its benefit, since the original borrower is likely to have recovered his entire equity at the time of the transfer, removing any incentive to see that the payments are made, and may be beyond the reach of the local courts.

An Iowa statute affecting purchase money mortgages secured by one or two family residences prohibits the enforcement of due-on-sale provisions if the transferee intends to use the property as a residence.\(^{172}\) An exception is made, however, if the lender reasonably believes, based on the same criteria used to evaluate a new mortgage loan application, that "its security interest or the likelihood of repayment is impaired."\(^{173}\) Under such circumstances, the lender may either accelerate the loan or "adjust the interest rate, the repayment schedule or the term of the loan."\(^{174}\)

Another provision of Iowa law,\(^{175}\) not restricted by property type or us-

\(^{170}\) Id. § 67-3002(a)(6).
\(^{173}\) Id. § 535.8(c).
\(^{174}\) Id.
\(^{175}\) Id. § 535.8(e).
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age, increases the normal redemption period after foreclosure if the foreclosure results from the enforcement of a due-on-sale provision. This section, which became effective in 1980, is applicable to any foreclosure occurring after enactment, regardless of the date the loan was made. An exception is made if the lender establishes, based on criteria no more restrictive than those used to evaluate new mortgage loan applications, that either the security interest or the likelihood of repayment is impaired by the transfer.

As indicated previously in the discussion of the state law in Illinois, the preemption of state usury laws, by the Depository Institutions Deregulation and Monetary Control Act of 1980 [the Act], may give rise to questions concerning restrictions contained in usury laws. The Act preempts state usury laws for most first mortgage transactions. It is likely that lenders will argue that restrictions of rate increases contained in such laws are as invalid as any other restriction. No doubt the courts will be asked to deal with this issue at some time.

South Carolina is another jurisdiction where that issue may be raised. One statute prohibits a change of the initial interest rate for mortgage loans without the agreement of the borrower. In any event, the rate cannot be increased by more than 1%. This provision is applicable to all loans of $100,000 or less, regardless of property type and usage.

VII. Federal Preemption

The disparity of the approaches taken to the question of due-on-sale enforcement by the various jurisdictions has a chilling effect on the creation of a national secondary market. The issue is complicated even further, however, since the identity of the lender has become significant.

The Home Owner's Loan Act of 1933 authorized the creation of a system of federal savings and loan associations as well as the Federal Home Loan Bank Board to regulate them. The Board's authority to preempt state regulation of federal savings and loan associations in the area of fair lending practices was affirmed in Conference of Federal Savings and Loan Associations v. Stein.

A 1948 regulation adopted by the Board required each loan contract

176. See note 98 and accompanying text supra.
180. 604 F.2d 1256 (9th Cir. 1979), aff'd mem., 445 U.S. 921 (1980).
of a federal association to provide for full protection to the association. In 1975, a United States District Court asked the Board to construe the regulation, to determine if it permitted federal savings and loan associations to employ a due-on-sale clause to update their portfolios.\textsuperscript{182} The Board's Office of Economic Research issued an advisory opinion\textsuperscript{183} approving the use of the clause and giving three reasons for its desirability. In the Board's view, the clause enabled an association to: (1) ensure the credit worthiness of the purchaser of the property; (2) adjust its mortgage portfolio yields to current market levels; and (3) sell its mortgages in the secondary mortgage market, thereby generating funds for investment in other mortgages.

In April 1976, the Board issued new regulations specifically authorizing federal savings and loan associations to employ a due-on-sale provision and providing that the exercise of an option to accelerate by the association "shall be exclusively governed by the terms of the loan contract [between the association and the borrower], and all rights and remedies of the association and borrower [respecting such acceleration] shall be fixed and governed by that contract."\textsuperscript{184} The regulation language expressed the view that the Board considered the authority to include a due-on-sale provision to be the continuation of an existing power.

For loans made after July 31, 1976, an association was not permitted to exercise the option to accelerate if the property was occupied by the borrower as a home and the transaction involved was one of the four exceptions contained in the FNMA/FHLMC covenant 17: (1) creation of a junior lien or encumbrance; (2) creation of a purchase money security interest for household appliances; (3) transfer by devise, descent or operation of law upon the death of a joint tenant; or (4) leasehold of three years or less without an option to purchase.\textsuperscript{185} The regulations further provided that no prepayment penalty could be collected if the association had exercised its option to accelerate and required the lender to release the original borrower from any liability where a transferee with an acceptable credit rating assumed the obligation at the new, agreed-upon rate. The regulations have effectively codified the provisions of uniform covenant 17 of the FNMA/FHLMC mortgage for all federal savings and loan associations.

Recently several courts have addressed the question of whether the Bank Board's regulations preempt state law that imposes a more restrictive use of the due-on-sale provision. All of the federal courts that have ruled

\begin{itemize}
\item \textsuperscript{182} Schott v. Mission Fed. Sav. & Loan Ass'n, No. CV-75-366 WMB (C.D. Cal. 1975).
\item \textsuperscript{183} \textit{In re} Schott v. Mission Fed. Sav. & Loan Ass'n, Advisory Op. of the Federal Home Loan Bank Board Resolution No. 75-647.
\item \textsuperscript{184} Current version at 12 C.F.R. § 545.8-3(f) (1980).
\item \textsuperscript{185} 12 C.F.R. § 545.8-3(g) (1980).
\end{itemize}
on the substance of the question have found that the Bank Board's regulations preempt conflicting state law.\textsuperscript{186} At least three state courts have agreed with that conclusion.\textsuperscript{187} Two California courts, however, recently found that Bank Board regulations do not preempt state law.\textsuperscript{188} A Florida appeals court has ruled that, while the Bank Board may authorize the use of due-on-sale clauses, enforcement in a state court of equity is subject to valid state defenses.\textsuperscript{189}

The question of which court is the proper forum has also been raised, with three federal district courts finding that they lacked jurisdiction to address the question of federal preemption.\textsuperscript{190} Yet, the lone federal circuit court to rule had no difficulty finding jurisdiction, although it upheld the validity of the clause on the basis of state law.\textsuperscript{191}

On July 31, 1981 the Bank Board reiterated its "longstanding policy regarding the preemptive nature of its regulation . . . to allay the uncertainty expressed by a few state court."\textsuperscript{192}

The complexity and irony of the existing situation, where the identity of


\textsuperscript{190} Schultz v. Coral Gables Fed. Sav. & Loan Ass'n, 505 F. Supp. 1003, 1009 (S.D. Fla. 1981); Smart v. First Fed. Sav. & Loan Ass'n, 500 F. Supp. 1147, 1167 (E.D. Mich. 1980); People v. Glendale Fed. Sav. & Loan Ass'n, 475 F. Supp. 728, 733 (C.D. Cal. 1979). Each of these cases were remanded to state courts because the federal preemption question was viewed as an anticipated defense rather than an issue raised in the complaint.

\textsuperscript{191} Williams v. First Fed. Sav. & Loan Ass'n, No. 80-1446 (4th Cir., filed May 26, 1981).

the originating lender is significant, was noted by a commentator regarding
the case of Nichols v. Ann Arbor Federal Savings and Loan Association.\textsuperscript{193}
Although the lender involved in the litigation was a federal savings and
loan association, the mortgage had been originated by a state chartered
institution, so the federal preemption argument was never made. Ann Ar-
bor Federal lost the case because the court determined that Michigan law
prohibits use of the due-on-sale clauses to raise interest rates. However, as
a federal savings and loan association, Ann Arbor Federal may enforce the
due-on-sale provision on loans it originates because the federal regulations
preempt the state laws. Thus, Ann Arbor Federal has assured itself of a
competitive advantage by losing the case. While there has been no sugges-
tion that this was part of a master strategy (nor is that suggestion being
made here) the possibilities of the situation would make Machiavelli
everious.\textsuperscript{194}

The courts that have disfavored the due-on-sale clause have done so for
two principal reasons. They have either found the clause to be an unreas-
sonable restraint on alienation, or ruled on equitable grounds that enforce-
ment was contrary to public policy. An examination of each of the
rationales follows.

VIII. **RULINGS AGAINST DUE-ON-SALE CLAUSES**

\textit{A. Restraint on Alienation}

A restraint on alienation is defined in the Restatement of Property as:

\[\text{A restraint on alienation is defined in the Restatement of Property as:}\]

- \[\text{A}n\ \text{attempt} \text{by} \text{an otherwise effective conveyance or contract}\]
- \[\text{to cause a later conveyance:}\]
  - \[\text{(a) to be void; or}\]
  - \[\text{(b) to impose contractual liability on the one who makes the}\]
  - \[\text{later conveyance when such liability results from a breach of an}\]
  - \[\text{agreement not to convey; or}\]
  - \[\text{(c) to terminate or subject to termination all or part of the}\]
  - \[\text{property interest conveyed.}\]

The public policy disfavoring restraints on alienation has been part of
the common law for seven centuries.\textsuperscript{196} Limitations on the right of a prop-

\textsuperscript{193} 73 Mich. App. 163, 250 N.W.2d 804 (1977). \textit{See also} notes 81-83 and accompanying
text \textit{supra}.

\textsuperscript{194} \textit{See Note, Mortgages—Due-on-Sale Clause: Restraint on Alienation—Enforceability,}

\textsuperscript{195} \textit{Restatement of Property} § 404 (1976).

\textsuperscript{196} \textit{Common Law on Restraints—Statute Quia Emptores (18 Edw. I c.1) 1290.}
erty owner to dispose of his property are not enforceable to the extent that they tend to remove land from the stream of commerce.

To date, no court, in determining a due-on-sale provision to be an unreasonable restraint on alienation, has identified how the clause satisfies the definition. The analysis, to the extent there has been any, has involved the weighing of the perceived social interest. The California Supreme Court in *Coast Bank*\(^{197}\) assumed, without analysis of the term, that the clause was a reasonable restraint on alienation. Its subsequent decisions in *La Sala*,\(^{198}\) *Lassen*\(^{199}\) and *Wellenkamp*\(^{200}\) were limited to the reasonableness of enforcement. Thus, the California Supreme Court has concluded that:

> [A]lthough circumstances may arise in which the interests of the lender justify the enforcement of a due-on clause in the event of an outright sale, the mere fact of sale is not in itself sufficient to warrant enforcement of the clause, and the restraint on alienation resulting therefrom, in the absence of a showing by the lender that such circumstances exist.\(^{201}\)

The California court, in these cases, never supported its conclusion that the clause is a restraint, reasonable or unreasonable, on alienation.

Not limiting itself to the Restatement definition, the Michigan Court of Appeals was more direct about concluding that the clause was a restraint on alienation. "If the mortgage clause defendant seeks to enforce can be labeled a restraint on alienation only by expanding the restatement definition, we do not hesitate to stretch the term to include this 'due-on-sale' clause."\(^{202}\)

While the Arizona Supreme Court had found the exercise of the clause to be unreasonable, a comparison of the California and Arizona cases may be illuminating. California has made the common law prohibitions of restraints on alienation part of its statutory scheme, declaring: "Conditions restraining alienation, when repugnant to the interest created, are void."\(^{203}\)

Thus, the proper analysis in California is whether or not the due-on-sale clause itself constitutes a condition restraining alienation. Furthermore, the California statute suggests that the restraint and interest restrained

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198. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).
201. Id. at 952, 582 P.2d at 976, 148 Cal. Rptr. at 386.
203. CAL. CIV. CODE § 711 (Supp. 1980).
arise from the same instrument, which is not the case in a due-on-sale acceleration of a mortgage debt.

In Arizona, the relevant statute prohibits the arbitrary withholding of consent to a transfer by the deed of trust beneficiary. Therefore, the Arizona courts are concerned solely with the reasonableness of the lender's decision to withhold consent. The Arizona legislature has removed the abstract question of whether or not the provision in a deed of trust constitutes a restraint on alienation and requires its courts to focus only on the conduct of the lender.

An American Bar Association's Subcommittee commented on the paucity of discussion by the various courts that have assumed that due-on-sale clauses constitute a restraint on alienation:

Although discussed at length by legal scholars, it has been ill-explained, if at all, in court decisions which most often proceed from the premise that a restraint on alienation results from the existence of enforcement of the clause. Obviously the due-on clause does not prohibit transfer and cannot be enforced to prevent the transfer. The clause first requires consent to transfer, but the borrower is able to avoid obtaining that consent by paying the debt. Any forfeiture or loss of the property can be avoided by "redemption," the payment of the debt then due.

Even the legal scholars who have discussed the restraining nature of due-on-sale clauses have been hard pressed to identify the way in which the clause fits the Restatement definition of restraint on alienation. Professor Volkmer has discussed the issue and reached the admittedly not totally satisfying conclusion:

Analytically . . . there is a problem with this classification since the due-on-sale clause does not fit exactly within any of the established categories of direct restraints, disabling, forfeiture, or promissory. Yet it would appear that the due-on-sale clause is so closely akin to the promissory restraint as to justify designating it a direct restraint . . . .

Although written as an acceleration clause, the due-on-sale clause directly and fundamentally burdens a mortgagor's ability to alienate as surely and directly as the classical promissory restraint. As such, the due-on-sale clause is truly a direct restraint.

insofar as the category of direct restraints can be articulated.\textsuperscript{206}

The cases and scholars who have criticized the enforcement of due-on-sale clauses for increases in the interest rate have contended either that enforcement reduces the value of the borrower's property, or that the clause was being used for other than its legitimate purpose. Those contentions will be explored further.

\textbf{B. Impact on Property Value}

One of the early commentators on the impact on property value stated the issue in relatively simple terms:

If the seller does not reduce the price he sustains a loss for the benefit of the lender and, in effect, sells the property for less than its true value. If he refuses to reduce the price and thereby loses the sale, a real estate broker will suffer severely for reasons having no legitimate connection with the normal operation of those economic forces which should govern the supply and demand and transfer of real property interests . . . .

It is economically irrational to have differentiations in the value of similar properties because of something having no reasonable connection with their productivity; and yet, because of the different rates of interest charged or chargeable on mortgages on otherwise identical pieces of property, one will have a higher value than the other.\textsuperscript{207}

This rationale is similar to that adopted by the \textit{Wellenkamp} court. This approach assumes that property has an inherent value, unrelated to market factors such as current interest rates. Surprisingly, although the impact on value has been discussed in many cases and scholarly legal writings, none of them have consulted the professional appraisal societies,\textsuperscript{208} whose members devote themselves to the determination of the value of real estate.

The major appraisal organizations have defined value as, "The quantity of one thing which can be obtained for another."\textsuperscript{209} More illuminating is their definition of "Market Value" as:

\textsuperscript{206} Volkmer, \textit{The Application of the Restraints on Alienation Doctrine to Real Property Security Interests}, 58 IOWA L. REV. 747, 773-74 (1973). The Restatement of Property § 404(3) designates the type of restraint defined in § 404(1)(b) as a promissory restraint. See text accompanying note 195 supra.


\textsuperscript{208} See, e.g., Wellencamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); Crockett v. First Fed. Sav. and Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976); Bonanno, supra note 207.

\textsuperscript{209} B. BOYCE, REAL ESTATE APPRAISAL TERMINOLOGY 215 (1975). (Sponsored jointly
The highest price in terms of money which a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus.

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- (5) financing, if any, is on terms generally available in the community at the specified date and typical for the property type in its locale.\(^\text{210}\)

Thus, in the eyes of the professional appraiser, financing at current market rates, rather than being a distortion of the value of the property, is an assumed condition of determining value. In other words, increasing the interest rate of the assumed mortgage, which results in a reduction of the sales price, does not reduce the fair price that the seller receives but eliminates a premium that the buyer would have otherwise paid. Commenting on this result, one author has explained that:

Attackers of the use of such clauses to allow increased interest rates upon the transfer of mortgaged property apparently feel that there exists an inherent right for one to assume another's mortgage at his favorable rate of interest. . . . When the relationship between the parties to a mortgage ceases, so also do the terms of their accord. Allowing a personal contract to be freely bartered runs counter to the nature of such an agreement. . . .

. . . It certainly cannot be deemed equitable to allow mortgagors to refinance their purchase whenever interest rates fall, while maintaining that lenders must be forever locked into terms which become oppressive because of a tight money market. The inequity of this situation becomes even more apparent when the mortgagor who is allowed such superior rights was not a party to the agreement, but rather received its favorable terms through a transfer from the original borrower.\(^\text{211}\)

C. Legitimate Purpose of Clause

It seems clear that neither buyer nor seller may fairly claim that the due-
on-sale clause deprives him of a right to which he is entitled. However, that does not respond to the claim that use of the clause to increase interest rates is a misuse providing the lender with benefits to which it is not entitled.

The commentators who have addressed the issue have differed sharply over what the contemplation of the parties might reasonably have been when the mortgage was originated. Thus, in a discussion of *Baltimore Life Insurance Co. v. Harn*, the court's assumption was challenged:

> The opinion presupposes that the only purpose for including such a clause, and the only purpose within the contemplation of the parties, is to reduce the lender's moral risks. To give binding authority to such a presupposition is unwise, for if acceleration clauses are truly bargained for, their use to increase the interest rate as provided by the acceleration clause, could easily be within the contemplation of both parties.

However, another commentator, has suggested that "if the clause's only purpose was to protect the security interest of the mortgagee, it would be ipso facto enforceable." This commentator differs as to the contemplation of the parties regarding possible interest rate increases:

> Unless made expressly clear, a borrower should not be chargeable with knowledge that consent will be denied a sale to an acceptable purchaser unless the interest rate is increased. . . .

> The enforcement of due-on-sale clauses should correspond with the expectations of the parties at the execution of the agreement. If the lender wants to extend control over the property so that the lending rate can be renegotiated, a clear statement of such intent should be evident.

Another commentator has indicated that the setting of the original bargaining may establish whether or not the due-on-sale clause was a bargained-for element. Thus, this commentator has suggested that if the borrower had been offered a variable rate mortgage, but chose a fixed rate loan instead, the due-on-sale clause could reasonably be considered a bar-

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It seems clear that a due-on-sale provision, which like covenant 17 of the FNMA/FHLMC form, puts the borrower on notice of the possibility of an interest rate increase as the price of approval of a transfer, is preferrable to a clause silent on the matter. However, there is still some disagreement as to the propriety of the use of the clause for this purpose. Thus, the Welenkamp court could say:

Economic risks such as those caused by an inflationary economy are among the general risks inherent in every lending transaction. They are neither enforceable nor unforeseen. Lenders who provide funds for long-term real estate loans should and do, as a matter of business necessity, take into account their projections of future economic conditions when they initially determine the rate of payment and the interest on these long-term loans.

The Nebraska Supreme Court in Occidental Savings and Loan took an entirely different view of the matter:

The assets of savings and loan associations are principally invested in long-term mortgages, while on the other hand, the funds necessary to make such loans are obtained from short-term and demand savings accounts and certificates. As the cost of obtaining deposits rises, the spread widens between what the association must pay for funds by way of interest and what the association receives from borrowers. Once the spread gets too great, the association will be unable to meet the standards set by government regulations and will fail.

A review of recent developments as they impact the savings and loan industry, the chief source of conventional mortgage financing, suggests that the Nebraska court was viewing the lending environment more realistically. Between 1976 and 1980, spread between the interest return on the mortgages held by FSLIC-insured savings and loan associations and the average cost of funds of those institutions has fallen from 1.57% to .037%. This squeeze is the result of the inability of the associations' mortgage investment yields to keep pace with the rapidly increased cost of obtaining funds.

Prior to June 1, 1978, the primary source of funds for savings and loan associations was passbook accounts. Regulation Q of the Federal Reserve

217. Id.
218. 21 Cal. 3d 943, 952, 582 P.2d 970, 976, 148 Cal. Rptr. 379, 386 (1978).
219. 206 Neb. 469, 293 N.W.2d 843 (1980).
220. Id. at 477, 293 N.W.2d at 849.
221. 14 FED. HOME LOAN BANK BOARD J., vol. 7, 89-90 (Tables S.4.8 and S.4.10).
Board\textsuperscript{222} established a differential of 0.25\% between the maximum rate of interest that thrift institutions could pay passbook depositors and the rate that commercial banks could pay. The Federal Home Loan Bank Board had established 5.25\% as the maximum passbook rate in 1973.\textsuperscript{223} (This was raised to 5.50\% on July 1, 1979.) Because of the relatively low fixed rates payable by thrift institutions in times of tight money, they frequently suffered large losses of deposits, a process termed disintermediation. On June 1, 1978, to enable depository institutions to compete with other money market instruments, the depository institutions were authorized to issue money market certificates (MMCs) for at least $10,000 with six month maturities and returns tied to the average rate of newly issued six month United States Treasury bills.\textsuperscript{224} On January 1, 1980, they were authorized to issue two and one-half year certificates of much smaller denomination (typically as little as $100) tied to the yield of newly issued thirty month United States Treasury securities.\textsuperscript{225}

As a result of providing savers with returns comparable to those available elsewhere, the average cost of funds payable by thrift institutions has skyrocketed.\textsuperscript{226} In addition, section 202 of the Depository Institutions Deregulation and Monetary Control Act of 1980 provides, within six years, for the phase out and ultimate elimination of all limitations on the maximum rates of interest and dividends payable by depository institutions.\textsuperscript{227} Thus, over the last few years the main source of mortgage financing has seen its cost of money skyrocket, and these institutions can anticipate being totally at the mercy of money market rates within six years. The changes that have and will occur are not those that were or could have been foreseen by these institutions.

Although mortgage rates have risen as rapidly as costs of funds,\textsuperscript{228} the

\begin{footnotesize}
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\item \textsuperscript{222}12 C.F.R. § 217.7(c) (1980).
\item \textsuperscript{223}Current version at 12 C.F.R. § 526.3(a)(1) (1980).
\item \textsuperscript{224}Id. § 526.3(a)(8) (1980).
\item \textsuperscript{225}Id. § 526.3(a)(4)(ii) (1980). \textit{See also} 14 \textsc{Fed. Home Loan Bank Board J.}, vol. 7, 91 (Table S.4.12 n.17—Maximum Rates of Return Payable on Savings Accounts by S & Ls that are Members of the FHLB System).
\item \textsuperscript{226}14 \textsc{Fed. Home Loan Bank Board J.}, vol. 7, 89 (Table S.4.8—The Average Cost of Funds to FSLIC Insured Savings and Loan Associations). Semiannual averages have risen dramatically recently. Actual averages were 6.35\%—1st half 1976, 6.40\%—2d half 1976, 6.39\%—1st half 1977, 6.48\%—2d half 1977, 6.54\%—1st half 1978, 6.79\%—2d half 1978, 7.23\%—1st half 1979, 7.71\%—2d half 1979, 8.77\%—1st half 1980, 9.11\%—2d half 1980.
\item \textsuperscript{227}Depository Institutions Deregulation and Monetary Control, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified at 12 U.S.C. § 1828(g) (Supp. IV 1980)).
\item \textsuperscript{228}The semiannual average for interest rates received on the portfolio of mortgages held by FSLIC-insured savings and loan associations was 7.87\%—1st half 1976, 8.03\%—2d half 1976, 8.14\%—1st half 1977, 8.28\%—2d half 1977, 8.39\%—1st half 1978, 8.54\%—2d half 1978, 8.70\%—1st half 1979, 8.95\%—2d half 1979, 9.18\%—1st half 1980, 9.44\%—2d 1980. \textit{Id.}
\end{enumerate}
\end{footnotesize}
impact of higher new mortgage rates for a portfolio of thirty year loans takes much longer to be felt than do changes in passbook accounts which are effected immediately, changes in the MMCs which mature semiannually, or even changes in the thirty month certificates. As mortgage rates rise, the volume of new mortgages has tended to decrease. Furthermore, borrowers who took out mortgages when rates were at their highest will tend to refinance their loans should rates fall. Thus, while rates paid to all savers tend to approach the maximums currently allowable, the return on the lender's mortgage portfolio is an average of all loans made over time, with a weighting in favor of the lower rates.

In the current environment, the reasonableness of enforcing due-on-sale clauses to protect the lender's portfolio must be reexamined. Some of the articles critical of the practice were written at a time when the mortgage rates were "at the extraordinary rate of 9.27%," which today would be referred to as "the good old days."

By restricting the use of due-on-sale clauses, courts have tended to view the conflict as that between the individual home seller and a large financial institution. It may not be coincidental that the defendant in Wellenkamp was the largest banking institution in the United States, the Bank of America. The Wellenkamp court indicated in a footnote that this factor made a difference:

In the instant case the party seeking enforcement of the due-on clause is an institutional lender. We limit our holding accordingly. We express no present opinion on the question whether a private lender, including the vendor who takes back secondary financing, has interests which might inherently justify automatic enforcement of a due-on clauses in his favor upon resale.

Refering to Nichols v. Ann Arbor Federal Savings and Loan Associ-
a commentator has suggested that the interests involved may not be those indicated above. Rather, the interests of the parties to the particular transaction involved may compete with those of all individuals in the market for mortgage money generally. As the author explained:

Perhaps the simplest way to analyze the problem that Nichols raises is to ask: Who should benefit from an increase in interest rates? If the mortgagor is allowed to use his low interest rate to enhance the marketability of the property, only he (and possibly the vendee) will profit. On the other hand, if the mortgagee is permitted to accelerate the loan and reblend at the prevailing rate, he presumably will be able to maintain lower interest rates on new loans, and the benefit will be spread among all home buyers.234

Another commentator has suggested that the balance clearly belongs with enforcement: "Due-on-sale clauses allow borrowers to receive a lower rate, longer terms on the mortgage contract and more readily available mortgage credit."235

While the need for a lending institution to maintain its portfolio at current interest rates has been conceded by many of the critics of due-on-sale provisions, they have suggested that the provision is not the appropriate mechanism, since other devices are at hand.236 The Wellenkamp court suggested that California lenders could protect their portfolios by use of variable interest rate mortgages.237 Effective April 1981, the Federal Home Loan Bank Board issued regulations authorizing federal savings and loan associations to make Adjustable Mortgage Loan Instruments.238 These are completely flexible regulations permitting interest rates tied to any index verifiable by the borrower and beyond the control of the lender. No limitations are placed on the frequency of rate adjustment or the size of adjustment (either periodically or in the aggregate). The Board indicated that market forces would provide any restraints required in the secondary market.

The Comptroller of the Currency has also issued regulations which per-

237. 21 Cal. 3d at 952 n.10, 582 P.2d at 976 n.10, 148 Cal. Rptr. at 386 n.10. See also Comment, supra note 41, at 523.
mit national banks to make adjustable rate mortgages.\textsuperscript{239} Under these regulations the interest rate is tied to one of three specified indices. Rates may not be adjusted more often than semiannually. Interest rate increases are limited to 2\% per year, but there is no aggregate limitation.

While each of these regulations represents significant steps toward allowing mortgages in lender portfolios to be sensitive to money market rates, it will be some time before they have an impact on existing portfolios. This is especially true since their introduction has coincided with a period of very low activity.

In addition to California, several other states have permitted variable rate mortgages, but the due-on-sale controversy has not been mooted.

While traditional policies and rules governing real property, such as the disfavor of restraints on alienation, cannot be ignored, courts must not lose sight of the fact that money lenders must be able to profit from their business. If savings and loans are not permitted to employ the due-on clause in their deeds of trust, they will be forced to utilize other methods of maintaining higher interest rates. At this point, the alternatives seem decidedly inferior. Variable interest rates have not met with enthusiasm and short term loans would prevent many individuals from borrowing at all.\textsuperscript{240}

The trend to adjustable rate or shorter term loans, as a means of keeping portfolio yields at current interest rates, is liable to have an effect unanticipated by the state policy makers, who have suggested such routes as alternatives to due-on-sale enforcement. There is little doubt that the critics of due-on-sale rate increases view themselves as consumer protectors. The main beneficiaries of their efforts presumably are the buyers and sellers of real estate. However, while protecting those who frequently buy and sell, they may be inadvertently harming those who remain in their homes for long periods of time. If the long term owner obtains a fixed rate loan, the initial interest rate is liable to be higher than if the lender had reasonable expectations of increasing the rate upon sale. Since the lender does not have the ability to turn over a statistically predictable portion of its portfolio through sales, it must try to project its costs further into the future; because of the uncertainty, higher initial interest rates may result. However, if the lender can exercise due-on-sale provisions, it knows that a certain percentage of its loans will be subject to renegotiation. It is, therefore, more likely to accept a lower initial interest rate.

\textsuperscript{240} Comment, \textit{The Due-on-Sale Clause As a Reasonable Restraint on Alienation—A Proposal for Texas}, 8 ST. MARY’S L.J. 514, 524 (1976).
Thus, the benefits of a restriction on due-on-sale enforcement that accrue to the home seller are at the expense, ultimately, not of the lending institution, but of the mortgagor who maintains his mortgage for the full term. Similarly, if the lender chooses to adopt a variable rate instrument, the mortgagor whose loan goes full term is likely to be subsidizing the short term homeowner. While generalizations are dangerous in this regard, the ultimate beneficiaries are liable to be the upwardly mobile elements of our society, while the costs will be most heavily borne by those on relatively fixed incomes, such as the elderly or lower income groups. While surely it is within the realm of possibility for policy makers to engage in such a choice, there does not appear to be evidence to suggest that it was, in fact, intended.

One commentator has suggested the possibility that due-on-sale restrictions will have an adverse impact on reverse annuity mortgages (RAMs).241 RAMs are one of the alternative mortgage instruments authorized for federal savings and loans by the FHLBB. Basically, they permit an owner with substantial equity in a home to draw down that equity by receiving a check from the lender for a period of time, building up a mortgage which is later retired. The author explains that:

All three types of RAMs fulfill the same purposes. They allow homeowners—in particular elderly homeowners—to remain in their homes while supplementing income. Yet ironically, the future of RAMs may have been clouded by recent decisions seeking to facilitate the sale rather than retention of homes.

Assuming that RAMs perform a socially valuable function, society might be harmed if lenders refused to offer RAMs in the future or offered them at higher interest rates to compensate for their inability to roll them over.242

D. Secondary Market Impact

The impact on the borrowing public may not be limited to just those interested in obtaining a RAM. On October 23, 1980, FNMA announced a major change in its approach to due-on-sale enforcement.243 Effective with loans it contracted to buy beginning November 10, 1980, it requires enforcement of the due-on-sale provision in the FNMA/FHLMC Uniform Mortgage or Deed of Trust. Transferees with acceptable credit will

\[\text{Note, Reverse Annuity Mortgages and the Due-on-Sale Clause, 32 Stan. L. Rev. 143 (1979).}\]

\[\text{Id. at 150 (emphasis added).}\]

be allowed to assume the existing loan, provided they agree to pay the current market interest rate. FNMA identified eleven jurisdictions in which its right to exercise the due-on-sale provision, in the manner they intend, is restricted by statutory or case law. In those jurisdictions, FNMA will only purchase mortgages if they contain a call option rider. This rider permits the lender to require payment in full of the mortgage when it is seven years old.

FNMA probably chose seven years as the call date since that represented the average life of loans in its portfolio. Thus, in those eleven jurisdictions, mortgagors who sell their homes within seven years retain some of the benefits of a due-on-sale restriction. However, those borrowers who stay in their homes more than seven years face uncertain refinancing probabilities, if not the loss of their homes.

Within days of FNMA’s announcement, the Wall Street Journal carried a feature story indicating that the nation’s largest savings and loan association was discontinuing the origination of first mortgages to concentrate on shorter term, higher rate second mortgage finance. That action made prophetic words written two years earlier: “[A] question legitimately may be asked whether a consumer, who is protected to the point that he or she can no longer get home financing because the sources of funds have dried out, is that much better off than before.”

The FNMA call option rider is not required of federal savings and loan associations since the due-on-sale provision is arguably enforceable under the FHLBB regulations. Earlier, FHLMC had announced its unwillingness to purchase loans in Minnesota and Georgia from lenders other than federal savings and loan associations because of these states’ restrictions on the credit underwriting aspects of transfers.

These actions present serious problems for state authorities in the states in which FNMA is requiring the call option rider. As current conditions make depository institutions less able to rely on deposits as their source of funds for long-term mortgage lending, greater reliance will have to be placed on the secondary mortgage market as a source of liquidity. Thus, even if immediate sale is not anticipated, prudent management will require any loans the institution makes to be potentially marketable. For institutions other than federal savings and loans associations, this will probably suggest inclusion of a call option rider for possible sale to FNMA.

244. They are Arizona, Arkansas, California, Colorado, Illinois, Iowa, Michigan, Minnesota, New Mexico, South Carolina and Washington.
However, federal savings and loan associations in those jurisdictions will be able to originate fixed rate mortgages without the call option rider. This could give the federal associations a competitive advantage over the state-chartered institutions. One way the state-chartered institutions might compete is to lower the yield requirements for the loans it makes with the call option rider. However, since state-chartered institutions compete with federal savings and loan associations for savers’ dollars, their costs of funds are likely to be nearly the same. If the average life of a mortgage loan is seven years, the federal association will be able to match the yield quotes of the state-chartered association. The only way the state-chartered institution could then attract business is by offering to make loans with interest rates that are unprofitable to its competition, but unfortunately, also unprofitable to themselves. So long as the federal savings and loan associations are able to offer mortgage terms that are more palatable than those available from state-chartered institutions, the state-chartered lenders are faced with the possibility of eventual insolvency. An interesting attempted solution to this problem has been enacted in Florida, where a statute gives Florida-chartered savings and loan associations the same rights afforded federal savings and loan associations.\textsuperscript{247}

Another way the state-chartered institution might seek to overcome the competitive disadvantage would be to become a federal savings and loan association. In either event, adherence to a policy of restricting due-on-sale enforcement by state policymakers is liable to lead to the attrition of the state-chartered savings and loan industry, by either insolvency or absorption into the federal system. Even if the institutions remain, they are unlikely to be able to compete for the first mortgage business and will have to confine their activities to other kinds of lending.

While the result might suggest a heavy-handed federal imposition of due-on-sale upon unwilling states, that is too much of an oversimplification. For one thing, in some of the states, the policy restricting due-on-sale has come from the judicial branch. In the absence of a pronouncement from the legislative branch of state government, it is difficult to say that the public policy of the state is contrary to enforcement of due-on-sale clauses, especially when no state court that has ruled against due-on-sale has adequately dealt with all the issues involved.

\section*{E. Uniform Land Transaction Act (ULTA) Approach}

The impact and desirability of a national secondary market was recognized by the Commissioners on Uniform State Laws. In 1975 they pro-
posed a Uniform Land Transaction Act (ULTA).\textsuperscript{248} In explaining the need for the ULTA, the Commissioners said:

For a number of years, persons concerned about generating sufficient resources for the production of adequate housing for all segments of society have been interested in restructuring of private law, as well as the use of various governmental programs, as a way of stimulating the housing market. Particularly, there is growing emphasis on a national secondary market for real estate mortgages which would encourage various financial entities to invest in mortgage backed securities . . . . One of the major purposes of this Act is to provide uniformity in state law which will facilitate the creation of a legal atmosphere which encourages development of a widespread secondary mortgage market. In addition to encouraging the secondary market, uniformity of state law will encourage widespread lending by financial entities which presently may restrict their lending to a few states because of the difficulties and additional expense involved in dealing in other states with widely varying laws.\textsuperscript{249}

The ULTA deals with the question of due-on-sale enforcement as follows:

(a) Notwithstanding any agreement to the contrary, a debtor's right to collateral may be voluntarily or involuntarily transferred. The security agreement may provide that a sale without consent of the secured creditor is a ground for acceleration of the debt.

(b) Notwithstanding any agreement to the contrary, if a secured creditor demands a rate of interest higher than that specified in the security agreement or other consideration (exclusive of reimbursement for reasonable expenses and reasonable assumption charges) as a condition of approval of a transfer by a protected party of his interest in residential real estate subject to a security interest, and the higher rate of interest or other consideration is not agreed to, a prepayment penalty may not be charged if the debt is paid in full within three months after the failure to agree to a higher rate of interest.\textsuperscript{250}

The FNMA/FHLMC documents are compatible with the ULTA approach since the note forms do not provide for a prepayment penalty at any time. However, to date, the ULTA has not been adopted in any state.

\textsuperscript{248} Uniform Land Transaction Act (1977).
\textsuperscript{249} HandBook of the National Conference of Commissioners on Uniform State Laws & Proceedings of the Annual Conference Meetings in Its Eighty-Fourth Year, 152 (1975).
\textsuperscript{250} Uniform Land Transaction Act § 3-208 (1977).
IX. CONCLUSION

It is clear that the supply of conventional mortgage financing in the future is dependent upon access to national sources of funds. It is equally clear that a national source of funds is dependent upon uniform instruments and reasonably similar approaches to basic questions of enforcement. Among the basic questions that require uniform approach is the enforcement of due-on-sale clauses. There appear to be at least two ways in which this uniformity can be accomplished. The states, acting independently, can provide for greater uniformity among the states by adoption of the ULTA or similar provisions. Second, Congress could mandate the uniformity by enacting ULTA-like legislation and imposing it on the states, much like it did with the usury law override.

To the extent that Congress has established two large secondary market facilities (FNMA and FHLMC), the argument might be made that Congress has already entered the arena of due-on-sale enforcement. If so, possibly any mortgage eligible for sale to either of the corporations might be found to be exempt from state law prohibition of enforcement of due-on-sale clauses.

While there are many possible arguments that could be made to the various courts dealing with the issue, that approach is a long, uncertain one and will probably lead to inconsistent results. In view of the increasing dependence that local real estate markets will have on national capital markets for sources of funds, the ultimate victims of a case by case approach are likely to be the intended beneficiaries. Thus, national adoption of a ULTA-like approach to due-on-sale enforcement, either by state or federal action, is vital to the real interests of borrowers and lenders alike.

The equity courts in states, like New Jersey and New York, which permit due-on-sale enforcement, have shown that they are capable of preventing abusive enforcement of the provision when unusual circumstances are present. Even under a ULTA approach, the courts could intervene in those unusual circumstances of lender overreaching. In the final analysis, that is all that is required to best protect the interests of all concerned.