

CASE COMMENT

DUE-ON-SALE CLAUSE NOT A RESTRAINT ON ALIENATION OF PROPERTY

Occidental Savings & Loan Association v. Venco Partnership,
206 Neb. 469, 293 N.W.2d 843 (1980)

Holding that a due-on-sale clause¹ does not restrain alienation of property, the Nebraska Supreme Court, in *Occidental Savings & Loan Association v. Venco Partnership*,² adopted a unique position among the states concerning exercise of the due-on provision by lending institutions.³

Plaintiff, Occidental Savings and Loan Association, loaned money to Venco Partnership and executed a promissory note providing that if the borrower violated any condition of the mortgage that secured payment of the note, the loan association could declare the remaining indebtedness due and payable.⁴ The mortgage contained a due-on-sale clause stating that in the event of the sale of the property without the lender's consent, the lender could accelerate the loan.⁵ Upon transfer of the property that was security for the loan, Occidental accelerated the debt pursuant to the loan agreement. Following defendant's failure to pay off its remaining indebtedness, Occidental sought foreclosure of the mortgage.⁶ The Nebraska district court found that the due-on clause was valid and enforceable and ordered foreclosure of the mortgage.⁷ The Nebraska Supreme Court on appeal affirmed and *held*: A due-on-sale clause in a mortgage contract neither directly⁸ nor indirectly⁹ restrains alienation of property and is therefore an enforceable contractual provision absent a showing by the mortgagor that enforcement

1. See note 38 *infra* and accompanying text.

2. 206 Neb. 469, 479, 293 N.W.2d 843, 848 (1980).

3. See notes 67-82 *infra* and accompanying text.

4. Petition for Foreclosure of Mortgage at 1, *Occidental Sav. & Loan Ass'n v. Venco Partnership*, No. 744-160 (Neb. Dist. Ct. April 2, 1979), *aff'd*, 206 Neb. 469, 293 N.W.2d 843 (1980).

5. *Id.* at 2.

6. *Id.*

7. *Occidental Sav. & Loan Ass'n v. Venco Partnership*, No. 744-160, slip op. at 3 (Neb. Dist. Ct. April 2, 1979), *aff'd*, 206 Neb. 469, 293 N.W.2d 843 (1980).

8. 206 Neb. at 473, 293 N.W.2d at 845. See notes 70-71 *infra* and accompanying text.

9. 206 Neb. at 479, 293 N.W.2d at 848. See notes 72-73 *infra* and accompanying text.

would produce an inequitable result.¹⁰

Since the enactment of the Statute Quia Emptores¹¹ in 1290, courts have consistently held that restraints on the alienation of property¹² are repugnant to the fee simple estate.¹³ Free alienability encourages property improvement,¹⁴ dispersion of wealth,¹⁵ and protection of creditors' rights.¹⁶ The broad prohibition encompasses both direct and indirect inhibitions on sales of property.

Direct restraints restrict or prohibit property owners from transferring their ownership interest.¹⁷ These restrictions, classified according to the mechanism by which property transfer is circumscribed, are either disabling, forfeiture, or promissory,¹⁸ all of which are per se ille-

10. 206 Neb. at 482, 293 N.W.2d at 850.

11. Stat. 18 Edw. I, c. 1 (1290).

12. See L. SIMES & A. SMITH, *THE LAW OF FUTURE INTERESTS* § 1115 (2d ed. 1956) [hereinafter cited as SIMES & SMITH]. The Statute Quia Emptores established the rule that no one could restrict the power to alienate an estate in fee simple. The statute changed the prior policy that perpetuated the feudal organization by allowing persons to "convey land in fee simple on the condition that the tenant might not alienate." SIMES & SMITH, *supra*, § 1114, at 6.

13. An inherent characteristic of a fee is that it is freely alienable. Any restriction on the transfer is therefore repugnant by definition. See Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 750 (1973). SIMES & SMITH, *supra* note 12, § 1133, at 19 argues that this is circular reasoning.

14. If a landowner could not receive value for his efforts, he might be less likely to invest time and money for improvements. Free alienation increases community development and increases taxable values. The restraints on alienation doctrine encourages property improvement because a land owner who invests time and money to improve the property can sell it and receive value for his effort. This increases community development and increases taxable values. See Schnebly, *Restraints Upon the Alienation of Legal Interests: I*, 44 YALE L.J. 961, 964 (1935). See also Morse v. Blood, 68 Minn. 442, 71 N.W. 682 (1897).

15. See Bernhard, *The Minority Doctrine Concerning Direct Restraints on Alienation*, 57 MICH. L. REV. 1173, 1179-80 (1959). See also SIMES & SMITH, *supra* note 12, § 1117, at 10-11.

The necessity of imposing some restraint on the power of protracting the acquisition of the absolute interest in, or dominion over property, will be obvious, if we consider, for a moment, what would be the state of a community in which a considerable portion of the land and capital was locked up. That free and active circulation of property, which is one of the springs as well as the consequences of commerce, would be obstructed; the improvement of land checked; its acquisition rendered difficult; the capital of the country gradually withdrawn from trade; and the incentives to exertion in every branch of industry diminished.

Id. (quoting T. JARMAN, *WILLS* 219 (2d ed. 1843)).

16. The restraints on alienation doctrine protects creditors by allowing them to foreclose on property in the event the borrower defaults on payments. Bernhard, *supra* note 15, at 1180; Schnebly, *supra* note 14, at 964.

17. SIMES & SMITH, *supra* note 12, § 1131.

18. RESTATEMENT OF THE LAW OF PROPERTY § 404, at 2381 (1944) [hereinafter cited as RESTATEMENT].

gal. A disabling restraint¹⁹ prevents a transferee from conveying land. A forfeiture restraint²⁰ denies the grantee his estate upon any attempt to dispose of the property; under a forfeiture clause, the grantor creates a reversion or a gift in favor of a third party in the event the property is alienated. A promissory restraint²¹ imposes contractual liability on the conveyee for breach of his agreement with the conveyor not to transfer property.

In contrast, an indirect restraint²² occurs as a result of an attempt to accomplish something other than the restraint of sale. Direct restraints limit the power to alienate, but indirect restraints inadvertently give rise to inalienability by the creation of a less marketable estate.²³ Most indirect restraints are legally unobjectionable.²⁴ Certain indirect restraints, however, are unreasonable and are controlled or prohibited by law. For example, the rule against perpetuities²⁵ limits the creation of contingent or executory future interests²⁶ and indestructible trusts,²⁷ all of which are indirect restraints.

Courts are divided in their evaluation of the exceptions to the direct restraints doctrine. Most courts²⁸ consider restraints on alienation according to well-defined exceptions,²⁹ following the format of the *Re-*

19. Examples of language creating a disabling restraint are: "that the conveyee shall not have the power to alienate, . . . the privilege of transferring, or that a transfer shall be null and void, or that the land shall not be subject or liable to conveyance, or that he shall not sell or that the land shall not be sold . . ." SIMES & SMITH, *supra* note 12, § 1136, at 21-22. Disabling restraints are the worst possible restraints because they "enable the person restrained to deny the validity of his own conveyance and also . . . deny his creditors resort to the property interests which he is enjoying." RESTATEMENT, *supra* note 18, § 405, at 2390.

20. RESTATEMENT, *supra* note 18, § 404(1)(c), at 2381.

21. *Id.* § 404(1)(b), at 2381.

22. SIMES & SMITH, *supra* note 12, § 1116, at 9-10.

23. *Id.* § 1201, at 88-89.

24. *Id.*

25. While the doctrine against restraints on alienation operates on direct restraints, the rule against perpetuities restricts the creation of future interests that cannot vest within a life or lives in being and twenty-one years. *Id.* § 1222, at 106-08. The rule does not eliminate all future interests but prohibits the creation of interests that are too remote. *Id.* § 1117, at 13.

26. *Id.* §§ 1235-1237.

27. *Id.* §§ 1391-1395.

28. *See, e.g.,* *Hinshaw v. Wright*, 124 Kan. 792, 262 P. 601 (1928); *Wright v. Jenks*, 124 Kan. 604, 261 P. 840 (1927); *Nebraska Nat'l Bank v. Bayer*, 123 Neb. 391, 242 N.W. 115 (1932). *See generally* Manning, *The Development of Restraints on Alienation Since Gray*, 48 HARV. L. REV. 373 (1935).

29. Professor Bernhard criticizes the majority view as both over- and underinclusive. It is overinclusive in that courts may sometimes uphold restraints that are unreasonable and, conversely, restrictions that are reasonable may not fall within one of the accepted categories of rea-

statement of the Law of Property.³⁰ These exceptions, or restraints that are prima facie reasonable, are categories in which the social benefits outweigh the repugnancy of the restraint.³¹

The land vendor contract is a well-recognized exception to the category of promissory restraint³² because, over time, courts have concluded that the validity of its purpose outweighs its impact on alienability. This type of contract prevents a vendee from transferring property before he possesses the deed. Although the vendee has equitable title, the vendor retains legal title until the debt is paid. The contract does not unduly restrain alienation because the contract provision relates directly to protection of the vendor's security interest. The vendee is free to transfer the property once he fulfills his contractual obligations.³³

sonable restraints. In Professor Bernhard's view, the majority approach causes courts to carve out a greater number of exceptions and "water down" the majority test. The better approach is to determine reasonableness on a case by case basis. Bernhard, *supra* note 15, at 1186.

30. The *Restatement* recognizes a group of valid restraints—exceptions distinguished by a reasonableness standard. According to the *Restatement*, a promissory or forfeiture restraint is void unless "(b) the restraint is qualified so as to permit alienation to some though not all possible alienees, and (c) the restraint is reasonable under the circumstances, and (d) if the restraint is a forfeiture restraint, the requirements of the rule against perpetuities are satisfied." RESTATEMENT, *supra* note 18, § 406, at 2393.

31. Generally, disabling restraints are void whether they apply to fee simple estates, estates for years, life estates, or fee tails. Courts, however, recognize the spendthrift trust as one exception to the rule prohibiting disabling restraints. The reason for this exception is that the conveyer wants to assure the continuing support of the conveyee. It is easy to make this exception because "the trust itself hinders alienability as a practical matter Secondly, persons, dealing with the owner of an equitable interest are perhaps less likely to place reliance on such ownership than if a legal interest were involved." Bernhard, *supra* note 15, at 1181. See also RESTATEMENT, *supra* note 18, § 405, at 2391.

Although forfeiture restraints are presumed invalid, courts recognize these restraints if they are applied to life estates or estates for years or if they create rights of preemption. A restraint is tolerated on a lesser estate because this type of estate is less marketable than an estate in fee simple. When a purchaser buys property from a person with a life estate he will own the property only for the life of the person who has a life estate. For this reason a restraint on a lesser estate will create no further restraint on alienability. RESTATEMENT, *supra* note 18, § 409, at 2421-28.

Promissory restraints are generally void on the theory that a restraint on the practical alienability of property is against public policy and contracts against public policy are void. SIMES & SMITH, *supra* note 12, § 1161, at 74. Courts, however, have allowed restraints in the form of provisions in business organizations, articles prohibiting the transfer of shares, and provisions protecting the vendor in a land sale contract. See, e.g., *Krebs v. McDonald's Ex'x*, 266 S.W.2d 87 (Ky. 1953) (transfer of shares); *Sloman v. Cutler*, 258 Mich. 372, 242 N.W. 735 (1932) (land sale contracts); *Farmer's Mercantile & Supply Co. v. Laun*, 146 Wis. 252, 131 N.W. 366 (1911) (provision in business organization).

32. RESTATEMENT, *supra* note 18, § 416, at 2448.

33. Goddard, *Non-Assignment Provisions in Land Contracts*, 31 MICH. L. REV. 1, 10 (1932).

Unlike the majority courts that strictly apply the *Restatement* in restraints tests, the minority courts³⁴ analyze the reasonableness of alleged restraints on the facts of each case. These courts weigh the social value of a particular restriction against its impact on alienability.³⁵

The due-on-sale clause is a provision in a mortgage contract, deed of trust,³⁶ or note secured by a deed of trust that allows a lender to accelerate³⁷ the debt if the mortgagor conveys the property without the lender's consent.³⁸ The clause has two purposes. First, lenders exercise

34. The minority doctrine first gained support in Nebraska and Kentucky. The Nebraska Supreme Court, in *Andrews v. Hall*, 156 Neb. 817, 58 N.W.2d 201 (1953), overruled application of the minority test, holding that any restraint on a fee simple estate is invalid. For Kentucky cases following the minority approach see *Cooper v. Knuckles*, 212 Ky. 608, 279 S.W. 1084 (1926). Some cases recognize the minority approach in dictum. See, e.g., *Roemhild v. Jones*, 239 F.2d 492 (8th Cir. 1957); *Commonwealth Realty Corp. v. Bowers*, 261 Md. 285, 274 A.2d 353 (1971); *Ink v. Plott*, 175 N.E.2d 94 (Ohio App. 1960). See also *SIMES & SMITH*, *supra* note 12, § 1150, at 50.

35. Under the minority view courts determine reasonableness on a case approach, using a balancing test. Because of the uncertainty of the approach, commentators criticize the minority doctrine arguing that it will encourage litigation. "If a court were to adopt simply a generalized proposition that any reasonable restraint is valid, it would be impossible, without litigation, to ascertain the validity of any particular provision." *SIMES & SMITH*, *supra* note 12, § 1150.5, at 11 (Supp. 1981). Persons might be more likely to include a restraint in an instrument if they knew a court might uphold it under a reasonableness test. Professor Bernhard disputes this argument by pointing out that Kentucky litigation in the area has not increased significantly more than litigation in other states. Bernhard, *supra* note 15, at 1187.

36. A deed of trust is "[a]n instrument . . . by which legal title to real property is placed in one or more trustees, to secure the repayment of a sum of money or the performance of other conditions." *BLACK'S LAW DICTIONARY* 373 (5th ed. 1979).

37. Acceleration in a loan context means that a lender, upon breach of conditions in the loan instrument, can call due the remaining indebtedness of the loan. *Id.* at 12.

38. A typical due-on-sale clause states, "should the mortgagor sell, transfer or dispose of the mortgaged property or any part thereof, without the written consent of the mortgagee, then the mortgagee shall have the right, at its option, to declare all sums secured by the mortgage to be immediately due and payable." Volkmer, *supra* note 13, at 768. Examples of transfers which operate to accelerate the remaining indebtedness are "(a) the transfer of title or possession by outright sale, sale on land contract, or lease; and devise, descent or distribution upon death . . ." Dunn, *Enforcement of Due-on-Transfer Clauses*, 13 *REAL PROP. PROB. & TR.* 891, 893 (1978).

The due-on encumbrance clause is a second kind of due-on provision. Encumbrance clauses enable lenders to accelerate payment of the remaining indebtedness when a mortgagor further encumbers the property by engaging in secondary financing. For a distinction between the due-on-sale and the due-on-encumbrance provisions see *LaSala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 880, 489 P.2d 1113, 1123, 97 Cal. Rptr. 849, 859-60 (1971); Volkmer, *supra* note 13, at 780. *But see Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 949-50, 582 P.2d 970, 973-75, 148 Cal. Rptr. 379, 383 (1978). See also *Medovoi v. American Sav. & Loan Ass'n*, 152 Cal. Rptr. 572, 583-84 (1979) (Thompson, J., concurring).

For a general discussion of the due-on-sale clause see Cohen, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 *STAN. L. REV.* 1109 (1975); Flaherty, *Illinois Land Trusts and the Due-on-Sale Clause*, 65 *ILL. B.J.* 376

the clause to protect their security interest in the property against waste or default by preventing a buyer with a bad credit record from assuming the mortgage.³⁹ Second, lenders use the clause to shorten the effective term of mortgages, enabling them to maintain their loan portfolios at current rates in times of rising interest.⁴⁰

(1977); Comment, *Mortgages—A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485 (1973); Comment, *The Due-on-Sale Clause as a Reasonable Restraint on Alienation—A Proposal for Texas*, 8 ST. MARY'S L.J. 514 (1976); Comment, *Debt Acceleration on Transfer of Mortgaged Property*, 29 U. MIAMI L. REV. 584 (1975); 47 MISS. L.J. 331 (1976).

39. See, e.g., *Peoples Sav. Ass'n v. Standard Indus.*, 22 Ohio App. 2d 35, 36-37, 257 N.E.2d 406, 407-08 (1970). Lenders fear a buyer who may allow property to deteriorate and thereby decrease in value. If the value diminishes and the buyer defaults on payments then the lender may be unable to satisfy his claim from the proceeds at a foreclosure sale. See Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F.L. REV. 267, 275 (1972). See also Cohen, *supra* note 38, at 1115.

Lenders investigate the financial stability of borrowers before making loans. This investigation includes researching a borrower's "income, employment, credit standing, and general financial condition." Dunn, *supra* note 38, at 894. In some transactions the lender will undertake a more rigorous investigation and consider the "borrower's experience in similar circumstances, its management capabilities, financial stability, sources of capital and business associates." *Id.* By following this procedure lenders hope to assure themselves of loaning capital to creditworthy borrowers. The due-on-sale clause offers continued protection to lenders upon transfer of property to potentially financially unstable buyers. See note 92 *infra* and accompanying text.

40. Under most circumstances the mortgagee will not consent to the transfer of the property unless the new buyer agrees to renegotiate the mortgage at a higher interest rate. This rate, however, is usually less than the market rate at the time of the transfer. See generally Note, *Use of "Due-on" Clauses to Gain Collateral Benefits: A Commonsense Defense*, 10 TULSA L. REV. 590 (1975).

Protecting the lender against changes in the money market generates the most controversy for courts in deciding whether enforcement of the due-on clause by state chartered institutions is valid. State courts that accept the lender's economic interest argue that the effect of not enforcing the clause is to increase interest rates. In order to attract savings customers who supply the loan capital, savings and loan companies must increase dividends, thereby increasing the cost of money to the association. These factors reduce the money available for new loans. The increase in the cost of money to the association is passed on to borrowers in the form of higher interest rates. *Id.* at 593.

The Bank Board, which regulates federally chartered institutions, strongly supports use of the due-on clause for the lender's economic protection. Federal associations receive their funds from short term sources such as passbook savings accounts, certificate savings accounts, and advances from the Federal Home Loan Bank system. The funds are invested in long term loans. "The difficult problem of borrowing short and lending long has been aggravated by the fact that in the post-war years the cost of funds to savings and loan associations, on balance, has been constantly increasing, and savings and loan associations . . . operate on a very thin margin of profit . . ." Advisory opinion of the Federal Home Loan Bank Board at 21, *Schott v. Mission Fed. Sav. & Loan Ass'n*, No. CIV-75-366-WMB (C.D. Cal. July 30, 1975). Economic analysis shows that the cost of funds to the savings and loan associations is increasing faster than portfolio yields. For this

Although many courts recognize that the due-on clause does not fit directly into any category described in the *Restatement*, they assert that the clause resembles a promissory restraint.⁴¹ The due-on clause is a contractual provision that may affect the practical alienability of property when financing is difficult to obtain. Other courts assume without analysis that the clause indirectly restrains alienation and enter judgments based on the reasonableness of enforcement.⁴²

After concluding that the due-on clause restrains alienation of property, courts differ on the issue of reasonableness.⁴³ All jurisdictions uphold use of the clause as reasonable when lenders exercise it to protect themselves from transfers to uncreditworthy buyers.⁴⁴ Although courts are split on the issue of enforcement when state chartered institutions seek to force renegotiation at higher interest rates,⁴⁵ at least one court has upheld discretionary use by federally chartered associations on post-1976 agreements.⁴⁶ Congress directed the Federal Home Loan Bank Board to pursue policies that support the financial health of member associations.⁴⁷ In 1976 the Bank Board adopted regulations

reason the Board has determined that the due-on clause is necessary to protect federally chartered institutions. *Id.* at 22.

41. *See, e.g., Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 124-26, 333 N.E.2d 1, 4 (1975).

42. "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." *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 166-67, 250 N.W.2d 804, 806 (1977). *See Crocket v. First Federal Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976). *See also First Commercial Title Inc. v. Holmes*, 550 P.2d 1271 (Nev. 1971); *Dunn, supra* note 38, at 901.

43. *See* notes 53-55 *infra* and accompanying text.

44. *Id.*

45. *See* notes 54, 56 *infra* and accompanying text.

46. In *Glendale Fed. Sav. & Loan Ass'n v. Fox*, 459 F. Supp. 903 (C.D. Cal. 1978), the district court held that federal law preempts state law on the validity of due-on clause enforcement in loan instruments executed after 1976. *Id.* at 912. For a discussion on procedural problems concerning federal court jurisdiction over claims brought against federally chartered savings and loan associations see O'Connell, *The Due-on-Sale Clause in Florida: A Potential Battleground for Borrowers and Lenders*, 31 U. FLA. L. REV. 933, 955-56 (1980). For a discussion of due-on clause enforcement in pre-1976 agreements see note 49 *infra*.

47. In 1932 Congress created the Federal Home Loan Bank Act to alleviate the emergency in home financing caused by the depression. 12 U.S.C. § 1421 (1976). The Bank Act created the Home Loan Bank Board, a federal agency that was directed to (1) set up twelve banks to serve as wholesale banks for member institutions, and (2) make mortgage loans directly to members of the public. There was no improvement in the system and over 40% of all home loans were in default. Brief of Federal Home Loan Bank Board as Amicus Curiae at 6, *First Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

In 1933 Congress established the Home Owners Loan Act (HOLA) to provide relief from home

that allow federal institutions to enforce the clause.⁴⁸ When federal and state law conflict, federal law preempts contrary state regulation of due-on clause enforcement.⁴⁹

mortgage indebtedness, amend the Bank Act and, most important, to create a system of federal savings and loan associations. 12 U.S.C. § 1464 (1976 & Supp. III 1979). *See* Schram v. Welton, 35 F. Supp. 889 (E.D. Mich. 1940); Prato v. Home Owners' Loan Corp., 24 F. Supp. 844 (D. Mass. 1938), *rev'd on other grounds*, 106 F.2d 128 (1st Cir. 1939); Bealkowski v. Powers, 310 Ill. App. 662, 35 N.E.2d 386 (1941); Walker v. Oakley, 347 Pa. 405, 32 A.2d 563 (1943). *See also* T. KENDALL, *THE SAVINGS AND LOAN BUSINESS* 6 (1962).

As part of the federal system Congress gave the Bank Board plenary power over the creation and regulation of federal associations. Under § (a) of the HOLA the Bank Board is directed to regulate federal institutions by giving authority to the best practices of local mutual thrift institutions in the United States. The Bank Board was to examine the practices of state institutions and select what it considered to be the best practices in order to achieve a uniform system of national regulation. Section (a) provides in part:

In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations", . . . and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States.

12 U.S.C. § 1464(a) (Supp. III 1979).

48. One area of federal institutions that the Bank Board regulates is the contract between the association and its borrowers. In 1976 the Bank Board specifically adopted amendments authorizing use of the due-on clause. The 1976 amendment provides in part:

A Federal association continues to have the power to include as a matter of contract between it and the borrower, a provision in its loan instruments whereby the association may, at its option, declare immediately due and payable all of the sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent. . . . [Such an acceleration option (hereinafter called a due-on-sale clause) shall be governed exclusively by the terms of the contract between the association and the borrower

§ 545.6-11(f), 41 Fed. Reg. 18,288 (1976).

49. *See* Glendale Fed. Sav. & Loan Ass'n v. Fox, 459 F. Supp. 903 (C.D. Cal. 1978). *Accord*, Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 377 F. Supp. 11, 17 (N.D. Ill. 1974). *See also* Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n, 499 F.2d 1145 (9th Cir. 1974); Greenwald v. First Fed. Sav. & Loan Ass'n, 446 F. Supp. 620 (D. Mass. 1978); Rettig v. Arlington Heights Fed. Sav. & Loan Ass'n, 405 F. Supp. 819 (N.D. Ill. 1975).

The supremacy clause, article 6, section 2, of the United States Constitution, grants Congress the power to preempt any legislative field over which it has jurisdiction. The Constitution states:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made under the Authority of the United States, shall be the supreme Law of the land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

U.S. CONST. art. VI, § 2. Congress may either implicitly or explicitly preclude state regulation. *See* Brief of Federal Home Loan Bank Board as Amicus Curiae, First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980). Under the occupation of the field theory, if Congress acts on a subject in which the federal interest is dominant, courts conclude that the

federal legislature left no room for concurrent state regulation even though Congress did not specifically declare its intent to preclude state law. *See Jones v. Rath Packing Co.*, 430 U.S. 519, 525-26 (1977) (federal law regulating meat inspection permitting reasonable variations in statement of package weight preempts state law requiring that package weight not be less than that stated on label); *City of Burbank v. Lockheed Air Terminal, Inc.*, 411 U.S. 624, 633 (1973) (federal law regulating airport noise preempts local control—reasonable inference that Congress left no room for states to supplement federal law). *See also DeCanas v. Bica*, 424 U.S. 351 (1976); *Campbell v. Hussey*, 368 U.S. 297 (1961).

The HOLA is evidence that Congress intended to preempt state regulation of federal associations. Congress directed the Bank Board to give primary consideration to the best practices of state law to create a uniform system of federal regulation. It is impossible to conclude from this directive to the Board that Congress left room for concurrent state regulation. To do so would have perpetuated in the federal system the state practices HOLA was designed to eliminate.

"[C]ourts have upheld the authority of the Board on the basis that the plenary powers given to the Board in the HOLA clearly evidence a Congressional intention to preempt the field, thus precluding any regulation of federal associations by state law." *Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 377 F. Supp. 11, 17 (N.D. Ill. 1974).

The Bank Board's 1976 amendment explicitly states the Board's intention to *exclusively* regulate the use of the due-on-sale clause in federal associations. *See* Preamble to 12 C.F.R. § 545.6-11(f). *See also* Brief of Federal Home Loan Bank as Amicus Curiae at 29, *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

Although prior to 1976 the Bank Board did not specifically regulate use of due-on-sale clauses by federal associations, the Bank Board interpreted an earlier 1948 regulation to authorize such. *See* Advisory Opinion of Federal Home Loan Bank Bd., Resolution No. 75-647, *Schott v. Mission Fed. Sav. & Loan Ass'n*, No. CV-75-366-WMB (C.D. Cal. July 30, 1975). The 1948 regulation broadly stated that a loan contract between the association and its customers shall fully protect Federal Associations.

Section 545.6-11 provides:

(a) *Required and authorized provisions.* Each loan shall be evidenced by note, bond, or other instrument . . . as in keeping with sound lending practices. The loan contract shall provide for full protection to the Federal association in accordance with applicable provisions of law, applicable governmental rules and regulations

40 Fed. Reg. 20,942-43 (1975).

In *Schott v. Mission Fed. Sav. & Loan Ass'n*, No. CV-75-366-WMB (C.D. Cal. July 30, 1975), the district court interpreted the 1948 regulation as authorizing use of the clause by the federal association to maintain its loan portfolio at current rates. The court ordered the Bank Board to consider the affidavits and economic analysis of both parties to determine whether the regulation was intended to authorize use of the clause by federal associations.

In 1975 Bank Board economists evaluated the material and issued a formal ruling that the 1948 regulation authorized federal associations to use the due-on clause for their economic protection. Advisory Opinion of Federal Home Loan Bank Bd., Resolution No. 75-647, *Schott v. Mission Fed. Sav. & Loan Ass'n*, No. CV-75-366-WMB (C.D. Cal. July 30, 1975). Although courts presume the validity of an administrative agency's interpretation of its regulation unless the interpretation is inconsistent with the plain language of the statute or contrary to public policy, *Udall v. Tallman*, 380 U.S. 1 (1965); *Bowles v. Seminole Rock Co.*, 325 U.S. 410 (1945); *Kupiec v. Republic Fed. Sav. & Loan Ass'n*, 512 F.2d 147 (7th Cir. 1975), whether federal law preempts contrary state regulation in the area of due-on clause enforcement prior to 1976 is unsettled. *See also Derenco, Inc. v. Benjamin Franklin Fed. Sav. & Loan Ass'n*, 281 Or. 533, 577 P.2d 477 (1978); *Kaski v. First Fed. Sav. & Loan Ass'n*, 72 Wis. 2d 132, 240 N.W.2d 367 (1976).

Courts applying state law adopt either the majority⁵⁰ or minority⁵¹ restraints tests to determine whether the due-on clause is reasonable. Under the majority approach, courts analogize the due-on provision to the land vendor contract exception described in the *Restatement*.⁵² These courts automatically enforce the clause⁵³ regardless of the lender's motive,⁵⁴ unless the claimant proves that enforcement in a par-

50. See notes 29-31 *supra* and accompanying text.

51. See notes 34-35 *supra* and accompanying text.

52. See, e.g., *Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

We see little difference in the end to be promoted by the restraint contained in the mortgage in this case from the end which is recognized as a legitimate object of protection by a restraint contained in a contract for sale of land. Section 416 of the *Restatement of the Law of Property* states that a restraint imposed by a vendor on the interest of a vendee under a contract for sale of land is valid. The restraint is imposed primarily for the protection of the security interest of the vendor.

Id. at 121, 333 N.E.2d at 4.

53. *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 303, 509 P.2d 1240, 1245 (1973) (protecting lender from inflationary conditions in money market reasonable grounds for enforcing due-on clause); *Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 126, 333 N.E.2d 1, 4-5 (1975) (protecting lender's interest in property is valid and clause is automatically enforceable without consideration of facts of particular case); *Century Fed. Sav. & Loan Ass'n v. Van Glahn*, 144 N.J. Super. 48, 54, 364 A.2d 558, 561 (1976) (acceleration clause is valid term in contract and automatically enforceable even for maintenance of lender's loan portfolio—transfer of equitable title sufficient to invoke clause); *Poydan, Inc. v. Agia Kiriaki, Inc.*, 130 N.J. Super. 141, 149, 325 A.2d 838, 842-43 (1974) (reasonable for creditors to reserve right to determine whom they will accept as debtor in possession of milk license, restaurant, and property); *Shalit v. Investors Sav. & Loan Ass'n*, 101 N.J. Super. 283, 289, 244 A.2d 151, 155 (1968) (due-on clause reasonable restraint on alienation); *Stith v. Hudson City Sav. Inst.*, 63 Misc. 2d 863, 867, 313 N.Y.S.2d 804, 808 (Sup. Ct. 1970) (automatically enforceable in recognition of lender's economic interests in protecting loan portfolio at current interest rates); *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 631, 224 S.E.2d 580, 587 (1976) (enforceable without showing of impairment to lender's security interest); *People's Sav. Ass'n v. Standard Indus., Inc.*, 22 Ohio App. 2d 35, 38, 257 N.E.2d 406, 407-08 (1970) (clause permitting lender to treat transfer of property without lender's consent as default entitling lender to balance due was automatically enforceable); *Gunther v. White*, 489 S.W.2d 529, 532 (Tenn. 1973) (increased rate of interest to protect economic interest of lender a valid reason for enforcing contractual provision); *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 406, 545 P.2d 546, 549 (1976) (provision allowing lender to increase interest rate automatically enforceable absent showing of unconscionability); *Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works*, 71 Wis. 2d 531, 538-39, 239 N.W.2d 20, 23-24 (1976) (contractual provision allowing acceleration automatically enforceable absent showing of laches).

54. Many courts that automatically enforce the clause specifically recognize lenders' interests in maintaining their loan portfolios at current rates as well as their interest in protecting their security from waste and depreciation. See *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 509 P.2d 1240 (1973); *Century Fed. Sav. & Loan Ass'n v. Van Glahn*, 144 N.J. Super. 48, 364 A.2d 558 (1976); *Stith v. Hudson City Sav. Inst.*, 63 Misc. 2d 863, 313 N.Y.S.2d 804 (Sup. Ct. 1970); *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976); *People's Sav. Ass'n v. Standard Indus. Inc.*, 22 Ohio App. 2d 35, 257 N.E.2d 406 (1970); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973); *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 545

ticular case is unconscionable.

An increasing number of jurisdictions, however, apply the minority doctrine to determine whether the clause is reasonable under the circumstances.⁵⁵ Under the minority test the due-on clause is not *prima facie* reasonable. Lenders must prove that the clause is necessary to protect their security interest in the property. These courts assert that the clause unreasonably restrains alienation when lenders exercise it to protect their loan portfolios in response to the problem of long-term commitments in an inflationary market.⁵⁶

Recent California decisions illustrate the movement of courts toward application of the minority restraints test in the area of due-on clause enforcement.⁵⁷ The California Supreme Court in *Wellenkamp v. Bank*

P.2d 546 (1976); *Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works*, 71 Wis. 2d 531, 239 N.W.2d 20 (1976).

55. *First S. Fed. Sav. & Loan Ass'n v. Britton*, 345 So. 2d 300 (Ala. Civ. App. 1977) (threat of acceleration to increase interest rate where there exists no jeopardy to security interest is not a reasonable ground for enforcement); *Patton v. First Fed. Sav. & Loan Ass'n*, 118 Ariz. 473, 578 P.2d 152 (1978) (exercise of due-on clause by beneficiary in deed of trust unreasonable without showing of impairment to security interest); *Lane v. Bisceglia*, 15 Ariz. App. 269, 488 P.2d 474 (1971) (mortgagee cannot condition consent to transfer on buyer's assumption of loan at increased interest rate from 6% to 6¾%); *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971) (lender must show impairment to security interest in order to foreclose on mortgage); *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974) (due-on clause in installment contract unreasonable restraint on alienation where there was no showing that contract between borrower and borrower's tenants injured lender's interests); *LaSala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971) ("due-on-encumbrance" clause permitting acceleration if borrower executes junior encumbrance unreasonable restraint on alienation where second lien poses no threat to lender's security); *Demey v. Joujon-Roche*, 63 Cal. App. 3d 46, 133 Cal. Rptr. 570 (1976) (due-on clause not enforceable where security interest was not impaired because original purchaser remained liable on note and there was little possibility of waste to desert land); *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970) (foreclosure denied where no harm resulted to mortgagee); *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804 (1977) (clause unreasonable restraint on alienation where sole basis for exercise is to maintain lender's loan portfolio); *Sanders v. Hicks*, 317 So. 2d 61 (Miss. 1975) (unreasonable restraint on alienation absent showing by lender of threat to legitimate interest); *Continental Fed. Sav. & Loan Ass'n v. Fetter*, 564 P.2d 1013 (Okla. 1977) (unreasonable for mortgagor to impose fee as condition precedent to giving consent to transfer where there was no provision for fee in contract); *Bellingham First Fed. Sav. & Loan Ass'n v. Garrison*, 87 Wash. 2d 437, 553 P.2d 1090 (1976) (lender justified in refusing consent to transfer because person assuming loan had bad credit rating); *Mutual Fed. Sav. & Loan Ass'n v. American Medical Servs.*, 66 Wis. 2d 210, 223 N.W.2d 921 (1974) (due-on clause not enforceable where no impairment to lender's security interest).

56. See cases cited note 55 *supra*.

57. See generally *The Supreme Court of California 1974-1975*, 64 CAL. L. REV. 239, 573-601 (1976).

In *Coast Bank v. Minderhout*, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964), the first

case to examine the validity of the due-on-sale clause in California, the court held the provision enforceable as a reasonable restraint on alienation. *Id.* at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508. In *Minderhout*, the plaintiff bank made loans to the Enrights, who executed a promissory note for their indebtedness. Two months later, the Enrights signed a separate instrument agreeing not to transfer certain property without the lender's consent until the full indebtedness was paid. Under the agreement, the bank had the option, upon default of any condition in the agreement, to declare the remaining indebtedness due and payable.

The Enrights subsequently sold the property without the lender's consent. The bank, after attempting to collect the unpaid balance, brought an action to foreclose the equitable mortgage. *Id.* at 313, 392 P.2d at 266, 38 Cal. Rptr. at 506. The Enrights argued that the agreement did not create an equitable mortgage and that, even if it did, the agreement would be invalid because it contained a restraint on alienation. *Id.* at 314, 392 P.2d at 267-68, 38 Cal. Rptr. at 507-08. The court decided in favor of flexible application of the restraints doctrine in cases involving valid interests of the parties and stated that it was reasonable for the lender "to condition its continued extension of credit to the Enrights on their retaining their interest in the property that stood as security for the debt." *Id.* at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508.

Professor Volkmer commented that it is unclear whether the *Minderhout* opinion supports the majority or minority view. He resolved the confusion in favor of the majority interpretation because the California Supreme Court mentioned other restraints that courts have considered reasonable—*i.e.*, the spendthrift trust, executory land contract, and lease for a term of years. "Since Justice Traynor did not elaborate the factors which made the challenged restraint reasonable," Professor Volkmer reasoned, "the implication is that the creditor-debtor relationship itself is a satisfactory basis for imposing a due-on-sale clause." Volkmer, *supra* note 13, at 774-75.

Automatic enforcement of the due-on clause was approved in *Cherry v. Home Sav. & Loan Ass'n*, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969), where the court of appeals posited two primary business reasons for the use of the clause. First, the court recognized the risk of loss to the lender from possible harm to property that is security for a loan. The lender has a valid interest in preventing a transfer to irresponsible buyers who may waste the property, thereby decreasing the security to a value less than the indebtedness on the loan. *Id.* at 579, 81 Cal. Rptr. at 138. Second, the court recognized the lender's risks when interest rates fluctuate. When rates are low, a borrower can refinance his loan at a lower rate of interest and prepay the existing loan. When interest rates rise, however, a lender cannot increase the rate on an outstanding loan to match inflation, except when the initial borrower terminates his interest in the property. *Id.* Thus, the court held, "[t]here is no inequity visible from such a provision." *Id.* See also *Hellbaum v. Lytton Sav. & Loan Ass'n*, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969) (due-on clause not unreasonable restraint on alienation); *Jones v. Sacramento Sav. & Loan Ass'n*, 248 Cal. App. 2d 522, 56 Cal. Rptr. 741 (1967) (due-on clause not unreasonable restraint on alienation).

The California courts began a gradual retreat from automatic enforcement of the due-on clause in *LaSala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971). The court in *LaSala* distinguished the due-on-encumbrance clause from the due-on-sale clause, rejecting automatic enforcement of the former. *Id.* at 879-80, 489 P.2d at 1122-23, 97 Cal. Rptr. at 858-59.

In *LaSala* plaintiffs borrowed funds from the defendant savings and loan association, executing promissory notes and trust deeds that contained due-on-encumbrance provisions. Each plaintiff then borrowed additional funds from third party individuals, securing these additional loans with the same property. The defendant notified the parties of its right to accelerate the loans and offered to waive the right if each party paid a small fee and agreed to an increased interest rate on the first deed of trust. *Id.* at 869-70, 489 P.2d at 1115-16, 97 Cal. Rptr. at 851-52. The California Supreme Court concluded that the reasoning in *Minderhout* and *Cherry* did not justify upholding the due-on-clause in encumbrance situations. *Id.* at 879-80, 489 P.2d at 1122-23, 97 Cal. Rptr. at

of America,⁵⁸ ended that state's automatic enforcement of the due-on clause⁵⁹ by institutional lenders.⁶⁰ The court reasoned that the clause has the practical effect of restraining alienation. When money is un-

858-59. While a sale of property divests its owner of all responsibility for maintaining the lender's security interest, the owner in an encumbrance situation maintains title to and possession of the property. In the event of foreclosure, the first loan has priority over the second and hence the encumbrance creates no additional risk to the first lender. *Id.* The court held that the due-on-encumbrance clause would be valid under *Minderhout* principles if the lender utilized the provision to prevent harm to its security interest. The lender, however, must prove likelihood of harm in each case. The court explicitly stated that it would be unreasonable for the lender to exercise the clause solely to achieve economic gain. *Id.* at 884, 489 P.2d at 1124-25, 97 Cal. Rptr. at 860-61.

In *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974), the California Supreme Court relied on *LaSala's* application of the minority doctrine to test the validity of the due-on clause in installment contracts. The court introduced the quantum of restraint test, judging the actual restraining effect of the clause against the presumed benefit to the lender. In applying this analysis to a sale by installment contract, the court contrasted the installment sales transaction with outright sales of property. In an outright sale, the seller relinquishes legal title to and possession of the property. In an installment sale, however, the original borrower retains legal title until the installment buyer pays off the debt for the land. Thus, the legal owner has an incentive to insure that the installment buyer protects the property from waste and depreciation. *Id.* at 638, 526 P.2d at 1174-75, 116 Cal. Rptr. at 638-39. As in *LaSala*, *Tucker* rejected improvement of the lender's economic position as a valid reason for enforcement of the due-on-sale provision. *Id.* at 639 n.10, 526 P.2d at 1175 n.10, 116 Cal. Rptr. at 639 n.10.

58. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). In *Wellenkamp*, the court extended the reasoning in *Tucker* and *LaSala* to outright sales of land. In *Wellenkamp*, the Mans purchased property and borrowed \$19,100 at eight percent annual interest from the defendant bank, executing a promissory note secured by a deed of trust. The deed of trust contained a due-on-sale clause that provided for acceleration of the debt in the event the trustor conveyed the property without the consent of the mortgagee. The Mans sold the property to the plaintiff, *Wellenkamp*, for the "difference between the total selling price to plaintiff and the balance outstanding on the Mans' loan . . ." *Id.* at 946, 582 P.2d at 972, 148 Cal. Rptr. at 381. The defendant bank agreed to waive acceleration if the plaintiffs assumed the loan at a higher interest rate. Plaintiffs refused to pay an increased rate and the bank filed notice of default, electing to sell under the deed of trust. Plaintiffs filed an action seeking an injunction against enforcement of the clause arguing that the provision unreasonably restrained alienation of property. *Id.* at 946-47, 582 P.2d at 972, 148 Cal. Rptr. at 381. The Supreme Court of California held the due-on clause unenforceable in an outright sale unless the lender "can demonstrate that enforcement is reasonably necessary to protect against impairment to its security or the risk of default." *Id.* at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86.

59. See note 57 *supra*. See generally Note, *Wellenkamp v. Bank of America: A Victory for the Consumer?*, 31 HASTINGS L.J. 275 (1979); Note, *Wellenkamp v. Bank of America: Exercise of Due-on-Sale Clauses as an Unreasonable Restraint Upon Alienation*, 33 U. MIAMI L. REV. 722 (1979).

60. The California Supreme Court limited its holding to institutional lenders, leaving open the question of whether courts could enforce the due-on-sale clause in private transactions. *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 952 n.9, 582 P.2d 970, 976 n.9, 148 Cal. Rptr. 379, 385 n.9 (1978). *Accord*, *Medovoi v. American Sav. & Loan Ass'n*, 152 Cal. Rptr. 572, 581 (1978). See also *Zeller, The Due-on Clause after Wellenkamp: Unresolved Issues*, 1980 CAL. B.J. 76.

available for new financing, enforcement of the due-on clause eliminates one available means for buyers to finance purchases. If a lender agrees to renegotiate an existing loan only at an increased interest rate, the seller may be forced to lower the purchase price or may refuse to sell. The court stated that the clause therefore inhibits practical alienability.⁶¹ The court then applied the reasonableness test to the facts of the case by measuring the effect on alienation against the factors advanced in justification of the restraint.⁶² In an outright sale,⁶³ a seller may have neither possession nor legal title. This does not necessarily increase the risk that an assuming buyer will commit waste to property or default on payments under the assumed mortgage contract.⁶⁴ Furthermore, the California court held that enforcing the clause to enable a lender to renegotiate interest rates with an assuming buyer is always unreasonable. Inflation is foreseeable, and lenders should consider it in their loan transactions.⁶⁵

The Nebraska Supreme Court in *Occidental Savings & Loan Association v. Venco Partnership*⁶⁶ held that the due-on clause neither theoretically⁶⁷ nor practically⁶⁸ restrains alienation, and consequently it never reached the issue of reasonableness. Relying on the *Restatement*,⁶⁹ the court reasoned that under the definition of direct restraints, the due-on provision theoretically does not prevent alienation because it does not

61. In such circumstances, if the lender is unwilling to permit assumption of the existing loan, and instead elects to enforce the due-on clause, transfer of the property may be prohibited entirely, because the buyer will be unable to substitute a new loan for the loan being called due, and the seller will not receive an amount from the buyer sufficient to discharge that loan, particularly when the balance due is substantial.

Wellenkamp v. Bank of America, 21 Cal. 3d 943, 950, 582 P.2d 970, 974-75, 148 Cal. Rptr. 379, 383-84 (1978).

62. The court adopted the quantum of restraint test applied in *Tucker*. *Id.* at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

63. The California Supreme Court in *LaSala* and *Tucker* distinguished between an encumbrance and installment sale and an outright sale in deciding the reasonableness issue. *Wellenkamp* eliminated the prior distinctions insofar as treatment of the due-on clause is concerned and defined outright sale to mean transfer of legal title. *See* note 57 *supra*.

64. Although the original borrower no longer retains an interest in the property, the assuming buyer has equity in the property. The assuming buyer's interest provides adequate incentive to maintain the property's value. *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 952, 582 P.2d 970, 975-76, 148 Cal. Rptr. 379, 384-85 (1978).

65. *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

66. 206 Neb. 469, 293 N.W.2d 843 (1980).

67. *Id.* at 472, 293 N.W.2d at 845.

68. *See id.* at 478, 293 N.W.2d at 848.

69. *Id.* at 472, 293 N.W.2d at 845. *See* notes 17-21 *supra* and accompanying text.

qualify as a disabling, forfeiture, or promissory restraint.⁷⁰ The clause does not void a later conveyance, terminate the ownership interest upon conveyance, or impose contractual liability on a conveyor for breaching an agreement not to convey. A conveyance of property under a mortgage that contains a due-on clause does not prevent the mortgagor from transferring the property⁷¹ but only affects his right to transfer the mortgage.

In addressing the question of practical alienability, the court reasoned that an indirect restraint by definition applies to any restriction that affects sales.⁷² This application, however, is overly broad. Although the clause may impede a sale if a prospective buyer cannot obtain financing, courts should not consider every impediment to a sale a restraint on alienation. Building restrictions, zoning restrictions, and covenants in deeds that require landowners to dedicate property for residential purposes are valid restrictions that may impair marketability, but they do not restrain alienation.⁷³

After concluding that the due-on clause is not a restraint on alienation, the court criticized the California court's decision in *Wellenkamp* for relying on policy rather than legal authority.⁷⁴ The *Wellenkamp* court had concluded that the due-on clause was invalid on the basis of its view of social need and the assumed effect of the clause on the mortgage industry.

The *Occidental* court further argued that the *Wellenkamp* decision unreasonably burdens lenders.⁷⁵ Not only does invalidating the clause call into question any device that lenders may use to protect their loan

70. *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 472, 293 N.W.2d 843, 845 (1980).

71. *Id.*

72. *Id.* at 473-79, 293 N.W.2d at 846-48.

73. *Id.*

74. 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 on the contrary.

Id. at 476, 293 N.W.2d at 847. In addition, the court found *Wellenkamp* inconsistent because *Wellenkamp* distinguished between the validity of enforcing a due-on clause by an institutional, as opposed to a private, lender. *Id.* See note 60 *supra*.

75. *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 477, 293 N.W.2d 843, 847 (1980).

portfolios from fluctuations in the money market,⁷⁶ but it also prevents lenders from obtaining the benefits of their loan contracts. Lenders need some mechanism to protect their portfolios against rising interest rates. Savings and loan associations' assets are invested long-term, while short-term demand savings accounts and certificates provide the funds necessary to make loans.⁷⁷ As the cost of obtaining deposits rises, lenders are unable to maintain a balanced portfolio.

In addition, the *Occidental* court asserted the freedom of parties to contract. A court should not declare a contract contrary to public policy unless it is unmistakably unconscionable.⁷⁸ In this case, the court examined the due-on-sale clause within the context of the total mortgage agreement. The mortgage did not contain a prepayment penalty clause, and the borrower could refinance the loan at a lower rate without charge if the interest rates dropped. It therefore should be reasonable, if interest rates rise, to allow the lender to increase the rate when the borrower sells the property.⁷⁹ Unless a lender has the opportunity to renegotiate the loan agreement upon sale, a borrower can obtain a premium by selling the property along with a low interest rate mortgage at the lender's expense.⁸⁰

The court concluded its discussion by conceding that due-on clauses produce inequitable results in particular cases.⁸¹ A court of equity may fashion an appropriate remedy when the mortgagor has pleaded and proved facts showing unconscionability. Excluding these circumstances, the due-on-sale clause is a valid device to protect lenders from unprofitable mortgage assumptions.⁸²

The Nebraska court correctly held that the due-on clause is enforcea-

76. If the due-on-sale clause restrains alienation, then courts may also interpret variable interest rate and short-term rollover mortgages as restraints because their impact on the market is the same as that of the due-on clause. *Id.* at 477-78, 293 N.W.2d at 847-48. For definitions of variable interest rate mortgages and short-term mortgages see note 94 *infra* and accompanying text.

77. *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 480, 293 N.W.2d 843, 849 (1980).

78. *Id.* at 479, 293 N.W.2d at 848.

79. *Id.* See also *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976).

80. The loan association's goal is to derive benefit from the sale of the property rather than to give the benefit to the borrower. Savings and loan associations anticipate an average turnover of mortgages after eight years on a twenty year mortgage. See Cohen, *supra* note 38, at 1109.

81. *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 480, 293 N.W.2d 842, 849 (1980).

82. *Id.* at 481-82, 293 N.W.2d at 849-50.

ble on both legal and policy grounds. The clause is not a restraint on alienation when viewed from the technical perspective of direct restraints⁸³ or from the more practical perspective of indirect restraints.⁸⁴

Under the direct restraint categories, a promissory restraint is a contractual provision requiring the conveyee to meet certain conditions before the property is sold.⁸⁵ Courts consider the land vendor contract exception reasonable under the majority test⁸⁶ because, although it stipulates performance before a sale is permitted, its requirements are reasonable in the context of the buyer-seller relationship. The due-on clause, however, imposes no prior conditions on a sale. Rather, where a loan agreement contains a due-on sale clause, the sale of property triggers the contractual repayment obligation,⁸⁷ in effect marking the termination of a specific agreement between the mortgagor and mortgagee regarding specific property. The clause, therefore, is not a restraint on alienation, and courts need not reach the issue of reasonableness under either the majority or minority tests.

The Nebraska court correctly rejected the argument that the clause is an unlawful, indirect restraint on alienation.⁸⁸ The widespread practice of sellers transferring mortgages along with their property gives the due-on clause the appearance of a restraint because the clause limits one available means of financing a sale. If a seller is prevented from transferring his mortgage, and a prospective buyer cannot obtain financing, the clause may impede the sale. This is a result of general economic conditions and not the due-on-sale clause.⁸⁹ Landowners challenging enforcement of the due-on-sale clause, however, are frus-

83. See notes 17-21 *supra* and accompanying text.

84. See notes 22-27 *supra* and accompanying text.

85. See note 21 *supra* and accompanying text.

86. See notes 32-33 *supra* and accompanying text.

87. See note 5 *supra* and accompanying text.

88. See notes 72-73 *supra* and accompanying text.

89. The dissenting justice in *Wellenkamp* stated that:

If a loan exists on the property with a due-on clause, no *increased* restraint on selling results if the lender cannot accept the proposed buyer, the situation then being the same as in the case of the unavailability of funds to the proposed buyer. If the lender will permit assumption but only at an increased interest rate, again no *increased* restraint results because without the existing loan the buyer would be required to pay the higher interest rate and the seller may be required to compromise his selling price. There is thus no increased restraint on alienation beyond that inherent in the economic condition postulated by the majority.

Wellenkamp v. Bank of America, 21 Cal. 3d 943, 956, 582 P.2d 970, 979, 148 Cal. Rptr. 379, 388 (1978) (Clark, J., dissenting).

trated not because they are unable to sell their property, but because they are unable to enjoy the profits of transferring a pre-inflation contract in an inflation wrought economy.⁹⁰ When courts hold the clause invalid, sellers with low interest mortgages are able to receive more for their property than sellers without such mortgages can receive.⁹¹

Finally, on policy grounds, the due-on-sale clause should be enforceable absent a showing by the mortgagor of unconscionability. The clause terminates the mortgage agreement when the lender is no longer assured of the security of the property. When courts hold the due-on clause unenforceable, they reverse the traditional relationship between lender and borrower in which the borrower is responsible for establishing credit as a prerequisite for negotiating a loan.⁹² This creates a situation in which the lender is forced to contest creditworthiness of potential transferees in costly litigation to protect its security interest.

Additionally, the due-on-sale clause mitigates the double bind situation of lenders in an inflationary market. Borrowers are able to refinance loans when interest rates fall but lenders must wait for loan repayment before raising interest rates in response to increases in the cost of money.⁹³ Prohibition of the due-on provision makes long-term agreements far riskier for lenders. This additional risk has two effects on consumers. Lenders will raise interest rates to protect against uncertainty and will also resort to novel loan instruments, such as short-term loans and variable interest mortgages, that ultimately reduce flexibility in addressing consumers' needs.⁹⁴

90. See cases cited in notes 53-57 *supra*.

91. See note 80 *supra* and accompanying text.

92. See note 39 *supra* and accompanying text.

93. The original borrower would be placed at an advantage over the lender if not for enforcement of the clause. The original borrower can transfer the existing mortgage, gaining a competitive advantage in the selling market. If there is a drop in interest rates the borrower can pay off the entire loan and refinance at a lower rate. Hence, absent enforcement of the clause, the borrower is at an advantage in times of both high and low interest rates. See *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 626, 224 S.E.2d 580, 585 (1976). See note 79 *supra* and accompanying text.

94. Short-term loans are issued for shorter terms with options to renew. In an effort to protect themselves from fluctuations in the interest rate, savings and loan associations readjust the rate to the current rate at the time of renewal. Variable interest rate mortgages are loans in which the interest rate is adjusted periodically to correspond to fluctuations in an indicator rate. These alternatives are less beneficial to the borrower because they deprive him of a permanent standard interest rate. As inflation increases, loan payments will increase accordingly. See *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 301-03, 509 P.2d 1240, 1244-45 (1973). See also *Bonnano*, *supra* note 39, at 302-07; Note, *supra* note 40, at 592.

The Nebraska Supreme Court has displayed insight in recognizing that the due-on-sale clause is not a restraint on alienation of property but is a restraint on transferability of a mortgage.⁹⁵ Other jurisdictions, finding the clause a restraint on alienation, face the policy issue of whether the clause is reasonable when lenders enforce it to adjust the interest rate on an assumed mortgage.⁹⁶ The consequence of voiding use of the clause for this purpose may weaken mortgage consumer rights by forcing lenders to resort to novel instruments⁹⁷ that will place more of the risk of inflation on the borrower.

95. *See* notes 8-9, 67-68 *supra* and accompanying text.

96. *See* notes 55-57 *supra* and accompanying text.

97. *See* notes 76, 94 *supra* and accompanying text.



ARTHUR ALLEN LEFF
1935-1981

The Washington University School of Law community was saddened by the death of Arthur Allen Leff. Professor Leff touched many students and faculty during his law teaching career. This Law School is fortunate to have been one beneficiary of his presence and special qualities. On behalf of his former colleagues on this faculty and the alumni of Washington University School of Law who were his students, the *Law Quarterly* wishes to honor the memory of Arthur Leff.