

# DUE-ON-SALE CLAUSES: AN ARGUMENT FOR ADOPTING THE MAJORITY APPROACH

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Due-on-sale clauses are mortgage agreement provisions which allow lenders to accelerate the due date on loans when borrowers sell secured property.<sup>1</sup> Courts question whether the exercise of due-on-sale clauses in security agreements by state chartered institutional lenders<sup>2</sup> constitute a restraint on alienation of property.<sup>3</sup> While states

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1. A due-on-sale clause "provides the lender an option to declare immediately due and payable all of the sums owed to the lender if all or any part of the real property securing the loan is sold or otherwise transferred by the borrower without the lender's prior consent." *Glendale Fed. Sav. and Loan Ass'n v. Fox*, 459 F. Supp. 903, 904 (C.D. Cal. 1978).

A typical due-on-sale clause reads as follows:

Should Trustor [mortgagor] sell, convey, transfer, dispose of . . . said property, or any part thereof, or any interest therein, or agree to do so without the consent of Beneficiary [mortgagee] being first obtained, then Beneficiary (mortgagee) shall have the right, at its option, to declare all sums secured hereby forthwith due and payable.

*LaSala v. American Sav. and Loan Ass'n*, 5 Cal. 3d 864, 869, 489 P.2d 1113, 1115, 97 Cal. Rptr. 849, 852 (1971).

2. This Note does not consider in detail whether restraints on alienation occur when institutional lenders exercise due-on-sale clauses. For cases considering this question, see *Dawn Investment Co., Inc. v. Superior Court of the State of Cal., County of Los Angeles*, 116 Cal. App. 3d 439, 172 Cal. Rptr. 142 (1981) (by measuring the quantum of restraint against the justification of restraint, the court found the exercise of a due-on-sale clause valid applying the general rule that acceleration clauses are not per se unlawful); *Pas v. Hill*, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978) (The court distinguished *Wellenkamp* by applying it only to institutional lenders. The court treats a conveyance as an encumbrance rather than an outright sale

vary in their treatment of this issue,<sup>4</sup> almost all courts have held that due-on-sale clauses are valid per se.<sup>5</sup> A majority of state courts presume the validity of the clause, squarely placing the burden to rebut on the mortgagor or his assignee.<sup>6</sup> Conversely, the minority of states uphold the validity of due-on-sale clauses only if institutional lenders reasonably exercise them.<sup>7</sup>

In contrast with the minority rule, the Federal Home Loan Bank Board (FHLBB) passed a regulation which allows federally chartered institutional lenders to use the accelerator provision.<sup>8</sup> While the FHLBB policy is consistent with the majority approach, federal and

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when a private lender attempted to exercise a first trust deed due-on-sale clause after trustor conveyed real property to junior mortgagee in lieu of foreclosure by the junior). For an extended discussion, see Note, *Due-on-Sale Clauses: A Suggested Approach for Dealing with Non-Institutional Lenders*, 8 WEST. ST. U.L. REV. 59 (1980).

3. Jurisdictions differ on what constitutes an unreasonable restraint on the alienation of property when considering due-on-sale clauses. For a detailed discussion, see *infra* notes 41-115 and accompanying text. For purposes of this Note, property shall mean real property.

4. Recent controversy discusses whether to apply federal or state law to federally chartered savings and loan associations. Federal law permits the use of due-on-sale clauses in security agreements; some state courts invoke a reasonableness test on an *ad hoc* basis, holding the clause unenforceable absent a proper showing. See *Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982) (while state court barred use of due-on-sale clause, Supreme Court upheld the use of the accelerator clause); Comment, *Holiday Acres v. Midwest Fed. Sav. & Loan Ass'n: Preemption of the Due-on-Sale Clause*, 23 URBAN L. ANN. 285 (1982) (a detailed and constructive analysis of the federal preemption question).

5. See *infra* notes 47-62 and accompanying text.

6. See *infra* notes 54-66 and accompanying text.

7. See *infra* notes 167-81 and accompanying text. Enforcement of a due-on-sale clause might prevent a homeowner from selling his property.

8. 12 C.F.R. § 545.8-3(f)(6) (1982). In the midst of the Great Depression when almost one-half of the people holding home mortgage loans defaulted, Congress enacted the Home Owners' Loan Act (HOLA) 12 U.S.C. § 1246 (1933). The depressed economic situation forced state and local lenders to cease doing business. As a result, almost 25 percent of the population was unable to obtain home loans. See H.R. CONF. REP. NO. 210, 73rd Cong., 1st Sess. 1 (1933). By 1933 over 1,500 state S & L's had to close their doors. Congress enacted the HOLA to improve the deficiencies of the state systems by creating a federally-sponsored program to regulate the home mortgage industry, which had previously been the province of the states. See *Conferrence of Fed. Sav. & Loan Ass'ns v. Stein*, 604 F.2d 1256, 1257 (9th Cir. 1979), *aff'd*, 445 U.S. 921 (1980). The act created a system of federally chartered S & L's. To regulate these newly created lenders, section 5(a) of HOLA established the Federal Home Loan Bank Board (FHLBB). The FHLBB's purpose was to issue rules to govern the administration of federal S & L's. The FHLBB received broad powers to issue rules and regulations. See 12 U.S.C. § 1464(a) (1976).

state laws clash in minority states.<sup>9</sup> The conflicting policies give rise to an anomaly because state chartered lenders may not unreasonably apply due-on-sale clauses, yet federally chartered lenders have the authority to invoke these provisions.<sup>10</sup> Judicial determination of the enforceability of due-on-sale clauses is important because the ultimate resolution of this issue will have an overwhelming effect on the interests on institutional lenders and homeowners.<sup>11</sup>

This Note considers the relative interests of institutional lenders and homeowners through an examination of less intrusive alternatives to due-on-sale provisions. And it examines the conflict between state and federally chartered lenders in minority jurisdictions. Part I considers the development of restraints on alienation, focusing upon those factors courts find relevant in determining whether there is an impermissible restraint. By examining applicable cases, Part II explains the different tests and ratios courts adopt to determine the validity of due-on-sale clauses. Part III analyzes the attributes and deficiencies of these tests and examines the conflicting interests of the institutional lenders and homeowners. Part IV proposes alternative approaches to due-on-sale clauses which reconcile competing interests and avoid unnecessary restraints on alienation.

## I. RESTRAINTS ON ALIENATION

Some courts have invalidated the enforcement of due-on-sale clauses, reasoning that the application of the accelerator provision unreasonably impairs a borrower's ability to sell his property.<sup>12</sup> For centuries courts have recognized that the owner of an absolute estate enjoys an inherent right to alienate his fee.<sup>13</sup> Restraints on alienation

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9. See *infra* notes 86-115 and accompanying text.

10. See *infra* notes 45, 116-53.

11. See *infra* notes 31-33.

12. See, e.g., *Baker v. Loves Park Sav. and Loan Ass'n*, 6 Ill. 2d 119, 333 N.E.2d 1 (1975) (provision in mortgage requiring mortgagee's consent to sale of property constituted a restraint on alienation); *Nichols v. Ann Arbor Fed. Sav. and Loan*, 73 Mich. App. 163, 250 N.E.2d 804, 809 (1977) (due-on-sale clause restrains vendor's ability to alienate property). See also Volkmer, *The Application of the Restraint on Alienation Doctrine to Real Property Security Transactions*, 58 IOWA L. REV. 747, 774 (1973). Cf. Bernhard, *The Minority Doctrine Concerning Direct Restraints on Alienation*, 57 MICH. L. REV. 1173 (1959).

13. See L. SIMES & A. SMITH, *THE LAW OF FUTURE INTERESTS* § 1114 (2d ed. 1956) [hereinafter cited as SIMES & SMITH]. "The statute Quia Emptores established the rule that all tenants in fee simple could freely alienate their land." *Id.* at 6.

of property,<sup>14</sup> which commentators classify as direct<sup>15</sup> and indirect,<sup>16</sup> arise upon the interference with this right. Courts identify three types of direct restraints: disabling,<sup>17</sup> forfeiture<sup>18</sup> and promissory.<sup>19</sup> Although these classifications are mechanical, they are important because each receives different treatment from courts.<sup>20</sup>

Authorities define a direct restraint as a clause in a legal instrument which expressly prevents the holder from conveying his property.<sup>21</sup> Since direct restraints preclude free alienability of property, courts consistently invalidate their use.<sup>22</sup> Judges do not favor disabling restraints on fee simple estates because of the resulting unmarketability of the subjected properties until the limitation period passes.<sup>23</sup> Forfeiture restraints, which extinguish an estate when its

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14. A restraint on alienation is a provision which by its terms, prohibits or penalizes the exercise of the power of alienation. These restraints are of three types: disabling restraints, forfeiture restraints, and promissory restraints. *Id.* § 112, at 237. The Restatement defines a restraint on alienation as "an attempt by an otherwise effective conveyance or contract to cause a later conveyance: a) to be void; or b) to impose contractual liability on the one who makes the later conveyance when such liability results from a breach of an agreement not to convey; or c) to terminate or subject to termination all or a part of the property interest conveyed." RESTATEMENT OF THE LAW OF PROPERTY § 404, at 2381 (1944) [hereinafter cited as RESTATEMENT].

15. *See infra* notes 21-26 and accompanying text.

16. *See infra* notes 27-29 and accompanying text. "[A]n indirect restraint on alienation arises when an attempt is made to accomplish some purpose other than the restraint of alienability, but with the incident result that the instrument, if valid, would restrain practical alienability." SIMES & SMITH, *supra* note 13, § 1112, at 5.

17. *See infra* note 23. "A disabling restraint exists when property is conveyed or devised with direction that it shall not be alienated. It is commonly designed to secure the continued enjoyment of the property to the conveyee, and if valid, it would operate to remove the power of alienation as a characteristic of the estate granted." SIMES & SMITH, *supra* note 13, § 1131, at 17.

18. Unlike a disabling restraint, a forfeiture restraint "always involves the creation of a future interest. It exists when, by the terms of an instrument of transfer, the estate transferred will be subject to forfeiture on alienation or will be terminated." *Id.* § 112, at 238.

19. "The term promissory restraint refers to a covenant in an instrument of conveyance, or to a contract, in which the promisor agrees not to alienate the property." *Id.*

20. *See id.* § 1132, at 18.

21. *Id.* § 1131, at 17. To create a direct restraint, one must insert a clause which specifically prohibits a property holder from alienating it.

22. *See Volkmer, supra* note 12, at 749. *See also Bernhard, supra* note 12, at 1173, 1174.

23. *See Bernhard, supra* note 12, at 1173. Courts have decided that disabling restraints on estates held in fee simple or less than fee simple are void. *Butterfield v.*

holder attempts to convey it, are not as paralyzing as disabling restraints.<sup>24</sup> Nevertheless, forfeiture restraints are also void because they deny title.<sup>25</sup> To enforce a promissory restraint, where the parties agree to the restraint mutually, the grantor must resort to equitable contract remedies because the power to restrain inheres in the agreement.<sup>26</sup>

While direct restraints are generally inimical to fee simple estates, the law regards indirect restraints less severely,<sup>27</sup> for courts enforce them although the effect of doing so renders land inalienable.<sup>28</sup>

While the law enforces certain types of restraints,<sup>29</sup> there are also compelling social and economic reasons for rejecting others.<sup>30</sup> Direct restraints prevent property owners from conveying, thereby reducing

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Reed, 160 Mass. 361, 35 N.E. 1128 (1893) (disabling restraint on life estate void); *Randolph v. Wilkinson*, 294 Ill. 508, 128 N.E. 525 (1920) (disabling restraint on estate for years invalid); *Payne v. Hart*, 178 Ark. 100, 9 S.W.2d 1059 (1928) (courts reject disabling restraint on fee simple estate).

Spendthrift trusts constitute the only exception to the rule voiding disabling restraints. Volkmer, *supra* note 12, at 1149; Bernhard, *supra* note 12, at 1175. The reason for this exception lies in the belief that courts should avoid invalidating an instrument which reasonably prevents imprudent individuals from disposing of their estates. Furthermore, courts are less likely to upset an equitable estate created for the benefit of the grantee than a legal one. See generally GRISWOLD, SPENDTHRIFT TRUSTS (2d ed. 1947). See SIMES & SMITH, *supra* note 13, § 1139, at 27.

24. Forfeiture restraints definitively deny title, whereas disabling restraints may require a great deal of time to extinguish an interest. *Id.* § 1131, at 17.

25. See Bernhard, *supra* note 12, at 1174.

26. Arguably, promissory restraints are similar to indirect restraints because they "operate only indirectly to affect alienation." However, courts have treated them as similar in effect. See SIMES & SMITH, *supra* note 13, § 1161, at 73. See also Bernhard, *supra* note 12, at 1174.

27. See RESTATEMENT, *supra* note 14, § 404, at 1005, 1006. Cf. SIMES & SMITH, *supra* note 13, § 1201, at 88, which states that any provision which tends to prevent the marketability of land restrains alienation.

28. See SIMES & SMITH, *supra* note 13, § 1201, at 88. One exception to this approach is the rule against perpetuities. The rule against perpetuities precludes giving legal effect to interests which are too remote to vest "not later than twenty-one years after some life in being at the creation of the interest." J. GRAY, THE RULE AGAINST PERPETUITIES, § 201 (4th ed. 1942).

29. See Bernhard, *supra* note 12, at 1175. See generally Goddard, *Non-Assignment Provisions in Land Contracts*, 31 MICH. L. REV. 1 (1932).

30. According to an authority, courts initially voided restraints as repugnant to a fee simple interest in property. SIMES & SMITH, *supra* note 13, § 1134, at 21. Simes & Smith recognize, however, that there is a sound reason to invalidate these impairments—economic undesirability. *Id.*, § 1135, at 21.

the total amount of land in the marketplace.<sup>31</sup> A creditor seeking to satisfy debts of a landowner who, by the express terms of the contract, cannot convey must forego attaching the property to collect the debt.<sup>32</sup> The inability to use the land efficiently puts it in a state of dormancy which constitutes waste.<sup>33</sup> The result is that courts invalidate instruments which restrain a property holder's ability to transfer his property.

In theory, due-on-sale clauses do not directly restrain alienation.<sup>34</sup> To free himself from the operation of the clause, the mortgagor may

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31. See Bernhard, *supra* note 12, at 179. See also SIMES & SMITH, *supra* note 13, § 1117, at 10.

The necessity of imposing 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 capital of the country gradually withdrawn from trade; and the incentives to exertion in every branch of industry diminished. Indeed, such a state of things would be utterly inconsistent with national prosperity.

T. JARMAN, WILLS § 219 (6th ed. 1896). See also 6 AMERICAN LAW OF PROPERTY § 26-30 (1952).

32. If considered on a larger scale, should all landowners' property within an area become unattachable, the result would include the diminution of the land's value and the subsequent halt to the extension of credit. See SIMES & SMITH, *supra* note 13, § 1135, at 21.

33. *Id.*, § 1117, at 11. As a matter of common sense, property owners expend funds needlessly by making improvements to real estate when their interest in the land ceases upon alienation. By encouraging waste, restraints are counter-productive to the longstanding social policy of property improvement. Restrained property is therefore ineffective to meet the public need for commercially viable land. See Bernhard, *supra* note 12, at 1180. "Dead hand control" shackles property.

While society recognizes the desire of a property owner to control the distribution of his property after his death, it also recognizes that life is for the living and not for the dead. Thus, the wishes of the passing generation to better property must be balanced against the desires of the coming generation to take property without restraint.

*Id.*

34. See *Miller v. Pacific First Fed. Sav. and Loan Ass'n*, 86 Wash. 2d 401, 545 P.2d 546 (1976) (due-on-sale clauses valid as they do not restrain alienation); *Mutual Fed. Sav. and Loan Ass'n v. Wisconsin Wire Works*, 71 Wisc. 2d 531, 239 N.W.2d 20 (1976) (due-on-sale clause is valid because it does not prevent mortgagor from alienating his property). See also G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW (1st ed. 1979) at 298 [hereinafter cited as OSBORNE]. *But cf.* Volkmer, *supra* note 12, at 773, 774, which states that a due-on-sale clause "is so closely akin to a promissory restraint as to justify designating it as a direct restraint." *Id.*

either obtain the lender's consent or convey the property.<sup>35</sup> Yet in practice, lenders seldom consent and mortgagors often lack the financial resources to satisfy the debt.<sup>36</sup> In fact, courts react differently in response to the exercise of due-on-sale clauses by lenders.<sup>37</sup> Courts that uphold the validity of such clauses declare *inter alia* that the accelerator provision poses no restraint.<sup>38</sup> These courts believe that the application of the clause does not deny the mortgagor his right to sell the property, but rather that it allows the mortgagor to receive a reasonable return rate which comports with economic trends.<sup>39</sup> Conversely, other courts invalidate the clauses on the ground that they constitute unreasonable impairments.<sup>40</sup> After a survey of the various types of restraints and the policy reasons for voiding them, it is appropriate to examine court decisions to determine the reasons why different state courts allow or deny the enforcement of due-on-sale clauses.

## II. JUDICIAL APPROACHES TO DUE-ON-SALE CLAUSES AND THE RESTRAINT DOCTRINE

Judicial treatment of due-on-sale clauses varies among the states.<sup>41</sup>

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35. See OSBORNE, *supra* note 34, at 298.

36. If a lender refuses to allow a third party to assume the mortgage and the homeowner cannot afford to remit the balance, the clause impairs the homeowner's ability to convey. 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).

37. Compare *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (absent reasonable justification mortgagees may not use due-on-sale clauses); *Tucker v. Lassen Sav. and Loan Ass'n.*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974) (application of due-on-sale clauses valid only in outright sales of property) with *Occidental Sav. and Loan Ass'n. v. Venco Partnership*, 206 Neb. 469, 293 N.W.2d 843 (1980) (mortgagee's use of due-on-sale clause is *per se* valid); *Crockett v. First Fed. Sav. and Loan Ass'n.*, 289 N.C. 620, 224 S.E.2d 580 (1978) (due-on-sale clauses which do not restrain alienation are valid and enforceable); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973) (accelerator provision in deed of trust valid although motive for use based on receiving greater interest rate).

38. See *supra* note 34.

39. *Id.*

40. *Baltimore Life Ins. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971) (acceleration clause clearly restrains mortgagor's ability to dispose of property); *Nichols v. Ann Arbor Fed. Sav. and Loan*, 73 Mich. App. 163, 250 N.W.2d 804 (1977) (due-on-sale clause in mortgage agreement constitutes restraint on vendor's ability to alienate property).

41. Compare *Baker v. Loves Park Sav. and Loan Ass'n.*, 61 Ill. 2d 119, 333 N.E.2d

Nonetheless, one may generalize. All courts enforce the exercise of due-on-sale provisions if a party shows reasonable grounds for their application.<sup>42</sup> Differences arise, however, in the judicial allocation of the burden of proof. The majority of courts declare due-on-sale clauses presumptively valid.<sup>43</sup> Therefore, the homeowner bears the onus of demonstrating unreasonableness.<sup>44</sup> In contrast, a minority of jurisdictions enforce the clause only when lenders substantiate the need for its use.<sup>45</sup> This Note focuses on California court decisions which cover both majority and minority approaches.<sup>46</sup>

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1 (1975) (exercise of due-on-sale clause valid when protecting mortgagee's security); *Century Fed. Sav. and Loan Ass'n v. Van Glahn*, 144 N.J. Super. 48, 364 A.2d 558 (1976) (mortgagee has right to strict enforcement of due-on-sale clause unless default of which he complains is attributable to the mortgagee himself); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973) (acceleration provision in deed of trust valid although motive for use based on receiving greater interest rate) *with* *First S. Fed. Sav. and Loan of Mobile v. Britton*, 345 So. 2d 300 (Ala. Civ. App. 1977) (use of due-on-sale clause is coercive if invoked solely to extract a higher rate of interest); *Tucker v. Pulaski Fed. Sav. and Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972) (mortgagee may not foreclose on property absent justifiable reason). Commentators have had difficulty categorizing the varying approaches of the courts because of the differing criteria articulated by each. *Id.* See OSBORNE, *supra* note 34, at 302-03. See also Note, *Judicial Treatment of the Due on Sale Clause: The Case for Adopting Standards of Reasonableness*, 27 STAN. L. REV. 1109, 1117 (1975).

42. See OSBORNE, *supra* note 34, at 303. The authors state that "[n]o court . . . has held a due-on-sale clause to be a per se invalid restraint on alienation." *Id.* For cases substantiating this point, see *supra* note 37 and accompanying text.

43. See OSBORNE, *supra* note 34, at 303.

44. See *Century Fed. Sav. and Loan Ass'n v. Van Glahn*, 144 N.J. Super. 48, 53, 364 A.2d 558, 561 (1976) (mortgagor bears the burden of showing the unlawful exercise of a due-on-sale clause). *But cf.* *Tucker v. Pulaski Fed. Sav. and Loan Ass'n*, 252 Ark. 849, 853, 481 S.W.2d 725, 728 (1972) (mortgagee may not foreclose on property absent justifiable reason).

45. *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971) (burden of valid exercise of due-on-sale clause on mortgagee), *cert. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); *Clark v. Lackenmeier*, 237 So. 2d 583, 585 (Fla. App. 1970) (mortgagee must prove actual harm before equity court will permit use of due-on-sale clause); *Sanders v. Hicks*, 317 So. 2d 61, 64 (Miss. 1975) (while a due-on-sale clause indirectly restrains alienation, it is not per se invalid providing that the mortgagee shows that the clause's use is not unreasonable).

46. In other jurisdictions decisions have varied, see *e.g.*, *Baker v. Loves Park Sav. and Loan Ass'n*, 61 Ill. 2d 119, 126, 333 N.E.2d 1, 4 (1975) (exercise of due-on-sale clause valid when protecting mortgagee's security); *Crockett v. First Fed. Sav. and Loan Ass'n*, 289 N.C. 620, 631, 224 S.E.2d 580, 596 (1976); *Gunther v. White*, 489 S.W.2d 529, 531 (Tenn. 1973) (accelerator provision in deed of trust valid although motive for use based on receiving greater interest rate).

A. *Background Decisions Upholding the Exercise of Due-On-Sale Clauses*

In *Coast Bank v. Minderhout*,<sup>47</sup> the Supreme Court of California upheld the enforcement of a due-on-sale clause, deciding that the common law rule against restraints improperly interfered with a lender's legitimate interest.<sup>48</sup> Coast Bank, the mortgagee, financed property secured by a mortgage agreement which contained a due-on-sale clause.<sup>49</sup> The problem arose when the mortgagor conveyed the property without the bank's knowledge and consent. The bank initiated foreclosure proceedings because the unauthorized conveyance expressly violated the mortgage.<sup>50</sup> In affirming the lower court decision which permitted the bank to foreclose,<sup>51</sup> the California Supreme Court rejected the mortgagor's argument that no lien existed because the instrument effectively restrained alienation.<sup>52</sup>

The *Minderhout* decision is significant because it demonstrates that the California courts would no longer follow the traditional rule against restraints on alienation.<sup>53</sup> The decision, however, is of limited precedential value. It does not support the notion that the application of due-on-sale clauses is per se reasonable.<sup>54</sup> The court determined the validity of the bank's action solely in terms of foreclosure rights, declining to address the matter of enforceability of the mortgagor's promise not to convey or to encumber.<sup>55</sup> Consequently,

47. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

48. *Id.* at 316, 392 P.2d at 268, 38 Cal. Rptr. at 508 (1964).

49. The Agreement of the Parties read: "In consideration of any loan by . . . 'Bank' 'Borrower' promises and agrees . . . if default be made (by borrower) in the performance of any of the terms hereof [including transfer, non-payment of taxes, or waste] Bank may, at its election . . . declare the entire remaining unpaid principal and interest of any obligations or indebtedness then remaining unpaid to the Bank due and payable forthwith." 61 Cal. 2d 311, 313, 392 P.2d 265, 266, 38 Cal. Rptr. 505, 506 n.2 (1964).

50. *Id.* at 313, 392 P.2d at 266, 38 Cal. Rptr. at 506 (1964).

51. *Id.* at 311, 392 P.2d at 265, 38 Cal. Rptr. at 505 (1964).

52. *Id.* The court unanimously held that § 711 of the California Civil Code disallowed only unreasonable restraints. CAL. CIV. CODE § 711 (West Supp. 1971). The statute provides that "conditions restraining alienation when repugnant to the interest created, are void." *Id.*

53. 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964). Applying a reasonableness test, the court adopted the minority approach. *See supra* note 48 and accompanying text.

54. 61 Cal. 2d at 316-17, 392 P.2d at 268, 38 Cal. Rptr. at 508.

55. *Id.* at 317, 392 P.2d at 267-68, 38 Cal. Rptr. at 508-09.

the court left unsettled the question of the enforceability of due-on-sale clauses.

In *Hellbaum v. Lytton Savings and Loan Association*,<sup>56</sup> the California Court of Appeals upheld the use of a due-on-sale clause when a mortgagee invoked the accelerator provision to protect his security interest.<sup>57</sup> In *Hellbaum*, the mortgagee applied the accelerator clause which caused the balance to become due immediately when the mortgagors failed to make a timely interest payment. This decision expanded upon *Coast Bank* by recognizing that lenders properly invoke due-on-sale clauses to protect their security interest. Thus, the *Hellbaum* court cited an explicit instance when the application of the accelerator provision is proper.

In *Cherry v. Home Savings and Loan Association*,<sup>58</sup> the court of appeals deviated from the reasonable standard articulated in *Coast Bank* by upholding the inherent right of a lender to accelerate.<sup>59</sup> When the mortgagor attempted to sell his property which the mortgagee secured by a deed of trust containing a due-on-sale clause,<sup>60</sup> the lender accelerated the debt.<sup>61</sup> The mortgagor argued that the mortgagee applied the accelerator provision unreasonably; the court disagreed.<sup>62</sup>

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56. 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969), *disapproved in* *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). For a detailed analysis of *Wellenkamp*, see *infra* notes 86-115 and accompanying text.

57. 274 Cal. App. at 460, 79 Cal. Rptr. at 11. Furthermore, the court found no support for the arguments that exercising the clause evoked a penalty or that tort liability arose for lender's purported negligence. *Id.* at 459-60, 79 Cal. Rptr. at 14-15.

58. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969), *disapproved in* *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

59. 276 Cal. App. 2d at 580, 81 Cal. Rptr. at 139. The *Cherry* court followed the majority approach. The mortgagee has "the power of free decision regarding the use of its money by others, the right to determine in its own discretion whether it would exercise its option, and it [has] no obligation to act only in a manner which other might term 'reasonable.'" *Id.* at 579-80, 81 Cal. Rptr. at 139. Furthermore, "[t]he courts cannot make better agreements for parties than they themselves [make]." *Id.* at 580, 81 Cal. Rptr. at 139 (quoting *Walnut Creek Pipe Distribs., Inc. v. Gates Rubber Co.*, 228 Cal. App. 2d 810, 815, 39 Cal. Rptr. 767, 771 (1964)).

60. *Id.* at 576, 81 Cal. Rptr. at 140. The clause allowed the mortgagee to declare the balance of the loan immediately due and payable if the mortgagor sold the property without the mortgagee's consent. *Id.*

61. *Id.*

62. *Id.* at 578, 81 Cal. Rptr. at 139. A mortgagee cannot protect its principal if an assuming buyer who extinguishes a mortgagor's personal liability fails to meet his payment. While a mortgagee can foreclose, there is no guarantee that the sale will

Departing from the established line of cases which enforced only those due-on-sale clauses found reasonable, the *Cherry* court clearly articulated the majority approach which *Coast Bank* previously rejected. The California Supreme Court, however, had yet to reaffirm the majority view.

### B. *Unreasonable Use of Due-On-Sale Clauses*

In *LaSala v. American Savings and Loan Association*,<sup>63</sup> the California Supreme Court shifted its position regarding a lender's ability to exercise a due-on-sale clause. LaSala, plaintiff-mortgagor, obtained a loan secured by a deed of trust.<sup>64</sup> LaSala then executed a note and a second deed of trust, further encumbering the property. Subsequently, American, defendant-mortgagee, threatened to accelerate unless LaSala agreed to pay an additional fee and three percent in interest because LaSala had breached the mortgage agreement by further encumbering the property.<sup>65</sup>

The acceleration clause of the deed provided that "should Trustor (mortgagor) sell, convey, transfer, dispose of or further encumber said property . . . then Beneficiary (mortgagee) shall have the right, at its option, to declare all sums due and payable."<sup>66</sup> The court re-

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yield enough of a return to mitigate a loss. Therefore, the mortgagee properly protects its pecuniary interest by forcing the mortgagor to obtain its approval before conveying. From an economic standpoint, a mortgagor saves money by refinancing if prevailing interest rates decrease. For example, mortgagor "X" obtains financing to buy a home which costs \$120,000. After making a \$20,000 deposit, "X" agrees to repay the loan at the prevailing market rate of 10% for 40 years. If, however, the interest rate drops to 5%, "X" should refinance at the new rate, thereby saving 5% a year in interest costs. If, on the other hand, interest rates increase and the mortgagor wants to sell to a third party, the mortgagee loses money by not adjusting the amount of interest due to the prevailing rate. The third party who assumes the loan at below market interest rates prevents the mortgagee from reusing the money which would yield a higher rate of return. Thus, if interest rates increase and the mortgagor transfers, the mortgagee is free to reuse the repaid principal and gain a higher rate of return. Conversely, if interest rates decrease the mortgagor may refinance to reduce his debt. *Id.* at 579, 81 Cal. Rptr. at 138. See generally Volkmer, *supra* note 12.

63. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

64. *Id.* at 869, 489 P.2d at 1115, 97 Cal. Rptr. at 857.

65. *Id.* at 870, 489 P.2d at 1116, 97 Cal. Rptr. at 852. LaSala refused American's demand. *Id.* at 1116. The court stated: "Although American's due-on-encumbrance clause is not per se an illegal restraint on alienation, the enforcement of that clause unlawfully restrains alienation whenever the borrower's execution of a junior encumbrance does not endanger the lender's security." *Id.* at 877, 489 P.2d at 1121, 97 Cal. Rptr. at 857 (emphasis in original).

66. *Id.* at 869, 489 P.2d at 1115, 97 Cal. Rptr. at 851.

ferred to this provision as a due-on-encumbrance clause.<sup>67</sup> A due-on-encumbrance clause differs from a due-on-sale clause in that the latter operates upon a transfer of property whereas a further encumbrance triggers the former. The supreme court determined that while earlier cases upheld the validity of due-on-sale clauses, none of those cases considered the enforceability of due-on-encumbrance clauses.<sup>68</sup> It distinguished *Coast Bank, Hellbaum and Cherry*, reasoning that those decisions considered "borrowers retaining their interest in the property that stood as security for the debt."<sup>69</sup>

The *LaSala* court also explained the differing effects that due-on-sale and due-on-encumbrance clauses have on the mortgagor's interest.<sup>70</sup> The court held that due-on-encumbrance clauses unreasonably restrain alienation absent a mortgagee's showing that it invokes these provisions to protect its security.<sup>71</sup> Although the scope of the opinion considered only the encumbrance issue, it is a return to the minority approach. The court applied this method again in *Tucker v. Lassen Savings and Loan Association*.<sup>72</sup>

*Tucker* questioned the application of a due-on-sale clause to an installment land contract.<sup>73</sup> *Tucker*, the mortgagor, purchased property and financed it with a loan secured by a deed of trust<sup>74</sup> which included a due-on-sale/encumbrance clause.<sup>75</sup> *Tucker* then entered

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67. *Id.*

68. *Id.* at 879, 489 P.2d at 1122, 97 Cal. Rptr. at 858.

69. *Id.*

70. *Id.* at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859. The court stated that "[a] junior encumbrance . . . does not terminate the borrower's interest in the property, and rarely involves a transfer of possession." *Id.* It also noted the possibility that junior liens could lead to foreclosure and a "a transfer of possession," but reasoned that this risk "cannot justify an endowment to a lender of an uncontrolled discretion to accelerate upon the making of junior encumbrances." *Id.*

71. *Id.* at 881, 489 P.2d at 1126, 97 Cal. Rptr. at 860. The court, however, restricted its holding to due-on-encumbrance clauses, specifically declaring its approval of the *Coast Bank* opinion. *Id.* at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 860.

72. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

73. *Id.* at 631, 526 P.2d at 1170, 116 Cal. Rptr. at 634. Under an installment land contract the obligor cannot obtain legal title to property until he makes the final payment. Thus, until the obligor makes the last payment, he is seized of only equitable ownership. See generally OSBORNE, *supra* note 34, at 79.

74. *Id.* at 630, 526 P.2d at 1170, 116 Cal. Rptr. at 634.

75. *Id.* at 632, 526 P.2d at 1171, 116 Cal. Rptr. at 634. The clause stated that if mortgagor should "sell, convey, or alienate or further encumber . . . [then] all obligations secured hereby, irrespective of the date expressed in any note evidencing the same, at the option of the beneficiary and without demand, or notice, shall immedi-

into an installment land contract.<sup>76</sup> Upon learning that Tucker had entered into an equitable sale, Lassen, the mortgagee, accelerated the balance due.<sup>77</sup> Tucker alleged that Lassen's application of the accelerator provision constituted an unreasonable restraint on alienation.<sup>78</sup> The supreme court, agreeing with Tucker's argument,<sup>79</sup> articulated a new test to determine the effect of due-on clauses.

In focusing its inquiry on the correct method to measure the validity of due-on clauses, the court balanced "the justification for enforcing a particular restraint" against "the quantum of restraint."<sup>80</sup> By adopting a format similar to *LaSala* it followed the test.<sup>81</sup> The court's opinion distinguished between the effect of an outright sale and an installment land contract,<sup>82</sup> considering the use of due-on-sale clauses as reasonable in an outright sale because "the terms of the second sale usually provide for full payment of the prior trust deed."<sup>83</sup> But the application of these clauses to installment land contracts "does not often provide the borrower with the means to discharge the balance secured by the deed of trust."<sup>84</sup> Thus, absent a mortgagee's justification for the application of the clause, installment land contracts unreasonably impair alienation. The court voided the acceleration clause because it failed to satisfy the burden of justifica-

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ately become due and payable." *Id.* at 633, 526 P.2d at 1171, 116 Cal. Rptr. at 635 n.3

76 *Id.*

77 *Id.*

78 *Id.* at 634, 526 P.2d at 1172, 116 Cal. Rptr. at 635.

79. *Id.* at 640, 526 P.2d at 1174, 116 Cal. Rptr. at 640. Lassen appealed the lower court decision which held that the application of the provision unreasonably restrained alienation. *Id.* at 634, 526 P.2d at 1176, 116 Cal. Rptr. at 636. The supreme court held that the lower court correctly decided that the mortgagee's use of a due-on-sale clause was an unreasonable restraint on alienation. Lassen argued that it validly used the acceleration provision to protect its pecuniary interest. *Id.*

80. *Id.* at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637. The court reasoned that "[T]o the degree that enforcement of the clause would result in an increased quantum of the 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." *Id.*

81 *Id.* at 635, 526 P.2d at 1172, 116 Cal. Rptr. at 636.

82. *Id.* at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 638. The court decided that a restraint on alienation arose when the mortgagee prevented the mortgagor from entering into an installment land contract to convey his property. *Id.*

83. *Id.*

84. *Id.* (quoting *LaSala v. American Sav. and Loan Ass'n*, 5 Cal. App. 2d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.17).

tion.<sup>85</sup> Nonetheless, the *Cherry* court's recognition of the per se enforceability of due-on-sale clauses remained because *Tucker* limited its application of the new test to installment land contracts. Consequently, the burden to defeat the operation of due-on-sale clauses in an outright sale remained with the mortgagor.

In *Wellenkamp v. Bank of America*,<sup>86</sup> the California Supreme Court extended the application of the minority approach to preclude the enforceability of due-on-sale clauses to outright sales of property.<sup>87</sup> Wellenkamp attempted to purchase the mortgagor's land which the Bank of America, the mortgagee, had secured by a trust deed.<sup>88</sup> The mortgagee, however, refused to allow the assumption unless the purchaser agreed to repay the loan at a higher interest rate.<sup>89</sup> Rejecting the mortgagee's demand, she brought suit to enjoin the enforcement of the provision alleging that the clause's operation necessarily restrained alienation.<sup>90</sup>

In determining the merit of the allegation, the supreme court first analyzed the cases in which other courts examined restraints.<sup>91</sup> The

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85. *Id.* at 640, 526 P.2d at 1175, 116 Cal. Rptr. at 640. The court found that due-on-sale clauses are valid and enforceable only if the mortgagee can show that a threat to one of its legitimate interests exists. The court recognized that legitimate interest included the protection of the mortgagee's security from depreciation and waste. *Id.* at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.

86. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). For a thorough discussion of this case, see Note, Wellenkamp v. Bank of America: *A Victory for the Consumer?* 31 HASTINGS L.J. 275 (1979).

87. 21 Cal. 3d at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86. The court declared, "we hold that a due-on clause contained in a . . . deed of trust cannot be enforced upon the occurrence of an outright sale unless the lender can demonstrate that enforcement is reasonably necessary to protect against impairment to its security or the risk of default." *Id.*

88. *Id.* at 946, 582 P.2d at 972, 148 Cal. Rptr. at 381.

89. *Id.* The bank refused to allow Wellenkamp to assume the mortgage unless she agreed to pay an increased interest rate. The original mortgagor paid interest at a rate of 8% per annum. The bank sought 9 1/4% from Wellenkamp. *Id.*

90. *Id.* at 947, 582 P.2d at 972, 148 Cal. Rptr. at 381. Wellenkamp appealed to the California Supreme Court when the California Superior Court sustained the bank's demurrer. *Id.*

91. *Id.* at 947-49, 582 P.2d at 973-74, 148 Cal. Rptr. at 382-83. By following the principles enunciated in *LaSala* and *Tucker*, the court answered the question of whether a due-on-sale clause is enforceable in outright sales. In order for the plaintiffs to have standing, the court adopted a broader definition of an "outright sale." It defined that phrase as a sale by a mortgagor of property who transfers his legal title. Absent a revision of the meaning of the phrase, the court would have been unable to hear the instant case as the *Tucker* definition remained extant. *Id.* at 950, 582 P.2d at

*Tucker* opinion allowed the application of due-on-sale clauses to "outright sales" presuming that buyers could tender full payment to mortgagors.<sup>92</sup> Conversely, *Wellenkamp* reasoned that in inflationary times or "tight money" periods a buyer will assume a mortgagor's loan because no other means of financing exists.<sup>93</sup> If a mortgagee accelerates, thereby negating the buyer's ability to assume financing, a seller cannot convey his property.<sup>94</sup> Using this expanded definition of "outright sale" the exercise of a due-on-sale clause restrains alienation.<sup>95</sup> Finding such an impairment, the court questioned whether the mortgagee's legitimate interests were such that the justification outweighed the restraint.<sup>96</sup>

The court generally recognized that lenders exercise due-on-sale clauses to protect their security interests.<sup>97</sup> First, they invoke the provision to prevent waste and depreciation.<sup>98</sup> Second, lenders reasonably enforce the clause where the effect of doing so denies buyers who are not credit-worthy the opportunity to purchase the secured property.<sup>99</sup> In the instance case, however, the court rejected the mortgagee's contention that it used the provision for justifiable reasons.<sup>100</sup>

The mortgagee argued that often waste or default occurs upon the outright sale of land because purchasers lack the incentive to maintain the newly acquired property.<sup>101</sup> The court rejected this argument and asserted that purchasers often make substantial down payments on property to obtain the mortgagor's equity.<sup>102</sup> Consequently, they

974, 148 Cal. Rptr. at 383. See also Maxwell, *The Due-on-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 U.C.L.A. L. REV. 197, 206 (1980).

92. See *Tucker v. Lassen Sav. and Loan Ass'n*, 12 Cal. 3d 629, 635-36, 526 P.2d 1169, 1172, 118 Cal. Rptr. 633, 636 (1974).

93. *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 950, 582 P.2d 970, 974, 148 Cal. Rptr. 379, 383 (1978).

94. *Id.*

95. *Id.* at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384. "[T]he result in terms of a restraint on alienation is clear." *Id.* See Note, *supra* note 41, at 1113.

96. 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

97. *Id.*

98. *Id.* See Hetland, *Real Property and Real Property Security: The Well-Being of the Law*, 53 CAL. L. REV. 151, 170 (1965).

99. 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

100. *Id.* at 951-52, 582 P.2d at 976, 148 Cal. Rptr. at 384.

101. *Id.* at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

102. *Id.* at 951-52, 582 P.2d at 976, 148 Cal. Rptr. at 384.

have an equitable interest to protect as does the seller in his capacity as a mortgagor.<sup>103</sup> Since these large deposits minimize the threat to the mortgagee's security, this argument standing alone fails to justify the application of the clause.<sup>104</sup>

The mortgagee also asserted that it exercised the due-on-sale clause in order to maintain its loan portfolio at current interest rates.<sup>105</sup> It argued that since mortgagors can refinance in periods of declining interest rates, mortgagees should likewise be able to protect their financial interests by using the clause in times of increasing rates.<sup>106</sup> Moreover, it stated that inflation increases business costs, yet lenders must simultaneously offer a greater rate of return to attract and maintain depositors.<sup>107</sup> To offset these rising costs, mortgagees invoke due-on-sale clauses to terminate mortgages which yield below market interest rates.<sup>108</sup> They can reinvest this money at a higher rate of return.

While the court recognized that lenders bear great business risks in inflationary periods, it refused to allow the mitigation of these risks through exercise of the clause.<sup>109</sup> The court held that lenders should apply the clause only to protect themselves against impairments of their security.<sup>110</sup> The court believed that lenders should measure financial risks such as inflation before setting interest rates.<sup>111</sup> The

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103. *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 384. The court recognizes that once a possessor has equity in property, he has a vested interest in maintaining the land. The key factor rests upon the finding of an equitable interest. The court does not question whether the mortgagor or assuming purchaser possesses the equity. *Id.*

104. *Id.* The court also noted that the purchaser of property in an outright sale might, in fact, be a better credit risk than the original mortgagor. *Id.*

105. *Id.*

106. Respondent's Brief in the Court of Appeals, at 44, *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

107. *See Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379, 385 (1978).

108. *Id.*

109. *Id.* The opinion stated: "we believe that exercise of the due-on clause to protect against . . . 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 to result from a transfer of title." *Id.*

110. *Id.* at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86. *See supra* notes 73-79 and accompanying text.

111. 21 Cal. 3d at 947, 582 P.2d at 976, 148 Cal. Rptr. at 385. By failing to consider and to provide for these risks, lenders undoubtedly would be unable to stay in business. It follows that the lenders cushion their rates to compensate for these contingencies.

court held: "it would be unjust to place the burden of the lender's mistaken economic projection on property owners exercising their right to alienate freely their property through the automatic enforcement of a due-on-sale clause by the lender."<sup>112</sup> The court invalidated the application of the clause because the quantum of restraint exceeded the justification for the provision's use.<sup>113</sup> In disapproving of the *Hellbaum* and *Cherry* decisions, the supreme court conclusively established that it would invalidate the use of due-on-sale clauses absent a lender's showing of security impairment.<sup>114</sup> The *Wellenkamp* decision decisively abolished the majority approach in California.<sup>115</sup> The California Supreme Court, however, left unanswered the question of whether the *Wellenkamp* holding applied to all California institutional lenders or only state chartered Savings and Loan Associations (S & Ls).

### C. Federal Preemption

In *Glendale Federal Savings and Loan Association v. Fox*,<sup>116</sup> a federally chartered S & L challenged the applicability of *Wellenkamp* to federally chartered lenders.<sup>117</sup> The S & L contended that federal law exclusively controlled the regulation of the use of due-on-sale clauses in home loans made by federally chartered lenders.<sup>118</sup> The *Glendale* court declared that federal due-on-sale regulations preempt conflicting state laws which invalidate accelerator clauses as a restraint.<sup>119</sup>

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112. *Id.* at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385. *But cf.* *Malouff v. Midland Fed. Sav. and Loan Ass'n*, 181 Colo. 294, 303, 509 P.2d 1240, 1244 (1973) (due-on-sale clause valid when protecting lender from inflationary conditions).

113. 21 Cal. 3d at 954, 582 P.2d at 977, 148 Cal. Rptr. at 386.

114. *Id.* *But cf.* *Occidental Sav. and Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 482, 293 N.W.2d 843, 850 (1980) (due-on-sale clause does not restrain alienation and is enforceable absent a showing of unreasonableness by mortgagor).

115. In fact, the California Supreme Court has refused to hear any case of this type after *Wellenkamp*. *Id.*

116. 459 F. Supp. 903 (C.D. Cal. 1978).

117. *Id.* at 904.

118. *Id.* at 906. *See supra* note 8 and *infra* notes 138-48 and accompanying text.

119. 459 F. Supp. at 910. Other cases holding that the FHLBB's due-on-sale regulations preempt state law include: *Price v. Florida Fed. Sav. and Loan Ass'n*, 524 F. Supp. 175, 178 (M.D. Fla. 1981), *aff'd*, *First Fed. Sav. and Loan Ass'n v. Brown*, 707 F.2d 1217 (2d Cir. 1983); *Williams v. First Fed. Sav. and Loan Ass'n*, 500 F. Supp. 307, 308 (E.D. Va. 1980); *Bailey v. First Fed. Sav. and Loan Ass'n*, 407 F. Supp. 1139, 1141 (C.D. Ill. 1979). *But cf.* *Williams v. First Fed. Sav. & Loan Ass'n of Arlington*, 651 F.2d 910, 922 (4th Cir. 1981) (court refused to decide preemption issue).

The *Glendale* holding allowed federally chartered S & Ls to use due-on-sale clauses in their home mortgage loans. The *Glendale* and *Wellenkamp* decisions resulted in a paradoxical situation: unlike federal lenders, state chartered S & Ls lacked the authority to use due-on-sale clauses.<sup>120</sup> California state courts, however, refused to recognize the *Glendale* holding and continued to limit federal lenders' use of due-on-sale provisions.<sup>121</sup>

The California Court of Appeal, in *De La Cuesta v. Fidelity Federal Savings and Loan Association*,<sup>122</sup> held that state law controlled the enforceability of due-on-sale clauses when lenders failed to show that they invoked the clause to prevent impairment of their security interests.<sup>123</sup> By holding that a federal regulation which gave federally chartered S & Ls the right to include due-on-sale clauses did not preempt state law,<sup>124</sup> the court recognized that the *Wellenkamp* doctrine remained extant.<sup>125</sup>

In *Fidelity*, the court heard three consolidated cases in which purchasers of real property brought suit seeking injunctive relief to prevent federally chartered S & Ls from foreclosing on property following the application of the trust deeds' due-on-sale clauses.<sup>126</sup> Fidelity Federal asserted that federal due-on-sale law preempted state law, and therefore it did not show that the mortgagors' sales caused an impairment of its security.<sup>127</sup> In short, Fidelity Federal followed the *Glendale* court's holding that federally chartered S & Ls are not bound by state law.<sup>128</sup>

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120. This inconsistency financially disadvantaged state lenders. In *Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982), the Supreme Court cited figures showing that state lenders lost over \$200 million because the California state courts denied them the rights to use due-on-sale clauses. *Id.* at 169 n.21 (1982).

121. *See De La Cuesta v. Fidelity Fed. Sav. & Loan Ass'n*, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), *rev'd*, *Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982).

122. 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981).

123. *Id.* at 341, 175 Cal. Rptr. at 474.

124. *Id.* at 336, 175 Cal. Rptr. at 473 (1981) (interpreting 12 C.F.R. § 545.8-3(f) and (g) (1983)).

125. *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). The Supreme Court of California determined that the operation of a due-on-sale clause unreasonably restrains alienation unless the lender can reasonably show that it used the clause to protect its security interest. *Id.*

126. 121 Cal. App. 3d at 330, 175 Cal. Rptr. at 468.

127. *Id.* at 333, 175 Cal. Rptr. at 469.

128. *Id.*

The California Court of Appeal disagreed with Fidelity Federal's contention, reasoning that while the Congress gave the Federal Home Loan Bank Board (FHLBB) plenary power to regulate federally chartered S & Ls, Congress did not intend to revoke state real property and mortgage laws.<sup>129</sup> By deciding that the regulations promulgated by the FHLBB did not expressly preempt state law, the court disregarded Fidelity Federal's reliance on *Glendale*.<sup>130</sup>

While the court realized that Congress has the authority to pass laws which expressly preempt state laws, it refused to equate congressional intent with that of the FHLBB.<sup>131</sup> The court reasoned that prior to the passage of the FHLBB regulation which granted federally chartered S & Ls the authority to use due-on-sale clauses, Congress had chosen not to enact any laws regulating the use of these clauses.<sup>132</sup> Thus, Congress consciously declined to regulate the states' enforcement of due-on-sale provisions.

To support its holding against preemption, the court attempted to harmonize state law with the FHLBB regulations.<sup>133</sup> It reasoned that the state law did not impinge upon the FHLBB's ability to regulate federally chartered lenders because it read *Wellenkamp* as a principle of state property and mortgage law.<sup>134</sup> The court stated that the FHLBB regulation and the *Wellenkamp* rule could coexist because the regulation authorized but did not compel the use of due-on-sale provisions, and *Wellenkamp* did not absolutely invalidate the use of the accelerator provision.<sup>135</sup>

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129. *Id.* at 336, 175 Cal. Rptr. at 471. The court reasoned that since almost all state and federally chartered S & Ls conduct business entirely within one state, preemption based on occupation of the field analysis was inapplicable. Preemption founded on occupation of the field mandates that federal law supersedes state law which regulates that field. It is immaterial whether the state law comports or conflicts with the federal law. *Id.* at 336, 175 Cal. Rptr. at 472.

130. 121 Cal. App. 3d at 339, 175 Cal. Rptr. at 474.

131. *Id.* The court stated: "the decision whether to displace state law is a fundamental one going to the very fabric of federalism; thus, the decision is one to be made by the people through their elected representatives in Congress rather than by agencies or tribunals insulated from the democratic pressures." *Id.* at 339-40, 175 Cal. Rptr. at 474.

132. 121 Cal. App. 3d at 341, 175 Cal. Rptr. at 475.

133. *Id.* at 341, 175 Cal. Rptr. at 475.

134. *Id.* at 341-42, 175 Cal. Rptr. at 475.

135. *Id.* at 341, 175 Cal. Rptr. at 475. The court also rejected the contention of the Federal Home Loan Mortgage Corporation (FHLMC), which submitted an *amicus curiae* brief, that the court should uphold preemption in recognition of the need to

The *Fidelity* court's application of *Wellenkamp* to federally chartered S & Ls left federally chartered lenders in a quandary. The *Fidelity* and *Glendale* decisions reach contradicting conclusions although the facts in the cases are nearly identical. The effect of the *Wellenkamp*, *Glendale*, and *Fidelity* holdings taken together left federally chartered California S & Ls in the following anomalous position: Borrowers challenging the enforceability of due-on-sale clauses in trust agreements which either state or federally chartered S & Ls held in state court could defeat the enforceability of the accelerator provision provided that they showed that the lenders had unreasonably used the clause. Conversely, borrowers whose trust deeds containing due-on-sale clauses were held by federally chartered lenders would probably fail in suing to defeat the operation of the clause in federal court. The United States Supreme Court, by granting *Fidelity Federal's* appeal, attempted to resolve the dichotomy.<sup>136</sup>

Affirming the *Glendale* decision, the Supreme Court held that the FHLBB's regulation which allowed federally chartered lenders to use due-on-sale clauses in mortgage agreements preempted conflicting state law.<sup>137</sup> Basing its reversal on a preemption analysis<sup>138</sup> the Court first considered whether the FHLBB intended to preempt state law.<sup>139</sup> Second, the Court examined whether the FHLBB's regulation fell within the Board's statutory authority.<sup>140</sup>

The Supreme Court decided that the FHLBB's regulations demonstrated the Board's intention to preempt state law.<sup>141</sup> The Court also stated that there are two types of preemption—express and implied.<sup>142</sup> Express preemption exists when federal law precludes the application of state law.<sup>143</sup> Lacking explicit preemptive language, courts infer congressional intent to supersede state law when the

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create and maintain uniform policies to regulate the use of mortgage agreements because Congress alone is the proper governmental entity to make such a finding. *Id.* at 342-43, 175 Cal. Rptr. at 476.

136. *Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982).

137. *Id.* at 170.

138. *Id.* at 152. *See infra* notes 143-48 and accompanying text.

139. *Id.* at 153.

140. *Id.* at 159.

141. *Id.* at 153.

142. *Id.*

143. *Id.* Express preemption is the clearest indication of Congress' intent to have federal law supersede state law. *See SIMES & SMITH, supra* note 13, at § 1154.

scope of federal regulation is so extensive as to create an inference that Congress wanted federal law to displace state law.<sup>144</sup> The Court declared that in areas where Congress did not regulate fully, state laws are valid only to the extent that they do not conflict with federal law.<sup>145</sup>

In holding that federal regulations and federal laws preempt conflicting state laws equally, the Court rejected the California Court of Appeal's finding that only Congress can legislate to displace state laws.<sup>146</sup> The Court recognized that federally chartered S & Ls could simultaneously comply with *Wellenkamp* and FHLBB regulation; nonetheless it determined that the California courts' enforcement of *Wellenkamp* frustrated the FHLBB's purpose of flexibility in regulating federal lenders.<sup>147</sup> Finding that the FHLBB's regulations demonstrated the Board's intention to preempt state law, the Court considered whether the Board had received statutory authority to make regulations which preempted conflicting state law.<sup>148</sup>

The Supreme Court concluded that the legislative history of the Home Owners' Loan Act (HOLA) sufficiently indicated Congress' intent to give the FHLBB the power to regulate federally chartered lenders.<sup>149</sup> The Court noted that the HOLA's purpose was to stabilize the home mortgage industry by providing funds to home purchasers through the creation of a system of federally chartered S & Ls.<sup>150</sup> The HOLA provided for the creation of the FHLBB to monitor and to regulate federal lenders in order to carry out the congressional purpose.<sup>151</sup> The Court determined that the use of broad

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144. *Id. See, e.g., Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) (when federal regulation is so pervasive as to allow inference that Congress left no room for supplemental state law, the federal regulation preempts state law).

145. *Id. See First Fed. Sav. & Loan of Gadsden County v. Petersen*, 516 F. Supp. 732, 737 (N.D. Fla. 1981), *rev'd*, *First Fed. Sav. & Loan Ass'n v. Brown*, 707 F.2d 1217 (2d Cir. 1983) (court upheld federal due-on-sale regulation over conflicting state law).

146. 453 U.S. at 154.

147. *Id.* at 156. The Court also noted that the FHLBB restated its policy that only the Board should delineate the guidelines which limit federally chartered lenders' ability to use due-on-sale clauses in mortgage agreements. *Id.* at 155. *See* 46 Fed. Reg. 39123, 39124 (1982).

148. 458 U.S. at 159.

149. *Id.* at 159-60.

150. *Id.* at 161. *See supra* note 8 and accompanying text.

151. *Id.* at 160.

language in the HOLA proved that Congress provided for no limits on the FHLBB's power to oversee federal S & Ls lending practices.<sup>152</sup> The Court reached this conclusion by reasoning that Congress enacted HOLA and created the FHLBB to guarantee the financial stability of the home mortgage industry.<sup>153</sup> Thus, by tacitly concluding that the FHLBB perceived due-on-sale clauses to be a method by which to preserve the ongoing operation of the mortgage industry, the Court refused to allow conflicting state law to obstruct federal policy.

The Supreme Court's *Fidelity* decision is significant because it resolved the federal preemption issue and effectively barred the application of *Wellenkamp* to federally chartered lenders. The decision, however, failed to provide relief for state chartered S & Ls which would have to continue to follow the *Wellenkamp* rule. The Court declined to overrule the *Wellenkamp* rule; instead, it allowed the dichotomy between state and federally chartered S & Ls to persist. The Supreme Court's *Fidelity* holding affirmed the *Glendale* decision but it did not compel minority state courts to follow the regulation. In order to achieve a consistent policy of enforcing the use of due-on-sale clauses in mortgage agreements, Congress would have to intervene.

After understanding the factors which courts consider when questioning the validity of due-on-sale clauses and examining the courts' preemption cases, one may analyze the majority and minority tests. Measurement of the propriety of either approach is meaningless without examining the effects of implementation of the tests on lenders and homeowners.

### III. ANALYSIS OF THE MAJORITY AND MINORITY TESTS

#### A. *The Majority*

The courts which follow the majority approach uphold the enforceability of due-on-sale provisions. They consider primarily the economic impact that due-on-sale clauses have on institutional lenders.<sup>154</sup> Courts which espouse this approach recognize the inherent

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152. *Id.* at 161. The court noted, however, that the power of the FHLBB is not all inclusive, but it did not define the limits of its preemptive authority. *Id.* at 164.

153. *Id.* at 168.

154. *See* *Cherry v. Home Sav. and Loan Ass'n*, 276 Cal. App. 2d 574, 579, 81 Cal. Rptr. 135, 138 (1969). "[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

right of lenders to accelerate for several reasons. First, lenders have an obligation to their depositors.<sup>155</sup> In return for depositors' investments, S & Ls invest depositors' money by financing such loans as mortgages. The S & Ls must pay interest on the savings of their depositors. Since they must lend money at a profitable margin to avoid insolvency, they must invest their borrowed funds prudently. Theoretically, they check the credit-worthiness of potential mortgagors before making a home loan. Yet if the lender lacks the ability to control a mortgagor's power to dispose of property through assumption, an S & L might lose its investment because an assuming purchaser has insufficient funds to meet the obligation.<sup>156</sup> Thus, these courts uniformly allow lenders to invoke due-on-sale clauses as a means to protect their security.<sup>157</sup>

Second, judicial awareness of the economic realities of lending money in a period dominated by high interest rates<sup>158</sup> results in judicial support for portfolio maintenance.<sup>159</sup> Economic justification for maintaining the repayment of loaned dollars at current interest rates exists. As stated above, S & Ls must maintain an income sufficient to meet creditors' demands. To remain solvent, lenders must not only protect their principal, but must also maximize their interest income.

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event his borrower transfers the security. This is merely one example of the ways taken to minimize risks by sensible lenders." *Id.*

155. See *Crockett v. First Fed. Sav. and Loan Ass'n*, 289 N.C. 620, 626, 224 S.E.2d 580, 585 (1976) (lenders finance loans to maximize profits for benefit of depositors).

156. See *Mutual Fed. Sav. and Loan Ass'n v. Wisconsin Wire Works*, 71 Wisc. 2d 531, 540, 239 N.W.2d 20, 24 (1976). "[I]f the lender in his evaluation of the business character and reputation of a subsequent obligor believes collection may be more difficult and foreclosure more probable than in the case of the original borrower . . . [the lender may] exercise its option in a 'due-on-sale' clause." *Id.*

157. *Id.* Even courts which take the minority view allow due-on-sale clauses. See, e.g., *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 953, 582 P.2d 970, 976-77, 148 Cal. Rptr. 379, 385-86 (1978).

158. See Note, *supra* note 86, at 291. "Stable rates of interest, however, are a thing of the past. The average cost of funds to federal savings and loan associations rose 50% from 1965 to 1976, while average yield on mortgage portfolios lagged behind, increasing 34%." *Id.*

159. See, e.g., *Gunther v. White*, 489 S.W.2d 529, 532 (Tenn. 1973). [Savings and loan] under their contract have the right to insist upon the repayment of their loan (sic) in the event of sale, so that they can relend the money at an increased interest rate, and so maintain their supply of lending money, at the level of their present cost of such money.

*Id.* See *Bonanno, supra* note 36, at 271.

For example, an S & L lends money to a mortgagor who pays five percent interest per annum for thirty years. But if the lender collected interest income at current market rates, which measure about ten percent, then the S & L in effect would more than double its earnings. This increased income would more than offset the financial obligation which S & Ls have to their depositors. In fact, these institutions could lend the excess to creditworthy individuals thereby expanding the mortgage market. The due-on-sale clause is a primary mechanism by which S & Ls can terminate long-term mortgages yielding below market rates.

Due to compelling economic reasons for allowing the use of due-on-sale clauses, courts which adopt this approach place the burden on the homeowner to rebut the presumption of the provision's validity.<sup>160</sup> Courts permit the exercise of the clause unless homeowners satisfy the burden. Homeowners can overcome this presumption by proving adhesion or unconscionability.<sup>161</sup> Alternatively, they can demonstrate that the sale of the home does not impair the lender's security.<sup>162</sup>

The effects of the majority test are multifarious. Arguably, while not adhesive, the invocation of the clause might prevent homeowners from selling property because buyers cannot afford to purchase without assuming at sellers' mortgage rates.<sup>163</sup> To offset buyers' higher interest rates, sellers will accept less money for the sale of their homes. Consequently, the clause tends to reduce the interest rate premium buyers pay when they assume a mortgage. Operation of due-on-sale provisions indirectly constrain a homeowner's ability to convey his property.

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160. See *supra* note 86-115 and accompanying text.

161. See Maxwell, *The Due-on-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 U.C.L.A. L. REV. 197, 209-15 (1980) (points out that institutional lenders possess greater resources and have great bargaining power in light of their position as extenders of credit); 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, 499, 502 (1973) (standards for regulating application of due-on-sale clauses).

162. See, e.g., *Tucker v. Pulaski Sav. & Loan Ass'n*, 252 Ark. 849, 854-55, 481 S.W.2d 725, 728-29 (1972) (mortgagee had obligation to justify its refusal to consent to sale of mortgaged property to purchasers; there must be legitimate grounds to refuse to accept a transfer, such as no impairment of security).

163. See *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 950-51, 582 P.2d 970, 974-75, 148 Cal. Rptr. 379, 383-84 (1978). See also Note, *supra* note 41, at 1113 (1975).

Conversely, S & Ls cannot invoke the clause absent a sale.<sup>164</sup> In addition, recognition of the per se validity of the clause avoids litigation on an ad hoc basis. Although S & Ls initially use the provision to protect their security, invocation of the clause now allows lenders to generate current interest rate income.<sup>165</sup> Application of due-on-sale clauses permits homeowners to obtain low-cost financing, the balance of which does not become due in fewer than five to seven years.<sup>166</sup> While these clauses may have a detrimental effect on the individual homeowner, their use tends to stabilize the mortgage market.

### B. *The Minority*

The minority approach recognizes the inherent right of a homeowner to convey his fee.<sup>167</sup> Courts adhering to this view believe that the application of due-on-sale clauses impairs practical alienability.<sup>168</sup> These courts, therefore, place the burden on the lender to show a valid reason for exercising the acceleration clause.<sup>169</sup> Courts

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164. One court declared that acceleration in no way restrains alienation. The "[home] owner is free to convey without legal restraint and the conveyance does not cause a forfeiture of the title, but only an acceleration of the debt." *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 472, 293 N.W.2d 843, 845 (1980).

165. When inflationary economic conditions exist and interest rates continue to increase, it becomes more expensive for a home buyer to finance the purchase of a home as the percentage of interest owed on the loan is higher than in less inflationary periods. If a homeowner sold his home and allowed the buyer to assume the mortgage at a below market rate, the buyer would avoid the effects of the inflated cost of borrowing money. Lenders who allow this assumption cheat themselves of income because if the prospective buyer had to obtain financing at the prevailing interest rate, the lender would receive a higher rate of return on his investment. Thus, due-on-sale clauses allow lenders to maximize their interest income by keeping their loan portfolios at current rates.

166. Homeowners repaying their mortgage obligations will find it less financially burdensome to repay their obligations in even payments over long periods of time, like thirty years. Conversely, borrowers who have to pay their entire obligation within five to seven years face the difficulty of having to pay increasing monthly rates. The long-term mortgages enable borrowers to acquire the funds necessary to purchase a home.

167. *See, e.g., Sanders v. Hicks*, 317 So. 2d 61, 64 (Miss. 1975) (an incident to ownership is owner's inherent right to sell and transfer his property).

168. While technically the invocation of a due-on-sale clause poses no direct restraint on alienation because a mortgagor has the right to convey his land, in practice, the minority believes that the provision's use effectively restrains alienation. *See Weltenkamp v. Bank of Am.*, 21 Cal. 3d 943, 951, 582 P.2d 970, 975, 148 Cal. Rptr. 379, 384 (1978).

169. *See supra* notes 86-115 and accompanying text.

enforce the provision if a lender can demonstrate that it uses the clause to prevent impairment to its security.<sup>170</sup> Thus, the minority realizes that S & Ls must act to protect their pecuniary interest.

For the minority to limit its acceptance solely to the security, though, is inconsistent. The California Supreme Court found the attempts of S & Ls to use the clause to update their mortgage portfolios unreasonable.<sup>171</sup> Loan portfolios of institutional lenders embody mainly long-term mortgages upward of thirty years.<sup>172</sup> S & Ls set the amount of interest based upon the prevailing market rates when the parties consummate the mortgage agreement, so the interest yield remains stable over time. But when interest rates increase dramatically, S & Ls find it more difficult to lend money because their below current mortgage interest income limits their ability to finance loans.<sup>173</sup>

The financial woes of S & Ls continue to worsen in 1980 and 1981 because these institutions paid depositors only 5.5 percent interest on savings.<sup>174</sup> While the federal government insures some savings accounts, many depositors reallocated their funds into money-market accounts which pay the prevailing interest rate.<sup>175</sup> S & Ls found themselves in a severe financial bind because their income from mortgages was less than prevailing market rates. Additionally, the

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170. See, e.g., *Cherry v. Home Sav. & Loan Ass'n*, 276 Cal. App. 2d 574, 578-79, 181 Cal. Rptr. 135, 139 (1969).

171. *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 951-52, 582 P.2d 970, 976, 148 Cal. Rptr. 379, 385 (1978). The court specifically "reject[ed] [the] contention that the lender's interest in maintaining its loan portfolio at current interest rates justifies the restraint imposed by exercise of a due-on-sale clause upon transfer of title in an outright sale." *Id.* This court held: "a restraint on alienation cannot be found reasonable merely because it is commercially beneficial to the restrainer." *Id.* at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385. *LaSala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 880-81 n.17, 489 P.2d 1113, 1124 n.17, 97 Cal. Rptr. 849, 860 n.17 (1971).

172. See Note, *supra* note 86, at 291. "[T]he average maturity on loans made by associations has been estimated . . . at 28.4 years for new homes and 26.6 years for existing homes." *Id.*

173. Common sense dictates that one cannot predict the future. S & Ls set their interest rates by evaluating present costs, not future expectations. See *Bonanno*, *supra* note 36, at 301.

174. Scharff, *The Savings Revolution*, TIME, June 8, 1981, at 58, 65.

175. See *id.* at 60-61. In 1981, depositors withdrew over \$43 billion from banks and S & Ls, reinvesting in money markets which often earn a return of 17%. *Id.* at 58, 65.

inability to attract depositors further restricted S & Ls' cash flow.<sup>176</sup> The vast majority of S & Ls lost money,<sup>177</sup> and the courts refusal to allow the application of due-on-sale clauses further debilitated the ability of S & Ls to generate profits. Courts which denied the availability of the clause for portfolio maintenance ignored the financial realities under which institutional lenders operated. It is anomalous for the minority to validate the protection of security and to reject attempts to maximize interest income at current rates.<sup>178</sup>

Arguably, lenders act unconscionably in applying due-on-sale clauses as a hedge against inflation and rising costs when they fail to state this purpose expressly in the mortgage. While homeowners may contemplate that a due-on-sale provision results in the acceleration of the debt, they are unaware that the effect of a sale also tends to increase the interest rate for the assuming purchaser. To eliminate the confusion, due-on-sale clauses should clearly explain that upon sale the lender retains the option to reset the rate of interest. Such a statement eliminates the problem of unconscionability.

Diverse effects result from the application of the minority view. Judicial placement of the burden on the lender of showing reasonableness forces S & Ls to justify their use of accelerator clauses.<sup>179</sup> Thus, homeowners may freely convey their mortgaged property unless the mortgagee can demonstrate a legitimate reason for using the clause. Consumers laud this result. A problem arises in determining what constitutes reasonableness. The lack of a clear and uniform standard for review had compelled litigators to bring suits on an *ad hoc* basis. These *ad hoc* suits waste court time and increase legal costs.

When invalidating due-on-sale clauses, minority courts place the consumer's interest above that of the lenders. Perhaps these courts believe that consumers occupy bargaining positions which are inferior to that of institutional lenders. From a financial standpoint, however, minority courts overlook the economic impact of a lender's

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176. *Id.* at 68. In 1980 the Federal Savings and Loan Insurance Corporation (FSLIC) regarded almost 250 of the 4,560 S & Ls as "problem cases." *Id.*

177. *Id.* at 58. To avoid insolvency, more and more of these institutions merged. In the past three years over 200 S & Ls combined to avoid liquidating. *Id.*

178. In light of the prevailing inflationary economy, the protection of interest income is as important as the protection of the principal investment.

179. The *Wellenkamp*, *Tucker* and *LaSala* courts placed the burden on the lender to show reasonableness. See *supra* notes 86-115 and accompanying text.

inability to earn income at current rates. Since *Wellenkamp*,<sup>180</sup> California S & Ls have shunned the use of due-on-sale clauses. Unlike their federally chartered counterparts, state lenders were disabled to the extent that they could not offer long-term, even-payment mortgages. The Federal Home Loan Bank Board permits lending institutions under its jurisdiction to use due-on-sale clauses.<sup>181</sup> Thus, homeowners seek long-term mortgage financing from federal S & Ls because state institutions lack the means to make these loans.

#### IV. ALTERNATIVE FINANCING INSTRUMENTS

##### A. *Variable Rate Mortgages*

The *Wellenkamp* court believed that the inability to apply due-on-sale clauses did not damage state lenders because they have other available methods of mortgage financing.<sup>182</sup> In fact, state chartered S & Ls resorted to other forms of lending to fill the void *Wellenkamp* created. Two of the more popular alternative financing instruments that are available are variable rate mortgages and rollover mortgages.

The variable rate mortgage<sup>183</sup> (VRM) is another method of mortgage financing which operates to insure that lenders earn interest income at the prevailing market rate.<sup>184</sup> Lenders structure VRMs so that when a specified interest rate index fluctuates, the interest rate payable on the mortgage correspondingly changes.<sup>185</sup>

The advantage of this financing method is that lenders obtain a fair return on their investment. Homeowners also benefit because the VRM provides for long-term repayment of the mortgage. VRMs fix the schedule for repaying much of the principal but allow for varia-

180. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1975). See Andrew, *Creative Financing Ends in Foreclosure for More Home Buyers*, Wall St. J., Feb. 26, 1982 at 1, col. 6. "In California, the economic pressures for creative financing were given impetus . . . when the state supreme court ruled that the due-on-sale clause in most California mortgages is illegal" because of the *Wellenkamp* decision. *Id.* at 19, col. 1.

181. The Federal Home Loan Bank Board resolved to empower federal S & Ls to invoke the due-on-sale clause in Resolution No. 75-647, FED. HOME LOAN BANK BOARD (1975).

182. 21 Cal. 3d 943, 950, 582 P.2d 970, 974, 148 Cal. Rptr. 379, 383 (1975). See Note, *supra* note 86, at 292.

183. For a thorough discussion of VRMs, see Bonanno, *supra* note 36, at 301-04.

184. See Kunkel, *The Due-on-Sale Clause and Alternative Mortgage Instruments* 1981 DEL. C.L. REV. 1105, 1121 (1981).

185. See Cowan and Foley, *New Trends in Residential Mortgage Financing*, REAL ESTATE FINANCING—TODAY AND TOMORROW 120 (1978).

ble interest rates. Theoretically, VRMs treat the lender and homeowner fairly, since the rate of interest payable can fluctuate on either direction depending upon economic conditions.

In practice, however, VRMs hinder borrowers. Economic indicators demonstrate that the interest rate will continue to rise.<sup>186</sup> Should the economic slump persist, interest rates will probably increase drastically. The effect of such a dramatic rise encourages mortgage foreclosures because homeowners will lack the funds to meet their obligations. Unless legislators place a ceiling on the interest rate payable, VRMs will lose their attractiveness to a significant segment of borrowers.<sup>187</sup>

### B. Rollover Mortgages

A second type of financing instrument lenders use to maintain current interest income is the rollover mortgage.<sup>188</sup> The typical rollover mortgage allows homeowners to amortize payment of the principal over a long period at a fixed rate. Lenders recalculate the rate of interest payable periodically and set a new interest rate for a new loan, in effect canceling the loan unless the parties agree to renew.<sup>189</sup>

Lenders benefit most from this form of financing. They may either renew the loan in order to bring it up to current interest rates or cancel it in the hope of reinvesting to obtain a higher return. There is no ceiling to the rise in the interest rate.<sup>190</sup> Lenders who retain the option to cancel enjoy a tremendous advantage over borrowers.

Conversely, borrowers who agree to rollover mortgage financing

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186. See Scharff, *The Saving Revolution*, TIME, June 8, 1981 at 58, 65. "[A]t current rates of inflation, money will lose about 10% in value each year." *Id.*

187. See, e.g., CAL. CIV. CODE § 1916.5 (Deering Supp. 1983) which states:

(2) The rate of interest shall change not more often than once during any semi-annual period, and at least six months shall elapse between any two such changes.

(3) The change in the interest rate shall not exceed one-fourth of one percent in any semiannual period, and shall not result in a rate more than 2.5 percentage points greater than the rate for the first loan payment due after the closing of the loan.

*Id.*

188. For an explanation of how rollover mortgages operate, see Cowan and Foley, *New Trends in Residential Mortgage Finance* 13 REAL PROP. PROB. & TR. J. 1075, 1084-85 (1978).

189. *Id.*

190. See Hill, *California S & Ls Signal Impeding Demise of Fixed-Rate 30-Year Home Mortgage*, WALL ST. J., Feb. 12, 1981 at 37, col. 1.

are in a precarious position since they may have to pay a higher interest rate or satisfy the entire debt because the balance becomes due in only a few years. If a borrower conveys his home before the rollover mortgage matures, he avoids difficulty. If the balance becomes due and the borrower can neither afford to meet higher interest payments nor find a buyer, foreclosure results. Absent an agreement by the lender to refinance, rollover mortgages deny homeowners the stability that long-term, even-payment mortgages containing due-on-sale clauses offer.

## V. CONCLUSION

The minority view of due-on-sale clauses places the burden of showing reasonableness on lenders because courts fear that innocent homeowners occupy an inferior bargaining position. Homeowners often enter into mortgage contracts without seeking the advice of counsel, and they fail to understand the legal implications of the agreement. To alert buyers that they may find it difficult to sell their homes, mortgages containing due-on-sale clauses should state clearly in bold print that lenders retain the option to accelerate upon sale and also reserve the right to demand the payment of a higher interest rate by the assuming purchaser. Arguably, such an explicit statement will obviate the need for placing the burden of reasonableness on lenders.

Minority courts reject lenders' attempts to invoke the due-on-sale clause based on economic grounds. They hold that in practice the use of the accelerator provision inhibits alienation. While minority courts realize that state lenders must protect their pecuniary interests by invalidating the accelerator provision to maximize profits, they protect the consumer because of the drastic effect of the clause. In light of the poor performance of S & Ls, the financial need of lenders to maintain their portfolios at current rates has never been greater. It is logically inconsistent for minority courts to protect a lender's security and disregard its interest income. Minority courts fail to recognize that long-term, fixed-rate mortgages attract potential homeowners by guaranteeing them steady payments. VRMs are too risky to homeowners who might lack the means to repay should interest rates skyrocket. Short-term mortgages which mature in fewer than five years also fail to resolve the problem because there is no

guarantee that homeowners can meet the obligations.<sup>191</sup>

To complicate the problem further, state lenders found it unfeasible economically to lock themselves into long-term, fixed-rate mortgages without being able to increase their income to offset the increasing cost of funds. Potential homeowners can obtain the more stable long-term mortgages from federally chartered S & Ls which received legislative approval to use due-on-sale clauses.<sup>192</sup> The dichotomy between federal lenders, who can use the accelerator clause to extract higher interest rates, and those state S & Ls who were precluded from benefiting by the provision results in a threat to the survival of the state institutions.<sup>193</sup>

While both home purchasers and institutional lenders need the stability which due-on-sale clauses offer in times of increasing interest rates, the courts have failed to respond adequately. The United States Supreme Court's *Fidelity* decision precluded the application of *Wellenkamp* to federally chartered lenders. The Court, however, failed to free state chartered S & Ls from the effect of the *Wellenkamp* rule. Consequently, in order to achieve a uniform policy concerning due-on-sale clauses in mortgage agreements, Congress must intercede.

Congress has resolved the inconsistency between the courts which follow the majority and minority approaches by passing an act which allows *all* S & Ls to use due-on-sale clauses in their mortgage agreements.<sup>194</sup> The Garn-St.-Germain Depository Institutions Act of

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191 Savings and loans and other thrift institutions first used rollover mortgages before the depression. President Roosevelt targeted the improvement of the housing market to stimulate the economy. Believing that lenders' use a rollover mortgages undercut the objective of the New Deal, federal legislation expressly disapproved of mortgages which ballooned after only a few years. See Ahearn, *Usury: The Depository Institution Deregulation and Monetary Control Act of 1980*, 1981 ARIZ. ST. L.J. 211-14 (1981).

192. See *People ex rel Deukmejian v. Glendale Fed. Sav. and Loan Ass'n*, 122 Cal. App. 3d 860, 865, 176 Cal. Rptr. 353, 358 (1981) (the Federal Home Loan Bank Board is not subject to state jurisdiction so *Wellenkamp* is inapplicable).

193. As the Court noted in *Fidelity Fed. Sav. and Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982), the California state court's restrictions of state chartered S & Ls' ability to use due-on-sale clauses caused state lenders to lose over \$200 million in 1981. Estimates indicated that if the minority restriction applied nationally, losses of over \$1.3 billion would result. *Id.* at 145 n.2 (1982).

194. See S. REP. NO. 536, 97th Cong., 2d Sess. (1982). The new act, which applies prospectively, allows both state and federally chartered S & Ls to invoke due-on-sale clauses not only to protect their security interests but also to update their loan portfolios.

1982,<sup>195</sup> received Congressional and executive approval and became effective October 15, 1982. Congress intended the Act to stabilize the finance business.<sup>196</sup> In keeping with its objective, Congress authorized the use and enforceability of due-on-sale clauses in mortgage instruments notwithstanding any state statutory or common law to the contrary.<sup>197</sup> The new law provides that the terms of the contract govern the lender's right to apply the accelerator provision.<sup>198</sup>

The effect of the new federal law is to preempt conflicting state laws which barred the use of due-on-sale clauses.<sup>199</sup> The Act includes one exception to the federal preemption, allowing a three-year period to expire before loans made in jurisdictions which denied the enforceability of due-on-sale clauses by non-federally chartered banks and savings institutions to use these accelerator provisions.<sup>200</sup>

The validity of the Act remains unchallenged; at present, the law

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195. 12 U.S.C. § 1701-23 (1982).

196. *Id.* Congress considered the following adverse effects on due-on-sale restrictions on the finance business:

Due-on-sale restrictions provide an advantage for existing homebuyers at the expense of new homebuyers. New homebuyers are punished by due-on-sale restrictions either by having to pay an inflated price for an existing home with a lower interest rate assumable loan, or by having to pay a premium for a new loan for a new home, or an existing home without an assumable loan.

Due-on-sales clauses encourage risky lending practices which intensify default risks. Studies have shown that due-on-sale clauses may lead to the total disappearance of the long-term fixed rate mortgage.

For lenders, due-on-sale restrictions further extend the lives of older low interest mortgages, and prevent lenders from increasing the yields on those loans at the time the property is transferred.

Due-on-sale restrictions also adversely affect secondary mortgage markets, which rely on uniform, homogeneous mortgage documents to efficiently operate and provide mortgage money for lenders and homebuyers.

Also, the recent Supreme Court decision in *Fidelity Federal Sav. & Loan Ass'n v. De La Cuesta* significantly disadvantaged state-chartered and other lenders, and created uncertainty among homebuyers and sellers regarding the enforceability of due-on-sale clauses.

Act of Oct. 1, 1982, P.L. No. 97-320 (96 Stat.) U.S. CODE CONG. & AD. NEWS 3 S. REP. NO. 536, 97th Cong., 2d Sess. 20.21, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 3054, 3075-75.

197. 12 U.S.C. § 1701-03(b)(1) (1982).

198. 12 U.S.C. § 1701-03(b)(2) (1982).

199. *Id.*

200. 12 U.S.C. § 1701-03(c)(1) (1982). When borrowers transfer loans made in minority jurisdictions which previously invalidated the enforceability of due-on-sale clauses, the effect of the new law prevents lenders from invoking a due-on-sale clause for a period of three years after the transfer. *Id.*

upholds the enforceability of due-on-sale clauses uniformly throughout all jurisdictions. Consequently, the use of due-on-sale clauses by commercial lenders will continue as a viable method of home financing.



## **COMMENTS**

