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The Due-On-Sale Clause: A Marriage Gone Sour - A Checklist For The Practitioner

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THE DUE-ON-SALE CLAUSE: A MARRIAGE GONE SOUR — A CHECKLIST FOR THE PRACTITIONER

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I. INTRODUCTION

The problem begins simply enough. Soon moving to another city a homeowner negotiates and signs a contract for the sale of his present home.[1] The contract provides that the purchasers are to assume the current mortgage with an interest rate of 9¼%.[2] The vendor and the purchasers notify the lender of the intended sale. Despite the fact that the proposed purchasers qualify as acceptable credit-risks,[3] the lender informs the parties that the current mortgage contains a "due-on-sale" clause and that he intends to accelerate the due date of the mortgage[4] unless the purchasers agree to

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1. The case touches many Americans, for it involves the common experience of purchasing a home . . . . It is from that common experience that the present case evolves. The facts are influenced by another common exprience of less ancient lineage, namely, persistent, consistently high, rates of inflation, accompanied by increased interest rates.

Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 912 (4th Cir. 1981).

> Of the 75 million homes across America, more than 64% are owned by the people who live in them, the largest percentage of owner-occupied housing in the world. Owning a home, long a part of the American dream, today is a realistic goal—if not a reality—for most of the people in this country.

FEDERAL NAT'L MORTGAGE ASS'N, PUB. No. 64 8/80, FANNIE MAE, AMERICA'S MORTGAGE RESOURCE 2 (1980) [hereinafter cited as FNMA or FANNIE MAE].

2. The hypothetical presented in the text is representative of a situation which, with minor variations, has occurred countless times in the last few years. *See generally* Bartke & Tagaropulos, *Michigan's Looking Glass World of Due-on-Sale Clauses,* 24 WAYNE L. REV. 971 (1978).

Most of the 75 million homes across America were purchased through mortgage loans. "In 1959 the outstanding home mortgage loans in the United States totaled $147 billion. By 1980 they had grown to more than one trillion dollars." FNMA, *supra* note 1, at 2.

3. Lenders, when underwriting a loan, use as a rule of thumb one-fourth of the gross monthly income or one-third of the net income of the prospective borrower.

4. Although the mortgage actually serves only as security for the note, one or both of these documents may contain a clause requiring the lender's approval of any transfer of the secured property. Throughout this article, the term "mortgage" will be used to represent both note and mortgage since the terms of the note are most often incorporated in the

accept an increase in the interest rate from 9¼% to 15%. The purchasers, their enthusiasm now substantially chilled since this would result in a substantial increase in their monthly payments,[5] inform the vendor that they are either unwilling or unable to close the deal.[6] The vendor, fearing a repeat of this experience or at least a substantial wait to find a buyer wanting to refinance by a new mortgage, must either pay points to the lender to reduce the interest rate to his proposed purchaser or reduce the purchase price to make the deal attractive to the purchaser.[7] Either way the vendor loses a substantial amount of the equity which he has built up in his home, equity which will be needed for the down payment on the home he intends to purchase in his new city.[8] The purchasers also are faced with the problem that the home of their dreams may no longer be within financial reach.[9]

A clause originally designed as a shield to protect the lender from the unacceptable credit-risk transferee has now become a

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mortgage. "Mortgage" shall also be used interchangeably with "deed of trust."

5. On an original $60,000 loan for 30 years at 9¾%, the monthly payment the borrower is required to make increases from $493.80 to $718.62 per month as the interest rate is increased from 9¾% to 15% at the end of the fifth year of the original 30-year term.

6. The amount of debt service (monthly payment composed of interest and amortization — the principal necessary to reduce the balance to zero by the end of the mortgage term) is derived from the balance of four factors:

1. Method of amortization
2. Interest
3. Length of mortgage
4. Loan-to-value ratio.

To date, most home loans are on level-payment amortization (the borrower pays the same amount each month during the term of the loan). Therefore, the other three factors have received the most attention, with interest being the most commonly understood. As interest increases so does the amount of monthly payment. Therefore, to prevent an increase in his monthly payment, the borrower must either (1) reduce the loan-to-value ratio (percentage borrowed of the appraised value) by making an increased down payment or (2) increase the term of the loan period. In times of rapid inflation the prospective purchaser/borrower may not be able to accumulate in savings the necessary funds for an increased down payment, nor are lenders (borrowing short and lending long) agreeable to locking themselves into a specified rate for long periods of time. The result is that the prospective purchaser is unable to make the purchase unless the seller reduces the purchase price. *See* A. AXELROD, C. BERGER & Q. JOHNSTONE, LAND TRANSFER AND FINANCE 100-56 (2d ed. 1978).

7. *Id.*

8. During periods of extreme inflation, the vendor will not only be faced with higher home prices but will need either a substantial down payment or a substantially increased monthly payment over that of his previous home, even if both homes are the same price.

9. *See generally* A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6.

sword in the lender's hand to extract assumption fees and a higher yielding interest rate in exchange for waiving acceleration of the loan.[10]

The lender should not be pictured as the villian through all of this, however. Lenders, like vendors and purchasers, have been caught in the unprecedented inflationary spiral. Lenders must pay higher interest rates on deposits to remain competitive for investors' funds;[11] they can not survive with revenues derived principally from low yielding long-term mortgages.[12]

Furthermore, lenders seeking to obtain new funds from the sale of mortgages in the secondary mortgage market are forced to accept increasing discounts on low yield mortgages.[13] Protection of their loan portfolio has become a primary concern.[14] It may be, however, that lenders have sought to protect their interest in the wrong way.[15] It has been suggested that lenders should use the newer variable rate mortgages or other alternative mortgage devices.[16] At the very least, a lender must provide the borrowers with

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10. *See* Nussbaum & Stein, *Due-on-Sale Clauses Split the Courts,* Nat'l L.J. Oct. 20, 1980 at 17, col. 1. *See also* Matis, *Due on Sale Clause,* PRACTISING LAW INSTITUTE, MORTGAGES AND ALTERNATE MORTGAGE INSTRUMENTS 408 (Feb.-Apr. 1981):

> The traditional purpose has been to protect what is seen as a lender's underwriting considerations such as the credit-worthiness of the borrower to repay the loan or, even if no personal liability is involved, to meet monthly debt service payments and other expenses of operating the security in a first-class manner, whether or not there is sufficient cash flow from the property. Other considerations are the management capabilities and the character of the borrower. The clause has been looked at as giving the lender an opportunity to make new underwriting decisions and either rejecting an unacceptable transferee or attempting to effect changes in the terms of the loan in consideration of accepting a new "borrower."

11. *See* Bartke & Tagaropulos, *supra* note 2, at 974-79.

12. Lenders make their profit from the point spread on money borrowed as opposed to money loaned. Deposits are received on which interest is paid to the depositor. The same money is then loaned at a higher rate of interest. When deposits are inadequate to meet borrowers' demands for loans, the lender sells a package of mortgages to secondary mortgage market purchasers and then lends the funds obtained from such sales at a higher yield.

13. *See* note 12 *supra* and accompanying text.

14. *See* Matis, *supra* note 10, at 408.

15. Suggestions for proper use of the due-on-sale clause may be found in O'Connell, *The Due-on-Sale Clause in Florida: A Potential Battleground for Borrowers and Lenders,* 31 U. FLA. L. REV. 933, 967 (1979).

16. 14 THE MORTGAGE & REAL ESTATE EXECUTIVE REP. 10 at 4 (1981); *see also* Browne, *Alternative Mortgage Instruments,* PRACTISING LAW INSTITUTE, MORTGAGES AND ALTERNATE MORTGAGE INSTRUMENTS 437 (Feb.-Apr. 1981); Comment, *The Due-on-Sale Clause in Cali-*

notice of its intention to accelerate because of rising interest rates, rather than impairment of the lender's security,[17] as the borrower believed when he contracted with the lender for the loan.[18]

A due-on-sale clause is a form of acceleration clause.[19] The intended effect is to allow the lender to accelerate the due date of the indebtedness secured by the mortgage and to foreclose the mortgage upon a conveyance of the mortgaged property without the consent of the lender.[20]

The expression of the clause itself, however, may take several forms, and the event which triggers acceleration may be one or more transfers. The clause may be expressed as either a positive or negative covenant in the mortgage,[21] the breach of which constitutes default; or it may be expressed as specified default to make a transfer without the lender's consent.[22] Acceleration may be automatic or at the lender's option, and his consent may be conditioned on certain requirements which include: satisfaction of credit-worthiness or managerial ability of the transferee; increase in interest rate; partial prepayment; and payment of an assump-

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fornia: A Case for Automatic Enforcement by the Private Lender, 13 U.S.F.L. Rev. 639, 652-56 (1979).

17. In First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300 (Ala. Civ. App. 1977), the Alabama court refused to allow the enforcement of a due-on-sale clause when the clause gave no indication that the financial interest of the lender could be the sole basis for exercising the clause and the proposed sale caused no risk to the lender's security. *See* O'Connell, *supra* note 15, at 945, 950.

18. 345 So. 2d at 303-04; *see* O'Connell, *supra* note 15, at 950 n.164.

19. The acceleration clause has long been used to permit the lender to accelerate the due date and to declare default of the entire indebtedness upon the default in payment of any installment, thus avoiding the burdensome and expensive necessity of suit on each installment as it becomes due. A typical clause reads:

> If any monthly installment under this Note is not paid when due and remains unpaid after a date specified by a notice to Borrower, the entire principal amount outstanding and accrued interest thereon shall at once become due and payable at the option of the Note holder. . . . The Note holder may exercise this option to accelerate during any default by Borrower regardless of any prior forbearance.

MFA 1-4 Family Uniform Note Instrument, Form 140 (Mar. 1977), *reprinted in* A. Axelrod, C. Berger & Q. Johnstone, *supra* note 6, at 1143.

20. Matis, *supra* note 10, at 407.

21. The following is an example of a standard "covenant" due-on-sale clause: "Mortgagor will not sell, lease, convey, assign, further mortgage or otherwise transfer or encumber the premises, or any portion thereof, or enter into an agreement for any of the foregoing, without mortgagee's prior written consent." *Id.* at 408.

22. *Id.*

tion fee.[23] The most common example of a "due-on" clause is found in the boilerplate provision of paragraph 17 of the uniform Federal National Mortgage Association (FNMA)/Federal Home Loan Mortgage Corporation (FHLMC) form.[24]

Conveyances which may trigger a due-on clause are not only an outright sale but also a lease, second mortgage,[25] contract for sale, transfer of partnership or stock interests, transfer of management responsibilities, transfer of any beneficial interests[26] such as from one spouse to another upon divorce,[27] from one co-tenant to another, or the creation of an easement.[28]

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23. *Id.* at 407.

24. Paragraph 17 of the FNMA/FHLMC Uniform Mortgage Instrument provides:

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

25. The acceleration clause which is triggered by further encumbrance of the mortgaged property is often referred to as a "due-on-encumbrance" clause. For the purposes of this article, the use of the term "due-on-sale" shall include "due-on-encumbrance" unless otherwise indicated. *See* La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864-869, 489 P.2d 1113, 1115, 97 Cal. Rptr. 849-851 (1971). *See also* Letter from Stephen H. Sachs, Attorney General of Maryland (Nov. 21, 1980), *reprinted in* 5 NAT'L PROP. L. DIG. 67, 69 (1981).

> In this regard, I agree with some of my critics that the Maryland Courts are less likely to prevent the exercise of a due-on-sale clause; nevertheless, I continue to adhere to the view that, in Maryland, an institutional lender's attempt to accelerate a residential mortgage under a due-on-encumbrance clause would be a violation of public policy if the lender's actions are solely for purposes of maintaining or improving its loan portfolio.

26. Matis, *supra* note 10, at 407; *see* FNMA/FHLMC ¶ 17, *supra* note 24.

27. Note, *Wellenkamp v. Bank of America: A Victory for the Consumer?*, 31 HASTINGS L.J. 275, 299 n.116 (1979).

28. The wording of most due-on-sale clauses, such as ¶ 17 of the FNMA/FHLMC Uniform Mortgage Instrument, *supra* note 24, is sufficiently broad to encompass almost any transfer of interest one can imagine.

Both prospective vendors and recent purchasers have challenged the enforcement of the due-on-sale clause, spawning numerous and divergent judicial precedents.[29] The principal defenses raised against enforcement of the clause by consumers have been along two lines—either that the use of the clause results in an unlawful restraint on alienation or that its enforcement is unequitable and against public policy for unconscionability due to the inherent inequality of the bargaining position between lender and consumer.[30] The key issue in recent litigation, however, appears to remain much the same regardless of the manner in which the arguments are couched: is it reasonable for a lender to accelerate the loan when its sole reason for doing so is to upgrade its loan portfolio?[31]

In those jurisdictions where courts have favored its enforcement, clever lawyers have sought financing methods to circumvent the clause such as the installment sales contract,[32] land trust[33] and long-term lease.[34] This in turn has ushered in the second generation of due-on-sale clause cases which have sub-issues often more difficult and ill-defined than the parent issues of reasonableness and equitability of the restraint on alienation. The lawyer preparing either a challenge to, or a defense of, the due-on-sale clause

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29. These precedents are discussed in Section III of this article.

30. *See generally* Bartke and Tagaropulos, *supra* note 2; Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives,* 6 U.S.F.L. REV. 267 (1972); Dunn & Nowinski, *Enforcement of Due-on-Transfer Clauses: An Update,* 16 REAL PROP., PROB. & TR. J. 291 (1981); *Enforcement of Due-on-Transfer Clauses, Report of the Subcommittee on "Due-on" Clauses of the Committee on Real Estate Financing,* 13 REAL PROP., PROB. & TR. J. 891 (1978) [hereinafter cited as *Subcommittee Report*]; O'Connell, *supra* note 15; Note, *supra* note 27; Comment, *supra* note 16.

31. [I]n lender-oriented jurisdictions, the courts summarily dismiss the plaintiff's argument by citing a mortgagee's interest in protecting its security, while in consumer-oriented jurisdictions, the lender is forced to demonstrate that the new owner will be a greater security risk, when in fact, the reason for the acceleration of the debt may have had no relation to such a fear on the part of the lender.

Nussbaum & Stein, *supra* note 10, at 17, col. 1.

32. Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

33. 651 F.2d 910 (4th Cir. 1981).

34. More purchasers are currently taking leases with options to purchase; sometimes they record a lien on the leasehold to avoid problems posed by bona fide purchasers without notice of the leasehold. The FNMA/FHLMC Uniform Mortgage Instrument ¶ 17, *supra* note 24, specifically exempts leases of three years or less which do not contain the option to purchase.

now must be aware of implications posed by federal preemption,[35] the Uniform Commercial Code,[36] commercial versus residential borrower,[37] institutional lender versus seller financed transaction,[38] and the possible antitrust challenges posed by the secondary mortgage market.[39]

Two recent cases illustrate the difficulty the courts have had reconciling competing interests of vendor, purchaser, and lender and the subsequent polarization of states into pro-lender and pro-consumer camps. In an opinion representing the so-called "automatic exercise" of the due-on-sale clause the Nebraska Supreme Court declared:

> Not only are we convinced that a "due-on-sale" clause is not repugnant to public policy but, to the contrary, we recognize that, under certain economic circumstances, they may favor the public interest and, therefore, be supportive of public policy. On the one hand, the assets of savings and loan associations are principally invested in long-term mortgages, while, on the other hand, the funds necessary to make such loans are obtained from short-term and demand savings accounts and certificates. As the cost of obtaining deposits rises, the spread widens between what the association must pay for funds by way of interest and what the association receives from borrowers. Once the spread gets too great, the association will be unable to meet the standards set by government regulations and will fail. The potential failure of savings and loan associations and the loss of their depositors' funds should be of no less a concern to the courts than the inability of a property owner to transfer its mortgage at a premium when selling its property. Balancing portfolio return with cost of money is an important factor in the survival of lending associations. The "due-on-sale" clause is an important device in maintaining that balance.[40]

Typical of judicial treatment in those jurisdictions which have chosen to restrict the exercise of the due-on-sale clause is that of

35. *See* text accompanying notes 434-38 *infra.*
36. *See* O'Connell, *supra* note 15, at 953.
37. *See* text accompanying notes 379-81 *infra.*
38. *See* text accompanying notes 374-78 *infra.*
39. *See* text accompanying notes 450-57 *infra.*
40. Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, _, 293 N.W.2d 843, 849 (1980).

Wellenkamp v. Bank of America:

> We . . . reject defendant's 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 clause upon transfer of title in an outright sale. Although we recognize that lenders face increasing costs of doing business and must pay increasing amounts to depositors for the use of their funds in making long-term real estate loans as a result of inflation and a competitive money market, we believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against impairment to the lender's security that is shown to result from a transfer of title. Economic risks such as those caused by an inflationary economy are among the general risks inherent in every lending transaction. They are neither unforeseeable nor unforeseen. Lenders who provide funds for long-term real estate loans should and do, as a matter of business necessity, take into account their projections of future economic conditions when they initially determine the rate of payment and the interest on these long-term loans.[41]

The purpose of this article is to identify and examine the influencing considerations and the attachment of significance given to them by the courts in the "due-on" cases. After a discussion of recent litigation addressing the enforceability of the "due-on" clauses in Virginia, a summarizing checklist will follow detailing the factors which must be considered by the practitioner preparing to draft or litigate the clause.

II. Reasonableness of Restraint: Full Circle in Fourteen Years?

No jurisdiction has given the due-on-sale clause as much attention in the courts as has California. Early California cases form much of the basis for opinions of the courts in lender-oriented states, while the more recent California cases are reflected in the judicial opinions of states taking a pro-consumer stance.

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41. Wellenkamp v. Bank of America, 21 Cal. 3d 943, 952, 582 P.2d 970, 976, 148 Cal. Rptr. 379, 385 (1978).

The seminal case of *Coast Bank v. Minderhout*[42] hardly seems the vehicle upon which much of the law concerning due-on-sale clauses in the nation would have developed. Chief Justice Roger Traynor's decision in that case principally determined whether an equitable mortgage was created.[43] Only in the alternative did the defendant argue that the equitable mortgage could not be given effect because the due-on clause was an invalid restraint on alienation.[44] After citing several examples of reasonable restraints on alienation, the court ruled that the due-on clause was, in this case, reasonable.[45] Despite the seeming insignificance of this holding, *Coast Bank* has been viewed as determinative of the validity of the clause. As Professor Hetland writes:

> The typical institutional trust deed will afford the lender the right to insist on full payment in the event of sale of the property by the trustor. When not used merely as a devise to obtain "prepayment" penalties, which probably are not collectible anyway when the "prepayment" is at the lender's option as it is upon exercise of the clause, the due-on-sale clause is a necessary protection for the lender. As is true with fire insurers, the lender must be given a choice of borrowers to guard against the moral risks, here usually waste or poor credit which increase the likelihood of having to retake the property. In the past, the validity of the clause was questionable because of the possibility of its being a restraint on alienation or of its being an acceleration subject to reinstatement under the Civil Code. Justice Traynor held it is not the former and implied it is not the latter. Both seem clearly correct.[46]

Jones v. Sacramento Savings & Loan Association,[47] decided three

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42. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

43. *Id.* at _, 392 P.2d at 267, 38 Cal. Rptr. at 507.

44. *Id.* at _, 392 P.2d at 267-68, 38 Cal. Rptr. at 507-08.

45. The examples include: spendthrift trusts, because of the settlor's interest in protecting potentially improvident beneficiaries; a lease for a term of years because of the lessor's interest in the personal character of the lessee; a life estate because of the interest of the remainderman in the life tenant's character; a corporation restricting its shares because of the interest of shareholders in the persons with whom they are in business; and an executory land contract because of the vendor's interest in the upkeep of the property and the character and integrity of the purchaser. *Id.* at _, 392 P.2d at 268, 38 Cal. Rptr. at 508.

46. Hetland, *Real Property and Real Property Security: The Well-Being of the Law*, 53 Cal. L. Rev. 151, 170 (1965).

47. 248 Cal. App. 2d 522, 56 Cal. Rptr. 741 (1967).

years later in the California Court of Appeal, affirmed without discussion the enforceability of the clause.

In 1969, two appellate decisions further expanded the rationale for enforcement of the clause.[48] The most notable of the two, *Cherry v. Home Savings & Loan Association,*[49] enlarged the rationale for upholding exercise of the clause to include the lender's economic risk in a time of rising interest rates.[50]

Two years later, however, when faced with upholding a due-on-encumbrance clause, the California Supreme Court began to restrict the expansiveness of enforcement promulgated by the appellate courts.[51] In *La Sala v. American Savings & Loan Association* the court distinguished the due-on-encumbrance provisions from the due-on-sale provision both as to the loss of lender's security interest and the maintenance of the lender's portfolio argument.[52] In refusing to enforce the clause based on the lender's impairment of his security argument, the court stated:

> A sale of property usually divests the vendor of any interest in that property, and involves the transfer of possession, with responsibility for maintenance and upkeep, to the vendee. A junior encumbrance, on the other hand, does not terminate the borrower's interests in the

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48. Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969); Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969). In *Hellbaum,* the court said:

> The right to acceleration bears the same relation to justifiable interest as did the total restraint on alienation upheld in *Minderhout.* A lender incurs certain administrative costs in issuing a loan and setting up provision for its servicing. Those costs may reasonably be spread differently in the lender's estimation, depending on the agreed-upon term of the loan. Hence the lender has a justifiable interest in motivating an intended long-term debtor to refrain from early payment of principal; that interest extends to recovery, through a prepayment fee, of its net costs and loss of profit incurred by reason of early payment. We conclude that the terms complained of do not necessarily constitute an unreasonable restraint on alienation. The complaint does not allege that the fees proposed to be exacted were so large as to have no reasonable relation to the justifiable interests of the lender which we have mentioned. Perhaps a fact question could have been presented as to whether in effect the restraint was unreasonable.

Id. at _, 79 Cal. Rptr. at 11.

49. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969).

50. *Id.* at _, 81 Cal. Rptr. at 138.

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

52. *Id.* at _, 489 P.2d at 1123-24, 97 Cal. Rptr. at 859-60.

property, and rarely involves a transfer of possession.[53]

The court also distinguished the loss of interest argument:

> A junior encumbrance on the other hand [as opposed to an outright sale] often represents only a small fraction of the borrower's equity in the property; it does not often provide the borrower with the means to discharge the balance secured by the trust deed. Thus under a due-on-encumbrance clause the borrower is exposed to a detriment quite different than that involved in a sale. He is restrained from executing any junior encumbrance unless he is willing to acceed [sic] to lender's demand for current interest rates not merely upon the sum secured by the second lien, but also upon the balance due under the first trust deed. . . .[54]

In its effort to distinguish between the junior mortgage and the outright sale, the court appeared to strengthen the position of the due-on-sale clause with the concluding dictum "that the lender may insist upon the automatic performance of the due-on-sale clause because such a provision is necessary to the lender's security."[55] Despite this apparent endorsement of the due-on-sale clause, the real significance of *La Sala* was its initiation of a judicial reappraisal of automatic enforcement *per se* and the scrutiny of the facts of individual cases to determine the reasonableness of restraint.[56]

Tucker v. Lassen Savings & Loan Association,[57] the next important case in California, took the rationale of *La Sala* one step further and refused to allow the exercise of a due-on-sale clause as applied to an installment sales contract.

> [I]t is not only the *justification* for enforcing a particular restraint which is relevant to the determination of whether such a restraint is "reasonable" within the meaning of *Coast Bank;* we must also consider the *quantum of restraint*— that is, the actual practical effect upon alienation which would result from enforcement of the re-

53. *Id.* at _, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
54. *Id.* at _, 489 P.2d at 1123-24 n.17, 97 Cal. Rptr. at 859-60 n.17.
55. *Id.* at _, 489 P.2d at 1126, 97 Cal. Rptr. at 862.
56. *Id.* at _, 489 P.2d at 1124, 97 Cal. Rptr. at 860.
57. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

> straint. It is the relationship between these two factors which must govern our consideration of the enforcement of a "due-on" clause in particular circumstances: To the degree that enforcement of the clause would result in an increased quantum of actual restraint on alienation in a 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.[58]

While adopting this two-prong balancing test for reasonableness, the *Tucker* court determined that the enforcement of such a clause upon an installment sale would result in a considerable restraint on alienation.[59] The court, however, carefully distinguished an installment sales contract from an outright sale. In the latter instance, automatic enforcement would result "in little if any restraint on alienation because the terms of the second sale usually provide for full payment of the prior trust deed."[60] On the other hand, enforcement against an installment land contract would virtually eliminate installment sales where the property was subject to a deed of trust since the vendor normally receives a small down payment and could not, therefore, discharge the balance.[61] Although the court recognized that there was a change of possession under an installment sale where there usually is not when a junior encumbrance is financed, it found "that whatever dangers of this nature might be deemed to exist *in the abstract,* they do not justify the *blanket* restraint on alienation."[62]

Significantly, the court, as it had done in the *La Sala* decision, rejected the proposition that the lender's interest in maintaining its loan portfolio is a legitimate reason for acceleration.[63] The court

58. *Id.* at _, 526 P.2d at 1173, 116 Cal. Rptr. at 637.
59. *Id.* at _, 526 P.2d at 1174, 116 Cal. Rptr. at 638.
60. *Id.*
61. *Id.*
62. *Id.*
63. In *Tucker,* the court stated:

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

determined that the clause is not to be automatically enforced, but enforced "only when the beneficiary-obligee [under the deed of trust] can demonstrate a threat to one of his legitimate interests sufficient to justify the restraint on alienation inherent in its enforcement."[64] The court, however, referred to automatic enforcement on an outright sale as involving "little if any restraint."[65]

The California court completed the circle with its decision in *Wellenkamp v. Bank of America.*[66] Considering the dicta of prior cases, it was presumed that the California Supreme Court would consider the assumption of a loan by a purchaser taking legal title as an outright sale and permit the automatic enforcement of a due-on-sale clause.[67] This was not to be. In a six to one decision, the court ruled "that a due-on clause contained in a promissory note or deed of trust cannot be enforced upon the occurrence of an outright sale unless the lender can demonstrate that enforcement is reasonably necessary to protect against impairment of its security or the risk of default."[68] The court further expressly disapproved *Hellbaum*[69] and *Cherry*[70] and overruled *Coast Bank*[71] to the extent that *Coast Bank* was inconsistent with *Wellenkamp.*[72]

Id. at _, 526 P.2d at 1175 n.10, 116 Cal. Rptr. at 638 n.10.

64. *Id.* at _, 526 P.2d at 1175, 116 Cal. Rptr. at 639. The court also noted:

> Such legitimate interests include not only that of preserving the security from waste or depreciation but also that of guarding against what have been termed the "moral risks" of having to resort to the security upon default. Thus, for example, if the beneficiary can show that the party in possession under the installment land contract is, or is likely to be, conducting himself with respect to the property in a manner which will probably result in a significant wasting or other impairment of the security, he may properly insist upon enforcement of the "due-on" clause. Similarly, if the beneficiary can show that the prospects of default on the part of the vendor (requiring the inconvenience of resort to the security) are significantly enhanced in the particular situation, such circumstances might constitute a significant justification for enforcement of the clause despite its restraining effect.

Id. at _, 526 P.2d at 1175, 116 Cal. Rptr. at 639 (citations omitted).

65. *Id.* at _, 526 P.2d at 1174, 116 Cal. Rptr. at 638.

66. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

67. *See, e.g.,* Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d at _, 526 P.2d at 1174, 116 Cal. Rptr. at 638.

68. 21 Cal. 3d at _, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86.

69. 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969).

70. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969).

71. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

72. 21 Cal. 3d at _, 582 P.2d at 977, 148 Cal. Rptr. at 383.

Although the *Wellenkamp* court adopted an even broader definition of an outright sale than would have been expected from the *Tucker* and *La Sala* dicta,[73] the surprise from the court came when it refused the conclusion that the restraint on alienation is slight in an outright sale.[74] The court chose instead to determine the reasonableness of the restraint by balancing the quantum of restraint against the justification for the restraint advanced by the lender. After a discussion of the general economic conditions of inflation and tight money, the court concluded that enforcement of the due-on-sale clause results in a clear restraint on alienation.[75] Against this restraint, the court then measured the justifying factors as enunciated in *Tucker*.[76] After reaffirming the *Tucker* ruling that a restraint on alienation can be justified only upon impairment of lender's security interest such as a threat of waste or the "moral risks" of having to resort to the security upon default, the court rejected the lender's argument that such a threat is present in an outright sale:[77]

> [W]e are now convinced that, although the original borrower/seller no longer retains an interest in the property after transfer of legal title in an outright sale involving no secondary financing by the seller . . . this fact does not necessarily increase the risk to the lender that waste or default will occur. Thus the buyer, in an outright sale, in order to pay off the seller's equity, may make a large down payment on the property, thereby creating an equity interest in the property *in him* which is sufficient to provide an adequate incentive not to commit waste or permit the property to depreciate. Moreover, the buyer in such an outright sale may be at least as good, if not a better credit risk than the original borrower/seller.[78]

The court also soundly rejected the premise that the lender's loan portfolio needed to be maintained at the current interest rate, by denying that this was one of the purposes for which due-on clauses

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73. *Id.* at _, 582 P.2d at 974, 148 Cal. Rptr. at 383.
74. *Id.*
75. *Id.* at _, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.
76. *Id.* at _, 582 P.2d at 975, 148 Cal. Rptr. at 384.
77. *Id.*
78. *Id.* at _, 582 P.2d at 975-76, 148 Cal. Rptr. at 384-85.

were legitimately designed.[79]

In his dissent, Justice Clark argued that the majority either misread or rejected *Tucker*—the very decision upon which it purported to rely so heavily.[80] The result of such error is a full circle departure from the court's earlier interpretation in *Coast Bank* and an obliteration of the prior distinction of an outright sale from a junior encumbrance and an installment sales contract.[81] Justice Clark further concluded that the majority had inaccurately weighed the relevant factors for justification of the restraint giving a marketable bonus to the owner of encumbered real property and penalizing the seller of unencumbered property.[82]

The *Wellenkamp* decision, however, was expressly limited to the institutional lender, thus leaving open the question of enforceability when a private lender is involved. Three appellate cases followed, each discussing the distinction between private and institutional lenders and then each deciding the case on other grounds.[83]

In the first of these cases, *Pas v. Hill*,[84] decided four months after *Wellenkamp*, Hill had sold the property to a partnership trading as Johnson House and sought to exercise the due-on-sale clause contained in the deed of trust against Pas, the transferee of Johnson House. Pas instituted an action to enjoin this exercise. Johnson House, after experiencing difficulty making payments under the deed of trust, quitclaimed the property to Pas as security for the repayment of a personal loan from Pas. This quitclaim became an absolute conveyance upon Johnson House's inability to repay Pas. Upon learning of the transfer, Hill demanded payment of the entire unpaid balance.[85] While finding that the deed was intended as a security interest rather than as an absolute conveyance at its inception and was merely a junior encumbrance, the trial court nevertheless determined that the transfer of title was sufficient to trig-

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

80. *Id.* at _, 582 P.2d at 977, 148 Cal. Rptr. at 386 (Clark, J., dissenting).

81. *Id.* at _, 582 P.2d at 977-78, 148 Cal. Rptr. at 386-87.

82. *Id.* at _, 582 P.2d at 978-79, 148 Cal. Rptr. at 387-88.

83. Guild Wineries & Distilleries v. Land Dynamics, 103 Cal. App. 3d 968, 163 Cal. Rptr. 348 (1980); Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 876, 152 Cal. Rptr. 572 (1979); Pas v. Hill, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978).

84. 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978).

85. *Id.* at _, 151 Cal. Rptr. at 100.

ger the clause.[86] The court also found, however, that the defendant's security was not impaired and concluded that this was an unlawful restraint on alienation.[87]

The appellate court upheld the trial court in light of the decisions in *La Sala, Tucker,* and *Wellenkamp,*[88] pointing out that this was really an absolute conveyance rather than a junior encumbrance which brought it under the ambit of *Hellbaum, Cherry,* and *Coast Bank.*[89] The court noted that these cases had been either disapproved or overruled by *Wellenkamp,*[90] but that *Wellenkamp* applied only to institutional lenders.[91] The implication was that these cases might still control the individual who lends purchase money and takes back a deed of trust with a due-on-sale clause. The court did not decide the case on this ground, however, and the question remained unresolved.[92]

Two months later in *Medovoi v. American Savings & Loan Association,*[93] the court held *Wellenkamp* inapplicable to situations involving involuntary transfers[94] and multi-family units or commercial transactions.[95] Implicit in this opinion, however, were misgivings about the *Wellenkamp* decision and a reluctance to apply it if possible.[96] Thus, the court construed *Wellenkamp* to be limited to voluntary outright sales by an owner-occupier of a single-family residence where the loan is made by an institutional

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86. *Id.* at _, 151 Cal. Rptr. at 101.
87. *Id.*
88. *Id.* at _, 151 Cal. Rptr. at 102-03.
89. *Id.* at _, 151 Cal. Rptr. at 102.
90. *Id.*
91. 87 Cal. App. 3d at _, 151 Cal. Rptr. at 102.
92. The court noted that:

> [T]he transaction between Johnson House and Pas in no way impaired Hill's security. . . . The only justification given at trial by defendant Hill for wanting to exercise the due-on-sale clause was that he "expected the property to be sold before the note went full term, and . . . wanted the cash to put into other investments." We conclude, therefore, that the trial court acted with propriety in enjoining defendants from enforcing the due-on-sale clause on the basis of the transaction between Johnson House and Pas.

Id. at _, 151 Cal. Rptr. at 104.
93. 89 Cal. App. 3d 876, 152 Cal. Rptr. 572 (1979).
94. *See* text accompanying notes 305-32 *infra.*
95. *See* text accompanying notes 381-83 *infra.*
96. 89 Cal. App. 3d at _, 152 Cal. Rptr. at 580-83.

lender.[97] Severe criticism of *Wellenkamp* is expressed in footnote one[98] of the case in a concurring opinion by Justice Thompson.[99] In the footnote the court agreed with the *Wellenkamp* dissent that the court had misread or rejected *Tucker*. Further it contended that the *Wellenkamp* decision was an unnecessary governmental intrusion into citizens' private lives by the judiciary and that if this intrusion were to be permitted at all it should be done by the legislature. Justice Thompson was reluctant to modify Justice Traynor's opinion in *Coast Bank* relating to reasonable restraints imposed to allow the lender to recapture profits caused by fluctuations in the interest rates. He urged that these restraints are reasonable because California competes in a national market and any limitations which make California property less desirable will allow limited funds to go to other more competitive states.[100]

The California Supreme Court denied the petition for rehearing in *Medovoi,* but ordered decertification of the appellate opinion.[101] Nevertheless, the opinion remains on record and at best adds confusion to the understanding of the effect of the due-on-sale clause in California.

The third decision involving a due-on-sale clause in California was that of *Guild Wineries & Distilleries v. Land Dynamics.*[102] This case involved a chattel mortgage between private parties, not an institutional lender. Although the court recognized that it had the opportunity to resolve the questions implied in *Wellenkamp* concerning the non-institutional lender's right to automatic enforcement of the clause, the court declined to do so because there was no unreasonable restraint on alienation.[103] Therefore, in its

97. *Id.* at _, 152 Cal. Rptr. at 580-81.
98. *Id.* at _, 152 Cal. Rptr. at 583.
99. *Id.* at _, 152 Cal. Rptr. at 583-84.
100. *Id.* at _, 152 Cal. Rptr. at 584.
101. Note, *supra* note 27, at 303.
102. 103 Cal. App. 3d 968, 163 Cal. Rptr. 348 (1980).
103. The court stated:

> [T]wo circumstances establish that in fact there was no unreasonable restraint on alienation. First, by virtue of the outright sale . . . [there] is no claim that [the borrower] could not raise the $150,000 balance of the accelerated debt. Second, the wine cooperage (the secured chattel) which is the major asset securing the debt is in its nature subject to removal and to deterioration . . . .

Id. at _, 163 Cal. Rptr. at 354.

view, neither the *Tucker* test nor an extension of *Wellenkamp* was needed.[104]

In the most recently reported decision[105] in California to consider the due-on-sale clause, the Court of Appeal for the Second District of California was faced with the applicability of *Wellenkamp* to a non-institutional seller of commercial real property who held a second deed of trust securing part of the purchase price.[106] After ruling that the defendants-vendors were non-institutional lenders, the court determined that "where the facts and reasons against allowing legal recognition discussed in *Wellenkamp* are not present, the due-on clause has been recognized as, and continues to be, valid."[107] Emphasized were both the non-institutional aspects of the lender and the investment and commercial nature of the ten unit apartment building involved in the sale and deed of trust.[108] Under the facts the court deemed the "quantum of re-

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104. "Because the affected property in *Wellenkamp* was realty, the [*Wellenkamp*] court did not discuss possible extension of the new rule to chattels subjected to a security interest. Here no institutional lender is involved and the major asset securing the obligation is personal property." *Id.* at _, 163 Cal. Rptr. at 354. The *Guild* court was also required to interpret the contract because the due-on-sale clause appeared only in the chattel mortgage. The court ruled:

> There is no support in the documents comprising the contract for the conclusion that the agreement merely placed a due-on-sale restraint on the separate sale of the cooperage without a sale of the realty. If it has any significance at all, the absence of the due-on-sale clauses in the deed of trust and note implies only that the realty could be sold separately, without actuating the acceleration clause, as long as the cooperage was retained. But in fact the cooperage was not retained.

Id.

105. A case awaiting appeal to the California Supreme Court concerns the applicability of the federal preemption doctrine to the enforcement of the due-on-sale clause by federally chartered savings and loans. *See* L.A. Times, Aug. 25, 1981, § CC, Part 4, at 1, col. 3. *See also* text accompanying notes 384-435 *infra.*

106. Dawn Inv. Co. v. Superior Court, 116 Cal. App. 3d 439, 172 Cal. Rptr. 142 (1981).

107. *Id.* at _, 172 Cal. Rptr. at 145. The court also held that:

> In view of the total lack of factual support for the conclusion that defendants . . . were institutional lenders, the only other charitable view of the [trial] court's conduct is that the court assumed that the rule of *Wellenkamp* is applicable to all due-on-sale clauses, irrespective of the status of the lender. This is not the law. . . . *Wellenkamp* did not make illegal or unenforceable acceleration clauses for all purposes and in any and all situations.

Id. at _, 172 Cal. Rptr. at 144-45.

108. "In *Wellenkamp* the security was a single-family, owner-occupied home. Here, the . . . property at bench, as to all parties, is investment commercial property. In *Wellenkamp* the court noted the added feature of the public policy favoring protection of equity in a

straint" to be evenly balanced with the "justification for enforcement."[109]

III. Other Due-on Clause Cases

Since the clause may be invoked in all jurisdictions if a threat of waste or default is shown,[110] what distinguishes jurisdictions as either pro-lender or pro-consumer[111] is the reason for enforcement.[112] It must be emphasized at the outset that such classifications may be imprudent. Some cases have involved multiple influencing factors.[113] Other cases have turned on unusual facts,[114] while still other opinions favoring the lender have been expressly limited to the specific facts of the case.[115] It is also important to stress the date of each case, keeping in mind the then prevailing state of economy with its corresponding interest rates and inflation.

Although not uniform in the rationale of their opinions, the

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person's home." *Id.* at _, 172 Cal. Rptr. at 145.

109. *Id.* at _, 172 Cal. Rptr. at 145.

110. "By the same token, no court has decided that such clauses are immune from judicial scrutiny or the usual equitable defenses. . . ." Bartke & Tagaropulos, *supra* note 2, at 985.

111. As Bartke and Tagaropulos noted, a word about nomenclature is necessary:

> The literature on the subject uses the terms majority and minority rules. Considering that . . . [less than half] of the 50 states have had cases dealing with the phenomenon, the term "majority rule" is something of a misnomer; . . . [a] more descriptive term, however, ranges the courts by their appreciation of the balance of public policy considerations on the side of the lender or the borrower. For those jurisdictions which are referred to generally as "the majority rule," therefore, the term "lender oriented jurisdictions" is substituted. By the same token, rather than speaking about "minority jurisdictions," the term "consumer oriented jurisdictions" is used.

Id. at 985.

112. "What is really involved . . . is a question of pleading and burden of proof. . . . [T]he differences are of procedure rather than substance." *Id.* at 984-85.

113. *See, e.g.*, Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 875, 152 Cal. Rptr. 572 (1979); Silver v. Rochester Sav. Bank, 73 App. Div. 2d 81, 424 N.Y.S.2d 945 (1980).

114. *See, e.g.*, Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. App. 1980) (transfer between co-mortgagors); Fidelity Land Dev. Corp. v. Rieder & Sons Bldg. & Dev. Co., 151 N.J. Super. 502, 377 A.2d 691 (1977) (transfer of undeveloped land to president and principal stockholder of mortgagor).

115. *See e.g.*, Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981) (enforcement of due-on-sale clause is *per se* unreasonable as applied to residential homeowner, although enforcement was permitted as to investment property).

states that can be considered lender oriented are: Alabama, Colorado, Illinois, Montana, Nebraska, Nevada, New Jersey, North Carolina, Tennessee, and Texas.[116] States that can be considered consumer oriented are: Arizona, Arkansas, California, Florida, Louisiana, Michigan, Minnesota, Mississippi, Oklahoma, and Washington.[117] It would be unwise to categorize New York, Ohio, Utah,

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116. ALABAMA: Tierce v. APS Co., 382 So. 2d 485 (Ala. 1979); Tidwell v. Wittmeier, 150 Ala. 253, 43 So. 782 (1907); First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300 (Ala. Civ. App. 1977).

COLORADO: Von Ehrenkrook v. Midland Fed. Sav. & Loan Ass'n, 196 Colo. 179, 585 P.2d 589 (1978); Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973). Colorado is now considered pro-consumer for new mortgages. *See* COLO. REV. STAT. § 38-30-165 (Cum. Supp. 1980) *infra* note 134.

ILLINOIS: Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill.2d 119, 333 N.E.2d 1 (1975).

MONTANA: Dobitz v. Oakland, 172 Mont. 126, 561 P.2d 441 (1977).

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

NEVADA: First Commercial Title Inc. v. Holmes, 92 Nev. 363, 550 P.2d 1271 (1976).

NEW JERSEY: Fidelity Land Dev. Corp. v. Rieder & Sons Bldg. & Dev. Co., 151 N.J. Super. 502, 377 A.2d 691 (1977); Century Fed. Sav. & Loan Ass'n v. Van Glahn, 144 N.J. Super. 48, 364 A.2d 558 (1976); Poydan, Inc. v. Agia Kiriaki, Inc., 130 N.J. Super. 141, 325 A.2d 838 (1974); Shalit v. Investors Sav. & Loan Ass'n, 101 N.J. Super. 283, 244 A.2d 151 (1968).

NORTH CAROLINA: Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976).

TENNESSEE: Parker v. Covington, 614 S.W.2d 810 (Tenn. App. 1981); Gunther v. White, 489 S.W.2d 529 (Tenn. 1973).

TEXAS: Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333 (Tex. Civ. App. 1981).

117. ARIZONA: Patton v. First Fed. Sav. & Loan Ass'n, 118 Ariz. 473, 578 P.2d 152 (1978); Lane v. Bisceglia, 15 Ariz. App. 269, 488 P.2d 474 (1971); Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P.2d 190 (1971), *pet. for rev. denied,* 108 Ariz. 192, 494 P.2d 1113 (1972).

ARKANSAS: Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972).

CALIFORNIA: Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971); Coast Bank v. Minderhout, 61 Cal.2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964); Dawn Inv. Co. v. Superior Court, 116 Cal. App. 3d 439, 172 Cal. Rptr. 142 (1981); Guild Wineries & Distilleries v. Land Dynamics, 103 Cal. App. 3d 968, 163 Cal. Rptr. 348 (1980); Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 876, 152 Cal. Rptr. 572 (1979); Pas v. Hill, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978); Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969); Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969); Jones v. Sacramento Sav. & Loan Ass'n, 248 Cal. App. 2d 522, 56 Cal. Rptr. 741 (1967).

FLORIDA: Woodcrest Apartments Ltd. v. IPA Realty Partners Richardson Palmer, 3rd Inv. KG, 397 So. 2d 364 (Fla. 1st Dist. Ct. App. 1981); First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. 2d Dist. Ct. App. 1980); Chopan v. Klinkman, 330 So. 2d 154

Wisconsin and Wyoming as either pro-lender or pro-consumer.[118]

A. *Pro-lender Jurisdictions*

Two cases frequently cited for authority in later opinions were

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(Fla. 4th Dist. Ct. App. 1976); Stockman v. Burke, 305 So. 2d 89 (Fla. 2d Dist. Ct. App. 1974); Home Fed. Sav. & Loan Ass'n v. English, 249 So. 2d 707 (Fla. 4th Dist. Ct. App. 1971); Clark v. Lachenmeier, 237 So. 2d 583 (Fla. 2d Dist. Ct. App. 1970).

LOUISIANA: Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. Ct. App 1980).

MICHIGAN: Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977); Lemon v. Nicolai, 33 Mich. App. 646, 190 N.W.2d 549 (1971); Pellerito v. Weber, 22 Mich. App. 242, 177 N.W.2d 236 (1970).

MINNESOTA: Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981).

MISSISSIPPI: Sanders v. Hicks, 317 So. 2d 61 (Miss. 1975).

OKLAHOMA: Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 P.2d 1013 (Okla. 1977).

WASHINGTON: Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 87 Wash. 2d 437, 553 P.2d 1090 (1976); Miller v. Pacific First Fed. Sav. & Loan Ass'n, 86 Wash. 2d 401, 545 P.2d 546 (1976); Terry v. Born, 24 Wash. App. 652, 604 P.2d 504 (1979).

Seventeen states are now considered pro-consumer by FNMA. They are: Arizona, Arkansas, California, Colorado, Florida, Georgia, Illinois, Iowa, Michigan, Minnesota, Mississippi, New Mexico, New York, Ohio, Oklahoma, South Carolina and Washington. In these states, FNMA requires the inclusion of a seven year call option for mortgages purchased on or after November 10, 1980. The call option permits FNMA to call loans due and payable-in-full seven years after the date of origination. FNMA NEWS RELEASE No. 4327 (Jan. 5, 1981).

> In these [seventeen states], FNMA legal counsel has determined that state law or court decisions limit full enforcement of standard due-on-sale mortgage provisions, under which lenders can evaluate the credit-worthiness of the proposed new borrower and increase the mortgage interest rate if market interest rates have increased since the loan was made.
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> . . . In all states, the due-on-sale provision in new conventional mortgages will be enforced to the extent permissible.

Id. "FNMA noted that a due-on-sale provision has been a part of its conventional mortgage documents for a number of years, but that until now the corporation had chosen not to enforce it." FNMA NEWS RELEASE No. 4286 (Oct. 23, 1980).

118. NEW YORK: Silver v. Rochester Sav. Bank, 73 A.D.2d 81, 424 N.Y.S.2d 945 (1980); Nichols v. Evans, 92 Misc. 2d 938, 401 N.Y.S.2d 426 (1978); Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (1977); Rogers v. Williamsburgh Sav. Bank, 79 Misc. 2d 852, 361 N.Y.S.2d 531 (1974); Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 313 N.Y.S.2d 804 (1970); Blomgren v. Tinton, 33 Misc. 2d 1057, 225 N.Y.S.2d 347 (Sup. Ct. 1962).

OHIO: Great N. Sav. Co. v. Ingarra, No. 9433 (Ohio 9th Dist. Ct. App. Apr. 23, 1980); Peoples Sav. Ass'n v. Standard Indus., Inc., 22 Ohio App. 2d 35, 257 N.E.2d 406 (1970).

UTAH: Walker Bank & Trust Co. v. Neilson, 26 Utah 2d 383, 490 P.2d 328 (1971).

WISCONSIN: Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 71 Wis. 2d 531, 239 N.W.2d 20 (1976); Mutual Fed. Sav. & Loan Ass'n v. American Medical Servs., Inc., 66 Wis. 2d 210, 223 N.W.2d 921 (1974); Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 58 Wis. 2d 99, 205 N.W.2d 762 (1973).

WYOMING: Young v. Hawks, 624 P.2d 235 (Wyo. 1981).

decided in 1973—*Gunther v. White*[119] in Tennessee and *Malouff v. Midland Federal Savings & Loan Association*[120] in Colorado. Both cases involved assumptions upon outright sale and both allowed the lender to accelerate the due-on-sale clause based solely on the lender's need to increase the interest rate. In *Gunther,* the Tennessee court held that the exercise of the clause did not constitute an unreasonable restraint on alienation,[121] did not violate the right to contract,[122] and was not unconscionable.[123] The real issue according to the court was whether the exercise of the option to accelerate in order to "secure an increase in the rate of interest"[124] is valid. Quoting extensively from *Cherry,*[125] the court held that such an exercise was valid.[126]

The *Gunther* opinion was recently affirmed in *Parker v. Covington.*[127] The court rejected the seller's argument that *Gunther* was distinguishable because the purchasers were already paying a higher interest rate. They had taken a wrap-around mortgage from the sellers and were not assuming the mortgage at the existing rate. Again, the lender's admitted motive was to increase the interest rate, and the court noted: "[N]or is it reasonable to put the burden upon a contracting party [lender] to show that the challenged provision was economically necessary."[128]

The Colorado court in *Malouff* also relied on *Cherry*[129] and *Coast Bank*[130] in allowing the lender to increase the interest rate by one percent. The court quoted from an affidavit of the executive vice president of the lender:

> The two primary ways that [the lender] may make interest rate adjustments essential for it to protect its depositors against inflation

119. 489 S.W.2d 529 (Tenn. 1973).
120. 181 Colo. 294, 509 P.2d 1240 (1973).
121. 489 S.W.2d at 530.
122. *Id.*
123. *Id.* at 531.
124. *Id.* at 530.
125. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969).
126. 489 S.W.2d at 531.
127. 614 S.W.2d 810 (Tenn. App. 1981).
128. *Id.* at 812.
129. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969).
130. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

are by making variable interest rate loans or by employing a 'due-on-sale' clause to adjust interest rates on assumptions of existing loans when circumstances warrant an adjustment.[131]

In 1978 the Colorado Supreme Court was again asked to examine the validity of a due-on-sale clause when the lender sought an increase in the interest rate from 5¾% to 9¼% per annum.[132] The purchasers claimed that a Colorado statute[133] enacted shortly after the *Malouff* decision made any increase in interest rate of more than 1% illegal. The court ruled that the purchasers' reliance upon the statute was misplaced in that the statute prohibited increases above 1% of mortgage instruments *executed* after July 1, 1975, the effective date of the statute, rather than mortgages *assumed* after that date.[134] The contention of the purchasers that the increase in interest rate was an unreasonable restraint on alienation was dismissed as the issue was not properly raised in the lower court.[135]

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131. 181 Colo. at ___, 509 P.2d at 1244-45.

132. Von Ehrenkrook v. Midland Fed. Sav. & Loan Ass'n, 196 Colo. 179, ___, 585 P.2d 589, 590 (1978).

133. The statute at issue in *Von Ehrenkrook* provides, *inter alia*, that:

> Unreasonable restraint on the alienation of property—prohibited practices. (1) Subject to the limitations and exceptions as provided in this section, any person with a security interest in real estate shall not, directly or indirectly:
>
> . . .
>
> (b) Increase the interest rate more than one percent per annum above the existing interest rate of the indebtedness or otherwise modify, for the benefit of the holder of the security interest, the terms and conditions of the indebtedness secured by such real estate, on account of the sale or transfer of such real estate or on account of the assumption of such indebtedness; or
>
> . . .
>
> (d) Enforce or attempt to enforce the provisions of any mortgage, deed of trust, or other real estate security instrument executed on or after July 1, 1975, which provisions are contrary to this section; but this section shall not be applicable to instruments executed prior to July 1, 1975, nor to the rights, duties, or interests flowing therefrom.

COLO. REV. STAT. § 38-30-165 (Cum. Supp. 1980).

134. 196 Colo. at ___, 585 P.2d at 590.

135. The *Von Ehrenkrook* court stated:

> In *Malouff* we held that an increase of the interest rate on an assumed note of 1% was not an unreasonable restraint on the alienation of real property. In reaching that decision we considered many factors including the current market rate of interest. Clearly *Malouff* does not stand for the proposition that prior to the enactment of section 38-30-165(1)(b), any increase over 1% would always be illegal or that a 1% increase would always be legal. Thus section 38-30-165(1)(b) is not expository of the

In a 1975 case involving a land-sale contract, the Illinois Supreme Court decided that a 1% increase in the interest rate was not an unreasonable restraint on alienation.[136] The court did not address the issue of increasing the interest rate to protect the lender's loan portfolio. Instead, the court spoke of protecting the security interest of the lender based upon "the appraisal of the personal integrity of the borrower."[137] The exact meaning of this case is unclear in that there was no showing of a threat to the security or of default.

Crockett v. First Federal Savings & Loan Association,[138] decided by the North Carolina Supreme Court, has become a standard in the arsenal of cases rolled out in every lender's brief since 1976. The case involved an assumption which triggered the clause. There was no evidence that the security was impaired, so the case revolved solely on the lender's desire to increase the interest rate from 7% to 9¾%.[139] Viewing the line of cases classified as pro-consumer as "too restrictive in [their] approach,"[140] the court ruled that the practical effect on alienation was insignificant and speculative.

The court was troubled by the "double risk" to the lender in that the mortgage instrument provided borrower the right of prepayment without penalty. This would surely occur through the borrower refinancing when interest rates decreased; yet if the rates increase the lender would be denied the same right.[141] In a strong dissent, however, it was urged that the mortgage note was an adhesion contract, cloaking the effect of its terms in seemingly innocuous clauses.[142]

Similarly, the New Jersey Superior Court has upheld the use of

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preexisting law. The legislature realized this fact by the provisions it included in paragraph (1)(d).

Id. at _, 585 P.2d at 591.

136. 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

137. *Id.* at _, 333 N.E.2d at 4.

138. 289 N.C. 620, 224 S.E.2d 580 (1976).

139. *Id.* at _, 224 S.E.2d at 582.

140. *Id.* at _, 224 S.E.2d at 587.

141. *Id.* at _, 224 S.E.2d at 585.

142. *Id.* at _, 224 S.E.2d at 589 (Lake, J., dissenting).

the clause to secure an increase in interest rates.[143] The court's position was that a lending institution has a fiduciary duty to the depositors "to obtain the best lawful yield of [its] mortgage portfolio."[144] "Calling a loan in order to get the full benefit of current interest rates is a legitimate and reasonable business practice—one which protects the association members and their savings investments as well as fulfilling the statutory purpose of the association."[145]

Although this case involved a land sale contract which the court perceived as a "change in ownership,"[146] one year later the same court decided in *Fidelity Land Development Corp. v. Rieder & Sons Building & Development Co.*[147] that a "mere paper transfer of title, without any accompanying jeopardy to plaintiff's security," did not trigger the clause.[148] In *Fidelity,* the corporate mortgagor had transferred undeveloped land to its president and principal stockholder.

The *Fidelity* court relied strongly on the Nevada case of *First Commercial Title, Inc. v. Holmes,*[149] which had observed:

> We do not suggest that the clause is absolutely enforceable without regard to surrounding circumstances. We would merely attach the same reverence to the due-on-sale clause as is accorded to any other provision which may appear in a contract.
>
> Although enforceability of the clause is automatic, it is not absolute and may be vulnerable to certain defenses (*i.e.*, waiver).[150]

Nevada, however, must be considered a pro-lender jurisdiction since the *Holmes* court upheld the clause's enforcement on freedom of contract principles.[151] Further, the court raised the important procedural point of who should bear the burden of showing

143. Century Fed. Sav. & Loan Ass'n v. Van Glahn, 144 N.J. Super. 48, 364 A.2d 558 (1976).

144. *Id.* at _, 364 A.2d at 562.

145. *Id.* at _, 364 A.2d at 561.

146. *Id.* at _, 364 A.2d at 562.

147. 151 N.J. Super. 502, 377 A.2d 691 (1977).

148. *Id.* at _, 377 A.2d at 695.

149. 92 Nev. 363, 550 P.2d 1271 (1976).

150. 151 N.J. Super. at _, 377 A.2d at 694 (citing 92 Nev. at _, 550 P.2d at 1272).

151. 92 Nev. at _, 550 P.2d at 1271-72.

the reasonableness of the restraint.[152]

With its recent decision of *Tierce v. APS Co.*,[153] the Alabama court overruled the 1977 intermediate appellate decision which formed the basis for its previous characterization as a pro-consumer jurisdiction. In its 1977 decision, *First Southern Federal Savings & Loan Association v. Britton*,[154] the appellate court had ruled that while a due-on-sale clause is valid to protect the security interests of the lender, the clause may not be used to extract higher interest rates.[155] The rationale for the decision was that a clause to obtain higher interest rates may be contracted for, but "such purpose may not be hidden behind a clause which is assumed to only provide protection for the security."[156]

Tierce held that the use of the clause to obtain higher interest rates is a "valid business purpose,"[157] that *Britton* was not the majority rule in the United States,[158] and that the court was persuaded by the rationale of the Tennessee Supreme Court's decision in *Gunther v. White*.[159] Chief Justice Torbert filed a dissent on the denial of the application for rehearing. He concluded that the logic of *Britton* was correct—that the lender can demand a higher interest rate with use of a specific clause for that purpose, but not with the due-on-sale clause.[160] He contended that the majority "has rewritten the agreement between the parties in the instant case and the meaning of the 'due-on-sale' clause in many other existing agreements."[161] It is interesting to note that Chief Justice Torbert's dissent was filed on the denial of the application for rehearing; he voted with the majority on the first appeal.

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152. The court stated that the mortgagor has the burden of showing that the enforcement of the clause is unreasonable. "A lender has the right to be assured in his mind of the safety of his security without the burden of showing at each transfer that his security is being impaired." *Id.* at —, 550 P.2d at 1272.

153. 382 So. 2d 485 (Ala. 1979).

154. 345 So. 2d 300 (Ala. Civ. App. 1977).

155. "The purpose of the clause was not being served by the threatened acceleration but the unrelated financial interest of the lender was the reason for the acceleration." *Id.* at 303.

156. *Id.* at 303-04.

157. 382 So. 2d at 487-88.

158. *Id.* at 487.

159. 489 S.W.2d 529 (Tenn. 1973).

160. 382 So. 2d at 490 (Torbert, C.J., dissenting).

161. *Id.* at 488.

The Montana Supreme Court has also been presented with the question of whether a due-on-sale clause was an invalid restraint on alienation in a 1977 case, *Dobitz v. Oakland*.[162] The court held in the negative, noting "the difference between a conveyance and a contract to convey."[163]

Nebraska, with its 1980 decision in *Occidental Savings & Loan Association v. Venco Partnership*[164] provides the strongest pro-lender expression to date. After a detailed discussion of direct and indirect restraints on alienation, the court concluded that enforcement of the clause was neither.[165] The court expressed its firm belief that ability to enforce the due-on-sale clauses was essential to the survival of lending associations.[166]

Texas[167] has recently joined these pro-lender jurisdictions in an appellate opinion which claimed that the "majority rule" permits acceleration without proof of an impairment of security.[168] The court noted that the indirect nature of the restraint did not fit into the usual classification of invalid restraints,[169] but added in dicta that it would not permit "enforcement of acceleration clauses activated by the lender's fraudulent inequitable conduct."[170]

B. *Pro-consumer Jurisdictions*

As was stated earlier, the defenses raised by borrowers to enforcement of due-on-sale clauses generally fall into two categories: (1) unreasonable restraint on alienation and (2) other equitable defenses. The line of cases in California discussed in section II of this article details the evolution of the restraint on alienation argument. Since the present status of the law in California fairly represents the pro-consumer point of view on restraint on alienation,

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162. Dobitz v. Oakland, 172 Mont. 126, 561 P.2d 441 (1977).

163. *Id.* at _, 561 P.2d at 443.

164. 206 Neb. 469, 293 N.W.2d 843 (1980).

165. "The restraint, if any, in this case does not attach itself to the title and the conveyance thereof but rather to the mortgage and the assumption thereof." *Id.* at _, 393 N.W.2d at 848.

166. *Id.* at _, 393 N.W.2d at 849.

167. Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333 (Tex. Civ. App. 1981).

168. *Id.* at 338.

169. *Id.* at 339.

170. *Id.* at 340.

the defense will be discussed only briefly in the section below. Other equitable defenses utilized by borrowers will be examined more closely in a subsequent section.

1. Defense of Unreasonable Restraint on Alienation

Many decisions upholding this defense involve a land sale contract and adopt the rationale of the 1974 California case, *Tucker v. Lassen Savings & Loan Association.*[171] Decisions in Arizona, Washington and Michigan explicitly adopt this reasoning.

Bellingham First Federal Savings & Loan Association v. Garrison[172] distinguished an earlier Washington Supreme Court case, *Miller v. Pacific First Federal Savings & Loan Association,*[173] wherein a clause calling for a 2% increase on transfer—as opposed to a due-on-sale/acceleration clause—was upheld. The *Miller* court perceived the provision as affecting only the sale price and not the actual *transfer* of the property.[174] *Bellingham,* on the other hand, involved a due-on-sale clause which the court refused to enforce unless the lender could show that acceleration was necessary to protect the lender's security. The court spoke in terms of both unreasonableness of restraint and violation of public policy.[175] Thus, the *Bellingham* case is cited for the proposition that unless expressly provided in the clause, Washington courts will refuse enforcement absent a showing of threat to security.[176]

In *Nichols v. Ann Arbor Federal Savings & Loan Association,*[177] also involving a land sale contract, the Michigan court followed *Tucker*[178] and distinguished *Baker,*[179] *Gunther,*[180] *Malouff*[181] and *Crockett.*[182] Upon the failure of the lender to claim waste or im-

171. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).
172. 87 Wash. 2d 437, 553 P.2d 1090 (1976).
173. 86 Wash. 2d 401, 545 P.2d 546 (1976).
174. *Id.* at _, 545 P.2d at 548-49.
175. 87 Wash. 2d at _, 553 P.2d at 1092-93.
176. *Id.* at _, 553 P.2d at 1091-92.
177. 73 Mich. App. 163, 250 N.W.2d 804 (1977).
178. 12 Cal.3d 624, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).
179. 61 Ill. 2d 119, 333 N.E.2d 1 (1975).
180. 489 S.W.2d 529 (Tenn. 1973).
181. 181 Colo. 294, 509 P.2d 1240 (1973).
182. 289 N.C. 620, 224 S.E.2d 580 (1976).

pairment to security, the court ruled that if the sole basis for enforcement is to maintain the lender's portfolio, the restraint is unreasonable.[183]

Similarly, the Mississippi Supreme Court[184] held that although restraints are not *per se* unreasonable, there must be a threat to the legitimate interest of the lender to justify exercise.[185]

While Minnesota can clearly be regarded as "pro-lender" in the case of investment residential property, it is pro-consumer when borrower-occupied residential property is involved. The court expressly exempted this latter situation from its holding in *Holiday Acres No. 3 v. Midwest Federal Savings & Loan Association,*[186] which adopted a freedom of contract approach to support enforcement in the former situation.

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183. 73 Mich. App. at _, 250 N.W.2d at 809.

184. Sanders v. Hicks, 317 So. 2d 61 (Miss. 1975).

185. *Id.* at 64.

186. 308 N.W.2d 471 (Minn. 1981). The court makes the following distinction:

> The legislature, by enacting Minn. Stat. § 47.20, subd. 6 . . . has determined, in effect, that the enforcement of due-on-sale clauses in the transfer of borrower-occupied residential property, as limited by the statute, is *per se* unreasonable except to protect against impairment of the lender's security interest. Accepting that determination, we hold that the enforcement of due-on-sale clauses in the transfer of investment residential property is not *per se* unreasonable.

Id. at 484.

MINN. STAT. ANN. § 47.20, Subd. 6 (Cum. Supp. 1980) reads as follows:

> If the purpose of a conventional loan is to enable a borrower to purchase a one to four family dwelling for his or her primary residence, the lender shall consent to the subsequent transfer of the real estate if the existing borrower continues after transfer to be obligated for repayment of the entire remaining indebtedness. The lender shall release the existing borrower from all obligations under the loan instruments, if the transferee (1) meets the standards of credit worthiness normally used by persons in the business of making conventional loans, including but not limited to the ability of the transferee to make the loan payments and satisfactorily maintain the real estate used as collateral, and (2) executes an agreement in writing with the lender whereby the transferee assumes the obligations of the existing borrower under the loan instruments. Any such agreement shall not affect the priority, validity or enforceability of any loan instrument. A lender may charge a fee not in excess of one-tenth of one percent of the remaining unpaid principal balance in the event the loan or advance of credit is assumed by the transferee and the existing borrower continues after the transfer to be obligated for repayment of the entire assumed indebtedness. A lender may charge a fee not in excess of one percent of the remaining unpaid principal balance in the event the remaining indebtedness is assumed by the transferee and the existing borrower is released from all obligations under the loan instruments.

2. Equitable Defenses.

As one commentator states, after due-on-sale clauses began to be viewed as reasonable restraints on alienation "[c]hancellors . . . began to display their historic 'conscience' as apparent inequities and injustices were increasingly worked by the implementations of these clauses."[187] This may be true, but for the litigator a two-pronged attack is suggested: allege that the clause is both an unreasonable restraint on alienation and that it is unconscionable. In the following cases the court relied upon equity to grant relief to the borrower or purchaser.

The Oklahoma case of *Continental Federal Savings & Loan Association v. Fetter*[188] is often cited for the proposition that it is unconscionable for a court of equity to grant the lender's foreclosure petition against the borrower. In this case, the lender conditioned his consent to the transfer on the payment of a 1% fee. The court found that there had been no bargained-for exchange, explaining that "[t]he rule of strict construction against the drafter of the instrument is particularly applicable in the case of a contract prepared by an expert or experienced party, and it has special force where it is sought to create and impose an obligation when none would otherwise appear."[189]

In Arizona, *Baltimore Life Insurance Co. v. Harn*[190] also found in favor of the borrower on equitable grounds. Holding that the lender could not arbitrarily enforce the clause without first demonstrating that his security interest would be impaired, the court commented: "[A]n action to accelerate and foreclose a mortgage being an equitable proceeding, it is not enough to allege merely that the acceleration clause has been violated."[191] Clearly, in Arizona, the lender has the burden of proof.

The Florida appellate court, in *Clark v. Lachenmeier*,[192] also

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187. 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, 486-87 (1973).

188. 564 P.2d 1013 (Okla. 1977).

189. *Id.* at 1019 (footnote omitted).

190. 15 Ariz. App. 78, 486 P.2d 190 (1971), *pet. for rev. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972).

191. 15 Ariz. App. at ___, 486 P.2d at 193.

192. 237 So. 2d 583 (Fla. 2d Dist. Ct. App. 1970).

held that the lender was not entitled to acceleration based solely on the provisions of the due-on-sale clause without a showing of impairment of security. The decision was based on the equitable principle of unconscionability. The Second District Court of Appeals of Florida recently reaffirmed this view in a case which will be discussed in connection with the issue of federal jurisdiction.[193]

Another Florida appellate jurisdiction, however, allowed the acceleration of a due-on-sale clause in a mortgage securing a promissory note. The court noted that this was an action at law involving personal property and not one involving equitable principles.[194] Yet a third Florida opinion held that a provision of a mortgage, making rents, issues and profits security and their assignment to a third party grounds for foreclosure, was not triggered upon the sale of the property, two apartment complexes.[195]

The Arkansas case of *Tucker v. Pulaski Federal Savings & Loan Association*[196] is a widely cited decision involving equitable defenses. The opinion is a factual discussion demonstrating that the lender did not justify its refusal to consent to the sale.[197] Agreeing with the *Harn* rationale, the court clearly placed the burden of going forward on the lender since the clause is not automatically enforceable.

A Louisiana case,[198] which can perhaps be distinguished by the fact that the transfer was between co-mortgagors, also stands for the view that it is inequitable for the mortgagee to require a 1% transfer fee for his consent when the provision for the fee is not expressed in the mortgage contract.

C. *Other Jurisdictions*

The cases discussed in this section are representative of jurisdictions which, either because of the unusual facts, conflicting appel-

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193. First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. 2d Dist. Ct. App. 1980). *See* text accompanying notes 384-435 *infra.*

194. Stockman v. Burke, 305 So. 2d 89 (Fla. 2d Dist. Ct. App. 1974).

195. Woodcrest Apartments, Ltd. v. IPA Realty Partners Richardson Palmer, 3rd Inv. KG, 397 So. 2d 364 (Fla. 1st Dist. Ct. App. 1981).

196. 252 Ark. 849, 481 S.W.2d 725 (1972).

197. *Id.* at __, 481 S.W.2d at 729-30.

198. Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. App. 1980).

late opinions or confusing dicta in the decisions, are difficult to categorize.

In two cases before the Wisconsin Court,[199] enforcement was allowed in one instance, and denied in the other. Wisconsin appears to balance the equities on a case by case basis as is done in pro-consumer oriented jurisdictions. But unlike those jurisdictions, Wisconsin permits consideration of interest rate adjustment as a factor in balancing and appears to place the burden on the mortgagor to affirmatively plead that the lender's security is not impaired.[200]

In the early decision of *Peoples Savings Association v. Standard Industries, Inc.*,[201] the Ohio appellate court specifically concurred with Justice Traynor in *Coast Bank* and ruled that the "right of the mortgagee to protect its security by maintaining control over the identity and financial responsibility of the purchaser is a legitimate business objective and is not illegal, inequitable or contrary to the public policy of the state of Ohio."[202] However, the economic considerations of the lender were not named as one of these justifiable interests. Yet, despite the absence of any evidence of threat to the security, the court allowed enforcement.

In 1980, the issue came before an Ohio court of appeals a second time in *Great Northern Savings Co. v. Ingarra.*[203] This time the court reversed the trial court's decision that the clause was automatically enforced and strongly disapproved of the lender's use of the clause for reasons other than protection of security.

In New York, the highest court of appeals has yet to decide the issue. Early opinions indicated a pro-lender stance—the clause was deemed automatically enforceable unless the borrower met the

199. Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 71 Wis. 2d 531, 239 N.W.2d 20 (1976) (enforced); Mutual Fed. Sav. & Loan Ass'n v. American Medical Servs., Inc., 66 Wis. 2d 210, 223 N.W.2d 921 (1974) (denied); Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 58 Wis. 2d 99, 205 N.W.2d 762 (1973) (remanded).

200. Bartke and Tagaropulos have suggested that Wisconsin should be designated as a separate intermediate classification between pro-consumer and pro-lender jurisdictions. Bartke & Tagaropulus, *supra* note 2, at 989.

201. 22 Ohio App. 2d 35, 257 N.E.2d 406 (1970).

202. *Id.* at _, 257 N.E.2d at 408.

203. No. 9433 (Ohio 9th Dist. Ct. App., Apr. 23, 1980).

burden of showing some equitable justification for refusal.[204] In two later cases, however, enforcement was denied.[205] The later opinions reflect a consumer-oriented approach since in both cases the courts determined that it would be inequitable to permit a lender to withhold his consent for adjustment of interest rates. As will be discussed in section V of this article, the unique facts of these two latter cases might permit their distinction in future litigation.

The Utah case of *Walker Bank & Trust Co. v. Neilson*[206] involved a tangential examination of the due-on clause. The lender, after losing on the issue that the mortgagor's late payments warranted acceleration of the note, claimed that the mortgagor's transfer of the property activated the due-on-sale clause. The court, after reciting that the clause was not void as against public policy, held for the borrower on the basis that the clause was not self-executing. No evidence had been presented showing the lender had exercised its option to accelerate.[207]

Finally, the Supreme Court of Wyoming recently held in favor of the mortgagor. In *Young v. Hawks*,[208] the court found that a due-on-sale clause could not be implied when none was actually in the contract.

IV. Virginia Law

While the applicability of the due-on-sale clause and ancillary issues have been the subject of extensive litigation in recent years, the highest courts of most states have yet to rule on these issues. Two cases are presently on appeal to the Virginia Supreme Court, providing the court with its first opportunity to address due-on-sale clause issues.[209]

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204. Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (1977); Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 313 N.Y.S.2d 804 (1970).

205. Silver v. Rochester Sav. Bank, 73 A.D.2d 81, 424 N.Y.S. 2d 945 (1980); Nichols v. Evans, 92 Misc. 2d 938, 401 N.Y.S.2d 426 (1978).

206. 26 Utah 2d 383, 490 P.2d 328 (1971).

207. *Id.* at _, 490 P.2d at 329.

208. 624 P.2d 235 (Wyo. 1981).

209. Lipps v. First Am. Serv. Corp., Ch. No. 13246 (Cir. Ct. Prince William Co., Va., Mar. 19, 1980), *appeal pending*, No. 800908 (Va. Sup. Ct., _); Best v. United Va. Bank/Nat'l, Ch. No. 58379 (Cir. Ct. Fairfax Co., Va., Feb. 22, 1979), *appeal pending*, No. 790777 (Va. Sup.

In *Lipps v. First American Service Corp.*,[210] the plaintiff executed a land contract for the sale of a townhouse. At the time of execution, the property was subject to a deed of trust which contained paragraph 17 of the FNMA/FHLMC Uniform Mortgage Instrument: "If all or any part of the property or an interest therein is sold or transferred by borrower without lender's prior written consent . . . lender may, at lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable."[211]

When the lender learned of the plaintiff's contract, which had been duly recorded, it proceeded to commence foreclosure proceedings on the property. The plaintiff subsequently sought injunctive relief.[212]

The lender's principal contention was that the Virginia Legislature had expressly sanctioned the use of due-on-sale clauses through section 6.1-330.34 of the Virginia Code,[213] which provides:

> *MORTGAGE, ETC., TO CONTAIN NOTICE THAT DEBT IS SUBJECT TO CALL OR MODIFICATION ON CONVEYANCE OF PROPERTY.* Where any loan is made secured by a mortgage or deed of trust on real property comprised of not more than four family residential dwelling units and the note, or mortgage or deed of trust evidencing such loan contains a provision that the holder of the note secured by such mortgage or deed of trust may accelerate payment of or renegotiate the terms of such loan upon sale or conveyance of the security property or part thereof, then the mortgage or deed of trust shall contain in the body or on the margin thereof a statement, either in capital letters or underlined, which will advise the borrower as follows: "Notice—The debt secured hereby is subject to call in full or the terms thereof being modified in the event of sale or conveyance of the property conveyed."[214]

Ct., _).

210. Ch. No. 13246 (Cir. Ct. Prince William Co., Va., Mar. 19, 1980), *appeal pending*, No. 800908 (Va. Sup. Ct., _).

211. 858 PRINCE WILLIAM CO., VA., LAND RECORDS, DEED BOOK 487. *See* note 24 *supra*.

212. Defendant's Trial Memorandum at 62-63, Lipps v. First Am. Serv. Corp., Ch. No. 13246 (Cir. Ct. Prince William Co., Va., Mar. 19, 1980).

213. *Id.* at 63-64.

214. VA. CODE ANN. § 6.1-330.34 (Repl. Vol. 1979).

The lender then urged that, pursuant to section 55-95 of the Virginia Code[215] the recorded contract had the effect of a deed, thus triggering the due-on-sale clause.[216] Finally, the defendant-lender, relying on *Glendale Federal v. Fox*,[217] argued that even in the absence of an applicable due-on-sale statute, federal preemption would permit automatic enforcement of the clause by application of Federal Home Bank Board (FHBB) policies[218] and would preclude any contrary finding by state courts.[219]

The circuit court found that the due-on-sale clause was enforceable in Virginia, and, given the plaintiff's breach of the clause without the defendant's consent, the permanent injunction sought by the plaintiff was denied.[220] The trial court, however, failed to make any mention of the federal preemption issue.[221]

On appeal to the Virginia Supreme Court the borrower has alleged three points of error: (1) that the due-on-sale clause is unenforceable absent a showing of impairment of security; (2) that section 6.1-330.34 of the Virginia Code is not determinative of the issue of enforceability, but rather is intended to provide notice to mortgagor of the presence of a due-on-sale clause; and (3) that section 55-95 of the Virginia Code dealing with recordation of contracts for sale of lands, serves to provide notice to any potential good faith purchaser and does not have the effect of a deed so as to constitute a transfer of title which triggers the due-on-sale clause.[222]

From the above it is obvious that appellant is urging the court to adopt the rationale of the *Wellenkamp* line of cases which prohib-

215. VA. CODE ANN. § 55-95 (Repl. Vol. 1981).

216. Defendant's Trial Memorandum at 64-65, Lipps v. First Am. Serv. Corp., Ch. No. 13246 (Cir. Ct. Prince William Co., Va., Mar. 19, 1980).

217. 459 F. Supp. 903 (C.D. Cal. 1978).

218. These policies are enumerated in 12 C.F.R. § 545.6-11 (1980) and are evidenced by 12 C.F.R. § 545.8-3(f) & (g) (1980). For the text of these regulations see note 385 *infra*.

219. Defendant's Trial Memorandum at 66, Lipps v. First. Am. Serv. Corp., Ch. No. 13246 (Cir. Ct. Prince William Co., Va., Mar. 19, 1980).

220. Lipps v. First Am. Serv. Corp., Ch. No. 13246 (Cir. Ct. Prince William Co., Va., Mar. 19, 1980).

221. *Id.* In its first finding, the decree states: "[T]he 'due on sale clause' does not violate any applicable Federal law." *Id.* That does not mean federal law requires enforcement of such clauses; the court carefully chose to bypass the federal preemption issue.

222. Brief for Appellant, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct., _).

its the exercise of the clause unless the lender can demonstrate some threat to his security interest.[223] In the second point of error the borrower asks the court to accord the Virginia due-on-sale statute the same degree of relevance as it was accorded in *Wellenkamp,* where the California court, when asked to construe a California statute similar to Virginia's declared: "[T]he purpose of [such a provision] is to provide notice to borrower; it cannot be reasonably interpreted in the manner the defendant suggests."[224] Appellant's counsel on the third point urges the court to reason that since record title remains with the original mortgagor the execution of an executory installment sales contract should not be interpreted as a transfer under the terms of the deed of trust.[225] Also, appellant contends that, as in *Tucker,* even if the court were to find that an installment sales contract is the equivalent of a deed, the clause under these facts should not be enforced because of the severe quantum of restraint on alienation.[226] Interestingly, appellants briefed the issue of federal law although it formed no part of the trial court's decree.[227]

In the second case now on appeal before the Virginia Supreme Court, *Best v. United Virginia Bank/National,*[228] the lender required a 1% transfer fee and an increase in the interest rate of the deed of trust as a condition of its consent to the transfer of residential property to plaintiffs-purchasers. Upon the purchaser's refusal to accede to the demands of the lender, the original mortgagor conveyed the property by deed to the purchasers.

The trial court found that this clause was an unreasonable restraint on alienation because the lender failed to show an impairment of its security interest. Moreover, the court found that if the lender had wanted to reserve the right to increase the interest rate, it should have specifically stated so in the deed of trust.[229] As a result, the court ruled that the plaintiff had the right to purchase

223. *See* text accompanying notes 110-208 *supra.*

224. 21 Cal. 3d at 953 n.12, 582 P.2d at 976 n.12, 148 Cal. Rptr. at 385 n.12.

225. *See* text accompanying notes 277-304 *infra.*

226. Brief for Appellant, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. _).

227. *Id.*

228. Ch. No. 58379 (Cir. Ct. Fairfax Co., Va., Feb. 22, 1979), *appeal pending,* No. 790777 (Va. Sup. Ct., _).

229. *Id.* at 3.

the property upon the conditions of the deed of trust and that the defendant was obligated to accept his payments on the note.[230]

On appeal, appellant has urged the Supreme Court of Virginia to adopt the majority position on enforceability of due-on-sale clauses which appellant has contended is represented by the *Crockett, Malouff* and *Gunther* line of cases.[231] The contentions of appellant's brief mirror the rationales of these cases— that it is not necessary for the lender to demonstrate an impairment to its security to entitle it to rely upon the clause of the deed of trust.[232] In a reverse *Britton* type argument, appellant has argued that section 6.1-330.34 of the Virginia Code should not be applied retroactively.[233] Interestingly, in *Britton* the Alabama court struck down the clause for the lender's failure to warn of its true intent, while here appellant contends that absent the Virginia statute, the lender need not disclose its intention of exercising the clause for reasons other than the uncreditworthiness of an assignee.[234]

Appellees point to the preamble to the covenants of the deed of trust: "[A]nd the said parties of the first part, in order more fully to protect the security of this Deed of Trust, do hereby agree. . . ."[235] Appellees, calling for strict interpretation of the contract (the rationale of the Washington cases of *Miller* and *Bellingham),*[236] contend that the lender violated the very provisions it drafted in attempting to impose conditions other than those expressly contained in the deed of trust.[237] With the express purpose of the deed of trust to protect the security interest of the lender, the appellees argue that the lender could not have used more misleading or devious language.[238] Appellees further contend that the majority rule is represented by the pro-consumer line of cases, and that the pro-lender cases cited in appellant's brief are based upon the early California case of *Coast Bank* which was expressly over-

230. *Id.* at 4.
231. Brief for Appellant, Best v. United Va. Bank/Nat'l, No. 790777 (Va. Sup. Ct., _).
232. *Id.*
233. *See* text accompanying note 213 *supra.*
234. *See* notes 213 & 231 *supra.*
235. 3700 FAIRFAX CO., VA., LAND RECORDS, DEED BOOK 609, 610.
236. *See* notes 172-76 *supra* and accompanying text.
237. Brief for Appellee, Best v. United Va. Bank/Nat'l, No. 790777 (Va. Sup. Ct., _).
238. *Id.*

ruled by *Wellenkamp*.[239]

In a third Virginia case, *Iron Castle Associates v. Wood*,[240] the Circuit Court of Richmond considered the enforceability of a due-on-sale clause upon an attempted foreclosure by a trustee. Plaintiff-purchaser sought an injunction to restrain the foreclosure sale, alleging that the defendant-lender had unreasonably withheld its consent to the transfer. After considering memoranda of both parties, the court concluded that there was no clear majority view, but that "since 1977 the due-on-sale clause is an unreasonable restraint unless necessary to protect the lender's security and consent cannot be withheld unless such a showing."[241] The court believed that the better line of cases is that of *Bellingham*, *Wellenkamp* and *Silver*.[242] Also, since there was no right to anticipate the mortgage (i.e., there was no prepayment clause), the facts of *Iron Castle* were distinguished by the court from the "double risk" aspect which had troubled the court in *Crockett*.[243] Finally, the Virginia court found that the enactment of section 6.1-330.34 of the Virginia Code represented no change in Virginia public policy toward the enforceability of such clauses.[244] The defendant lender chose not to appeal.

The decision in *Iron Castle* can perhaps be explained by the provision in the deed of trust which provides that consent to transfer will not be unreasonably withheld by the lender.[245] Like the New York court in *Silver*,[246] the Virginia court was impressed by this express provision. Nevertheless, the Virginia court went further in its broad declaration that such clauses constitute unreasonable restraints on alienation and in its preference for the *Bellingham* and *Wellenkamp* requirement that impairment of security is necessary to entitle the lender to accelerate.[247]

239. *Id.*
240. Ch. No. G-4808-2 (Cir. Ct. Richmond, Va., Feb. 26, 1981).
241. *Id.*
242. *Id.*
243. *Id.*; *See also* text accompanying notes 441-48 *infra*.
244. Ch. No. G-4808-2 (Cir. Ct. Richmond, Va., Feb. 26, 1981).
245. "The Grantors covenant that they will not transfer the title to the property so long as this deed of trust remains in full force and effect, without the consent of the holder or holders of the two notes, which consent shall not be unreasonably withheld." *Id.*
246. 73 A.D. 2d 81, 424 N.Y.S.2d 945 (1980).
247. Ch. No. G-4808-2 (Cir. Ct. Richmond, Va., Feb. 26, 1981).

In yet a fourth case arising in Virginia concerning the enforceability of a due-on-sale clause, *Williams v. First Federal Savings & Loan Association*,[248] the conflict focused on whether the activity of the borrowers constituted a transfer so as to activate the clause. The plaintiffs-purchasers of the beneficial interests in three lands trusts created by the original mortgagors and the plaintiff-trustee of one of the trusts sought a declaratory judgment in federal district court that the creation of land trusts and the subsequent transfer of the beneficial interests did not constitute a sale or conveyance under the due-on-sale clause.[249]

In language stopping just short of holding that federal preemption applied without specifically mentioning it, the district court ruled that:

> "due on sale" clauses in issue in this case [are] governed by federal law and the regulations promulgated by the Federal Home Loan Bank Board. . . .
>
> The Arlington-Fairfax Savings and Loan Association, an institution chartered by the Commonwealth of Virginia, is also subject to the jurisdiction of this Court by virtue of its membership in the Federal Home Loan Bank, the insurance of its accounts by the Federal Savings and Loan Insurance Corporation, and its eligibility to sell residential mortgages to the FHLMC.[250]

After this determination of jurisdiction, the district court ruled that the transfer of the real estate could not be disguised so as to defeat the rights of the lender to accelerate under the due-on-sale clause.[251]

The court of appeals affirmed the decision in a lengthy opinion.[252] In turn the court disposed of the following issues: (1) transfers which activate the clause,[253] (2) exemption under the subordinate lien exclusion under paragraph 17 of the FNMA/

248. 500 F. Supp. 307 (E.D. Va. 1980), *aff'd*, 651 F.2d 910 (4th Cir. 1981).
249. 500 F. Supp. at 307-08.
250. *Id.* at 308 (citations omitted); *see* text accompanying notes 384-435 *infra*.
251. 500 F. Supp. at 309.
252. 651 F.2d 910 (4th Cir. 1981) (four cases consolidated on appeal).
253. *See* text accompanying notes 277-304 *infra*.

FHLMC uniform mortgage instrument document,[254] (3) restraint on alienation,[255] and (4) antitrust challenge.[256] Circuit Court Judge Murnaghan casually dismissed the plaintiff's contentions on each issue.[257] Although the Virginia decisions of *Best v. United Virginia Bank* and *Iron Castle Associates v. Wood* were acknowledged, the court distinguished both cases as involving "a flat restraint on alienation;"[258] also, "the deed of trust in each case [*Best* and *Iron Castle*] antedated the 1974 enactment of Va. Ann. Code §§ 6.1-330.33 and .34."[259]

The court's reliance on sections 6.1-330.33 and .34 is misplaced. The purpose of these sections is to provide notice of the existence of a due-on-sale clause in the mortgage instrument.[260] They in no

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254. *See* text accompanying notes 277-332 *infra.*
255. *See* text accompanying notes 333-61 *infra.*
256. *See* text accompanying notes 452-59 *infra.*
257. 651 F.2d 910 (4th Cir. 1981).
258. *Id.* at 925.
259. *Id.* at 926.
260. *See* text accompanying note 224 *supra.* The *Wellenkamp* court rejected the same interpretation which the lender in *Lipps* has asked the Supreme Court of Virginia to adopt—that the legislature impliedly sanctioned the automatic enforcement of due-on-sale clauses by enacting a statute which provides for notice when such a clause is to be contained in the loan instrument. VA. CODE ANN. § 6.1-330.34 might be distinguishable from CAL. CODE § 2924.5 (which was before the *Wellenkamp* court) on the basis that the former contains the additional language: "*or* renegotiate the terms of such loan. . . ." VA. CODE ANN. § 6.1-330. 34 (Repl. Vol. 1979)(emphasis added). However, when that statute is viewed in light of its precise wording, its code provisions, and the legislative history, § 6.1-330.34 appears more restrictive than the California statute. The lender may enforce the due-on-sale clause, but only if it expressly provides for the modification of the terms. The legislative committee on Corporations, Insurance and Banking, to which the original bill was referred when it was introduced, substituted the current language in § 6.1-330.34 for that of the original 1974 bill which would have prohibited enforcement of a due-on-sale clause so long as the original borrowers remained liable for repayment of the loan. Taken together, it appears that the legislature deliberately chose to eliminate its enforcement for a hidden purpose (as addressed later by the Alabama court in *Britton*), rather than the blanket prohibition envisioned under the original bill. The legislature opted for a result similar to that reached by the Washington court in *Miller*—enforcement is permitted for interest rate adjustment if such purpose is expressly contained within the document. The wording of § 6.1-330.34 supports this view: "Where any loan . . . contains a provision . . . [that the lender] may accelerate payment of *or* renegotiate the terms of such loan upon sale . . ., then the mortgage or deed of trust shall contain in the body or on the margin thereof a statement . . . which will advise the borrower [of the clause] . . . ." VA. CODE ANN. § 6.1-330.34 (Repl. Vol. 1979) (emphasis added). Had the Virginia legislature wanted to blanketly endorse the automatic enforcement of due-on clauses in the Commonwealth, the legislature certainly is sophisticated enough to have drafted such a provision. It is hardly likely that the legislature in-

manner define what constitutes the legitimate interests of the lender which may be relied upon to exercise the clause.[261] Further, any real difference in the language of the clauses, which would cause them to be any more "a flat restraint on alienation" than the FNMA/FHLMC uniform clause in *Williams*, is of doubtful significance.[262] It may be that the court found a particular disdain for the

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tended to broaden enforcement toward the class of borrowers protected in § 6.1-330.34. Rather, the legislature sought to strike a balance between the needs of the lender and the protection of the unskilled consumer.

Thus, the lender's position in *Lipps* is weakened. The FNMA/FHLMC Uniform Mortgage Instrument contains no provision of the type required in § 6.1-330.34. Unless the court were to construe the language of the notice which appears in the left margin of the first page of the *Lipps* deed of trust, as a term of the document itself, the instrument fails to expressly provide for renegotiation upon transfer. There are at least two reasons why the court should not do so. First, the wording of the statute itself suggests that the deed of trust contain both a provision and a notice. In addition, it would be illogical to have the very notice designed to protect the consumer serve as the due-on-sale clause, whose exercise the legislature sought to regulate. The *Wellenkamp* court dealt with this issue and found that the notice clause served as notice required by statute but should not be considered an additional term of the agreement between the parties. Paragraph 10 of the Uniform Mortgage Instrument would also cause the borrower to believe that creditworthiness of the transferee is the key factor for lender's consent as the document now reads within its four corners.

Finally, it could also be contended that by expressly prohibiting the enforcement of the due-on-sale clause upon a further encumbrance of the property as applied to the one-to-four family residential dwellings in § 6.1-2.5, the legislature sanctioned the exercise of due-on-sale clauses in other situations. The better interpretation of the two statutes is that the legislature sought only to absolutely protect the borrower in the *La Sala* situations, i.e., execution of a second mortgage. Section 6.1-330.34 should not be expanded by a liberalized reading of § 6.1-2.5. Further, § 6.1-330.33 also evidences a desire on the part of the Virginia legislature to protect residential homeowners from the inequities resulting when demand for prepayment penalties is made upon acceleration of maturity by the call of the loan. No mention is made in § 6.1-330.33 of the situation where acceleration results from the failure of a transferee to accede to the modified terms posed by the lender. The legislature, in enacting this series of acts aimed specifically to the residential borrower, did not mean to afford the skilled businessman another weapon against the unskilled homeowner, but sought to shift the balance toward "arms of equal length."

261. *See* text accompanying notes 305-32 *infra*.

262. Comparing the clauses in *Best*, *Lipps* and *Williams*, one finds little difference. In fact, *Lipps* and *Williams* used the FNMA/FHLMC Uniform Mortgage Instrument. *See* note 24 *supra*. The language of the clause in *Best*, although not the same, does not vary substantially:

> And the said parties of the first part, in order more fully to protect the security of this Deed of Trust, do hereby agree as follows:
>
> . . . .
>
> 7. The maker of the note covenants and agrees that he will not assign or transfer the property secured by this deed of trust without prior approval of the noteholder.

3700 FAIRFAX CO., VA. LAND RECORDS, DEED BOOK 610-11. The clause in *Best* does not preclude transfer any more than does ¶ 17 of the FNMA/FHLMC form. The express purpose "attempted ingenuity"[263] employed by appellants' counsel in attempting to prove that a sale is not a sale.[264] It is unfortunate that the first case to reach the appellate level in Virginia was decided on these facts and these grounds. The preferred result would have been for the court to face squarely the issues of reasonableness of restraint and interpretation.

The two cases now before the Supreme Court of Virginia provide the court with several options. The court might take a sweeping pro-lender stance that mortgage portfolio adjustment is a legitimate purpose for the exercise of the clause. It could, conversely, take the approach that the due-on-sale clauses are unenforceable as written unless the lender proves that the security has been impaired. The evidence in neither case shows any threat to the security.

On the other hand, the decisions could turn on the particular facts presented in each case, which could result in a decision either to affirm or to reverse either case. The court could affirm the *Best* case on the principle of strict interpretation of the contract.[265] The decision in *Best* could be reversed under the restraint on alienation view that an outright sale results in slight quantum of restraint.[266] Conversely, since an installment land sales contract is involved in the *Lipps* case, the court could reverse the trial court under the rationale of *Tucker v. Lassen Savings & Loan Association*[267]—that is, the greatest quantum of restraint of alienation is imposed upon transfer by a land sales contract. The result of the trial court's decision in *Lipps* could be affirmed on the basis of federal preemption.[268]

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for acceleration for interest rate adjustment is not provided in any of the three. The clause in *Iron Castle* differs only (but perhaps significantly) in that "consent shall not be unreasonably withheld." *See* note 245 *supra*. May the borrower rely upon the traditional reason (custom?) for withholding consent? Does the absence of such a phrase impliedly expand the intention of the parties to permit acceleration for interest rate adjustment? What was the parties' real and original intent? One can only echo other authors who have called for a new mortgage form. *See Subcommittee Report*, *supra* note 30; O'Connell, *supra* note 15.

263. 651 F.2d at 918.

264. *Id.* at 918 n.13.

265. *See* text accompanying notes 305-32 *infra*.

266. *See* text accompanying notes 333-43 *infra*.

267. *See* notes 59-67 *supra* and accompanying text.

268. *See* text accompanying notes 305-32 *infra*.

The court could also examine the two cases for inequity or unconscionability.[269] Since neither the clause in *Lipps* nor that in *Best* expressly provided for acceleration for the purpose of interest rate adjustment, the real motive for which exercise is now sought may have been hidden from the borrower when the deed of trust was executed.[270] Whether the court adopts this approach or not, it is hoped that the court will resist the invitation offered by the lender in *Lipps* to misconstrue section 6.1-330.34 of the Virginia Code.[271] The true intent of the statute is to forewarn a borrower of the presence of a due-on clause. The statute does not conclusively decide, in either case, either the legality of enforceability or what constitutes a legitimate justification for exercise of a due-on clause.[272] Specifically exempted from the code section are deeds of trust on "property comprised of not more than four family residential dwelling units." It can hardly be contended that Virginia is any less concerned than its sister states which have recognized that the residential homeowner needs more protection than the commercial mortgagor. As several courts have maintained, freedom of contract only strikes a balance when the parties are on equal footing.[273]

Since the two Virginia cases have been consolidated on appeal, it appears that the court is prepared to define a general policy toward due-on-sale clauses. Texas and Minnesota, the two jurisdictions to have most recently considered the issue, each have issued definitive statements of the law.[274] Texas favors the pro-lender view, namely, that the clause is reasonable *per se* and exercise is permitted for the sole purpose of increasing mortgage portfolio yield.[275] Minnesota, conversely, requires that the lender demonstrate an impairment to security before exercise of the clause is permitted against the residential homeowner.[276] It is time for Vir-

269. *See* text accompanying notes 362-75 *infra*.

270. *See* text accompanying notes 305-32 *infra*.

271. VA. CODE ANN. § 6.1-330.34 (Repl. Vol. 1979).

272. *See* note 260 *supra*.

273. *See* text accompanying notes 381-83 *infra*.

274. Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, _ Minn. _, 308 N.W.2d 471 (1981); Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333 (Tex. Civ. App. 1981).

275. Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333 (Tex Civ. App. 1981).

276. Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, _ Minn. _, 308 N.W.2d 471 (1981).

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V. A CHECKLIST

A. *Is the Clause Triggered?*

The initial inquiry of anyone involved in a real estate transaction to be closed by any form of mortgage takeover[277] must be: What will or will not activate the due-on clause providing the lender with the option of accelerating the maturity of the debt?

Not only an outright sale[278] but any of several varied transactions may fall within the scope of transfers potentially prohibited by the clause. They include: sale on land contract;[279] lease;[280] devise, descent or distribution on death;[281] secondary financing[282] or any realization of borrower's equity by further encumbrance—voluntary or involuntary;[283] sale and leaseback;[284] and sale and buyback.[285] In a commercial setting the clause may be sophisticated enough to prevent transfers of partnership or stock interest; transfers of management responsibilities; or transfers of bene-

277. This assumes that a due-on-sale clause exists in the current mortgage. Takeover is distinguished here from refinancing in that the former involves any arrangement whereby the purchaser takes the property "subject to" the existing mortgage or assumes the existing mortgage obligation, whereas with refinancing the existing mortgage is paid in full. *See* A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6, at 204-74.

278. *See Subcommittee Report, supra* note 30, at 914-16. The court in *Wellenkamp* explained: "We do not here so restrict the meaning of the term 'outright sale,' but instead, and in accordance with actual real estate parlance, we refer by that term to any sale by the trusts of property wherein legal title (and usually possession) is transferred." 21 Cal. 3d at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

279. *See* Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 663 (1974).

280. Paragraph 17 expressly exempts leases of three years or less unless an option to purchase is included. *See* note 24 *supra*.

281. *See Subcommittee Report, supra* note 30, at 893.

282. Matis, *supra* note 10, at 407. *See also* Dunn & Nowinski, *supra* note 30, at 300-02.

283. *See Subcommittee Report, supra* note 30, at 893-94.

284. *Id.* at 893. *See also* A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6, at 1030-48. "As the name implies, a sale-and-lease-back agreement commonly involves a sale of land and buildings to an investor . . . which simultaneously leases them back upon a long-term contract, frequently making some provision for renewal or repurchase." Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations*, 62 HARV. L. REV. 1, 2 (1948).

285. *See* A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6, at 134.

ficial interests in ownership.[286]

Efforts persist in devising ways to circumvent the clause.[287] Recent attempts by drafters to circumvent the clause have, by in large, been cooly received by the courts.[288]

The borrower in *Williams v. First Federal Savings & Loan Association*,[289] in an obvious attempt to avoid the clause, executed a land trust agreement conveying the property to herself as trustee, and then assigned all of her interest as beneficiary under the trust to the purchaser. The borrower also contended that the Virginia land trust statute[290] controlled, causing the creditor's right to follow through the creation of the trust.[291] The Federal District Court for the Eastern District of Virginia held that the transfer, however labeled, plainly constituted a sale causing breach of the due-on-sale clause.[292] The Fourth Circuit Court of Appeals affirmed the decision of the district court in May, 1981.[293] It should be emphasized that the borrower did not primarily contest the validity of the clause, but rather attempted to avoid activating it by this form of transfer.

In those cases where an attack focused both on equitable grounds and on the "is a sale really a sale" argument, challengers met with more success.[294] In *Rayford v. Louisiana Savings Association*,[295] a 1980 opinion, the principal issue presented was whether the due-on-sale clause was intended to govern transfers between co-mortgagers. The case also involved a Louisiana statute[296] which

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286. *See Subcommittee Report*, *supra* note 30, at 893.

287. *See* Liss, *Drafting Around the Mortgage "Due-on-Sale" Clause in the Installment Sale of Real Estate*, 1981 CHI. B. REC. 312.

288. Dunn & Nowinski, *supra* note 30, at 300.

289. 500 F. Supp. 307 (E.D. Va. 1980), *aff'd*, 651 F.2d 910 (4th Cir. 1981). For a more complete discussion of the case, see text accompanying notes 248-63 *supra*.

290. VA. CODE ANN. § 55-17.1 (Repl. Vol. 1981) reads in part: "Nothing in this section shall be construed (1) to affect any right which a creditor may otherwise have against a trustee or beneficiary. . . ."

291. 500 F. Supp. at 308-09.

292. *Id.* at 309.

293. 651 F.2d 910.

294. *See, e.g.*, Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. App. 1980); Nichols v. Evans, 92 Misc. 2d 938, 401 N.Y.S.2d 426 (1978).

295. 380 So. 2d 1232 (La. App. 1980).

296. LA. REV. STAT. ANN. § 6:837 (West Supp. 1981) reads in pertinent part:

> A. Whenever property is subject to a . . . mortgage in favor of an association and,

the court ultimately determined to be inapplicable to the facts. The court found that the contract was ambiguous and, construing it against the lender, held the clause could not restrict such transfers.[297] Significantly, however, the court did not stop there but couched a second compelling reason for the holding—that the lender could not condition its approval upon the payment of a loan transfer fee absent a showing that security would be impaired.[298]

In a recent New York case,[299] a jurisdiction perhaps previously considered lender-oriented,[300] the court held it clearly would be inequitable to permit the lender to accelerate when the transfer involved the borrowers' conveyance to a corporation in which the borrowers were the principals. Unlike the *Williams* case, the attack in *Nichols v. Evans*[301] centered on the equitability of enforcement when transfer is involved.

Recent controversy has also arisen over the interpretation of the "subordinate lien or encumbrance" section of paragraph seventeen of the FNMA/FHLMC Uniform Mortgage instrument.[302] Borrowers who have sold mortgaged property and taken back some form of secondary financing have contended such transfers are expressly exempted from sales designation under the clause.[303] Although no decisions yet have addressed this issue squarely, it is likely that this argument will receive limited success.[304] It would appear from the cases that any real challenge should be merged with equitable relief.

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without the written consent of the latter, the property is sold or transferred, by contract, either with or without the assumption of the association loan, the loan and obligation held by the association shall at the option of the association immediately mature and become at once subject to enforcement according to law and to the terms of the loan contract.

297. 380 So. 2d at 1238. Interestingly, the due-on clause involved was the boilerplate provision of ¶ 17 of the FNMA/FHLMC Uniform Mortgage Instrument. *See* note 24 *supra*.

298. 380 So. 2d at 1239.

299. Nichols v. Evans, 92 Misc. 2d 928, 401 N.Y.S.2d 426 (1978).

300. For a list of New York cases cited see note 118 *supra*.

301. 92 Misc. 2d 938, 401 N.Y.S.2d 426 (1978).

302. *See* Dunn & Nowinski, *supra* note 30, at 300-01.

303. *Id.*

304. *Id.* Under VA. CODE ANN. § 6.1-195.4(23) (Cum. Supp. 1981), a land contract is considered a vendor's lien. Although this might lend weight to this argument in Virginia, it appears that the true intent was to exclude second mortgages executed by the original mortgagor. *See* text accompanying notes 305-32 *infra*.

B. *Specificity of the Language of the Clause*

With one exception,[305] no court in the United States has denied enforcement of a due-on-sale clause where the overt purpose of increasing the interest rate as a condition for consent to the sale was specifically mentioned in the clause.[306] In fact courts which have refused the enforcement of a due-on-sale clause often have specifically reserved from their decisions the situation where the right to increase the rate of interest upon sale of the mortgaged property is drafted into the clause.[307] While denying enforcement, other courts have focused upon the hidden,[308] the collateral,[309] or the misleading[310] purpose of allowing interest rate adjustment where the clause fails to expressly provide notice to the consumer that the lender intends to accelerate the loan for reasons other than transfer to an uncreditworthy transferee.[311]

Representative of such a view is the opinion in *Silver v. Rochester.*[312] After determining that it would constitute an intrinsic breach of the contract with the borrower to allow the lender to condition approval of sale upon an interest rate increase, the court held that the clause should not be construed beyond its "normal inference" of protection of the security upon transfer. The court also held that to grant a right to withhold approval for interest note adjustment is a "giant step,"[313] a step the court was unwilling to take.[314]

One author, in his 1979 assessment of due-on-sale clause cases,

305. Great N. Sav. Co. v. Ingarra, No. 9433 (9th Cir. 1980).

306. *See* Dunn & Nowinski, *supra* note 30, at 306.

307. *See, e.g.*, Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977).

308. First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300 (Ala. Civ. App. 1977).

309. Great N. Sav. Co. v. Ingarra, No. 9433 (9th Cir. 1980).

310. *See* Dunn & Nowinski, *supra* note 30, at 304.

311. In Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 P.2d 1013, 1019 (Okla. 1977), the court stated that: "The rule of strict construction against the drafter of the instrument is particularly applicable in the case of the contract prepared by an expert or experienced party, and it has special force where it is sought to create and impose an obligation when none would otherwise appear."

312. 73 A.D.2d 81, 424 N.Y.S.2d 945 (1980).

313. *Id.* at _, 424 N.Y.S.2d at 947. The clause also contained language that consent would not be unreasonably withheld. *Id.* at _, 424 N.Y.S.2d at 946.

314. *Id.* at _, 424 N.Y.S.2d at 948.

has concluded that most of the clauses as presently worded belie their intended use, the increase of the interest rate upon sale.[315] Other authors have observed "a lack of candor in the drafting of the security instrument in a manner which would advise a borrower that conditions for nonexercise of the acceleration right might exist or what they were."[316]

A companion issue is the effect to be given language in a due-on-sale clause which provides that consent will not be unreasonably withheld. In *Silver v. Rochester Savings Bank*[317] it was concluded that such an express covenant made it improper for the lender to condition its consent to a sale to a creditworthy transferee upon an increase in the rate of interest.

The most troublesome issue, however, is the degree of responsibility to be placed on the lender in the exercise of the clause when, as is usually the case, the clause makes no mention either that the lender may exercise the clause to secure interest rate adjustments or that the lender is under covenant to act reasonably in the decision to accelerate.[318] In two cases decided just prior to the *Silver* decision where no express restriction of reasonableness was placed on the lender's conduct, the court refused to imply a duty to act reasonably in conditioning consent.[319] In both instances the court recognized that enforcement might be refused if the effect of acceleration would be unconscionable or unfair but that the burden of proof fell upon the borrower.[320] In contrast, the courts in *Tucker v. Pulaski Federal Savings & Loan Association*[321] and *Clark v. Lachenmeier*[322] found the exercise of the clause to be inequitable and unconscionable in the absence of specific proof of impairment of security. In *Sanders v. Hicks*[323] the Mississippi court adopted this latter rationale and held that the issue of reasonableness

315. O'Connell, *supra* note 15, at 946.
316. *Subcommittee Report, supra* note 30, at 935.
317. 73 A.D.2d at _, 424 N.Y.S.2d at 948.
318. *See* FNMA/FHLMC Uniform Mortgage Instrument ¶ 17, *supra* note 24.
319. Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (1977); Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 313 N.Y.S.2d 804 (1970).
320. *See* Bartke & Tagaropulos, *supra* note 2, at 985 (importance of burden of proof).
321. 252 Ark. 849, 481 S.W.2d 725 (1972).
322. 237 So. 2d 583 (Fla. 1970).
323. 317 So. 2d 61 (Miss. 1975).

would be determined on a case-by-case approach, yet in *Baker v. Loves Park Savings & Loan Association*,[324] the Illinois court rejected this case-by-case approach and opted for the *per se* reasonableness of restraint approach which does not require the lender to establish proof of reasonableness.

Here the equitable defenses of unreasonableness of restraint, unconscionability, inequity and duty to act reasonably become hopelessly merged. It may well be that the determinative factor in each case is the court's pre-disposition as to who should bear the burden of proof. Should the lender show justification for exercise or should the borrower show unreasonableness?[325] The key issue still remains whether, absent express authorization for interest rate adjustment in the clause, the lender may properly accelerate the debt for reasons other than an increased risk to the security. When dealing with equitable defenses and notions of balancing the equities, it obviously is wise to be as explicit as possible when drafting a due-on clause.[326]

Since the real operators of the secondary mortgage market require the use of a uniform mortgage document containing paragraph 17 prior to their purchase of mortgage paper from primary lenders, the FNMA/FHLMC form is the most widely used language in a mortgage clause.[327] The principal recent judicial activity regarding this clause has revolved around the issues of federal preemption and whether transfers involving secondary financing devices are exempt from the effect of paragraph 17. The first of these issues will be discussed later in detail.[328] The thrust of the latter issue is that the borrower, by transferring the property and taking back some form of secondary lien, may exempt such a transfer from the prohibition of the clause as provided in exclusion (a) of paragraph 17 which reads in part: "17. Transfer of the Property; Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior

324. 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

325. *See* Bartke & Tagarpulos, *supra* note 2, at 985.

326. *See generally Subcommittee Report*, *supra* note 30.

327. First Fed. Sav. & Loan Ass'n v. Peterson, 516 F. Supp. 732 (N.D. Fla. 1981). *See* note 24 *supra* for text of ¶ 17.

328. *See* text accompanying notes 384-435 *infra*.

written consent, excluding (a) the creation of a lien or encumbrance subordinate to this Mortgage. . . ."[329]

Such attempts to avoid the activation of the clause may take any of several forms: by installment contract, by deed and second mortgage back, or by deed and wraparound mortgage back.[330] It would appear that the real purpose of exception (a) of the uniform document is not to exempt transfers where the borrower-seller retains some type of vendor's lien but rather to exempt the *La Sala* type situations where a subordinate lien is created "upon the borrower's interest."[331] Unofficial opinions of counsel for both the Federal Home Loan Bank Board (FHLBB) and Federal Home Loan Mortgage Corporation (FHLMC) support such a view[332] which appears to be the true intention and the better reasoned interpretation of the exclusion.

C. *Restraint on Alienation*

The vast majority of jurisdictions have found that the exercise of the clause results in some restraint on alienation.[333] Thus, the real issues in the cases involved the test for reasonableness, the burden of proof and sometimes the concepts of direct and indirect restraints.[334]

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329. *See* note 24 *supra*. *See also* text accompanying notes 277-304 *supra*.

330. *See* Dunn & Nowinski, *supra* note 30, at 301.

331. *Id.*

332. *Id.* at Appendices A & B.

333. *See generally* O'Connell, *supra* note 15, and Dunn & Nowinski, *supra* note 30.

334. *See generally* authorities cited in note 30 *supra*. *See, e.g.*, Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, _ Minn. _, 308 N.W.2d 471 (1981); Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 293 N.W.2d 843 (1980); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976); and Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333 (Tex. Civ. App. 1981). RESTATEMENT OF PROPERTY § 404(1) (1944) defines a restraint on alienation:

> A restraint on alienation, as that phrase is used in this Restatement, is 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 part of the property interest conveyed.

One writer concluded that:

> [T]he due-on-sale clause does not fit exactly within any of the established categories

A few jurisdictions have disagreed entirely that the exercise of the clause results in any restraint on alienation.[335] A Montana case[336] and an early Washington case[337] both found that enforcement of the clause resulted in a restraint on a mere contractual interest and not on the actual transfer itself. In *Occidental Savings & Loan Association v. Venco*,[338] the Nebraska court agreed with this analysis and rejected the concepts of "indirect restraint and practical alienability."[339] The court, in language which must be considered a lender's dream, stated:

> the error committed by most jurisdictions in deciding this matter is their willingness to assume that a due-on-sale clause is a restraint on alienation and that the only issue is reasonableness . . . . [T]he 'due-on-sale' clause is not a restraint on alienation as that concept is legally defined. . . . [It] cannot be so considered for any purpose, theoretical or practical.[340]

In going further, however, the court seemed to be applying the familiar balancing test of *Tucker*—quantum of restraint versus justification for restraint.[341]

> The potential failure of savings and loan associations and the loss of their depositors' funds should be of no less a concern to the courts than the inability of a property owner to transfer its mortgage at a premium when selling its property. Balancing portfolio return with

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> of direct restraints, disabling, forfeiture or promissory. . . . [However, the] due-on-sale clause is so closely akin to the promissory restraint as to justify designating it a direct restraint.

Volkmer, *The Application of the Restraints in Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 773-74 (1973). In Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, _, 250 N.W.2d 804, 806 (1977), the court found that if "the mortgage clause defendant seeks to enforce can be labeled a restraint on alienation only by expanding the restatement definition, we do not hesitate to stretch the term to include this 'due-on-sale' clause."

335. Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 293 N.W.2d 843 (1980); Miller v. Pacific First Sav. & Loan Ass'n, 86 Wash. 2d 401, 545 P.2d 546 (1976); Dobitz v. Oakland, 172 Mont. 126, 561 P.2d 441 (1977).

336. Dobitz v. Oakland, 172 Mont. 126, 561 P.2d 441 (1977).

337. Miller v. Pacific First Sav. & Loan Ass'n, 86 Wash. 2d 401, 545 P.2d 328 (1971).

338. 206 Neb. 469. 293 N.W.2d 843 (1980).

339. *Id.* at _, 293 N.W.2d at 847.

340. *Id.* at _, 293 N.W.2d at 845.

341. *See* text accompanying note 58 *supra*.

> cost of money is an important factor in the survival of lending associations. The due-on-sale clause is an important device in maintaining that balance.[342]

Viewed in this light, it appears that the Nebraska court actually perceived the restraint as insignificant, rather than non-existent, when weighed against the public benefit to be gained by allowing lenders to enforce the clause. It should be noted that the impact of this opinion on the residential borrower is weakened somewhat by the fact that the security consisted of unimproved urban land.[343] The insight, if any, to be gained from the *Wellenkamp* and *Occidental* rationales is that the real battleground concerns the issue of what should go into the scales to be balanced.

D. *Is the Restraint on Alienation Reasonable?*

As noted in the previous section, only a few cases have ruled that the due-on-sale clause does not result in any restraint on alienation.[344] No court has directly held that the due-on-sale clause is invalid *per se*.[345] Rather most courts have struggled to balance the conflicting interests of the economic triangle—lender, mortgagor and purchaser.[346] To determine the reasonableness of the restraint in this balancing process, courts have attempted to assign merit to each of several factors under the rationale made popular by the California courts. This rationale measures the quantum of the restraint against the justification for enforcement.[347] A pinch of public policy has been thrown into this boiling stew although courts have disagreed completely, sometimes heatedly, as to whose interests genuinely represent the public interests.[348] Other courts

342. 206 Neb. at —, 293 N.W.2d at 849.

343. "The land in question was unimproved urban land subject to a 30-year mortgage. . . . It is not realistic to argue that the owner here intended the mortgage to remain in effect for the entire mortgage term. . . ." *Id.* at —, 293 N.W.2d at 846.

344. *See* cases cited in note 335 *supra.*

345. *See* text accompanying notes 112-208 *supra.*

346. *Id.*

347. *See* Tucker v. Lassen Sav. & Loan, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974). *See also* text accompanying notes 42-109 *supra.*

348. *See* Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (dissenting opinion); Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 876, 152 Cal. Rptr. 572 (1979) (majority and concurring opinion). *See also* text accompanying notes 112-208 *supra.*

have resisted the temptation to use the conflict before it as a forum to legislate public policy and have restricted their decision to the issue before it through strict interpretation of the contract.[349]

The traditional justification for exercise of the due-on-sale clause has been to protect a lender against risk to its security upon non-payment and threat to the security by waste or depreciation.[350] The more recent justification for a due-on-sale clause is the protection of the lender's portfolio from the economics of rising interest rates.[351] This latter justification draws the battle lines between borrowers and lenders. In times of rapid inflation the risks upon default and subsequent foreclosure are minimal.[352] Courts have also scrutinized the individual circumstances of each case[353] in an effort to distinguish the facts and to accurately weigh the merits of each situation,[354] such as the type of lender,[355] type of borrower[356] and the nature of property serving as security.[357] Absent a clause specifically providing for adjustment of interest rates upon transfer of the secured property, courts have split on the is-

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349. *See* text accompanying notes 305-32 *supra.*

350. *See Matis, supra* note 10.

351. *Id.*

352. With the advent of private mortgage insurers, conventional lenders can now shift the risk of default on high loan-to-value mortgages. [FHA and VA mortgages under the National Housing Act of 1934 are insured and guaranteed respectively so that the lender will not bear any loss resulting from a defaulted loan—the U.S. government bears the loss].

> . . . .
>
> Other factors that cushion the lender's risk when making seemingly dangerous loans are exacting credit standards, a steady full employment economy, and a housing demand that exceeds the available supply. Time also works in the lender's favor, even though, as we shall see, the rate of mortgage reduction usually begins quite modestly. The pressures of inflation and scarcity tend to force up real estate values, adding to the owner's equity wholly apart from mortgage reduction. Moreover, inflation also allows the debtor to repay fixed dollars of debt service with dollars of shrinking value, thereby making default itself less likely.

A. Axelrod, C. Berger & Q. Johnstone, *supra* note 6, at 102.

353. *See* Sanders v. Hicks, 319 So. 2d 61 (Miss. 1975). *See also* text accompanying notes 305-32 *supra. But see* Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

354. *See* Wellenkamp v. Bank of America, 21 Cal. 3d 943, 982 P.2d 970, 148 Cal. Rptr. 379 (1978) (Clark, J., dissenting).

355. *See* text accompanying notes 376-80 *infra.*

356. *See* text accompanying notes 381-83 *infra.*

357. *See* text accompanying notes 381-83 & 436-40 *infra.*

sue of the weight to be given lenders' portfolio concerns.[358]

The Ohio Court of Appeals has strongly denounced the legitimacy of protecting a lender's portfolio through the exercise of a due-on clause:

> The purpose of purchasing land by note and mortgage is not only to acquire land, but also to purchase the use of money at the then current rate of interest. Business risks of all kinds, including those pronounced by economic inflation, are factored into the then current interest rate. . . . The balancing process which we require . . . must recognize more than the lending institution's desire to update its portfolio or increased profits . . . . [I]t must also consider the property rights of the [mortgagors]. In this regard, we believe that the balance by the *Tucker* court . . . is the correct one: "When such enforcement is not reasonably necessary to protect the lender's security, the lender's use of the clause to extract collateral benefits must be held an unlawful restraint on alienation."[359]

Yet, in the strongest expression of the pro-lender view, the Nebraska court found that balancing portfolio return with the cost of money is essential to the survival of lenders.[360] The Attorney General of Maryland, expressing similar sentiment in an opinion letter on the issue, felt that the exercise of the clause to permit the lender to maintain its portfolio was not only an unlawful restraint but also a violation of public policy.[361]

E. *Unconscionable or Inequitable to Enforce*

Numerous opinions state that although the clause is activated and appears enforceable on its face, courts in equity may refuse to enforce the due-on-sale clause if enforcement would be unconscionable or unfair.[362] However, the majority of courts have then gone on to find that the lender's refusal of consent to assignment is

358. *See* text accompanying notes 305-32 *supra*.
359. Great N. Sav. Co. v. Ingarra, No. 9433 (9th Cir. 1980).
360. Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 293 N.W.2d 843 (1980).
361. Letter, *supra* note 25.
362. *See, e.g.*, Miller v. Pacific Fed. Sav. & Loan Ass'n, 86 Wash. 2d 401, _, 545 P.2d 546, 548 (1976). *See also* Annot., 92 A.L.R.3d 822 (1979).

neither unconscionable nor inequitable.[363] The few cases which have barred enforcement due to unconscionability or the inequity between the parties have generally hinged on the special facts of the case, such as that the conveyance by the borrowers was to a corporation in which they were the principals[364] or that the lender held some unfair advantage by, or gained some personal interest in, withholding consent.[365]

Some courts have denied enforcement on the basis that if enforcement is allowed absent a showing of impairment to the lender's security, it permits the lender to enforce the clause for a hidden purpose—a purpose other than that which the parties bargained for and one which catches the borrower unaware.[366] The lender should have provided notice to the borrower of its intention to exercise the clause for interest rate adjustment.[367] Although some authors would gloss over this "lack of notice" issue,[368] it appears that for mortgages of earlier dates, this purpose for acceleration is one that neither lender nor borrower contemplated due to the unforeseeability of climbing interest rates. It may be an exactment of a condition not provided in the contract—a result which permits the lender an unfair advantage because of the vague and general nature of the language of the clause.[369]

Other courts have criticized any forfeiture or penalty resulting from enforcement of the clause absent a showing of impairment of security or a reasonable ground for accepting the new transferee.[370]

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363. *See e.g.*, Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (1977). *But see* Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. App. 1980).

364. Nichols v. Evans, 92 Misc. 2d 938, 401 N.Y.S.2d 426 (1978).

365. Silver v. Rochester Sav. Bank, 73 A.D.2d 81, 424 N.Y.S.2d 945 (1980). (The lender was the tenant of the borrower. Upon the sale of the property, the lender demanded an increase in the interest rate for the sole purpose of portfolio adjustment. The new purchaser then demanded an increase in rent. The lender refused.)

366. *See* text accompanying notes 305-32 *supra. See also* First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977).

367. *See* O'Connell, *supra* note 15, at 946.

368. *See* Dunn & Nowinski, *supra* note 30, at 308.

369. *See* text accompanying notes 305-32 *supra.*

370. Baltimore Life Ins. Co. v. Harm, 15 Ariz. App. 78, 486 P.2d 190 (1971), *cert. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972); Clark v. Lachenmeier, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970). *But*

This seems an especially troublesome issue when the exactment is a transfer fee rather than interest rate increase.[371]

Still other courts have considered the traditional concepts of waiver,[372] estoppel[373] and laches.[374] These defenses obviously are dependent upon particular facts, and enforcement depends on equity under the circumstances of the case. There appears to be no valid reason why the due-on-sale clause should be treated differently than the more traditional acceleration clauses based on default and as such it should remain subject to equitable defenses.[375] This absence of notice to borrower of lender's intention to exercise the clause for reasons other than assumption by an uncreditworthy assignee appears to be easily cured by appropriate drafting.

F. *Institutional or Private Lender*

In the landmark *Wellenkamp* case, the court specifically limited its holding to the institutional lender and introduced the uncertainty of whether the restraints on enforcement of the clause should apply to the private lender. No reason was given why the court expressly reserved from its opinion the issue of whether a private lender might be justified in automatically enforcing a due-on-sale clause. Several authors have suggested reason to justify the distinction.[376] The key reasons revolve around the limited sophistication of the private lender and the relatively equal bargaining po-

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see Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 313 N.Y.S.2d 804 (1970); Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 71 Wis. 2d 531, 239 N.W.2d 20 (1976).

371. *See* Rayford v. Louisiana Sav. Ass'n, 380 So. 2d 1232 (La. App. 1980); Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 P.2d 1013 (Okla. 1977).

372. Guild Wineries & Distilleries v. Land Dynamics, 103 Cal. App. 3d 968, 163 Cal. Rptr. 348 (1980); Medovoi v. American Sav. & Loan Ass'n, 62 Cal. App. 3d 317, 133 Cal. Rptr. 63 (1976).

373. Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 87 Wash. 2d 437, 553 P.2d 1090 (1976).

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

375. *See* O'Connell, *supra* note 15, at 933 n.7. *But see* Miller v. Pacific First Fed. Sav. & Loan Ass'n, 86 Wash. 2d 401, 545 P.2d 546 (1976) (clause held not to be an acceleration clause but instead a clause which directly permitted increase in interest rate upon transfer of property, when clause expressly provided for increase on transfer).

376. *See, e.g.*, Goodman, *The Wellenkamp Decision: How it Will Affect Real Estate Financing*, 54 CAL. ST. B.J. 34, 38 (1979); Hetland, *After Wellenkamp*, CAL. REAL EST., Jan. 1979, at 38; Note, *supra* note 27, at 301.

sitions of the parties.[377] Further, private lenders, unlike institutional lenders, are ill equipped to assess lending risks, and credit and personal backgrounds are less accessible.[378] These reasons might well justify the automatic enforcement of the clause. However, in three cases decided after *Wellenkamp* which involved non-institutional lenders, enforcement was permitted in two instances[379] and was refused in another.[380]

G. *Commercial or Residential Borrower*

Many lenders have claimed that there is a valid distinction between residential and commercial loans, primarily based on the relatively equal bargaining positions and sophistication inherent in the commercial transactions.[381] Such lack of any adhesion contract overtones permits a freedom of contract which should not be disturbed by the courts.[382] It appears from a survey of the cases that the courts are influenced by this rationale, and are more inclined to permit enforcement of the clause in the setting of commercial transactions.[383]

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377. *See* Note, *supra* note 27, at 301.

378. Goodman, *supra* note 376, at 40.

379. Medovoi v. American Sav. & Loan Ass'n; 89 Cal. App. 3d 876, 152 Cal. Rptr. 572 (1979) (enforcement allowed). In Dawn Inv. Co., Inc. v. Superior Court, 116 Cal. App. 3d 439, _, 172 Cal. Rptr. 142, 145 (1981) the court declared:

> In *Wellenkamp* the lender was a large bank with tremendous strength, resources, and bargaining power far superior to that of the individual homeowner. . . . In relative positions of safety, security, bargaining and ability in an open interest market the parties are much more equal than in *Wellenkamp*. . . . [T]he actual practical effect upon alienation which would result from enforcement is . . . evenly balanced by the justification for enforcement.

A fourth case involving a non-institutional lender was decided on other grounds. *See* Guild Wineries & Distilleries v. Land Dynamics, 103 Cal. App. 3d 968, 163 Cal. Rptr. 348 (1980).

380. Pas v. Hill, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978) (enforcement denied).

381. *See* authorities cited in note 376 *supra*.

382. *Id.*

383. *See, e.g.*, Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 876, 152 Cal. Rptr. 572 (1979); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, _ Minn. _, 308 N.W.2d 471 (1981). In *Holiday Acres*, the court stated:

> We do not find the economic concerns which have motivated the courts to hold that a due-on-sale clause is a restraint on alienation unless it is exercised to protect the lender's security interest to be as compelling where the loan is used to finance investment residential property, even though the use of the due-on-sale clause to increase interest rates may restrict the transfer of both borrower-occupied residential property and investment residential property in the same manner. The need of the

H. *State or Federally Chartered Association*

In the same year that *Wellenkamp* was decided, the Federal District Court for the Central District of California decided *Glendale Federal Savings & Loan Association v. Fox.*[384] In *Glendale Federal v. Fox,* the court reasoned that the federal regulations[385] promulgated by the Federal Home Loan Bank Board had preempted state regulation of the due-on-sale clauses in loan docu-

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borrower-occupier for quick and easy transfer of personal residence is greater than that of the investment borrower. The tension between restraint on alienation principles and the freedom to contract strikes a different balance when the validity of the use of a due-on-sale clause to increase interest rates is questioned in a commercial setting, where economic considerations outweigh all others. This court views the transaction in an investment setting as one presumably less subject to overreaching, not because the borrower will in all cases be more sophisticated but because of the forces compelling the transaction.

_ Minn. at _, 308 N.W.2d at 484.

384. 459 F. Supp. 903 (C.D. Cal. 1978).

385. 12 C.F.R. § 545.8-3(f) and (g) (1980) reads:

(f) *Due-on-sale clauses.* An association continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instrument whereby the association may, at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the associations's [*sic*] prior written consent. Except as provided in paragraph (g) of this section with respect to loans made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, exercise by the association of such option (hereafter called a due-on-sale clause) shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract.

(g) *Limitations on the exercise of due-on-sale clauses.* With respect to any loan made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, a Federal association: (1) Shall not exercise a due-on-sale clause because of (i) creation of a lien or other encumbrance subordinate to the association's security instrument; (ii) creation of a purchase money security interest for household appliances; (iii) transfer by devise, descent, or operation of law on the death of a joint tenant; or (iv) granting of a leasehold interest of three years or less not containing an option to purchase; (2) shall not impose a prepayment charge or equivalent fee for acceleration of the loan by exercise of due-on-sale clause; and (3) waives its option to exercise a due-on-sale clause as to a specific transfer if, before the transfer, the association and the person to whom the property is to be sold or transferred (the existing borrower's successor in interest) agree in writing that the person's credit is satisfactory to the association and that interest on sums secured by the association's security interest will be payable at a rate the association shall request. Upon such agreement and resultant waiver the association shall release the existing borrower from all obligations under the loan instruments, and the association is deemed to have made a new loan to the existing borrower's successor in interest.

ments of federally chartered lenders. The result of the conflict between the *Glendale Federal v. Fox* and *Wellenkamp* decisions is that federal associations operating in California can enforce due-on-sale clauses while state chartered associations may only enforce the clause if they are able to demonstrate that their security is threatened.

The picture is blurred, however, in that Judge Byrne decided not only *Glendale Federal v. Fox*, but also *People v. Glendale Federal Savings & Loan Association.*[386] In *People v. Glendale Federal,* the California Attorney General filed an action in state court against Glendale Federal seeking to enjoin the Association from enforcing the due-on-sale clause against any borrower. Glendale Federal removed the action to federal court and the Attorney General moved to remand the case back to state court. Judge Byrne remanded the action to state court, reasoning that removability of an action filed in state court is determined solely by the presence of a federal question in the state court complaint.[387] Thus, in *Glendale Federal v. Fox,* federal law was held to exclusively govern the exercise of a due-on-sale clause. Simultaneously, the state court, which is not bound to follow *Glendale Federal v. Fox,* was invited by the decision in *People v. Glendale Federal* to apply state law.[388]

Other courts have disagreed with both of Judge Byrne's opinions, thus leaving the law concerning preemption and jurisdiction even more confused.[389] In *First Federal Savings & Loan v. Lockwood,*[390] the applicability of the preemption doctrine was completely rejected. The Florida court, seeing that the interpretation of contracts and foreclosures of mortgages are areas traditionally left to the equity jurisdiction of the state courts, declared that a federal lender submits itself to state law equitable restrictions.[391] Thus a federal lender could be required to prove an impairment of

386. 475 F. Supp. 728 (C.D. Cal. 1979).

387. *Id.* at 731-32.

388. *See* Dunn & Nowinski, *supra* note 30, at 298.

389. Bailey v. First Fed. Sav. & Loan Ass'n, 467 F. Supp. 1139 (C.D. Ill. 1979) (jurisdiction question); First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980) (preemption question). *But see* Dantus v. First Fed. Sav. & Loan Ass'n, 502 F. Supp. 658 (D. Colo. 1980).

390. 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

391. *Id.* at 159-60.

its security before it is permitted to exercise the clause.[392] *Schultz v. Coral Gables Federal Savings & Loan Association,*[393] although dealing primarily with the jurisdictional issue, reaffirmed this view:

> This [federal] Court is reluctant to inject itself in a case, such as this, which involves issues traditionally governed by state law and traditionally and competently dealt with by state judicial tribunals sitting in equity. It is noteworthy that, in analogous cases involving predominance of state law and matters intimately connected with the sovereign power of the state, federal courts have concluded that abstention is warranted. . . .[394]

Subsequent litigation has centered along these lines of controversy.[395] Both federal preemption and the jurisdictional issue will be examined below.

1. Federal Preemption?

The federal preemption doctrine, which is based on the supremacy clause of the United States Constitution,[396] applies when Congress either explicitly or impliedly by creation of legislation manifests an intent that federal law shall govern to the exclusion of conflicting or inconsistent state law.[397] Federally chartered lenders have argued that the traditional property law of the states has been usurped by the Home Owners Loan Act of 1933 (HOLA)[398] and the FHLBB's subsequent regulations under the Act.[399] Lenders claim that, since Board regulations permit the due-

392. "Other Florida decisions have clearly relied on impairment of security as an essential element of a plaintiff's right to foreclose a mortgage." *Id.* at 159 n.6.

393. 505 F. Supp. 1003 (S.D. Fla. 1981).

394. *Id.* at 1011.

395. *See* Dunn & Nowinski, *supra* note 30.

396. U.S. CONST. art. VI, cl. 2.

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

Id. See also McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

397. First Fed. Sav. & Loan Ass'n v. Peterson, 516 F. Supp. 732, 736 (N.D. Fla. 1981).

398. 12 U.S.C. §§ 1461-1468 (1980).

399. 12 C.F.R. § 545.8-3(f) and (g) (1980) (formerly 12 C.F.R. § 545.6-11(f) and (g). For text of regulations see note 385 *supra.*

on-sale clause, state law has been preempted and they are entitled to an absolute and automatic right of enforcement of the clause.[400]

There is no express statement in HOLA itself concerning congressional intent with regard to state laws which may address the same subject matter.[401] The United States Supreme Court has been hesitant to use the supremacy clause to preempt a state's exercise of its historic police powers unless the federal act indicates a clear and manifest purpose of Congress to do so.[402] That Congress has authority to legislate in this area generally has not been questioned.[403] The real question is whether Congress impliedly preempted state law on the enforceability of due-on-sale clauses of federally chartered associations.

Congressional intent to preempt may be implied in several ways:

> [T]he scheme of federal regulation may be so pervasive as to make reasonable the inference that Congress left no room for States to supplement it. Or the Act of Congress may touch a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject. Likewise, the object sought to be obtained by the federal law and the character of obligations imposed by it may reveal the same purpose. Or the state policy may produce a result inconsistent with the objective of the federal statute.[404]

Under HOLA Congress clearly intended to create a uniform nationwide system of savings and loans regulated by a central regulatory agency—the Federal Home Loan Bank Board. The dispute continues, however, as to which areas or what operations are reached by preemption.[405]

Courts have acknowledged a greater need for judicial reluctance to find federal preemption in traditional state matters when pre-

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400. *See, e.g.*, First Fed. Sav. & Loan Ass'n v. Peterson, 516 F. Supp. 732, 735 (N.D. Fla. 1981). *See generally* Dunn & Nowinski, *supra* note 30; 11 PAC. L.J. 1085 (1980).

401. First Fed. Sav. & Loan Ass'n v. Peterson, 516 F. Supp. 732, 737 (N.D. Fla. 1981).

402. "Consideration under the Supremacy Clause starts with the basic assumption that Congress did not intend to displace state law." *Id.* at 736.

403. *Id.*

404. *Id.* (citations omitted). *See also* Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

405. *See* Dunn & Nowinski, *supra* note 30, at 292.

emption is to be implied.[406] Consequently, courts take a detailed look at the subject matter of the law and restrict preemption to the narrowest possible subject matter.[407] Matters involving "internal affairs"[408]—traditionally assumed to be the relationships among directors, officers, members and associations as well as fiduciary duties of officers and directors and the rights of members to inspect records—are undisputably within the exclusive domain of the FHLBB. It is unclear, however, whether Congress intended the issue of the enforceability of the due-on-sale clause to be an activity which falls outside the field that HOLA was to preempt.[409] Other association activities have been broadly lumped into a category identified as "all other activities."[410]

For activities where there is no specific regulation dealing with the disputed activity such as the charging of usurious interest rates, state law is deemed to control.[411] However, preemption may arise by administrative regulation as well as by statute.[412] The FHLBB passed specific regulations governing due-on-sale clauses on May 3, 1976.[413] The FHLBB also has maintained that the due-on-sale clause "is vital and necessary to enable savings and loan associations to adjust their portfolios towards current market rates, thereby protecting the associations' financial stability. . . ."[414] Although the 1976 regulation does not appear to be retroactive, the specific wording of the regulation and the pre-regulation *Schott*[415] advisory opinion indicate that the FHLBB certainly considered the issue of enforceability as exclusively governed by federal law both before and after the effective date of the 1976 regulation.

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406. 516 F. Supp. at 736.

407. *Id.*

408. *See* Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n, 499 F.2d 1145 (9th Cir. 1974); 11 PAC. L.J. 1085 (1980).

409. 11 PAC. L.J. at 1100-01.

410. *Id.*

411. *Id.* at 1101.

412. 516 F. Supp. at 737.

413. *See* note 385 *supra* for text of the regulations.

414. 516 F. Supp. 732, 738 (quoting FHLBB's Advisory Opinion, Resolution No. 75-647 (July 30, 1975) to the court in Schott v. Mission Fed. Sav. & Loan Ass'n, No. CIV-75-366 WMB (C.D. Cal)).

415. *Id.* For discussion of the cases before and after the issuance of 12 C.F.R. § 545.6-11(f) and (g), see O'Connell, *supra* note 15, at 956-61.

Neither the Board's regulation nor the advisory opinion, however, has effectively deterred further litigation of the preemption issue.[416] This has resulted not only in the continuing conflict in California but also in the intriguing dispute posed in Florida by the *Lockwood, Peterson* and *Schultz* cases.[417] In its June, 1980 decision in *Lockwood,* the District Court of Appeals of Florida specifically rejected the preemption argument of the federally chartered lender and applied Florida law which requires proof by the lender that there is an impairment of security.[418] Conversely, one year later in *First Federal Savings & Loan Association v. Peterson,*[419] the United States District Court for the Northern District of Florida concluded that federal law, embodied in the FHLBB's regulations, impliedly preempted all state law concerning acceleration of a due-on-sale clause to obtain a higher interest rate from the purchaser.

It should be noted that the three due-on clauses in *Peterson* each plainly stated that acceptance in writing of an interest rate acceptable to the association might be required before the association waived its right to accelerate upon sale by the borrowers. *Peterson* and *Lockwood* could perhaps be distinguished on this point. Nevertheless, the conclusion is inescapable. For a lender to enforce a due-on-sale clause in state court, he must bear the burden of showing an impairment to security or enforcement will be denied; whereas in federal court, a federal lender may automatically enforce the clause for the sole purpose of raising its interest rates—a purpose expressly rejected as a legitimate justification for enforcement in the state court. Where federal lenders seek enforcement in jurisdictions which permit enforcement only upon showing of impairment to security, a race to the courthouse between lender and consumer appears imminent.[420] Moreover, some mortgagors have asserted that the choice of law provision in paragraph 15 of the

416. *See* text accompanying note 386 *supra.*

417. *Compare* First Fed. Sav. & Loan Ass'n v. Peterson, 516 F. Supp. 732 (N.D. Fla. 1981) (federal law controls enforceability) *with* Schultz v. Coral Gables Fed. Sav. & Loan Ass'n, 505 F. Supp. 1003 (S.D. Fla. 1981) (to consider federal law, a federal question must appear on the face of the complaint) *and* First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980) (state law controls enforceability).

418. 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

419. 516 F. Supp. 732 (N.D. Fla. 1981).

420. 505 F. Supp. 1003, 1010 (S.D. Fla. 1981).

FNMA/FHLMC Uniform Mortgage Instrument[421] requires that where a due-on-sale clause is unenforceable under the law of the jurisdiction, such law is incorporated into the agreement of the parties.[422] The essence of this contention is that the parties have stipulated that state law govern the enforceability of the clause. The courts split in two 1980 cases which considered this point.[423]

2. Federal Jurisdiction—A Race to the Courthouse

If the cases of *Wellenkamp, Glendale Federal v. Fox, Lockwood,* and *Peterson* are true indicators of the reception a due-on-sale clause will receive in the state courts versus the federal courts, then when a federal lender is involved the single most important factor to consider is the forum where the issue of enforceability is to be determined. A race between lenders and consumers is certain to occur in those jurisdictions where the lender can enforce a due-on-sale clause only upon demonstrating an impairment to security. Counsel for the mortgager or purchaser would be well-advised to begin a state court action for declaratory judgment in order to determine the enforceability of the clause as soon as the sale is certain. Since purchasers obviously are in position to know of the sale before the lender gains knowledge of it, they should win the race. However, counsel for the federal lender may respond to the action for declaratory judgment with a motion to remove to federal court. It is here that the courts have struggled with the scope of federal jurisdiction and the pleadings of the parties.[424]

Federal courts have general original jurisdiction over cases in-

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421. Paragraph 15 provides:

> *Uniform Mortgage; Governing Law; Severability.* This form of mortgage combines uniform covenants for national use and nonuniform covenants with limited variations by jurisdiction to constitute a uniform security instrument covering real property. This Mortgage shall be governed by the law of the jurisdiction in which the Property is located. In the event that any provision of clause of this Mortgage of the Note conflicts with applicable law, such conflict shall not affect other provisions of this Mortgage or the Note which can be given effect without the conflicting provision, and to this end the provisions of the Mortgage and the Note are declared to be severable.

422. Dunn & Nowinski, *supra* note 30, at 299-300.

423. Kirkland v. Fidelity Fed. Sav. & Loan Ass'n, No. 79-859 (M.D. Fla., May 16, 1980); Great Western Union Fed. Sav. & Loan Ass'n v. Walters, No. C-79-906V (W.D. Wash., June 18, 1980).

424. *See, e.g.,* Schultz v. Coral Gables Fed. Sav. & Loan Ass'n, 505 F. Supp. 1003 (S.D. Fla. 1981); Bailey v. First Fed. Sav. & Loan Ass'n, 467 F. Supp. 1139 (C.D. Ill. 1979).

volving a federal question.[425] The difficulty is that the scope of federal jurisdiction is narrowed by application of a rigid pleading rule requiring that the federal question must appear on the face of the complaint.[426] As a result, it does not suffice for federal jurisdiction that the answer raises the federal question.[427] The principal issue now becomes whether the mortgagor, by "artful pleading," can avoid the federal question and federal preemption defense of the lender and thus prevent removal to federal court.[428] Courts have split on the issue. *Schultz* and *People v. Glendale Federal* fairly represent the majority view that the federal question must appear on the face of the complaint.[429] *Bailey v. First Federal Savings & Loan Association*[430] represents the opposite view. The problem is made even more intriguing because orders of remand are not reviewable on appeal.[431]

The issue of federal preemption continues to be the most crucial element when enforcement is sought by a federal association. It is unfortunate that such an important issue is to be resolved by a

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425. C. WRIGHT, LAW OF FEDERAL COURTS 69 (3d ed. 1976).

426. *Id.*

427. *Id.* at 69-72. The *Schultz* court noted:

> [T]he federal question of preemption enters this case only by way of defense. Just as Schultz could not have created federal jurisdiction by anticipating the defense of federal preemption in his complaint, Coral Gables cannot create removal jurisdiction by anticipating the defense of federal preemption in its petition for removal or its answer.

505 F. Supp. at 1009.

428. C. WRIGHT, *supra* note 425, at 71.

429. *Id.* at 69.

430. In *Bailey*, the court stated that:

> Normally, the federal question must appear on the face of the complaint, but artful pleading cannot be used to defeat a defendant's right to remove by concealing the true nature of the plaintiff's claim. The court may look beyond the "verbiage of the state complaint" and take judicial notice of federal statutes necessarily brought into play.

467 F. Supp. at 1141. The court in *Schultz* dismissed the *Bailey* decision in its opinion:

> The decision in *Bailey*, although certainly deserving of some measure of deference from this Court, is subject to criticism on at least two distinct grounds. First, while ostensibly ruling upon the threshold issue of whether removal was proper, the Court's decision in *Bailey* employs language which is tantamount to a decision on the merits of the case, i.e., state law has been preempted by federal law. This determination was not only premature; it is, by no means, unequivocally correct. Second, the decision in *Bailey* is simply against the weight of authority.

505 F. Supp. at 1009.

431. Dunn & Nowinski, *supra* note 30, at 299.

pleading rule. It would be better to have the issue resolved on the merits of federal preemption rather than on a question of the jurisdiction of the courts. It may be that the regulations of the FHLBB have gone beyond the scope originally intended by Congress when it passed the HOLA.[432] The Senate hearings and communicators support such a view.[433] Other authors have vigorously argued that blanket preemption by FHLBB is necessary for the full protection of the federal savings and loan associations.[434] It is an unfortunate result if state and federal lenders are to be treated differently. In certain jurisdictions this unseeming race to the courthouse is certain, and the courts are compelled to guess whose interest public policy really favors. Judge Aronovitz's words in *Schultz*, "resolution lies with Congress not the court,"[435] should be answered.

I. *Non-recourse Financing*

Although not solely the decisive factor in any case, it would seem that courts would be more inclined to allow enforcement if the purchaser takes the property "subject to" the mortgage lien as opposed to an assumption. In the former, the borrower is not personally liable for any deficiency judgment on foreclosure and consequently the risk of waste and default increases.[436]

The non-recourse nature of the secured obligation between the lender and the original mortgagor may also influence the courts. The New Jersey court which denied enforcement to the plaintiff-lender in *Fidelity Land Development Corp. v. Rieder & Sons*

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432. "Under date of April 13, 1933, President Roosevelt wrote the Congress: 'I ask the Congress for legislation to protect small homeowners from foreclosure and relieve them of a portion of the burden of excessive interest and principal payments incurred during the period of higher values and higher earning power' " Conference of Fed. Sav. & Loan Ass'ns v. Stein, 604 F.2d 1256, 1257 (9th Cir. 1979) (quoting H.R. Doc. No. 19, 73d Cong., 1st Sess. 1618, 1702 (1933)).

433. *Hearings on Home Owners' Loan Act of 1933, H.R. 4980, Before the House Comm. on Banking and Currency*, 73d Cong., 1st Sess. 23-24 (Apr. 20, 1933); *Hearings on Home Owners' Loan Act of 1933, S. 1317, Before a Subcommittee of the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess. 11-12 (Apr. 20, 1933). *See also* 11 PAC. L.J. 1085 (1980).

434. *See* Dunn & Nowinski, *supra* note 30.

435. 505 F. Supp. at 1010.

436. A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6, at 205, 229. Under the statutes or case laws of some jurisdictions, collection of deficiency judgments may be restricted or illegal. *Subcommittee Report, supra* note 30, at 918.

Building & Development Co.[437] emphasized the fact that the mortgage was non-recourse: "The note and mortgage limited plaintiff's recourse to the land itself; the principals were under no personal obligation to plaintiff. Since the transfer was made subject to plaintiffs mortgage . . . there existed no possibility that its security interest . . . would be compromised thereby."[438] It has been suggested that the converse actually may be true—the credit worthiness of the borrower is of greater significance in non-recourse financing than in many instances where personal liability exists.[439] The underwriting of a non-recourse loan may be justified upon the security itself; however, the borrower's experience and managerial ability are even more crucial in such loan approvals.[440] If such is the case, transfer could pose a substantial threat to the lender's position.

J. *Prepayment Clauses—"Double Risk"*

If the mortgage instrument does not contain a prepayment clause the borrower may be caught in a Catch-22—he can not prepay the debt nor can he sell the property and have the purchaser assume his obligations.[441] This has not proved to be a common problem, however, in that loan instruments often provide the borrower with the right of prepayment.[442] Often the jurisdiction will have a statute providing that it is unlawful to extract prepayment penalties upon acceleration by the lender under a due-on-sale clause.[443] The potential for a problem, nevertheless, remains as

437. 151 N.J. Super. 502, 377 A.2d 691 (1977).

438. *Id.* at _, 377 A.2d at 695.

439. *Subcommittee Report, supra* note 30, at 918.

440. *Id.*

441. Rogers v. Williamsburgh Sav. Bank, 79 Misc. 2d 852, 361 N.Y.S.2d 531 (1974). The lender refused to consent to a transfer subject to the existing mortgage or alternatively that the balance of the principal due be paid upon lender's waiver of the prepayment fee. The court retroactively applied a New York statute which precluded prepayment penalties upon failure of the lender to consent to transfer (mortgage executed October 27, 1971; statute effective May 29, 1972; sale by borrower January, 1974). *See also* Terry v. Born, 24 Wash. App. 652, 604 P.2d 504 (1979); A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6, at 105-12.

442. *See, e.g.*, Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580, 582 (1976).

443. *See, e.g.*, CAL. BUS. & PROF. CODE § 10242.6 (West Cum. Supp. 1981); CONN. GEN. STAT. ANN. § 36-9g(c) (1981); MICH. COMP. LAWS § 438.31(c) (1981); MO. REV. STAT. §

prepayment is frequently restricted in the first few years of the mortgage term or is conditioned upon the payment of a penalty—a percentage of the unpaid balance.[444]

On the other hand, lenders have contended that if the lender is restricted in the exercise of the due-on clause and the mortgage instrument gives the borrower the right to prepay, the lender is exposed to a "double risk."[445] Borrowers can take advantage of a decrease in interest rates by refinancing, while lenders are denied the opportunity to renegotiate upon sale as interest rates climb. This rationale has been attacked by some as unrealistic considering the inherent inertia and lack of sophistication of the average home owner/mortgagor.[446] In *Crockett v. First Federal Savings & Loan Association,*[447] the most frequently cited authority for the "double risk," the lender sought to increase the interest rate from 7 to 9¾%. Given the recent 20% interest rates, arguments citing *Crockett* as precedent have a particularly hollow ring in equity and are not likely to be the key factor in current disputes.[448]

K. *Unimproved Land*

Courts continue to be influenced by the nature of the security.[449] Although the fact that the security was unimproved land has not been seen as the key factor in any due-on decision, it nevertheless has received considerable attention.[450] There is a reduced risk of waste when the land is unimproved, and it seems somewhat un-

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408.036 (Cum. Supp. 1981); N.J. STAT. ANN. § 46:10B-2 (1979); N.Y. REAL PROP. LAW § 254-a (McKinney's Supp. 1981); OHIO REV. CODE ANN. § 1321.58 (1981); VA. CODE ANN. § 6.1-330.27:1 (Repl. Vol. 1979).

444. A. AXELROD, C. BERGER & Q. JOHNSTONE, *supra* note 6, at 110.

445. *See* O'Connell, *supra* note 15, at 938, 944.

446. *Id.* at 944.

447. 289 N.C. 620, 224 S.E.2d 580 (1976).

448. In the Amicus Curiae brief filed on behalf of Virginia Savings and Loan League in *Lipps v. First Am. Serv. Corp.*, which is now on appeal before the Supreme Court of Virginia, the court is asked to adopt the "double risk" rationale of *Crockett.*

449. *See* Guild Wineries & Distilleries v. Land Dynamics, 103 Cal. App. 3d 968, _, 163 Cal. Rptr. 348, 354 (1980), where the court found circumstances to establish that there was no unreasonable restraint on alienation: "[T]he wine cooperage which is the major asset securing the debt is in its nature subject to removal and to deterioration if it is misused or neglected."

450. *See, e.g.*, Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 293 N.W.2d 843 (1980).

realistic to expect a borrower to maintain the land in an unimproved urban state to the end of the term of the standard mortgage.[451]

L. *Antitrust*

Lending institutions which originate mortgage loans for subsequent resale to the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation are required to use uniform mortgage documents and follow standards prescribed by these institutions.[452] Even state chartered associations are intimately related to the FNMA, FHLMC and FHLBB, as certain re-

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451. *See* Fidelity Land Dev. Corp. v. Rieder & Sons Bldg. & Dev. Co., 151 N.J. Super. 502, _, 377 A.2d 691, 695 (1977): "The land in question being undeveloped could not be subjected to depreciation for lack of care in maintenance. . . . Plaintiff's recourse to this tract of undeveloped land in satisfaction of defendant's debt remained unimpaired by the transfer. . . ."; Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, _, 293 N.W.2d 843, 846 (1980): "It is not realistic to argue that the owner here intended the mortgage to remain in effect for the entire mortgage term, nor is it realistic to argue that the lender could not reasonably expect the mortgage to be prepaid well in advance of its due date."

452. *See* 12 U.S.C. § 1717 (b)(2) (1976); 12 U.S.C. §§ 1451 *et. seq.* (1976). Neither Fannie Mae (FNMA) nor Freddie Mac (FHLMC) will purchase a conventional mortgage originated after January 1, 1976 unless the Uniform Mortgage Instrument form is used. U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, SURVEY OF MORTGAGE LENDING ACTIVITY, Rpt. No. 80-298 (1980).

> The Federal National Mortgage Association, . . . Fannie Mae, as the corporation is often called . . . a private corporation owned by its shareholders . . . is the largest single provider of funds for housing in the United States. Approximately 3,500 lenders across the country—mainly mortgage companies, savings and loan associations, commercial banks, and credit unions—are approved to sell mortgages to Fannie Mae.

FEDERAL NATIONAL MORTGAGE ASSOCIATION, FANNIE MAE, AMERICA'S MORTGAGE RESOURCE Pub. 64 (Aug. 1980).

Substantially all of the $22.4 billion in conventional mortgages which have been purchased by the FHLMC were originated using the FNMA/FHLMC standard instruments. Similarly, substantially all of the $16.2 billion in conventional mortgages owned by the FNMA as of December 31, 1979 were originated on the FNMA/FHLMC instruments. FHLMC estimates that approximately 80% of all conventional mortgages currently being originated are originated on the FNMA/FHLMC instruments. Conventional single family mortgage originations by savings and loan associations for the first six months of 1980 alone aggregated $21.7 billion. U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, SURVEY OF MORTGAGE LENDING ACTIVITY, Rpt. No. 80-298 (1980). *See also* Consolidated Farmers Mut. Ins. Co. v. Anchor Sav. Ass'n, 480 F. Supp. 640 (D. Kan. 1979) (FNMA and FHLMC required standards that hazard insurance be provided by a company with at least a class VI rating in BEST'S INSURANCE REPORTS as condition for acceptance of mortgages). FNMA requires a "call" provision in lieu of a due-on-sale clause in 17 states.

quirements are placed on any lender intending to participate in the secondary mortgage market operated by these institutions.[453]

The required use of uniform contractual documents and the operational regulations imposed on lenders operating in the secondary market may constitute concerted action to restrain trade in violation of federal and state antitrust laws.[454] Although it is certain that these regulations have the effect of forcing uniformity, the few challenges to regulations prescribed by FNMA and FHLMC have enjoyed little success in the courts.[455] The primary obstacle to the success of such a challenge has been proving the required concerted action on the part of the lenders.[456] Rather, the uniform regulations have forced the uniform activity. FHLMC has plead successfully statutory immunity while other defendants have espoused statutory exemption.[457] The Virginia antitrust act, for example, excludes conduct by certain administrative agencies, state or federal.[458] The propriety of exempting FNMA under such a statute could possibly be challenged since FNMA operates as a private

453. *See* Williams v. First Fed. Sav. & Loan Ass'n, 500 F. Supp. 307, 308 (E.D. Va. 1980) (state chartered savings and loan association subject to court's jurisdiction by virtue of its "membership in the Federal Home Loan Bank, the insurance of its accounts by the Federal Savings and Loan Insurance Corporation, and its eligibility to sell residential mortgages to the FHLMC."). *See also* Consolidated Farmers Mut. Ins. Co. v. Anchor Sav. Ass'n, 480 F. Supp. 640, 644 (D. Kan. 1979).

454. *See* Williams v. First Fed. Sav. & Loan Ass'n, 651 F. 2d 910 (4th Cir. 1981); Consolidated Farmers Mut. Ins. Co. v. Anchor Sav. Ass'n, 480 F. Supp. 640 (D. Kan. 1979) (antitrust action brought under Sherman Act, 15 U.S.C. §§ 1 & 2 (1976) challenging FNMA's and FHLMC's requirements for hazard insurance on secured properties as condition for acceptances of mortgages). The Sherman Act, 15 U.S.C. § 1 (1976) reads, in pertinent part: "Every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal. . . ."

455. *See* notes 454 *supra* and 459 *infra.*

456. 480 F. Supp. at 648: "In order to prevail on a § 1 [15 U.S.C.] claim a plaintiff must show (1) concerted action, and (2) an unreasonable restraint of trade."

457. *Id.* at 644.

458. VA. CODE ANN. § 59.1-9.4(b) (Cum. Supp. 1981) provides:

> Nothing contained in this chapter shall make unlawful conduct that is authorized, regulated or approved (1) by a state, or (2) by an administrative or constitutionally established agency of this State or of the United States having jurisdiction of the subject matter and having authority to consider the anticompetitive [*sic*] effect, if any, of such conduct. Nothing in this paragraph shall be construed to alter or terminate any other applicable limitation, exemption or exclusion.

corporation through the sale of stock in the private sector.[459] The antitrust challenge has not been extensively explored in any due-on-sale case to date and remains subject to development.

VI. CONCLUSION

As variable rate mortgages and other alternative mortgage devices gain popularity, some of the tension between lender, borrower and purchaser will subside.[460] However, these new financing devices will not eliminate the problems posed by due-on clauses. First, the problem of the fixed-rate mortgages executed prior to the advent of the variable rate mortgage will have to be addressed. It will take years before lenders are able to completely shift their portfolios. Secondly, the typical homebuyer is fearful of these new complicated financing techniques. As a result, the young couple buying a home borrows substantially all of the purchase price.[461] Their purpose is not investment, but the acquisition of a residence. They like the idea of "knowing" what their monthly payments are

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459. In *Williams*, the Fourth Circuit noted that a state-chartered lender was "intimately related to activities of FNMA, FHLMC and the FHLBB," and concluded that the lender's conduct in use of the due-on-sale clause was exempt as FHLMC had authority to address the anti-competitive effect of due-on-sale clauses. 651 F.2d at 930. The antitrust action in *Williams* was brought under the Virginia antitrust law, which mirrors the federal act. *See* VA. CODE ANN. § 59.1-9.5 (Cum. Supp. 1981), which makes unlawful "[e]very contract, combination or conspiracy in restraint of trade or commerce. . . ."

The Fourth Circuit rejected the borrower's contention that VA. CODE ANN. § 6.1-330.34, which calls for prominent display of a notice of the presence of a due-on-sale clause in the mortgage, is not an approval of the clause: "[T]he manifestly broader coverage of 'authorized, regulated *or* approved' suffices to insulate due-on clauses from the Virginia antitrust law, at any rate when considered solely in and of themselves and not in connection with other activities." 651 F.2d at 931. The Fourth Circuit also found: "In the first place, there is no evidence of any kind to suggest that adoption of the due-on-sale clause by the lenders to the Potes [borrowers in one of the four consolidated cases in the *Williams* opinion] proceeded from a conspiracy or other combination." *Id.* at 924.

460. The term "adjustable-rate mortgage" is used broadly to describe all of several types of variable interest rate mortgages. Fannie Mae has approved eight basic types as of Aug. 7, 1981. Washington Post, June 26, 1981, at Al, col. 1. The types differ in the manner in which the increase in debt service due to the interest rate increase is to be paid, the time period over which adjustments are to be made, and the index used to reflect the change in interest rate. *See* Browne, *Alternate Mortgage Instruments,* MORTGAGES AND ALTERNATE MORTGAGE INSTRUMENTS 437 (PLI Feb. - Apr. 1981).

461. Because of leverage, the seasoned investor also ordinarily wants to borrow as much as possible. *See* A. AXELROD, C. BERGER, & Q. JOHNSTONE, *supra* note 6, at 275-329 (tax considerations of the transaction).

and what they are going to be.[462] Conventional fixed-rate mortgages provide them with their only real foothold against the tide of runaway inflation.

Yet, lenders can not be expected to do business as usual. Lenders must have a means of maintaining a positive point spread between monies loaned and monies deposited or borrowed.

Drafting the security instrument in a manner which would clearly advise the mortgagor of the conditions for exercising the clause would alleviate much of the problem in future loans. With existing mortgages the courts will be asked to strike a balance between restraint on alienation and the freedom to contract. Continued controversy over the issue of federal preemption is certain.

There are no quick solutions on the horizon.[463] For the present, the economic triangle of lender, borrower and purchaser will pass their sour marriage before the court.

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462. *See* notes 6 & 460 *supra*.

463. Even if legislation were passed, the problem of applying it retroactively to pre-existing mortgages remains. *But see* Rogers v. Williamsburgh Sav. Bank, 79 Misc. 2d 852, 361 N.Y.S.2d 531 (1974).

ADDENDUM

At the heart of much of the discussion in this article has been the question of whether the acceleration of the maturity of a loan by a lender on transfer of the security, absent a showing of impairment to the security, constitutes an unreasonable restraint on alienation. Just before the presses were scheduled to roll on this issue of the *University of Richmond Law Review*, the Supreme Court of Virginia answered no. The purpose in this limited space is not to criticize the two decisions in which the court reached this conclusion,[1] although criticism surely and justly will come. The goal here is to update this article's earlier discussion of Virginia law.[2] Since the facts and arguments of counsel of the two cases involved are comprehensively detailed in that earlier section, the present discussion will be devoted principally to explaining or reconciling the decisions of *Lipps v. First American Service Corp.*[3] and *United Virginia Bank v. Best*[4] with the conclusions in this article.

Albert and Judith Lipps borrowed $31,500 from First American Savings and Loan with interest at the rate of 9½% per annum. They executed a deed of trust to secure the loan. The deed of trust document was the standard FNMA/FHLMC uniform mortgage document containing paragraph number 17,[5] which reads as follows: "If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent . . . Lender may, at Lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable."[6] Mr. and Mrs. Lipps entered into a land contract with Sandmar Associates, Inc., as purchaser. A general warranty deed was placed in escrow until payment was made by the purchaser of the remaining balance of $30,986.97 due on the note. Upon learning of the land contract, the lender demanded that purchaser pay a

1. Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982); United Va. Bank v. Best, No. 790777 (Va. Sup. Ct. Jan. 22, 1982).

2. *See* text accompanying notes 209-76 *supra*.

3. Opinion, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982).

4. Opinion, United Va. Bank v. Best, No. 790777 (Va. Sup. Ct. Jan. 22, 1982).

5. *See* note 24 *supra*. *See also* text accompanying notes 333-61 *supra*.

6. Opinion at 1, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982). *See* note 24 *supra*.

2% assumption fee and allow the interest rate to be increased to 13¼%. When the purchaser refused the lender's demand, the lender began foreclosure proceedings.

In the *Lipps* decision, the court faced three questions: Does paragraph 17 of the FNMA/FHLMC uniform mortgage instrument constitute an invalid restraint on alienation? Is impairment to the lender's security a condition to enforcement of the due-on-sale provision of paragraph 17?[7] Does transfer of the security by land contract constitute a transfer under the provision of the due-on-sale clause?[8] The court resolved all three questions in favor of the lender.

The court began by determining when a restraint such as a restraint on alienation will be a reasonable one and defined the "reasonableness" of restraint in the context of *Hercules Powder Co. v. Continental Can Co.*:[9]

> The reasonableness of a restraint on the use of property "is to be determined by considering whether it is such only as to afford a fair protection to the interest of the party in favor of whom it is given, and not so large as to interfere with the interest of the public."[10]

After an analysis of the language of paragraph 17, the court concluded "that enforcement of the covenant does not defeat or forfeit the estate conveyed. The transaction does not affect the quantity or quality of the conveyance between Borrowers and Purchaser. Its effect is confined to the acceleration of the due date of the indebtedness."[11]

In support of its conclusion that paragraph 17 is not an unreasonable restraint, the court viewed paragraph 17 as "sanctioned as part of the public policy of the Commonwealth" and validated by the law of Virginia.[12] In reaching this result the court quoted *Wal-*

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7. *See* text accompanying notes 344-75 *supra*.
8. *See* text accompanying notes 277-332 *supra*.
9. 196 Va. 935, 86 S.E.2d 128 (1955).
10. Opinion at 3, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982) (quoting Hercules Powder Co. v. Continental Can Co., 196 Va. 935, 940, 86 S.E.2d 128, 131 (1955)).
11. Opinion at 4, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982).
12. *Id.* at 6.

lihan v. Hughes:[13]

> The law looks with favor upon the making of contracts between competent parties upon valid consideration and for lawful purposes. Public policy has its place in the law of contracts,—yet that will-o'-the-wisp of the law varies and changes with the interests, habits, need, sentiments and fashions of the day, and courts are averse to holding contracts unenforceable on the ground of public policy unless their illegality is clear and certain.[14]

Section 55-59 of the Virginia Code[15] was deemed by the court to require that a general acceleration clause is to be read into every deed of trust in Virginia and that the clause may be triggered upon "the breach of any of the covenants entered into or imposed upon the grantor . . . ."[16] Additionally the court reviewed the legislative history of section 6.1-330.34 of the Virginia Code,[17] wherein the "General Assembly, instead of prohibiting acceleration upon sale or transfer,"[18] chose rather to provide for notice if a deed of trust is to contain such a clause. Citing *Williams v. First Federal Savings & Loan,*[19] the court unfortunately concluded that if the due-on-sale provision is "a restraint on alienation, it is one validated by Virginia law as an inescapable conclusion from this statutory enactment."[20]

The second issue in the *Lipps* case—whether impairment of the lender's security is a condition to enforcement of the due-on-sale clause—was dismissed by the court in a single paragraph. In rejecting borrowers' and purchasers' contention that a condition to the above effect must be implied into the clause, the court cited *White v. Commonwealth*[21] and *Stonega Coke & Coal Co. v. Louis-*

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13. 196 Va. 117, 82 S.E.2d 553 (1954).

14. Opinion at 5, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982) (quoting Wallihan v. Hughes, 196 Va. 117, 125, 82 S.E.2d 553, 558 (1954)).

15. VA. CODE ANN. § 55-59 (Repl. Vol. 1981).

16. Opinion at 5, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982) (quoting VA. CODE ANN. § 55-59 (Repl. Vol. 1981)).

17. VA. CODE ANN. § 6.1-330.34 (Repl. Vol. 1979).

18. Opinion at 6, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982).

19. 651 F.2d 910, 923-34 (4th Cir. 1981). *See* text accompanying notes 209-76 *supra*.

20. Opinion at 6, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982).

21. 158 Va. 749, 164 S.E. 375 (1932).

ville & N.R.R.:[22]

> While the court, in construing a contract, may take into view the circumstances under which it was made, yet when a breach of it is averred its language must determine to what the parties to it bound themselves. Courts are not authorized to make contracts for them or to add to any stipulation which they have not seen proper to insert.[23]

In deciding the final issue of the case, whether a land contract constitutes a transfer so as to trigger the due-on-sale clause, the court considered the equitable interest transferred to the purchaser under the doctrine of equitable conversion as sufficient to activate paragraph 17.[24] The federal issues[25] were not discussed, as the court believed it was unnecessary since the validity of paragraph 17 was established under state law.[26]

In the companion case of *United Virginia Bank v. Best*,[27] the court reversed the circuit court which had found that the due-on-sale provision in the deed of trust constituted an unreasonable restraint on alienation absent a showing that enforcement was necessary to protect the lender's security interest. Edward and Anna Firth borrowed $66,800 from United Virginia Bank in August, 1972, and executed a deed of trust to secure this amount to the bank. In March, 1978, Stephen and Letty Best signed a contract to purchase the secured property. Upon notice to the bank of the intended sale, the bank demanded a 1% assumption fee and an increase in the interest rate of 1¾%. The Bests refused the bank's demand, and the property was transferred to the purchasers by

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22. 106 Va. 223, 55 S.E. 551 (1906).

23. Opinion at 6, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982) (quoting Stonega Coke & Coal Co. v. Louisville & N.R.R., 106 Va. 223, 226-27, 55 S.E. 551, 552 (1906)).

24. Opinion at 7, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982) (quoting Sale v. Swann, 138 Va. 198, 208, 120 S.E. 870, 873 (1924)).

25. *See* text accompanying notes 384-435 *supra*. By sidestepping the federal issues, the court has avoided a troublesome quagmire, but it has also swept away any possible antitrust challenges similar to those which were successful in Goldfarb v. Virginia State Bar Ass'n, 421 U.S. 773 (1975).

26. Opinion at 7-8, Lipps v. First Am. Serv. Corp., No. 800908 (Va. Sup. Ct. Jan. 22, 1982).

27. United Va. Bank v. Best, No. 790777 (Va. Sup. Ct. Jan. 22, 1982).

deed. The lender then notified the Firths that it was accelerating the note.

The provisions of the deed of trust differed from those of the federal boilerplate deed of trust involved in the *Lipps* decision. The deed of trust in *Best* contained the language:

> And the said parties of the first part, *in order more fully to protect the security of this Deed of Trust*, do hereby agree as follows:
>
> . . . .
>
> 7. The maker of the note covenants and agrees that he will not assign or transfer the property secured by this deed of trust without prior approval of the noteholder.[28]

The Supreme Court of Virginia construed the phrase, "in order more fully to protect the security of this Deed of Trust," as a prefatory clause "a preamble, a recital, or a purpose clause."[29] As such the court concluded that if a prefatory clause conflicts with the obligatory provisions of the contract, the obligatory provisions prevail.[30]

The court expressed its concern that if the clause were construed as requiring impairment of security before a lender could exercise acceleration, lenders would be compelled to show that its risk in the obligation had increased on a case by case basis.[31]

> [B]efore a lender could avail itself of the use of the acceleration clause, it would be compelled to show that its security had been impaired or its risk in the obligation increased. If this were true, lenders in each and every case, as a practical matter, would have to resort to litigation to activate an acceleration clause because impairment of security or increase of risk would entail factual-value judgments which only a court could provide. We do not believe this result was contemplated in the execution of the deed of trust.[32]

28. Opinion at 1, United Va. Bank v. Best, No. 790777 (Va. Sup. Ct. Jan. 22, 1982) (emphasis added by the court).
29. *Id.* at 3.
30. *Id.*
31. *Id.* at 2-3.
32. *Id.* at 3. *But see* Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975) and text accompanying notes 305-32 *supra*.

The conclusions reached by the Virginia Supreme Court in these two brief but sweeping decisions clearly and unequivocally place the Commonwealth in the pro-lender column. In refusing to distinguish the two cases on their facts and in refusing to consider the quantum of restraint as weighed against the purpose for acceleration, the court has adopted for Virginia a blanket endorsement for the enforcement of the due-on-sale clause.

Just given the *Lipps* opinion, one could have argued that the court approached the security documents with an eye toward strict interpretation by refusing to read into the deed of trust in *Lipps* the necessity for showing impairment to security as a condition for enforcement. Yet, by sweeping aside the statement of purpose clause in the deed of trust in *Best* upon the premise that it was a prefatory clause conflicting with an obligatory provision, the court ignored another equally well-founded principle of contract law—that the document should be construed based on the parties' intention as ascertained from the four corners of the document.[33]

In failing to consider the possible inequity of the situation (the unequal bargaining positions and relative ignorance of the residential borrower;[34] the severity of restraint in a land contract sale;[35] and the possible penalty or unconscionability issues[36]), the court has opened the door to the exercise of the clause in a host of other lender-consumer conflicts. If the court genuinely believes, as it states, that *any* transfer of a legal or an equitable interest permits acceleration by the lender, homeowners have a number of situations to fear:

(1) leasing an above-garage apartment or taking in a boarder;[37]
(2) adding a sun porch or room to the house and executing a second mortgage;[38]
(3) the widening of a street by the city in front of the house which results in the conveyance of a one foot strip of land relative

33. *See, e.g.,* Camp v. Camp, 220 Va. 595, 260 S.E.2d 243 (1979).

34. *See* text accompanying notes 362-75 and 381-83 *supra. See also* Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981).

35. *See* text accompanying notes 333-61 *supra.*

36. *See* text accompanying notes 362-75 and 441-48 *supra.*

37. *See* text accompanying notes 277-304 *supra.*

38. *Id. See, e.g.,* La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

to eminent domain action;[39]

(4) executing a deed to VEPCO, a telephone company, or a cable television company which requires an easement across the secured property;[40]

(5) taking an extended summer vacation and leasing the home for that time.[41]

Because of the court's sweeping endorsement of the due-on-sale clause in *Lipps* and *Best,* the court can be expected to perceive these transactions as transfers and to favor a lender's acceleration. At the very best, its sweeping endorsement of the clause may be enough to deter further challenge by consumers. The court never mentioned the need for portfolio adjustment by the lender in its opinions, but under the court's blanket endorsement of the due-on-sale clause the lender need not give any justification for enforcement. To those who would describe the above discussion as a reduction to the absurd, recall that a few years ago lenders chose not to exercise due-on-sale clauses even in an outright sale.

Because of the court's reliance upon section 6.1-330.34 of the Virginia Code for support of its endorsement of the due-on-sale clause, one might anticipate a revival of legislation similar to House Bill 601 of the 1974 General Assembly.[42] The presence of the strong banking lobby makes such a result seem doubtful. The court gave no significance to the retroactivity of current legislation to those mortgages executed before its effective date. Borrowers who executed deeds of trust in an era when lenders chose not to exercise the clause may find their intent altered by this current judicial and legislative endorsement of the clause.

The final chapter of this conflict, however, has not been written. The Supreme Court of the United States recently granted certiorari to hear the federal preemption and jurisdiction issues.[43] For

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39. Involuntary conveyance has also been claimed by lenders to activate the clause. *See, e.g.,* Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 244, 152 Cal. Rptr. 572 (1979). *See also* text accompanying notes 227-304 *supra.*

40. *See* text accompanying notes 227-304 *supra.*

41. *Id.*

42. *See* text accompanying note 260 *supra.*

43. Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), *cert. granted,* 50 U.S.L.W. 3585 (U.S. Jan. 26, 1982) (No. 81-750).

The questions presented to the United States Supreme Court are the following: (1) Is the

the present, lenders in Virginia, like those in Nebraska after the

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state law of California, which prohibits the enforcement of due-on-sale clauses as unreasonable restraints on alienation, preempted by the Home Owners' Loan Act of 1933 and Federal Home Loan Bank Board regulations promulgated thereunder? (*See* text accompanying notes 384-435 *supra*.) (2) Does the "law of jurisdiction" clause (*see* paragraph 15 of the FNMA/FHLMC uniform mortgage instrument at note 421 *supra* and text accompanying notes 384-88 *supra*) in the mortgage loan contract prevent Federal Home Loan Bank Board regulations from governing due-on-sale practices of federal savings and loan associations? An equally intriguing issue is whether a state chartered association is subject to federal jurisdiction by virtue of its membership in the Federal Home Loan Bank, the insurance of its accounts by the Federal Savings and Loan Insurance Corporation, and its eligibility to sell residential mortgages to FHLMC. *See, e.g.*, Williams v. First Fed. Sav. & Loan Ass'n, 500 F. Supp. 307 (E.D. Va. 1980).

In the *de la Cuesta* decision three cases were consolidated by the trial court. Purchasers of property encumbered by deeds of trust in the three cases—*de la Cuesta, Moore* and *Whitcombe*—each brought actions for declaratory and injuntive relief against a federally chartered savings and loan association against the threatened foreclosure following the purported exercise of the deed of trust's due-on-sale clause. The trial court granted the defendant savings and loan association's motion for summary judgment on the ground that application of state law was precluded by federal preemption. The Fourth District Court of Appeal of California reversed in each of the three cases. After a comprehensive discussion of the various methods in which federal preemption arises, the court deemed state law to control and as such enforcement of the due-on-sale clause was barred as an unreasonable restraint on alienation. In the *Moore* and *Whitcombe* cases the deeds of trust were the standard FNMA/FHLMC uniform mortgage instrument which contained in paragraph 15: "[This form of deed of trust combines uniform covenants for national use and non-uniform covenants with limited variations *by jurisdiction* . . . .] *This Deed of Trust shall be governed by the law of the jurisdiction in which the Property is located.*" (175 Cal. Rptr. at 475) (emphasis added by the court). In the *de la Cuesta* case the deed of trust instrument was executed many years prior to FHLBB's promulgation of its due-on-sale regulation of June 8, 1976. *See* text accompanying notes 384-435 *supra*. Further, the deed of trust secured alleged commercial property. Although the provisions of paragraph 15 (the FNMA/FHLMC uniform mortgage instrument as modified for use in California) were not present in the *de la Cuesta* deed of trust as they were in the *Moore* and *Whitcombe* deeds of trust, the court concluded that application of state law was not preempted and denied enforcement of the due-on-sale clause:

> We recognize that the deed of trust here involved does not contain a provision such as that found in the other two deeds of trust to the effect that it shall be governed by the law of the jurisdiction in which the property is situated. However, our conclusion in the *Moore* case was not based so much on an agreement between the parties for the application of state law as on the conclusion that the general use of a provision containing such language by federal savings and loan associations with the approval of the Board persuasively evidences a recognition by the Board and federal savings and loan associations that state law would govern the interpretation, validity and enforcement of security instruments. Thus, the absence of the special provision in the particular trust deed, here, is of no great significance to our resolution of the preemption issue.

175 Cal. Rptr. at 477.

The court further was unmoved by the savings and loan association's claim that the com-

Occidental[44] decision, have much cause to rejoice for this wholesale victory.

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mercial nature of the secured property prompted a different result. The court accordingly forbade the exercise of the due-on-sale clauses in the absence of any threat of impairment to the security or any increased risk of default.

44. Occidental Sav. & Loan Ass'n v. Venco, 206 Neb. 469, 293 N.W.2d 843 (1980). *See* text accompanying notes 164-66 *supra*.