The Due-on-Sale Mortgage Clause as a Method of Reconciling the Competing Interests of Lender and Borrower

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Recommended Citation

Brenda D. Crocker, The Due-on-Sale Mortgage Clause as a Method of Reconciling the Competing Interests of Lender and Borrower, 84 W. Va. L. Rev. (1982).

Available at: https://researchrepository.wvu.edu/wvlr/vol84/iss2/4
THE "DUE-ON-SALE" MORTGAGE CLAUSE AS A METHOD OF RECONCILING THE COMPETING INTERESTS OF LENDER AND BORROWER

BRENDA D. CROCKER*

I. INTRODUCTION

Mortgage law long has been conservative, steeped in the common law and the traditions of the business world. Since 1976, however, significant changes have emerged in judicial treatment of due-on-sale clauses and the acceleration of mortgage debt. Outlined by a trilogy of recent court decisions, the emerging theory supports the due-on-sale clauses as a reasonable business device, and seeks to restore socio-economic balance within the residential mortgage industry. In tandem, these decisions present a rational alternative to the demise of the savings and loan industry.

A. The Trilogy

In February of 1968, First Federal Savings and Loan Association of Charlotte, North Carolina, became the holder of an $80,000 promissory note at seven percent.¹ The note was secured by a deed of trust on three apartment buildings and contained a standard due-on-sale acceleration clause.² In October of 1978 the debtor sold the property to Elizabeth Crockett, who arranged with First Federal to assume the seven percent loan. Eleven years later, Ms. Crockett arranged to sell the property to Mr. and Mrs. Proctor, pending First Federal's consent to their assumption of the loan at seven percent. When First

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² Id. at 621-22, 224 S.E.2d at 582. The due-on-sale clause provided in pertinent part:

[If the property herein conveyed is transferred without the written assent of Association, then in all or any of said events the full principal sum with all unpaid interest thereon shall at the option of Association, its successors or assigns, become at once due and payable without further notice and irrespective of the date of maturity expressed in said note. . . .]
Federal conditioned its consent on the Proctors' agreement to pay the current market rate of nine and three-quarters percent, Ms. Crockett and the Proctors brought suit to restrain First Federal from accelerating the debt and sale of the property. The trial court found for the mortgagor and denied First Federal exercise of the agreed upon provision. In the landmark decision of Crockett v. First Federal Savings & Loan Association, the North Carolina Supreme Court reversed the trial court and set forth the rational modern approach to lender acceleration pursuant to a due-on-sale clause.

The Crockett court addressed each of the major substantive theories on which American courts have relied when confronted with a similar fact pattern. The breadth of its conclusions set North Carolina as a leader in mortgage lending theory and established what has become the national trend. Most importantly, the court held that a standard due-on-sale clause is not a direct restraint on alienation. The court reasoned that such a clause neither prevents the mortgagor from transferring the property nor demands forfeiture upon the attempt. The mortgagor is free to sell whenever he locates a buyer to his liking. Moreover, even if the clause were construed as an indirect restraint, it must be considered reasonable and thereby valid in comparison to the traditionally approved indirect restraints having greater practical effect on alienability.

As a second reason for its decision, the court applied equity theory and held that a mortgagor's unconsented to transfer justifies acceleration even where the mortgagee's sole purpose is to exact an increase in the loan rate. In view of escalating in-

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3 Id. at 632, 224 S.E.2d at 588.
4 Id. at 624-25, 224 S.E.2d at 584.
5 Id. at 625, 224 S.E.2d at 584.
6 The Crockett court found that the "practical effect" of a due-on-sale clause may be to hinder or indirectly restrain alienation. Id. at 625, 224 S.E.2d at 584. The court adopted the definition of indirect restraints contained in L. SIMES & A. SMITH, THE LAW OF FUTURE INTERESTS § 1112 (2d ed. 1956):
   "An indirect restraint on alienation arises when an attempt is made to accomplish some purpose other than the restraint of alienability, but with the incidental result that the instrument, if valid, would restrain practical alienability."
   Although the court failed to make a specific finding whether the due-on-sale clause at issue was an indirect restraint, its result may indicate that it considered the clause not to be an indirect restraint. See text accompanying note 67 infra.
7 289 N.C. at 628-31, 224 S.E.2d at 586-87.
8 Id. at 629-30, 224 S.E.2d at 586-87.
flation, such action constitutes a valid business purpose rather than a penalty. Furthermore, since the mortgagor has the advantage of prepaying the loan when interest rates fall below his loan rate, equity should spread the risks by providing the mortgagee the counterbalancing right to increase the rate when the current market rate rises. Adding contract theory, the court stated that the due-on-sale clause is a bargained-for provision within a contract between parties of equal bargaining power. Absent proof of inequitable conduct, a court must refuse to rewrite the agreement.

The Crockett court disagreed with those state courts which consider acceleration to maintain a current portfolio inequitable conduct, and which further require the mortgagee to show impairment of his security to justify acceleration. Instead, the Crockett court stated, a request for repayment of funds lent to a mortgagor to finance the purchase of property is the exercise of an express contractual right pursuant to a valid business purpose. Because acceleration is not expressly conditioned upon proof of impairment, and occurs only as a result of the mortgagor's conduct, the court held proof of impairment unreasonably burdensome.

Expanding on these views in Occidental Savings & Loan Association v. Venco Partnership, the Nebraska Supreme Court held that the standard due-on-sale clause is neither a direct nor

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9 See id. at 630, 224 S.E.2d at 587.
10 Id. at 627, 224 S.E.2d at 585. The court also stated that in absence of a due-on-sale clause, a mortgagor would receive a "fortuitous" premium from the sale of his realty and the favorable assumption of his outstanding loan. The court suggested that the due-on-sale clause, on the other hand, allows the mortgagor to receive the fair market value of his property, but no more. Id. For discussion on this point by the Fourth Circuit Court of Appeals, see text accompanying notes 20-30 infra.
11 Id. at 626-27, 224 S.E.2d at 585.
12 See id. at 626, 224 S.E.2d at 585.
13 Id. at 629-30, 224 S.E.2d at 587.
14 Id. at 626-27, 224 S.E.2d at 585.
15 See id. at 630, 224 S.E.2d at 587. The court rejected the argument that the impairment requirement of U.C.C. § 1-208 provides a standard for the enforcement of due-on-sale clauses. The court distinguished "insecurity clauses" subject to § 1-208 from "default-type" clauses such as the due-on-sale clause at issue. Id. at 631, 224 S.E.2d at 588; see U.C.C. § 1-208. The court noted that the right to accelerate in a due-on-sale clause is conditioned upon conduct within the control of the debtor, eliminating the need for imposing a good faith standard on the lender. Id. at 631, 224 S.E.2d at 588.
an indirect restraint on alienation. The court acknowledged that lenders use the clause as "the main vehicle for increasing interest rates when money is scarce" and made two arguments in its favor. Under the standard clause the terms plainly warn the mortgagor that he has no right to transfer his loan rate with the property. More importantly, however, public policy considerations which favor lender solvency and disfavor judicial eradication of contractual obligations demand that the court allow lending institutions to upgrade their portfolios.

Completing the trilogy in May of 1981, the United States Court of Appeals for the Fourth Circuit explored the economic implications of escalation in Williams v. First Federal Savings & Loan Association. Essentially, the court held that the mortgagor's use of a standard due-on-sale clause does not constitute a restraint on alienation and that his exercise of the clause upon unconsented to transfer constitutes reasonable business practice.

The facts, as stated by the court, reveal that in 1977 the Baileys purchased a home with a $55,000 thirty-year mortgage at ten percent. The loan was secured by a first deed of trust with a standard due-on-sale clause, which First Federal sought to exercise upon unconsented to transfer of the property in 1979. Judge Murnaghan, writing for the court, stated that the interest rate at the time of transfer was approximately fifteen percent. Judge Murnaghan reasoned that to allow assumption at ten percent would be to provide the mortgagor with "a distinct economic value," since [he] would be able to realize

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17 Id. at 478, 293 N.W.2d at 848.
16 Id.
15 Id. at 479-82, 293 N.W.2d at 849.
20 651 F.2d 910 (4th Cir. 1981). Three cases were consolidated for trial in the district court. The fourth case presented to the Fourth Circuit was consolidated with Williams on appeal. Id. at 912.
21 Id. at 910.
22 Id. at 913.
23 Id. at 914.
24 Id. at 916. The issue of what constitutes a transfer under the clause, which was presented in this case, exceeds the scope of this article.
25 Id. at 914. Judge Murnaghan further noted that although the face value of the loan was $53,903.63, the actual value was $38,000, a discount of twenty-nine percent. Id.
more from the sale of [the] house than if [he] were forced to comply with the due-on-sale clause." Judge Murnaghan further reasoned that in inflationary times the mortgagor who sells his lower loan rate with his property reaps both his profit from the real estate market and "artificial profit attributable to the decline in value of the . . . loan." Noting further that the mortgagor is not the risk holder in a mortgage transaction, the court refused to condone such a windfall. Moreover, the court determined in Williams that the mortgagee was "entitled to enforce [its] due-on-sale clauses, for they are simply not restraints on alienation." The essence of the court's position was that "[i]t is simply a misperception to eviscerate . . . as a restraint on alienation, a clause that only precludes the homeowner from realizing an additional and unbargained for economic advantage because interest rates have risen since the time when he secured . . . his promise to repay what he borrowed."

B. The Divided Remainder

In the last thirty years similar fact patterns have given rise to a great many judicial decisions. Courts have applied four analytical approaches. These approaches include restraint on alienation theory, contract theory, equity theory, and the preemption doctrine.

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24 Id. at 915.
27 Id. at 915 n.8.
28 Id.
29 Id. at 926. See also n.29, citing with approval Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 293 N.W.2d 843 (1980). The court reasoned that:

the due-on-sale clause does not preclude, forbid, or deter sale of the property free and clear at any time. It concerns instead only the time when the borrower must pay his obligation. It could hardly be seriously contended that, if a loan secured by a deed of trust to provide funds to purchase a house were, from the outset payable on demand, it would amount to an unreasonable restraint of alienation. . . . [Plaintiffs] seek to convert an advantage obtained by them when they first borrowed to buy the house, which there was no legal obligation for the lender to provide, into an even greater advantage.

What . . . [they] argue is that, when they acquired the property, they should have been granted a better deal, allowing full rights to maintain the full 30 year term status of the loan, despite a change in the home ownership.

Id. at 36-37.
30 Id. at 924 n.29.
The majority of courts that have applied restraint theory agree that the due-on-sale clause is not an invalid restraint on alienation if its exercise is reasonable. In many of these jurisdictions, reasonableness turns on whether the mortgagee can show that transfer to a particular buyer impairs the value of his security.\textsuperscript{31}

Courts which apply contract theory agree that the due-on-sale clause is no more than a bargained-for term in a contract, which should not be ignored absent proof of unconscionable or inequitable conduct on the part of the mortgagee. Under the current trend, these courts uphold the mortgagee in his refusal to consent to transfer unless the buyer will agree to pay the prevailing market interest rate. The rationale is that the mortgagor and the mortgagee were the only parties to the contract, and that the mortgagor and a stranger to the contract should not be allowed to profit by a rising interest market at the expense of the mortgagee's solvency. Consequently, the mortgagee can meet his burden by showing both a transfer without consent and a current market rate in excess of the original loan rate.\textsuperscript{32}

Courts which base their decisions on equity theory draw heavily from the reasonableness theory or the contract theory.\textsuperscript{33} Courts using the preemption doctrine, on the other hand, usually refrain from the first three theories. Instead, they find that federal law governing thrift institutions preempts state law; they apply federal regulations which support the mortgagee's exercise of the clause to maintain a current portfolio.\textsuperscript{34}

This article has two purposes. The first is to illustrate the dilemma economic conditions and judicial rigidity pose currently for residential real estate mortgagees. The second is to encourage a judicial approach in keeping with \textit{Crockett, Occidental}, and \textit{Williams}. The ultimate conclusion is that only by reevaluating their historical response to the rights and duties involved in residential mortgages can the courts achieve a rational balance between the interests of the mortgagor and mortgagee.

\textsuperscript{31} See text accompanying notes 65-72 infra.
\textsuperscript{32} See text accompanying notes 187-230 infra.
\textsuperscript{33} See text accompanying notes 231-86 infra.
\textsuperscript{34} \textit{Id.}
II. THE PROBLEM FROM THE PERSPECTIVE OF THE THRIFT INSTITUTION

Thrift institutions have grown in number at an unprecedented rate since World War II.\(^{35}\) During this same period, and especially since the mid-1960's, the American economy has experienced escalating inflation.\(^{36}\) Currently, thrift institutions dominate the residential money market.\(^{37}\) To withstand the enormous pressure of competition and escalating inflation, these institutions have attempted to devise efficient short and long term lending policies. To be efficient these policies must of course promote solvency.

During periods of diminishing or low level inflation, thrift institutions concentrated their policy-making efforts on combating competition within the industry.\(^{38}\) They can afford to offer mortgage packages designed to increase their share of the market for several reasons. The cost of money is low in comparison to the cost in periods of escalating inflation. Investors are attracted to their longer term moderate yield securities. Moreover, loan prepayments tend to increase, since many obligors can obtain money at a rate lower than their original loan rate.\(^{39}\) As a result of these factors, thrift institutions have available a larger number of dollars to invest in the mortgage market.

By contrast, in periods of higher or escalating inflation, thrift institutions generally find themselves locked into the bargain packages they offered when money was cheaper. When the

\(^{35}\) By the end of 1972, there were 5,317 thrift institutions competing in the mortgage money market. See Stafford, 1972 Statistical Report for Savings Associations, 173 SAVINGS AND LOAN ANNALS 250, 251-55 (1974).

\(^{36}\) See Appendix, Chart 1.

\(^{37}\) In 1977, thrift institutions held approximately $383.05 billion in 1-4 member family real estate debt, whereas commercial banks held $105.11 billion and FHA held approximately $11.39 billion. FEDERAL RES. BULL., Chart A41 (May 1980). By the close of 1979, thrift institutions held approximately $473.35 billion, commercial banks approximately $146.07 billion, and FHA approximately $14.88 billion. See generally L. KANDALL, THE SAVINGS AND LOAN BUSINESS (1962).

\(^{38}\) The author wishes to acknowledge the contribution of Mark Sauers, President of the Savings & Loan League, for the compilation of facts appearing in this section, and for the development of some of the ideas appearing herein.

current market interest rates are high, the rate previously
charged for mortgage money, and the effective rate of return on
these mortgage dollars, no longer yields a reasonable profit. Money becomes more expensive. Total deposits drop or increase
at a lower rate, as investors make substantial withdrawals in
search of shorter term high-yield securities. Moreover, because
obligors may be unable to locate funds at a rate lower than that
on their original loan, prepayments tend to decrease.

In the short run, when thrift institutions find fewer dollars
available for mortgage lending, more expensive money and a
large number of mortgage loans outstanding at unfavorable
rates, induce increased interest rates on new mortgage loans.
Given the unpredictability of the economy, and the severe infla-
tion since the mid-1960s, however, these institutions face two
devastating problems. First, they recognize that they can no
longer predict the long term interest rate which will provide a
buffer against double digit inflation. Secondly, they recognize
that increased rates on new business alone will not ensure their
solvency. As a consequence, thrift institutions have been forc-

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42 See Appendix, Chart 1. A comparison between the yield rate on mort-
gages (column 2) and the accompanying rate of inflation in the economy (column 4) reveals the unfavorable impact of progressive inflation on thrift institutions.

44 See Appendix, Charts 1 & 2. Investors first seek high yield, low risk
returns, such as treasury bonds afford. See Financing Real Estate During the In-
flationary 80s, ABA Real Property Section 23. Although the author also suggests
a resulting increase in the corporate bond market, it is more likely that investors
would seek extremely short-term investments, since the value of the fixed
amount of corporate debt in dollars inflated over years would be far short of a
real return, which is return discounted for inflation.

44 See Downs, “Real Interest Rates Short-Change Lenders,” NATIONAL REAL
ESTATE INVESTOR 26 (Oct. 1980). This Brookings Institute study revealed alarming
danger signals for thrift lenders. Assuming self-amortizing loans over twenty-five
years and prepayment at the end of ten years, it found the average contract rate
and real return figures over the last thirty years were as follows:

<table>
<thead>
<tr>
<th>Loans Made</th>
<th>Average Contract Rate</th>
<th>Average Real Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-1959</td>
<td>5.02</td>
<td>3.51</td>
</tr>
<tr>
<td>1960-1969</td>
<td>6.58</td>
<td>2.15</td>
</tr>
<tr>
<td>1970-1975</td>
<td>9.34</td>
<td>1.73</td>
</tr>
</tbody>
</table>

44 See generally, Comment, Use of Due-on Clauses to Gain Collateral
The basic dilemma of the savings association business is an inability to
adjust earnings upward during periods of inflation accompanied by ris-
ing interest rates. . . . quoting United States League of Savings & Loan
Associations, RECOMMENDATIONS OF THE COMMITTEE ON SAVINGS ASSOCIA-
tIONS NEEDS (1970).
ed to come up with long term measures designed to remedy these problems. One important measure to ensure solvency consists in innovative drafting of the terms in writings which embody mortgage rights and obligations.

One such drafting device is the due-on-sale clause. By its plain meaning, this clause allows the mortgagee to require the mortgagor to repay the loan immediately and in full if he fails to make timely payments or if he transfers his interest in the property without the mortgagee's consent. During periods of falling interest rates, conflict over this clause is unlikely. The mortgagor may seek additional funds in an attempt to prepay his debt to the mortgagee. If he tenders prepayment, the mortgagee must absorb the lost interest payments as a risk of doing business. Moreover, if the mortgagor is contemplating sale of his property, his purchaser will seek refinancing at the current market rate.

In periods of escalating inflation, however, this clause gives rise to a severe conflict between the mortgagor and mortgagee. Cognizant that the market rate exceeds the mortgagor's loan rate, the mortgagor and his prospective purchaser frequently seek the mortgagee's approval of a loan assumption at the original mortgage rate. Clearly, if a borrower were able to pass on to a vendee the borrower's low interest rate without interference by the lender, all mortgages would continue at the rate until their original maturity date. The effect of this increased payoff time over the current average actual payoff time of eight to ten years would be to freeze a lender's income at unprofitable levels for twenty to thirty years. Id.

These clauses were used extensively during the Great Depression, but have made their strongest appearance since the early 1960's. Kratovil, A New Dilemma For Thrift Institutions: Judicial Emasculation of the Due-on Sale Clause, 12 J. MAR. J. OF PRAC. & PROC. 299 (1979). They now are common boilerplate in residential mortgage arrangements. See G. OSBORNE, G. HELSON, & D. WHITMAN, REAL ESTATE FINANCE LAW 295 (1979) [hereinafter cited as OSBORNE]. For an example of a standard due-on-sale clause, see note 2 supra.

The mortgagor's loss is equal to the total yield he would have received had the original loan gone to maturity minus the sum of the interest received on the original loan plus the yield on loans made with the prepayment funds invested at the lower current market rate.

Many commentators suggest that the mortgagor obtains the added advantage of being able to obtain a higher selling price for his property when interest rates fall. See, e.g., Dunn, Enforcement of Due-On Transfer Clauses, 13 REAL PROP., PROB. & TR. 891, 926-30 (1978).
ginal loan rate. The mortgagee, seeking to cover costs, often withholds consent to the assumption until the prospective purchaser agrees to pay the current market rate.

If the parties cannot reach an agreement on new terms, the mortgagor must await a willing purchaser, lower his price to compensate for the higher current market rate of interest, or transfer the property without consent. If he elects this third option, the mortgagee will accelerate the debt, demanding that its loan be returned. If the mortgagor cannot repay the loan immediately, the mortgagee will institute foreclosure proceedings.

Since the mid-1960s, mortgagees increasingly have sought foreclosure following a breakdown in negotiations over a loan assumption. Since residential real estate market activity is dependent directly upon mortgage financing, widespread judicial disapproval of the use of due-on-sale clauses to maintain a current

47 In such a transaction the prospective purchaser agrees to assume primary liability on the loan. The original mortgagor becomes secondarily liable. The loan rate does not increase unless increase is a condition of the mortgagee's agreement to the assumption. See Osborne, supra note 44, at 296.

48 See note 49 infra and accompanying text.

49 Alternatively, the mortgagee may demand payment of a transfer or assumption fee. This fee is expressed as a percentage of the loan outstanding. Many states set a limit on the rate mortgagees can charge. See, e.g., Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. at 626, 224 S.E.2d at 585. If the current market rate exceeds the rate on the original loan to the mortgagor by more than the allowable fee percentage, the mortgagee will net a loss. In such cases, the mortgagee's only alternative is to renegotiate the loan at the current rate to avoid a loss. Assume, for example, that a mortgagor obtained a loan in December of 1971 for 7.6% and attempted to transfer the property in March of 1980, when the contract rate was 12.25%. See Appendix, Chart 1. If this prospective purchaser was able to force the mortgagee to agree to an assumption at 7.6%, then the mortgagee could have expected to lose approximately 4.88% (the March 1980 yield rate minus the 1971 yield rate), for 17.95 years (26.2 years, the average maturity of a 1971 loan minus 8.25 years, the period of time that the mortgagor used the funds). Id. See also Occidental & Loan Ass'n v. Venco Partnership, 206 Neb. 469 at 479, 293 N.W.2d 843 at 849.

50 See, e.g., 206 Neb. at 470-71, 292 N.W.2d at 844.


52 Gibbons, The Money Market: A Key to Real Estate Valuation 37 The Real Estate Appraiser No. 5 at 24-29 (Sept.-Oct. 1971) [hereinafter cited as Gibbons].
portfolio must place the mortgagee on one of the two horns of a dilemma. Mortgagees either must increase the rate on all new residential mortgagee loans to cover the losses attendant in maintaining below market assumed loans, or they must operate at a long term loss and a diminished capacity to provide new mortgage dollars. The economic impact of either alternative is a depression in the mortgage money market and a subsequent decrease in housing production. As the following sections suggest, improper judicial application of restraint on alienation theory, or the equitable reasonableness test promotes these results without adequate justification in traditional legal theory or public policy goals. In contrast, application of contract theory is wholly justifiable in legal theory and promotes the public policy objectives of economic growth by aiding lender solvency and providing the base for consumer access to mortgage dollars.

III. RESTRAINT THEORY: THE PER SE RULE AND THE REASONABleness TEST

Establishing a satisfactory statement of restraint on alienation theory has been a source of continuing judicial controversy since the passage of the statute Quia Emptores in 1290. On its face this statute addresses certain limitations of the feudal system. Lord Coke addressed a broader purpose in discussing the legal basis for the statute. Essentially, he states, one who has divested himself of a parcel of property such that he no longer has an interest in it inhibits economic growth when he seeks to control the new owner’s ability to transfer an interest in the property.

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55 See note 49 supra and accompanying text.

56 Id. For a discussion on this point, see infra and accompanying text. See also N.J. STAT. ANN. § 17:128-12 (West 1975), stating that the purpose behind savings and loan associations is the promotion of thrift, home ownership, housing and investing to serve these purposes.

57 Gibbons, supra note 52, at 24-29.

58 18 Edw. 1, cc. 1-3 (1289-90). Enacted to quell powerful barons’ discontent with certain entrapments of the feudal system, the statute limited subinfeudation by providing that tenants in fee, but not in capite, could alienate their land freely. See L. Simes & A. Smith, THE LAW OF FUTURE INTERESTS § 1114 (2d ed. 1966) [hereinafter cited as Simes & Smith].

59 [It] is absurd and repugnant to reason that he, that hath no possibility to have the land revert to him, should restrain his feoffee in fee simple of all his power to alien . . . . [The] condition . . . . is void, because his whole
The English courts' response to the passage of the statute was a dogged resolve to thwart those who would control the transfer of a fee. The evils the courts perceived were dead hand control over property, massive accumulation of wealth by one class, and the imposition of disguised feudal incidents. American courts through the turn of this century continued to hold rigidly to the view that restraints on alienation were void because they offended the public policy objective of free marketability. Even though imposition of disguised feudal incidents was no longer a realistic reason for applying the rule, it remained true that the agrarian but rapidly modernizing society of that time required greater judicial support of free marketability with the corollary goal of as few limitations as possible.

By mid-century, American society had developed a steadily growing urban population and industrial sector. The pronounced judicial trend was toward a more flexible approach to restraint theory, rather than the per se rule of invalidity. The emerging interest and propriety is out of him, so as he hath no possibilitie of a reverter, and it is against trade and traffique, and bargaining and contracting between man and man.


Anti-Lien, supra note 58, at 717.

See, e.g., Porter v. Tracey, 179 Iowa 1295, 162 N.W. 800 (1917); DePeyster v. Michael, 6 N.Y. 467, 57 Am. Dec. 470 (1852); Anderson v. Cary, 36 Ohio St. 506, 38 Am. Rep. 602 (1881); Richardson v. Danson, 44 Wash.2d 760, 270 P.2d 802 (1954).

Judge Murnaghan in Williams v. First Fed. Sav. & Loan Ass'n remarks on this point as follows:

Appellants' counsel traces the origins of the legal concept outlawing unreasonable restraints on alienation to the 1290 Statute Quia Emptores, the Statute of Westminster, 18 Edw. I. ch. 1. That statute, eliminating the feudal relationship of the feoffee to all mesne lords beneath the king, and limiting to the king the right to impose restraints on alienation, is only of historical interest. There has been little occasion to invoke the statute in the United States, because of the alodial nature of holdings in this country. 28 Am. Jur.2d pp. 74-75 (Estates § 4). Tenure in Virginia is alodial. 1 Minor, Real Property, § 16 (2d ed. 1928).

In considering the due-on-sale clause it merits remembering that it is "imposed" not by a predecessor in the homeowner's chain of title—a mesne landlord, but by a collateral lender concerned with security for its loan. Quia Emptores hardly seems to extend to such matters.

651 F.2d 910, 921 n.25.
rule, already well entrenched in Kentucky, for example, was to allow restraints which were reasonable under the circumstances.\textsuperscript{63} Even states not directly supporting the reasonableness test had alluded \textit{obiter dictum} to its desirability.\textsuperscript{64}

As the inflationary spiral gathered momentum in the 1960s and 1970s, however, the reasonableness rule came to be an unsatisfactory solution even though it gained judicial favor. During this period the judicial struggle precipitated three patterns.

Under the first pattern, the mortgagee cannot show reasonableness without alleging and proving that his security has been impaired. Under the second pattern, reasonableness is presumed. Under the third pattern reasonableness is presumed, but the reasonableness concept includes the current portfolio argument.

The Michigan Court of Appeals, in \textit{Nichols v. Ann Arbor Federal Savings \\ & Loan Association},\textsuperscript{65} provided a prime example of the first pattern. There, the mortgagor transferred his property by land contract without having obtained the mortgagor's consent.\textsuperscript{66} Finding the standard due-on-sale clause an indirect restraint, the court held that the mortgagee cannot establish reasonableness without alleging and proving "a threat to . . . [a] legitimate interest sufficient to justify the restraint on alienation inherent in its enforcement."\textsuperscript{67} Such threats include


\textsuperscript{64} In Maryland, for example, the courts arguably approved the reasonableness test by limiting the judicial definition of a restraint on alienation. \textit{See}, e.g., Hardgrove v. Hardgrove, 240 Md. 634, 215 A.2d 183 (1965) (temporal restriction on power of sale in a devise not a restraint on alienation); Harman v. Hurst, 160 Md. 96, 153 A.2d 24 (1931) (grantor reservation of power of sale not a restraint); Weinbeck v. Dahms, 134 Md. 464, 107 A. 12 (1919) (court should construe deed as conveying limited estate, where the language permits, rather than as containing restraint on alienation).


\textsuperscript{66} \textit{Id.} at 164, 250 N.W.2d at 805.

\textsuperscript{67} \textit{Id.} A direct restraint is a provision "which, by its express terms, or by implication of facts purports to prohibit or penalize the exercise of the power of alienation." \textit{Simes \\ & Smith} § 1112 (2d ed. 1956). The three categories of direct restraints include disabling, promissory and forfeiture restraints. \textit{Simes \\ & Smith} § 1131. \textit{See also Restatement of Property} § 404 (1944) [hereinafter cited as \textit{Restatement}]. A disabling restraint arises when the grantor withholds from the grantee the power to convey. \textit{Simes \\ & Smith} § 1148; \textit{Restatement} at § 401(1)(a).
waste, depreciation and the "moral risk" of having to resort to the security. According to this court, however, acceleration solely to maintain a current portfolio is not enforceable as an exercise of a reasonable restraint.

The Mississippi Supreme Court reached the same result with less explanation in Sanders v. Hicks. Although in Sanders the property involved was a gasoline station, the court gave no indication that it would treat residential mortgages differently. Reasoning that the right to transfer property is an incident of ownership, the court held that the standard due-on-sale clause is an invalid restraint unless the mortgagee can demonstrate impairment of his security interest.

The second pattern, unlike the first, includes cases in which the court considers acceleration reasonable without the mortgagee's allegation or proof of impairment. The mortgagor or new purchaser may rebut this presumption by establishing the existence of such defenses as inequitable or unconscionable conduct by the mortgagee.

The Illinois Supreme Court in Baker v. Loves Park Savings & Loan Association provided the best illustration of this second pattern. In Baker, the mortgagee conditioned its consent to the mortgagor's transfer on a one percent increase in the loan rate. Reviewing only the question of whether the standard due-on-sale clause is a reasonable restraint, the court held that the utility of the restraint must be weighed against its harmful ef-

A promissory restraint arises when the grantor conditions the grant on the grantee's promise. SIMES & SMITH at § 1131; RESTATEMENT at § 401(1)(b). A forfeiture restraint arises when under the terms of the grant the grantee must forfeit the interest conveyed if he attempts to transfer the property. SIMES & SMITH § 1131; RESTATEMENT § 404(1)(c).

An indirect restraint arises where a restraint exists for a "purpose other than the restraint of alienability, but with the incidental result that the instrument, if valid, would restrain practical alienability." SIMES & SMITH § 1112.


70 Id. at 174, 250 N.W.2d at 809.

71 Id. at 63.

72 Id. at 63-64.

73 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

74 Id. at 121, 333 N.E.2d at 3.
Where economic and social considerations "dictate that a partial restraint is reasonably necessary for their fulfillment, such a restraint should be sustained." Since the mortgagee's extension of credit depends on the existence of both the property as security and the personal integrity of the borrower, the clause serves the socially and economically important purpose of protecting the mortgagee's security interest. Moreover, the court reasoned, such a restraint must carry a presumption of validity instead of depending solely upon the facts of each case for enforcement. The court explained that such a policy promotes necessary certainty in this area of the law, using as an example its belief that an attorney should be able to determine the effect of such a restraint when he searches a title.

The Colorado Supreme Court has presented a third approach to the issue whether a mortgage provision for acceleration and subsequent rate escalation unlawfully restrain alienation. In Malouff v. Midland Federal Savings & Loan Association, the court held that the clause was a reasonable restraint when balanced against the mortgagee's "justifiable interests" in the property. It held, moreover, that the mortgagee has such a "justifiable interest" in protecting itself against interest rate increases that its rate escalation to maintain a current portfolio is equally valid. The court explained that the loan supply and demand imbalance, created in an inflationary economy, had "required . . . [lenders] to adopt measures which would protect the borrowers as well as the lenders from the hazards of long-term loans (20-30 years) at fixed interest rates." The court reasoned

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76 Id. at 124-26, 333 N.E.2d at 4.
77 Id. at 124, 333 N.E.2d at 3-4, (quoting Gale v. York Center Comm. Coop., Inc., 21 Ill. 2d 86, 92-93, 171 N.E.2d 30, 33 (1960)).
78 Id. at 122-23, 333 N.E.2d at 4.
79 Id. at 125-26, 333 N.E.2d at 5.
80 Id. See also Miller v. Pacific First Fed. Sav. & Loan Ass'n 545 P.2d 546 (Wash. 1976). The Washington Supreme Court stated that the mortgagee's exercise of the clause to increase the loan rate upon transfer was a reasonable restraint, even where the mortgagee does not allege impairment of his security. Id. at 549. The thrust of the court's analysis, however, is a discussion of contract principles. For discussion on this point, see generally text accompanying notes 187-230 infra.
82 Id. at 300, 509 P.2d at 1243.
83 Id. at 301, 509 P.2d at 1244.
84 Id. at 302, 509 P.2d at 1244.
that lenders have adopted the standard due-on-sale clause and the variable interest rate to balance the cost of lending money with the cost of holding deposit accounts with even minimal assurance of solvency in severely inflationary times. Finding the variable rate less advantageous to the consumer, the court determined that the due-on-sale clause and escalation provided the best solution. If the market rate declines, the consumer can prepay. If it rises, the mortgage rate remains the same. When the mortgagor transfers the property, the new loan is usually lower than market, but certainly no higher. In this court's view, the only remaining alternative—short-term loans of less than ten years and significantly higher rates—fails to provide a balanced solution.

The one leading case which does not fall into an established pattern is Wellenkamp v. Bank of America. Decided in 1978,
this case illustrates the pernicious effect of restraint theory on lenders, brought on by judicial misunderstanding of inflationary economics.

Breaking with the California Supreme Court progression which initiated the modern trend, the Wallenkamp court held that the mortgagee's exercise of a standard due-on-sale clause and subsequent rate escalation after the mortgagor's sale of the property constituted an unreasonable restraint on alienation unless the security actually was impaired. In the usual case, the court explained, the new purchaser's down payment is his incentive against waste or depreciation. Secondly, the court held that a mortgagee's use of the clause to maintain a current portfolio is an unreasonable restraint for two reasons. First, the clause was developed to protect the mortgagee's security interest, which purpose is not served by the rate escalation. Second, since in this court's view the economic risks inherent in inflation exist in every transaction, lending institutions should determine their interest rates accordingly, and not attempt to burden mortgagors with the consequences of mistaken economic projections. With no discussion of the economic and public policy ef-

refused the offer and subsequently sought to enjoin the bank from foreclosing. Id. Mrs. Wallenkamp claimed that the bank must allege and prove impairment of its security, while the bank argued that it was entitled to automatic exercise of the due-on-sale clause. Id. The superior court dismissed the action with prejudice for failure to state a claim. Id.

See Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); Lasala 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). In Coast Bank, the court established the reasonableness approach to restraint theory and held that reasonableness turned on whether the restraint was reasonably necessary to prevent impairment of the mortgagee's security. 61 Cal 2d at 316-17, 392 P.2d at 268, 38 Cal. Rptr. at 508. In Lasala, the court approved the exercise of a due-on-encumbrance clause, stating that the reasonableness test requires a weighing of the degree of restraint and its effects against justifications for use of the clause. 5 Cal. 3d at 877-80, 489 P.2d 1121-24, 97 Cal. Rptr. at 857-59. In Tucker, the court applied Lasala and held that exercise of the standard due-on-sale clause upon transfer via land contract was an unreasonable restraint when weighted against its justification. 12 Cal. 3d at 637-40, 526 P.2d at 1172-75, 116 Cal. Rptr. at 638-39. The lender in such cases, therefore, must allege and prove impairment to recover. Id.
fects of this ingenuous solution to mortgage financing, the \textit{Wallenkamp} court struck down mortgagee escalation under the standard due-on-sale clause.

\textit{Wallenkamp}, like the cases within the three current patterns, rests on shaky analytical ground. Based on the erroneous assumption that the due-on-sale provision constitutes the type of restraint to which at least the spirit of the statute \textit{Quia Emptores} was directed, the most that can be said of these cases is that they promote a common law concept which has outlived its usefulness. Moreover, they support a theory too inflexible to allow the current portfolio argument, without which the public policy objectives of encouraging economic growth, consumer access to the lowest priced mortgage dollars, and marketability of property, will suffer.

In explaining the purpose behind the statute \textit{Quia Emptores},\textsuperscript{95} Lord Coke remarked on the absurdity of allowing a grantor, who had conveyed all of his interest in a piece of property, to control how his grantee disposed of the property.\textsuperscript{96} Allowing such control, he reasoned, is contrary to settle principles of trade and contract.\textsuperscript{97}

The current residential mortgage transaction, whether in a state which follows the lien theory or title theory of mortgages, falls outside the difficulty Lord Coke envisioned. In lien theory states\textsuperscript{98} the mortgagee holds only a security interest in the property.\textsuperscript{99} Because he does not hold title, the statute as Lord Coke understood it cannot apply. In title theory states,\textsuperscript{100} technically the mortgagee holds legal title until default, at which time he obtains the right to possession.\textsuperscript{101} In practical terms, however, title theory courts have chosen to denominate the mortgagor as

\textsuperscript{95} See note 56 supra and accompanying text.
\textsuperscript{96} See notes 56, 57 & 61 supra and accompanying text.
\textsuperscript{97} Id.
\textsuperscript{98} These states include Arizona, California, Colorado, Florida, Georgia, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, New York, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming. \textit{Osborne, supra} note 44, § 4.2.
\textsuperscript{99} Id.
\textsuperscript{100} These states are primarily those east of the Mississippi River, excepting South Carolina, New York and Missouri. \textit{Osborne, supra} note 44, § 1.5.
\textsuperscript{101} \textit{Osborne, supra} note 44, § 4.1.
the property owner and to treat the mortgagee as the lien holder. 102 In many title states, the mortgagee's interest is now limited specifically to a chose-in-action or a chattel interest. 103 In practice, then, the statutory purpose behind *Quia Emptores*, as Lord Coke explains it, is equally inapplicable to mortgage transactions in title theory states.

Most likely, the reason that a comparison of the purpose of a very old statute with the modern residential mortgage transaction causes confusion is that the latter is primarily contractual, whereas the former is caught up in the vagaries of common law property conveyancing. 104 Although the mortgage appears similar in form to a deed because it involves a conveyance, 105 it is actually a commercial instrument, because it has no function without a debt to secure. 106 The debt is the heart of the transaction, while the technical transfer of property rights is merely security for payment. In the commercially unsophisticated fourteenth century, all of the ceremonies of a transfer of ownership accompanied the creation of the mortgage. 107 In modern times, however, as courts in both lien and title states appear to agree, the property interest transfer is in name only and the mortgagee is essentially no more than a secured creditor. 108

Courts that insist on tying mortgage debt transactions to property law through restraint theory encounter yet another hurdle. They must categorize the due-on-sale provision as either a direct or an indirect restraint on alienation. As the North Carolina and Nebraska courts have pointed out, 109 neither characterization is correct. 110 The due-on-sale clause is not a direct restraint, because by its express terms it neither limits nor prohibits alienation of the property. 111 Moreover, the clause is not

102 See R. Kratovil, Modern Mortgage Law and Practice 117 (1977) [hereinafter cited as Kratovil]. The alternative was for the courts to call the mortgagor a tenant at sufferance or at will, either being a strained construction. *Id.* at 117.
103 *Id.*
104 *Id.* at 23.
105 *Id.* at 47.
106 *Id.* at 71.
107 *Id.* at 23.
108 See notes 98-103 supra and accompanying text.
109 See notes 1-19 supra and accompanying text.
110 See notes 1-19 and 67 supra and accompanying text.
111 See notes 2 and 67 supra and accompanying text.
an indirect restraint, because it does not limit the freedom to alienate in any meaningful sense. Instead, the standard due-on-sale clause is a provision requiring the initial borrower to give the lender notice that he intends to place the security beyond the facile reach of the lender as expressed in the original agreement. The purpose of this notice is to allow the lender to determine whether he would prefer to keep the same or make different arrangements with the prospective purchaser. In periods of severe inflation, then, the indirect restraint on transfer results from market escalation instead of from the exercise of the standard due-on-sale clause.

From a public policy standpoint, restraint theory is highly offensive. Application of traditional property rules regarding mortgagee acceleration and upgrading of loan portfolios requires that mortgagees absorb losses which, over the long run, will precipitate insolvency or require federal government financial support. While the impact on economic growth is disconcerting, the impact on consumers is even worse. In an effort to protect consumers against the moneylenders, the courts have added upward pressure to new loan rates and placed mortgage financing beyond many consumers' reach. By failing to reevaluate the purposes of restraint theory, the courts have created a legally unjustifiable economic hardship.

IV. EQUITY AND CONTRACT THEORY: THE STRUGGLE BETWEEN THE REASONABLENESS TEST AND THE CURRENT PORTFOLIO ARGUMENT

Since traditional foreclosure has been a proceeding in equity, many courts have framed their decisions in large part with a discussion of equitable principles. These courts agree that a due-on-sale clause, bargained for by the parties, provides a reasonable means by which the mortgagee can protect his final interests.

The split of authority arises in how the courts define protection. One faction limits the mortgagee to protection of his security interest. In essence, this view is a restatement in equity

112 Id.
113 See generally notes 117-230 infra and accompanying text.
114 See generally notes 187-230 infra and accompanying text.
language of the reasonableness test. The second faction applies contract theory to the problem. These courts recognize that the mortgagee cannot remain solvent in an inflationary market unless he can adjust revenues to match costs in the long run. Following this current portfolio argument, these courts support the mortgagee's decision to accelerate even though his sole purpose is to obtain the current market rate on the new loan.

A. The Reasonableness Test Restated in Equity

Courts in Arkansas, Arizona, Florida and Oklahoma have been the strongest proponents of the first view. Applying equity theory, these courts deny the mortgagee foreclosure unless it can be demonstrated that the mortgagor's transfer has jeopardized the value of his security. This analysis falls short of the mark in several respects. It assumes an overly expansive reading of equitable principles as they are set out by the authorities. It further erroneously assumes that the due-on-sale provision incorporated into the mortgage is the type of acceleration clause to which Uniform Commercial Code section 1-208 is addressed. Moreover, it ignores the severely disproportionate financial impact the mortgagee suffers when he cannot pass on to new loan consumers his increased costs of doing business.

The Arkansas Supreme Court set forth the fullest statement of this view in Tucker v. Pulaski Federal Savings & Loan Association. There, Tucker executed a note secured by a

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115 Id.
116 See generally notes 187-230 and accompanying text.
118 See, e.g., Tucker, 252 Ark. at 851-54, 481 S.W.2d at 728-31.
119 For discussion of authority on equity theory, see notes 136-147 infra and accompanying text.
120 For discussion on this point see notes 177-186 infra and accompanying text. Cf. discussion of U.C.C. § 9-506 notes 187-191 infra and accompanying text.
121 For a discussion of the effect on mortgages, see notes 45-52 supra and accompanying text.
122 252 Ark. 849, 481 S.W.2d 725 (1972).
mortgage on a small apartment building he intended to use for residential and rental purposes. After unsuccessfully seeking Pulaski's approval of a prospective purchaser, Tucker sold the property. Pulaski accelerated the debt and sought foreclosure, alleging a violation of the agreement. In his answer, Tucker asserted that Pulaski's action constituted an oppressive and arbitrary exercise of its rights under the agreement. The trial court granted foreclosure, finding that Pulaski validly had exercised its right to accelerate the debt. It further found that, even though Pulaski had "valid business reasons" for its refusal to consent to the transfer, it owed no duty to justify its decision.

Reversing the trial court, the Arkansas Supreme Court stated that a mortgagor should be granted relief from foreclosure where the mortgagee's conduct is inequitable. Restating the reasonableness test in equity terms, the court held that accelerating the debt without proof that the security had been jeopardized constitutes a penalty as well as an unreasonable exercise of rights under the agreement. To obtain foreclosure, the mortgagee must show valid business reasons for withholding consent to the transfer. As examples of transfers to which a mortgagee would have valid business reasons to object, the court postulated a sale to a buyer having a history of conducting illegal operations on his property, wasting his property, ignoring his debts, or intermittently being unemployed. Absent this or similar evidence that the security has been impaired, the Arkansas court apparently is inclined to balance the equities in favor of the mortgagor. If the mortgagee can withhold his consent without justification, the court reasoned, the mortgagor

123 Id. at 849-50, 481 S.W.2d at 726.
124 Id.
125 Id.
126 Id.
127 Id.
128 Id. at 851, 481 S.W.2d at 727.
129 Id.
130 Id.
131 Id. at 852, 481 S.W.2d at 728.
132 Id. at 853, 481 S.W.2d at 729.
133 Id. at 853-55, 481 S.W.2d at 729-31.
134 Id. at 853, 481 S.W.2d at 729.
who must sell his property quickly will be forced to suffer a financial loss.\(^{135}\)

In finding that Pulaski's exercise of the mortgage acceleration clause constituted an unenforceable penalty, the Arkansas court promoted an unjustifiable expansive reading of equity theory. By cursory analysis, the court ignored two issues, the resolution of which, it is suggested, requires a balancing of equities in favor of the lender.

The first issue concerns what relief an equity court will give a mortgagee who seeks enforcement of an acceleration provision. Authorities agree that equity will not enforce a penalty or forfeiture where the provision's sole purpose is to ensure performance under the agreement and where the harm can be measured in damages.\(^{136}\) If the sole purpose of the provision is to secure the debt, however, the harm is not measureable in damages and equity may refuse the debtor relief until he pays both principal and interest due.\(^{137}\) Applied to the mortgagee's request for acceleration, this clause makes clear that, even were acceleration a penalty, his remedy is the payment he seeks from the mortgagor.

The second issue is whether a standard due-on-sale clause in mortgage constitutes a penalty. Pomeroy, a leading authority on equity, states that acceleration upon default of an installment note which expressly conditions acceleration upon default of installment payments "has nothing in common with a penalty and is as valid and operative in equity as at the law."\(^{138}\)

Of the two acceleration provisions Pomeroy denounced as a penalty, neither resembles the acceleration clause the mortgagee exercises under a standard agreement.\(^{139}\) The first is the mortgagee's acceleration of the debt upon default of punctual payment of taxes or assessments where default is "due to mere

\(^{135}\) Id.

\(^{136}\) Id. See also § 450 stating that forfeiture will be set aside upon payment of money owed.

\(^{137}\) Id. See also § 450 stating that forfeiture will be set aside upon payment of money owed.

\(^{138}\) Id. See also § 450 stating that forfeiture will be set aside upon payment of money owed.

\(^{139}\) Id. See also § 450 stating that forfeiture will be set aside upon payment of money owed.

\(^{135}\) POMEROY, EQUITY JURISPRUDENCE § 433 (5th ed. Symons ed. 1941) [hereinafter cited as POMEROY].

\(^{136}\) POMEROY § 439.

\(^{137}\) For content of the standard due-on-sale clause, see note 2 supra and accompanying text.
venial inattention" and the mortgagee is not harmed.\textsuperscript{140} In Pomeroy's view, such an oversight, absent harm to the mortga-
gee, does not warrant acceleration, even though the parties have so agreed.\textsuperscript{141} By contrast, the standard due-on-sale clause provides for acceleration upon far more than an oversight, and the resulting harm to the mortgagee is severe.\textsuperscript{142}

Pomeroy's second example of a penalty is a case in which a non-installment contract provision conditions acceleration upon "any breach," but damages are easily ascertainable or the out-
standing balance due would be disproportionate as a damages award.\textsuperscript{143} When damages are not easily ascertainable or the out-
standing balance due is not disproportionate to the harm, then the provision is one for liquidated damages.\textsuperscript{144} By this principle, the due-on-sale clause constitutes a liquidated damages provi-
sion and not a penalty. The mortgagee's damages equal the amount of interest he must forgo in a rising interest market if he is denied exercise of the clause and forced to allow assump-
tion at the lower rate. Consequently, an equity court should allow him to exercise his acceleration rights under the clause to maintain a current portfolio and thereby allow him liquidated damages.

The other problem Pulaski raises is whether the court should have balanced the equities and thereby considered a signi-
ficant increase in the mortgagee's costs a valid business reason for exercising an acceleration clause. By defining reason-
ableness solely by reference to impairment of security, the Ar-
kansas court overlooked the financial burden it placed on Pulaski and other Arkansas lenders. The lending rate increased approximately two percent during the five years that Tucker held his loan,\textsuperscript{145} increasing Pulaski's costs. Tucker's costs, on the other hand, did not increase relatively. On the contrary, several authorities argue that a seller in Tucker's position usually will

\textsuperscript{140} POMEROY § 439. See also § 451 and § 455a. Equity will relieve a mortgagor from forfeiture if his circumstance is the result of unavoidable accident, fraud, surprise or ignorance, or "unusual circumstances beyond his control."

\textsuperscript{141} Id.

\textsuperscript{142} For a discussion of the effect on the lender, see text accompanying notes 45-52, supra.

\textsuperscript{143} POMEROY § 444a. See also § 445 and § 459. Equity will deny a forfeiture claim where forfeiture is disproportionate to the harm.

\textsuperscript{144} Id.

\textsuperscript{145} See Appendix, Chart I, infra.
obtain a higher selling price because of the favorable loan rate he can offer a purchaser.⁴⁶ In an inflationary market, then, the Arkansas court's balancing of equities likely guarantees the mortgagor a windfall, while it signifies to the mortgagee that his current rates must include future cost increases if he is to remain solvent.⁴⁷

On similar facts, the Arizona Court of Appeals in *Baltimore Life Insurance Co. v. Harn*⁴⁸ dismissed the claim of the mortgagee's assignee for failure to allege impairment of security. There, the Harns executed a note and mortgage containing a standard due-on-sale clause to Western American Mortgage Company.⁴⁹ Western American then negotiated the note and assigned the mortgage to Baltimore Life.⁵⁰ When the Harns subsequently transferred the property without consent, Baltimore Life accelerated the debt and eventually instituted foreclosure proceedings.⁵¹

The court of appeals acknowledged that the parties to a note and mortgage "may enter into such agreements as they deem necessary to the transaction of their business."⁵² It held, however, that unless the mortgagee alleges that his security has been impaired and, therefore, that the purpose of the clause has been jeopardized, foreclosure on these facts would constitute "an extreme penalty."⁵³ Essentially, then, the Arizona court adopted the same reasonableness test as the Arkansas court.⁵⁴ The difference is that the Arizona court characterized the acceleration as a penalty without explanation and specifically stated that the purpose of the clause is to prevent impairment of security.

Citing *Baltimore Life*, the Supreme Court of Oklahoma in *Continental Federal Savings & Loan Association v. Fetter* expressly adopted the Arizona approach on slightly different

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⁴⁶ See text accompanying notes 45-52 supra.
⁴⁷ Id.
⁴⁹ Id. at 79, 486 P.2d at 191.
⁵⁰ Id. at 80, 486 P.2d at 192.
⁵¹ Id.
⁵² Id.
⁵³ Id. at 81, 486 P.2d at 193.
⁵⁴ The Arizona court decided *Baltimore Life* one year before the Arkansas court decided *Tucker*. 
facts. There, the Fetters executed a note and mortgage containing a standard due-on-sale clause to Continental. When they sought Continental's consent to a loan assumption, however, they learned that consent would be forthcoming upon payment of a one percent transfer fee. The Fetters ignored the conditional consent and transferred the property. Continental accelerated the debt and, upon non-payment, brought suit to foreclose. Following discovery, the trial court granted summary judgment for the Fetters, finding the transfer fee unreasonable.

On appeal, the supreme court affirmed, stating that equity will not impose "an extreme penalty on the mortgagor with no showing that he has violated the substance of the agreement" by impairing the security. The court offered no explanation of how the transfer fee constituted a penalty. Furthermore, the court was mistaken in its finding that the fee was three times the actual transfer cost. Apparently considering only the administrative costs, the court ignored the six and two-tenths percent inflation rate and the increased contract rate during the year for which the Fetters held the property. In so doing, the court overlooked the fact that Continental had demanded less than the rate which would reflect its full costs upon transfer.

Following the view set forth by the Arkansas, Arizona and Oklahoma courts, the Florida appellate court in First Federal Savings & Loan Association v. Lockwood affirmed the trial court's entry of summary judgment against First Federal. In that case, the Lockwoods in 1973 executed a note which contained a standard due-on-sale clause and which was incorporated by

156 Id. at 1015.
157 Id. The Fetters purchased the property in 1972 and approached Continental about assumption in 1973. Although Continental policy dictated the one percent transfer fee, the inflation rate for 1973 was 6.2 percent and the contract rate had increased from 7.45 to 8.22. See Federal Reserve Bulletin Chart A31 (April 1974). See also Business Conditions Digest, Historical Data For Selected Series 99 (May 1980).
158 564 P.2d at 1015.
159 Id. at 1016.
160 Id.
161 Id. at 1018.
162 Id. at 1019.
163 See Appendix, Chart 1. See also text accompanying note 157 supra.
164 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).
reference in the mortgage. In March 1978 the Lockwoods transferred the property without First Federal's consent but with actual knowledge that First Federal had conditioned its consent on escalation of the loan rate to the current market level. First Federal accelerated the debt and instituted foreclosure proceedings, alleging a violation of the agreement.

The appellate court noted the split of authority on the issue whether the mortgagor's interests must be threatened before an equity court will grant him foreclosure. Nevertheless, it held that the purpose of the clause was to protect the mortgagor's security. Relying on the Florida precedent of Clark v. Lachenmeier, the court conditioned recovery in a court of equity on a showing of impairment. In so doing, the First Federal court ignored the full import of Clark. In Clark the court had stated that equity must deny foreclosure where the mortgagor has transferred the property without consent and "where no harm has resulted to [the] mortgagee from such a conveyance." Apparently construing this language in favor of the mortgagor, the First Federal court read "no harm" to mean "no impairment of security." Had the court balanced the equities at all, it would have recognized that First Federal indeed had been harmed by a transfer which denied it recovery of its increased costs between 1973 and 1978.

The final difficulty each of these cases raises is the court's failure to distinguish between acceleration clauses conditioned on the creditor's insecurity and those conditioned on default. Insecurity clauses expressly condition acceleration on the creditor's whim or on his assessment of the point at which he deemed himself insecure. Default clauses expressly condi-

165 Id. at 157.
166 Id.
167 Id.
168 Id. at 159.
169 Id.
170 So. 2d 583 (Fla. Dist. Ct. App. 1970). In Clark, the court stated without supporting rationale that foreclosure on essentially the same facts would be in equitable absent a showing that the security was impaired by the transfer. 237 So. 2d at 585.
171 385 So. 2d at 159.
172 237 So. 2d at 585.
173 See Appendix, Charts 1 & 2.
tion acceleration on specified acts which only the mortgagor can commit.\textsuperscript{175} By requiring the mortgagee to demonstrate impairment of his security, the courts which restate the reasonableness test in equity have overlooked the default language contained in the due-on-sale clause.\textsuperscript{176} Moreover, they have severely altered the equities in favor of the mortgagor.

As Justice Fogleman suggested in his dissent in \textit{Tucker v. Pulaski},\textsuperscript{177} if these courts insist on applying insecurity clause theory in mortgage default cases, they should align mortgage theory with the standards set out in Uniform Commercial Code section 1-208.\textsuperscript{178} This standard provides a balancing of the equities by lessening the inordinate burden the reasonableness test places on the mortgagee in a severely inflationary market. Under section 1-208, the mortgagee must demonstrate his good faith belief that his security has been impaired and the mortgagor must prove lack of good faith.\textsuperscript{179} Were this standard applied, the mortgagee could make a colorable argument that he in good faith believes his security to be impaired if he can show that the value of the security is less than the amount of the loan plus his costs, including the amount he must forgo if he is forced to accept assumption at a rate far below the current market rate. Under the reasonableness test, however, the mortgagee carries the entire burden since he must demonstrate actual impairment. The mortgagee who conditions consent to transfer solely on assumption at the current market rate in order to remain solvent cannot meet this test. Instead, in a severely inflationary market he can obtain his objective more easily by consenting to transfer to a marginally stable buyer, foreclosing upon default in payment and renegotiating a new loan at the

\textsuperscript{175} \textit{Id.} For the contents of a standard due-on-sale clause, see text accompanying note 2 \textit{supra}.

\textsuperscript{176} \textit{Id.}

\textsuperscript{177} 252 Ark. at 856-61, 481 S.W.2d at 732-37 (Fogleman, J., dissenting).

\textsuperscript{178} "A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral 'at will' or 'when he deems himself insecure' or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised." U.C.C. § 1-208 (1972 version).

\textsuperscript{179} \textit{Id.} See also 252 Ark. at 856-61, 481 S.W.2d at 732-37 (Fogleman, J., dissenting).
higher current rate. Although no court has condoned such marginal practices, application of the reasonableness test is such a fashion clearly pressures the mortgagee to await anxiously the transferee’s default.

Despite the equitable balance section 1-208 provides, the proper procedure in due-on-sale clause costs arises from Code section 9-506.1 This section governs cases in which the parties' express agreement conditions acceleration upon a specified act constituting default and provides that upon default the entire amount is due in one installment.2 When acceleration occurs, the debtor may forgo his interest in the collateral or may redeem it from his creditor by payment in full.3 The mortgagee need not demonstrate his belief that his security has been impaired. This requirement, while necessary in security clause cases where the mortgagor ultimately controls the conditions of acceleration, is unnecessary in default cases. The mortgagor who enters into such an agreement has notice of which acts constitute default. Under the standard due-on-sale clause he is on notice that these acts include transfer without the mortgagee's consent.4 To obtain relief he must bear the burden of showing that acceleration pursuant to the agreement is inequitable. As Pomeroy suggests, equity will not rescue the mortgagor from the consequences of his agreement by deeming the acceleration a penalty.5 In attempting to show inequity in a typical case, the mortgagor's defense boils down to an argument that acceleration pursuant to the agreement lowers his selling price on the property6 and increases the cost to his transferee, a stranger to the bargain. Further, if the court balances the equities, it must

160 "At any time before the secured party has disposed of collateral or entered into a contract for its disposition under section 9-504 or before the obligation has been discharged under section 9-505(2) the debtor or any other secured party may unless otherwise agreed in writing after default redeem the collateral by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party in retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorneys’ fees and legal expenses." U.C.C. § 9-506 (1972 version).

161 Id. See also Official Comment.

162 Id.

163 See text accompanying note 2 supra.

164 For discussion on this point, see text accompanying notes 136-147 supra.

165 See, e.g., Tucker, 252 Ark. at 853, 481 S.W.2d at 729.
consider the severe effect forced assumption at the lower rate will have on the mortgagee. While the effect may be slight in a quiet market, it may threaten the mortgagee's solvency in periods of high inflation.186

B. Contract Theory: The Current Portfolio Argument

Many courts have adopted an approach similar to that of section 9-506, thereby placing on the mortgagor the burden of proving inequities to justify relief.187 These courts apply contract principles on the theory that the due-on-sale clause is a bargain-ed for provision in a lending contract.188 The basic premise of this argument is the leading authorities' definition of the modern real estate mortgage.189 Under this definition, the mortgage is a conveyance of an interest in property as security for performance of an obligation.190 In the cases under consideration here, the underlying obligation is the repayment of money. Unlike a deed, the object of the mortgage agreement is more than a conveyance of land. The object is to provide security for the repayment of a debt.191 Accordingly, the agreement sounds in contract and the mortgagor, who has entered freely into a commercial transaction which conditions default upon transfer without consent, must accept the consequences of his bargain. Equity will not provide him relief unless he can show inequitable conduct or results. Proof that the mortgagee has conditioned transfer on escalation to the current market rate is insufficient to invoke equitable relief.

Equity favors the mortgagee on this point for two reasons.

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186 For discussion on this point, see text accompanying notes 45-52 supra.
187 See generally text accompanying notes 137-230 infra.
188 Id.
189 Kratovil, note 102 supra, at 35; Osborne, note 33 supra, § 1.
190 See also United States v. Angel, 362 F. Supp. 445 (E.D. Pa. 1973). There, the court summarizes this view as follows:

When a mortgagor delivers to the mortgagee his bond and mortgage, the primary obligation is the debt, i.e., the mortgagor's personal undertaking to pay the debt in accordance with the provisions of the bond. The mortgage itself is merely the collateral security for the payment of this personal obligation. The mortgagor is simply in the position of a person who owes money to another and has given him collateral as security for the payment of this obligation. See Levin, Mortgages and Other Liens § 72 (1961).

Id. at 447-48.
191 Kratovil, note 102 supra, at 35; Osborne, note 44 supra, § 1.
First, assumption at the original loan rate provides a windfall to the mortgagor and his transferee. The mortgagor may exact a higher selling price on property to which he can attach a low interest loan. The transferee, who was not a party to the original loan contract, reaps the benefit of the bargain without incurring detriment. Second, this windfall threatens the mortgagee’s solvency, inasmuch as it forces him into a new loan agreement which does not cover his costs.

Courts in nine states have expressed approval of the mortgagee’s current portfolio argument and no longer condition his recovery on a showing of impairment. The seminal case on this point is Gunther v. White, in which the mortgagor sought to prevent the mortgagee from conditioning consent on payment of the higher rate. Relying on a 1911 Tennessee case which viewed the note and mortgage as a contract, the Tennessee Supreme Court affirmed the chancellor’s dismissal of the case for failure to state a claim. The court acknowledged that equity must provide relief against mortgagee oppression, but held that “exercise of the option to gain the benefit of a current rate” is neither unconscionable nor inequitable. Briefly articulating the public policy argument against providing the mortgagor a windfall at the expense of mortgagee solvency, the Tenn-
essee court approved a rate escalation from six and one-quarter percent to eight percent.\textsuperscript{199}

\textit{Gunther} set in motion the current trend in American courts. Seven of the nine states have adopted the \textit{Gunther} rationale. The remaining states, New York and Georgia, have reached the same result on similar grounds.

The Washington Supreme Court adopted \textit{Gunther} on slightly different facts in \textit{Miller v. Pacific First Federal Savings \& Loan Association}.\textsuperscript{200} The oddities were that the note expressly provided that the loan was “personal to” the mortgagor and that transfer “shall be deemed to increase the risk of lender.”\textsuperscript{201} Transfer without consent authorized the mortgagee to accelerate the loan or to condition assumption on a rate increase of up to two percent “to compensate for such increased risk.”\textsuperscript{202} When the mortgagor sold the property, Pacific First Federal invoked the rate increase language and increased the loan rate by one-half of one percent.\textsuperscript{203} The Washington Supreme Court affirmed the trial court's favorable ruling on Pacific First Federal's summary judgment motion.\textsuperscript{204} It carefully noted the distinction between the facts in this case and those in the standard acceleration clause case, but expressly adopted the \textit{Gunther} rationale in full.\textsuperscript{205}

The supreme courts of Wisconsin\textsuperscript{206} and New Jersey\textsuperscript{207} also have cited \textit{Gunther} with approval. These cases are noteworthy for their peculiar application of this case. In \textit{Mutual Federal Savings \& Loan Association v. Wisconsin Wire Works}, the Wisconsin court reviewed for the second time Mutual Federal's foreclosure action against Wisconsin Wire Works and two subse-

\begin{footnotesize}
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\item the appellants, make the profit on the interest rate occasioned by the increased cost of money.
\item Id. at 532.
\item \textsuperscript{199} Id. at 529.
\item \textsuperscript{200} 86 Wash. 2d 401, 545 P.2d 546 (1976).
\item \textsuperscript{201} Id. at 402, 545 P.2d at 547-48.
\item \textsuperscript{202} Id., 545 P.2d at 547.
\item \textsuperscript{203} Id.
\item \textsuperscript{204} Id.
\item \textsuperscript{205} Id. at 405, 545 P.2d at 549-50.
\item \textsuperscript{206} Mutual Fed. Sav. \& Loan Ass'n v. Wisconsin Wire Works, 71 Wis. 2d 531, 239 N.W.2d 20 (1976).
\end{itemize}
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quent transferees pursuant to a land contract.\textsuperscript{208}

In the first appeal the court had remanded for further findings, holding that the standard due-on-sale clause is an unambiguous and enforceable contract provision which neither constitutes a penalty nor offends public policy unless its exercise is inequitable.\textsuperscript{209} In an intervening decision, the court clarified its position by stating that impairment of security is only one of the factors it will consider when balancing the equities.\textsuperscript{210} Little more than one year later in the second appeal of Wisconsin Wire Works, the court went even further, citing Gunther with approval and including as factors both impairment of security and rising interest rates.\textsuperscript{211} As a result of this diluted application of Gunther, however, the Wisconsin court may have confined its reduction of lender risks to severely inflationary market periods.\textsuperscript{212}

\textsuperscript{208}71 Wis. 2d at 432-33, 239 N.W.2d at 21-22 (1976).
\textsuperscript{209}Mutual Fed. Sav. & Loan Ass’n v. Wisconsin Wire Works, 58 Wis. 2d 99, 205 N.W.2d 762 (1973). The court instructed the lower court to determine on remand whether the mortgagor could prove equitable defenses. 58 Wis. 2d at 112, 205 N.W.2d at 770. Finding no defenses available to this mortgagor, the trial court granted foreclosure.
\textsuperscript{210}Mutual Fed. Sav. & Loan Ass’n v. American Med. Serv., 66 Wis. 2d 210, 216-17, 223 N.W.2d 921, 925 (1974).
\textsuperscript{211}71 Wis. 2d at 537, 239 N.W.2d at 23.
\textsuperscript{212}Similarly, one New Jersey court has indicated that its state court precedent does not preclude consideration of whether the security was impaired. The case is so aberrational, however, that it should not be read as a limitation on earlier New Jersey cases which allow acceleration to maintain a current portfolio. In Fidelity Land Dev. Corp. v. Reider & Sons Bldg. & Dev. Co., 151 N.J. Super. 502, 377 A.2d 691 (Sup. Ct. App. Div. 1977). Fidelity had accelerated the debt pursuant to a standard due-on-sale clause when Reider and Sons conveyed the premises to Solomon Reider, its principal stockholder. Id. at 506, 377 A.2d at 692-93. While the issue was whether subsequent conveyance to the corporation reversed the acceleration, the dictum was far reaching. The court acknowledged that New Jersey courts consider the due-on-sale clause a valid contractual term which must be enforced “without regard to whether the underlying purposes . . . have been frustrated.” Id. at 508-09, 377 A.2d at 694. Despite this acknowledgement, the court proceeded to mix the contract and reasonableness theories to justify its application of the reasonableness test. Exploring the surrounding circumstances, the court found neither impairment, nor that the parties intended that acceleration occur absent impairment, and denied the mortgagee recovery. The court’s reasoning was as follows. The “obvious purpose” of a due-on-sale clause is “the protection of a lender’s security for an obligation and his need to have a borrower known by him to be conscientious, experienced and able.” Id. at 508, 377 A.2d at 694. The split of authority is no more than a disagreement over which party must bear the burden of proving impairment. Many courts require
The New Jersey Supreme Court adopted the Gunther rationale in Century Federal Savings & Loan Association v. Van Glahn. First of all, the Century Federal court approved the automatic enforcement view of the due-on-sale clause. The court reasoned that, since the due-on-sale clause is a valid and enforceable contractual term, the mortgagor may insist upon "strict observance" unless his improper conduct has caused the default. It found that escalating the rate to obtain the benefit of the higher current market rate is "a legitimate and reasonable business practice" which fulfills the statutory purpose of providing an outlet for investment and home financing. Further noting the equity rationale behind Gunther, the court held that "institution of a foreclosure action in order to maintain the portfolio of the Association at current interest rates is eminently proper."

In an equally expansive commercial foreclosure case, Tierce v. APS Co., the Alabama Supreme Court adopted the Gunther rationale for both residential and commercial mortgage actions. Two years prior to Tierce, the Alabama court had decided First Southern Federal Savings & Loan Association v. Britton, a suit brought by a residential mortgagor. There, the
Court of Civil Appeals reviewed a claim for recovery of sums paid under protest to obtain the mortgagee's consent to transfer. The court acknowledged the enforceability of acceleration clauses as a bargained-for contract provision under settled Alabama law. Nevertheless, it held that because the purpose of the clause is to protect the security of the mortgagee, acceleration exclusively to maintain a current portfolio "must be openly stated and bargained for from the inception of the contract." In Tierce, however, the court ignored Britton's disclosure rationale and held that upgrading the portfolio is a valid business reason for acceleration.

Courts in the remaining states, Georgia and New York, have reached similar results on state statutory theory without adopting Gunther. In Barclay Arms Associations v. Midwest Federal Savings & Loan Association, the federal district court relied on Georgia Supreme Court enforcement of the provision as written and cited a plethora of state authority for the proposition that the mortgagee need not show impairment of his security to recover.

The landmark decision in New York is Stith v. Hudson City Savings Institution. In a declaratory judgment action brought by the mortgagor, the court held that the residential mortgagor "may not compel the mortgagee to accept [the prospective purchasers] as debtors and owners of the security; nor do they become parties to the mortgage and its covenants by assuming the obligation." The court grounded its decision in contract theory and in New York General Obligations law. Under New York case authority, an acceleration clause is a valid contractual provision. Since the clause under consideration was unambiguous, Hudson City validly exercised its rights by conditioning consent to transfer upon an agreement that the rate escalate from six

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221 Id. at 302-03, citing Tidwell v. Wittmeier, 150 Ala. 253, 43 So. 782 (1907).
222 345 So. 2d at 303-04.
223 382 So.2d at 487 (citing Tidwell v. Wittmeier, 150 Ala. 253, 43 So. 782 (1907)). See also 382 So. 2d at 488 (quoting Gunther v. White 489 S.W.2d at 532).
225 Id. at 5.
227 Id. at 865, 313 N.Y.S.2d at 807. See also Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583 (Sup. Ct. 1977) (mortgagee's refusal to consent to transfer to financially responsible buyer does not constitute inequitable conduct).
percent to seven and one-half percent. The \textit{Stith} court rejected the argument that the escalation constituted a violation of New York law, which prohibits an increase beyond the rate established in the initial agreement. It reasoned that, since the statute expressly excepts escalation following obligor default, the mortgagor cannot invoke this statute to force assumption at the original rate.

\section*{V. The Preemption Doctrine}

The fourth analytical approach courts have used when faced with a federally chartered institution's exercise of a standard due-on-sale clause is the preemption doctrine. With one possible exception, courts have agreed that the Homeowners' Loan Act (HOLA) and its companion regulations for federal lending institutions preempt state laws, even though the state laws are designed to regulate all mortgagees within the jurisdiction. Without exception, those courts which have considered this issue in the context of the standard due-on-sale clause have held that the statutory scheme and the specific regulations covering such clauses preempt state laws restricting mortgagee practices.

\begin{itemize}
  \item For brief discussion of four theories see text accompanying notes 31-34 supra.
  \item For discussion of possible exception see text accompanying notes 277-285 infra.
  \item 12 U.S.C. \textsection\textsection 1461-1470 [hereinafter cited as HOLA]. Congress's express purpose of enacting HOLA included the following: To provide emergency relief with respect to home mortgage indebtedness, to refinance home mortgages, to extend relief to the owners of homes occupied by them and who are unable to amortize their debt elsewhere, to amend the Federal Home Loan Bank Act, to increase the market for obligations to the United States and for other purposes. Pub. L. No. 43, 48 Stat. 128 (1933).
  \item 12 C.F.R. \textsection\textsection 500.1-590.5 (1981).
  \item For a listing of cases in which courts have applied the preemption doctrine to controversies between state and FHLBB asserted authority to regulate federally chartered associations see text accompanying note 247 infra.
  \item Id. The United States Supreme Court has agreed to review a California decision in which the state court held that federal law under the Homeowners' Loan Act of 1933 permitting the use of due-on-sale clauses did not pre-empt state law restricting the use of the clauses. de la Cuesta v. Fidelity Fed. Sav. & Loan, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), \textsl{cert. granted}, 50 U.S.L.W. 3585 (U.S. Jan. 26, 1982) (No. 81-750). The same issues have been presented to the Court in Glendale Fed. Sav. & Loan v. Hehir, (unpublished opinion, Cal. Ct. App., 4th Dist., July 7, 1981), \textsl{petition for cert. filed}, 50 U.S.L.W. 3594 (U.S. Jan. 26, 1982) (No.
The first premise on which rests the preemption doctrine is that the HOLA legislative history and language demonstrate Congressional intent that a federal agency govern the operation of federally chartered institutions. The legislative history is particularly helpful in this regard, disclosing grave congressional and presidential concern over what both considered a crisis in residential mortgage financing. This dissatisfaction, which Congress attributed in major part to varied and unsound state practices, culminated in 1933 in the provision for a federal network of mortgages pursuant to the HOLA.

Read in light of this history, the statutory language unmistakably reveals congressional preemptive intent. Although Congress might have placed regulatory responsibility on the states, it created the Federal Home Loan Bank Board (FHLBB) to which it delegated plenary authority. Through the capstone provision, section 1464, Congress authorized the FHLBB to charter, supervise and regulate federal savings and loan associations and to enforce compliance with its regulations. It further


238 Id.

239 12 U.S.C. § 1464 (1979) [hereinafter cited as FHLBB]. Currently, the FHLBB is an independent agency within the executive branch.

(b) The Home Loan Bank Board which was, pursuant to Reorganization Plan Numbered 3 of 1947 [5 USCS § 903 note], established and made a constituent agency of the Housing and Home Finance Agency shall, from Aug. 11, 1955, [the effective date of the Housing Amendments of 1955] cease to be such a constituent agency and shall be an independent agency [including the Federal Savings and Loan Insurance Corporation] in the executive branch of the Government.


240 § 1464. Federal Savings and Loan Associations (a) Organization authorized. In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations," and to issue charters therefore, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States.


241 (d) Proceedings to enforce compliance with law and regulations; cease
directed that the FHLBB promulgate regulations for its member associations with no more than "primary consideration [for] the best practices" of state chartered institutions. Consequently, without prohibiting FHLBB adoption of sound state practices, Congress made clear its intent that the FHLBB devise uniform and well-advised standards suitable for a network of federally chartered institutions.

Pursuant to its statutory charge the FHLBB has set forth numerous lending regulations, many of which comport with state practices. Among these regulations is a provision which supports the federally chartered mortgagee's inclusion and exercise of the standard due-on-sale clause in residential loan contracts. Although few courts have been faced with the question

and-desist proceedings; temporary cease-and desist orders; suspension or removal of directors or officers; appointment and removal of conservator or receiver; hearings and judicial review; regulations for reorganization, dissolutions, etc.; penalties; definitions; application to other institutions. (1) The Board shall have power to enforce this section and rules and regulations made hereunder.


24 12 C.F.R. §§ 545.8-3(f) and (g) (1981) state in full that:

(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 association's 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 on 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
of whether the FHLBB's due-on-sale provision preempts conflicting state regulations, several courts have applied the preemption doctrine to other regulations. The overwhelming weight of authority is that Congress intended FHLBB determinations of "the best practices" to preempt state regulation.  

For a standard due-on-sale clause see text accompanying note 2 supra. Although this regulation was not promulgated until 1979, 44 C.F.R. 5.7386 (Oct. 5, 1979), the FHLBB long has supported the use of the standard clause. See, e.g., Conference of Fed. Sav. & Loan Ass'n v. Stein, 495 F. Supp. 12, 16-17 (E.D. Cal. 1979).

See generally text accompanying notes 254-276 infra. See also Williams v. First Fed. Sav. & Loan Ass'n 651 F.2d 910 (4th Cir. 1981); see note supra and accompanying text.

See, e.g., First Fed. Sav. & Loan Ass'n v. Greenwald, 591 F.2d 417 (1st Cir. 1979) (federal regulations preempt Massachusetts requirement that mortgagees pay interest on escrow accounts); Conference of Fed. Sav. & Loan Ass'n v. Stein, 604 F.2d 1256 (9th Cir. 1979) (California Housing Financial Discrimination Act is preempted by FHLBB regulations); Kupiec v. Republic Fed. Sav. & Loan Ass'n, 612 F.2d 147 (7th Cir. 1975) (FHLBB construction of HOLA and regulations since it is agency charged with administration and enforcement of act); Mayers v. Beverly Hills Fed. Sav. & Loan Ass'n, 499 F.2d 1145 (9th Cir. 1974) (FHLBB regulation regarding prepayments to federal associations preempts state law); Central Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 422 F.2d 504 (6th Cir. 1970) (FHLBB regulation regarding establishment and operation of mobile facilities for federal associations preempts state law); Rettig v. Arlington Heights Fed. Sav. & Loan Ass'n, 405 F. Supp. 819 (N.D. Ill. 1975) (FHLBB approval of federal association choice of insurance agency preempts state law); Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 377 F. Supp. 11 (N.D. Ill. 1974) (FHLBB approval for federal associations to open branch officers preempts state law); Kaski v. First Fed. Sav. & Loan Ass'n, 72 Wis. 2d 132, 240 N.W.2d 267 (1976) (FHLBB regulation of interest rate escalation clause used by federal associations preempts state law). But see First S. Fed. Sav. & Loan Ass'n v. First S. Sav. & Loan Ass'n, 614 F.2d 71 (5th Cir. 1980) (HOLA does not govern savings and loan associations chartered by state, even if F.S.L.I.C. insured).


In applying the preemption doctrine, these courts have taken varied approaches. Essentially, they agree that congressional "occupation of a legislative field" pursuant to a granted power renders state law inapplicable to any issue arising in that field. Alternatively, they hold that when a state regulation is challenged, a court must assume that state power is not superseded absent a showing that preemption was Congress's "clear and manifest purpose." With rare exception, these courts differ only in how they support their perception of Congress's "clear and manifest" preemptive intent.

The leading state case is *Kaski v. First Federal Savings & Loan Association.* Wisconsin mortgagors brought a class action against a federally chartered savings and loan association for a declaration that the interest rate escalation clause in the mortgage note was, under state law, "unconscionable [...] vague, and invalid." Denying relief, the court found that Congress had devised a comprehensive regulatory scheme through HOLA and the authority it had delegated to the FHLBB. All

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221 See, e.g., Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n, 499 F.2d 1145 (9th Cir. 1974).
223 The doctrine of federal preemption arises from the Supremacy Clause of the Constitution. "This Constitution, and the Law of the United States which shall be made in Pursuance thereof ... shall be the supreme law of the Land." U.S. CONST. art. VI, cl. 2. In a series of cases the Supreme Court has indicated that Congress's "clear and manifest purpose" may appear in any of five ways. Ray v. Atlantic Richfield Co., 435 U.S. 151 (1978); Jones v. Rath Packing Co., 430 U.S. 519, rehearing denied, 431 U.S. 925 (1977); Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963); Rice v. Santa Fe Elevator Corp., 331 U.S. 218 (1947); Hines v. Davidowitz, 312 U.S. 52 (1941). The first situation is that in which the federal regulatory scheme is "so pervasive as to make reasonable the inference that Congress left no room for the states to supplement it." 331 U.S. at 230. The second circumstance occurs where the regulated field is one in which "the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws of the same subject." Id. The third situation arises when the object of the regulation or the nature of the obligations indicate a dominant federal interest. Id. The fourth circumstance is that in which state law so conflicts with federal regulation that "compliance with both federal and state regulation is a physical impossibility." 373 U.S. at 142-43. The fifth situation arises when state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." 312 U.S. at 67.

224 72 Wis. 2d 132, 240, N.W.2d 367 (1967).
225 Id. at 133, 240 N.W.2d at 369.
226 Id. at 136-39, 240 N.W.2d at 370-71.
though it acknowledged that this scheme allows the states to regulate such areas as recordation, the court held that the states were divested of any control which would “impinge upon the exclusivity of the Congress and the Board to set policies relating to federal lending practices.”257 The court further held that since Congress clearly had expressed the need for uniformity, state regulation which affects internal operation of the federal network and which conflicts with FHLBB policies must fall under the preemption doctrine.258

Similarly, in the leading federal case of Glendale Federal Savings & Loan Association v. Fox259 a federal district court in California upheld the FHLBB’s authority to approve the validity and exercise of the standard due-on-sale clause by federally chartered associations. The case arose out of a dispute over Glendale Federal’s inclusion of the clause in its loan contracts despite California limitations on its use.260 Glendale and sued both the FHLBB and California officials, seeking injunctive and declaratory relief.261

In the process of granting Glendale’s and the FHLBB’s motion for partial summary judgment,262 the court reviewed hornbook law on the preemption doctrine and what it interpreted as congressional intent behind the HOLA.263 Satisfied that Congress intended informed FHLBB regulation of a federal network of associations,264 it appeared to favor preemption on two rationales.265 The first rationale was that congressional occupation of an entire legislative field pursuant to a granted power renders state regulation inapplicable.266 The second was that state regulation in conflict with valid federal regulation is void.267 Since the

257 Id. at 139, 240 N.W.2d at 371.
258 Id. at 139-42, 240 N.W.2d at 372-73. See also Rettig v. Arlington Heights Fed. Sav. & Loan Ass’n, 405 F. Supp. 819 (N.D. Ill. 1975).
260 Id. at 904-7. See note 236 supra and accompanying text.
261 Id.
262 Id. at 912.
263 Id. at 908-10.
264 Id.
265 Id. at 912. The court reviewed the preemption doctrine at length without directly tying the facts to each preemption rationale.
266 Id. at 907. For discussion on this point see text accompanying note 253 supra.
267 Id. at 907-08. For discussion on this point see text accompanying note 253 supra.
FHLBB had promulgated a due-on-sale clause regulation pursuant to its delegated authority, the court based the rule of the case on the second rationale. Consequently, it held that the FHLBB due-on-sale regulation preempted conflicting California law and authorized federal lending associations to employ the standard clause.

Several federal courts have achieved like results in considering the preemptive effect of HOLA regulations. Although generally these courts have predicated their holdings on only one of the two rationales, the overwhelming majority has favored preemption.

In one case, First Federal Savings & Loan Association v. Greenwald, the court found no need to determine whether Congress had occupied the field. The Massachusetts statute which required that all mortgagees pay interest on escrow accounts directly conflicted with FHLBB regulations. The court held, therefore, that the Commissioner of Banks must accede to federal preemptive control.

Similarly, in Bailey v. First Federal Savings & Loan Association, a federal district court approved federally chartered associations' exercise of the standard due-on-sale clause following unconsented to transfer. The court acknowledged the FHLBB's duty to consider the best state practices in formulating its regulations. Nevertheless, it held that the decision to approve the use of such clauses emanated from FHLBB plenary authority to regulate federal associations. Denying the mortgagor injunctive relief, the court based its holding on the first enunciated Glendale rationale and declined to reach the preemption issue raised by conflicting state and federal directives.

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258 Id. at 912.
259 591 F.2d 417 (1st Cir. 1979).
260 Id. at 419-20.
261 Id. at 425-26.
263 Id. at 1141.
264 Id.
265 Id. at 1142.
The one strikingly dissimilar opinion is *Derenco, Inc. v. Benjamin Franklin Federal Savings & Loan Association.*277 There, Oregon mortgagors brought a class action against a federally chartered association for an accounting of funds maintained in tax and insurance payment reserve accounts.278 In an express attempt to accommodate both state and federal law,279 the Oregon Supreme Court stated that detailed federal regulations alone do not invoke the preemption doctrine.280 It was reasoned that where a court finds that state law "has an effect in an area outside the thrust of the federal enactment," it may uphold the state regulation subject to three qualifications.281 State regulations must fall when they "actually conflict" with the federal regulation, when they "interfere with federal purposes," or when "Congress or the federal regulatory body unmistakably indicates" an intent that federal law preempt state law.282 Without explanation, the court apparently found each qualification inappropriate. Instead, it held that regulatory control of these accounts is not an area in which uniformity is so critical that federal law must control exclusively.283 Consequently, federal law does not preempt this aspect of the state's regulatory power.284

Despite the *Derenco* court's holding on the issue of reserve accounts, the case can be construed in a way fully consonant with the majority view. The court's rationale supports a prediction that the Oregon court would uphold FHLBB exclusive authority to approve the inclusion and exercise of due-on-sale clauses in federal associations' loan contracts. Any state regulation which forbade the inclusion of due-on-sale clauses by federal associations, or limited the mortgagee's exercise of such clauses, would "actually conflict" with federal regulations and thus fall.285

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278 Id. at 535-37, 577 P.2d at 480-81.
279 Id. at 538-39, 577 P.2d at 482-83.
280 Id., 577 P.2d at 483.
281 Id. at 540, 577 P.2d at 483-84.
282 Id. at 540-42, 577 P.2d at 484-85.
283 Id. at 548, 577 P.2d at 487.
284 Id. at 548-49, 577 P.2d at 487-88. See also note 236 supra and accompanying text.
285 For federal regulations concerning the due-on-sale clause, see text accompanying note 245 supra.
Given the courts' unanimous agreement on this point, federally chartered savings and loan associations need consider only FHLBB limitations and solvency goals in determining whether to include the standard due-on-sale clause in residential loan contracts. In a severely inflationary market, the goals of solvency may further dictate the federally chartered associations' exercise the clause solely to escalate loan rates to current market levels. Barring a major change in FHLBB regulations, federal mortgagees should be free to maintain current portfolios by denying assumptions at original loan rates, despite disapproval by state statute or regulation.

VI. CONCLUSION

The burgeoning growth of the savings and loan industry has increased the availability to the public of residential financing. While economic hard times serve to winnow out less efficient producers within most markets, such a rejoinder cannot account for the dilemma currently facing the savings and loan industry. Committed to the dual purposes of encouraging thrift and providing consumer access to home ownership, these institutions have attempted to operate with inexpensive dollars. Persistently high levels of inflation, and a concomitant increased demand for short-term, higher yield investments, however, have eroded their financial position.

Additionally, the reluctance of many courts to recognize this dilemma in the face of superficially attractive consumer arguments has essentially locked these institutions into a downward slide. In failing to join the trend of viewing the standard due-on-sale clause as a bargained-for contract provision between the mortgagor and mortgagee, these courts are forcing most thrift institutions into an unhappy choice between receivership and the federal government. The rational alternative, as presented by the trend, decry this purely reflexive response as being without foundation in either legal or socio-economic theory. More importantly, it converts a no-win result into one that is productive and just for both lenders and borrowers.
<table>
<thead>
<tr>
<th>Year</th>
<th>(1) Savings and Loan Contract Rate</th>
<th>(2) Yield Rate</th>
<th>(3) Maturity (Years)</th>
<th>(4) Inflation Rate</th>
<th>(5) Savings and Loan Total Deposits (Millions of Dollars)</th>
<th>(6) Mortgage Loan Com-[entes Outstanding at End of Period (Millions of Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>5.74</td>
<td>5.87</td>
<td>25</td>
<td>1.2</td>
<td>124,493</td>
<td>110,306</td>
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<tr>
<td>1967</td>
<td>6.33</td>
<td>6.40</td>
<td>25.2</td>
<td>2.8</td>
<td>135,538</td>
<td>121,805</td>
</tr>
<tr>
<td>1969</td>
<td>7.66</td>
<td>7.81</td>
<td>25.5</td>
<td>5.4</td>
<td>174,197</td>
<td>140,347</td>
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<tr>
<td>1971</td>
<td>7.60</td>
<td>7.74</td>
<td>26.2</td>
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<td>227,254</td>
<td>174,250</td>
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<tr>
<td>1973</td>
<td>8.31*</td>
<td>7.95</td>
<td>26.3</td>
<td>4.3</td>
<td>386,800</td>
<td>232,104</td>
</tr>
<tr>
<td>1977</td>
<td>8.80</td>
<td>9.01</td>
<td>27.9</td>
<td>6.5</td>
<td>430,953</td>
<td>381,163</td>
</tr>
<tr>
<td>1978</td>
<td>9.30</td>
<td>9.54</td>
<td>28.0</td>
<td>7.7</td>
<td>*475,797</td>
<td>432,808</td>
</tr>
<tr>
<td>1980 (1st qtr.)</td>
<td>12.25</td>
<td>12.62</td>
<td>27.4</td>
<td>13.5</td>
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<td>478,065</td>
</tr>
</tbody>
</table>

(1) **FEDERAL RES. BULLETIN**, Chart A31 (April, 1974); Chart A40 (May, 1980).

(2) **FEDERAL RES. BULLETIN**, Charts A31 and A49 (April, 1974), Chart A40 (May, 1980).

(3) **FEDERAL RES. BULLETIN**, Chart A34 (April, 1974); Chart A23 (May, 1980).

(4) **BUSINESS CONDITIONS DIGEST**, Historical Data for Selected Series 99 (May, 1980).


*ACTUALLY REPRESENTS FIGURE FOR 4TH QUARTER OF 1979.


**CHART 1**
<table>
<thead>
<tr>
<th>Year</th>
<th>(1) Total Savings and Loan Repayments (including prepayments)</th>
<th>(2) Ratio of Prepayment to Loans Outstanding</th>
<th>(3) Savings and Loan Contract Rate</th>
<th>(4) Inflation Rate</th>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CPI</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>% Increase</td>
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<tr>
<td>1965</td>
<td>15,907</td>
<td>8,065/110,306</td>
<td>1965 5.74</td>
<td>94.5 1.72</td>
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<tr>
<td>1966</td>
<td></td>
<td></td>
<td>1966</td>
<td>97.2 2.85</td>
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<tr>
<td>1967</td>
<td>13,875</td>
<td>4,365/121,805</td>
<td>1967 6.33</td>
<td>100.0 2.88</td>
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<td>104.2 4.2</td>
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<tr>
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<td>14,144</td>
<td>2,450/140,209</td>
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<td>109.8 5.4</td>
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<td></td>
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<td>125.3 3.3</td>
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<td>161.2 9.1</td>
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<td>195.4 7.7</td>
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<td></td>
<td>1979</td>
<td>217.4 11.3</td>
</tr>
<tr>
<td>1980</td>
<td></td>
<td></td>
<td>1980</td>
<td>246.8 13.5</td>
</tr>
</tbody>
</table>


CHART 2