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Due-On-Sale Clauses And Clogging The Equity Of Redemption

DUE-ON-SALE CLAUSES AND CLOGGING THE EQUITY OF REDEMPTION

With the advent of the rising money market[1] the use of due-on clauses in mortgages and deeds of trust has become increasingly prevalent.[2] A due-on clause provides for the automatic or optional acceleration of the balance owing on a mortgage debt in the event of sale, encumbrance or other disposition of the underlying security.[3] Generally, the money-lending industry utilizes two types of due-on clauses, the more common due-on-sale clause[4] and the due-on-encumbrance clause.[5] The event which prompts the operation of the clauses distinguishes them.[6] Due-on clauses serve primarily as risk averters for lenders who wish to protect themselves against fluctuations in market interest rates,[7] although proponents of the clauses advance other justifications.[8] The clauses have come under critical scru-

[1] Throughout the 1950's and until the mid-1960's interest rates for mortgage loans remained fairly stable, with increases in the rates being slow and steady. Bartke & Tagaropulos, *Michigan's Looking Glass World of Due-On-Sale Clauses*, 24 WAYNE L. REV. 971, 975-77 (1978) [hereinafter cited as Bartke & Tagaropulos]. The interest rate for real estate transactions remained stable at 6% from the middle of 1961 until the end of 1965, at which time a credit crisis affected the market dramatically with interest rates increasing at an unusually fast rate and credit becoming tight. *Id.* at 977 & 977 n.18.

[2] Due-on clauses originally were included in the mortgages as additional protection for the lender's security interest. Lending institutions which faced rising interest rates experienced liquidity problems and consequently their ability to continue making loans was impaired. Bartke & Tagaropulos, *supra* note 1, at 978-79. As a means of increasing earning capacity, the lending insitutions began to invoke the due-on clauses contained in the mortgages. *Id.* at 979; *see* Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U. SAN. FRAN. L. REV. 267, 267-71 (1972) [hereinafter cited as Bonanno]. *See also* Bonanno, *supra* at 271-74 (historical background of use and development of due-on-sale clauses); Volkmer, *The Application of the Restraints On Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 769 (1973) [hereinafter cited as Volkmer].

[3] Bonanno, *supra* note 2, at 272; Comment, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1110 (1975) [hereinafter cited as *Judicial Treatment of the Due-on-Sale Clause*].

[4] The sale of the property which stands as security for a loan invokes the operation of a due-on-sale clause. *See* Bonanno, *supra* note 2, at 272; *Judicial Treatment of the Due-on-Sale Clause, supra* note 3, at 1110 n.5.

[5] The due-on-encumbrance clause becomes operable upon the placement of any encumbrances on the secured property subsequent to the execution of the governing agreement. *See* La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971); Bonanno, *supra* note 2, at 272 & 272 n.14; *Judicial Treatment of the Due-on-Sale Clause, supra* note 3, at 1110 n.5.

[6] *See* notes 4-5 *supra.*

[7] *See* note 2 *supra.* The lender protects itself with the due-on clause during periods of declining interest rates as well as during periods of rising rates. Attaching prepayment and/or assumption fees as conditions for tranfer afford such protection, thus enabling the lender to avoid loss of the interest income anticipated at the inception of the original loan. *See generally* Bonanno, *supra* note 2, at 270-71; text accompanying notes 17-21 *infra.*

[8] Proponents of the due-on clause argue that the clause provides protection against

tiny because of the harsh results involved for the borrower-homeowner who is unable to satisfy the balance owing on the mortgage or to secure new financing of the debt.[9] A lender's exercise of the option to accelerate the outstanding debt may interfere directly with the homeowner's right to sell his property if a potential buyer is unwilling to purchase the property unless the lender permits the buyer to assume the existing mortgage.[10] Additionally, the use of due-on clause is likely to foster a situation in which the borrower-homeowner is restrained economically from alienating his property if he is unable to meet the lender's conditions for transfer.[11] Such conditions may include a prepayment penalty,[12] an assumption fee,[13] an increased interest charge after transfer[14] or any combination of these penalties.[15]

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impairment or waste of the underlying security. *See* Baker v. Loves Park Sav. & Loan Ass'n, 21 Ill. App. 3d 42, 45, 314 N.E.2d 306, 308 (1974) (utility of restraint in enabling lender to monitor possessor or property in determining ability to keep the property in repair, outweighs injurious consequences); Volkmer, *supra* note 2, at 769-70. *But see* Valensi, *The Due On Sale Clause—A Dissenting Opinion*, 45 L.A. BULL. 121, 121, 123 (1970) (primary purpose of due-on clause is regulation of interest rates; impairment of security is collateral purpose). *See generally* G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 5.21 (1979) [hereinafter cited as OSBORNE].

[9] *See* Wellenkamp v. Bank of America, 21 Cal. 3d 943, 950, 582 P.2d 970, 974, 148 Cal. Rptr. 379, 383 (1978).

[10] *See Judicial Treatment of the Due-on-Sale Clause, supra* note 3, at 1113. Additionally, if assumption is permitted only upon the condition of a higher interest rate, the purchaser may force the homeowner to lower the selling price of the property, forcing a "loss" onto the homeowner. *Id.*; Note, *The Case For Relief From Due-On-Sale Provisions: A Note To Hellbaum v. Lytton Savings And Loan Association*, 22 HASTINGS L.J. 431, 436 (1971) [hereinafter cited as *Case for Relief*]. *See generally* Wellenkamp v. Bank of America, 21 Cal. 3d 943, 950, 582 P.2d 970, 974-75, 148 Cal. Rptr. 379, 383 (1978) (economic impact of due-on clauses on borrower-mortgagors).

[11] *See* Wellenkamp v. Bank of America, 21 Cal. 3d 943,____, 582 P.2d 970, 974-75, 148 Cal. Rptr. 379, 383 (1978); *Judicial Treatment of the Due-on-Sale Clause, supra* note 3, at 1113; note 10 *supra*.

[12] A lender may charge a prepayment "penalty" against a debtor who seeks to pay off an indebtedness prematurely, thus denying the lender of potential interest earnings. *See* Bloomfield Sav. Bank v. Howard S. Stainton & Co., 60 N.J. Super. 524, 159 A.2d 443 (1960) (approving prepayment penalty).

[13] A lender may charge a homeowner-borrower's grantee an "assumption fee" for the privilege of assuming the grantor's mortgage. This fee often is defended as a necessary administrative charge to defray cost incurred when a new borrower assumes a mortgage. *See* Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969) (assumption fee of five percent assessed as condition to assume). *See generally Case for Relief, supra* note 10, at 434-37.

[14] Rising interest rates in the market as a whole, *see* text accompanying notes 1-2 *supra*, have made commonplace the increase of interest rates as a condition for assumption by grantees. *See, e.g.*, Gunther v. White, ____ Tenn. ____, 489 S.W.2d 529 (1973); Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 58 Wis. 2d 99, 205 N.W.2d 762 (1973).

[15] *See, e.g.*, Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973) (sale approved on condition of executing "assumption and Modification Agreement" raising interest rate from seven to eight percent); Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P.2d 190 (1971) (mortgage provided for prepayment penalty and acceleration); Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (Ct. App. 1969)

Opponents of the clauses attack their validity by arguing that they violate the common law prohibition of restraining the alienation of land.[16] Historically, restraints on the alienation of property[17] have been opposed for various reasons, such as their tendency to remove the property from commerce[18] and to discourage property improvements.[19] The majority of courts have viewed all such restraints as void unless they qualify for specifically defined exceptions.[20] A minority view, however, ruled restraints void

(savings & loan refused consent of proposed sale unless grantee agreed to pay assumption fee and higher interest rate).

[16] *See, e.g.,* Coast Bank v. Minderhout, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964); Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976).

At common law, any and all restraints on the alienation of land generally were void. Sanders v. Hicks, 317 So. 2d 61, 63 (Miss. 1975). The basis for this rule was the social and economic desirability of giving an owner of a fee simple in land the power to transfer his interest. Schnebly, *Restraints Upon the Alienation of Legal Interests: I,* 44 YALE L.J. 961, 961 (1934) [hereinafter cited as Schnebly]. The rule against restraints is aimed primarily at attempts to render vested interests inalienable. *Id.* at 963; *see* text accompanying notes 18-20 *infra. See generally,* 3 L. SIMES & A. SMITH, THE LAW OF FUTURE INTERESTS § 1111, 1114, 1133 (2d ed. 1956) [hereinafter cited as SIMES & SMITH]; *see also* 3 SIMES & SMITH, *supra* § 1153 (consent of third party condition to alienation).

[17] Restraints on alienation of property may take various forms and generally are classified as either disabling, forfeiture or promissory restraints. *See* 3 SIMES & SMITH, *supra* note 11, § 1131. Disabling restraints withhold the power to convey from the grantee, while forfeiture restraints go even further in purportedly divesting the grantee of his title upon an attempted alienation. A.CASNER & W. LEACH, CASES AND TEXT ON PROPERTY 1008 (2d ed. 1979). Valid promissory restraints are consensual agreements which are specifically enforceable. *Id.* The due-on clause does not fit precisely into any of these classifications because, although consensual, the clause has not been found to be specifically enforceable but rather merely a legitimate justification for acceleration of the mortgage debt. *See* Coast Bank v. Minderhout, 61 Cal. 2d 311, 316, 391 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964) (doubt as to enforceability of due-on-sale clause by injunction, specific performance or action for damages). *See generally* Volkmer, *supra* note 2, at 748-53, 768-70 (summary of restraint classification and analysis of due-on clause as analogous to forfeiture restraint).

[18] While objection to keeping property out of commerce is most important when there is a shortage of marketable properties, Schnebly, *supra* note 16, at 964, the restraint also would tend to stagnate the economy if buying and selling were discouraged. *See* 3 SIMES & SMITH, *supra* note 16, § 1135. *See generally Judicial Treatment of the Due-on-Sale Clause, supra* note 3, at 1113 n.16; Comment, Coast Bank v. Minderhout *And The Reasonable Restraint On Alienation: Creature of Commercial Ambiguity,* 12 U.C.L.A. L. REV. 954, 956-57 n.14 (1965) [hereinafter cited as *Commercial Ambiguity*].

[19] Schnebly, *supra* note 11, at 964. The effect of a restraint to discourage improvement of property because of the inability of the owner to sell and realize a profit has been noted as the chief objection to restraints, especially since maximum utilization of the land subject to a restraint is virtually impossible. *Id.* at 964 n.17.

[20] *See* Bernhard, *The Minority Doctrine Concerning Direct Restraints on Alienation,* 57 MICH. L. REV. 1173, 1174 (1959) [hereinafter cited as Bernhard].

Among the interests which have been recognized as justifiable restraints on alienation are spendthrift trusts, leases for terms of years, life estates and executory land contracts. *See* Coast Bank v. Minderhout, 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964); Schnebly, *supra* note 17, at 989-93.

only if unreasonable.[21]

In addition to the common law doctrine opposing alienation restraints, the common law doctrine which prohibits clogging[22] the equity of redemption[23] is adaptable to due-on clause analysis. The equity of redemption represents the right of the mortgagor after default to perform his obligations under the mortgage prior to a valid foreclosure sale, thereby having title restored to him free of the mortgage.[24] Although rarely discussed in American judicial decisions,[25] the anti-clogging doctrine prohibits, among other things, the "fettering away" of a mortgagor's equity of redemption,[26] an arguably unavoidable consequence when mortgage terms include a due-on clause.[27]

The first judicial treatment and approval of due-on clauses came in 1964 with the California Supreme Court decision of *Coast Bank v. Minderhout.*[28] *Coast Bank* involved foreclosure of an equitable mortgage,[29] the existence of which the defendant-transferees contested.[30] The court

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[21] Bernhard, *supra* note 20, at 1174. The minority position viewed a restraint as reasonable if the justification for the restraint outweighed the actual resulting restraint. *Id.* at 1177: *cf.* Baker v. Loves Park Sav. & Loan Ass'n, 21 Ill. App. 3d 42, 45, 314 N.E.2d 306, 309 (1974) ("consent to sale" clause found enforceable since utility of restraint outweighed injurious consequences).

[22] A clog is an impairment of the mortgagor's right to the equity of redemption. Santley v. Wilde, [1899] 2 Ch. 474, 475, 478; Bacon v. Bacon, 21 Eng. Rep. (1639); OSBORNE, supra note 8, § 3.1; text accompanying notes 84-86 *infra.*

[23] *See* Williams, *Clogging The Equity of Redemption,* 40 W. VA. L.Q. 31, 36-37 (1933) [hereinafter cited as Williams]; OSBORNE, *supra* note 8, § 3.1.

[24] OSBORNE, *supra* note 8, § 7.1; *see* Burgess v. Wheate, 28 Eng. Rep. 652, 670 (Ch. 1759) (equity of redemption descends, may be granted, devised and entailed).

[25] *But see* Humble Oil & Ref. Co. v. Doerr, 123 N.J. Super. 530, 303 A.2d 898 (1973) (doctrine of clogging examined in context of lease and leaseback transaction).

[26] *See* Santley v. Wilde, [1898] 2 Ch. 474, 475 (explanation of clog or fetter on mortgagor's equity of redemption). *See generally* The Conveyancer, 177 L.T. 361 (1934).

[27] *See* text accompanying notes 83-98 *infra.*

[28] 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964). *See generally Commercial Ambiguity, supra* note 18.

[29] 61 Cal. 2d 311, 313, 392 P.2d 265, 266-67, 38 Cal. Rptr. 505, 506 (1964). The plaintiff-bank made several loans to Burton and Donald Enright for the improvement of property they owned. In addition to executing a promissory note for the indebtedness, the parties executed a separate instrument containing a provision in which the borrowers agreed not to encumber or transfer their property without the lender's consent. The provision further provided that if the borrower did not abide by the agreement, the lender could accelerate the balance at its discretion. *Id.* at 313, 392 P.2d at 266 & 266 n.2, 38 Cal. Rptr. at 506.

Without the consent or knowledge of the bank, the Enrights conveyed the property to the defendants. *Id.* at 313, 392 P.2d at 266, 38 Cal. Rptr. at 506. The bank apparently exercised its option to accelerate the due date for the outstanding debt, but was unable to collect the unpaid balance. *Id.* Subsequently, the bank sought to foreclose the equitable mortgage which it maintained the instrument created. *Id.;* text accompanying notes 44-48 *infra*

[30] 61 Cal. 2d 311, 314, 392 P.2d 265, 267, 38 Cal. Rptr. 505, 507 (1964). The defendants maintained that the bank extended unsecured credit to the Enrights while retaining the right to withdraw the credit if the property was conveyed or encumbered in contravention of the agreement which the parties executed. *Id.*

determined, however, that the inclusion of the due-on clause evidenced the intention of the parties to create an equitable mortgage.[31] Responding to the court's determination that the instrument did in fact create an equitable mortgage,[32] the defendants contended that the instrument was ineffective because the due-on-sale clause constituted an invalid restraint on alienation.[33] The circuity of the *Coast Bank* decision becomes apparent with the realization that the due-on clause in the governing instrument served as the basis for the court's finding that the parties intended to create a security interest in the property[34] and, therefore, that the instrument created an equitable mortgage.[35] Simply, the court ruled that the instrument created an equitable mortgage relying on the inclusion of the due-on provision, which was valid because it operated within the context of an equitable mortgage protecting the lender's security.[36] Had the court found the clause to be an invalid, and consequently inoperable, restraint on alienation, the basis for the mortgage would have been invalidated.[37]

The situation that arose in *Coast Bank* was attributable to the common desire of the lending industry to avoid the antideficiency judgment legislation then effective in California.[38] Generally, anti-deficiency judgment legislation restricts creditors' rights to enforce mortgage debts, and consequently is disfavored by institutional lenders.[39] The statutory enactments in California may limit the creditor's right to a judgment for a deficiency if the security should prove insufficient to satisfy the debt.[40] In an attempt to escape the restrictions of the anti-deficiency judgment statutes when

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[31] *Id.*

[32] *Id.*

[33] *Id.* at 314, 392, P.2d at 267-68, 38 Cal. Rptr. at 507.

[34] *Id.* at 314, 392 P.2d at 267, 38 Cal. Rptr. at 507; *see Commercial Ambiguity, supra* note 13, at 958-59 n.29.

[35] 61 Cal. 2d 311, 314, 392 P.2d 265, 267, 38 Cal. Rptr. 505, 507 (1964).

[36] *See* text accompanying notes 34-37 *supra.*

[37] *See Commercial Ambiguity, supra* note 13, at 958-59 & 959 n.30 (procedural technique of *Coast Bank* court questioned).

[38] Unless a statute provides otherwise, a creditor secured by a deed of trust or mortgage on real property is entitled to recover the full amount of the outstanding debt upon the debtor's default. Roseleaf Corp. v. Chierighino, 378 P.2d 97, 98, 27 Cal. Rptr. 873, 874 (1963). The creditor may choose to satisfy the debt by realizing on the security or directly suing the debtor on the obligation, or both. *Id.* Most states, however, have enacted legislation restricting the creditor's right to enforce such debts. *Id.* In California, the statutory enactments which govern in the event that the security is insufficient to satisfy the debt may limit the creditor's right to a judgment for the deficiency, *id.*, hence the term "anti-deficiency" legislation. *See* CAL. CODE CIV. PROC. § 580a, 580b, 580d, 726; Hetland, *Real Property and Real Property Security: The Well-Being of the Law,* 53 CALIF. L. REV. 151, 159-65 (1965) [hereinafter cited as Hetland] (antideficiency legislation and related case law); Hetland, *Deficiency Judgment Limitations in California—A New Judicial Approach,* 51 CALIF. L. REV. 1, 1-7, 28, 35-37 (1963) (legislative purpose in promulgating anti-deficiency statutes); Riesenfeld, *California Legislation Curbing Deficiency Judgments,* 48 CALIF. L. REV. 705, 705-07 (1960) (history, nature and scope of legislation).

[39] *See* note 38 *supra.*

[40] *Id.*

advantageous,[41] California lenders avoided the absolute classification of their interests as secured or unsecured by creating a "masked security device."[42] The borrower normally would desire a determination that the governing instrument was in fact a mortgage so to acquire the protections of the antideficiency judgment statutes.[43] In the *Coast Bank* setting, however, the lender benefitted from the foreclosure on the property following the finding that an equitable mortgage existed.[44]

The *Coast Bank* context justifies the court's determination since a contrary decision would prove burdensome to the future debtor seeking the statutory protections provided by the legislature.[45] Furthermore, the nature of the loan provides support for the *Coast Bank* decision because the advances were made for improvements on the subject property[46] and arguably the original borrower's interest in the condition of the property is diminished upon the transfer of the property to a third party.[47] Therefore, although the lending industry subjected its instruments to classification as mortgages which were thus susceptible to the anti-deficiency statutes, the effect of the court's ruling on the validity of due-on clauses was, in fact, to the lender's advantage.[48]

In upholding the validity of the due-on-sale clause, the *Coast Bank* court noted that not all restraints are invalid.[49] The court emphasized that in several instances, courts had found restraints to be reasonable when the proponents could demonstrate a justifiable interest which warranted the protection afforded by the restraint.[50] Accordingly, the *Coast Bank* court concluded that the constraints of the due-on-sale clause were not unreasonable conditions to impose, in exchange for the bank's continued extension of credit to the original borrower.[51] Consequently, the court approved

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[41] Since the anti-deficiency legislation curbs the creditor's right to a deficiency judgment with transactions involving deed of trust and mortgages, see CAL. CODE CIV. PROC. § 580b, 580c, the lender, by structuring transactions without formal deed of trust or mortgage instruments, stood to benefit if exempted from the statutory dictates. *See* Hetland, *supra* note 38, at 167-70.

[42] *See* Hetland, *supra* note 38, at 167.

[43] *Id.*

[44] 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964); *see* Hetland, *supra* note 38, at 167; note 29 *supra.*

[45] *See* Hetland, *supra* note 38, at 167-71.

[46] 61 Cal. 2d 311, 313, 392 P.2d 265, 266, 38 Cal. Rptr. 505, 506 (1964); *see* text accompanying note 51 *infra.*

[47] *See* Coast Bank v. Minderhout, 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964); Hetland, *supra* note 38, at 170.

[48] *See* Hetland, *supra* note 38, at 170-71; text accompanying note 43 *supra.*

[49] Hetland, *supra* note 38, at 170-71.

[50] *Id., see Commercial Ambiguity, supra* note 18, at 955-58; note 20 *supra.*

[51] 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964). While the court's decision did not emphasize the difference between a loan for property improvement and a purchase money mortgage, the distinction should be considered. With a purchase money mortgage, the money lent is tied intimately to the land and the land itself can answer for any default in payment by the mortgagor through foreclosure proceedings. *See* OSBORNE *supra*

the acceleration of the debt and subsequent foreclosure of the mortgage.[52] More importantly for the commercial lender, however, the due-on-sale clause received judicial recognition as a potentially reasonable restraint on alienation.[53]

Judicial treatment of the due-on clause since *Coast Bank* has focused on the restraint on alienation aspect of the clause.[54] Courts have tended either to be lender-oriented, with the onus on the borrower to demonstrate that the operation of the due-on clause is unconscionable or inequitable,[55] or borrower-oriented, with the burden resting on the lender to establish justifiable interests which render the operation of the clause to be reasonable.[56] No jurisdiction has declared a due-on clause invalid per se,[57] although recent decisions by the Arizona and California Supreme Courts have indicated an increasing disdain for the clause and its underlying policies.[58]

Perhaps the most intriguing judicial treatment of the due-on clause during the last fifteen years originated in the California courts.[59] The Cali-

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note 9, § 1.1. In contrast, the loan made for property improvement does not have the built-in security of the purchase money mortgage, thus requiring the lender to depend more heavily upon the character of the debtor as protection for its extension of credit. *Cf.* U.C.C. § 9-107 (purchase money security interest).

[52] 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964).

[53] *See id.* The court expressed doubt as to the success a lender, who sought specific performance of the borrower's promise not to transfer property, might have, recognizing this situation as a potentially unreasonable restraint on alienation. *Id. See generally* Hetland, *supra* note 38, at 170.

[54] *See* Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 F.2d 1013, 1017 n.4 (10th 1974) (judicial treatment of due-on-sale clauses); note 12 *supra.*

[55] The lender-oriented position displays a keen awareness of the lender's economic considerations in a market of rising interest rates. *See, e.g.,* Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135, 138-39 (Ct. App. 1969) (disapproved in *Wellenkamp*); Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294,____, 509 P.2d 1240, 1244-45 (1973); Century Fed. Sav. & Loan Ass'n v. Van Glahn, 144 N.J. Super. 48, 364 A.2d 558, 561-62 (1976); Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 395 N.Y.S.2d 583, 585-86 (1977). *See generally* Bartke & Tagaropulos, *supra* note 1, at 984-85, 988.

[56] *See, e.g.,* Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 80, 486 P.2d 190, 192 (1971) (underlying reason for clause goes to responsibility of party in possession; exercise must be reasonable on face); Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972) (grounds for invocation of due-on clause must be reasonable on face); La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 868, 489 P.2d 1113, 1121, 97 Cal. Rptr. 849, 854 (1971) (exercise of due-on-encumbrance clause must be reasonably necessary to protect security).

[57] Barke & Tagaropulos, *supra* note 1, at 984-85. Nineteen states have addressed the due-on-sale clause controversy. *Id.* at 985.

[58] *See* Patton v. First Fed. Sav. & Loan Ass'n, 118 Ariz. 473, 578 P.2d 152 (1978) (enforcement of due-on-sale clause requires showing that nonenforcement will jeopardize security); Wellenkamp v. Bank of America, 21 Cal. 3d 953, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (assumes borrower oriented position by requiring showing of justification for enforcement of clause); Comment, *Arizona, California High Courts Adopt Minority View Re Due-on-Sale Clause Enforcement,* 54 LEGAL BULL. 370 (1978).

[59] After *Coast Bank,* the due-on-clause conflict was addressed again in Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969). Hellbaum, the borrower's successor, sued the lender for allegedly negligent processing of the successor's

application for assumption by the successor's transferee of the balance owing on the borrower's secured note. *Id.* at 458, 79 Cal. Rptr. at 10. The instruments governing the original transaction contained a clause providing for a prepayment fee which was expressly applicable to any early payment that the borrowers might be obligated to pay under the instrument's due-on clause. *Id.* The borrower's successor contracted to sell the subject property, applying to the lender for approval of the assumption since the transferee was unable to meet the financial burden of prepayment fees in addition to loan fees which would be incurred upon refinancing. *Id.* The lender approved the assumption provided that a five percent assumption fee would be paid, causing the transferee to withdraw from the transaction. *Id.* The successor then defaulted and the property was sold at a trustee's sale, at which time the successor sued for damages representing the difference between what would have been realized on the proposed sale and amount owed under the promissory note. *Id.*

The successors conceded that under *Coast Bank,* the due-on clause was a reasonable restraint on alienation so long as the restraint protected the justifiable interest of the lender in "maintaining the direct responsibility of the parties on whose credit the loan was made." *Id.* at 459, 79 Cal. Rptr. at 11. The successors contended, however, that the combination of the lender's right to accelerate and to charge a prepayment fee upon acceleration constituted an unlawful restraint on alienation. *Id.* The court held that the lender had a justifiable interest in discouraging early payment. Because of this interest and the previously acknowledged justifiable interest of borrower identity, the terms of the instrument did not constitute an unreasonable restraint on alienation. *Id.*

Shortly after *Hellbaum,* the court decided another due-on case, Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969). The court in *Cherry* gave the lender essentially unbridled power to avail itself of the due-on clause benefits. *See* text accompanying notes 60-63 *infra.*

The decision of La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971), exposed to judicial scrutiny the questions raised by a due-on-encumbrance clause. The borrowers in *La Sala* brought a class action seeking a declaration of the invalidity of the clause which permitted acceleration if the borrower executed a junior encumbrance on the secured property. *Id.* at 864, 489 P.2d at 1113, 97 Cal. Rptr. at 849. Without holding the clause invalid *per se,* the court concluded that the legality of enforcing the clause would depend upon the necessity of protecting the lender's security through enforcement. *Id* at 882, 489 P.2d at 1121, 1125, 97 Cal. Rptr. at 859. Thus, the court denied the lenders automatic performance of due-on-encumbrance clauses, while preserving such performance of due-on-sale clauses. *Id.* at 887, 489 P.2d at 1126, 97 Cal. Rptr. at 863; *see id.* at 880 n.17, 489 P.2d at 1125 n.17, 97 Cal. Rptr. at 859 n.17.

The California courts' first serious opposition to the due-on-sale clause came in the 1974 decision of Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. (1974). The instrument governing the transactions provided for the assessment of prepayment penalties and acceleration as in *Hellbaum.* The execution of an installment land contract by the borrowers and their tenants prompted acceleration of the balance. *Id.* at 631, 526 P.2d at 1170, 116 Cal. Rptr. at 634. In an extension of the *La Sala* court's balance of the necessity of protection against the effect of restraint, the *Tucker* court explored the distinctions between an installment loan contract and an outright sale, *see id.* at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639. Demonstration of a threat to a lender's legitimate interest must be made for the court to validate enforcement of a due-on clause. *Id.*

The California court thus laid the groundwork for overruling the *Coast Bank* decision, and pursued this goal in Wellenkamp v. Bank of America, 21 Cal. 3d 953, 582 P.2d 970, 148 Cal. Rptr. 379 (1978), the latest California decision to discuss the due-on clause controversy. The borrower's transferee challenged the enforcement of a due-on-sale clause following an outright sale, *id.* at 946, 582 P.2d at 972, 148 Cal. Rptr. at 382, upon the bank's conditioning its forebearance of acceleration on an increase in the loan interest rate from 8% to 9 ¼%. *Id.* The California Supreme Court accepted the transferee's arguments, holding that a due-on clause cannot be enforced upon an outright sale unless the lender demonstrates the necessity of enforcement to protect against impairment to the security or the risk of default. *Id.* at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 385.

fornia courts extended the decision of *Coast Bank* to the point of virtually unchallengeable acceptance of the due-on clause with the decision of *Cherry v. Home Savings & Loan Association.*[60] The lender in *Cherry* charged an assumption fee in addition to increasing the interest rate on the loan, as conditions precedent to consenting to a property transfer.[61] The borrowers and their transferees, as appellants, contended that the lender was required to act reasonably in withholding consent to transfer the property.[62] After reciting business justifications for the due-on clause, the court ruled that the lender had the discretionary right to exercise its option and was under no obligation to act reasonably.[63]

The California court qualified the position assumed in *Cherry*, however, when the validity of a due-on-encumbrance clause was questioned.[64] The court applied further restrictions to the *Cherry* holding when a borrower who alienated his property by means of an installment land contract challenged the operation of the due-on-sale clause.[65] Finally, in the most recent California decision to examine the force and effect of a due-on-sale clause, *Wellenkamp v. Bank of America,*[66] the court assumed a borrower-oriented position, holding that a due-on clause is unenforceable upon outright sale unless the lender demonstrates the necessity of its enforcement.[67] Thus, the *Wellenkamp* decision substantially erodes the once-favored status of the due-on clause in California.[68]

Examination of the other jurisdictions which have considered the due-on clause question since *Coast Bank* reveals a divergence similar to that demonstrated by the California courts.[69] While the majority of jurisdictions

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The *Wellenkamp* court stated expressly that the maintenance of the lender's portfolio at current legal rates was an insufficient interest to justify the exercise of a due-on-sale clause. *Id.* at 953, 582 P.2d at 976, 143 Cal. Rptr. at 385. In addition, the court noted that the lender should bear the risk of economic fluctuation and should protect itself against such a risk when making the loan. *Id.* While minimizing the effect that a transfer of the property involved might have on a lender, the court maximized the potential harm to the borrower by restraining alienation. *Id.* The court emphasized that the borrower should not bear the harm of the lender's "mistaken projections." *Id. See generally* Note, *The Demise Of The Due-On-Sale Clause,* 64 CALIF. L. REV. 573, 576-79 (1976); *Case for Relief, supra* note 10, at 435-39.

[60] 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (Ct. App. 1969).

[61] *Id.* at 575, 81 Cal. Rptr. at 136-37.

[62] *Id.* at 575, 81 Cal. Rptr. at 137.

[63] *Id.* at 576, 81 Cal. Rptr. at 139.

[64] *See* La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 97 Cal. Rptr. 849, 489 P.2d 1113 (1971); note 59 *supra.*

[65] *See* Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 116 Cal. Rptr. 633, 526 P.2d 1169 (1964); note 59 *supra.*

[66] 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); *see* Note, Wellenkamp v. Bank of America: *Invalidation of Automatically Enforceable Due-on-Sale Clauses,* 67 CALIF. L. REV. 886 (1979); note 59 *supra.*

[67] 21 Cal. 3d 943, 953, 582 P.2d 970, 976-77, 148 Cal. Rptr. at 385; *see* note 59 *supra.*

[68] *See* note 59 *supra. But see* Medovoi v. American Sav. & Loan Ass'n, 89 Cal. App. 3d 875, 152 Cal. Rptr. 572 (1979) (California Supreme Court ordered that opinion not be officially published) (limits *Wellenkamp* to voluntary transfers of secured property).

[69] In *Cherry,* the California court rendered its most extreme pro-lender opinion when the

have been lenient in enforcing due-on clauses, few have been as lender oriented as New Jersey[70] or Tennessee.[71] In *Century Federal Savings & Loan Association v. Van Glahn,*[72] a New Jersey court held the lender's intent to maintain portfolio interest rates to be a legitimate exercise of a due-on-sale clause. Notwithstanding the holding in *Van Glahn* regarding the lender's intent, the court stated that the legitimacy of a lender's motive was an immaterial consideration when evaluating the enforceability of a due-on clause.[73] Similarly in support of the lender position, the Tennessee Supreme Court has stated that while due-on clauses would not be enforced unequivocally, no imaginable justification existed for rendering the exercise of an acceleration clause invalid by characterizing the exercise of a due-on-sale clause as unconscionable or inequitable.[74] Absent fraud or un-

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lender's interest rate increase was recognized as reasonable justification for the enforcement of the due-on clause. *Compare* Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (Ct. App. 1969) *with* Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973) *and* Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976). In contrast to *Cherry,* the recent decision of *Wellenkamp* demonstrates the California court's altered attitude with respect to due-on clauses. The *Wellenkamp* decision requires a showing that the mortgagee's security is jeopardized before the enforcement of a due-on clause will be mandated. *Compare* Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) *with* Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972) *and* Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P.2d 190 (1971).

[70] *See* Century Fed. Sav. & Loan Ass'n v. Van Glahn, 144 N.J. Super. 48, 364 A.2d 558 (App. Div. 1976); text accompanying notes 72 & 73 *infra.*

[71] *See* Gunther v. White, ___ Tenn. ___, 489 S.W.2d 529 (1973); text accompanying note 74 *infra.*

[72] 144 N.J. Super. 48, 364 A.2d 558 (App. Div. 1976). The New Jersey court addressed the question of whether an acceleration provided for in a due-on-sale acceleration clause was valid and enforceable. The court upheld the acceleration as a legitimate and valid contractural term. *Id.* at ___, 364 A.2d at 559-60. As further support for the lender's position, the court stated that the motivations in exercising the provisions of the clause were immaterial and that an improper motive would not necessarily invalidate a foreclosure action subsequent to acceleration and default. *Id.* at ___, 364 A.2d at 561. In addition, the court specifically held that acceleration motivated by a desire to keep the lender's portfolio at current interest rates was "eminently proper." *Id.*

[73] *Id.*

[74] *See* Gunther v. White, ___ Tenn. ___, ___, 489 S.W. 2d 529, 530-31 (1973). The appellant-debtors in *Gunther* negotiated a sale of property encumbered by a deed of trust and promissory note in favor of the appellees. *Id.* at 529. The agreement to purchase was conditioned on the appellee consenting to an assumption of the obligation by the prospective purchaser at the original 6 ¼% interest rate. *Id.* The appellees chose to withhold consent unless the interest rate was increased to 8%, causing the potential buyer to cancel the sale transaction. *Id.* The appellants subsequently brought suit claiming that the appellees action in withholding consent to transfer at 6 ¼% interest was a restraint of trade, was against public policy and would unduly restrain appellants' right to sell and convey their property. *Id.*

The court recognized the economic advantages and disadvantages to both parties involved in a lender-borrower relationship, finding the lender's position to be more defensible and worthy of support. *Id.* at 532. Since the rights of the parties had been fixed by contract, the court declined to invalidate the contract or the acceleration simply because the lender rather than the borrower would benefit from the increased interest rate. *Id.*

conscionability in enforcement, these lender oriented jurisdictions appear impervious to the arguments of an economically distraught borrower.[75]

In contrast to the lender oriented jurisdictions are those jurisdictions which have embraced the arguments advanced by the consumer-borrowers.[76] Among the jurisdictions espousing the borrower position are Arkansas,[77] Florida,[78] and Oklahoma.[79] In these borrower-oriented jurisdictions the courts permit enforcement of due-on clauses only if acceleration is reasonable under the circumstances of the case.[80] The determination of reasonableness is tied to a required showing of actual or probable injury to the lender, absent enforcement of the clause. Once this determination of reasonableness is made, an inquiry into the reasonableness of the restraint on alienation is academic only.[81] The *Wellenkamp* decision espouses a philosophy aligned with these borrower-oriented jurisdictions.[82]

Although the validity of the due-on clause has been disputed repeatedly as an encroachment of the common law doctrine forbidding restraints on the alienation of property,[83] the clause has not been challenged as violative of the common law doctrine which prohibits clogging[84] the equity of re-

[75] For additional discussion of the fraud and unconscionability standards used as basis for denial of due-on clause enforcement, *see* Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, ____, 509 P.2d 1240, 1245 (1973) (effort to extract excessive interest rate unrelated to current market rate might constitute unconscionable conduct, relieving borrower of effect on due-on-sale clause); Mutual Real Estate Inv. Trust v. Buffalo Sav. Bank, 90 Misc. 2d 675, 677, 395 N.Y.S.2d 583, 586 (1977) (lender's right to accelerate could be restrained if unconscionable or unfair result); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 629, 224 S.E.2d 580, 586 (1976) (absent allegations and proof that lender acted fraudulently, inequitably, oppressively or unconscionably in demanding increased interest rate, exercise of due-on-sale clause reasonable).

[76] *See* text accompanying notes 56-57 *supra,* 77-80 *infra.*

[77] For an early decision espousing the borrower's position in a due-on clause controversy, see Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972). For the enforcement of a due-on clause to be valid, the court required the invocation to be based on reasonable grounds. *Id.* at 728. The court offered circumvention of the due-on clause's purpose or impairment of the lender's security as reasonable to support enforcement. *Id.* at 729.

[78] In Clark v. Lachenmeier, 237 So. 2d 583 (Fla. 1970), the court denied the lender's foreclosure sought solely on the basis of a violation of a due-on clause where the lender was not harmed.

[79] In Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 P.2d 1013 (Okla. 1974), the court held that charging an assumption fee of 1% was unreasonable and inequitable as a condition precedent to transferring a mortgage which contained a due-on provision. The court reached its conclusion after determining that there was not an express provision in the governing instruments for a 1% transferring fee that the fee did not reflect the actual costs of transferring the mortgage and that the transfer did not jeopardize the lender's security.

[80] *See* note 56 *supra.*

[81] *See* text accompanying note 67 & notes 77-80 *supra.*

[82] 21 Cal. 3d 943, 453, 582 P.2d 970, 976-77, 148 Cal. Rptr. at 385.

[83] *See* text accompanying notes 11-14 *supra.*

[84] *See* note 22 *supra. See generally* Williams, *supra* note 23, at 33-37 (theories on the origin of doctrine opposing clogs). The most reasonable theory of the doctrine's origin is that associated with a general theory of equity abhorring oppression. *Id.* at 36. Traditionally, equity courts disfavored hard bargains in contracts and favored the weaker party to the bargain. *Id.* at 36-37, 42-45, 45 n.80.

demption.[85] The lack of such an analytical attack is attributable in part to the sporadic application of the doctrine in American judicial history.[86] Such omission, however, should not prevent an examination of the doctrine with respect to the due-on clause and its operation. Basic to the doctrine was the equity court's aim to prevent overreaching by a lender[87] of a "necessitous borrower."[88] The equity court's belief that the borrower-mortgagor should, in effect, be protected from himself and his lender caused the court to disallow any action prior to, or contemporaneous with, a mortgage agreement that tended to impair the mortgagor's right to the equity of redemption.[89] The right to the equity of redemption has been guarded closely since its development by the courts as a means to circumvent the strict foreclosure of law day.[90] Essentially, the equity of redemption permits the mortgagor, after default, to perform the obligation under the mortgage and then to hold the property free from the mortgage lien.[91] Equity thus grants relief to the mortgagor because of the nature of the transaction entitling the mortgagee to security only in the mortgagor's land.[92] Redemption rights accrue in anyone who has obtained an interest from or through the mortgagor.[93] As a result of the prohibition against clogging, the equity courts historically have voided agreements which "fettered away" the mortgagor's right[94] or which bestowed a collateral advantage on the mortgagee at the expense of the mortgagor's equity of redemption.[95]

From the mortgagor's viewpoint, the typical due-on clause routinely included in a commercial lender's agreement clogs the equity of redemp-

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[85] *See* notes 23-24 *supra.*

[86] The doctrine aimed at preventing clogging has enjoyed extensive discussion in English jurisprudence, *see, e.g.*, Kreglinger v. New Patagonia Meat & Cold Storage Co., [1914] A.C. 25; Biggs v. Hoddinott, 2 Ch. 307 (1898); Mainland v. Upjohn, [1899] 41 Ch. D. 126; Casborne v. Scarfe, 26 Eng. Rep. 377 (Ch. 1737); Jennings v. Ward, 23 Eng. Rep. 935 (Ch. 1705). However, American treatment of the doctrine, especially of late, has been cursory. *See* OSBORNE, *supra* note 9, § 3.1. The doctrine was discussed in the New Jersey decision of Humble Oil & Refining Co. v. Doerr, 123 N.J. Super. 530, 303 A.2d 898 (Ch. Div. 1973). In *Doerr* the court addressed the specific point of whether the doctrine bars a mortgagor's guarantor from taking an option to purchase the property from the mortgagor, as part of the original mortgage transaction. *Id.* at 540, 303 A.2d at 906. Relying on the clogging doctrine, the court concluded that the equity of redemption was clogged, and denied enforcement of the option provision. *Id.* at 540-44, 303 A.2d at 906-08.

[87] *See* Toomes v. Conset, 26 Eng. Rep. 952, 952-53 (Ch. 1745).

[88] *See* Williams, *supra* note 23, at 45 n.80.

[89] *See Osborne, supra* note 8, § 3.1.

[90] *See* Williams, *supra* note 23, at 42.

[91] *See Osborne, supra* note 8, § 3.1.

[92] *See* Santley v. Wilde, [1899] 2 Ch. 474, 474.

[93] *See Osborne, supra* note 8, § 7.2. *See also* Burgess v. Wheate, 28 Eng. Rep. 652, 670 (Ch. 1759).

[94] *See* Mainland v. Upjohn, [1889] 41 Ch. D. 126, 137.

[95] *See In re* Edwards' Estate, [1861] 11 Ir. Ch. Rep. 367. *But see* Biggs v. Hoddinott, [1898] 2 Ch. 307, 322-23 (collateral advantage to mortgagee not forbidden so long as reasonable trade bargain).

tion.[96] By preventing the transfer of the mortgagor's equity of redemption on the terms with which he acquired that equity, the value of the right diminishes and the equity of redemption is impaired.[97] Clogging thus has occurred and the common law doctrine is violated.[98] Accordingly, the seminal decision of *Coast Bank*,[99] while recognizing due-on clauses as reasonable restraints on the alienation of property,[100] induced the violation of another equally revered doctrine of the common law.[101]

In retrospect, the decision of *Coast Bank* should be evaluated both in terms of that which is stated expressly and that which is left unsaid. The circuity of the court's reasoning in *Coast Bank*[102] is important when determining the validity of its extension to the many jurisdictions which followed the California court's lead when ruling on enforceability of due-on clauses.[103] Jurdisdictions which have adopted strong lender positions[104] would do well to reconsider their philosophies, especially in light of the California court's retreat from the virtually unquestioned approval of the due-on clause to a more cautious reasonableness standard, requiring justification.[105] An awareness of the circumstances surrounding the *Coast Bank* decision, particularly the anti-deficiency judgment legislation effective in California, should motivate the courts to re-examine the prudence of espousing the lender-oriented position encouraged by *Coast Bank*.[106]

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[96] *See* text accompanying notes 97-98 *supra*.

[97] Since the mortgagor is prevented from transferring the subject property, and thus his equity of redemption, at its true market value, *see* note 10 *supra*, the mortgagor has imposed a reduction in value upon himself by agreeing to the due-on provision.

[98] *See* text accompanying note 97 *supra*.

[99] 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964); *see* text accompanying notes 29-37 *supra*.

[100] 61 Cal. 2d 311, 316, 392 P.2d 265, 268 38 Cal. Rptr. 505, 508 (1964).

[101] *See* text accompanying notes 83-95 *supra*.

[102] *See* text accompanying notes 34-37 *supra*.

[103] *See* note 59 *supra*.

[104] *See* text accompanying notes 70-74 *supra*.

[105] *See* text accompanying notes 59-68 *supra*.

[106] *See* text accompanying notes 38-47 *supra*.