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Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act

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By GRANT S. NELSON
and DALE A. WHITMAN

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Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act†

By GRANT S. NELSON*
and DALE A. WHITMAN**

The law of real property usually develops in an evolutionary fashion. Change is often measured in terms of decades and centuries rather than in months and years. Yet economic turmoil can accelerate this process. Just as the Great Depression of the 1930s spurred the enactment of mortgage moratoria and antideficiency legislation,¹ so too has the inflationary economic climate of the 1970s and early 1980s engendered new mortgage law.

The major focus of this latter period has been on the due-on-sale clause, a mortgage provision that affords the mortgagee the right to accelerate the mortgage debt and to foreclose if the mortgaged real estate is transferred without the mortgagee's consent.² While the clause is sometimes used to protect mortgagees against transfers that endanger mortgage security or increase the risk of default, its major purpose is to enable mortgagees to recall lower-than-market interest rate loans during periods of rising interest rates.³ Because its use in this context pits lenders against borrowers and real estate buyers, the clause has become

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1. See G. OSBORNE, *MORTGAGES* § 333 (2d ed. 1970).

2. A typical due-on-sale clause provides: "If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, . . . Lender may, at Lender's option, declare all the sums secured by this mortgage to be due and payable." Federal National Mortgage Association/Federal Home Loan Mortgage Corporation Mortgage, Clause 17 (one to four family) [hereinafter cited as FNMA/FHLMC Mortgage].

3. See G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* § 5.21 (1979) (citing Volkmer, *The Application of Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 769 (1973)) [hereinafter cited as OSBORNE, NELSON & WHITMAN]. The clause usually does not mention interest rate increases per se, but the lender will frequently use the threat of acceleration as leverage to exact from the transferee an agreement to pay a higher interest rate.

a major economic, political, and legal issue. It has been confronted and evaluated by most state supreme courts,⁴ many legislatures,⁵ certain federal regulatory agencies,⁶ the United States Supreme Court,⁷ and ultimately Congress.⁸ It has also been the subject of a great deal of scholarly commentary.⁹

Given recent economic conditions, this close scrutiny is hardly surprising. Due to high interest rates and the limited availability of home financing, large numbers of potential home buyers have been excluded from the housing market.¹⁰ For many purchasers, the assumption of an existing lower-than-market interest mortgage has represented one of the few practical financing alternatives. The financial climate has also made it much more difficult for owners to sell. Many sellers have been forced either to reduce significantly the price of their properties to en-

4. See *infra* text accompanying notes 36-61.

5. See *infra* text accompanying notes 73-80.

6. See *infra* text accompanying notes 81-88.

7. See *infra* text accompanying notes 89-100.

8. See *infra* text accompanying notes 101-06.

9. See Ashley, *Use of "Due-On" Clauses to Gain Collateral Benefits: A Common Sense Defense*, 10 TULSA L.J. 590 (1975); Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F.L. REV. 267 (1972); Hetland, *Real Property and Real Property Security: The Well-Being of the Law*, 53 CALIF. L. REV. 151 (1965); Maxwell, *The Due-On-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 U.C.L.A. L. REV. 197 (1982); Segreti, *The Borrower as Servant of the Lender: Enforcement of Mortgage Due-on-Sale Clauses*, 51 U. CIN. L. REV. 779 (1982); Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747 (1973); Comment, *The Future of the Due-On-Sale Clause in Alabama*, 33 ALA. L. REV. 83 (1981); Comment, *Mortgages—A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485 (1973); Comment, *Applying the Brakes to Acceleration Clauses: Controlling Their Misuse in Real Property Secured Transactions*, 9 CAL. W.L. REV. 514 (1973); Comment, *Beyond Tucker v. Lassen: The Future of the Due-on-Sale Clause in California*, 27 HASTINGS L.J. 475 (1975); Comment, *South Dakota's Approach to the Due-on-Sale Clause: An Analysis of Automatic Enforcement*, 27 S.D.L. REV. 261 (1982); Comment, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109 (1975) [hereinafter cited as Comment, *Judicial Treatment*]; Note, *Property—The Demise of the Due-on-Sale Clause*, 64 CALIF. L. REV. 573 (1976); Note, *Mortgages—Due-on-Sale Clause: Restraint on Alienation—Enforceability*, 28 CASE W. RES. L. REV. 493 (1978); Note, *Due on Sale and Due on Encumbrance Clauses in California*, 7 LOY. L.A.L. REV. 306 (1974); Note, *Deeds of Trust—Restraints Against Alienation—Due-on Clause is an Unreasonable Restraint on Alienation Absent a Showing of Protection of Mortgagee's Legitimate Interests*, 47 MISS. L.J. 331 (1976) [hereinafter cited as Note, *Unreasonable Restraint*]; Note, *Mortgages—Use of Due on Sale Clause by a Lender is Not a Restraint on Alienation in North Carolina*, 55 N.C.L. REV. 310 (1977); Note, *The Due-on-Sale Clause: Enforcement Standards*, 60 NEB. L. REV. 594 (1981); Note, *Due-on-Sale Clauses: Separating Social Interests From Individual Interests*, 35 VAND. L. REV. 357 (1982) [hereinafter cited as Note, *Separating Interests*].

10. See, e.g., *The Great Housing Collapse*, NEWSWEEK, Mar. 29, 1982, at 61-62.

able buyers to qualify for institutional high-interest financing, or to suffer an effective price reduction by financing part of the purchase price themselves at lower-than-market interest rates. Thus, for those sellers with lower-than-market interest rate mortgages on their properties, assumability of the mortgage may be the key to obtaining a higher asking price for the property.¹¹

On the other hand, the economic stake of institutional lenders in upholding due-on-sale clauses is also great. During the past several years many institutional lenders, especially savings and loan associations, have experienced severe economic difficulty. Because they hold portfolios that include large numbers of fixed rate, lower-yielding mortgage loans, they have been hard pressed to pay the higher short-term rates demanded by depositors.¹² Many savings and loan associations and similar institutions have failed, and others remain in precarious financial positions.¹³ Because the due-on-sale clause provides one means of eliminating lower-interest mortgage loans from institutional portfolios, and does so without resort to expensive federal "bailout" or other subsidy schemes, its enforceability has been deemed important for the economic health of the thrift industry.¹⁴

11. See *Williams v. First Fed. Sav. & Loan Ass'n*, 651 F.2d 910 (4th Cir. 1981), where the court suggested that real estate that would sell for \$100,000, assuming the buyer obtained new 30-year, fixed rate first mortgage financing at 15% per annum, would sell for \$115,000 if the buyer were able to assume an existing \$50,000 fixed rate mortgage at 10% with a remaining term of 27 years. *Id.* at 915 n.8. For further consideration of the seller's situation, see Note, *Separating Interests*, *supra* note 9, at 376. See also Sirmans, Sirmans & Smith, *The Effect of Assumption Financing on Residential Property Values*, 16 FED. HOME LOAN BANK BOARD J., Aug. 1983, at 22 (suggesting that home sellers capture only about 35% of the value of their assumable below-market-rate loans).

12. This problem has been with the thrift industry at least since the first major post-war interest rate upswing in 1966. See, e.g., STAFF OF SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 92D CONG., 1ST SESS., FEDERAL NATIONAL MORTGAGE ASSOCIATION PUBLIC MEETING ON CONVENTIONAL MORTGAGE FORMS 203-04 (Comm. Print 1971) (statement of the Executive Vice President of the California Savings and Loan League); see also *infra* notes 13-14.

13. The Federal Savings and Loan Insurance Corporation, which bears the responsibility for salvaging or liquidating failed savings and loan associations carrying deposit insurance, placed 14 associations in receivership during 1982. All but one of these insolvencies were resolved by mergers with other associations (the remaining one was liquidated). In all, there were 210 "supervisory mergers" of financially troubled associations during 1982. Of those, 44 required financial assistance from the FSLIC to compensate for the weakness of one of the merger partners. These statistics are higher than for any previous year. See *Federal Home Loan Bank Board Annual Report 1982*, 16 FED. HOME LOAN BANK BOARD J., Apr. 1983, at 13-20.

14. "[T]he [savings and loan associations'] practice of borrowing short and lending long, . . . combined with rising interest rates, has increased the cost of funds to these institutions and reduced their income. Exercising due-on-sale clauses enables savings and loan associations to alleviate this problem by replacing long-term, low yield loans with loans at

Other policy arguments have been utilized to buttress due-on-sale enforceability. Several years ago we summarized them as follows. First, one should focus on the reasonable expectations of the mortgagor at the time a mortgage loan is first made. Usually, at least in the residential setting, the borrower is concerned most with his immediate cost, *i.e.*, the interest rate and how much his monthly payment is going to be. Normally, he will not be concerned with his mortgage as a method for facilitating a future sale of his home. In other words, perhaps it is simply unwise to conceive of a method utilized to *acquire* a home as also a device to *facilitate its sale*. Second, the enforcement of due-on-sale clauses tends to reduce the discrimination that otherwise exists in favor of those buyers who are fortunate enough to find a low interest loan to assume against those who are forced to obtain new mortgage financing. Indeed, because existing low interest loans have been paid down to some extent, and because of inflation in the value of real estate, those who are able to assume an existing loan generally will be those who can come up with a significant amount of cash, whereas those who are not so fortunate in this regard will be forced to obtain new financing at higher market interest rates. Thus, to the extent that due-on-sale clauses are not enforced, an inordinate interest rate advantage may be afforded to higher net worth buyers over those who are less fortunate.¹⁵

Congress, responding to the financial distress of many institutional lenders¹⁶ after a decade of judicial, legislative, and regulatory turmoil at both the state and federal levels, has attempted to resolve the due-on-sale controversy by enacting section 341 of the Garn-St. Germain Depository Institutions Act of 1982 (Act).¹⁷ The Act generally favors enforcement of due-on-sale clauses. This Article explores the provisions, scope, and impact of the Act in substantial detail.

We first describe the several major types of mortgagor transfer restrictions, and the judicial and legislative responses to these restrictions

the prevailing interest rates and thereby to avoid increasing interest rates across the board." *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 168 (1982).

15. OSBORNE, NELSON & WHITMAN, *supra* note 3, § 5.23. See also Cassidy, *Monte Carlo Simulation Estimates of the Expected Value of the Due-on-Sale Clause in Home Mortgages*, 2 HOUSING FIN. REV. 33 (1983), estimating that prohibition of due-on-sale enforcement would result in mortgage interest rates 0.3% to 0.8% higher than without the prohibition.

16. See *The Depository Institutions Amendments of 1982: Hearings on S. 2879, H.R. 4603, and H.R. 6267 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 2d Sess.* (1982) (containing the statements of representatives of savings and loan associations and banks); see also *supra* notes 13-14.

17. Pub. L. No. 97-320, 96 Stat. 1505 (1982) (codified at 12 U.S.C. § 1701j-3 (1982)).

before the Act. Second, we analyze the effect and coverage of the important provisions of the Act and its attendant regulation. The complex exceptions to the application of the Act known as "window periods" are then considered. These window periods were created by Congress in an attempt to soften the impact of the Act on states that previously restricted due-on-sale enforcement, and are based on preexisting state law. We examine the difficult standards for identifying such window periods and suggest alternative approaches, using California and Arizona as models. We then describe the Act's impact on certain federally-chartered lenders, prepayment penalties, the mortgagor's duty to respond, and release of the original mortgagor. Finally, we discuss the problem of concealment of transfers under the Act. Throughout, we evaluate the extent to which the Act and Regulations achieve sound public policy goals. We conclude that while the intent of the Act and the resulting national uniformity should be applauded, poor drafting has resulted in needless complexity and uncertainty.

The Other Types of Mortgage Transfer Restrictions

Due-on-Encumbrance Restrictions

Mortgages may restrict mortgagor transfers by means other than a due-on-sale clause.¹⁸ For example, a mortgage may contain a clause authorizing the mortgagee to accelerate the debt if the mortgagor "further encumbers" the mortgaged real estate. Such language is usually referred to as a "due-on-encumbrance" provision.¹⁹ While due-on-encumbrance language is often included as part of a due-on-sale clause,²⁰ it is not uncommon for a mortgage to contain a separate due-on-encumbrance clause.²¹ Unlike the due-on-sale situation, in which the mortgagee's desire to increase the interest rate predominates, due-on-

18. For an unusual illustration, see *Investor Sav. & Loan Ass'n v. Ganz*, 174 N.J. Super. 356, 361, 416 A.2d 918, 921-22 (1980) (upholding a clause giving the mortgagee the right to accelerate if the property ceased to be owner-occupied).

19. See OSBORNE, NELSON & WHITMAN, *supra* note 3, § 5.21; Volkmer, *supra* note 9, at 769.

20. For an example of this approach, consider the following clause: "Should trustor (mortgagor) sell, convey, transfer, dispose of, or further encumber said property, or any part thereof, or any interest therein, or agree so to do, without the written consent of the Beneficiary (mortgagee) being first obtained, then Beneficiary shall have the right at his option, to declare all sums secured hereby forthwith due and payable." Comment, *Judicial Treatment*, *supra* note 9, at 1110 n.5 (emphasis added).

21. See, e.g., *Chilivis v. Tumlin Woods Realty Ass'n, Inc.*, 250 Ga. 179, 179, 297 S.E.2d 4, 4 (1982) ("If Grantor further encumbers the premises by any mortgages, loans or security deeds securing loans made to Grantor without notice to and prior written permission from Grantee (mortgagee), such will constitute an event of default.").

encumbrance language is utilized mainly to protect against impairment of mortgage security by a debtor who incurs a junior mortgage debt and thus reduces his or her economic stake in the mortgaged real estate.²² However, the due-on-encumbrance clause probably is used much less frequently than its due-on-sale counterpart.²³

Increased-Interest-on-Transfer Clauses

Another provision closely related to the due-on-sale clause authorizes the mortgagee to increase or adjust the mortgage interest rate in the event of a transfer by the mortgagor. We refer to this as an "increased-interest-on transfer" clause.²⁴ This type of clause fulfills the same economic function as the due-on-sale clause in that it enables the mortgagee to use a transfer by the mortgagor as the basis for increasing the interest yield on the mortgage. However, unlike a due-on-sale clause, it does not confer on the mortgagee an absolute right to accelerate the mortgage debt upon a transfer; hence it gives no direct protection against transfer to an uncreditworthy buyer. Only if the transferee fails to pay the increased mortgage payments will there be grounds for declaration of a default and acceleration of the debt.

Installment Land Contract Prohibitions on Transfer

Transfer restrictions may also appear in installment land contracts, which are probably the most commonly used mortgage substitute.²⁵ Known in many areas of the country as a "contract for deed" or "long term land contract," the installment land contract performs the same economic function as a purchase-money mortgage: it provides seller

22. See Volkmer, *supra* note 9, at 769-70.

23. The mortgage form specified for use by lenders who sell mortgages to the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) on the secondary market specifically excludes any restriction on further encumbrances: "If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to this Mortgage . . . Lender may, at Lender's option, declare all the sums secured by this mortgage to be due and payable." FNMA/FHLMC Mortgage, *supra* note 2, Clause 17 (one to four family).

24. A recent example of an "increased interest on transfer clause" provides: "the Mortgagees hereby agree that the Mortgagors may assign this Purchase Money Mortgage, but the rate of interest, at the time of assignment, shall be adjusted upward to correspond with the prevailing interest rate of banks, savings and loan associations, and other mortgage lenders in the community." *O'Connell v. Dockendorff*, 415 So. 2d 35, 36 (Fla. App. 1982). See also *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 402, 545 P.2d 546, 547 (1976).

25. See *Randall v. Riel*, 465 A.2d 505, 507 (N.H. 1983) (citing Nelson & Whitman, *The Installment Land Contract—A National Viewpoint*, 1977 B.Y.U. L. REV. 541).

financing of all or part of the unpaid real estate purchase price.²⁶ Vendors often find the installment land contract attractive because of its forfeiture clause—language specifying that “time is of the essence” and that upon vendee default in payment or other contract obligations the vendor has the option to terminate the contract, retake possession of the premises, and retain all prior payments as liquidated damages.²⁷ However, in many jurisdictions legislatures and courts have placed restrictions on the forfeiture remedy, especially when the vendee has acquired substantial equity in the property.²⁸ Other jurisdictions have gone so far as to treat the installment land contract as a mortgage, thus affording the vendee the traditional substantive and procedural rights of a mortgagor, including the right to a public sale after a judicial foreclosure proceeding.²⁹

Installment land contracts frequently include a provision that prohibits assignment by the vendee without the vendor's permission.³⁰ Violation of such a provision constitutes a default and might result in vendor termination of the contract and loss of the purchaser's equity. In this respect the provision differs from a due-on-sale clause, under which an unapproved transfer will at most trigger an acceleration of the mortgage debt and, if the accelerated debt is unpaid, a public foreclosure sale of the mortgaged real estate.³¹

Events Triggering Acceleration

A common question is what kind of event will trigger acceleration of a debt under a due-on-sale or other transfer restriction clause. While some early clauses used a “sale” alone as the triggering event, most of the recent forms employ broader language, often modeled after the mortgage form specified for use by lenders who sell mortgages to

26. Nelson & Whitman, *The Installment Land Contract—A National Viewpoint*, 1977 B.Y.U. L. REV. 541, 541.

27. *Id.* at 542. See also *Jenkins v. Wise*, 58 Hawaii 592, 596, 574 P.2d 1337, 1341 (1978); *Sebastian v. Floyd*, 585 S.W.2d 381, 382 (Ky. Ct. App. 1979); Comment, *Forefeiture: The Anomaly of the Land Sale Contract*, 41 ALBANY L. REV. 71, 72 (1977).

28. See, e.g., ARIZONA REV. STAT. ANN. §§ 33, 741-742 (1974); IOWA CODE ANN. §§ 656.1-.6 (West 1950 & Supp. 1982); MINN. STAT. ANN. § 559.21 (West 1947 & Supp. 1982). See also OSBORNE, NELSON & WHITMAN, *supra* note 3, §§ 3.27-.28.

29. See, e.g., *Skendzel v. Marshall*, 261 Ind. 226, 301 N.E.2d 641 (1973); *Sebastian v. Floyd*, 585 S.W.2d 381 (Ky. 1981); *Bean v. Walker*, 95 A.D.2d 70, 464 N.Y.S.2d 895 (1983); OKLA. STAT. ANN. tit. 16, § 11a (West Supp. 1976).

30. See OSBORNE, NELSON & WHITMAN, *supra* note 3, § 5.26; see also Volkmer, *supra* note 9, at 753 n.34.

31. In the context of the traditional restraint-on-alienation analysis considered later in this article, see *infra* text accompanying notes 36-48, the “no-transfer” provision probably represents a forfeiture type of direct restraint.

the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). This language refers to a transfer of any part of the property or any interest in it.³² Under such language, in principle at least, even a short-term lease³³ or a grant of an easement or other limited interest in the land would suffice to trigger the lender's right to accelerate.

Perhaps the most significant question is whether a sale by installment land contract permits acceleration. The answer depends on the exact wording of the clause in question,³⁴ but under broad language like that of the FNMA/FHLMC clause the courts have nearly uniformly permitted acceleration.³⁵

32. See *supra* note 2 for the text of the due-on-sale clause found in the FNMA/FHLMC Mortgage.

33. *But see* FNMA/FHLMC Mortgage, *supra* note 2 (expressly exempting leases for less than three years which include no option to purchase).

34. In *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974), for example, a sale by installment contract under a clause as broad as that of the FNMA/FHLMC was held not to trigger acceleration. *Id.* at 638-39, 526 P.2d at 1174, 116 Cal. Rptr. at 639-40. The court felt enforcing the clause would constitute an unreasonable restraint on alienation where the vendor retained legal title under the contract and the vendor's legitimate interest was not threatened. *Id.* at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 639. This distinction between installment and "outright" sales was subsequently discarded by the California Supreme Court in *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 950, 582 P.2d 970, 974, 148 Cal. Repr. 379, 383 (1978). See *infra* text accompanying notes 217-19; see also *Income Realty & Mortgage, Inc. v. Columbia Sav. & Loan Ass'n*, — Colo. —, —, 661 P.2d 257, 260 (1983) (rejecting any distinction between installment and "outright" sales on policy grounds). It is doubtful that today any court would follow the distinction.

35. See *Income Realty & Mortgage, Inc. v. Columbia Sav. & Loan Ass'n*, — Colo. —, —, 661 P.2d 257, 259-60 (1983); *Century Fed. Sav. & Loan Ass'n v. Van Glahn*, 144 N.J. Super. 48, 50, 55, 364 A.2d 558, 563 (1976); *In re Foreclosure of a Deed of Trust Given by Bill M. Taylor*, 60 N.C. App. 134, 135, 298 S.E.2d 163, 165-66 (1982); *Smith v. Frontier Fed. Sav. & Loan Ass'n*, 649 P.2d 536, 538 (Okla. 1982); *Lipps v. First Am. Serv. Corp.*, 223 Va. 131, 140, 286 S.E.2d 215, 216-17, 220 (1982); *Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works*, 58 Wis. 2d 99, 101, 110, 205 N.W.2d 762, 769 (1973). *But see* *Fidelity Fed. Sav. & Loan Ass'n v. Grieme*, 112 Ill. App. 3d 1014, 1019, 446 N.E.2d 292, 295 (1983) (entering into agreement for deed held insufficient to trigger clause allowing lender to accelerate upon "change of ownership").

Most courts permitting acceleration rely on the equitable conversion doctrine, which holds that a buyer of real estate has "equitable title" as soon as the contract is entered into. See generally 3A A. CORBIN, CONTRACTS § 667 (1960); Davis, *The Origin of the Doctrine of Equitable Conversion by Contract*, 25 KY. L.J. 58 (1936).

The Washington courts, which generally do not follow the doctrine of equitable conversion, have nonetheless concluded that a contract sale will trigger a due-on-sale clause. See *Bellingham First Fed. Sav. & Loan Ass'n v. Garrison*, 87 Wash. 2d 437, 439, 553 P.2d 1090, 1091 (1976); *Terry v. Born*, 24 Wash. App. 652, 654, 604 P.2d 504, 506 (1979); see also *Williams v. First Fed. Sav. & Loan Ass'n*, 651 F.2d 910, 919-20 (4th Cir. 1981) (seller placed land in an inter vivos trust and then transferred beneficial ownership of the trust; held, FNMA/FHLMC due-on-sale clause was triggered). *But see* *Wachta v. First Fed. Sav. &*

Judicial Responses to Mortgagor Transfer Restrictions Before the Act

Due-on-Sale Clauses

Due-on-sale clauses have come under judicial attack as unreasonable restraints on alienation.³⁶ Traditionally, a direct restraint on alienation has been viewed by many courts as invalid per se unless the restraint falls within certain limited exceptions.³⁷ Under a minority approach, a direct restraint is void unless the policy underlying its purpose outweighs the degree of restraint imposed on the property interest.³⁸ Indirect restraints, on the other hand, are generally deemed valid if they are reasonable.³⁹ An indirect restraint is one that arises "when an attempt is made to accomplish some purpose other than the restraint on alienability, but with the incidental result that . . . [it] would restrain practical alienability."⁴⁰ Thus, a mortgage that provides for forfeiture of the mortgaged real estate to the mortgagee upon an impermissible transfer probably constitutes a direct restraint.⁴¹ To the extent that the mortgagee is able to enforce, through specific performance or injunctive relief, a mortgagor's promise not to convey without the mortgagee's consent, a promissory and presumably direct restraint exists.⁴²

Under this analysis it is unclear whether the due-on-sale clause constitutes a direct or an indirect restraint on alienation. On the one hand, it can be argued that it constitutes an indirect restraint: enforcement of the clause will result in a foreclosure sale rather than a forfeiture of the mortgaged real estate to the mortgagee, and the due-on-sale mortgagee does not have an enforceable right to prevent the mortgagor from transferring the property.⁴³ Moreover, while the practical effect of the clause may be to discourage the mortgagor from selling the mort-

Loan Ass'n, 103 Ill. App. 3d 174, 183, 430 N.E.2d 708, 715-16 (1981) (assignment of beneficial interest in Illinois land trust is not a "conveyance of title . . . to all or any portion of the premises" as phrase is used in due-on-sale clause). See also *Hodge v. DMNS Co.*, 652 S.W.2d 762, 765 (Tenn. Ct. App. 1982) (due-on-sale clause not triggered by contract of sale which is immediately rescinded).

36. See *infra* notes 37-61 & accompanying text.

37. See cases cited in Note, *Unreasonable Restraint*, *supra* note 9, at 335-36.

38. *Id.*

39. L. SIMES & A. SMITH, *THE LAW OF FUTURE INTERESTS* § 1112, at 5 (2d ed. 1956).

40. *Id.*

41. Volkmer, *supra* note 9, at 748.

42. *Id.*

43. R. BERNHARDT, *CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE* 47-48 (1979); 1 H. MILLER & M. STARR, *CURRENT LAW OF CALIFORNIA REAL ESTATE* 179 (Supp. 1982).

gaged real estate, its primary purpose is to confer an economic benefit, not to restrain alienability.⁴⁴

On the other hand, at least one commentator has concluded that a due-on-sale clause is so "closely akin" to a promissory restraint as to "justify designating it as a direct restraint."⁴⁵

Although written as an acceleration clause, the due-on-sale clause directly and fundamentally burdens a mortgagor's ability to alienate as surely and directly as a classical promissory restraint. As such, the due-on-sale clause is truly a direct restraint insofar as the category of direct restraints can be articulated.⁴⁶

The vast majority of courts has been unconcerned about classifying the clause into traditional "restraint" categories. No court has held that a due-on-sale clause is per se unlawful as a restraint on alienation. Indeed, some courts have suggested that it is not a restraint on alienation at all.⁴⁷ While many courts probably view the clause as an indirect restraint on alienation, all courts recognize that there are circumstances in which enforcement of the clause is reasonable and thus permissible.⁴⁸ Some courts, however, are more sympathetic to enforcement than others, and two broad judicial approaches to the clause have emerged.

Under the predominant judicial approach, the clause is deemed per se reasonable unless the borrower can show that the lender engaged in unconscionable conduct.⁴⁹ The courts employing this approach have recognized the desirability of protecting the mortgagee from the vagar-

44. OSBORNE, NELSON & WHITMAN, *supra* note 3, § 5.21.

45. Volkmer, *supra* note 9, at 773-74.

46. *Id.*

47. *See, e.g.*, *Martin v. Peoples Mut. Sav. & Loan Ass'n*, 319 N.W.2d 220, 228 (Iowa 1982); *Occidental Sav. & Loan Ass'n v. Venco*, 206 Neb. 469, 471, 293 N.W.2d 843, 846 (1980); *Sonny Arnold, Inc. v. Sentry Sav. Ass'n*, 633 S.W.2d 811, 815 (Tex. 1982).

48. *See, e.g.*, *State ex rel. Bingaman v. Valley Sav. & Loan Ass'n*, 97 N.M. 8, 12, 636 P.2d 279, 289 (1981); *Continental Fed. Sav. & Loan Ass'n v. Fetter*, 564 P.2d 1013, 1018-19 (Okla. 1977).

49. *See, e.g.*, *Tierce v. APS Co.*, 382 So. 2d 485, 487 (Ala. 1979); *Income Realty & Mortgage Inc. v. Columbia Sav. & Loan Ass'n*, — Colo. —, —, 661 P.2d 257, 265 (1983); *Olean v. Treglia*, 190 Conn. 756, 765, 463 A.2d 242, 248 (1983); *Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 125, 333 N.E.2d 1, 5 (1975); *Martin v. Peoples Mut. Sav. & Loan Ass'n*, 319 N.W.2d 220, 228-29 (Iowa 1982); *Dunham v. Ware Save. Bank*, 384 Mass. 63, 68, 423 N.E.2d 998, 1001 (Mass. 1981); *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 482, 293 N.W.2d 843, 848 (1980); *First Commercial Title Ins. Co. v. Holmes*, 92 Nev. 363, 365, 550 P.2d 1271, 1272 (1976); *Mills v. Nashua Fed. Sav. & Loan Ass'n*, 121 N.H. 722, 725, 433 A.2d 1312, 1315-16 (1981); *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 630-31, 224 S.E.2d 580, 587 (1976); *Gunther v. White*, 489 S.W.2d 529, 530 (Tenn. 1973); *Sonny Arnold, Inc. v. Sentry Sav. Ass'n*, 633 S.W.2d 811, 815 (Tex. 1982); *United Va. Bank v. Best*, 223 Va. 112, 114-15, 286 S.E.2d 221, 223 (1982); *Magney v. Lincoln Mut. Sav. Bank*, 34 Wash. App. 14, 20, 659 P.2d 537, 541 (1983).

ies of the interest rate market.⁵⁰ The mortgagee need not establish that a proposed transfer would impair security; the validity of the due-on-sale clause is not normally judged by the facts of an individual case.⁵¹ Under one variant of this approach, such facts are relevant only to the extent that the mortgagor attempts to meet the burden of proving that enforcement is unconscionable or inequitable in his or her case.⁵² An increase in the market interest rate is not usually thought sufficient to meet this burden, and due-on-sale clauses in such jurisdictions are usually enforced.⁵³

Under the minority approach, enforcement of due-on-sale clauses must be reasonable in individual cases, necessitating a case-by-case determination.⁵⁴ Under this approach, the mortgagee's desire to increase interest rates is not considered a sufficient reason to justify the clause. The mortgagee has the burden to establish reasonableness, and normally must establish that the transfer would result in security impairment or an increased risk of default.⁵⁵ As a practical matter, lenders have rarely sought due-on-sale enforcement in jurisdictions that follow this approach.

Some of the courts that apply the majority approach display a concern that the borrower be fairly warned that the clause can be employed to exact a higher interest rate upon transfer, and insist that language explicitly stating that possibility be included in the documents.⁵⁶ There may well be a valid need for such a warning; the FNMA/FHLMC clause, for example, is extraordinarily technical and

50. See, e.g., *Income Realty & Mortgage Inc. v. Columbia Sav. & Loan Ass'n*, — Colo. —, —, 661 P.2d 257, 261 (1983).

51. See, e.g., *Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 124, 333 N.E.2d 1, 5 (1971).

52. See, e.g., *Tierce v. APS Co.*, 328 So. 2d 485 (Ala. 1979).

53. *Id.* at 487.

54. See, e.g., *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 81, 486 P.2d 190, 193 (1971); *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 855, 481 S.W.2d 725, 728 (1972); *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 953, 582 P.2d 970, 976-77, 148 Cal. Rptr. 379, 385-86 (1978); *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 168, 173, 250 N.W.2d 804, 808 (1977) (does not decide if a rate increase would have been reasonable if the clause had mentioned rate increases); *State ex rel. Bingaman v. Valley Sav. & Loan Ass'n*, 97 N.M. 8, 12, 636 P.2d 279, 283 (1981) (judicial extension of statute to loans made before statute's effective date); *Consolidated Capital Properties, II, Ltd. v. National Bank of N. Am.*, 420 So. 2d 618, 622 (Fla. App. 1982); *Magney v. Lincoln Mut. Sav. Bank*, 34 Wash. App. 14, 20, 659 P.2d 537, 541 (1983).

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

56. See *First Southern Fed. Sav. & Loan Ass'n v. Britton*, 345 So. 2d 300, 304 (Ala. Civ. App. 1977), *overruled by* *Tierce v. APS Co.*, 382 So. 2d 485 (Ala. 1979); *Silver v. Rochester Sav. Bank*, 73 A.D.2d 81, 86, 424 N.Y.S.2d 945, 947 (1980).

difficult for a lay reader to follow, and its implication that a higher interest rate may result from a transfer is oblique at best.⁵⁷ One court has been even more punctilious, requiring that the clause be inserted in the promissory note and not merely in the mortgage.⁵⁸

As noted above, majority or "automatic enforcement" jurisdictions often state that due-on-sale clauses are unenforceable when the mortgagor can establish that enforcement would be "unconscionable" or "inequitable."⁵⁹ While it is difficult to articulate precisely when due-on-sale clauses will be so categorized, it is probable that most courts will be unwilling to enforce the clauses in "non-substantive" or "non-sale" transfers. For example, one court has indicated that enforcement should be denied in situations such as transfers to a spouse who becomes a co-owner, transfers to a spouse incidental to a marriage dissolution proceeding or settlement, and transfers to an inter vivos trust of which the mortgagor is a beneficiary.⁶⁰ This principle is recognized in the FNMA/FHLMC form due-on-sale clause, which specifically exempts transfers "by devise, descent or by operation of law upon the death of a joint tenant."⁶¹

Yet due-on-sale clauses should not be automatically unenforceable in all "non-substantive" or "non-sale" settings. For example, if a mortgagor transfers realty as a gift to a donee-charity that is barely solvent, the possession and ownership by the charity is likely to reduce the value of the property or reduce the probability of payment of the debt. In this situation it would hardly seem "unconscionable" or "inequitable" to enforce a due-on-sale clause.

57. The FNMA/FHLMC Mortgage, *supra* note 2, Clause 17 is thoroughly critiqued in Squires, *A Comprehensible Due-on-Sale Clause*, 27 PRAC. LAW 67 (1981).

58. See 2140 Lincoln Park West v. American Nat'l Bank & Trust Co., 88 Ill. App. 3d 660, 664, 410 N.E.2d 990, 993 (1980) (requirement justified on ground that rule of law requires mortgage and trust deed to be interpreted separately). It is not clear that this sort of technicality serves any purpose, and it may simply reflect the hostility of the court to enforcement of the clause.

59. See *supra* text accompanying notes 49-53.

60. Mills v. Nashua Fed. Sav. & Loan Ass'n, 433 A.2d 1312, 1316 (N.H. 1981). See also Powell v. Phoenix Fed. Sav. & Loan Ass'n, 434 So. 2d 247, 253 (Ala. 1983) (suggesting that enforcement of a due-on-sale clause may be "unconscionable" where the mortgagor sells part of the mortgaged real estate, but retains title to and continues to live on the other part); Home Sav. Bank v. Baer Properties, Ltd., 92 A.D.2d 98, 101, 460 N.Y.S.2d 833, 835-36 (1983) (mortgagee attempt to invoke due-on-sale clause upon transfer of property from a corporation to its sole shareholder held unconscionable and unenforceable). On the other hand, the sale to a third party of all the shares of a mortgagor-corporation has been deemed sufficient to trigger due-on-sale enforcement. See United States v. Med O Farm, Inc., 701 F.2d 88 (9th Cir. 1983).

61. FNMA/FHLMC Mortgage, *supra* note 2, Clause 17 (one to four family).

Due-on-Encumbrance Clauses

The validity of due-on-encumbrance clauses rarely has been litigated. As we noted earlier,⁶² such clauses are used primarily as a means of protecting against security impairment that may occur when junior mortgage indebtedness reduces the mortgagor's economic stake in the mortgaged real estate. Interest market motivation, if it exists in the due-on-encumbrance situation, is clearly less significant than in the due-on-sale setting.⁶³ Thus it is not surprising that the few reported due-on-encumbrance decisions permitted enforcement of the clause only when "reasonably necessary to protect the lender's security."⁶⁴

Increased-Interest-on-Transfer Clauses

Increased-interest-on-transfer clauses are much less common than due-on-sale clauses and there is relatively little case law concerning their validity. Interestingly, the few courts that have confronted such clauses have upheld them,⁶⁵ even though these same jurisdictions restrict due-on-sale enforcement to situations in which the mortgagee can prove impairment of security.⁶⁶ One of these courts justified the difference in treatment between the two types of clauses by saying that an increased-interest-on-transfer provision, unlike a due-on-sale clause, "simply raises the interest rate should the mortgagor assign his rights and benefits under the mortgage to a subsequent purchaser."⁶⁷ From a policy viewpoint this distinction makes little sense, as the primary goal of both types of clauses is higher interest rates. Legally there is some difference, in that an unconsented transfer under an increased-interest clause does not automatically constitute a default; acceleration and foreclosure ensue only if the transferee refuses to make mortgage payments based on the increased interest rate.⁶⁸ Increased-interest clauses

62. See *supra* text accompanying note 22.

63. See Volkmer, *supra* note 9, at 770.

64. *La Sala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 881, 489 P.2d 1113, 1124, 97 Cal. Rptr. 849, 860 (1971). See also *Chilivis v. Tumlin Woods Realty Ass'n, Inc.*, 250 Ga. 179, 184, 297 S.E.2d 4, 8 (1982) (suggesting a "reasonableness—impairment of security" standard).

65. See, e.g., *O'Connell v. Dockendorff*, 415 So. 35, 36-37 (Fla. App. 1982); *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 406-07, 545 P.2d 546, 549 (1976).

66. See *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156, 159 (Fla. App. 1980); *Bellingham First Fed. Sav. & Loan Ass'n v. Garrison*, 87 Wash. 2d 437, 441, 553 P.2d 1090, 1092 (1976).

67. *O'Connell v. Dockendorff*, 415 So. 2d 35, 36 (Fla. App. 1982).

68. However, even with a due-on-sale clause, foreclosure cannot automatically follow the transfer. The loan principal must first be accelerated; the default is the failure to pay the accelerated amount upon demand. See *Miller v. Cote*, 127 Cal. App. 3d 888, 179 Cal. Rptr. 753 (1982).

should find an even more favorable enforcement environment in states that automatically enforce due-on-sale clauses in the absence of unconscionability. Because increased-interest clauses are technically less burdensome on alienation than are due-on-sale clauses, logically they should be enforced at least to the same extent as their due-on-sale counterparts.

No-transfer Provisions in Installment Land Contracts

While there was some early support for enforcement of "no-transfer" provisions in installment land contracts,⁶⁹ contemporary courts are much less sympathetic. This attitude is reflected in two ways. First, "no-transfer" language is often construed narrowly against the vendor.⁷⁰ Second, in contrast to the majority approach to due-on-sale clause enforcement, courts often eschew an "automatic enforcement" approach; the "no-transfer" language is enforced only when it is established that the transfer will impair the vendor's security.⁷¹ Moreover, even when a vendor demonstrates such an impairment, it is likely that a court will avoid the imposition of forfeiture by permitting the transferee to pay off the contract balance, or by ordering that the real estate be foreclosed by public sale.⁷²

69. See L. SIMES & A. SMITH, *supra* note 39, § 1164; Goddard, *Non-Assignment Provisions in Land Contracts*, 31 MICH. L. REV. 1, 9-11 (1932); Grismore, *Effect of a Restriction on Assignment in a Contract*, 31 MICH. L. REV. 299, 316-17 (1933).

70. See, e.g., *Conner v. First Nat'l Bank & Trust Co.*, 108 Ill. App. 3d 534, 537, 439 N.E.2d 122, 125 (1982) (transfer by trustee holding the vendee's contract interest to a successor trustee held not to constitute a "conveyance or assignment" for purposes of no-transfer clause); *Murray First Thrift & Loan Co. v. Stevenson*, 534 P.2d 909, 911 (Utah 1975) (transfer by vendee to a lender as security for a loan held not within meaning of a no-transfer clause).

71. See *Lemon v. Nicolai*, 33 Mich. App. 646, 649, 190 N.W.2d 549, 550 (1971); *Pelle-rito v. Weber*, 22 Mich. App. 242, 244-45, 177 N.W.2d 236, 237-38 (1970); *Terry v. Born*, 24 Wash. App. 652, 655, 604 P.2d 504, 506 (1979).

72. See *Handzel v. Bassi*, 343 Ill. App. 281, 289, 99 N.E.2d 23, 26 (1951) (assignee permitted to perform fully rather than undergo forfeiture); *Murray First Thrift & Loan Co. v. Stevenson*, 534 P.2d 909, 912 (Utah 1975) (assignee allowed to pay off balance); *Coraci v. Noack*, 61 Wisc. 2d 183, 190, 212 N.W.2d 164, 167 (1973) (assignee granted right to redemption). In *Terry v. Born*, 24 Wash. App. 652, 604 P.2d 504 (1979), for example, the court held that the vendor should have been required to establish that enforcement of the contract provision was necessary to protect his security. *Id.* at 655, 604 P.2d at 506. The court also emphasized that even if, on remand, the trial court found the requisite impairment of security, it should give serious consideration to permitting vendee to prepay the contract balance as an alternative to forfeiture. *Id.* See also OSBORNE, NELSON & WHITMAN, *supra* note 3, at 313-14.

State Legislative Regulation of Mortgage Transfer Restrictions Before the Act

Several states have imposed legislative limitations on due-on-sale clauses.⁷³ While the details of these statutes vary considerably, they commonly prohibit due-on-sale enforcement in residential mortgages unless the mortgagee can establish that a transfer would impair mortgage security.⁷⁴ Most of the statutes permit the mortgagee to condition transfer of the property upon payment of a limited "assumption fee" or upon an increase in the mortgage interest rate by a modest amount, usually no more than one percent.⁷⁵ Some of the statutes impose similar restrictions on increased-interest-on-transfer provisions.⁷⁶ In addition, at least one state, Iowa, confers generous post-foreclosure redemption rights when real estate is foreclosed incident to enforcement of a due-on-sale clause.⁷⁷

73. See ARIZ. REV. STAT. ANN. § 33-806.01 (1971); COLO. REV. STAT. § 38-30-165 (1982); GA. CODE ANN. § 67-3002 (1982); IOWA CODE ANN. § 535.8 (West Supp. 1982); N.M. STAT. ANN. §§ 48-7-11 to -14 (Supp. 1981); MINN. STAT. ANN. § 47.20 (West Supp. 1983); UTAH CODE ANN. § 57-15-1 to -10 (Supp. 1981).

A few additional states have statutes of only minor or procedural importance, and are not discussed in the text. See CAL. CIV. CODE §§ 2924.5 (West 1974) (requiring that due-on-sale clause in loan secured by one to four unit dwelling be placed in both the promissory note and deed of trust to be enforceable); N.Y. REAL PROP. LAW § 254-a (McKinney Supp. 1982) (if due-on-sale clause is triggered, mortgagee may not collect any prepayment penalty); PA. STATE ANN. tit. 41, § 403(6) (Purdon Supp. 1982) (prior to foreclosure, lender must notify debtor of debtor's right, if any, to transfer the property to another subject to the security interest); S.D. COMP. LAWS ANN. § 44-8-28 (Supp. 1982) (due-on-sale clause enforceable only if notice by statutory language is given in the mortgage in capital letters or underlined). See also LA. REV. STAT. ANN. § 6.837 (West Supp. 1982) (building and loan associations expressly authorized to enforce due-on-sale clauses).

74. See, e.g., COLO. REV. STAT. § 38-30-165(a) (1981); IOWA CODE ANN. § 535.8 (West Supp. 1982); N.M. STAT. ANN. § 48-7-13 (Supp. 1979).

75. See, e.g., ARIZ. REV. STAT. ANN. § 33-806.01(c) (1971) (1/2 of 1% maximum rate increase); COLO. REV. STAT. § 38-30-165(b)-(c) (1982) (1% maximum rate increase, 1/2% maximum fee); GA. CODE ANN. § 67-3002 (1982) (1% maximum rate increase, 1/2% to 1% maximum fee, depending on whether borrower is released and whether rate is raised); IOWA CODE ANN. § 535.8 (West Supp. 1982) (1% maximum fee); N.M. STAT. ANN. § 48-7-14 (Supp. 1981) (1/2% maximum fee); UTAH CODE ANN. § 57-15-8.5 (Supp. 1981) (1% maximum rate increase at time of assumption, further 1% increase 5 years later, but rate may never exceed 1% below weighted average yield at most recent FHLMC weekly auction; 1% maximum fee).

76. See, e.g., GA. CODE ANN. § 67-3002 (Supp. 1982) (1% maximum rate increase per annum); UTAH CODE ANN. §§ 57-15-2, -4 (Supp. 1981) (assumption fee limited to 1% of outstanding indebtedness).

77. See IOWA CODE ANN. § 535.8(2)(e) (West Supp. 1982). While normally an Iowa mortgagor has only a one year post-sale redemption right, *id.* § 628.3 (West 1950), when foreclosure of a mortgage on real property results from the enforcement of a due-on-sale clause, the mortgagor may redeem the real property at any time within three years from the day of sale, *id.* § 535.8(2)(e) (West Supp. 1982). In the meantime, the mortgagor is entitled

A few other states legislatively prohibit due-on-sale enforcement in "non-substantive" and certain non-sale transfers.⁷⁸ In California, for example, acceleration is prohibited in residential mortgages when there is a transfer to a spouse resulting from the death of the mortgagor, to a spouse who becomes a co-owner, to a spouse incident to a marriage dissolution, or to an inter vivos trust of which the mortgagor is a beneficiary.⁷⁹ In addition, some statutes deny enforcement of due-on-encumbrance clauses in a variety of residential housing settings.⁸⁰

Federal Regulation of Due-on-Sale Clauses Before the Act

In 1976 the Federal Home Loan Bank Board (Board), the federal agency that regulates federally-chartered and federally-insured savings and loan associations, became concerned about the increasing controversy over whether federally-chartered associations had the authority to enforce due-on-sale clauses. The Board issued a regulation effective July 31, 1976 (1976 Regulation) which provided that a federal association

continues to have the power to include. . . 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.⁸¹

Except as provided in paragraph (g) of the regulation, the Board authorized federal associations to exercise the due-on-sale option and provided that all rights and remedies of the association and borrower "shall be exclusively governed by the terms of the loan contract."⁸² Paragraph (g) prohibited due-on-sale enforcement in certain "non-substantive" transfers of mortgagor-occupied homes resulting from junior liens, purchase-money security interests in household appli-

to possession of the property and for the first thirty months after the sale, the right of redemption is exclusive. *Id.* The time for redemption by creditors is extended to thirty-three months in any case in which the mortgagor's period for redemption is extended. *Id.* This statute represents a significant burden on lenders.

This type of redemption should not be confused with "equitable redemption," available in every state, which allows the mortgagor and junior lienors to pay off a mortgage in default at any time until a valid foreclosure sale has occurred. *See* OSBORNE, NELSON & WHITMAN, *supra* note 3, at 425.

78. *See, e.g.*, CAL. CIV. CODE § 2924.6 (West Supp. 1983).

79. *Id.*

80. *See, e.g., id.* § 2949 (West 1974) (single family, owner-occupied dwellings); VA. CODE § 6.1-2.5 (1979) (one to four family residential dwellings).

81. 12 C.F.R. § 545.8-3(f) (1983).

82. *Id.*

ances, transfers by devise, descent, or operation of law upon the death of a joint tenant, and leaseholds for less than three years with no option to purchase.⁸³ In the preamble to the 1976 Regulation the Board also expressed its intent that the due-on-sale practices of federal associations be governed exclusively by federal law, and emphasized that federal associations "shall not be bound by or subject to any conflicting state law which imposes different . . . due-on-sale requirements."⁸⁴

A similar regulation was promulgated in 1978 by the National Credit Union Administration (NCUA) to apply to due-on-sale clauses in federal credit union mortgages.⁸⁵ The NCUA regulation went beyond the 1976 Board Regulation by specifically requiring federal credit unions to utilize due-on-sale clauses as well as preempting state restrictions on due-on-sale clause enforcement.⁸⁶

While lower federal courts concluded that the 1976 Board Regulation foreclosed the application of state due-on-sale law to federal associations,⁸⁷ a few state courts reached contrary results.⁸⁸ Ultimately, this conflict was resolved by the United States Supreme Court in *Fidelity First Federal Savings & Loan Association v. de la Cuesta*,⁸⁹ a case that addressed the effect of the 1976 Regulation on California law. California generally limited due-on-sale enforcement to situations in which impairment of mortgage security was established.⁹⁰ In *de la Cuesta*, the Supreme Court held that: 1) the Board intended to preempt state law;⁹¹ 2) the 1976 Regulation in fact conflicted with California law, despite the fact that it merely authorized, and did not require, federal associations to utilize due-on-sale clauses;⁹² 3) the Board acted

83. *Id.* § 545.8-3(g). This language tracks the FNMA/FHLMC Mortgage, *supra* note 2, Clause 17 (one to four family).

84. 41 Fed. Reg. 18,286, 18,287 (1976).

85. See 12 C.F.R. § 701.21-6(d) (1983).

86. *Id.*

87. See, e.g., *Dantus v. First Fed. Sav. & Loan Ass'n*, 467 F. Supp. 1139, 1141 (C.D. Ill. 1979), *appeal dismissed*, 638 F.2d 1221 (7th Cir. 1980); *Glendale Fed. Sav. & Loan Ass'n v. Fox*, 459 F. Supp. 903, 907 (C.D. Cal. 1978).

88. See, e.g., *Panko v. Pan Am. Fed. Sav. & Loan Ass'n*, 119 Cal. App. 3d 916, 924, 174 Cal. Rptr. 240, 245 (1981), *vacated*, 458 U.S. 1117 (1982); see also *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156, 160 (Fla. App. 1980) (Board Regulation, while "not invalid," does not prohibit a state court from applying traditional equitable principles to deny acceleration "absent any allegation or proof of impairment of security"); *Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n*, 308 N.W.2d 471, 477-78 (Minn. 1981).

89. 458 U.S. 141 (1982). For a critical analysis of *de la Cuesta*, see Segreti, *supra* note 9, at 803-06.

90. See *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 953, 148 Cal. Rptr. 379, 385-86, 582 P.2d 970, 976-77 (1978).

91. *Fidelity First Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. at 154, 159.

92. *Id.* at 154.

within its statutory authority under section 5(a) of the Home Owner's Loan Act,⁹³ which authorized the Board to promulgate rules for the operation and regulation of federal associations;⁹⁴ and 4) although the 1976 Regulation's merits might be debatable, it was a reasonable, and therefore a valid, exercise of the Board's authority.⁹⁵

The *de la Cuesta* Court did not address the enforceability of due-on-sale clauses included in the mortgage loans made by federal associations before the effective date of the 1976 Board Regulation.⁹⁶ The Board had issued an earlier regulation⁹⁷ that one federal court held sufficient to preempt contrary state due-on-sale law as to pre-1976 Regulation loans.⁹⁸ Also, the 1976 Regulation specified that a federal association "*continues*" to have the power to include due-on-sale clauses in their mortgages.⁹⁹ Although this language may have represented bureaucratic timidity in dealing with the retroactivity issue, it can be argued that it signified the Board's view that it had already preempted state law before 1976. The Supreme Court in *de la Cuesta*, however, expressly avoided reaching the retroactivity question.¹⁰⁰ While *de la Cuesta* confirmed the validity of the Board's response to the needs of federally-chartered savings associations with respect to due-on-sale clauses, it did nothing for other types of lenders. Therefore, these lenders sought a uniform national solution: congressional preemption of state laws restricting the enforcement of due-on-sale clauses.

The Garn-St. Germain Depository Institutions Act of 1982

The enactment of section 341 of the Garn-St. Germain Depository

93. 12 U.S.C. § 1464(a) (1982).

94. Fidelity First Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. at 159-61.

95. *Id.* at 170.

96. *Id.* at 170-71.

97. 12 C.F.R. § 545.8-3(a) (1983) (originally promulgated July 3, 1979). The regulation stated only that loan instruments "shall . . . provide for full protection to the Federal association." *Id.*

98. Conference of Fed. Sav. & Loan Ass'ns v. Stein, 495 F. Supp. 12 (E.D. Cal. 1979). Note that this decision was rendered prior to *de la Cuesta*.

99. 12 C.F.R. § 545.8-3(f) (1983). See *supra* text accompanying note 81.

100. Two of the deeds of trust in *de la Cuesta* were executed prior to both the *Wellenkamp* decision in 1978 and the effective date of the Board Regulation in 1976. The debtors argued that the Board Regulation could not be applied so as to destroy the debtors' rights. However, the Supreme Court avoided this question because it concluded that California law in effect at the date the two deeds of trust were executed was consistent with the Board Regulation. See Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 170 n.24 (1982). For further consideration of the California law, see *infra* text accompanying notes 204-52.

Institutions Act of 1982 (Act)¹⁰¹ signaled the dawn of a new era for due-on-sale clause enforcement. The Act broadly preempts state laws that restrict the enforcement of due-on-sale clauses, thereby making such clauses generally enforceable.

Yet Congress responded to effective lobbying by the real estate brokerage industry and related interests¹⁰² by softening the impact of the Act in most states that previously restricted due-on-sale enforcement. To accomplish this, Congress created complex exceptions to the preemption based on so-called "window periods,"¹⁰³ and conferred authority on states with window periods to enact legislation to avoid the impact of the Act on certain mortgage loans.¹⁰⁴ In so doing, Congress created a host of important and difficult interpretation problems. Congress delegated to the Board the authority to issue regulations interpreting the Act,¹⁰⁵ and in April, 1983, the Board issued a final regulation entitled "Preemption of State Due-on-Sale Laws" (Regulation).¹⁰⁶ The following sections of this Article analyze the more important provisions of the Act and Regulation, their scope, and the complex problems of interpretation they have engendered. We consider whether the Regulation reflects congressional intent, and to what extent the Act and Regulation achieve sound public policy goals.

Lenders Covered

The Act covers any "person or government agency making a real property loan."¹⁰⁷ According to the Regulation, the foregoing definition includes,

without limitation, individuals, Federal associations, state-chartered savings and loan associations, national banks, state-chartered banks and state-chartered mutual savings banks, Federal credit unions, state-chartered credit unions, mortgage banks, insurance companies

101. 12 U.S.C. § 1701j-3 (1982).

102. See generally *Savings and Loan Aid Package Boosts Powers of Banks, Thrifts*, 40 CONG. Q. 2423 (1982); *Mortgage Assumption Plan Approved*, 40 CONG. Q. 2126 (1982); *Senate Passes Comprehensive Financial Institutions Bill*, 10 Hous. & Dev. RPT. (BNA) 356 (1982); *The Washington Front*, CAL. REAL EST., Nov. 1982, at 2; *U.S. Law on Home-Mortgage Assumptions Will Create Legal Limbos in Some States*, Wall St. J., Oct. 4, 1982, at 10, col. 1.

103. 12 U.S.C. § 1701j-3(c)(1) (1982). See *infra* text accompanying notes 178-302.

104. 12 U.S.C. § 1701j-3(c)(1) (1982). See *infra* notes 303-09 & accompanying text.

105. 12 U.S.C. § 1701j-3(e)(1) (1982). The Board is required to consult with the National Credit Union Administration and the Comptroller of the Currency before issuing regulations.

106. 48 Fed. Reg. 21,554 (1983) (to be codified at 12 C.F.R. 591).

107. 12 U.S.C. § 1701j-3(a)(2) (1982). Also included is "any assignee or transferee, in whole or in part, of such a person or agency."

and finance companies which make real property loans, manufactured-home retailers who extend credit, agencies of the Federal government, [and] any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act.¹⁰⁸

The Board emphasized that the foregoing list is "intended to be representative and not exclusive."¹⁰⁹ Consequently, every mortgagee, whether a natural person, business entity, or government agency, is covered by the Act.

Although Congress clearly has the power under the commerce clause of the United States Constitution¹¹⁰ to regulate institutional lenders insofar as their activities affect interstate commerce,¹¹¹ an argument could be made that Congress lacks the power to regulate due-on-sale clauses in purely intrastate mortgage transactions between private, non-institutional parties. Congress is authorized to regulate intrastate activity so long as it rationally concludes that the activity affects interstate commerce or commerce in more than one state.¹¹² At first glance, it seems difficult to conclude that an isolated, intrastate, non-institutional mortgage transaction meets this test.¹¹³ However, under the pre-

108. 48 Fed. Reg. 21,561 (1983) (to be codified at 12 C.F.R. § 591.2(g)).

109. 48 Fed. Reg. 21,555 (1983) (definitions section of the Regulation). In one recent case, *Lucas v. Jones*, 148 Cal. App. 3d 1008, 1012 n.6, 196 Cal. Rptr. 437, 440 n.6 (1983), the California Court of Appeal held that the Regulation is inapplicable to individuals making private loans. This conclusion is obviously wrong: the Regulation refers to coverage of "individuals," see *supra* text accompanying note 108, and the Act refers to "a person . . . making a real property loan," 12 U.S.C. § 1701j-3(a)(2) (1982). The *Lucas* court's mistaken interpretation is based on language in the Preamble to the Regulation, as published in the Federal Register, that describes "Small entities to which the rule will apply." 48 Fed. Reg. 21,560 (1983). While this description mentions only financial institutions and government and corporate entities, it clearly is not intended to limit the coverage of the Regulation to such entities. Rather, the language was inserted in the Preamble merely to comply with the Regulatory Flexibility Act, 5 U.S.C. § 604(a)(3) (1982), which requires an agency publishing a final rule to describe "alternatives . . . designed to minimize any significant economic impact of the rule on small entities." The Act defines "small entity" to include businesses, nonprofit enterprises, and local government jurisdictions. *Id.* § 601(6). Since individuals are not included in this definition, they were not explicitly mentioned by the Board in the portion of the Preamble described above.

110. U.S. CONST. art. I, § 8, cl. 3.

111. See *McInnis v. Cooper Communities, Inc.*, 271 Ark. 503, 611 S.W.2d 767 (1981); J. NOWAK, R. ROTUNDA & J. YOUNG, CONSTITUTIONAL LAW 165-67 (2d ed. 1983).

112. See, e.g., *Perez v. United States*, 402 U.S. 146, 151-54 (1971); *Katzenbach v. McClung*, 379 U.S. 294, 301-05 (1964); *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 255, 248 (1964); *Wickard v. Filburn*, 317 U.S. 111, 125 (1942). See generally *McLain v. Real Estate Bd. of New Orleans*, 444 U.S. 232, 241 (1979); J. NOWAK, R. ROTUNDA & J. YOUNG, *supra* note 111, at 161-70.

113. Suppose, for example, that after the effective date of the Act, ME sold an unimproved lake lot located in State X to MR and that ME took back a note and mortgage for part of the purchase price. Both ME and MR were residents of State X. The mortgage

vailing commerce clause interpretation the impact on commerce of a single transaction is largely irrelevant.¹¹⁴ Indeed, the Court has suggested that federal courts lack the power to make an independent determination as to the interstate ramifications of each litigant's behavior: "Where the *class of activities* is regulated and that *class* is within the reach of federal power, the courts have no power 'to excise, as trivial, individual instances' of the class."¹¹⁵

Application of this reasoning leads to the conclusion that Congress has ample power under the commerce clause to reach purely local and private mortgage transactions. Perhaps Congress believed that making due-on-sale clauses enforceable in non-institutional mortgage settings would encourage private seller financing at a time when institutional financing was both expensive and difficult to obtain. In any event, while a due-on-sale clause included in an isolated private mortgage transaction probably cannot be said to affect interstate commerce, it was not irrational for Congress to conclude that the cumulative impact of many such transactions on the national mortgage market is significant.

Loans Covered

The Act covers every "loan, mortgage, advance, or credit sale secured by a lien on real property, the stock allocated to a dwelling unit in a cooperative housing corporation, or a residential manufactured home, whether real or personal property."¹¹⁶ Although the Act makes no reference to mortgages on leasehold interests, the Regulation provides that a loan is secured by a lien on real property if it is made on the "security of any instrument . . . which makes . . . a leasehold or subleasehold . . . specific security for payment of the obligation secured by the instrument."¹¹⁷

contained a due-on-sale clause. A year later MR sold and conveyed the lot to Grantee, a wealthy resident of State X, without permission of ME. ME then accelerated the mortgage debt and commenced a judicial foreclosure proceeding. If under the case law of State X, a due-on-sale clause is enforceable only if the transfer impairs mortgage security, a requirement which ME cannot satisfy, ME cannot accelerate the loan. If the Act applies, however, the due-on-sale clause is automatically enforceable. The issue is whether Congress has sufficient commerce clause authority to reach this type of isolated, intrastate non-institutional transaction.

114. See *Wickard v. Filburn*, 317 U.S. 111 (1942) (cumulative effect of "trivial" local activities can have substantial impact on interstate commerce); see also *Perez v. United States*, 402 U.S. 146 (1971); *Katzenbach v. McClung*, 379 U.S. 294 (1964).

115. *Perez v. United States*, 402 U.S. 146, 154 (1971) (quoting *Maryland v. Wirtz*, 392 U.S. 183, 193 (1968)) (emphasis in original).

116. 12 U.S.C. § 1701j-3(a)(3) (1982).

117. 48 Fed. Reg. 21,561 (1983) (to be codified at 12 C.F.R. § 591.2(h)).

As Professor Richard Powell aptly observed, “[w]hen a statute affecting ‘real property’ is in preparation, careful consideration should be addressed to the policy question of its applicability to the interests of lessees, and . . . unambiguous language should be inserted in the statute to define its intended inclusion, or exclusion, of such interests.”¹¹⁸ It is unfortunate that Congress neglected to follow this useful advice. Since Congress failed specifically to place leasehold mortgages within the coverage of the Act, it could be argued that the Board lacked authority to do so in the Regulation. Under this reasoning, a leasehold mortgage cannot be a “lien on real property” because the leasehold is personal property or a “chattel real.”¹¹⁹ The phrase “real or personal” property, as utilized in the Act,¹²⁰ refers only to liens on residential manufactured homes, and thus cannot be used to buttress a conclusion that the Act covers all leasehold mortgages.

It seems probable, however, that the foregoing argument will fail. To be sure, courts continue to characterize leaseholds as personal property for some purposes¹²¹ and, as Professor Powell noted, this is a “field of judgment and of pragmatic utility, where disagreement is not unlikely.”¹²² Nevertheless, the courts have treated leasehold mortgages as mortgages on real estate in a variety of contexts.¹²³ Most contemporary mortgages on leasehold interests arise in commercial real estate settings where the mortgagor is often an experienced and sophisticated real estate developer.¹²⁴ It seems unlikely that Congress intended due-on-sale

118. 2 R. POWELL, REAL PROPERTY 190-91 (1982).

119. See 1 AMERICAN LAW OF PROPERTY § 3.12 (1952); RESTATEMENT OF PROPERTY § 8 comment c (1936).

120. See *supra* text accompanying note 116.

121. See, e.g., Stagecrafters' Club, Inc. v. District of Columbia Div. of Am. Legion, 110 F. Supp. 481 (D.D.C. 1953) (leasehold deemed personalty and thus subject to execution sale for federal taxes owed by lessee); Shaeffer v. Baeringer, 345 Pa. 32, 29 A.2d 697 (1943) (lessee held not a person having an “interest in land” under a statute requiring all such persons to join in a judicial application to compel a mortgagee to assign his mortgage after payment).

122. 2 R. POWELL, *supra* note 118, at 189. See also MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY 64 (1962).

123. See, e.g., Harbel Oil Co. v. Steele, 83 Ariz. 181, 184-86, 318 P.2d 359, 361 (1957) (assignment of lease as security for a loan and sublease back to lessee deemed to be a real property mortgage which could only be foreclosed by judicial action); Fidelity Trust Co. v. Wayne County, 244 Mich. 182, 188, 221 N.W. 111, 112 (1928) (statute imposing tax on real estate mortgages held applicable to a mortgage on a term for years); Abraham v. Fioramonte, 158 Ohio St. 213, 222-25, 107 N.E.2d 321, 326-27 (1952) (leasehold could not be made subject of chattel mortgage, but must be mortgaged in accordance with formalities associated with real estate mortgages).

124. See generally G. NELSON & D. WHITMAN, REAL ESTATE TRANSFER, FINANCE AND DEVELOPMENT 1062-75 (2d ed. 1981); Committee on Leases, Ground Leases and Their Financing, 4 REAL PROP. PROB. & TR. J. 437, 438 (1969).

clauses to be enforceable against residential fee owner mortgagors, who generally have a relatively weak bargaining position as against their mortgagees, while states remain free to restrict enforcement of such clauses for the benefit of commercial mortgagor-lessees who frequently have relatively strong negotiating strength vis-a-vis their mortgage lenders.

Types of Mortgage Transfer Restrictions Covered

The Act preempts state law only with respect to due-on-sale clauses that "authoriz[e] a lender, at its option, to declare due and payable sums secured by the lender's security instrument if all or any part of the property, or an interest therein, securing the real property loan is sold or transferred without the lender's prior written consent."¹²⁵ The Regulation adopts this statutory definition virtually unchanged.¹²⁶

Presumably the Act is inapplicable to an increased-interest-on-transfer clause because that type of clause confers on the lender only the right to modify or increase the interest rate upon a sale or transfer and not the "option to declare [the debt] due and payable."¹²⁷ Consequently, every state is probably free to make increased-interest-on-transfer provisions unenforceable. This result is bizarre, for such clauses have an economic effect similar to that of the due-on-sale clauses.¹²⁸ Nevertheless, the practical effect of excluding increased-interest-on-transfer provisions from the scope of the Act is unlikely to be substantial. Mortgagees can simply include due-on-sale language in any mortgages executed after the Act's effective date. As to pre-Act loans, few state courts are likely to exercise their freedom. In states that follow an automatic enforcement approach to the due-on-sale clause,¹²⁹ courts are unlikely to restrict enforcement of an increased-interest-on-transfer provision, as it is the less burdensome of the two clauses. Even in states that impose substantial restrictions on due-on-sale clause enforcement, courts that have addressed the issue have been less hostile toward enforcement of increased-interest-on-transfer

125. 12 U.S.C. § 1701j-3(a)(1) (1982).

126. 48 Fed. Reg. 21,561 (1983) (to be codified at 12 C.F.R. § 591.2(b)). The only substantive difference in the Regulation's due-on-sale definition is the insertion of the word "immediately" prior to the words "due and payable."

127. See *supra* text accompanying note 24. Acceleration can occur only if the transferee defaults in paying the increased mortgage payments. See also *O'Connell v. Dockendorff*, 415 So. 2d 35 (Fla. Ct. App. 1982) (increased interest on transfer provision is not a due-on-sale clause for purposes of state case law that limits due-on-sale enforcement to impairment of security situations).

128. See *supra* text accompanying notes 24, 65-68.

129. See *supra* notes 49-53 & accompanying text.

clauses.¹³⁰ Courts in these latter states are thus not likely to take advantage of this "loophole" in the Act's preemptive effect.

One could draft mortgage language that would fall outside the Act's definition of a due-on-sale clause. For example, a provision for *automatic* acceleration upon transfer seems to be outside the definition, which speaks of the lender's "option" to accelerate. Similarly, a clause that merely makes an unapproved transfer by the mortgagor a default, but says nothing about acceleration, may fall outside the Act. However, this argument is weakened if the mortgage or note also contains a standard acceleration-for-default clause that the courts could read together with the no-transfer clause to find the equivalent of a due-on-sale clause. These illustrations should have little practical importance, since in post-Act mortgages well-advised lenders will simply refrain from using such uncommon and idiosyncratic language. An occasional pre-Act document may raise this sort of problem, but the number of documents with such non-standard clauses is small. In any event, only clauses in states that restrict due-on-sale enforcement potentially pose a problem. In overall economic terms, then, the Act's narrow definition of a due-on-sale clause is likely to be of little importance.

Coverage of Installment Land Contracts

While the Act itself does not specifically mention installment land contracts, its preemption does apply to any "loan, mortgage, advance, or credit sale secured by a lien on real property."¹³¹ Does an installment contract vendor retain a "lien on real property," as well as legal title? The Regulation answers affirmatively,¹³² and is probably correct.¹³³ While a few courts have had conceptual difficulty with the notion that one can have legal title to land and a lien on it simultaneously,¹³⁴ there is substantial authority that the installment land contract vendor retains a "vendor's lien" for the unpaid purchase price.¹³⁵ Moreover, courts are increasingly equating installment land

130. See *supra* text accompanying notes 65-66.

131. 12 U.S.C. § 1701j-3(a)(3) (1982).

132. 48 Fed. Reg. 21,561 (1983) (to be codified at 12 C.F.R. § 591.2(h)) ("loan secured by a lien on real property" means a loan on the security on any instrument (whether a mortgage, deed of trust, or *land contract*) which makes the interest in real property (whether in fee or on a leasehold or subleasehold) specific security for the payment of the obligation secured by the instrument") (emphasis added).

133. See *Karim v. Werner*, 333 N.W.2d 877, 878 n.1 (Minn. 1983) (noting the possible application of the Act, but concluding that the due-on-sale clause was valid under state law).

134. See, e.g., *Allen v. Wilson*, 178 Cal. 674, 174 P. 661 (1918).

135. See, e.g., *Forty-Four Hundred East Broadway Co. v. 4400 E. Broadway*, 135 Ariz. 265, 267, 660 P.2d 866 (1983); *Bean v. Walker*, 95 A.D.2d 70, 73, 464 N.Y.S.2d 895, 897

contracts with mortgages, and requiring foreclosure as the vendor's primary remedy. In such cases the vendor is surely foreclosing a "lien."¹³⁶ Finally, while the analytical underpinnings for their decisions are not always clear, numerous courts routinely afford the vendor the option to foreclose an installment land contract as a mortgage.¹³⁷ This practice constitutes a persuasive argument that the contract vendor is also a "lienor."

The conclusion that the Act's preemption applies to installment land contracts does not mean that a violation of a contract prohibition on transfer will necessarily result in a forfeiture of the vendee's interest. When no-transfer provisions are upheld, it is likely that foreclosure of the contract will instead be ordered, and then only after the vendee has been afforded the opportunity to pay off the contract balance.¹³⁸ The Act does not appear to change this. Literally, it only validates "due-on-sale" clauses—those that authorize the acceleration of the debt when the real estate is transferred without the lender's consent.¹³⁹ A prohibition on transfer that purports to go beyond simple acceleration, and defines the remedies (such as forfeiture) to be imposed on the vendee, is unaffected by the Act and is thus still subject to pre-Act state law. It is highly improbable that a state court would enforce forfeiture, with its harsh consequences, simply because a transfer was made without the vendor's consent. A more likely judicial response would be to permit foreclosure of the contract as a mortgage. Such an approach would not be inconsistent with the policy inherent in the Act.

Time of Transfer

The Act applies to all mortgage *loans*, whether consummated before or after October 15, 1982, the effective date of the Act. However, a *transfer* is covered only if it is made after the Act's effective date.¹⁴⁰ Although the Act itself does not state this, this conclusion is supported by the well-settled rule that a statute has only prospective effect unless

(1983); *Braunstein v. Trotter*, 54 Or. App. 687, 690, 635 P.2d 1379, 1381 (1981); 3 AMERICAN LAW OF PROPERTY § 11.73 (1952); Comment, *supra* note 26, at 89.

136. See *supra* text accompanying note 29.

137. See, e.g., *Land Assocs. v. Becker*, 294 Or. 308, 314, 656 P.2d 927, 931 (1982); Comment, *supra* note 26, at 89; Note, *Forfeiture and the Iowa Installment Land Contract*, 46 IOWA L. REV. 786, 795-96 (1961).

138. See *supra* text accompanying note 72.

139. 12 U.S.C. § 1701j-3(a)(1) (1982).

140. See *Home Sav. Bank v. Baer Properties, Ltd.*, 92 A.D.2d 98, 101, 460 N.Y.S.2d 833, 835-36 (1983). The Regulations seem to agree with respect to window period loans. See 12 C.F.R. § 591.4(c)(2) (1983).

Congress evinces a clear intent that it have retroactive effect.¹⁴¹ Congress indicated no such intent regarding the Act. Note, however, that federally-chartered savings and loan associations have the authority to enforce due-on-sale clauses as to many pre-Act transfers by virtue of the 1976 Regulation upheld in the *de la Cuesta* case.¹⁴² The Act itself recognizes this authority.¹⁴³

The application of the Act can be illustrated as follows. Suppose that on March 1, 1982, MR transferred mortgaged real estate located in State X to Grantee in violation of a due-on-sale clause contained in the mortgage executed in 1980. During early 1983, ME (a state-chartered lender) accelerated the debt and commenced judicial foreclosure proceedings. Because the transfer took place before October 15, 1982, the Act is inapplicable and the State X court is free to apply state law to such pre-Act transfers.

While the Act is inapplicable to pre-Act transfers, it is retroactive in the sense that it governs mortgage loans executed prior to the Act's effective date. Thus, if in the previous example the property had been mortgaged in 1980, but the transfer had taken place on December 20, 1982, the Act would have applied, and the due-on-sale clause would have been enforceable.

Is this type of retroactivity unconstitutional? While the contract clause¹⁴⁴ of the United States Constitution limits only state power to impair the obligation of contracts, certain restrictions on federal power to enact retroactive legislation are implicit in the due process clause of the fifth amendment.¹⁴⁵ In applying the due process clause to legislation that has retroactive effects, the Supreme Court has often focused on whether the legislation defeats the reasonable expectations of the parties.¹⁴⁶ However, even when this is the case, retroactive legislation will be sustained if it is rationally related to a valid governmental purpose.¹⁴⁷

The Act clearly satisfies this constitutional standard. First, it applies only to mortgages that contain due-on-sale clauses. Consequently, the Act is relevant only when the parties have specifically

141. *United States v. Security Ind. Bank*, 103 S. Ct. 407, 413 (1982).

142. *See supra* text accompanying notes 81-100.

143. *See* 12 U.S.C. § 1701j-3(c)(2)(C) (1982); *see also* 48 Fed. Reg. 21,562 (to be codified at 12 C.F.R. § 591.3).

144. U.S. CONST. art. I, § 10, cl. 1.

145. U.S. CONST. amend. V. *See* J. NOWACK, R. ROTUNDA & J. YOUNG, *supra* note 111, at 471-72.

146. J. NOWACK, R. ROTUNDA & J. YOUNG, *supra* note 111, at 474-75.

147. *See, e.g.,* *Usery v. Turner Elkhorn Mining Co.*, 423 U.S. 1, 19 (1976).

agreed that the debt could be accelerated in the event of an unapproved transfer. Under these circumstances a mortgagor can hardly argue that enforcement of the agreement is a total surprise. In a sense, therefore, the Act enhances rather than impairs the obligations created by the contract. Second, although certain mortgagors in states that previously restricted due-on-sale enforcement may argue that they executed their mortgages under the assumption that such clauses were usually unenforceable and that the Act upset their reasonable expectations, such mortgagors are protected by the "window period" concept, examined in detail later in this Article.¹⁴⁸ Finally, even without the window period provisions, the retroactive effect of the Act is rationally related to a valid governmental purpose. The Act reflects a legitimate congressional concern about the economic distress of the savings and loan industry.¹⁴⁹ Enforcing due-on-sale clauses as to future transfers under pre-Act mortgages surely is one rational means of alleviating that financial distress.¹⁵⁰

Transfers in Which Due-on-Sale Enforcement is Prohibited

The Act expressly enumerates several types of transfers that may not be used as the basis for due-on-sale acceleration. The list is similar, but not identical, to the analogous provisions of the FNMA/FHLMC mortgage form and the 1976 FHLBB regulations.¹⁵¹ It includes:

- 1) the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;
- 2) the creation of a purchase money security interest for household appliances;
- 3) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;
- 4) the granting of a leasehold interest of three years or less not containing an option to purchase;
- 5) a transfer to a relative resulting from the death of a borrower;
- 6) a transfer where the spouse or children of the borrower become an owner of the property;
- 7) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;
- 8) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or

148. See *infra* text accompanying notes 178-302.

149. See *supra* notes 12-14 & accompanying text.

150. See *supra* note 14 & accompanying text.

151. See *supra* note 83 & accompanying text.

9) any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board.¹⁵²

When a transfer of one of these types is involved, the Act is preemptive: acceleration under a due-on-sale clause is prohibited even if permitted by state law. Moreover, these prohibitions apply on their face to all types of loan documents.

Most of these transfers fall within the "non-substantive" or "non-sale" category considered earlier,¹⁵³ as to which due-on-sale enforcement probably would be impermissible under state law. Not all of these transfers, however, can be so categorized. For example, in item (1) above, the Act prohibits due-on-sale enforcement upon the creation of a junior lien if no transfer of occupancy is involved.¹⁵⁴ Suppose a first mortgage on a shopping center contains a prohibition on further encumbrances without the mortgagee's consent. If the mortgagor borrows money for a non-business purpose and gives the lender a junior mortgage on the center, the Act appears to prohibit acceleration. This is true even if the first mortgagee can establish that the junior lien will increase the risk of mortgagor default or will impair the security of its mortgage. This result may come as an unpleasant surprise to countless mortgage lenders who rely on the due-on-encumbrance concept in a variety of commercial lending contexts.

The 1983 Bank Board Regulation

The Board sought to avoid such a result by limiting the application of the statutory list to mortgage loans made "on the security of a home occupied . . . by the borrower."¹⁵⁵ Even though such a limitation is absent from the Act itself, the Board argued in its preamble to the Regulation that "this approach is most consistent with the Congressional purpose of restricting due-on-sale exercise to protect consumers."¹⁵⁶ While it is true that courts sometimes defer to an interpretation of a statute by the agency charged with its administration,¹⁵⁷ there is also a strong tradition that the "plain meaning" of an unambiguous statute should be respected.¹⁵⁸

The Board justified its interpretation of what seems to be an un-

152. 12 U.S.C. § 1701j-3(d) (1982).

153. *See supra* text accompanying notes 59-61.

154. 12 U.S.C. § 1701j-3(d)(1) (1982).

155. 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.5(b)).

156. *Id.* at 21,559.

157. Federal Deposit Ins. Corp. v. Sumner Fin. Corp., 451 F.2d 898, 902 (5th Cir. 1972).

158. *See e.g.*, United States v. American Trucking Ass'ns, 310 U.S. 534 (1940); Caminetti v. United States, 242 U.S. 470 (1917). *See generally* H. READ, J. MACDONALD, J. FORDHAM & W. PIERCE, MATERIALS ON LEGISLATION 790-815 (1973).

ambiguous statute on two grounds. First, it relied on a report about the Act issued by the Senate Committee on Banking, Housing and Urban Affairs.¹⁵⁹ In discussing the prohibition on acceleration in the further encumbrance situation, the Committee referred to home improvement loans and loans to send a mortgagor's child to college.¹⁶⁰ The Report also stated that the Act's exceptions were intended "to provide protections for *consumers* by prohibiting the enforcement of due-on-sale clauses where such enforcement would be inequitable."¹⁶¹ Second, in its preamble to the Regulation, the Board emphasized that "[t]o a large extent, the exemptions in the Act are extracted directly from the [1976 regulations] in which the exemptions were intended only to apply to borrower-occupants."¹⁶²

The Board's arguments are not persuasive. The language of the Senate Committee Report may well indicate that Congress intended to protect borrower-occupants of homes in the further encumbrance situation. However, the Report also states that "[a]ll loans . . . are subject to" the exceptions to due-on-sale enforcement.¹⁶³

Although limiting the further encumbrance exception to loans made on the security of owner-occupied homes may be justifiable,¹⁶⁴ the case for restricting the other exceptions to such loans is less appealing. The Senate Committee Report, for example, emphasized that it would be unfair for lenders to enforce due-on-sale clauses under certain circumstances, such as "involuntary transfers resulting from the death of a borrower, transfers which rearrange ownership rights within a family, or transfers resulting from a separation or dissolution of a marriage."¹⁶⁵ If it is unfair to enforce a due-on-sale clause when a marriage dissolution necessitates a title transfer of a family home, is it less unfair to invoke the clause when the real estate is the family grocery store? If an owner of a family home should be able to transfer it to an inter vivos trust of which she is the beneficiary, why should her transfer of raw land held for speculation be treated any differently?

Perhaps the Board would have been wiser to impose the owner-occupant limitation only under the further encumbrance exception.

159. REPORT OF SEN. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS ON S. 2879, S. REP. NO. 536, 97th Cong., 2d Sess. (1982) [hereinafter cited as SENATE COMMITTEE REPORT].

160. *Id.* at 24.

161. *Id.* at 25 (emphasis added).

162. 48 Fed. Reg. 21,559 (1983).

163. SENATE COMMITTEE REPORT, *supra* note 159, at 25 (emphasis added).

164. *See infra* text accompanying notes 166-68.

165. SENATE COMMITTEE REPORT, *supra* note 159, at 24.

Such an approach would have accommodated the Senate Committee's specific concern for the owner-occupant in the further encumbrance situation, while at the same time deferring in the main to the language of the Act. In the further encumbrance situation, we believe that lenders have a legitimate concern that further liens may reduce the mortgagor's economic stake in the real estate to the point of security impairment.¹⁶⁶ It is true, of course, that certain of the other "non-substantive" or "non-sale" transfers can occasionally threaten mortgage security.¹⁶⁷ Yet we believe concerns about security impairment, in general, are normally less justified in most "non-substantive" or "non-sale" transfers than in the further encumbrance setting.¹⁶⁸

The Regulation modifies the Act's exceptions to due-on-sale enforcement in other respects. For example, the Regulation adds to the further encumbrance exception by making it clear that a transfer by installment land contract does not constitute "[t]he creation of a lien or other encumbrance subordinate to the lender's security instrument."¹⁶⁹ This addition is probably unnecessary because installment land contract transfers almost always entail the transfer of occupancy rights while, in order for the exception to apply, the Act states that the creation of the lien or encumbrance must "not relate to a transfer of rights of occupancy in the property."¹⁷⁰ In any event, the Board's interpretation of the exception is correct. The Act's "further encumbrance" exception is aimed at protecting mortgagors who have no intent to sell or transfer ownership, but want to create non-purchase money junior liens on their real estate for a variety of business or personal reasons.¹⁷¹

The Regulation, unlike the Act itself, specifies that for certain non-substantive transfers to escape due-on-sale enforcement, the transferee must be a person "who occupies or will occupy the property."¹⁷² This requirement is applicable to any transfer resulting from the death of the borrower, and to transfers to a spouse or child or those incident to marriage dissolution.¹⁷³ For example, if a parent gives his home to a daughter, and the daughter then occupies it herself, under the Regula-

166. See *supra* text accompanying notes 21-23, 62-63.

167. For example, the building that houses a family grocery business may, because of the death of the original mortgagor, wind up in the hands of an inexperienced and unreliable spouse or child whose actions may result in security impairment.

168. See *supra* text accompanying notes 21-23, 59-61.

169. 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.5(b)(1)(i)).

170. 12 U.S.C. § 1701j-3(d)(1) (1982).

171. See SENATE COMMITTEE REPORT, *supra* note 159, at 24. At least one case supports this conclusion. See *Smith v. Frontier Fed. Sav. & Loan Ass'n*, 649 P.2d 536 (Okla. 1982).

172. 48 Fed. Reg. 21,563 (1983) (to be codified at 12 C.F.R. § 591.5(b)(1)(v)).

173. *Id.*

tion no acceleration may take place. However, if the daughter chooses to rent it out, the due-on-sale clause is enforceable. There appears to be no direct support in the legislative history for the Board's addition of this "transferee occupancy" requirement, and its validity is dubious at best.

Finally, while the Act prohibits due-on-sale enforcement when there is "a transfer into an inter vivos trust in which the borrower is and remains a beneficiary"¹⁷⁴ and retains the right of occupancy, the Regulation conditions this exception on the borrower providing the lender with "reasonable means acceptable to the lender" by which the lender will be "assured of timely notice of any subsequent transfer of the beneficial interest or change in occupancy."¹⁷⁵ Lenders had told the Board that under certain devices, such as the Illinois land trust,¹⁷⁶ the beneficiary is free to direct the sale of the beneficial interest without any public record or notice to the lender.¹⁷⁷ The Regulation seems consistent with congressional intent on this issue as it simply aids the mortgagee in making future determinations as to whether a "real" or "substantive" transfer has occurred that would justify invoking the due-on-sale clause.

The Exemption for Window Period Loans

As a result of pressure from the real estate brokerage industry¹⁷⁸ and a desire to protect the reasonable expectations of borrowers who believed that they had acquired "assumable" loans for purposes of future resale,¹⁷⁹ Congress provided partial relief from the Act's preemption. Thus, in some states the Act's effect is deferred and state law continues to govern enforcement of certain due-on-sale clauses. This was accomplished through creation of "window periods," which give rise to the postponement of the Act's preemptions.¹⁸⁰ The concept of window periods is complex, and is not clearly defined in the Act or susceptible to easy explanation.

174. 12 U.S.C. § 1701j-3(d)(8) (1982).

175. 48 Fed. Reg. 21,563 (1983) (to be codified at 12 C.F.R. § 591.5(b)(1)(vi)).

176. Under such a trust, the trustee (typically a financial institution) holds "bare" legal title, but has no management duties. See Flaherty, *Illinois Land Trusts and the Due-on-Sale Clause*, 65 ILL. B.J. 376 (1977).

177. 48 Fed. Reg. 21,559 (1983).

178. See *supra* note 102.

179. See SENATE COMMITTEE REPORT, *supra* note 159, at 22.

180. 12 U.S.C. § 1701j-3(c)(1) (1982). States may also extend this window period protection indefinitely. See *infra* notes 303-09 & accompanying text. The term "window period" appears in SENATE COMMITTEE REPORT, *supra* note 159, at 22, rather than in the Act.

A state may be a window period state if it restricted enforcement of due-on-sale clauses before the Act. The window period in such a state began when the state first restricted enforcement of due-on-sale clauses, and ended when the state ended such restrictions, or upon passage of the Act. Certain loans in a state that had a window period may remain assumable for three years if they would have been assumable under state law prior to the passage of the Act. This three-year deferral period began on October 15, 1982, (the effective date of the Act), and will continue until October 15, 1985.¹⁸¹ Only states that "prohibited the exercise of due-on-sale clauses"¹⁸² before the effective date of the Act qualify for window period treatment and the three year extension. To qualify, a state must have prohibited exercise of the due-on-sale clause by a statute, its constitution, or a decision of its highest court (or if no such decision, a decision by the state's next highest appellate court whose decisions apply statewide).¹⁸³

However, not all loans in states qualifying for window period treatment will remain assumable for this three year period. Only loans that were "made or assumed" between the date of the state's prohibition of enforcement of the due-on-sale clause and October 15, 1982, will be governed by state law and thus remain assumable.¹⁸⁴ The Regulation defines "assumed" to include transfers under which a grantee takes "subject to" the mortgage but does not agree to be personally liable for the mortgage debt.¹⁸⁵

The window period concept can be best understood through factual examples. Suppose State X enacted a statute on July 1, 1979, limiting due-on-sale enforcement in mortgages on single family dwellings to situations in which the mortgagee can establish impairment of mortgage security. MR purchased his house on September 1, 1980, and simultaneously executed a mortgage on it that contained a due-on-sale clause. If MR sells his house on April 1, 1984, to Grantee, the mortgage will be assumable by Grantee unless the mortgagee can establish that the transfer would impair mortgage security. This would also be true if MR had assumed an existing mortgage on September 1, 1980, rather than obtaining a new loan, since the assumption would have occurred after July 1, 1979, the effective date of the state statute. Finally, the transferees of Grantee, if any, will be able to assume the

181. 12 U.S.C. § 1701j-3(c)(1) (1982).

182. *Id.*

183. *Id.*

184. *Id.*

185. 48 Fed. Reg. 21,561 (1983) (to be codified at 12 C.F.R. § 591.2(a)).

mortgage so long as the transfer takes place prior to October 15, 1985, and the mortgagee is not able to establish that such a transfer impairs mortgage security.

Although the Board was requested to identify the states that qualify for window period treatment, it declined to do so¹⁸⁶ on the ground that Congress intended window period determinations to be left to "state interpretation and state judicial decision."¹⁸⁷ However, the Board anticipates that its Office of General Counsel will, from time to time, issue advisory opinions with respect to state window period questions.¹⁸⁸

State Law Restrictions That Qualify A State for Window Period Treatment

Only states that have "prohibited the exercise of due-on-sale clauses"¹⁸⁹ qualify for window period treatment. This language is susceptible to several possible interpretations. If it is taken to refer to total and absolute prohibitions, no window periods would be created anywhere, as no state bars the enforcement of due-on-clauses under all circumstances.¹⁹⁰ Such a reading would mean that no post-Act transfers would be exempt from the Act's preemption, even though the transfers took place in a state that substantially restricts due-on-sale enforcement. This result would obviously be contrary to congressional intent. In reliance on language in the Senate Committee Report,¹⁹¹ the Regulation takes a more moderate view, providing that a state qualifies for window period treatment when it has "adopted a law . . . prohibiting the *unrestricted* exercise of due-on-sale clauses upon *outright transfers* of property."¹⁹²

186. *Id.* at 21,555.

187. *Id.*

188. *Id.*

189. 12 U.S.C. § 1701j-3(c)(1) (1982).

190. *See supra* text accompany note 48.

191. *See* SENATE COMMITTEE REPORT, *supra* note 159, at 22 (citing *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 170 n.24 (1982)).

192. 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.2(p)(2)(i)-(ii)) (emphasis added). The Board expressly refused to identify specific window period states. *See id.* at 21,555. However, the two major federally-sponsored purchasers of mortgage loans on the secondary market have attempted to identify such states. The FNMA listed Arizona, California, Colorado, Georgia, Iowa, Michigan, Minnesota, New Mexico, Utah, and Washington as "window period" states. *See* FNMA Press Release, Feb. 22, 1983.

The FHLMC designated the same states as having window periods. The only variation is the date of commencement of the Arizona period, with the FNMA listing of Mar. 13, 1978 (the date of *Patton v. First Fed. Sav. & Loan Ass'n*, 118 Ariz. 473, 578 P.2d 152 (1978)), and the FHLMC listing of July 8, 1971 (the date of *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971)). *See Freddie Mac Issues Guidelines for Due-on-Sale Enforce-*

The Regulation identifies two specific types of state restrictions (whether legislative or judicial) that will trigger a window period. These are restrictions on mortgagee's rights to exercise due-on-sale clauses when 1) the security or probability of repayment is impaired, or 2) the lender is required to permit a transfer of the property without raising the interest rate to the current market level.¹⁹³ Thus, the Regulation asserts that different or less restrictive state law limitations on

ment, 11 Hous. & Dev. Rep. (BNA) 26 (1983). On the Arizona window period, see generally *infra* text accompanying notes 253-63.

The Comptroller of the Currency has issued a regulation that includes a state-by-state list of window periods. See *infra* note 317 & accompanying text. This list agrees with that of the FHLMC, except that it adds Arkansas.

Several states not listed by FNMA or FHLMC may have window periods. The Arkansas Supreme Court adopted a rule requiring lenders to show impairment of security in *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972). Subsequent cases have held that *Tucker's* restrictions on due-on-sale clause enforcement have been preempted by federal regulation as to savings and loan associations. See *First Fed. Sav. & Loan Ass'n v. Myrick*, 533 F. Supp. 1041, 1045-46 (W.D. Ark. 1982); *Schulte v. Benton Sav. & Loan Ass'n*, 279 Ark. 275, 651 S.W.2d 71 (1983); *Independence Fed. Sav. & Loan Ass'n v. Davis*, 278 Ark. 387, 646 S.W.2d 336 (1983). However, *Tucker* still appears to be good Arkansas law except for federal and state savings associations, and it is unclear why Arkansas was omitted from the FNMA and FHLMC lists.

The Florida district courts of appeals have consistently required a showing of impairment of security for due-on-sale enforcement. See *Consolidated Capital Properties, II, Ltd. v. National Bank of N. Am.*, 420 So. 2d 618, 622-23 (Fla. App. 1982); *Woodcrest Apartments, Ltd. v. IPA Realty Partners*, 397 So. 2d 364, 366 (Fla. App. 1981); *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156, 159-60 (Fla. App. 1980); see also *Turner, Due-on-Sale Clause: Forcing the Issue*, 56 FLA. B.J. 360 (1982). However, there is no Florida Supreme Court decision. Florida may have been omitted from the FNMA and FHLMC lists on the supposition that the decisions of the Florida Courts of Appeals are not decisions which apply State-wide, whatever that phrase from the Act may mean. See 12 U.S.C. § 1701j-3(c)(1) (1982); see also *infra* text accompanying notes 275-91.

It is arguable that Mississippi, although not listed by FNMA and FHLMC, also has a window period. In *Sanders v. Hicks*, 317 So. 2d 61 (Miss. 1975), the court refused to enforce a mortgage clause which prohibited the mortgagor from transferring or encumbering the property. *Id.* at 64. While the language was not literally a due-on-sale clause, the court cited with approval several cases restricting due-on-sale enforcement. *Id.* It held that the no-transfer clause would be enforceable only upon a showing of increased risk to the mortgagee's security. *Id.* The opinion surely suggests hostility to due-on-sale clauses, but it is unclear whether that is enough to create a window period. In terms of reasonable reliance by mortgagors, it probably is.

The Louisiana situation is even more ambiguous. *Rayford v. Louisiana Sav. Ass'n*, 380 So. 2d 1232 (La. App. 1980) refused to enforce a due-on-sale clause, *id.* at 1234, but the case's impact for window period purposes is unclear because of the presence of several unusual factors: an intermediate appellate court was involved, see *infra* text accompanying notes 275-91; the lender actually did not seek acceleration but rather an "assumption fee"; the proposed sale was from one co-owner to another; and a Louisiana statute, LA. REV. STAT. ANN. § 6:837 (West 1951 & Supp. 1983), appeared to authorize savings and loan associations (but not other lenders) to exercise due-on-sale clauses. See *Breaux, Due-on-Sale Litigation*, 30 LA. B.J. 18 (1982).

193. 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.2(p)(3)).

enforcement of due-on-sale clauses will not trigger a window period. For example, even state courts in "automatic enforcement" jurisdictions will not usually enforce due-on-sale clauses when to do so would be "unconscionable" or "inequitable."¹⁹⁴ Almost all courts will refuse to enforce the clauses in non-substantive transfers such as a transfer to a spouse who becomes a co-owner, a transfer incident to a marriage dissolution, or a transfer by operation of law upon the death of a joint tenant.¹⁹⁵ Yet such judicial restrictions probably will not trigger a window period under the Regulation. The Board, in its preamble, offers the illustration of a state statute that imposes a more onerous foreclosure procedure than the standard procedure used when the default results from the exercise of a due-on-sale clause.¹⁹⁶ This type of restriction, according to the Regulation, will not create a window period, and the state statute itself will be preempted by the Act.¹⁹⁷

It is doubtful that the Board acted within its power in limiting window periods to states with the two enumerated types of restrictions. When "non-substantive" or "non-sale" transfers, such as spousal, marriage dissolution, and death transfers are involved, the question has little practical importance. This is because federal law and state law are likely to have much the same effect.¹⁹⁸ But the Iowa statute, which grants a longer post-sale redemption period when foreclosure results from due-on-sale enforcement,¹⁹⁹ presents a more serious problem. If Congress intended to preserve the reasonable expectations of mortgagors until 1985, it seems improper for the Board to deny them the benefit of the long redemption period provided by the state statute. In its desire to aid lenders, the Board may have neglected congressional intent.

The Regulation also expressly provides that a state with a window period cannot modify its law to extend the protection from due-on-sale enforcement to loans that were not of a type protected during the window period.²⁰⁰ Thus, in our prior example,²⁰¹ suppose that on March 1, 1983 (after the effective date of the Act), the state legislature amended

194. See *supra* text accompanying notes 59-61.

195. *Id.*

196. Iowa has such a statute. IOWA CODE ANN. § 535.8(2)(e) (West Supp. 1983). See *supra* note 77.

197. See 48 Fed. Reg. 21,556 (1983) (preamble).

198. See *supra* notes 59-61 & accompanying text.

199. See *supra* note 77.

200. 48 Fed. Reg. 21,561 (1983) (to be codified at 12 C.F.R. § 591.2(p)(1)) (a window period loan must have been "made or assumed during a window-period created by state law and *subject to that law*") (emphasis added).

201. See *supra* text following note 185.

its 1979 statute to include mortgages on duplexes within the restriction on due-on-sale enforcement. Suppose further that MR purchased a duplex that he resold to Grantee in 1984. Mortgagee would be entitled to accelerate the mortgage debt incident to the transfer to Grantee, even though no security impairment was shown, because during the window period state law only affected enforcement of due-on-sale clauses contained in mortgages on single family dwellings. Although the Act itself does not limit its protection in this way, this result seems sensible in light of the Act's purpose of protecting the reasonable expectations of those who purchased property in reliance on state law.²⁰²

The Board's position that the window period concept protects only loans of a type that were protected by state law during the window period itself is highly significant. It strongly suggests that multiple window periods could exist within the same state, if that state had several statutes or judicial decisions governing different types of loans at different times. We will return to this point in our analysis of California law below.

Defining the Window Period—The California Example

In several states it is difficult to tell when the window period begins and what loans it encompasses. We will not attempt to analyze each state's situation here, but will discuss two of the more interesting ones: California and Arizona. The California case is especially important, both because California has the largest population of all window-period states and because Californians were heavily involved in the political negotiation leading to the Act.²⁰³

An overview of California's pre-Act case law is necessary to understand that state's window period problem. In 1964 the California Supreme Court, in *Coast Bank v. Minderhout*,²⁰⁴ held that a borrower's written agreement not to convey certain realty until a loan secured by the realty was repaid created an equitable lien on the property. The court upheld the right of the lender to accelerate the debt upon sale of the property, stating:

In the present case it was not unreasonable for [the lender] to condition its continued extension of credit to the [borrowers] on their retaining their interest in the property that stood as security for the debt. Accordingly, [the lender] validly provided that it might accel-

202. *Id.*

203. See Kemper, *Spirit of Conciliation Watchword for 1982*, CALIF. REAL EST., June 1982, at 22 (describing the competing lobbying efforts of California realtors and bankers).

204. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

erate the due date if the [borrower] . . . transferred the property.²⁰⁵ *Coast Bank* and two subsequent 1969 court of appeal decisions, *Hellbaum v. Lytton Savings & Loan Association*²⁰⁶ and *Cherry v. Home Savings & Loan Association*,²⁰⁷ were widely interpreted at the time as placing California in the "automatic enforcement" category.²⁰⁸

The California Supreme Court then decided a series of cases that ultimately reversed this position. In *La Sala v. American Savings & Loan Association*,²⁰⁹ the court held that a due-on-encumbrance clause could not be enforced unless the mortgagee could establish that creation of the junior lien impaired mortgage security. The court concluded:

[F]ollowing our ruling upholding reasonable restraints on alienation, we have distinguished the due-on-sale from the due-on-encumbrance clause; we have concluded that the lender may insist upon the automatic performance of the due-on-sale clause because such a provision is necessary to the lender's security. We have decided, however, that the power lodged in the lender by the due-on-encumbrance clause can claim no such mechanical justification. We sustain it only in the case of a trial court's finding that it is reasonably necessary to the protection of the lender's security²¹⁰

In *Tucker v. Lassen Savings & Loan Association*²¹¹ the court moved further from *Coast Bank*, holding that a due-on-sale clause was unenforceable when the borrower sold by an installment land contract rather than by an "outright sale,"²¹² unless the lender could establish that the transfer would impair mortgage security or increase the likelihood of mortgage default. The court emphasized that

in the case of the installment land contract the vendor retains legal title until the purchase price has been fully paid. Thus in the normal case the vendor, having received a small down payment and retaining legal title, has a considerable interest in maintaining the property until the total proceeds under the contract are received; in this he differs markedly from the vendor of property where there has been an outright sale.²¹³

Interestingly, while the court neither criticized *Coast Bank* nor mentioned *Hellbaum*, it expressly disapproved *Cherry* to the extent that it

205. *Id.* at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508.

206. 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969).

207. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969).

208. *See* *Tan v. California Fed. Sav. & Loan Ass'n*, 140 Cal. App. 3d 800, 807-08, 189 Cal. Rptr. 775, 780-81 (1983).

209. 5 Cal. 3d 864, 489 P.2d 113, 97 Cal. Rptr. 849 (1971).

210. *Id.* at 883-84, 489 P.2d 1126, 97 Cal. Rptr. at 862.

211. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

212. *Id.* at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 638.

213. *Id.* at 638, 526 P.2d at 1174-75, 116 Cal. Rptr. at 638-39.

was inconsistent with *Tucker*.²¹⁴

What the *Tucker* court meant by "outright sale" was far from clear. In light of its emphasis on the vendor's retained interest, common sense suggests that the court must have defined an "outright sale" as including only transactions in which the purchaser paid the seller in cash the difference between the sale price and the mortgage assumed—in other words, transactions in which no seller purchase-money financing was involved. Under this reasoning, any type of seller financing, whether by installment contract, purchase-money mortgage, or purchase-money deed of trust, would be less than an "outright sale."

As Professor Maxwell has pointed out, however,

common sense must yield to several features of the [*Tucker*] opinion itself: the court's frequent references to the installment sale, its assertion that it was dealing only with the installment land contract, and its statement that "in the case of the installment land contract the vendor retains legal title until the purchase price has been fully paid."²¹⁵

Thus, he concluded, "[c]areful reading . . . left the possibility that 'outright sale' as used in *Tucker* meant a transaction in which a conveyance, or a conveyance with a trust deed back to the seller, was utilized."²¹⁶

In 1978, the California Supreme Court decided *Wellenkamp v. Bank of America*,²¹⁷ a case involving an institutional lender. The court held that even in an outright sale situation, only a threat to security or increased risk of default justified enforcement of a due-on-sale clause. Unlike *Tucker*, the *Wellenkamp* decision unambiguously defined "outright sale" as "any sale by the trustor of property wherein legal title (and usually possession) is transferred."²¹⁸ The *Wellenkamp* court "express[ed] no present opinion on the question of whether a private lender, including the vendor who takes back secondary financing, has interests which might inherently justify automatic enforcement of a due-on clause in his favor on resale."²¹⁹

In the 1979 case of *Medovoi v. American Savings & Loan Associa-*

214. *Id.* at 640, 526 P.2d at 1176, 116 Cal. Rptr. at 640.

215. Maxwell, *supra* note 9, at 204-05.

216. *Id.* at 205. Cf. Hetland, *After Wellenkamp, Part Two*, CALIF. REAL EST., Jan. 1979, at 36, 39 (concluding there is an "overwhelming probability" that *Tucker* applied to vendor purchase-money deeds of trust).

217. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

218. *Id.* at 950, 482 P.2d at 974, 148 Cal. Rptr. at 383. For a thorough analysis of both *Tucker* and *Wellenkamp*, see Maxwell, *supra* note 9, at 203-08.

219. *Wellenkamp v. Bank of Am.*, 21 Cal. 3d at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 385 n.9.

tion,²²⁰ the California Court of Appeal issued a scathing attack on *Wellenkamp* and construed it as “expressly limited to loans made by institutional lenders”²²¹ and as applying only when an owner-mortgagor of a “single family residence engages in a voluntary transfer of interest in the secured property to a prospective purchaser.”²²² The California Supreme Court denied a hearing, but ordered that the *Medovoi* opinion be depublished,²²³ thereby depriving it of any precedential value. Subsequently, three other court of appeal decisions²²⁴ concluded that there was no reason to distinguish between residential and investment property.

In the 1982 case of *Dawn Investment Co. v. Superior Court*,²²⁵ the California Supreme Court confronted and decided most of what *Wellenkamp* had left unresolved. The mortgagee in *Dawn* was not an institutional lender, but a corporation that had taken a purchase money deed of trust in a land sale transaction. The court concluded that “no substantial reason has been shown to treat private lenders differently than institutional lenders in respect to the restraint on alienation resulting from enforcement of due-on-sale clauses.”²²⁶ Further, the court acknowledged that while *Wellenkamp* did not “show whether the property there involved was residential or investment property”, the rule of that case was applicable to both types of property.²²⁷ A year after *Dawn*, the court of appeal in *West v. Buffo*²²⁸ recognized that “an individual homeowner falls into a special subclass of private lenders which was never expressly dealt with in *Dawn*,”²²⁹ but saw no substantial reason to apply a non-*Wellenkamp* due-on-sale standard to such lenders.²³⁰

220. 152 Cal. Rptr. 572 (1979) (depublished).

221. *Id.* at 581 (depublished).

222. *Id.* at 580 (depublished).

223. *Id.* at 572 (depublished).

224. *de la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n*, 121 Cal. App. 3d 328, 346-48, 175 Cal. Rptr. 467, 477-78 (1981), *rev'd*, 458 U.S. 141, 169 (1982); *Panko v. Pan Am. Fed. Sav. & Loan Ass'n*, 119 Cal. App. 3d 916, 920 n.4, 174 Cal. Rptr. 240, 243 n.4 (1981), *vacated*, 458 U.S. 1117 (1982). Apparently, but less clearly, to the same effect was *Wilhite v. Callihan*, 121 Cal. App. 3d 661, 669, 175 Cal. Rptr. 507, 512 (1981), *vacated*, 135 Cal. App. 3d 295, 185 Cal. Rptr. 215 (1982).

225. 30 Cal. 3d 695, 639 P.2d 974, 180 Cal. Rptr. 332 (1982) (decided before the effective date of the Act).

226. *Id.* at 702, 639 P.2d at 978, 180 Cal. Rptr. at 335.

227. *Id.* at 702, 639 P.2d at 978-79, 180 Cal. Rptr. at 335-36.

228. 139 Cal. App. 3d 93, 98, 188 Cal. Rptr. 535, 537 (1983).

229. *Id.* at 95, 188 Cal. Rptr. at 536.

230. *Id.* at 96, 188 Cal. Rptr. at 537.

The Bank Board's Definition of California's Window Period

It is from this interesting and complex web of case law that a California window period or periods must be identified. Under the language of the Act, a window period begins when state law "prohibit[s] the exercise of due-on-sale clauses."²³¹ However, the Regulation adds a further gloss, providing that a window period begins when a "state adopted a law . . . prohibiting the unrestricted exercise of due-on-sale clauses upon *outright transfers* of property."²³² The phrase "outright transfers" is taken verbatim from the Senate Committee Report.²³³ The Report, in turn, based its definition on language contained in a footnote in the United States Supreme Court's decision in *de la Cuesta*²³⁴ that the Court included in the course of its attempt to avoid retroactive application of the 1976 Regulation. The Court reasoned that pre-1976 California case law allowed automatic enforcement of due-on-sale clauses with respect to "outright transfers," and it thus was unnecessary to confront the retroactivity questions inherent in the 1976 Regulation.²³⁵ Based on this history, the Board concluded that it was "Congress' intent to extend window-period protection only to assumptions of land-sales contracts after 1978 in California, notwithstanding the anomalies which might result."²³⁶

While the Board's conclusion that the California window period commences with *Wellenkamp* has the apparent virtues of simplicity and ease of application, it is vulnerable to substantial criticism. First, it suggests that the *de la Cuesta* Court's assessment of California law should be dispositive of the window period question. This is inconsistent with the Board's position that Congress intended that window period questions be left to "state determination and state judicial decision."²³⁷ Moreover, the Board's approach seems sharply at odds with congressional intent to protect those who "relied on state due-on-sale restrictions and reasonably believed that they had assumable loans."²³⁸ A property owner who obtained or assumed a mortgage loan after *Tucker* but before *Wellenkamp*, and who examined the *Tucker*

231. 12 U.S.C. § 1701j-3(c)(1) (1982).

232. 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.2(p)(2)) (emphasis added).

233. See SENATE COMMITTEE REPORT, *supra* note 159, at 22.

234. Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 170 n.24 (1982).

235. *Id.*

236. 48 Fed. Reg. 21,556 (1983). The quoted language is clumsy; it is more apt to say that the Board believed Congress extended window period protection only to transfers made after Aug. 25, 1978, even if made by installment contract.

237. See *supra* text accompanying note 187.

238. See SENATE COMMITTEE REPORT, *supra* note 159, at 22.

opinion, would have expected to be able to resell the property by installment contract without triggering a due-on-sale clause. The Board's approach does not protect such an owner.

Finally, the Board's approach to the California window period problem is probably overinclusive in terms of congressional intent. Because of the Board's apparent insistence that a state can have only one window period, it may, in some situations, afford too much protection to certain mortgagors. In view of the California Supreme Court's statement in *Wellenkamp* that it was not deciding whether non-institutional lenders were subject to its due-on-sale restrictions, it is difficult to see how a 1979 California purchaser who obtained or assumed a mortgage loan held by a non-institutional lender could reasonably have thought that he or she was acquiring an assumable loan. Yet under the Board's approach, this transaction would apparently be treated as a window period loan. While the Board's approach has the advantage of simplicity and predictability, it runs afoul of congressional intent by affording protection to mortgagors and grantees who may not have had reason to rely on the unenforceability of due-on-sale clauses in their transactions.

Reasonable Reliance and Multiple Window Periods

A better, if more complex, way to determine if a particular mortgage qualifies as a window period loan is to focus on whether the mortgagor or grantee could *reasonably have believed*, based on the then current state law and the nature of the transaction, that she was acquiring an assumable mortgage. If so, window period protection should be available. Admittedly, this "reasonable reliance" approach may result in separate window periods for different types of mortgage transactions, and will inevitably entail a close analysis of state law. Nevertheless, it is probably most consistent with congressional intent to protect those who consummated transactions in reliance on state law.

This reasonable reliance approach can be illustrated in the context of the California due-on-sale case law. Certainly, no window period could have been created prior to *La Sala* because a prospective borrower or grantee during that time should have assumed that due-on-sale clauses were generally enforceable.²³⁹ Therefore, the requisite detrimental reliance would not have been present. *La Sala* probably did not significantly alter reasonable expectations regarding enforceability of due-on-sale clauses. While the decision restricted enforcement of due-on-encumbrance clauses, it seemed to reaffirm an automatic en-

239. See *supra* text accompanying notes 204-08.

forcement approach to due-on-sale situations.²⁴⁰

The *Tucker* decision, which restricted due-on-sale enforcement in installment land contract transfers to situations involving impairment of security or increased risk of default,²⁴¹ is more troublesome. A relatively weak argument could be made that *Tucker* created a window period for all residential transfers because it expressly disapproved *Cherry*, the 1969 court of appeal decision that favored an automatic enforcement approach. However, *Tucker* did not mention *Hellbaum*, another 1969 court of appeal decision that did not seem to involve facts significantly different from those in *Cherry*.²⁴² Moreover, the *Tucker* court's reasoning in several respects reinforced the impression that due-on-sale clauses would continue to be automatically enforceable in the "outright sale" setting.²⁴³

As we suggested above, under a reasonable reliance approach post-*Tucker* residential installment land contract transfers should have the benefit of window period protection, the Board's approach notwithstanding. Surely a property owner who obtained a mortgage loan after *Tucker* would reasonably have believed that no acceleration could result from resale by an installment contract. On the other hand, post-*Tucker* junior purchase-money mortgages and deeds of trust present serious analytical difficulty. If the "less than outright sale" concept in *Tucker* encompassed all transfers in which the seller retained an interest in the mortgaged real estate, then an assuming purchaser whose seller took back a purchase-money mortgage might be protected by a window period. If, on the other hand, Professor Maxwell is correct that *Tucker* could be read to define "less than outright sale" as encompassing only installment land contract transfers,²⁴⁴ then *Tucker* created no window period for the purchaser whose seller provided financing by means of a mortgage rather than an installment land contract. Even though *Wellenkamp* ultimately defined the outright sale concept broadly to include all transfers in which legal title is transferred,²⁴⁵ a pre-*Wellenkamp* purchaser could not, based on *Tucker*, have been rea-

240. See *supra* text accompanying notes 209-10.

241. See *supra* text accompanying notes 211-16.

242. See *supra* note 214 & accompanying text. However, *Cherry*, unlike *Helbaum*, contained language that approved due-on-sale enforcement for interest rate market reasons. To the extent that the express disapproval of *Cherry* contained in *Tucker* indicated a disapproval of the interest rate market motive, it can be argued that *Tucker* foreshadowed *Wellenkamp's* rejection of the automatic enforcement approach to due-on-sale clauses in non-installment land contract transfers.

243. See *supra* text accompanying notes 211-14.

244. See *supra* text accompanying notes 215-16.

245. *Wellenkamp v. Bank of Am.*, 21 Cal. 3d at 950, 148 Cal. Rptr. at 383.

sonably assured of such an interpretation. Consequently, the "reasonable reliance" approach would negate a *Tucker* window period for all but installment land contract transactions.

Under the Board's approach, the California window period began in 1978 with *Wellenkamp*, since *Wellenkamp* prohibited the "unrestricted exercise of due-on-sale clauses upon outright transfers of property."²⁴⁶ The *Wellenkamp* window period, in the Board's view, encompasses all lenders whether institutional or private, and all real estate whether residential or commercial. As we have already observed, the Board seems to conceive of each state as having a single window period for all types of loans. Yet it is doubtful that this approach is sound in terms of reasonable reliance by borrowers.

For example, it is unclear from the *Wellenkamp* opinion whether its reasoning applied to noninstitutional lenders or to loans on nonresidential properties.²⁴⁷ The intermediate courts of appeal split on these questions after *Wellenkamp*, and even *Dawn* did not fully resolve them.²⁴⁸ We will return to *Wellenkamp* and *Dawn*, and will apply the reasonable reliance theory to them in detail below.²⁴⁹ The present point is simply that it is entirely conceivable that borrowers with certain types of loans from certain kinds of lenders might reasonably have relied on *Wellenkamp* or *Dawn*, while others could not have done so. If this is correct, then we think it inevitable that several different window periods may exist within California, the Board's contrary view notwithstanding. In principle, the same may be true in other states as well.

A Literal Application of the Act to California

In view of the complexity and interpretational difficulties of the reasonable reliance concept and the inherent problems with the Board's approach, is there an acceptable third alternative for resolving window period questions? One possibility simply would be to focus on the literal language of the Act. According to the Act, a window period begins when a "[s]tate adopted . . . [a law] prohibiting the exercise of due-on-sale clauses."²⁵⁰ While the word "unrestricted" would necessarily be inserted before "exercise" to avoid rendering the window period con-

246. 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.2(p)(2)). See *supra* notes 215-16 & accompanying text.

247. See *supra* text accompanying note 219. The opinion made no explicit statement as to whether its rule was restricted to residential properties. See *infra* note 269.

248. See *supra* text accompanying notes 220-30 and *infra* note 272 & accompanying text.

249. See *infra* text accompanying notes 269-74.

250. 12 U.S.C. § 1701j-3(c)(1) (1982).

cept meaningless,²⁵¹ the "outright transfer" language of the Regulation would be discarded. Thus, in California, since *Tucker* represented the first decision by the California Supreme Court that "restricted" due-on-sale (as opposed to due-on-encumbrance) enforcement, mortgages made or assumed after *Tucker* would be window period loans. This would be true whether the lender was institutional or private, the real estate residential or commercial, or the transfer by deed or installment land contract.

While such an approach, like the Board's, has the advantage of simplicity and predictability, it appears to run afoul of congressional intent by affording protection to mortgagors and grantees who may not have had reason to rely on the unenforceability of due-on-sale clauses in their transactions. In California, it would mean that a person who obtained or assumed a mortgage loan containing a due-on-sale clause in the interim between *Tucker* and *Wellenkamp* would be afforded window period protection, even though he or she may have had no reasonable basis for concluding that the clause would be unenforceable in other than installment land contract transfers. Thus, this approach unnecessarily violates the general pro-enforcement policy of the Act.

In the last analysis, as the California example demonstrates, there may simply be no acceptable alternative to the "reasonable reliance" window period approach. Whatever its difficulties, it is most clearly consistent with congressional intent.²⁵²

Window Periods in Arizona

Other states also face difficult window period questions. Arizona confronted the issue before the promulgation of the Regulation, and its resolution of the problem illustrates the complexity of the window period concept. In the 1971 case of *Baltimore Life Insurance Co. v. Harn*,²⁵³ the Arizona Court of Appeals held that while due-on-sale clauses in mortgages were not per se invalid restraints on alienation, they were enforceable only when the mortgagee's security interest was threatened or "the purpose of the clause is in some respect being circumvented."²⁵⁴ The mortgagee in the *Harn* case was an institutional lender and the transfer was by deed. However, it is unclear whether commercial or residential real estate was involved, or whether the court

251. See *supra* text accompanying notes 189-92.

252. See SENATE COMMITTEE REPORT, *supra* note 159, at 22 ("homebuyers who . . . relied on state due-on-sale restrictions and reasonably believed they had assumable loans").

253. 15 Ariz. App. 78, 486 P.2d 190 (1971), *petition for review denied*, 108 Ariz. 192, 494 P.2d 1322 (1972).

254. *Id.* at 81, 486 P.2d at 193.

thought these factors significant. Shortly after *Harn*, Arizona enacted legislation²⁵⁵ that applied only to deeds of trust on certain types of residential real estate. The statute prohibited a beneficiary (mortgagee) from arbitrarily withholding consent from a trustor (mortgagor) to transfer, and from increasing the interest rate upon a transfer unless the transferor was released from liability.²⁵⁶ The interest rate could in no event be increased by more than one-half of one percent.²⁵⁷ In *Patton v. First Federal Savings & Loan Association*,²⁵⁸ a 1978 Arizona Supreme Court decision involving residential real estate and an installment land contract transfer, the court cited *Harn* as well as the Arizona statute with approval and held that due-on-sale clauses in deeds of trust, as well as in mortgages, were enforceable only when impairment of security was established.²⁵⁹

In *Scappaticci v. Southwest Savings & Loan Association*,²⁶⁰ the Arizona Supreme Court held that the "beginning of the window period [in Arizona] is triggered by [*Harn*]" for deeds of trust as well as mortgages.²⁶¹ Even though *Harn* was decided by the Arizona Court of Appeals, a lower appellate court, it could be used to mark the beginning of the window period since that court's decisions have "statewide application."²⁶² Thus, the *Scappaticci* court concluded, "[t]o cut off contracts made prior to *Patton* but after *Harn* would render a great injustice to those borrowers who reasonably believed the due-on-sale clauses were not enforceable under *Harn*."²⁶³

The court in *Scappaticci* plainly employed a "reasonable reliance" approach. Yet in Arizona, as in California, it is easy to disagree as to what constitutes reasonable reliance. For example, does the Arizona window period begin with *Harn* for commercial as well as residential loans? Borrowers of both types of loans could reasonably have relied on *Harn*. What about loans made by non-institutional lenders? Only institutional financing was involved in *Harn* (and, for that matter, in *Scappaticci*); could vendees who gave installment contracts or

255. ARIZ REV. STAT. ANN. § 33-806.01 (West 1974).

256. *Id.*

257. *Id.*

258. 118 Ariz. 473, 578 P.2d 152 (1978).

259. *Id.* at 478-79, 578 P.2d at 157-58.

260. 135 Ariz. 456, 662 P.2d 131 (1983).

261. *Id.* at 462, 662 P.2d at 136.

262. *Id.* Unless there is an Arizona Supreme Court decision compelling a contrary result, "a decision by one division of the Court of Appeals is persuasive with the other division." *Id.* See *infra* notes 276, 284.

263. *Scappaticci v. Southwest Sav. & Loan Ass'n*, 135 Ariz. at 462, 662 P.2d at 136.

purchase-money mortgages to their private party vendors reasonably have relied on *Harn*? These questions require further analysis.

Subsequent Judicial "Clarification" of Window Periods

The Act and the Regulation prohibit a legislature or court from expanding the window period.²⁶⁴ Yet, a later case can always "clarify" an earlier one. Suppose, for example, that the Arizona Supreme Court now files an opinion in which it asserts that *Harn* was meant from the beginning to apply to all types of loans by all types of lenders. This would constitute an explanation rather than an expansion. Nonetheless, it is hard to see how such a statement can properly influence the determination of the window period, at least if reasonable reliance is the touchstone. After all, a court's later statements about what it meant earlier are hardly strong evidence of what lawyers or lay people believed its original meaning to be.

This precise issue is raised at least twice by the California cases described earlier: the *Dawn* court interpreted *Wellenkamp* as applying to non-institutional loans and to non-residential properties,²⁶⁵ and the *West v. Buffo* court interpreted *Dawn* as applying to mortgagees who are private parties.²⁶⁶ *Dawn* and *West* did not focus on the distinction between clarifying a prior holding and extending a holding to a new situation, and we do not think that this distinction should matter in window period determinations. The fact is that both *Wellenkamp* in California and *Harn* in Arizona were unclear as to the precise coverage of the rules they enunciated. Reasonable people might have read them narrowly or broadly.²⁶⁷

264. See *supra* text accompanying notes 200-02.

265. See *supra* text accompanying notes 225-27.

266. See *supra* text accompanying notes 228-29. We are tempted to add a third example: *Wellenkamp* "clarifying" *Tucker*. See *supra* text accompanying notes 217-19. But this is inappropriate, for it appears clear that the *Tucker* opinion regarded due-on-sale clauses as automatically enforceable unless the transfer involved vendor financing. See *supra* text accompanying notes 211-16. By the time *Wellenkamp* arose, the court had simply changed its mind; it stated that, notwithstanding *Tucker*, "we are now convinced that . . ." the clause should be enforced only where security is impaired, even in "outright sales". *Wellenkamp v. Bank of Am.*, 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384. *Tucker*'s concept of "outright sales" was being overruled, not clarified.

267. See, e.g., Hetland, *After Wellenkamp*, CALIF. REAL EST., Dec. 1978, at 40 (asserting that both nonresidential and residential properties are covered by *Wellenkamp*, but arguing for an exemption from *Wellenkamp*'s coverage for at least some types of "private" as opposed to institutional lenders); Zeller, *The Due-on Clause after Wellenkamp: Unresolved Issues*, 55 CALIF. STATE B.J., Feb. 1980, at 76 (agreeing with Hetland on the coverage of both residential and nonresidential properties, and arguing for an even broader exemption for noninstitutional lenders). But see Goodman, *The Wellenkamp Decision: How It Will Affect Real Estate Financing*, 54 CALIF. STATE B.J., Jan.-Feb. 1979, at 34, 40 (arguing that nonresi-

Determining Window Periods from Ambiguous Judicial Decisions— A Proposal

It is essential that we formulate some workable test for determining whether a rather vague judicial opinion triggers the beginning of a window period. How then should window period determinations be made? One possibility is to hark back to the Act's basic objective, which is to make due-on-sale clauses enforceable. If this premise controls, only borrowers whose claim to reasonable reliance is strong and clear-cut will be entitled to exemption from the Act's preemptive effect. But we recommend a contrary approach, on the ground that lay people (and many real estate agents and lawyers, for that matter) usually have only a hazy understanding of their state appellate courts' decisions, and are likely to take newspaper headlines such as "Broad Impact Seen in Mortgage Ruling"²⁶⁸ at face value. It would theoretically be possible for courts to consider the subjective reliance of each individual borrower, but that course is fraught with opportunities for fraud and factual error. It is most sensible simply to assume that borrowers reasonably relied on the broadest plausible view of the judicial opinion, protecting the broadest spectrum of loans, except to the extent that the opinion itself contained specific warnings as to the situations it did not cover.

The effect of this proposed test can be illustrated by applying it to the *Harn* and *Wellenkamp* cases. The *Harn* opinion gave no hint as to whether the court even considered the application of its holding to non-residential properties or noninstitutional loans. The same is true of *Wellenkamp* regarding the residential-nonresidential distinction.²⁶⁹ Thus, we believe all Arizona borrowers should be given window period protection from the date of *Harn*'s decision forward. All California borrowers, whether residential or not, should be protected from the date of *Wellenkamp*, if their loans were originated by institutional lenders.

On the other hand, *Wellenkamp* involved an institutional lender and the court expressly warned, in a footnote, that it had no view as to

dential properties are outside *Wellenkamp*'s holding, and also that some types of noninstitutional lenders should not be considered within *Wellenkamp*).

268. L.A. Times, Sept. 9, 1978, § II, at 11, col. 5 (reporting the *Wellenkamp* decision by the California Supreme Court). See also *Ruling Could Save Home Buyers a Bundle*, S.F. Chron., Nov. 11, 1978, § A, at 8, col. 1.

269. One footnote in *Wellenkamp* does make reference to preservation of home equities, but the opinion seems to give the phrase no particular weight. See *Wellenkamp v. Bank of Am.*, 21 Cal. 3d at 950 n.6, 582 P.2d at 970, 148 Cal. Rptr. at 84 n.6.

the *Wellenkamp* rule's applicability to noninstitutional lenders.²⁷⁰ As we suggested above,²⁷¹ it is difficult to see how a borrower from a non-institutional lender, faced with this language, could reasonably have expected *Wellenkamp* to protect her. Such a borrower should have no window period protection unless she obtained or assumed her loan after *Dawn* in early 1982, when the court finally made it clear that the *Wellenkamp* reasoning applied to noninstitutional loans. Two California Court of Appeal cases had previously held *Wellenkamp* inapplicable to noninstitutional loans, and a third had held the contrary.²⁷² Given this conflict, no borrower could reasonably have relied on the third case as establishing that noninstitutional loans were covered by the *Wellenkamp* rationale.²⁷³ Hence, the window period for loans from non-institutional lenders should commence only with *Dawn*, and not earlier.²⁷⁴

270. *Id.* at 952 n.9, 582 P.2d at 970, 148 Cal. Rptr. at 379 n.9.

271. *See supra* note 224 & accompanying text.

272. *Compare* *Dawn Inv. Co. v. Superior Court*, 116 Cal. App. 3d 439, 172 Cal. Rptr. 142 (1981), *vacated*, 30 Cal. 3d 695, 180 Cal. Rptr. 332 (1982), *and* *Medovoi v. American Sav. & Loan Ass'n*, 89 Cal. App. 3d 244, 152 Cal. Rptr. 572 (1979) (depublished) (dictum that noninstitutional loans not covered), *with* *Wilhite v. Callihan*, 121 Cal. App. 3d 661, 175 Cal. Rptr. 507 (1981), *vacated*, 135 Cal. App. 3d 295, 185 Cal. Rptr. 215 (1982) (noninstitutional loans covered).

Judge Thompson, concurring in *Medovoi*, put it well: "Any lender would be unwise indeed to rely upon any Court of Appeal opinion in this area of the law." 152 Cal. Rptr. at 584 (depublished). The same is true of borrowers.

273. *See* *Columbia Sav. & Loan v. Easterlin*, 191 N.J. Super. 327, 466 A.2d 968 (1983) (when two intermediate appellate decisions exist, but seem to conflict with each other, there is no window period).

274. Two recent California cases disagree. In *Lucas v. Jones*, 148 Cal. App. 3d 1008, 196 Cal. Rptr. 437 (1983), the California Court of Appeal held that a private loan made between the dates of *Wellenkamp* and *Dawn* was covered by the *Wellenkamp* rationale, notwithstanding the language of *Wellenkamp's* footnote 9, and hence that a window period for such loans dates from *Wellenkamp*. The court reasoned that since the *Dawn* opinion made no reference to its own retroactivity, the California Supreme Court must have believed that *Wellenkamp* covered noninstitutional loans, and that *Dawn* merely represented the Court's refusal to create an exception to the *Wellenkamp* rule. *Id.* at 1011-12, 196 Cal. Rptr. at 439. This view is apparently supported by another recent case from the court of appeal, *Miranda v. Macias*, 141 Cal. App. 3d 188, 191 Cal. Rptr. 177 (1983). The *Macias* court held that *Dawn* was, in effect, retroactive and applicable to a transfer of a noninstitutional loan made after *Wellenkamp* and before *Dawn*. Like the *Lucas* court, the *Macias* court held that the loan was covered by the window period. It apparently assumed that a state can have only one window period. *See supra* text accompanying notes 239-49 for our argument to the contrary.

This reasoning misses the point. The question is not what the supreme court, four years after issuing the *Wellenkamp* opinion, may have thought that opinion meant; rather, it is whether a borrower or an assuming grantee of a noninstitutional loan who read *Wellenkamp* at the time reasonably could have relied on it as making a loan assumable. *See supra* text accompanying notes 264-65. In light of the language of *Wellenkamp's* footnote 9, the answer to that question is no.

The Statewide Application Requirement

There are also serious difficulties with the manner in which the Act permits intermediate appellate court decisions to trigger window periods. We have thus far assumed that decisions of the California Court of Appeal, for example, are relevant to a window period analysis.²⁷⁵ This assumption requires examination. The Act allows intermediate appellate decisions to be used only if the highest state court has rendered no applicable decision, and if the "next highest appellate court has rendered a decision resulting in a final judgment if such decision applies State-wide."²⁷⁶

By "decision," Congress evidently meant the court-made rule of law announced by the opinion. But this notion introduces all of the ambiguities and complexities of *stare decisis*. For example, did Congress intend to distinguish a "holding," which announces a rule essential to the decision and thus possibly "applies Statewide," from a dictum that is not required for the decision, is not binding as precedent, and thus does not "apply" at all, except as a general indication of what the court might do in a future case? The Act and legislative history contain no clue. The preamble to the Regulation asserts that dicta cannot start a window period.²⁷⁷ We suggest, however, that an answer can be found in the "reasonable reliance" approach used in our earlier analysis.²⁷⁸ As a practical matter, lawyers and their clients very often rely on dicta if it is the best authority available. Dicta should be a perfectly sound basis for the commencement of a window period, so long as readers of the opinion could reasonably have relied on it.

A further problem is introduced by the Act's statement that intermediate appellate decisions can be considered only "if the highest court has not so decided."²⁷⁹ Can this mean that once the highest court has

275. See *supra* text accompanying notes 248, 266.

276. 12 U.S.C. § 1701j-3(c)(1) (1982). Congress apparently intended to limit the application of this language to the "unique situation of the State of Michigan." SENATE COMMITTEE REPORT, *supra* note 159, at 22-23. However, as explained *infra* at note 284, the Senate Committee was mistaken in its belief that Michigan appellate decisions have binding rather than merely persuasive effect on other appellate courts.

The Regulation muddies the statutory language, rewriting it to refer to the appellate court rendering "a decision resulting in a final judgment which applies statewide." 48 Fed. Reg. 21,562 (1983) (to be codified at 12 C.F.R. § 591.2(p)(2)(ii)). Read literally, the Regulation is meaningless, for all judgments by appellate courts apply statewide to the parties who were before the court. Congress obviously intended to ask whether the rule of law, not the judgment, has statewide application.

277. 48 Fed. Reg. 21,557 (1983).

278. See *supra* text accompanying note 238.

279. 12 U.S.C. § 1701j-3(c)(1) (1982).

rendered any decision involving due-on-sale restrictions (as in *Wellenkamp*²⁸⁰), no future intermediate court decision (as in *West*²⁸¹) has any relevance? Such a literal interpretation makes little sense. Of course the highest court's decision controls so far as it goes, but if it leaves significant questions unanswered, the intermediate courts' decisions can resolve them and by doing so make further law. As to these unanswered questions, then, the highest court has not "so decided," and the intermediate courts' decisions should be considered to initiate window periods if they otherwise qualify under the Act.

What does it mean for a judicial decision to apply statewide? The stare decisis effect of intermediate appellate court opinions varies from state to state. In Arizona, for example, there is only a single intermediate court that may sit in divisions, and a decision by one division is binding on the others unless the supreme court of the state disagrees. Such a decision has statewide application, as the Arizona court noted in *Scappaticci*.²⁸² Perhaps more common is the approach of California, Florida, and Michigan: one intermediate court's opinions are merely persuasive and not binding on another court of the same rank.²⁸³ Such opinions are, however, binding on trial level courts throughout the state, and not merely on those in the district where the appellate court sits.²⁸⁴

280. 21 Cal. 3d 943, 148 Cal. Rptr. 379 (1978).

281. *West v. Buffo*, 139 Cal. App. 3d 93, 188 Cal. Rptr. 535 (1983).

282. *Scappaticci v. Southwest Sav. & Loan Ass'n*, 135 Ariz. 456, 662 P.2d 131 (1983) (discussed *supra* text accompanying notes 260-63).

283. *See, e.g., McGlothlen v. Department of Motor Vehicles*, 71 Cal. App. 3d 1005, 1017, 140 Cal. Rptr. 168, 176 (1977); *Prescod v. California Unemployment Ins. Appeals Bd.*, 57 Cal. App. 3d 29, 39, 127 Cal. Rptr. 540, 546-47 (1976); *State v. Hayes*, 333 So. 2d 51, 53 (Fla. App. 1976); *People v. Plamondon*, 64 Mich. App. 413, 426 n.3, 236 N.W.2d 86, 91 n.3 (1975). Some decisions indicate that the divisions of the California Court of Appeal consider themselves bound by a sister court's decision if the California Supreme Court has denied review. *See Scott v. E.L. Yeager Constr. Co.*, 12 Cal. App. 3d 1190, 1194, 91 Cal. Rptr. 232, 234 (1970); *Burns v. State Comp. Ins. Fund*, 265 Cal. App. 2d 98, 102, 71 Cal. Rptr. 326, 329 (1968).

284. *Auto Equity Sales Inc. v. Superior Court*, 57 Cal. 2d 450, 455, 369 P.2d 937, 939-40, 20 Cal. Rptr. 321, 323-34, (1962); *Arentz v. Blackshere*, 248 Cal. App. 2d 638, 640, 56 Cal. Rptr. 809, 810-11 (1967); *State v. Hayes*, 33 So. 2d 51, 57 (Fla. App. 1976); *Matter of Hague*, 412 Mich. 532, 552, 315 N.W.2d 524, 532 (1982); *Hackett v. Kress*, 1 Mich. App. 6, 11, 133 N.W.2d 221, 223 (1965). The Senate Report confuses the matter by apparently referring to *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804 (1977), as an intermediate appellate decision which applies statewide, and then by asserting in contrast that Florida intermediate appellate decisions do not have statewide effect. SENATE COMMITTEE REPORT, *supra* note 159, at 22-23. The Report appears simply to be wrong; as the cases above show, intermediate appellate decisions in both Michigan and Florida have exactly the same effect—binding on trial courts throughout the state, but merely persuasive to other appellate courts.

Under this latter approach, should intermediate court decisions be regarded as applying statewide, in the sense that the Act uses the phrase? Again, a reasonable reliance analysis is helpful. The window period concept was designed to protect property owners who reasonably could have expected that an existing rule of law would protect their right to transfer without acceleration of the debt.²⁸⁵ If a California, Florida, or Michigan intermediate court decision announced such a rule, even property owners in other districts within the state could reasonably expect to be protected by it, since if their transactions were litigated the rule would be binding at the trial level and would have some persuasive power in the event of appeal. Indeed, the power of intermediate decisions to bind all state trial courts seems, in itself, enough to satisfy the Act's test.

Conflicting intermediate appellate decisions, however, present more difficult problems. Obviously the persuasive power of any one decision in this context is somewhat limited. Even trial level courts cannot be bound by contradictory rules, and they ordinarily follow the view expressed by the appellate court of the district in which they are located.²⁸⁶ Consider the examples of Florida and California. There is no Florida Supreme Court due-on-sale decision, but intermediate appellate cases decided in the 1980-1982 period in three of Florida's five districts consistently adopted an "impairment of security" approach to due-on-sale enforcement.²⁸⁷ By contrast, after *Wellenkamp* several divisions of the California Court of Appeal diverged sharply in their attempts to decide whether the *Wellenkamp* reasoning applied to nonresidential mortgages and noninstitutional lenders.²⁸⁸ Under a "reasonable reliance" approach, a window period should certainly exist in Florida from the date of the first of the three cases mentioned. On the other hand, the earliest California intermediate case after *Wellenkamp* refused to extend it to nonresidential and noninstitutional situations.²⁸⁹ The case was depublished, but had it not been, no property owner could have reasonably relied on the later contrary cases²⁹⁰ since a conflict among the districts would have existed.

If, hypothetically, the first intermediate appellate case in California after *Wellenkamp* had held the rule applicable to nonresidential and noninstitutional loans, and later appellate cases had disagreed, a

285. See *supra* text accompanying notes 178-79.

286. See *supra* cases cited in note 284.

287. See *supra* note 192.

288. See *supra* note 272.

289. *Medovoi v. American Sav. & Loan Ass'n*, 152 Cal. Rptr. 572 (1979) (depublished).

290. See *supra* note 224 & accompanying text.

more difficult problem would have been created. Again employing a reasonable reliance analysis, we suggest that in this situation a window period for such loans would have existed from the date of the initial decision until the date of the first opinion to conflict with it; a further window period would then have commenced with the date of the California Supreme Court's opinion in *Dawn*,²⁹¹ which would have resolved our postulated conflict among the districts.

The complexity of the foregoing analysis is readily apparent. It is further evidence that both Congress and the Board have failed to recognize the implications of the window period concept, and have seeded a fertile field for litigation.

The Effect of the U.C.C.C. on Window Periods

Even legislation restricting due-on-sale enforcement can pose difficulties when used to define window periods, although the difficulties are more likely to stem from ambiguous content than from questions of coverage or effective date. Consider section 5.109 of the 1974 version of the Uniform Consumer Credit Code (U.C.C.C.), adopted in Iowa,²⁹² Kansas,²⁹³ and Maine,²⁹⁴ and in variant forms as part of installment contract or consumer lending statutes in several other states.²⁹⁵ This section, entitled "Default," provides:

An agreement of the parties to a consumer credit transaction with respect to default on the part of the consumer is enforceable only to the extent that:

- (1) the consumer fails to make a payment as required by agreement; or
- (2) the prospect of payment, performance, or realization of collateral is significantly impaired; the burden of establishing the prospect of significant impairment is on the creditor.²⁹⁶

It is clear that some types of mortgage loans are included in the U.C.C.C. definition of "consumer credit transaction."²⁹⁷ Does the lan-

291. 30 Cal. 3d 695, 639 P.2d 974, 180 Cal. Rptr. 335 (1982).

292. IOWA CODE ANN. § 537.5109 (West Supp. 1983).

293. KAN. STAT. ANN. § 16a-5-109 (1981).

294. ME. REV. STAT. ANN. tit. 9-A, § 5-109 (1980).

295. See, e.g., MASS. GEN. LAWS ANN. ch. 255D, § 21(a) (West Supp. 1983); MO. REV. STAT. § 408.552 (Supp. 1982); NEB. REV. STAT. § 45-179 (Supp. 1982).

296. UNIFORM CONSUMER CREDIT CODE § 5.109 (1974) [hereinafter cited as U.C.C.C.].

297. Under U.C.C.C. § 1.301(13) (1974), "consumer credit transaction" includes both a "consumer credit sale" and a "consumer loan." Both of these, in turn, include credit for personal, family, household, or agricultural purposes, not exceeding \$25,000, payable in installments. *Id.* §§ 1301(12)(a)(iii)-(v), (15)(a)(ii)-(iv). If the credit is secured by an interest in land, the interest rate must exceed 12%. *Id.* §§ 1.301(12)(b)(ii), (15)(b)(ii). The \$25,000 figure is subject to adjustment for inflation under *Id.* § 1.106. Many second mortgages and

guage quoted above, when applied to a mortgage loan, "prohibit the exercise of a due-on-sale clause" and thus trigger a window period? A technical argument can be made that it does not. Under this view, a due-on-sale clause has nothing to do with *default*; rather, its exercise produces an *acceleration* of the debt. Whether a default ensues depends on whether the debtor then fails to pay the accelerated amount, and the language in the note or mortgage which makes failure to pay a default is fully enforceable under U.C.C.C. section 5.109(1).

But this interpretation may be too literal. As a practical matter, the creditor's ultimate sanction underlying a due-on-sale clause is foreclosure. The due-on-sale clause and the clause that makes failure to pay the accelerated debt a default may be separate in the instrument, but they are intended to work in tandem. In effect, the due-on-sale clause is "an agreement . . . with respect to default," as the U.C.C.C. uses the phrase. This conclusion is buttressed by U.C.C.C. section 5.109(2)'s use of a standard that is strikingly similar to the "impairment of security" language typically found in judicial opinions that restrict due-on-sale enforcement.²⁹⁸ The U.C.C.C.'s comment uses "insolvency, illegal activity, or an impending removal of assets from the jurisdiction" as illustrations of this impairment.²⁹⁹ Plainly, a debtor's transfer of title to real estate collateral, without some further showing, would not "impair" the "prospect of payment." Thus, the U.C.C.C. may well be read to prohibit the use of due-on-sale clauses by lenders as a device for raising interest rates.

We can find no cases or scholarly commentary on this question. It may not have occurred to the drafters, or might have seemed unimportant to them, since the major focus of the U.C.C.C. is not on real estate security.³⁰⁰ The matter could be decided either way. In any event the question is unlikely to be of overwhelming importance. Most of the real estate loans covered by the U.C.C.C. are probably small, short term, and carry relatively high interest rates,³⁰¹ so it is unlikely that large numbers of real estate purchasers will be interested in assuming them. Nonetheless, the problem exists and will have to be dealt with.

The Board has consistently maintained that the window period exemption is available only for loans of the type covered by the state law that created the window period, and that a state cannot extend this pro-

home improvement mortgage loans are obviously covered by the U.C.C.C. and at least a few senior purchase-money mortgages as well.

298. See *supra* text accompanying notes 54-55.

299. U.C.C.C. § 5.109 comment 2 (1974).

300. See generally *id.* prefatory note.

301. The rate must exceed 12%. See *supra* note 295.

tection to borrowers under other types of loans.³⁰² This position is sensible, but not compelled by the language of the Act. If the courts conclude that all states with window periods (even periods with minor impact like those that U.C.C.C. section 5.109 might create) have the power to expand protection to new types of borrowers, the impact of the U.C.C.C. provision could be vastly increased.

State Extension of Window Period Protection

If a state has a window period, it may, prior to October 15, 1985, enact legislation "otherwise regulat[ing]" window period loans originated by lenders other than certain federally-chartered institutions.³⁰³ Thus, the legislature in such a state conceivably could insulate window period loans from the Act's preemption indefinitely. While this means that such a state may effectively extend preexisting state law with regard to some loans, it must recognize the power of mortgagees to use due-on-sale clauses as a tool to ensure that proposed transferees meet customary credit standards.³⁰⁴ Thus, in no circumstances can a state absolutely prohibit enforcement of the clause. Since virtually all state judicial decisions and statutes have recognized the validity of the clause for the limited purpose of insuring the credit worthiness of proposed transferees,³⁰⁵ the Act is not likely to present a serious conflict with state law in this respect. Finally, it should be emphasized that states without window periods may not restrict enforcement of due-on-sale clauses.

The exact nature of this authority to "otherwise regulate" certain window period loans is not clear. Suppose that in 1980 the Supreme Court of State X held that a due-on-sale clause could not be enforced with respect to loans on single family dwellings unless the mortgagee could establish that the transfer would impair security or create an in-

302. See *supra* text accompanying notes 200-02 and *infra* text accompanying notes 306-07.

303. See 12 U.S.C. § 1701j-3(c)(1)(A) (1982). The Senate Committee noted that the three year period . . . provides State Legislatures . . . with the opportunity to review the impact Due-On-Sale restrictions have imposed . . . on lenders . . . and to formulate an alternative approach to window period loans if they so desire. For example . . . a State might repeal existing Due-On-Sale restrictions. A State might also lengthen the time that State Due-On-Sale restrictions would apply to window period loans

SENATE COMMITTEE REPORT, *supra* note 159, at 23. The Arizona legislature has exercised this power, extending the grace period for window-period loans to October 15, 1987. 1983 Ariz. Legis. Serv. ch. 321 (West).

304. 12 U.S.C. § 1701j-3(c)(2)(A) (1982).

305. See *supra* text accompanying notes 48, 54-55, 74.

creased risk of default. State X thus has a window period for mortgage loans that were made or assumed on such dwellings after the 1980 judicial decision. A mortgagor or his transferee is free to transfer, subject only to state law restrictions, until October 15, 1985.

Suppose further that during 1984 State X enacted legislation with a clear intent to insulate such window period loans from the Act's preemption. Assume that the legislation extended this protection to pre-Act mortgage loans on duplexes made or assumed after the 1980 judicial decision. The time extension is valid, but according to the preamble to the Regulation, the duplex provision is invalid because a state cannot "expand the type of loan to which the window period applies."³⁰⁶ This seems a justifiable restriction on state legislative action. If, as was noted earlier,³⁰⁷ a state legislature cannot expand the type of loan protected from the Act's preemption during the 1982-1985 grace period, it surely should be unable to do so for the life of the loan.

The Board's interpretation on this point is entirely reasonable. Unfortunately, the drafting of the relevant portion of the Act was extremely inept. While the Act provides that state legislatures "may otherwise regulate such contracts,"³⁰⁸ it is unclear whether "such contracts" refers to all real property loans except those originated by federally-chartered lenders, or only to window period loans. The latter construction is more consistent with the Act's overall objective of protecting reasonable reliance, and the Board's view should be upheld.

On the other hand, it appears that legislatures in window period states have the power to modify the *content* of existing state law so long as they do not attempt to extend it to non-window period loans. In the example above, the legislature could theoretically affect due-on-sale enforcement for window period loans by adopting specific credit standards, either more or less severe than those in the hypothetical 1980 judicial decision, which a prospective grantee would then be required to meet. As we noted, however, the legislature may not take away the power of lenders to apply "customary credit standards."³⁰⁹ In light of this limitation, the practical ability of legislatures to change credit standards is unidirectional: they may only impose standards stiffer than "customary" standards.

A more significant possibility for change lies in the area of foreclosure procedure. It seems fully within the power of a window period

306. 48 Fed. Reg. 21,558 (1983).

307. See *supra* text accompanying notes 200-02.

308. 12 U.S.C. § 1701j-3(c)(2)(A) (1982).

309. See *supra* text accompanying note 304.

state's legislature to adopt a new foreclosure process, either more or less burdensome to lenders than the standard procedure, for defaults triggered by due-on-sale clauses.

Window Periods—Conclusion

The mind-boggling complexity and ambiguity of the window period concept in practice illustrates how unwise it is to make broad national policy turn on the date that a particular court-made rule became law or on the precise coverage of the rule; such judicial law-making is not well suited to achieve Congress' goals. When legislation such as the U.C.C.C. is involved, questions of scope of coverage and effective date are usually easier to answer, for the statute will often be quite explicit on these points. But even a statute's interpretation may be open to doubt and may confound Congress' intent.

The Board's apparent refusal to recognize reasonable reliance as the key to interpretation of the window period principles is equally troubling. By pretending that there is only one window period for all types of loans and lenders in a given state, it has sacrificed common sense for administrative simplicity. Even the simplicity is illusory, for the Regulation is certain to be attacked in court as contrary to the intent of Congress. The combined result of Congress' flawed conception and the Board's faulty execution will be a mountain of litigation.

Special Rules Under the Act for Certain Federally-Chartered Lenders

As noted earlier, federally-chartered savings and loan associations have had the pre-Act power to enforce due-on sale clauses by virtue of the 1976 Bank Board regulation upheld in *de la Cuesta*.³¹⁰ The Act, with minor modifications, simply continues that power.³¹¹ Moreover, while prior to the Act some doubt existed as to the enforceability of due-on-sale clauses in pre-1976 regulation mortgage loans, the Act's preemption definitely applies to such clauses, which are now clearly enforceable.³¹² Neither the window period concept nor a window period state's ability to "otherwise regulate" window period loans is applicable to such federal associations.³¹³ Thus, so far as any post-Act

310. See *supra* text accompanying notes 89-100.

311. 12 U.S.C. § 1701j-3(c)(2)(C) (1982). The Act's modifications involve transfers which are exempt from due-on-sale enforcement. See *supra* text accompanying notes 83, 152.

312. 12 U.S.C. § 1701j-3(b)(1), (c)(2)(C) (1982).

313. *Id.* § 1701j-3(c)(2)(C).

transfer is concerned, federal associations are entirely free of state due-on-sale law.

With respect to national banks and federal credit unions, window period loans originated by these lenders are subject to state law until October 15, 1985,³¹⁴ unless the Comptroller of the Currency (Comptroller) or the National Credit Union Administration (NCUA) acts prior to that date otherwise to regulate these loans.³¹⁵ Thus, the Comptroller or the NCUA has the power to either extend or contract the time period in which these loans are subject to state law. The NCUA acted, effective November 18, 1982, to render immediately enforceable due-on-sale clauses in transfers made on or after that date.³¹⁶ In effect, the NCUA's rules preempt state law, regardless of the reasonable expectations of the consumers in states that would otherwise have had assumable window period loans.

The Comptroller's rule, effective December 8, 1983, is similar to the NCUA rule but is more lenient to owners of one to four family homes who obtained or assumed loans during a window period. Until April 15, 1984, such loans can be assumed to the extent allowed by state law, except that the lender may increase the interest rate to a "blended" level that is the average of the original contract rate and the current average contract interest rate on existing homes, as published by the Board. For other types of loans, the full federal preemption is effective immediately.³¹⁷

Prepayment Penalties Incident to Due-on-Sale Enforcement Under the Act

Mortgagees frequently include in loan agreements a provision that exacts a fee or "prepayment penalty" for the "privilege" of prepaying a mortgage loan. While the amount of the penalty varies, a common amount is six months' interest.³¹⁸ Such prepayment penalties are uti-

314. *Id.* § 1701j-3(c)(1)(B).

315. *Id.*

316. 47 Fed. Reg. 54,425 (1982) (to be codified at 12 C.F.R. § 701.21-6 (d)(2)(i)).

317. 48 Fed. Reg. 51,283 (1983) (to be codified at 12 C.F.R. § 30.1). The Comptroller took the unprecedented step of expressly designating, for purposes of his regulation, the window period for each state. *See supra* note 192.

The Comptroller's use of "blended" rates is supported by the Act, which specifically encourages the use of such rates. 12 U.S.C. § 1701j-3(b)(3) (1982). The Board, believing this provision to be merely persuasive and not mandatory, did not include a similar provision in the Regulation. *See* 48 Fed. Reg. 21,561-63 (1983) (to be codified at 12 C.F.R. §§ 591.1-.6).

318. A Board regulation, applicable to all federally chartered savings and loan associations, limits the penalty for payment of the entire principal balance to a maximum of six months' interest. This regulation also permits penalty-free prepayment of up to 20% of the

lized for at least two reasons. First, it is argued that the mortgagee's fixed costs of making a loan are not recaptured entirely if the loan is terminated early. The collection of a prepayment penalty is aimed at enabling the mortgagee to recapture these costs.³¹⁹ Second, such provisions are utilized as a complement to the due-on-sale clause.³²⁰ While the due-on-sale clause enables a mortgagee to recall lower-than-market-interest-rate loans, the prepayment penalty is utilized to discourage mortgagor refinancing when market interest rates fall below the rate being collected by the mortgagee on an existing loan.

While judicial attacks on prepayment penalties have largely been unsuccessful,³²¹ state legislation and federal regulation limit such penalties in a variety of residential mortgage settings.³²² There has also been some success in challenging collection of the penalty when prepayment was triggered by an involuntary disposition of the mortgage security, such as by casualty loss or condemnation.³²³ Moreover, courts have at times been reluctant to permit the collection of a prepayment

mortgage balance in any twelve month period. *See* 12 C.F.R. § 545.8-5(b) (1983); *see also* Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 23 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971); Note, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CALIF. L. REV. 923, 925 n.14 (1963).

319. *See, e.g.*, Bonanno, *supra* note 9, at 295.

320. *See* OSBORNE, NELSON & WHITMAN, *supra* note 3, § 6.1.

321. *See, e.g.*, Meyers v. Home Sav. & Loan Ass'n, 38 Cal App. 3d 544, 546, 113 Cal. Rptr. 358, 359 (1974); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 311, 99 Cal. Rptr. 417, 422 (1971); Aronoff v. Western Fed. Sav. & Loan Ass'n, 28 Colo. App. 151, 155, 470 P.2d 889, 891 (1970).

322. *See, e.g.*, KAN. STAT. ANN. § 17-5512 (1981) (prohibiting any prepayment penalty in excess of 1.5% of the prepayment); MICH. COMP. LAWS ANN. § 438.31c (West 1978) (a penalty may not be imposed after three years from the date of the mortgage and any charges within that three year period are limited to one percent of the amount of any prepayment); MO. ANN. STAT. § 408.036 (Vernon 1979) (imposition of prepayment penalties prohibited after five years from the date of the execution of the loan); N.J. STAT. ANN. 45:10B-2 to -3 (West Supp. 1982) (amount of any prepayment penalty is reduced each year during the first three years of a mortgage loan; no prepayment may be collected thereafter); N.Y. BANKING LAW § 393(2) (McKinney 1971) (prepayment penalties may be imposed only during the first year of the loan and may not exceed interest for a period of three months on the principal so prepaid, or interest for the remaining months in the first year, whichever is the lesser amount).

As noted earlier, the Board also restricts prepayment penalties. *See supra* note 318. The FNMA does not enforce prepayment clauses in mortgages it owns, and its 1980 mortgage form does not include a prepayment penalty provision. *See* FNMA Conventional Home Mortgage Selling Contract Supplement § 301.05. The FHLMC prohibits the collection of a prepayment charge on any mortgage acquired by it in 1980 and thereafter. *See* FHLMC SELLER'S GUIDE CONVENTIONAL MORTGAGES § 3.201(e).

323. *See, e.g.*, Associated Schools, Inc. v. Dade County, 209 So. 2d 489, 490 (Fla. App. 1968); Silverman v. State, 48 A.D.2d 418, 414, 370 N.Y.S.2d 234, 236 (1975); Sala v. Berkeley Sav. & Loan Ass'n., 104 N.J. Super. 394, 400, 250 A.2d 150, 154 (1969); Chestnut Corp. v. Bankers Bond & Mortgage Co., 395 Pa. 153, 156, 149 A.2d 48, 50 (1959).

penalty incident to a default on the mortgage indebtedness and foreclosure. This reluctance is sometimes justified on the theory that when default in payment of the indebtedness occurs and there is an acceleration, no prepayment, as such, can take place. At that stage, the mortgagor cannot opt to prepay, but only to exercise his equity of redemption from the mortgage.³²⁴

The Act itself is silent concerning collection of prepayment penalties incident to due-on-sale enforcement. The Board has vacillated in its regulatory approach. Its proposed Regulation, issued in January of 1983, would have prohibited all lenders from collecting prepayment penalties resulting from acceleration under due-on-sale clauses.³²⁵ However, the final Regulation, issued in April of 1983, backed away from this position and prohibited assessment of penalties only as to loans originated by federally-chartered savings and loan associations between July 31, 1976, and May 10, 1983.³²⁶ As to all other loans the Board chose not to restrict prepayment penalties, but rather to leave the matter to state law.³²⁷

This result was confusing to many lenders, since in most states there was no clear state law. The Board received numerous requests for clarification, and on July 7, 1983, it reverted to its original proposal; the Regulation was amended to prohibit all prepayment penalties in connection with due-on-sale enforcement.³²⁸ This step eliminated the discrimination between federal and state-chartered lenders and probably forestalled considerable litigation.

Yet there is no language in the Act that gives the Board authority to extend the prepayment penalty prohibition to state lenders. The Board relied on a statement in the Senate Report that referred to the need for uniform, homogeneous mortgage documents in the operation of an efficient secondary mortgage market.³²⁹ While it is hard to quarrel with this goal, it is also hard to see how this rather ambiguous and insubstantial statement can authorize Board action that changes a type of mortgage clause never mentioned in the Act. Lenders are likely to attack the amended Regulation as *ultra vires*, and they may well succeed.

The validity of the Board's attempted preemption of the prepay-

324. See *George H. Nutman, Inc. v. Aetna Business Credit Inc.*, 115 Misc. 2d 168, 453 N.Y.S.2d 586 (1982); *OSBORNE, NELSON & WHITMAN*, *supra* note 3, at 376.

325. 48 Fed. Reg. 2,378 (1983).

326. *Id.* at 21,563 (to be codified at 12 C.F.R. § 591.5(b)(2)).

327. *Id.* See also *id.* at 21,560.

328. *Id.* at 32,160 (amending 12 C.F.R. § 591.5(b)(2)).

329. SENATE COMMITTEE REPORT, *supra* note 159, at 21.

ment penalties issue may not have much practical importance. State law consistently has been unsympathetic to this type of "double-dipping." A few state statutes prohibit the enforcement of a prepayment penalty if the prepayment is triggered by the mortgagee's enforcement of a due-on-sale clause.³³⁰ Several courts have reached the same result without the benefit of a statute. These cases reason that once a mortgagor has exercised the due-on-sale clause and accelerated the mortgage debt, payment by the mortgagor is then legally due and by definition cannot be a "prepayment."³³¹

This result is sound from a policy perspective as well. As the Board has pointed out, "[w]hile the ability to impose a prepayment or equivalent fee upon due-on-sale acceleration may be of some economic benefit to the lender, it is in no sense essential to effective use of the due-on-sale clause for the purpose of raising portfolio yields to current market rates."³³² Moreover, neither of the two reasons normally used to justify prepayment penalty provisions justify their use incident to due-on-sale enforcement. First, collection of the penalty is not, in this context, needed to "lock in" a loan that earns a higher than market interest rate. Except in the relatively rare situation in which the due-on-sale clause is invoked to prevent impairment of security, it is used when current market interest rates exceeded the rate being paid by the mortgagor-transferor and any rational mortgagee would be only too delighted to accept a prepayment. Further, while any prepayment of the loan principal without collection of the penalty may frustrate the mortgagee's ability to recover fully the fixed cost of making the loan, such an argument is hardly persuasive when, in the due-on-sale context, it is the mortgagee rather than the mortgagor who is insisting on prepayment.

Mortgagee's Duty to Respond Under the Act

When a mortgagor and a proposed transferee seek mortgagee approval for a transfer of a window-period loan, the Regulation requires the mortgagee to respond in writing with its decision within thirty days after receipt of a completed credit application and supporting informa-

330. See, e.g., N.Y. REAL PROPERTY LAW § 254-a (McKinney Supp. 1982); VA. CODE § 6.1-330.33 (1983).

331. See, e.g., *Tan v. California Fed. Sav. & Loan Ass'n*, 140 Cal. App. 3d 800, 809, 189 Cal. Rptr. 775, 782 (1983); *American Fed. Sav. & Loan Ass'n v. Mid-America Serv. Corp.*, 329 N.W.2d 124, 125-26 (S.D. 1983); see also 48 Fed. Reg. 21,560 (1983) (citing *Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n*, 98 Ill. App. 3d 646, 648, 424 N.E.2d 939, 94 (1981)).

332. 48 Fed. Reg. 21,560 (1983).

tion.³³³ If the mortgagee decides to disapprove a proposed transfer, its decision must be accompanied by a statement of the reasons supporting the disapproval.³³⁴ Failure to respond in this way prohibits a mortgagee from enforcing a due-on-sale clause as to the proposed transfer.³³⁵ The foregoing requirements are apparently inapplicable to non-window period loans and to all loans originated by federally-chartered savings and loan associations.³³⁶ Perhaps this exclusion was based on a Board belief that since the due-on-sale clauses in such loans are usually enforceable, the mortgagor and his or her transferee should be deemed to assume that permission to transfer will be denied. Thus, the Board could have concluded that the imposition of a formal response requirement on the mortgagee under such circumstances would not be justifiable.

This limitation of the response requirement to window period loans whose due-on-sale clauses are likely to be unenforceable is unfortunate. To be sure, the probability of obtaining permission to transfer may be significantly lower in circumstances involving a non-window period loan. On the other hand, there may well be instances when a mortgagee will permit a transfer with no interest rate change, notwithstanding the enforceability of the due-on-sale clause. This could occur, for example, if the current market rate does not differ markedly from the mortgage rate. It is common for lenders to approve transfers on the condition that the interest rate be raised to a "blended" level somewhere between the original and current market rates. The Senate Report and the Act itself specifically encourage this practice.³³⁷ In any event, it hardly seems equitable to leave the parties to a proposed transfer in a state of uncertainty for an unduly long period. This is espe-

333. *Id.* at 21,562 (to be codified at 12 C.F.R. § 591.4(d)(3)).

334. *Id.*

335. *Id.*

336. The language of 12 C.F.R. § 592.4(d)(3) does not specifically exempt non-window period loans and all loans originated by federally-chartered savings and loan associations from the formal mortgagee response requirement. But when it is read in context with other parts of 12 C.F.R. § 591.4, an inference that the Board intended such an exclusion is strongly warranted. For example, the section itself is entitled "Loans originated by lenders other than Federal associations." Moreover, 12 C.F.R. § 591.4(d)(2), which immediately preceeds the formal response requirement, deals specifically with the circumstances under which a transfer of a *window period loan* may be denied when the transferee does not meet the mortgagee's customary credit standards. In this context it is unlikely that the Board could have intended to apply 12 C.F.R. § 591.4(d)(3) to non-window period loans or to those loans originated by federally-chartered lenders.

337. See 12 U.S.C. § 1701j-3(b)(3) (1982); SENATE COMMITTEE REPORT, *supra* note 159, at 21.

cially true where, as here, the response requirement appears to impose a relatively insignificant burden on the mortgagee.

In certain relatively rare situations, a mortgagee may by judicial decision be held estopped to assert, or to have waived, its rights under an otherwise enforceable due-on-sale clause.³³⁸ Suppose a mortgagor requests permission to transfer and receives no reply from the mortgagee. Nonetheless, the proposed transfer is consummated. If the mortgagee delays acceleration of the mortgage debt for a significant period of time, a court may be convinced that any subsequent attempt to enforce the clause as to that transfer is barred by waiver or estoppel principles. The probability of this result will be increased if the transferee has made significant improvements to the mortgaged real estate or has entered into substantial commercial relationships with respect to that real estate, prior to a belated attempt by the mortgagee to accelerate the mortgage debt. Unfortunately, the judicial application of waiver or estoppel concepts in this setting is uncertain at best. Ideally, the Board should simply broaden the lender-response requirement to encompass loans that contain enforceable due-on-sale clauses.

The Board's authority to take this step is debatable. The Act contains nothing about lender response. It merely states that lenders of window period loans may insist that transferees meet customary credit standards.³³⁹ The Board apparently reasoned from this provision that it had authority to standardize the procedure by which the meeting of applicable credit standards would be determined and communicated. This conclusion seems unexceptionable. Of course, the Board's plenary power to regulate federally chartered associations³⁴⁰ would permit it to apply this rule to such lenders with respect to all loans originated by them. A harder case would arise if the Board attempted to make non-federally chartered lenders comply with the response rule for non-window period loans. On the one hand, the Act provides that the power of such lenders to enforce their due-on-sale clauses "shall be exclusively governed by the terms of the loan contract, and all rights and remedies

338. The cases frequently focus on whether the lender has delayed an unreasonable time after the transfer before accelerating. *See, e.g.*, *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 304, 509 P.2d 1240, 1245-46 (1973) (one-month delay is reasonable, but one year would not be); *First Nat'l Bank v. Brown*, 90 Ill. App. 3d 215, 219, 412 N.E.2d 1078, 1082 (1980) (18-month delay gave rise to estoppel where mortgagee had notice and mortgagor detrimentally relied). *Cf.* *Bakker v. Empire Sav., Bldg. & Loan Ass'n*, 634 P.2d 1021, 1022 (Colo. App. 1981) (no waiver despite lender's acceptance of payments after notice of transfer); *Dunham v. Ware Sav. Bank*, 384 Mass. 63, 67, 423 N.E.2d 998, 1000 (1981) (three month delay, no waiver or estoppel).

339. 12 U.S.C. § 1701j-3(c)(2)(A) (1982).

340. *See Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 160 (1982).

of the lender and the borrower shall be fixed and governed by the contract."³⁴¹ This language may prevent the Board from interposing even mere procedural requirements if they are not mentioned in the loan contract.

On the other hand, the Act gives the Board authority "to issue rules and regulations and to publish interpretations governing the implementation of this section."³⁴² The grammatical structure of this sentence seems to suggest that issuing rules and publishing interpretations are separate activities, and this in turn may indicate that rules can be issued that go beyond mere interpretations of the Act. Under this view, a rule giving non-window period borrowers a right to a timely response to their requests for loan assumption approval might well be within the Board's powers. At least, such a rule is well within the general subject matter of the Act, something that cannot be so easily said about the Board's rule on prepayment penalties.

Further support for this position is found in the Act's language, appearing at the end of the list of "non-substantive transfers" discussed earlier in this article,³⁴³ that prohibits due-on-sale enforcement upon "any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board."³⁴⁴ The Senate Committee Report indicates that the Board was given this authority "to provide protections for consumers by prohibiting the enforcement of due-on-sale clauses where such enforcement would be inequitable."³⁴⁵ Since it is probably inequitable for a lender to accelerate after failing to give a timely response to the borrower's request for approval to transfer title, this language seems to fit the present situation rather nicely. It seems very likely that if the Board issued a broad rule requiring all lenders to respond to such requests within a reasonable time, the courts would uphold it.

Release of The Original Mortgagor Under the Act

When a mortgagee waives its right to accelerate under a due-on-sale clause (typically after a higher interest rate or "assumption fee" is agreed upon) and the transferee assumes (rather than merely takes "subject to"³⁴⁶) the existing mortgage, the Regulation requires that the

341. 12 U.S.C. § 1701j-3(b)(2) (1982).

342. *Id.* § 1701j-3(e)(1).

343. *See supra* text accompanying notes 151-52.

344. 12 U.S.C. § 1701j-3(d)(9) (1982).

345. SENATE COMMITTEE REPORT, *supra* note 159, at 25.

346. A grantee who "assumes" an existing mortgage becomes personally liable for the payment of the mortgage debt. A grantee who merely takes "subject to" the mortgage im-

mortgagee release the original mortgagor from personal liability on the mortgage debt.³⁴⁷ For several years this requirement has been part of Board regulations applicable to federally-chartered savings and loan associations.³⁴⁸ The mortgage form specified for use by lenders who sell mortgages to the FNMA and the FHLMC on the secondary market also imposes such a requirement on mortgagees.³⁴⁹ There is no policy ground for objecting to the Board's requirement, but there is also no justification for it in the Act. Hence the Board's authority to impose the requirement on lenders other than federally-chartered savings associations must rest on the rather thin reed of its general power to issue rules.³⁵⁰

Concealment of Transfers

In jurisdictions where due-on-sale clauses have been automatically enforceable or where there has been some doubt as to their enforceability, parties to real estate transactions may be tempted to avoid the consequences of the due-on-sale clause by concealing the transfer from the mortgagee. Because the Act will increase the number of enforceable due-on-sale clauses, these concealment attempts will probably increase. For example, to decrease the risk of discovery, the parties may arrange to have the transferee make the mortgage payments to the mortgagor-transferor or to a third party, who in turn will make the payment to the mortgagee in the mortgagor's name. Usually the parties continue to use the payment book originally issued to the mortgagor-transferor.

For a variety of reasons these concealment strategies often fail. Some mortgagees, for example, may closely monitor the public records for evidence of new real estate recordings affecting their mortgaged properties. Ownership changes may also become apparent from the annual real estate tax statements that the mortgagee receives in its capacity as an escrow agent for real estate taxes and insurance. Similar information can be obtained when a new casualty insurance policy is issued and the mortgagee's copy reveals the new owner. Moreover,

explicitly agrees that if the debt is not paid the mortgagee may look to the mortgaged real estate for satisfaction of the debt, but the grantee does not become personally liable on that debt. *See, e.g.*, *Del Rio Loan, Inc. v. Haument*, 110 Ariz. 7, 9, 514 P.2d 1003, 1005 (1973); *Elluckson v. Dull*, 34 Colo. App. 25, 28, 521 P.2d 1282, 1284 (1974); *Brice v. Griffin*, 269 Md. 558, 561, 307 A.2d 660, 661 (1973); *Nutz v. Sheperd*, 490 S.W.2d 366, 372 (Mo. App. 1973).

347. 48 Fed. Reg. 21,563 (1983) (to be codified at 12 C.F.R. § 591.5(b)(3)).

348. 12 C.F.R. § 545.8-3(g) (1983).

349. FNMA/FHLMC Mortgage, *supra* note 2, Clause 17 (one to four family).

350. *See supra* text accompanying note 342.

mortgagees can keep abreast of transfers through a program of regular inspection of the real estate on which they hold mortgages.

Transferees may attempt to reduce the chances of discovery by not recording the transfer. This approach not only frustrates mortgagee discovery of the transfer from an examination of the public records, but also usually prevents the revelation of a new owner incident to the issuance of new tax statements. In addition, the parties may also keep the casualty insurance policy in force in the mortgagor's name, but utilize a side agreement that purports to assign the beneficial interest in the policy to the transferee.

Even assuming that the foregoing tactics succeed in preventing mortgagee discovery of a transfer, the failure to record can create substantial problems for transferees in some states. If the transferee takes possession, in most jurisdictions that constitutes constructive notice of the transferee's interest and should protect the transferee against mortgages or other interests that are created by or arise against the mortgagor-transferor.³⁵¹ In such situations, possession is the functional equivalent of recording.³⁵² A few jurisdictions, however, require actual notice; possession alone does not qualify as constructive notice.³⁵³ Even when possession constitutes constructive notice, "establishing the existence of that possession could require litigation, while the fact of a recorded document would not."³⁵⁴ Failure to record is unacceptably risky, in our view.

If the mortgagee ultimately discovers the transfer, as will often happen, does it have a remedy against the parties to the concealment beyond a belated acceleration of the mortgage debt? The answer will depend in part on whether the parties have a duty to notify the mortgagee of the transfer. One court suggested that no such duty is implicit in the due-on-sale clause itself.³⁵⁵ This conclusion is by no means inescapable. A court could conceivably impose a duty of good faith on the mortgagor that would be violated by concealment attempts. Moreover, some mortgagees have begun to include express mortgage language that requires the mortgagor-transferor to notify the mortgagee in the event of a transfer. When such language is utilized, the mortgagee may

351. See G. NELSON & D. WHITMAN, *supra* note 124, at 194-95.

352. See *McCannon v. Marston*, 679 F.2d 13, 16 (3d Cir. 1982); *Grand Island Hotel Corp. v. Second Island Dev. Co.*, 191 Neb. 98, 214 N.W.2d 253, 257 (1974).

353. See, e.g., *Drey v. Doyle*, 99 Mo. 459, 469, 12 S.W. 287, 289 (1889); MASS. ANN. LAWS ch. 183, § 4 (West 1982); Comment, *Possession as Notice Under Missouri Recording Act*, 16 Mo. L. REV. 142 (1951).

354. OSBORNE, NELSON & WHITMAN, *supra* note 3, at 102.

355. *Medovoi v. American Sav. & Loan Ass'n*, 152 Cal. Rptr. 572 (1979) (depublished).

have a cause of action even when a window period loan is involved. Even though the due-on-sale clause in such a loan will often prove to be unenforceable, the mortgagee has a valid interest in discovering the identity of the transferee so as to be able to assess his or her creditworthiness or the impact of the transfer on mortgage security.

Suppose there is a duty to notify the lender, or at least a duty of good faith that would be violated by active concealment efforts. What damages might the lender recover for breach? If the mortgagee had been informed at the time of the transfer and had accelerated, and if the funds could have then been re-lent at a higher rate, the mortgagee has lost this interest income. In reality, most lenders are willing to forego acceleration under due-on-sale clauses in a rising-interest market if the transferee agrees to begin paying an interest rate that is higher than that provided in the original contract but nearer to the current market rate. In a concealment case the mortgagee might show damages by proving the interest rate that it customarily demanded on transferred properties at the time the concealed transfer occurred. It is doubtful that punitive damages could be recovered even for bad faith on the mortgagor's part.³⁵⁶ It would appear that only the original mortgagor can be liable for compensatory damages; the transferee who has taken subject to a mortgage has no contractual relationship with the lender, and it is hard to see any other basis for liability.

Concealment can raise serious legal problems between the mortgagor and the transferee. If the lender subsequently discovers the transfer and accelerates, the transferee may well sue his seller for damages. The suit could claim, for example, a breach of an implied warranty or covenant that the loan would not be called due. We have found no case authority for such an action, but it is not inconceivable. This implied covenant notion is, in a sense, the exact opposite of the traditional implied covenant of marketable title,³⁵⁷ for here a continuing encumbrance is desired by the buyer and bargained for by the parties. The buyer would argue that acceleration by the lender breaches this term and understanding of the sales agreement. The buyer's damages would represent the excess interest (and possibly settlement and related costs) that the buyer would incur in the future upon refinancing the property after acceleration. Moreover, if the buyer is unable to qualify for new

356. Punitive damages are not generally available for contract breaches unless a tort has also been committed. See RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981); 5 A. CORBIN, *supra* note 35, § 1077.

357. See 6A R. POWELL, *supra* note 118, at ¶ 925(2); 3 AMERICAN LAW OF PROPERTY, *supra* note 119, § 11.47.

financing and foreclosure ensues, the seller may be liable for damages incident to the buyer's loss of his or her equity in the mortgaged real estate. Conceivably the seller could be faced with two suits: one by the lender for lost interest up to the date of actual acceleration, and one by the buyer for increased interest payments or loss of the property thereafter. In any transaction in which the lender is not fully informed, the seller is well-advised to include in the sale contract language by which the transferee acknowledges the risk of future acceleration and agrees to hold the seller harmless in the event acceleration occurs.³⁵⁸

Should a lawyer be troubled by the ethical implications of counseling a client to conceal a transfer, or of arranging the details of the transaction? At most, the concealment is a breach of contract, and the Model Code of Professional Responsibility apparently does not prohibit advising a client to breach a contract, although Disciplinary Rule 7-102(A)(7) provides that a lawyer shall not "counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent."³⁵⁹ Of course, "illegal" is a slippery word, and could conceivably include contract breaches. But the opinions of the American Bar Association's Committee on Ethics and Professional Responsibility consistently treat this rule as referring only to criminal conduct or something very close to it.³⁶⁰ The rule has never been regarded as applying to breaches of contract.

The lawyer who counsels concealment in the face of an enforceable due-on-sale clause may be (and we think usually is) guilty of giving poor advice, but it does not appear to be an ethical violation under the Code. We are uncomfortable with this conclusion. The Code does not adequately deal with the issue, and perhaps reflects the larger societal indecision regarding the morality of breaching contracts.³⁶¹

Conclusion

Congressional preemption of due-on-sale clauses under the Act can be evaluated on two levels: whether the Act's objective is sound, and whether it can accomplish the objective in a satisfactory manner.

358. See Liss, *Drafting Around the Mortgage "Due on Sale" Clause in the Installment Sale of Real Estate*, 62 CHI. B. REC. 312 (1981) (suggesting various other protective clauses).

359. MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 7-5 (1980) states the same principles in even more general terms.

360. See ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1314 (1975) (perjury by client); ABA Comm. on Ethics and Professional Responsibility, Formal Op. 335 (1974) (securities fraud); ABA Comm. on Professional Ethics and Grievances, Formal Op. 281 (1952) (representation of a criminal syndicate).

361. Liss, *supra* note 358, appears to see no ethical problems in concealment. *Id.* at 312.

On the first level, we have no difficulty applauding the Act. A uniform national policy enforcing due-on-sale clauses was long overdue. The arguments that have been raised against enforceability of due-on-sale clauses as interest rate adjustment tools do not appear to us to be logical. As the mortgage finance market has evolved, the arguments seem even less persuasive, even if one ignores the grave economic crisis that depository financial institutions have weathered.³⁶² In an era when short-term balloon mortgages and adjustable rate loans have become common, the latter with rate adjustments perhaps every six months or every year, we believe it does not make sense to regard enforcement of the due-on-sale clause as unconscionable. From the borrower's viewpoint, a fixed-rate long-term mortgage with a due-on-sale clause is usually much more humane and agreeable than a short-term rollover loan or a frequently-adjusted variable interest mortgage. With the former, the borrower is at least assured that the rate will be stable so long as he or she owns the property. When one considers the general decline in the use of prepayment penalties in the past few years, the fixed-rate loan with a due-on-sale clause often gives the borrower the best of all available worlds—protection against rising rates, and at the same time, freedom to refinance if rates fall—so long as the property is not transferred. Of course, the contract is not as advantageous as it would be if continued restrictions on enforcement of due-on-sale clauses made the loan transferrable at its existing contract rate. However, compared to the alternative kinds of contracts that have become popular without so much as a wimper of protest from the courts, it is very attractive.

The restraint on alienation argument has always been, in our opinion, a weak one. Those who have pressed it have usually managed to avoid direct discussion of its major premise: that mortgage lenders somehow have an obligation to finance not only the ownership of their immediate borrowers, but of the transferees of those borrowers as well. If one accepts this premise, then it is true that the due-on-sale clause is

362. The impact of decisions restricting due-on-sale enforcement on the well-being of financial institutions has been substantial. One economist has estimated that the effect of the *Wellenkamp* decision, *supra* note 217, in calendar year 1981 was to transfer between \$58 million and \$170 million from California state-chartered savings and loan associations to borrowers. Ozanne, *The Financial Stakes in Due-on-Sale: The Case of California's State Chartered Savings and Loans 2* (unpublished paper prepared for the Federal Home Loan Bank Board, July 1982).

Another study estimated that *Wellenkamp* reduced the market value of the mortgage portfolios of California-chartered associations by an amount equal to about 45% of the associations' net worth. See Dietrich, Langetieg, Dale-Johnson & Campbell, *The Economic Effects of Due-on-Sale Clause Invalidation*, 2 HOUSING FIN. REV. 19 (1983).

a practical restraint on alienation. On the other hand, if lenders have no such duty then their insistence on being paid off when the borrower sells the property, or on extending the loan only at a higher interest rate, cannot be thought to restrain the sale, any more than would the refusal of some other lending institution to finance the new owner's purchase. Again, the analogy to more recently popularized forms of mortgage financing is telling. Does the lender who takes only a one-year or three-year note have a duty to extend it merely because the property that secures it is sold? Does the lender who contracts for an adjustable interest rate have a duty to refrain from adjusting it upward because that action may make it more difficult for the borrower to sell the property? If these lenders do not have the sorts of duties outlined, as they quite obviously do not, why should a fixed-rate long-term lender have any analogous duty? Viewed in this light, the notion that the due-on-sale clause is a restraint on alienation does not withstand analysis.

While we applaud the spirit of the Act, the implementation of its objectives is quite another matter. In important ways the legislation is clearly deficient. The principal problems arise with the window period concept. Congress apparently wanted to protect, for at least a three-year period, those borrowers who reasonably relied upon favorable state law. This objective is praiseworthy, but the technique Congress selected to accomplish it is fraught with pitfalls. To make legal rights turn on when and how a state rule of law was adopted by a state court ignores the vagaries and complexities of judicial lawmaking. The language of the Act itself foreshadows the problems when it refers to the date "on which the next highest appellate court has rendered a decision resulting in a final judgment if such decision applies State-wide."³⁶³ The fallacy is obvious: judicial judgments "apply" only to the parties before them and their privies; the reasoning that underlies them may subsequently influence future decisions involving other parties, but the process by which that occurs is subtle, complex, and often unpredictable. There is typically (and surely in the due-on-sale situation) much room to explain, distinguish, reargue, and expand or contract the scope of prior opinions. This is hardly a solid basis for establishing national legislative policy.

The Bank Board has compounded the problem by failing to adopt a consistent and rational interpretation of the window period concept. It has sought simplicity where simplicity does not exist, and in doing so it has almost certainly disregarded the intent of Congress. There is

363. 12 U.S.C. § 1701j-3(c)(1) (1982).

nothing inherently objectionable about a window period, or the benefits to borrowers that the window period concept makes possible. But we believe Congress would have been far wiser to have simply enacted a list of window period states and corresponding dates. If it had done so, the great volume of litigation now anticipated could easily have been avoided. The Act was drafted and passed in haste,³⁶⁴ and perhaps it is understandable that Congress was not able to reflect maturely on these problems. Yet unless Congress moves to clarify the Act (and there is no sign at this writing that it will), we can expect years of confusion and litigation.

364. On September 24, 1982, the Senate took the House version of the bill, H.R. 6267, and deleted everything in it except for the title and the statement of intent, replaced the text with S. 2879, and sent it back to joint conference. *See generally* 128 CONG. REC. S12,221-63 (daily ed. Sept. 24, 1982). On September 30, Representative St. Germain won from the rules committee a closed rule waiving certain procedural requirements—essentially those prohibiting consideration of the bill without debate. The text of the bill was distributed to the House members on the morning of October 1, 1982. At approximately 9:30 p.m. on the last night of the second session (October 1, 1982) the bill was put on the floor for a vote, despite the fact that most of the members had not yet seen the legislation. Intense controversy ensued: “[T]here is total disagreement as to what is in this bill. Very likely it perpetuates high interest rates—but we don’t know, because we don’t know what is in this bill. We ought to vote down this rule until we can take a good look at this legislation, none of us knows what it does.” 128 CONG. REC. H8429 (daily ed. Oct. 1, 1982) (statement of Rep. Perkins). Even one of the senior members of the banking committee—Representative Gonzalez—asked to postpone voting on the bill because he had not been able to study it. 128 CONG. REC. H8434-35 (daily ed. Oct. 1, 1982) (statement of Rep. Gonzalez).