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Federal Pre-Emption of State Due-on-Sale Clause Restrictions: Jurisdictional Considerations

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**FEDERAL PRE-EMPTION OF STATE
DUE-ON-SALE CLAUSE
RESTRICTIONS: JURISDICTIONAL
CONSIDERATIONS**

JAN W. HENKEL* AND ROBERT J. DILWORTH**

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I. INTRODUCTION

Insolvency threatens the nation's thrift institutions:¹ the number of troubled federal savings and loan institutions more than tripled in the first half of 1981.² These institutions' low-earning, long-term mortgage loans have not provided income sufficient to pay the high interest rates required for short-term loans of operating funds. To alleviate this financial strain, lenders have vigorously sought enforcement of due-on-sale clauses when borrowers transfer property securing old mortgage loans. A lender may use the clause either to declare the entire debt due or to force a purchaser who wishes to assume the loan to agree to an interest rate at or near the current rate. The use of due-on-sale clauses, federal approval of them, and state attempts to

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1. "Thrift institutions" as used in this Article means federal savings and loan associations and savings banks chartered pursuant to 12 U.S.C. § 1464 (1976 & Supp. IV 1980).

2. Wall Street Journal, Nov. 20, 1981, at 2, col. 3.

limit their enforcement increased in the 1970s, with a resultant increase in litigation and legal commentary.³

Courts in many recent decisions have abandoned discussion of the virtues and vices of due-on-sale clauses as interest escalators. The debate has shifted to federal pre-emption of state restrictions on the enforcement of due-on-sale clauses by federal savings and loan associations. This litigation can arise in several procedural forms and has caused a related debate over the proper jurisdiction for assertion of the pre-emption defense. A number of courts have avoided discussing pre-emption on the merits by deciding cases on jurisdictional grounds.⁴ These recent decisions have returned the issue of pre-emption to the state courts. In most states that restrict enforcement of due-on-sale clauses, a predictable result occurs: state courts find no federal pre-emption of state restrictions.⁵

The avoidance of this controversial issue by the federal courts increases the likelihood of congressional or Supreme Court resolution of the uncertainty.⁶ This Article, after briefly discussing the foundations necessary for understanding the pre-emption controversy, addresses jurisdiction to

3. For partial bibliographies, see *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 482-85, 293 N.W. 2d 843, 850-51 (1980); Dunn, *Selected Current Legal Issues in Mortgage Financing*, 13 REAL PROP., PROB. & TR. J. 812, 838 (1978); Kratovil, *New Dilemma for Thrift Institutions: Judicial Emasculation of the Due-On-Sale Clause*, 12 J. MAR. J. PRAC. & PROC. 299, 301 n.6 (1979). See also Blocher, *Due-on-Sale in the Secondary Mortgage Market*, 31 CATH. U.L. REV. 49 (1981); Dunlavey, *Wellenkamp's Wake: California Courts Divide on the Continued Enforceability of Due-on-Sale Clauses*, 3 WHITTIER L. REV. 517 (1981); Dunn & Nowinski, *Enforceability of Due-on-Transfer Clauses: An Update*, 16 REAL PROP., PROB. & TR. J. 291 (1981); Guerin, *Selected Problems in Wrap-Around Financing: Suggested Approaches to Due-on-Sale Clauses and Purchaser's Depreciable Basis*, 14 U. MICH. J.L. REF. 401 (1981); Henkel & Selzer, *Acceleration Clauses in Mortgages: Misuse During Periods of Tight Money*, 17 AM. BUS. L.J. 441 (1980); Henkel & Selzer, *Using Due-on-Sale Clauses to Increase Mortgage Rates*, REAL ESTATE REV., Fall 1979, at 84; Note, *Due-on-Sale Clauses: A Suggested Approach for Dealing with Non-institutional Lenders*, 8 W. ST. U.L. REV. 57 (1980).

4. See, e.g., *Nalore v. San Diego Fed. Sav. & Loan Ass'n*, 663 F.2d 841 (9th Cir. 1981) (federal question removal jurisdiction), *cert. denied*, 50 U.S.L.W. 3765 (U.S. Mar. 22, 1982); *Conference of Fed. Sav. & Loan Ass'ns v. Stein* ("Conference II"), 495 F. Supp. 12 (E.D. Cal. 1979), *rev'd*, No. 79-4818 (9th Cir. Sept. 23, 1981) (ripeness); *Glendale Fed. Sav. & Loan Ass'n v. Fox*, 481 F. Supp. 616 (C.D. Cal. 1979), *rev'd*, No. 79-3573 (9th Cir. Sept. 23, 1981) (same), *petition for cert. filed*, No. 81-1192 (U.S. Dec. 21, 1981).

5. See, e.g., *dé la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n*, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), *probable jurisdiction noted*, No. 81-750 (U.S. Jan. 25, 1982); *Panko v. Pan Am. Fed. Sav. & Loan Ass'n*, 119 Cal. App. 3d 916, 174 Cal. Rptr. 240 (1981), *appeal docketed*, No. 81-922 (U.S. Nov. 13, 1981); *Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n*, 308 N.W.2d 471 (Minn. 1981).

6. See note 174 *infra*.

decide pre-emption cases and the substantive bases of pre-emption. The Article concludes that the federal courts generally do not have jurisdiction over the pre-emption cases and that most findings of pre-emption are substantively erroneous.

A. *Due-on-Sale Clauses: A State Law Primer*

A due-on-sale or due-on-encumbrance clause permits the lender to declare the entire balance of the debt due and payable on the sale or further encumbrance of the secured property without the prior consent of the lender. The clause technically may be triggered when the buyer and seller enter into an executory contract for a cash sale because the doctrine of equitable conversion makes the buyer the equitable owner of the land on execution of the contract.⁷ The due-on-sale clause, however, is aimed at transactions such as loan assumptions and purchases "subject to" existing mortgages.⁸

The original justification for the due-on-sale clause was simple and practical: a lender who had made a loan to one creditworthy individual could use the threat of acceleration to insure that the purchaser also would be creditworthy.⁹ This use of the clause is still legitimate, even for the purpose of exacting escalated interest. If the substitution of the purchaser for the mortgagor would jeopardize the security, acceleration is justified, either to defeat the sale or to force a higher interest rate to compensate for the increased risk.

Recently, however, lenders have accelerated or threatened to accelerate assumed debts to increase their portfolio yield. Although full repayment would allow lenders to reinvest the money at prevailing rates, lenders more often use the threat of acceleration to exact a higher interest rate from the purchasers in exchange for waiver of the right to accelerate. This enables lenders to bring long-term investment portfolios up to current rates without the delays and costs of acceleration and foreclosure.¹⁰

Lenders maintain that they have been able to offer reasonable rates over terms as long as thirty years only because the average homeowner does not remain in one residence the full term of the mortgage. In 1980, the Federal National Mortgage Association (the "FNMA") purchased thirty-year mortgages in the secondary market at discounted purchase prices based on projected payoff within twelve years.¹¹ The Federal Home Loan Bank Board (the "Board") expects that half of the conventional mortgages made in a

7. Kratovil, *supra* note 3, at 308.

8. For an explanation of the difference between an assumption and a purchase "subject to" the existing mortgage, see G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* §§ 5.3-.4 (1979).

9. Note, *Due-on-Sale Clauses in Deeds of Trust: State Regulation or Pre-emption?*, 1979 ARIZ. ST. L.J. 367, 367-69.

10. Note, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1111 (1975).

11. *Dunham v. Ware Sav. Bank*, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E. 2d 988, 1001 (1981).

given year will be repaid well within ten years.¹² Accordingly, lenders adjust interest rates to cover projected inflation only for about one-third of the stated term. Thus, people who pay off their mortgages early and enter new mortgages at the current rate subsidize loans to people who do not pay off early. Loan assumptions deprive lenders of the early payoffs needed to subsidize low-profit and no-profit loans. Allowing the exercise of due-on-sale clauses as interest escalators locks lenders into fixed rates only for relatively short periods, thus minimizing losses during periods of inflation and disintermediation.

Courts sympathetic to lenders approve this money market rationale or portfolio maintenance justification, explaining that nonexercise of due-on-sale clauses would increase average interest rates for all home buyers.¹³ One court has characterized those wishing to assume loans at old interest rates as "simply too eager to shift to others burdens properly belonging on their own shoulders."¹⁴

Courts hostile to the money market rationale also advance various justifications. These courts presumptively favor the borrower and require the lender to justify the interest escalation.¹⁵ The mere desire to increase the interest, unaccompanied by proof of security impairment resulting from the transfer, is insufficient to overcome the presumption favoring the borrower. Proving security impairment is difficult for most lenders.

Courts favoring the borrower justify the presumption with two principal rationales. First, they argue that interest escalation is an unreasonable and, therefore, unlawful restraint on alienation because the seller must lower his price to entice the purchaser to accept the lender's demands.¹⁶ This approach confuses market factors with classical restraints on alienation analysis.¹⁷ Any increase in costs, whether from high interest rates or increased sales prices, discourages purchasers.

The second justification advanced by courts favoring borrowers is based

12. *Schott* Advisory Op., Res. No. 75-647, at 22 (F.H.L.B.B. July 30, 1975).

13. See *Dunham v. Ware Sav. Bank*, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1001-02 (1981).

14. *Williams v. First Fed. Sav. & Loan Ass'n*, 651 F.2d 910, 916 (4th Cir. 1981).

15. *Bartke, Michigan's Looking Glass World of Due-on-Sale Clauses*, 24 WAYNE U.L. REV. 971, 989-90 (1978); *Dunn*, *supra* note 3, at 824-35. *But see* *First Fed. Sav. & Loan Ass'n of Rapid City v. Kelly*, 312 N.W.2d 476 (S.D. 1981).

16. *Wisconsin Ave. Assocs., Inc. v. 2720 Wis. Ave. Cooperative Ass'n*, Nos. 79-631, 79-1102, 79-1103 (D.C. Feb. 2, 1982); *Patton v. First Fed. Sav. & Loan Ass'n*, 118 Ariz. 473, 578 P.2d 152 (1978); *Dawn Inv. Co. v. Superior Court*, 30 Cal. 3d 695, ___, P.2d ___, ___, Cal. Rptr. ___, (1982); *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). *Contra*, *Lipps v. First Am. Serv. Corp.*, No. 800908 (Va. Jan. 22, 1982).

17. *Occidental Sav. & Loan Ass'n v. Venco Partnership*, 206 Neb. 469, 471, 293 N.W. 2d 843, 845 (1980).

on equitable principles. These courts correctly state that foreclosure historically has been a creature of equity courts and that one seeking foreclosure is subject to equitable defenses.¹⁸ This approach sometimes proves too much, however. When the due-on-sale clause does not explain that interest escalation might be a condition for waiver of the right of acceleration, a borrower might reasonably believe that the clause's sole purpose was prevention of security impairment. Equitable relief in the form of a disallowance of interest escalation is appropriate in such a case¹⁹ and is more intellectually honest than the unreasonable restraints approach. To suggest, however, that the money market rationale is inherently inequitable, even when the clause fully and fairly informs the borrower of the possibility of interest escalation, stretches credulity,²⁰ and gives the same inflexible rule as the unreasonable restraints approach.

B. *The Federal Role in Residential Financing*

The Federal Home Loan Bank System was created by the Federal Home Loan Bank Act of 1932.²¹ Modeled after the Federal Reserve System, the system serves as a central credit facility and regulatory body for member associations.²² The supervisor of the system is the three-member Federal Home Loan Bank Board, an independent government agency that charters and regulates federal associations and governs the Federal Savings and Loan Insurance Corporation (the "FSLIC") and the Federal Home Loan Mortgage Corporation (the "FHLMC").²³ All federal associations are members of the system and must be insured by the FSLIC. The FHLMC is a private

18. See *Clearwater Fed. Sav. & Loan Ass'n v. Knight*, 396 So. 2d 1238 (Fla. Dist. Ct. App. 1981); *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980). Both cases were rejected by the court in *First Fed. Sav. & Loan Ass'n v. Peterson*, 516 F. Supp. 732 (N.D. Fla. 1981). But see *First Fed. Sav. & Loan Ass'n of Winter Haven v. Siegel*, 529 F. Supp. 562 (M.D. Fla. 1982) (controversy was not over federal law, but over state's authority to deny enforcement in exercise of equitable jurisdiction).

19. See *First Fed. Sav. & Loan Ass'n v. Lockwood*, 516 F. Supp. 732 (N.D. Fla. 1981); *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970); *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 633-34, 224 S.E.2d 580, 589 (1976) (Lake, J., dissenting); *Great N. Sav. Co. v. Ingarr*, 66 Ohio St. 2d 503, 423 N.E.2d 128 (1981); *Bellingham First Fed. Sav. & Loan Ass'n v. Garrison*, 87 Wash. 2d 437, 553 P.2d 1090 (1976). But see *In re Bonder*, No. 8111SC332 (N.C. App. Jan. 5, 1982).

20. *Clearwater Fed. Sav. & Loan Ass'n v. Knight*, 396 So. 2d 1238 (Fla. Dist. Ct. App. 1981).

21. 12 U.S.C. §§ 1421-1449 (1976).

22. U.S. DEP'T OF HOUSING & URB. DEV., *HOUSING IN THE SEVENTIES* 73 (1974).

23. Comment, *A Case for Preemption, Wellenkamp v. Bank of America is Inapplicable to Federal Savings and Loan Associations*, 20 SANTA CLARA L. REV. 219, 223 (1980).

corporation controlled by the Board. The FHLMC is the central credit facility and a secondary purchaser of conventional mortgages and should be distinguished from the Federal National Mortgage Association (the "FNMA"), another secondary purchaser of mortgages. Created by the Federal Housing Administration in 1938,²⁴ the FNMA primarily purchases government insured or guaranteed mortgages. Since 1968, the FNMA has been a nongovernmental corporation.²⁵ The FHLMC and the FNMA are the principal secondary purchasers of home mortgages in this country. Both have developed uniform lending instruments that, with special nonuniform covenants, are used in every state.

Congress authorized the creation of the Board in 1932 in response to a crisis in home financing,²⁶ but this legislation did not cure the crisis.²⁷ In 1933, President Roosevelt requested more help from Congress to relieve homeowners from some of the burden of excessive accrued interest and principal payments and to protect borrowers from foreclosure.²⁸ The financing crisis probably resulted, in part, from ill-advised state practices in home financing. The states had created a hodgepodge of savings and loan regulations, and Congress hoped that the Board, infused with new powers under the Home Owners' Loan Act of 1933²⁹ (the "HOLA"), would create rules setting an example for sound and uniform practices.³⁰ The HOLA created the Home Owners' Loan Corporation (the "HOLC"), which was authorized to exchange its bonds for mortgages held by various lenders, including state savings and loan associations. The only mortgages eligible for HOLC exchange were those with equal monthly payments. Loans featuring balloon payments, rollover of principal at specified intervals, and repayment by sinking funds were considered pernicious and were not eligible for exchange, in spite of their widespread use by state associations.³¹

Pursuant to authority granted by the HOLA,³² the Board has pro-

24. See 12 U.S.C. § 1717(a) (1976).

25. HOUSING IN THE SEVENTIES, *supra* note 22, at 75.

26. Glendale Fed. Sav. & Loan Ass'n v. Fox, 459 F. Supp. 903, 908 (C.D. Cal. 1978), *rev'd*, No. 79-3573 (9th Cir. Sept. 23, 1981), *petition for cert. filed*, No. 81-1192 (U.S. Dec. 21, 1981).

27. T. MARVELL, THE FEDERAL HOME LOAN BANK BOARD 23-24 (1969).

28. Conference of Fed. Sav. & Loan Ass'ns v. Stein ("Conference I"), 604 F.2d 1256, 1257 (9th Cir. 1979), *aff'd mem.*, 445 U.S. 921 (1980).

29. 12 U.S.C. §§ 1421-1470 (1976 & Supp. IV 1980).

30. T. MARVELL, *supra* note 27, at 23-24.

31. Glendale Fed. Sav. & Loan Ass'n v. Fox, 459 F. Supp. at 908-09.

32. In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as 'Federal Savings and Loan Associations', and to issue charters therefor, giving primary con-

mulgated a myriad of regulations that some courts consider so comprehensive that they cover all aspects of every federal savings and loan association "from its cradle to its corporate grave."³³ Such statements paint with too broad a brush because purely local aspects are not federally regulated. The generalization is, however, quite close to the mark with respect to purely internal operations of federal associations.

Four regulations concerning due-on-sale clauses fuel the current litigation over whether federal authorization of due-on-sale clauses pre-empts state enforcement of state restrictions of the clauses. Section 545.8-3(a) of Title 12 of the Code of Federal Regulations³⁴ requires that loan instruments provide "full protection" to the association. Sections 545.8-3(f) and (g)³⁵ specifically allow the enforcement of a due-on-sale clause according to the terms of the loan contract, with certain limitations. Section 556.9(a)-(d)³⁶ clarifies the Board's position regarding late charges, prepayment penalties assessed in conjunction with due-on-sale clauses, exercise of the clause as an interest escalator, and the waiver of the right of acceleration. In section 556.9(f),³⁷ the Board re-affirmed its entire policy.

Lenders in states that restrict enforcement of due-on-sale clauses have several alternatives. First, they can use new alternative mortgage instruments that vary the yield with the cost of the debt. Second, they can shorten the terms of loans by exercising due-on-sale clauses when possible. Third, they can refuse to purchase instruments with nonexercisable due-on-sale clauses and include call or renegotiation clauses in all new instruments. Fourth, lenders can seek relief in Congress.³⁸

Fighting economic storms paralleled only by the depression of the 1930s and armed with federal regulations, federal associations hoped to avoid the application of state restrictions on the enforcement of due-on-sale clauses by asserting a pre-emption defense. Just as the associations began to obtain favorable judgments, a concomitant issue arose: which courts have jurisdiction over these pre-emption cases?

II. JURISDICTION TO DECIDE PRE-EMPTION CASES

The requisites of federal subject matter jurisdiction are found in Title

sideration to the best practices of local mutual thrift and home-financing institutions in the United States.

12 U.S.C. § 1464(a) (1976).

33. *People v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311, 316 (S.D. Cal. 1951).

34. 12 C.F.R. § 545.8-3(a) (1981).

35. *Id.* § 545.8-3(f) to (g).

36. *Id.* § 556.9(a)-(d).

37. 46 Fed. Reg. 39,124 (1981) (to be codified in 12 C.F.R. § 556.9(f)).

38. *See* S. 1703, 97th Cong., 1st Sess. (1981); S. 1720, 97th Cong., 1st Sess. (1981).

28, chapter 13, of the United States Code. Federal courts do not have subject matter jurisdiction over federal associations solely by virtue of their federal charters. A district court has jurisdiction over a corporation based on incorporation by Congress only if the United States owns more than one-half the corporation's capital stock.³⁹ If a federal association cannot meet this test, two other bases of jurisdiction might apply. Diversity of citizenship of the parties⁴⁰ is the most easily met basis of federal subject matter jurisdiction over a due-on-sale clause controversy.⁴¹ The second basis of federal jurisdiction exists when the cause of action arises under federal law⁴² or under an act of Congress regulating commerce.⁴³

Three caveats are in order concerning the satisfaction of the federal question basis. First, the same federal question provisions apply to both original and removal jurisdiction.⁴⁴ There is an appealing surface symmetry in applying the same tests to each, but the pre-emption litigation illustrates that this leads to bizarre results in federal question cases.⁴⁵ Second, cases that decide the meaning of "arising under" for purposes of the "arising under federal law" basis may be relied on in cases dealing with the "arising under an act of Congress regulating commerce" basis, and vice versa.⁴⁶ Third, the cases discussing the meaning of "arising under" are numerous, but no litmus test has emerged.⁴⁷

Chief Justice Marshall, in one of the earliest Supreme Court cases that discussed federal subject matter jurisdiction, said that Congress constitutionally could extend federal question jurisdiction to any case involving federal law, whether substantially or tangentially, whether raised in the com-

39. 28 U.S.C. § 1349 (1976).

40. *Id.* § 1332.

41. For a due-on-sale clause case in which the court questioned the diversity of a limited partnership, see *Trent Realty Assocs. v. First Fed. Sav. & Loan Ass'n*, 657 F.2d 29, 32 (3d Cir. 1981).

42. Act of Dec. 1, 1980, Pub. L. No. 96-486, § 2(a), 94 Stat. 2369 (1980).

43. 28 U.S.C. § 1337(a) (Supp. III 1979).

44. *Id.* § 1441(a) (1976).

45. The defendant can remove a case from a state court if the plaintiff relied on federal law, but neither can get into federal court when the defendant sets up a federal defense to the plaintiff's nonfederal claim, *see pp.* 234-36 *infra*.

46. *See, e.g., Peyton v. Railway Express Agency*, 316 U.S. 350 (1942) (*per curiam*); *Maritime Serv. Corp. v. Sweet Brokerage de Puerto Rico, Inc.*, 537 F.2d 560 (1st Cir. 1976); *Yancoskie v. Delaware River Port Auth.*, 528 F.2d 722 (3d Cir. 1975).

47. *See generally* C. WRIGHT, *LAW OF THE FEDERAL COURTS* §§17-18 (1976); 32 AM. JUR. 2D, *Federal Practice & Procedure* §§ 47-77 (1967). The requirements of the pleading in a federal question case, however, are well-established. The plaintiff's statement of his cause of action must show that it is based on federal law and be self-supporting, unaided by allegations in anticipation or avoidance of possible defenses. *Louisville & N. R.R. v. Mottley*, 211 U.S. 149, 153-54 (1908).

plaint or in the answer.⁴⁸ Congress has not been so expansive in considering federal question jurisdiction. For example, Congress in 1971 rejected a proposal that would have allowed removal from a state court when a "substantial defense" under federal law was asserted.⁴⁹ Congress' only recent major extension of federal question jurisdiction was elimination of the minimum amount in controversy requirement.⁵⁰ The Supreme Court also has been restrained in the extension of jurisdiction.⁵¹ In 1916, Justice Holmes first tried to give meaning to "arising under" with these words: "A suit arises under the law that creates the cause of action."⁵² Twenty years later, Justice Cardozo observed that a case is within federal question jurisdiction if

a right or immunity created by the Constitution or laws of the United States . . . [is] an element, and an essential one, of the plaintiff's cause of action. . . . The right or immunity must be such that it will be supported if the Constitution or laws of the United States are given one construction or effect, and defeated if they receive another. . . . A genuine and present controversy, not merely a possible or conjectural one, must exist with reference thereto . . . , and the controversy must be disclosed upon the face of the complaint, unaided by the answer or by the petition for removal. . . . Indeed, the complaint itself will not avail as a basis of jurisdiction in so far as it goes beyond a statement of the plaintiff's cause of action and anticipates or replies to a probable defense.⁵³

The problem with many of the due-on-sale clause pre-emption cases is that a right or immunity created by the Constitution or laws of the United States is not an element, let alone an essential element, of the plaintiff's cause of action.

Typical state litigation can take two forms. The lender might foreclose on the property. The borrower would raise a defense of state restrictions on the enforcement of the due-on-sale clause, and the lender would counter with the pre-emption argument.⁵⁴ Alternatively, the borrower or his purchaser facing the threat of foreclosure might sue in a state court for declaratory or injunctive relief based on the state restrictions, and the lender would raise

48. *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 738 (1824).

49. *See* 117 Cong. Rec. 15,089 (1971) (remarks of Sen. Burdick).

50. Act of Dec. 1, 1980, Pub. L. No. 96-486, § 2(a), 94 Stat. 2369 (1980).

51. *T.B. Harms Co. v. Eliscu*, 339 F.2d 823, 825 (2d Cir. 1964) (Court has "long given a narrower meaning to the 'arising under' language" than *Osborn* suggested).

52. *American Well Works Co. v. Layne & Bowler Co.*, 241 U.S. 257, 260 (1916).

53. *Gully v. First Nat'l Bank*, 299 U.S. 109, 112-13 (1936) (citations omitted).

54. *See, e.g., Panko v. Pan Am. Fed. Sav. & Loan Ass'n*, 149 Cal. App. 3d 916, 174 Cal. Rptr. 240 (1981), *appeal docketed*, No. 81-922 (U.S. Dec. 11, 1981); *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

the pre-emption defense.⁵⁵ The borrower or his purchaser can establish his prima facie case fairly easily. He need show only that the loan instrument contained a due-on-sale clause, that the borrower attempted to transfer the property, and that the lender invoked or threatened to invoke the clause. State restrictions force the lender to prove that the transfer would impair his security or that acceleration otherwise would not be inequitable or an unreasonable restraint on alienation. The state courts have not been receptive to lenders' pre-emption arguments. If a state court rejects the argument, the lender's only avenue of appeal is through the state court system, with final appeal to the United States Supreme Court.

Federal question jurisdiction exists in neither of the two forms of litigation discussed above, because neither satisfies the Holmes creation test or the Cardozo essential element test for the "arising under" standard. The claim for relief is based on state foreclosure law or state due-on-sale clause restrictions. Federal pre-emption is interjected only as a defense, in anticipation or avoidance of arguments based on state law.⁵⁶ A stronger case for federal question jurisdiction would exist if the complaint directly challenged the constitutionality of the HOLA.⁵⁷ Cases to the contrary ignore⁵⁸ or assume away the issue.⁵⁹

Typical federal litigation also may take two forms. The lender may seek declaratory relief in a federal district court. Alternatively, the lender, as defendant in a state suit, may seek removal to a federal court.

In the first form, the lender alleges that the action arises under the HOLA and the supremacy clause of the United States Constitution. The lender asks the federal court to declare that federal regulations pre-empt state laws and exclusively govern the validity and exercise of the due-on-sale clause. Because the Declaratory Judgment Act⁶⁰ expands only the remedies available in, and not the jurisdiction of, the federal courts,⁶¹ the court must find an independent source of jurisdiction.⁶²

55. See, e.g., *de la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n*, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), *probable jurisdiction noted*, No. 81-750 (U.S. Jan. 25, 1982); *Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n*, 308 N.W.2d 471 (Minn. 1981).

56. See *Louisville & N.R.R. v. Mottley*, 211 U.S. 149 (1908).

57. See *Smart v. First Fed. Sav. & Loan Ass'n*, 500 F. Supp. 1147, 1161-62 (E.D. Mich. 1980).

58. *Lindenberg v. First Fed. Sav. & Loan Ass'n*, No. 80-983A (N.D. Ga. Dec. 8, 1981).

59. See *Williams v. First Fed. Sav. & Loan Ass'n*, 651 F.2d 910, 912 n.2 (4th Cir. 1981). See also *Trent Realty Assocs. v. First Fed. Sav. & Loan Ass'n*, 657 F.2d 29, 34-35 (3d Cir. 1981) (criticizes *Williams*).

60. 28 U.S.C. §§ 2201-2202 (1976 & Supp. III 1979).

61. *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 240 (1937).

62. For a case in which the court erroneously based its jurisdiction on the

In *Skelly Oil Co. v. Phillips Petroleum Co.*,⁶³ a case concerning the validity of certain contracts for the purchase of natural gas, the Supreme Court said that if the declaratory plaintiff had sued for specific performance or damages, the case would have been decided under state law. By seeking a declaratory judgment, the plaintiff only injected federal law in anticipation of a defense.⁶⁴ Thus, no federal question jurisdiction existed. The same conclusion was reached above in the discussion of borrower suits for declaratory relief,⁶⁵ and the same is true in lender suits in federal court for declaratory relief.⁶⁶ The lender injects federal law only in anticipation of the borrower's defense of state restrictions on the enforcement of due-on-sale clauses.⁶⁷

In *Twin City Federal Savings & Loan Association v. Gelhar*,⁶⁸ the United States District Court for the District of Minnesota concluded that pre-emption is always defensive, even if asserted in the plaintiff's complaint, and thus cannot support federal question jurisdiction.⁶⁹ The court also stated that even if it had jurisdiction, pre-emption suits by lenders were not appropriate cases for exercise of the court's discretion to grant declaratory relief.⁷⁰ A declaratory

Declaratory Judgment Act, see *First Fed. Sav. & Loan Ass'n v. Peterson*, 516 F. Supp. 732 (N.D. Fla. 1981).

63. 339 U.S. 667 (1950).

64. *Id.* at 672.

65. See note 56 and accompanying text *supra*.

66. See *California Fed. Sav. & Loan Ass'n v. Horn*, No. CV 76-238-WMB (C.D. Cal. Feb. 28, 1979).

67. See *Phillips Petroleum Co. v. Texaco, Inc.*, 415 U.S. 125, 127-28 (1974) (per curiam) (footnote omitted). *Public Serv. Comm'n v. Wycoff Co.*, 344 U.S. 237 (1952), is a case often misconstrued in pre-emption cases. Wycoff sought to avoid state regulation of its transportation business by seeking a declaratory judgment that Congress had pre-empted state regulation of the field. The Supreme Court found no case or controversy and suggested in dictum that even if the case were ripe, no federal question jurisdiction existed. "Federal courts will not seize litigations from state courts merely because one, normally a defendant, goes to federal court to begin his federal law defense before the state court begins the case under state law." *Id.* at 248 (dictum) (footnote omitted). In *Conference of Fed. Sav. & Loan Ass'ns v. Stein* ("Conference I"), 604 F.2d 1256 (9th Cir. 1979), *aff'd mem.*, 445 U.S. 921 (1980), a case involving state anti-redlining regulations, the court incorrectly assumed from *Wycoff* that once a case or controversy is found in a pre-emption case, federal question jurisdiction automatically follows. 604 F.2d at 1259. *Accord*, *First Fed. Sav. & Loan Ass'n v. Greenwald*, 591 F.2d 417, 423 n.8 (1st Cir. 1979) (dictum). This analysis confuses ripeness with "arising under" federal law. See *Smart v. First Fed. Sav. & Loan Ass'n*, 500 F. Supp. 1147 (E.D. Mich. 1980). Indeed, the *Wycoff* Court recognized that the case or controversy inquiry is distinct from the federal question requirement. 344 U.S. at 246 (dictum).

68. 525 F. Supp. 802 (D. Minn. 1981).

69. *Id.* at 804 (citing *Home Fed. Sav. & Loan Ass'n v. Insurance Dept.*, 571 F.2d 423 (8th Cir. 1978)).

70. 525 F. Supp. at 804.

judgment should be granted only when it would serve a useful purpose by terminating the controversy in a manner that would clarify and settle legal relations.⁷¹ In these lender actions, a declaratory judgment would not terminate the controversy but would only preface foreclosure under state law, especially when the lender's complaint evinces an intention to foreclose and essentially asks for a declaration of his right to prevail in the foreclosure action. The court concluded:

[W]hile the availability of another remedy does not preclude declaratory relief in appropriate cases, where that other remedy can afford more effective relief, an action for declaratory relief should not be entertained. . . . In this instance, direct, appropriate and complete relief can be afforded in the state court foreclosure proceedings.⁷²

The second form of federal litigation is removal by the defendant lender of the borrower's or purchaser's state court action. Removal jurisdiction, like that for declaratory judgments, is dependent on original federal subject matter jurisdiction.⁷³ Thus, absent diversity of the parties, the federal question issues discussed above apply. The defendant cannot create removal jurisdiction by raising the federal question in his petition for removal because the federal question must be disclosed in the complaint, unaided by the answer or petition for removal.⁷⁴

In *Bailey v. First Federal Savings & Loan Association*,⁷⁵ the United States District Court for the District of Illinois made an erroneous distinction between raising a federal defense in anticipation of a state claim and raising federal pre-emption. The court explained:

This case is to be distinguished from one in which a federal question is asserted as a defense, or by plaintiff in anticipation of a defense When the complaint discloses, however, as it does here, a controversy in an area in which federal law has pre-empted state law, a federal question is necessarily implicit in the complaint. . . . Because the regulation of federal savings and loan associations is such a pre-empted area, the complaint necessarily presents a federal question⁷⁶

In another removal case, the United States District Court for the Eastern District of Michigan correctly responded to the *Bailey* distinction:

71. *Public Serv. Comm'n v. Wycoff Co.*, 344 U.S. 237, 241 (1952); *Alsager v. District Court*, 518 F.2d 1160, 1163-64 (8th Cir. 1975).

72. 525 F. Supp. at 804-05 (citations omitted). The United States Court of Appeals for the Ninth Circuit recently reversed, on other jurisdictional grounds, two cases factually similar to *Twin City* in which the lower courts found pre-emption. See cases cited note 4 *supra*.

73. See note 44 and accompanying text *supra*.

74. *Gully v. First Nat'l Bank*, 299 U.S. 109 (1936).

75. 467 F. Supp. 1139 (C.D. Ill. 1979).

76. *Id.* at 1141-42 (citations omitted).

The difficulty with these cases is that they make an irrelevant distinction between the ordinary federal question defense . . . and the federal preemption defense Under the first situation there would be no removal jurisdiction but under the second there would be removal jurisdiction according to these cases. The court can see no rationale for making this distinction and it declines to do so.⁷⁷

In *Trent Realty Associates v. First Federal Savings & Loan Association*,⁷⁸ the United States Court of Appeals for the Third Circuit applied the correct reasoning. The purchaser had sued in a New Jersey state court for declaratory and monetary relief after he had agreed to pay off the principal and to pay into escrow a demanded interest penalty. The lender removed the suit to the federal district court, claiming diversity and federal question jurisdiction. The district court refused to remand the case to the state court. The court of appeals found no federal question jurisdiction and seriously doubted the diversity claim, which was remanded to the district court for further inquiry. The lender maintained that federal question jurisdiction existed because the plaintiff's state court complaint raised substantial issues of federal law: it concerned the activities of a federal association governed by the HOLA and regulated by the Board pursuant to the HOLA. The lender argued that the complaint implicitly challenged the federal right to impose an acceleration charge.⁷⁹ Admitting that no clear test for "arising under federal law" exists, the court of appeals concluded that the most widely followed test was a summarization by Professor Mishkin: for original federal question jurisdiction there must be a *substantial* claim founded *directly* on federal law.⁸⁰ This test differs little from the Cardozo essential element test. The court restated that the federal question must appear on the face of the complaint and cannot anticipate a state law claim because "'[n]ot every question of federal law emerging in a suit is proof that a federal law is the basis of the suit.'" ⁸¹ The traditional analytical framework applies to a declaratory judgment action.⁸² To hold otherwise would allow artful pleading to provide federal question jurisdiction in contravention of the whole trend of Congress' jurisdictional legislation, would disregard the effective functioning of the judicial system, and would distort the limited purpose of the Declaratory Judgment Act.⁸³ The court of appeals found that the plaintiff's

77. *Johnson v. First Fed. Sav. & Loan Ass'n*, 418 F. Supp. 1106, 1109 (E.D. Mich. 1976).

78. 657 F.2d 29 (3d Cir. 1981).

79. *Id.* at 32.

80. *Id.*; Mishkin, *The Federal "Question" in the District Courts*, 53 COLUM. L. REV. 157, 168 (1953).

81. 657 F.2d at 32-33 (quoting *Gully v. First Nat'l Bank*, 299 U.S. 109, 115 (1936)).

82. 657 F.2d at 33.

83. *Id.* (citing *Skelly Oil Co. v. Phillips Petroleum Co.*, 339 U.S. 667, 673-74 (1950)).

complaint was based solely on state law. Thus, even assuming that federal regulations did pre-empt state law, no federal question jurisdiction existed.⁸⁴

The United States Court of Appeals for the Ninth Circuit also dashed lenders' hopes for a federal court of appeals' finding of pre-emption in *Nalore v. San Diego Federal Savings & Loan Association*.⁸⁵ The Nalores purchased property subject to a loan with a due-on-sale clause and refused the lender's demand for a higher interest rate. The lender exercised the due-on-sale clause. The Nalores sought declaratory and injunctive relief in a California state court and obtained a temporary restraining order enjoining foreclosure. The lender removed the case to the federal district court, asserting federal question jurisdiction and pre-emption. The district court denied the plaintiff's motion for remand, denied a request for injunctive relief, found federal pre-emption, and granted summary judgment for the lender. The court of appeals found *Guinasso v. Pacific First Federal Savings & Loan Association*,⁸⁶ a case decided by the court two days earlier, dispositive. The Nalore's complaint, like that in *Guinasso* to recover interest on escrow accounts, relied solely on state law; the federal pre-emption argument was merely a defense.⁸⁷ Under the Cardozo test, a substantial proposition of federal law did not form "a direct and essential element of the plaintiff's cause of action."⁸⁸ Federal question jurisdiction could not rest on proposi-

84. See also *Gully v. First Nat'l Bank*, 299 U.S. 109, 117 (1936), in which Justice Cardozo wrote:

The most one can say is that a question of federal law is lurking in the background, just as farther in the background there lurks a question of constitutional law, the question of state power in our federal form of government. A dispute so doubtful and conjectural, so far removed from plain necessity, is unavailing to extinguish the jurisdiction of the states.

The *Trent Realty Associates* court also rejected, on the basis of *Louisville & N.R.R. v. Mottley*, 211 U.S. 149 (1908), several cases suggesting that, "notwithstanding plaintiff's failure to plead a federal question or base its action on a federal statute or regulation, a federal court will have removal jurisdiction if federal laws are necessarily brought into play." 657 F.2d at 35. Those rejected cases were *Bailey v. First Fed. Sav. & Loan Ass'n*, 467 F. Supp. 1139 (C.D. Ill. 1979); *First Fed. Sav. & Loan Ass'n v. First Fed. Sav. & Loan Ass'n*, 446 F. Supp. 210 (N.D. Ala. 1978); and *Rettig v. Arlington Heights Fed. Sav. & Loan Ass'n*, 405 F. Supp. 819 (N.D. Ill. 1975).

85. 663 F.2d 841 (9th Cir. 1981), *cert. denied*, 50 U.S.L.W. 3765 (U.S. Mar. 22, 1982).

86. 656 F.2d 1364 (9th Cir. 1981), *cert. denied*, 50 U.S.L.W. 3765 (U.S. Mar. 22, 1982).

87. *Nalore v. San Diego Fed. Sav. & Loan Ass'n*, 663 F.2d at 842 (citing *Guinasso v. Pacific First Fed. Sav. & Loan Ass'n*, 656 F.2d at 1367).

88. *Guinasso v. Pacific First Fed. Sav. & Loan Ass'n*, 656 F.2d at 1366 (quoting *Smith v. Grimm*, 534 F.2d 1346, 1350 (9th Cir.), *cert. denied*, 429 U.S. 980 (1976)).

tions merely anticipating a federal defense.⁸⁹

Nalore suggests a shift in the ninth circuit court of appeals' approach to federal question cases. The court had held earlier in *Meyers v. Beverly Hills Federal Savings & Loan Association*⁹⁰ that federal law pre-empted California restrictions on the enforcement of prepayment penalties.⁹¹ As in *Nalore* and *Guinasso*, the lender in *Meyers* had removed a state action to a federal court. Unlike *Nalore* and *Guinasso*, the court in *Meyers* did not deal with the removal jurisdiction issue. The lender in *Guinasso* suggested that *Meyers* implicitly authorized removal of all cases in which a federal savings and loan association asserts a pre-emption defense. Because jurisdiction was not discussed in *Meyers*, the *Guinasso* court rejected the suggested implication.⁹²

In summary, recent lower federal court decisions have not been favorable to the federal associations.⁹³ The ninth circuit court of appeals has reversed, *sub silentio*, its former approach to federal question cases. The reasoning of decisions holding that state courts are the proper forums has substantial Supreme Court support. The principles of federalism are served well by these decisions, as state courts can decide pre-emption questions and apply state law if appropriate. This privilege of the state courts is not lightly abrogated in favor of the district court. It also may be argued that if the federal courts were to be the proper forums for the pre-emption arguments, the Constitution and jurisdiction statutes would have provided for exclusive federal jurisdiction. Finally, the remand decisions are reviewable only through the state court system, with final appeal to the Supreme Court.⁹⁴

III. SUBSTANTIVE BASES OF PRE-EMPTION

Pre-emption stems from the supremacy clause of the Federal Constitution,⁹⁵ which declares that the Constitution and federal laws enacted pursuant to it shall be the supreme law of the land. The federal system has a central government of limited, albeit sometimes exclusive, powers. While

89. *Guinasso v. Pacific First Fed. Sav. & Loan Ass'n*, 656 F.2d at 1366 (citations omitted).

90. 499 F.2d 1145 (9th Cir. 1974).

91. *Id.* at 1147.

92. *Guinasso v. Pacific First Fed. Sav. & Loan Ass'n*, 656 F.2d at 1366. The lender also asserted that the court's earlier finding of federal question jurisdiction in *Conference of Fed. Sav. & Loan Ass'ns v. Stein* ("Conference I"), 604 F.2d 1256 (9th Cir. 1979), *aff'd mem.*, 445 U.S. 921 (1980), supported federal question jurisdiction in *Guinasso*. The court improperly distinguished *Conference I* by noting that in that case the court found a case or controversy, whereas the plaintiff in *Guinasso* did not rely on federal law. See 656 F.2d at 1367 n.10. The court confused ripeness with the concept of "arising under" federal law. See note 67 *supra*.

93. *But see Price v. Florida Fed. Sav. & Loan Ass'n*, 524 F. Supp. 175 (M.D. Fla. 1981).

94. 28 U.S.C. § 1447(d) (1976).

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

federal law sometimes occupies a field so completely that it excludes all state participation, it usually builds on legal relationships already established by the states, altering and supplanting them only as necessary for federal purposes.⁹⁶ This concept acknowledges the federal government's humble origins: the states ceded power to create a central government—the central government did not create the states. When laws of the two sovereigns conflict, federal law controls if the contradiction is strong enough to trigger the supremacy clause. The pre-emption inquiry is whether Congress' purpose expressly or implicitly requires subordination of state policy.

Federal laws must be enacted pursuant to the federal government's constitutional powers to have pre-emptive effect. Recent due-on-sale clause cases dispute the constitutionality of the federal regulations because of disagreement over what Congress could empower the Board to do, what Congress actually empowered the Board to do, and what the Board purports to do. Expansive interpretations of the general welfare clause, the necessary and proper clause, and the commerce clause of the Constitution have permitted Congress to govern many aspects of modern life. Although the Constitution does not specifically authorize Congress to charter and regulate financial institutions, Congress' power to do so has remained undisputed for the more than 160 years since *McCulloch v. Maryland*.⁹⁷ The Supreme Court in *McCulloch* recognized the importance of allowing Congress implied powers to implement express powers. This rationale justified Congress' creation of a bank to aid federal fiscal operations. *McCulloch* has been used several times to uphold the constitutionality of the HOLA.⁹⁸ Congress' establishment of the federal savings and loan system and regulation of that system by the Board have been justified under the general welfare clause.⁹⁹

The problem in the pre-emption cases is whether Congress expressly or implicitly authorized the Board to displace state due-on-sale clause restrictions that are grounded in property, contract, and equity jurisprudence. Does an agency with the power to grant federal charters and regulate the associations also have the power to abrogate entire areas of state law?

Certain principles apply to all pre-emption cases. State law governs the acquisition, transmission, and transfer of property and defines the rights

96. P. BATOR, P. MISHKIN, D. SHAPIRO & H. WECHSLER, *HART & WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 470-71 (2d ed. 1973).

97. 17 U.S. (4 Wheat.) 316 (1819).

98. *Fahey v. Mallonee*, 332 U.S. 245, 250 (1947); *United States v. Kay*, 89 F.2d 19, 21-22 (2d Cir. 1937); *People v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311 (S.D. Cal. 1951).

99. *First Fed. Sav. & Loan Ass'n v. Loomis*, 97 F.2d 831, 839 (7th Cir. 1938), *cert. denied*, 305 U.S. 666 (1939); *Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n*, 499 F.2d 1145, 1146 (9th Cir. 1974).

of its owners relative to the state or to private parties.¹⁰⁰ “Even when federal [common] law was in its heyday, an exception was carved out for local laws of real property.”¹⁰¹ Likewise, commercial agreements generally are governed by state law.¹⁰² When the states traditionally have governed the field in question, the Supreme Court assumes that federal law will not supersede the historic police powers of the states unless that was the clear and manifest purpose of Congress.¹⁰³ This assures that the federal-state balance will not be disturbed unintentionally by Congress or unnecessarily by the courts.¹⁰⁴ The clear and manifest purpose of Congress is the ultimate touchstone because “[t]he exercise of federal supremacy is not lightly to be presumed” and is not to be found on the basis of superficial analysis or imaginary conflicts.¹⁰⁵ An express statement of pre-emption would meet this requirement, but often Congress neglects to state clearly in its legislation whether it intends to pre-empt state laws.

When Congress fails to express its intent, a clear and manifest purpose still may be implied.¹⁰⁶ First, the scheme of federal regulation may be so pervasive that it is reasonable to conclude that Congress excluded the states completely. Second, an act might touch a field in which the federal interest is so dominant that it is reasonable to conclude that Congress intended that only federal law apply. Third, even if Congress has not completely foreclosed state law in an area, state law is void to the extent it conflicts with a valid federal law.

Recent decisions suggest that the courts will construe conflicts as narrowly as possible,¹⁰⁷ illustrating the trend of the Burger Court to reconcile the operation of state and federal provisions when possible.¹⁰⁸ Sound policy reasons support the Court’s narrow pre-emption principles. Congress can change by legislation the result of an erroneous finding of no pre-emption, but states cannot correct erroneous findings of pre-emption.

A. *Express Pre-emption by Legislation and Regulation*

Congress may have expressly pre-empted state restrictions of the exer-

100. *State Land Bd. v. Corvallis Sand & Gravel Co.*, 429 U.S. 363, 378-79 (1977).

101. *United States v. Little Lake Misere Land Co.*, 412 U.S. 580, 591 (1973).

102. *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257, 262 (1979).

103. *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

104. *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).

105. *New York State Dep’t of Social Servs. v. Dublino*, 413 U.S. 405, 413 (1973).

106. *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 132 (1978) (The Supreme Court is, however, “generally reluctant to infer pre-emption.”).

107. *Id.*; *First Fed. Sav. & Loan Ass’n v. Peterson*, 516 F. Supp. 732, 737 (N.D. Fla. 1981).

108. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 127 (1973).

cise of due-on-sale clauses by passing the HOLA, which authorized the Board to regulate the organization, incorporation, examination, and operation of federal associations.¹⁰⁹ One federal court has declared that the HOLA allows the Board to govern the entire range of federal association activities because the HOLA did not provide for sharing the Board's authority with state agencies.¹¹⁰ This statement may be correct regarding regulation of purely internal operations of the associations, but it overstates Congress' delegation of other powers to the Board. Merely because Congress gave the Board plenary authority to regulate federally chartered associations does not mean that, by virtue of a federal charter, a federal association need not abide by the real property and mortgage laws of the state in which it does business.

Congress probably did not intend to give the Board the power to suspend these substantive state laws. First, the HOLA's preamble states that the legislative purpose was to respond to an economic emergency: to extend relief to home owner-occupants who were unable to amortize their debts elsewhere.¹¹¹ The HOLA states that it was passed to provide home financing and to create local mutual thrift institutions.¹¹² It suggests nothing regarding suspending substantive state law. Federal associations are not immune from all state laws. Congress has specified areas in which substantive state law governs federal associations.¹¹³ The Board's power was to be similar to that given the Comptroller of the Currency regarding national banks, which generally is not pre-emptive regarding the enforceability of loan contracts.¹¹⁴ The first chairman of the Board told a House committee that the Board would be cautious in authorizing federal associations to conduct activities not authorized by state law. Federal associations would have no more authority than state associations, and the Board would subject federal associations to the same limitations applied to state associations. The chairman finally said that the Board wanted the latitude to fit the regulations to state law.¹¹⁵ A

109. 12 U.S.C. § 1464(a) (Supp. IV 1980).

110. *People v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311, 316 (S.D. Cal. 1951).

111. Home Owners Loan Act of 1933, ch. 64, Preamble, 48 Stat. 128 (1933).

112. 12 U.S.C. § 1464(a) (Supp. IV 1980). *See* 77 Cong. Rec. 2,480 (1933) (remarks of Rep. Luce). At that time, one-half of all counties contained no savings and loan associations, thrift institutions, or insurance companies. *Id.*

113. Federal associations are subject to state taxes not exceeding those assessed state associations. 12 U.S.C. § 1464(h) (1976).

114. 77 Cong. Rec. 4,987 (1933) (remarks of Sen. Bulkley). Recently, however, the power of the Comptroller of the Currency to regulate adjustable rate mortgage practices of national banks, even though such regulations might displace inconsistent state laws, including due-on-sale laws, was upheld. *See* Conference of State Bank Supervisors v. Lord, Civil Action No. 81-1591 (D.D.C. Feb. 11, 1982).

115. *Hearings on HOLA, S. 1317, Before a Subcomm. of Senate Comm. on Banking & Currency*, 73d Cong., 1st Sess. 11-12 (Apr. 20, 1933) (statement of William F. Stevenson, Chairman, FHLBB).

general counsel of the Board who helped draft the HOLA told a Senate committee that the bill was to protect homeowners, not investors.¹¹⁶ Pre-emption would deprive homeowners of perceived state consumer protections.

Some attorneys have tried to use a 1978 branching amendment¹¹⁷ to the HOLA as evidence of Congress' reaffirmation of its intent of pre-emption. A colloquy between Senators Brooke and Proxmire suggested that the Board's power is plenary over activities such as branching, antidiscrimination, and lending authority.¹¹⁸ Attorneys for lenders and the Board used this interchange in briefs as authority for the proposition that Congress reaffirmed the intent to give the Board supremacy under the HOLA. Senator Proxmire publicly disapproved this use of his remarks as a misinterpretation of their basis and intent.¹¹⁹

The final argument for express pre-emption under the HOLA is based on the "best practices" language of the HOLA. That provision allows the Board, in chartering and regulating new associations, to give "primary consideration to the best practices of local mutual thrift and home financing institutions in the United States."¹²⁰ One court interpreted this language to mean that the Board can determine what the best practices are, regardless of state practices, and implement these federally ordained practices nationally on a uniform basis.¹²¹ This analysis assumes that the "best practices" language grants exclusive governing powers, rather than merely providing standards for the enactment of regulations. This assumption is invalid because it conflicts with other bases of the Board's authority. For example, the Board is authorized to examine state laws concerning conveyances, recording of land titles, and enforcement of mortgage holders' rights. If the Board finds that state law inadequately protects advances made by the Board or by member or nonmember banks, the Board can limit or withhold operations in that state until the state laws is changed to the Board's satisfaction.¹²² The HOLA did not authorize the Board to pre-empt objectionable substantive state laws governing mortgagees' rights.

In summary, the language and history of the HOLA only weakly support express pre-emption by Congress, whether by outright statement or by delegation of power to the Board. If Congress did not intend pre-emption,

116. *Id.* (statement of Horace Russell, General Counsel FHLBB, Atlanta, Georgia).

117. Financial Institutions Regulatory and Interest Rate Control Act of 1978, § 1202, 12 U.S.C. § 1464(a) (Supp. IV 1980).

118. 124 Cong. Rec. 18,471-72 (1978) (remarks of Sen. Brooke & Sen. Proxmire).

119. 125 Cong. Rec. 2,166 (1979) (remarks of Sen. Proxmire).

120. 12 U.S.C. § 1464(a) (Supp. IV 1980).

121. *Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 377 F. Supp. 11, 17-18 (N.D. Ill. 1974).

122. 12 U.S.C. § 1428 (1976).

the Board's regulations are invalid to the extent they purport to pre-empt state law.

Even if the Board properly could pre-empt state law, problems exist in the Board's attempt to provide for pre-emption of state laws through the promulgation of regulations. Section 545.8-3¹²³ contains no express language of pre-emption. Pre-emption is mentioned only in a preamble to the regulation.¹²⁴ Preambles do not have the force of law because they are not rules affecting individual rights or obligations.¹²⁵ This introductory language was not enacted pursuant to the procedural requirements of the Administrative Procedure Act¹²⁶ for the promulgation of regulations.¹²⁷

The Board contends that the language in section 545.8-3(a)¹²⁸ requiring "full protection" to associations authorizes the use of due-on-sale clauses.¹²⁹ Yet, the regulation mentions protections relating to recording, insurance, taxes, government levies, maintenance, repairs, and assignments of rent, without mentioning contract terms that displace state laws. Additionally, due-on-sale clauses are not of the same genus as those protections listed.¹³⁰ The section does provide that loan contracts "shall comply with applicable provisions of law."¹³¹ Is the applicable law state law or state law as pre-empted by federal law? One court concluded that the word "federal" must be read into regulations that ambiguously refer to "statutes" or "applicable laws."¹³²

Finally, the *Schott Advisory Opinion*¹³³ and section 556.9(f)¹³⁴ contain express language of pre-emption, but the weight of their authority is not great. Courts rarely respect clear expressions of agency intent to supersede or preserve state laws.¹³⁵ An agency opinion is not decisive; its weight turns on the circumstances surrounding promulgation.¹³⁶ Courts may give less

123. 12 C.F.R. § 545.8-3 (1981).

124. 41 Fed. Reg. 18,286-87 (1976).

125. See *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979).

126. 5 U.S.C. § 553 (1976).

127. For example, the preamble that appeared in the first publication of the proposed regulation was not the same as that which appeared in the adopted regulation. Compare 41 Fed. Reg. 6,283 (1976) with *id.* at 18,286.

128. 12 C.F.R. § 545.8-3(a)(1981).

129. *Schott Advisory Op.*, Res. No. 75-657, at 15 (F.H.L.B.B. July 30, 1975).

130. *Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n*, 308 N.W.2d 471, 477 (Minn. 1981).

131. 12 C.F.R. § 545.8-3(a) (1981).

132. *Kaski v. First Fed. Sav. & Loan Ass'n*, 72 Wis. 2d 132, 138, 240 N.W.2d 367, 371 (1974).

133. Res. No. 75-657, at 13-14 (F.H.L.B.B. July 30, 1975).

134. 46 Fed. Reg. 39,124 (1981) (to be codified in 12 C.F.R. § 556.9(f)).

135. *Hirsh, Towards a New View of Federal Preemption*, 1972 U. ILL. L.F. 515, 521.

136. *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

weight to opinions issued in response to a particular controversy, as was the *Schott Advisory Opinion*. The Board views section 556.9(f) only as a general statement of policy and, therefore, did not promulgate it according to the notice and public comment procedures used for the promulgation of regulations.¹³⁷ Thus, the section cannot add much new to the law.

B. *Implied Pre-emption*

In the absence of express pre-emption, the satisfaction of one of three tests indicates implied pre-emption. First, does federal law occupy the field so pervasively that it is reasonable to conclude that Congress intended pre-emption of state law?¹³⁸ Second, is the federal interest in the field so dominant that it is reasonable to conclude that Congress intended that only federal law apply?¹³⁹ Third, do state and federal laws in the field conflict?¹⁴⁰

Pre-emption under the first test requires an intent to enter the field of regulation, which is evident from the HOLA, and an intent to displace all state legislation.¹⁴¹ If federal law occupies only part of the field, state law outside that limited field is not displaced unless otherwise impermissible.¹⁴² Federal supremacy should not unduly restrict the ability of the courts to protect important state interests.¹⁴³ These narrow formulations led one state court to conclude that the occupation concept was losing ground as a pre-emption method.¹⁴⁴ Proper application of the occupation concept requires defining the proper field. Different conclusions may result depending on whether the field is the regulation of the internal affairs of federal associations or substantive state law.

Courts consistently find regulatory schemes pervasive enough to displace state attempts to regulate the internal affairs of federal associations, even when no federal regulation is on point.¹⁴⁵ One court found displacement of

137. 46 Fed. Reg. 39,124 (1981) (to be codified in 12 C.F.R. § 556.9(f)).

138. See, e.g., *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 157-58 (1978).

139. See, e.g., cases cited notes 161-63 *infra*.

140. See, e.g., *De Canas v. Bica*, 424 U.S. 351, 357-58 (1976).

141. *N.Y. State Dep't of Social Servs. v. Dublino*, 413 U.S. 405, 413 (1973).

142. *Kelly v. Washington ex rel. Foss Co.*, 302 U.S. 1, 10 (1937).

143. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 139-40 (1973).

144. *Derenco, Inc. v. Benjamin Franklin Fed. Sav. & Loan Ass'n*, 281 Or. 542, 577 P.2d 477, 484, *cert. denied*, 439 U.S. 1051 (1978).

145. *Murphy v. Colonial Fed. Sav. & Loan Ass'n*, 388 F.2d 609, 612 (2d Cir. 1967) (by implication); *Rettig v. Arlington Heights Fed. Sav. & Loan Ass'n*, 405 F. Supp. 819, 823 (N.D. Ill. 1975); *City First Fed. Sav. & Loan Ass'n v. Crowley*, 393 F. Supp. 644, 654-55 (E.D. Wisc. 1975); *Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 377 F. Supp. 11, 17-18 (N.D. Ill. 1974); *Kaski v. First Fed. Sav. & Loan Ass'n*, 72 Wis. 2d 132, 139, 240 N.W.2d 367, 370 (1976). For cases in which a court properly found pre-emption based on a direct conflict between state law and a federal regulation on point, see *First Fed. Sav. & Loan Ass'n v. Green-*

state law and then implied a federal right to inspect an association's shareholder list from a regulation allowing members to vote by proxy.¹⁴⁶ Another court held a HOLA provision¹⁴⁷ broad enough to displace state restrictions on branch banking, even though the federal regulations at that time did not mention branch banking.¹⁴⁸

The Board has tried to read the "internal affairs" concept broadly enough to find implied pre-emption in the due-on-sale clause cases. In the *Schott Advisory Opinion*,¹⁴⁹ the Board made the following argument. First, all borrowers are either members or potential members of the associations.¹⁵⁰ Second, membership can give a borrower voting rights.¹⁵¹ Third, uniform bylaws prescribed by the Board allow associations to reject applications for membership.¹⁵² Therefore, the Board concludes, the right of a purchaser to become a member of an association by assuming a loan is an internal affair of the association, which is governed exclusively by federal law.¹⁵³ This argument breaks down when the party assuming the loan is already a member of the association. The logical consequences of this argument also show its weakness. If the due-on-sale clause issue is an internal matter, all disputes would have to be handled through internal procedures¹⁵⁴ before resort to the courts.¹⁵⁵ The Board's chief function, however, as an administrative body is oversight, not dispute resolution. Also, including the due-on-sale clause issue within the internal affairs concept extends the concept beyond its traditional bounds of government of the relations among directors, officers, members, and associations.¹⁵⁶

wald, 591 F.2d 417, 423 n.8 (1st Cir. 1979); Conference of Fed. Sav. & Loan Ass'ns v. Stein ("Conference I"), 604 F.2d 1256, 1260 (9th Cir. 1979), *aff'd mem.*, 445 U.S. 921 (1980).

146. *Murphy v. Colonial Fed. Sav. & Loan Ass'n*, 388 F.2d 609, 611-12 (2d Cir. 1967).

147. 12 U.S.C. § 1464(a) (Supp. IV 1980).

148. *Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 377 F. Supp. 11, 17-18 (N.D. Ill. 1974).

149. Res. No. 75-647, at 18 (F.H.L.B.B. July 30, 1975).

150. 12 U.S.C. § 1464(b)(1) (Supp. IV 1980).

151. *Id.*

152. *Schott Advisory Op.*, Res. No. 75-647, at 18 (F.H.L.B.B. July 30, 1975).

153. *Id.*

154. 12 U.S.C. § 1464(d)(2)(A) (Supp. IV 1980); 12 C.F.R. § 508.13 (1981).

155. *See, e.g.*, *First Nat'l Bank v. Board of County Comm'rs*, 264 U.S. 450, 453-54 (1923); *Home Loan Bank Bd. v. Mallonee*, 196 F.2d 336, 366 (9th Cir. 1952); *California v. Coast Fed Sav. & Loan Ass'n*, 98 F. Supp. 311, 317 (S.D. Cal. 1951).

156. *See, e.g.*, *Murphy v. Colonial Fed. Sav. & Loan Ass'n*, 388 F.2d 609 (2d Cir. 1966); *Rettig v. Arlington Heights Fed. Sav. & Loan Ass'n*, 405 F. Supp. 819 (N.D. Ill. 1975); *City Fed. Sav. & Loan Ass'n v. Crowley*, 393 F. Supp. 644 (E.D. Wis. 1975); *Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 377 F. Supp. 11 (N.D. Ill. 1974).

Cases holding that all regulation of loan practices directly affects the internal affairs of associations can be distinguished.¹⁵⁷ First, most due-on-sale clause restrictions are substantive, not regulatory. Second, these cases state that federal associations are by law instrumentalities of the federal government. If this were true, the federal question jurisdiction debate probably would not exist¹⁵⁸—Congress would not have made jurisdiction based on the federal status of the association so difficult to achieve.¹⁵⁹ Even if the associations were federal instrumentalities, substantive state law would apply unless it prevented the associations from discharging duties owed directly to the federal government.¹⁶⁰

The occupation of the field doctrine should not be applied so loosely to the HOLA that it confuses the Board's plenary authority to regulate and control federal associations, which no one questions, with congressional intent to supplant every state law of real property and mortgages, areas of fundamental and traditional state concern.

Under the second implied pre-emption test, state law is pre-empted in fields in which the federal interest is so dominant that it is reasonable to conclude that Congress intended that only federal law apply. For example, the Court has found implied pre-emption of state laws concerning sedition,¹⁶¹ local restrictions on noise pollution from aircraft,¹⁶² and state interference with Indian affairs.¹⁶³

Congress has a strong interest in the maintenance of the savings and loan system it has created. Its principal interests today are the economic health of the associations and the efficient functioning of the secondary market system. The furtherance of these interests promotes home ownership on a national scale and reduces the risks underwritten by the FSLIC. Savings and loan associations face recurring economic problems of disintermediation and profit squeezes. Congress' attempts to attract deposits to savings and loan associations by fixing the interest rates banks and associations could pay were not successful. When interest rates paid by other institutions exceeded the federal ceiling, disintermediation occurred. Profit squeezes occur when associations must borrow funds at short-term interest rates higher than the rates the associations charge on their loans.

157. See, e.g., *Kaski v. First Fed. Sav. & Loan Ass'n*, 72 Wis. 2d 132, 139-40, 240 N.W.2d 367, 373 (1974).

158. See *Gibson v. First Fed. Sav. & Loan Ass'n*, 347 F. Supp. 560, 563 (E.D. Mich. 1972); *Midwest Fed. Sav. & Loan Ass'n v. Commissioner of Revenue*, 259 N.W.2d 596, 598 (Minn. 1977).

159. See 28 U.S.C. § 1349 (1976).

160. *McClellan v. Chipman*, 164 U.S. 347, 356-57, 359 (1896).

161. *Pennsylvania v. Nelson*, 350 U.S. 497, 505 (1956).

162. *City of Burbank v. Lockheed Air Terminal, Inc.*, 411 U.S. 624, 638-39 (1973).

163. *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136, 152 (1980).

In the past, these problems have strongly supported the need for uniform federal due-on-sale clause policy to infuse new money into thrift institutions. Recent events, as well as Board policy, however, reduce the need for uniformity. Thrift institutions now can compete in the marketplace to attract money. Savings institutions can offer higher interest rates for passbook and retirement accounts and all savers' certificates. Profit squeezes also can be checked without the use of due-on-sale clauses as interest escalators. The Board now authorizes a variety of alternative mortgage instruments, including graduated payment, variable rate, reverse annuity, and renegotiable rate mortgages.¹⁶⁴ Some of these instruments allow for as much as a five percent overall rate change during the term of the loan. As use of these instruments increases, due-on-sale clause enforcement will diminish, along with the problems attending their interpretation and validity.¹⁶⁵ Although conflicting views over their marketability exist,¹⁶⁶ some suggest that short-term, high interest rate instruments are advantageous for most buyers.¹⁶⁷ The new instruments are not as attractive to lenders as escalation at will, but they at least can replace anachronistic fixed rate mortgages in a sound, congressionally sanctioned manner that provides consumers with new marketplace choices. As long as associations have other methods of portfolio adjustment, state restrictions on the enforcement of due-on-sale clauses will not thwart dominant federal interests and objectives. Even under the restrictions, the interest in security protection remains protected, because an association can reject an uncreditworthy purchaser or raise the interest rate as compensation for the increased risk presented by such a purchaser.

The Board's behavior also suggests a reduced need for uniformity of state laws on enforcement of due-on-sale clauses. First, as state courts recently have observed,¹⁶⁸ the Board only permits, not requires, inclusion and exercise of the clause. If the Board considered use of the clause critical to the survival of the system, it would have required inclusion and exercise. Instead, the Board prefers to give lenders flexibility.¹⁶⁹ Second, the Board limits use of the clause,¹⁷⁰ which also undercuts the argument that uniform use is necessary to the survival of the system. Third, the Board has dealt with state laws governing transfers of title and debtor obligations without disrupting the secondary mortgage market. It has approved fifty uniform mortgage instruments that, with nonuniform covenants, are required for ready ac-

164. See 12 C.F.R. §§ 545.6-4, -4a (1981); 46 Fed. Reg. 24,148 (1981). See generally Draper, *Alternative Mortgage Instruments*, REAL ESTATE REV., Fall 1981, at 32.

165. G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 8, § 5.23, at 307.

166. See Kratovil, *supra* note 3, at 306.

167. Beers, *Shorter Mortgage Terms Are Better for Home Buyers*, REAL ESTATE REV., Fall 1981, at 93.

168. See, e.g., *Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n*, 308 N.W.2d 471 (Minn. 1981).

169. 46 Fed. Reg. 39,124 (1981) (to be codified in 12 C.F.R. § 556.9(f)).

170. 12 C.F.R. §§ 545.8-3(g), 556.9(c) (1981).

ceptance in the secondary market.¹⁷¹ Thus, the Board concedes the applicability of some substantive state laws and processes. Fourth, section 545.8-3(f)¹⁷² states that the exercise of the due-on-sale clause is governed generally by the contract, and uniform covenant 15 of the uniform mortgage instruments subjects the instruments to the law of the jurisdiction in which the secured property is located. The Board's approval of the uniform instruments, coupled with section 545.8-3(f), is thus somewhat inconsistent with its position that federal law pre-empts state laws restricting the enforcement of due-on-sale clauses.

Under the third implied pre-emption test, federal law pre-empts state law to the extent the two conflict. The Supreme Court has construed "conflict" narrowly, even in areas of exclusive federal power, such as immigration,¹⁷³ to reconcile both provisions whenever possible. Dual compliance must be a physical impossibility¹⁷⁴ or the state law must be an obstacle to the accomplishment of the full objectives of Congress.¹⁷⁵ No irreconcilable conflict exists between state and federal law of due-on-sale clauses, because the Board does not *require* inclusion, exercise, or enforcement of the clause. These decisions are made by the local associations. Mere federal permission to use the clause does not conflict with state restriction of enforcement of the clause.

IV. CONCLUSION

Savings and loan associations have sought to bring low-yield investment portfolios up to current interest rates by the enforcement of due-on-sale clauses. Property, contract, and equity laws of some states limit this use of due-on-sale clauses. Some of these limitations are very broad, being the products of attempts to protect consumers. Federally chartered associations have claimed, with some success, immunity from these substantive restrictions on the basis of federal pre-emption. Two misconceptions exist in the courts that have found pre-emption. First, the federal courts do not have jurisdiction to decide the pre-emption cases; pre-emption is properly raised only as a defense in a state court, with review in the state court system and,

171. For example, three of the four deeds of trust in *Williams v. First Fed. Sav. & Loan Ass'n*, 651 F.2d 910 (4th Cir. 1981), were FNMA/FHLMC uniform deeds of trust that contained nonuniform notice language required by VA. CODE § 6.1-330.34 (1979). See 651 F.2d at 914-15 nn. 6 & 7. Similarly, the New York uniform instruments comply with the "plain language" requirements of N.Y. GEN. OBLIG. LAW § 5-702 (McKinney Cum. Supp. 1981-1982).

172. 12 C.F.R. § 545.8-3(f) (1981).

173. See, e.g., *De Canas v. Bica*, 424 U.S. 351, 355 (1976).

174. *Florida Lime & Avocado Growers v. Paul*, 373 U.S. 132, 146-47 (1963).

175. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

ultimately, in the Supreme Court.¹⁷⁶ Second, the courts have erred in their findings of pre-emption, mistaking federal power to regulate the internal operations of federal associations for congressional intent to displace substantive state law. Lenders would do better to appeal directly to Congress for a resolution of the pre-emption issue.

176. The Supreme Court has noted probable jurisdiction in *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*. 50 U.S.L.W. 3591 (U.S. Jan. 25, 1982).