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NOTES AND COMMENTS

USE OF “DUE-ON” CLAUSES TO GAIN COLLATERAL BENEFITS: A COMMON-SENSE DEFENSE

Philip S. Ashley

INTRODUCTION

Acceleration clauses, used to protect mortgage lenders from waste, depreciation, and other risks tending to jeopardize a lender’s security, have long been popular. An acceleration clause is a bargained-for element of modern mortgages, promissory notes, and deeds of trust, reserving to the lender the option of declaring, upon the happening of a stated event, the loan balance and accrued interest to be immediately due and owing; in effect, to accelerate the maturity date of the loan.

This comment will discuss two of the many species of acceleration clauses and their use by lenders to maintain lending portfolios at current interest rates. These are the “due-on-sale” clause, triggered when the borrower sells the loan security without the lender’s approval, and the “due-on-encumbrance” clause, whose triggering event is the giving of a junior encumbrance by the borrower without the lender’s consent.

In illustrating a lender’s use of a “due-on” clause the following pre-litigation events are typical: borrower and lender enter into a mortgage agreement containing a “due-on” clause; without lender’s permis-

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2. Other common triggering events are failure to pay a monthly installment when due and failure to pay property taxes.
3. Lenders often include an acceleration provision in the note as well as the mortgage but that may not always be necessary. See Am. Sav. & Loan Ass’n v. Blomquist, 21 Utah 2d 289, 445 P.2d 1 (1968); holding that a note and mortgage, though separate instruments, are not separate contracts; but, being executed at the same time, constitute
sion, borrower conveys or encumbers the property; lender may now ex-

ercise the acceleration option, declare the balance of the debt due, and

foreclose to enforce this choice, or, as usually happens, the lender may

agree to waive his acceleration right upon payment to the lender by

the assuming vendee of an assumption fee or upon vendee’s agreement
to assume the mortgage at the higher current interest rate.

The traditional purpose of “due-on” clauses, and in times of stable

interest rates the only purpose, has been to protect the lender’s inter-

est “in maintaining the direct responsibility of the parties on whose

credit the loan was made.”

This is a form of debtor-selection reducing the moral risks of waste and depreciation which could accompany a conveyance to a third party vendee with a questionable credit rating, or with a poor reputation for home maintenance and upkeep.

Because the lender has a legitimate interest in maintaining the value of the security, all jurisdictions allow enforcement of “due on” clauses to prevent such a third party from being forced upon the lender.

However, with the advent of run-away inflation, accompanied by

unprecedentedly high interest rates, “due-on” clauses have begun to

a single contract, and acceleration provisions in the mortgage operate on the note the

same as upon the mortgage itself and mature the note for all purposes.

The following is a typical acceleration clause:

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 creating of a lien or encumbrance subordinate to this Mortgage, (b) the creation of a purchase money security interest for household appliances, (c) a transfer by devise, descent or by operation of law upon the death of a joint tenant or (d) the grant of any leasehold interest of three years or less containing an option to purchase, Lender may at Lender’s option, declare all the sums secured by this Mortgage to be immediately due and payable. Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender and that the interest payable on the sums secured by this Mortgage shall be at such rate as Lender shall request.


6. Cherry v. Home Sav. & Loan Ass’n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (2d Dist. 1969), holding: Lenders run the risk that the security may depreciate in value, or be totally destroyed. This risk of loss is reduced in the lender’s viewpoint if the borrower is known to be conscientious, experienced and able. Often as here, a trust deed requires the borrower to maintain the property in good repair, secure and keep adequate insurance in force, satisfy liens, taxes and other encumbrances and in other ways to protect the security. If a borrower were able to sell the security without concern for the debt, he may take the proceeds of the sale, leaving for parts unknown, and the new owner of the property might permit it to run down and depreciate. Thus the lender places some value on his belief that the person who takes out the loan is reliable and responsible, and will not be willing to loan to some persons or entities at one rate of interest but to other, less desirable risks only at an increased interest rate.

7. An excellent presentation of the inflation/interest rate roller coaster appears in Bonanno, Due on Sale and Prepayment Clauses in Real Estate Financing in California
serve a second and equally vital function for the lender—that of helping to maintain the lending portfolio at current interest rates through the lender's ability to renegotiate interest rates upward upon a sale or encumbrance. However, unlike the uniform enforceability accorded "due-on" clauses when used to protect the security, use of "due-on" clauses to produce the collateral benefits of increased interest rates have met with conflicting treatment in the state courts. Before looking at the reported cases of specific jurisdictions, however, a discussion of the economic facts of life currently facing savings and loan associations and other mortgage lenders is necessary, including a discussion of how "due-on" clauses ameliorate the often drastic consequences of a tight money supply and rapidly increasing interest rates.

A 1970 study reported that:

[T]he basic dilemma of the savings association business is an inability to adjust earnings upward during periods of inflation accompanied by rising interest rates. This dilemma is traced to the fact that the great bulk of liabilities of the business continues to be virtually demand obligations while the average actual life of its principal assets—real estate mortgage loans—is approximately eight to ten years.\(^8\)

Clearly, if a borrower were able to pass on to a vendee the borrower's low interest rate without interference by the lender, all mortgages would continue at that rate until their original maturity date. The effect of this increased payoff time over the current average actual payoff time of eight to ten years would be to freeze a lender's income at unprofitable levels for twenty to thirty years.\(^9\)

In order to compensate for the earnings lost on these low interest loans a savings and loan association would be forced either to make a series of loans with shorter maturity periods allowing for renegotiation of rates at the end of each renewable period or to initially charge higher rates in anticipation of, and as protection against, the possibility of rising rates in the future. Short-term loans would also increase monthly payments, thus making the obtaining of such loans prohibitive to many people.\(^10\)

In addition to reducing the payoff time of mortgages with the ac-
companying opportunity for interest rate re-evaluation and adjustment, use of “due-on” clauses tends to spread the cost of money, at least to the extent sales occur, to all borrowers and not just to those who borrow when rates are high. The California Supreme Court cited this argument in favor of “due-on” clauses noting:

To permit the lender to accelerate ensures that all buyers of property must finance at the current interest rate, and that none obtain an advantage because of the fortuitous fact that the seller originally purchased during a period of low interest rates.11

Professor Bonanno, in an article generally critical of “due-on” clauses12 cites a Wall Street Journal article13 pointing out that new borrowers in early 1970 were being charged 9% to make up for those paying 4% on loans that had been in existence for a few years.14 This would indicate that the real estate brokers’ arguments against “due-on” clauses as inhibitors of home sales are misplaced. While it is true that the prospect of having to assume a mortgage at a rate higher than the borrower/vendor’s may deter some potential vendees from buying, it appears that the “due-on” clauses have actually played a part in holding down overall rates. In addition, upon assumption the lender will often accept less than the current rate, usually, lower by ¼%.

Now consider the liquidity crisis. In attempting to better compete with the short-term money markets and stem the outflow of funds from the savings and loan associations to short-term investments,16 the

12. Supra note 7, at 302.
14. See speech by Stuart Davis, Chairman of the Board & Chief Executive Officer of Great Western Savings & Loan Association, Nov. 13, 1974, to Annual Convention of the United States League of Savings & Loan Associations, entitled: The Variable Interest Rate Mortgage, which stated in part:

Loans made in Dec. 1965, had an average effective yield of 5.92%. After we had paid the average cost of money and our operating expenses, we had a net margin of 47 cents per $100 on loans made that month. But when the money crunch hit in 1966, this margin quickly eroded. By the middle of the crunch it had dropped to 19 cents per $100. But . . . the end of the money crunch did not signal the end of the erosion in the margin on the Dec. 1965 loans. By the next year, 1971, the margin on those loans was a negative 66 cents per $100. Today we are losing more than $1.75 on each $100 loaned in 1965, still held in our portfolio.
16. Net savings outflow (i.e. negative savings or negative net inflow), considering all operating savings and loan associations, was experienced in the months of April, July,
savings and loan associations increase dividends to accountholders for money on deposit. One example would be the offering of 7½% savings certificates in July of 1973. If mortgage rates remain fixed throughout the loan period without any chance to increase rates upon a sale or an encumbrance, then any increase in dividend rates reduces the amount of money available for loans while increasing the cost of money to the savings and loan association. This increased cost of money is passed on to new borrowers, again tending to force interest rates upward. “Due-on” clauses provide the essential safety valve; the lender’s portfolio is kept closer to current rates and liquidity is improved.

Continuing with the attempt to evaluate the essential function of “due-on” clauses from the lender’s perspective, one final and highly cogent argument remains. The California Court of Appeals has recognized that:

[Loan agreements frequently permit a borrower to pay off a loan before it is due. When interest rates are high, a lender runs the risk they will drop and that the borrower will refinance his debt elsewhere at a lower rate and pay off the loan, leaving the lender with money to loan, but at a less favorable interest rate. On the other hand, when money is loaned at low interest, the lender risks losing the benefit of a later increase in rates. As one protection against the foregoing contingency, a due-on-sale clause is employed permitting acceleration of the due date by the lender so that he may take advantage of rising interest rates in the event his borrower transfers the security.]  

The preceding discussion hopefully has equipped the reader with enough of the background theories and arguments so that critical evaluation of recent cases is possible. The lender’s interest in litigating “due-on” clauses has been shown. Borrowers and buyers litigate the validity of these clauses because a borrower/vendor can obviously sell his house at a higher price if he can pass along to his vendee a low interest rate mortgage. Predictably, case law on such an important issue varies widely.

**STATE LAW DEVELOPMENTS**

The first group of jurisdictions, comprising the minority view, fol-

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and August for the period January-October 1974 alone, as reported in Table S.4.3. of the *Federal Home Loan Bank Bd. Journal*, December 1974, at 27.


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Follows a “strict equity” line of reasoning. Arizona, Arkansas and Florida represent this group. 19

The leading case is Baltimore Life Insurance Co. v. Harn, 20 wherein the assignee of the mortgage, upon borrowers’ action in agreeing to sell the property without approval, exercised the acceleration option and brought suit to foreclose. At trial, plaintiff's suit was dismissed for failure to state a claim upon which relief could be granted. The appellate court, however, found that the agreement to sell was a conveyance within the scope of the acceleration clause entered into between the parties, but held that that in itself was insufficient to require relief. Defendant/borrower contended that the clause restrained alienation, was unenforceable and was against public policy.

Recognizing that acceleration clauses were bargained-for elements of mortgage transactions designed to protect a lender’s legitimate interest of insuring that a responsible party is in possession, the appellate court affirmed the trial court’s dismissal of plaintiff’s action, stating its major considerations as follows:

An action to accelerate and foreclose a mortgage being an equitable proceeding [citation omitted] it is not enough to allege merely that the acceleration clause has been violated. Absent an allegation that the purpose of the clause is in some respect being circumvented or that the mortgagor's security is jeopardized, a plaintiff cannot be entitled to equitable relief. Otherwise the equitable powers of the trial court would be invoked to impose an extreme penalty on a mortgagor with no showing that he has violated the substance of the agreement, that is, that he would not make a conveyance that would impair the security. 21

By so holding, this court repudiated use of “due-on” clauses for any purpose other than that of protecting a lender from having an unsuitable vendee forced upon him. The opinion presupposes that the only purpose for including such a clause, and the only purpose within the contemplation of the parties, is to reduce the lender’s moral risks. To give binding authority to such a presupposition is unwise, for if acceleration clauses are truly bargained-for their use to increase the interest rate, as provided by the acceleration clause, could easily be within the contemplation of both parties.

21. Id. at 193.
One year later, the Arkansas Supreme Court adopted the Harn rationale in the case of Tucker v. Pulaski Federal Savings & Loan Association. Borrower/appellant Tucker's unauthorized sale of the mortgaged property prompted Pulaski to accelerate and foreclose. Tucker's answer alleged that the acceleration was capricious, oppressive, arbitrary, and an unconscionable restraint on his right to freely convey the equity of redemption in the mortgaged property, and that the provision was invalid and void.

In holding for Pulaski, the trial court found the acceleration clause valid and not against public policy; that plaintiff had validly exercised its right to accelerate; that plaintiff had no obligation to justify its refusal to consent to the sale of the property; that plaintiff had valid business reasons for withholding its consent; and that plaintiff was entitled to foreclose. Of the four points relied upon by the Arkansas Supreme Court in reversing, only one is relevant to this discussion. It was error to permit the acceleration, the court held, because the acceleration provision "is against public policy and void." Following several lengthy quotations from Harn, the court declares:

[A] mortgagor could be transferred from his job to another location and, if persons to whom he desired to sell the property could be arbitrarily disapproved by the loan company, he could be in the position of being forced to sell to someone at great sacrifice. This could well be true even though a loan might be three-fourths paid.

As in Harn, the lender failed to allege jeopardy to the security because of the sale and in the absence of such a showing, Arkansas joined Arizona in holding acceleration clauses unenforceable. Both states, though for different reasons, failed to enforce "due-on" clauses when used to increase interest rates. Implicit in each decision is the view that "due-on" clauses may be invoked only to protect the lender against a borrower's substitution of an unsuitable debtor in his place.

In sharp contrast to the "strict equity" decisions are the decisions

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22. 252 Ark. 849, 481 S.W.2d 725 (1972).
23. 481 S.W.2d at 727.
24. Id. at 729.
25. The Florida Court of Appeals has held that a mortgage foreclosure is an equity matter and that a mortgagee has a right to accelerate on the default of the mortgage conditions only if they are necessarily related to the preservation of the security. A Florida court will refuse to enter a foreclosure judgment when the acceleration of the due date would be unconscionable and its result would be inequitable and unjust. Clark v. Lachenmeier, 237 So. 2d 583, (Fla. App. 2d Dist. 1970).
of California, Wisconsin, Colorado and Tennessee. These states follow the majority rule, characterized by a reduced emphasis on equity principles, a clear perception of the need for accommodating both legal precepts and economic realities, and a willingness automatically to accord validity and enforceability to "due-on" clauses, even if used solely to raise interest rates.

One of the earliest cases to discuss "due on" clauses as interest-raising devices was Cherry v. Home Savings & Loan Association, a California case. This was a declaratory judgment action brought by the borrower's vendee, who had attempted to purchase the property "subject to" borrower's mortgage and at borrower's low rate of interest. Lender refused to consent to the sale unless Cherry, the vendee, would "assume" the indebtedness at the current higher interest rate. Though the "due-on" clause was challenged on every relevant ground, none was found to have merit. The court found the clause to be clear and unambiguous, so the central issue for consideration was whether the implied covenant of good faith and fair dealing, implied in law in every contract, requires a lender to exercise reasonableness in giving or withholding its consent prior to declaring the debt accelerated. This question was answered in the negative:

[I]mplied covenants are not favored by the law; and courts will declare the same to exist only where there is a satisfactory basis in the express contract of the parties which makes it necessary to imply certain duties and obligations in order to effect the purposes of the parties to the contract made.

Vendee's final argument, that the "due-on-sale" clause constituted an invalid restraint on alienation, had already been litigated and rejected in California in the case of Coast Bank v. Minderhout. Coast Bank did not concern a mortgage or deed of trust but simply an agreement between the parties, filed in the land records, reserving to the bank acceleration rights if the borrower should "transfer, sell, hypothecate, or assign . . . said real property." Justice Traynor's majority opinion found the agreement sufficient to create a security interest in

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26. This is not intended to be a complete list of all states which enforce the due-on clause to secure collateral benefits.
28. Lender also requested a $471 assumption fee which Cherry ultimately paid though under protest.
the property, but more importantly he held that the clause was not a restraint or alienation:

The view that the common-law rule against restraints on alienation prohibits all such restraints has been forcefully criticized on the ground that it loses sight of the purposes of the rule and needlessly invalidates reasonable restraints designed to protect justifiable interests of the parties.\(^{31}\)

The not-an-invalid-restraint language of \textit{Coast Bank} has been sharply criticized as extraneous and confusingly dangerous dicta by opponents of “due-on” clauses who have argued that the case should have been decided in favor of the bank on the more concrete ground that borrower’s promissory note securing the mortgage was past due and therefore in default when the suit was instituted.\(^{32}\) Be this as it may, the argument is now academic, for \textit{Coast Bank} has been followed by an unbroken line of cases, each reaffirming the \textit{Coast Bank} “dicta.”\(^{33}\)

\textit{Cherry}’s lasting significance rests with its lucid language recognizing the value of “due-on” clauses both in maintaining the borrower’s responsibility for the security\(^{34}\) and in protecting the lender from the drastic effects of rapidly increasing interest rates by giving the lender a means of updating the lending portfolio.\(^{35}\) \textit{Cherry} established an automatic enforcement rule for “due-on” clauses, allegations of jeopardy to the security being unnecessary.

Despite growing dissatisfaction with acceleration clauses among real estate brokers and home owners no case reached the California Supreme Court until 1971, when, ironically, interest rates had begun to ease from a peak in 1970. The case was \textit{La Sala v. American Savings \\& Loan Association},\(^{36}\) a class action seeking a declaration that acceleration based upon borrower’s execution of a junior encumbrance was invalid. After addressing several class action related challenges

\begin{itemize}
  \item \textit{supra} note 6.
  \item \textit{see} text accompanying note 18 \textit{supra}.
  \item 5 Cal. 3d 864, 97 Cal. Rptr. 849, 489 P.2d 1113 (1971).
\end{itemize}
which had resulted in the suit’s dismissal in the trial court, the California Supreme Court announced that where enforcement of a “due-on-encumbrance” clause is not reasonably necessary to protect security, lender’s use of the clause to exact collateral benefits is an unlawful restraint on alienation.

In support of its holding, the *La Sala* court reaffirmed *Coast Bank*, holding that only unreasonable restraints on alienation are invalid, and distinguished *Cherry* because it involved a sale not a junior encumbrance. The court explained:

Thus, although California cases have clearly held “due-on-sale” clauses valid, the language in such cases respecting “due-on-encumbrance” provisions is . . . . entirely dictum.37

It further concluded that the justifications for “due-on-sale” clauses do not apply with equal force to restraints against future encumbrances:

A sale of the property usually divests the vendor of any interest in that property, and involves a transfer of possession, with responsibility for maintenance and upkeep, to the vendee. A junior encumbrance, on the other hand, does not terminate the borrower’s interests in the property, and rarely involves a transfer of possession.38

Continuing its reasoning in a footnote the court stated:

Acceleration upon sale of the property . . . does not seriously restrict alienation because the sale terms can, and usually will, provide for payment of the prior trust deed.

A junior encumbrance . . . often represents only a small fraction of the borrower’s equity . . . ; it does not often provide the borrower with the means to discharge the balance secured by the trust deed. Thus, under a due-on-encumbrance clause the borrower is exposed to a detriment quite different than that involved in a sale.39

Some exceptions to the foregoing were admitted however. One example would be a conveyance to a mortgage in possession, as that could lead to waste and depreciation. A more important exception is where the second lien is a guise to effect a sale of the property, as that will sooner or later leave the borrower with little or no equity. Acceleration in these situations is reasonably necessary to protect the lender’s security.

In summary then, the relevant holdings for which *La Sala* stands are these:

37. *Id.* at 1122.
38. *Id.* at 1123.
39. *Id.* at 1123 n.17.
(a) a lender's right to automatic enforceability of "due-on-sale" clauses is upheld and reaffirmed because of the necessity of protecting the security;
(b) the "due-on-encumbrance" clause can claim no mechanical justification but may be used where the security is truly endangered; and
(c) a second lien used as a guise to sell the property sufficiently endangers the security to justify acceleration.

In La Sala the opponents of "due-on" clauses realized a partial victory, but those who had hoped for relief from "due-on-sale" provisions received a fatal setback.

La Sala's bifurcated treatment of the two "due-on" provisions is a necessary and logical refinement. A borrower in possession who executes a second lien not intended as a sale is protected from any interest rate increases because the lender suffers no endangerment to the security. Indeed, proceeds from the second lien may even be used to improve the real estate, thus enhancing the lender's security. The essential fairness of the court's treatment is unassailable. It is therefore all the more regrettable that the latest expression of the California Supreme Court on this subject should have so completely perverted the La Sala logic.

Tucker v. Lassen Savings & Loan Association,40 litigated this question: whether a "due-on" clause contained in a promissory note or deed of trust can be enforced simply because the borrower enters into an installment land contract for the sale of the security? Unfortunately, the court, sitting in bank, held that it could not. For the clause to be enforceable the lender must demonstrate how the installment land contract, entered into between the borrower and his vendee, impinges upon the lender's legitimate interests to an extent justifying acceleration.

Lassen's "due-on" clause clearly applied to cases of encumbrance. The installment land contract involved here provided that the borrower/vendor would retain legal title until the full purchase price was paid, with vendees being entitled to immediate possession. Lender threatened to accelerate unless the vendee agreed to assume the mortgage and to do so at the current rate of 9¼%, a substantial increase over the 8% rate vendee had agreed to pay the borrower/vendor.

No impairment of or endangerment to lender's security was found by the trial court, and it therefore concluded that lender's acceleration

was an unreasonable restraint on alienation. This holding, affirmed by the Supreme Court of California, places in doubt much of what La Sala stands for.

For example, La Sala recognized:

[A] sale of the property usually divests the vendor of any interest in that property, and involves the transfer of possession, with responsibility for maintenance and upkeep, to the vendee.\(^{41}\)

In Tucker the vendees were in possession at the time of trial with the borrower/vendor's interest being that of bare legal title. With each month’s installment, borrower’s equity diminished, and with it diminished borrower’s interest in the vendee’s reliability in maintaining the security. Nevertheless, the court held that automatic enforcement of the clause was not justified because a junior encumbrance . . . “does not terminate the borrower’s interests in the property, and rarely involves a transfer of possession.”\(^{42}\) Completely ignored is La Sala’s caveat that a second lien may be employed as a guise to effect the sale of the property. In relying upon the technical fact that the borrower/vendor retains legal title in an installment land contract, the court refused to look through form to substance. Further, the La Sala decision had approved of the practice of permitting a lender to accelerate upon a sale to insure that all buyers of property must finance at the current rate, and that none obtain an advantage because of the fortuitous fact that his vendor originally purchased during a period of low interest rates.\(^{43}\)

In effect, the court now treats outright sales one way and sales by installment land contract another. On the one hand the court allows acceleration for an outright sale because of the security risks and because the lender has a legitimate interest in raising interest rates to current levels; but, on the other hand, the court disallows use of acceleration for installment land contracts, though that form of alienation is intended as a sale, results in immediate possession by strangers with accompanying moral risks, and allows a vendee “to obtain an advantage because of the fortuitous fact that his seller originally purchased during a period of low interest.”\(^{44}\)

Finally, throughout Tucker the court reaffirmed the basic tenet,

\(^{41}\) La Sala v. Am. Sav. & Loan Ass'n, 5 Cal. 3d 864, 97 Cal. Rptr. 849, 489 P.2d 1113, 1123 (1971).
\(^{42}\) Id. at 1123.
\(^{43}\) Id. at 1123 n.17.
\(^{44}\) Id.
first laid down in *Coast Bank*, that “it is 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.”\textsuperscript{45} However, the only interest retained by a borrower/vendor under an installment land contract is bare legal title, and that interest, rather than being retained intact, is periodically diminished over time until there is little and ultimately no equity left. If this bare legal title is enough to fulfill *Coast Bank’s* standards of borrower’s interest, then *Tucker* has emasculated that decision.

By placing undue importance upon the greater “quantum of restraint” a borrower/vendor experiences with an encumbrance rather than a sale, and by reneging on *La Sala’s* warning that an encumbrance intended as a sale poses grave risks to a lender, the court upholds, in the installment land contract, a method of transferring property to strangers with accompanying moral risks while simultaneously denying to a lender his most effective means of self-protection.\textsuperscript{46} Absent the use of an acceleration device in an installment land contract, the mortgage will have a tendency to run until its full maturity date, and this will mean an increase in the average payoff time of the lender’s portfolio, aggravating what was earlier referred to as the basic dilemma of savings and loan associations.\textsuperscript{47} Lenders will be forced to compensate for whatever losses they sustain by having money loaned for longer periods at sub-current rates by increasing the interest rates charged to new borrowers. One group of mortgage consumers will pay artificially high rates because of the court-sanctioned advantage accorded another group of mortgage consumers, while *La Sala’s* expectation that “all buyers must finance at the current rate” is forgotten.

It is this author’s opinion that junior encumbrances which are intended to and do transfer equitable title and immediate possession, and which intend ultimately to convey legal title, should be accorded the same automatic enforcement under “due-on-encumbrance” clauses that lenders enjoy when the sale is outright. This “enlightened” treatment of installment land contracts has been adopted in Wisconsin.

*Mutual Federal Savings & Loan Association v. Wisconsin Wire Works*\textsuperscript{48} involved a land contract entered into by mortgagor/vendor Wire Works and a vendee contrary to a prior mortgage agreement that

\textsuperscript{46} *Supra* note 14 and accompanying text.
\textsuperscript{47} See text accompanying note 9 *supra*.
\textsuperscript{48} 58 Wis. 2d 99, 205 N.W.2d 762 (1973).
DUE-ON-SALE CLAUSES

Wire Works had with Mutual as mortgagee. When Mutual discovered this land contract it elected to accelerate and foreclose. No mortgage payments were delinquent, nor did Mutual allege waste or any apprehension of waste to the property. At trial, Mutual's "consent to transfer" clause, with its acceleration provision, was found to be ambiguous as it was unclear whether the restriction was intended to limit transfer of equitable as well as legal title. Due to this ambiguity the borrower's action did not constitute a conveying away, or a vesting of title in another person, within the meaning of Mutual's clause. Mutual appealed.

In reversing the trial court's dismissal the court found the clause was clear, not ambiguous, and broad enough to cover the transfer from Wire Works to its vendee. Under Wisconsin's lien theory of mortgages, a mortgagee is merely a lienholder, while full ownership, both legal and equitable, and full right of possession remains with the mortgagor. The land contract, by the process of equitable conversion, transferred both an immediate right of possession and equitable title to the vendee. Therefore, the court held that a land contract is a conveyance.

The court then reviewed Coast Bank and Cherry, citing with approval the concepts that a lender has a legitimate interest in maintaining the interest of its borrower in the security. More importantly, La Sala was cited to emphasize the possibility that a second lien can, in certain instances, endanger the security of the first lien, thus posing the "same dangers of waste and depreciation as would an outright sale." And finally, the court approved the language in Cherry to the effect that "due-on-sale" clauses may be used by sensible lenders to take advantage of rising interest rates and thereby minimize risks.

This review of the authorities must have convinced the court that it is the degree of hazard to the security posed by a transfer rather than the "quantum of restraint" imposed which is important. Looking through form to substance the court held:

It is difficult to see, given the general policy behind a "due-on-sale clause," why a transfer of land title by a land contract does not pose the same potential hazard to the interests of the mortgagee as most other recognized types of conveyances.

We, accordingly, hold that a due-on-sale clause or in this case, to use the terms of the mortgage note, "due . . . if . . .

49. La Sala v. Am. Sav. & Loan Ass'n, 5 Cal. 3d 864, 882, 97 Cal. Rptr. 849, 860, 489 P.2d 1113, 1124 (1971).
50. See text accompanying note 18 supra.
convey[ed] away . . . or if the title thereto shall become vested in any other,” is not against public policy and is enforceable as a contractual condition of the note and mortgage.\textsuperscript{51}

Unlike the California court, the Wisconsin court construed “transfer of title” to mean a transfer of legal or equitable title, either of which is a sufficient triggering event. This decision in essence upholds the use of “due-on-encumbrance” clauses when the encumbrance is intended as a sale.

The final two decisions to be discussed are important for their specific treatment of a lender’s interest in and right to acceleration for the purpose of increasing interest rates without regard to impairment of the security.

\textit{Malouff v. Midland Federal Savings & Loan Association}\textsuperscript{52} was a case of first impression in Colorado. In 1966 Midland received a trust deed from borrower, Gordon Price, securing a loan at 7%. In 1971, Price attempted to sell the property to plaintiff, Virginia Malouff, subject to the original mortgage, but could not obtain Midland’s permission as required unless Malouff agreed to assume the mortgage at the rate of 8%, which was about one percentage point below current interest rates. Malouff refused; instead she sued for a temporary and permanent injunction against Midland’s threatened foreclosure, and for a declaratory judgment that she was legally entitled to assume the original loan. She prevailed in the trial court, which held that the acceleration clause was an unlawful restraint on alienation, that it was too vague and uncertain to be enforceable, and that the clause requiring assumption could not be enforced.

In reversing, the Colorado Supreme Court, following \textit{Coast Bank} and its progeny, noted that the “question of the invalidity of a restraint depends upon its reasonableness in view of the justifiable interests of the parties.”\textsuperscript{53} The court further held that “due-on-sale” clauses were reasonable restraints on alienation, thus leaving the remaining inquiry to be what conditions a lender may impose upon a vendee in return for waiver of the acceleration clause.

One such condition a lender may validly impose is a higher interest rate. In support of this holding the \textit{Malouff} opinion exten-

\textsuperscript{51} Mutual Fed. Sav. & Loan Ass’n v. Wisconsin Wire Works, 58 Wis. 2d 99, 205 N.W.2d 762, 767 (1973).
\textsuperscript{52} — Colo. —, 509 P.2d 1240 (1973).
\textsuperscript{53} Id. at 1243.
sively quoted both *Cherry* and an affidavit submitted by a Midland vice-president which described the risks encountered by a lender when loan demand and money supply are out of balance. The affidavit read in part:

As of November 30, 1971, Midland held 60,388 deposit accounts. Midland used these accounts to make loans. Midland must make loans at reasonable rates to its borrowers, but it also has the responsibility to give its depositors a reasonable rate of return on their deposits. A reasonable rate of return on dollars invested in home loans is an interest rate which is comparable to the current rate of return of the lending industry. Midland is willing to deal with the original borrower on a long term basis, but not with any other party without an opportunity to consider the substituted borrower and current interest rates.

If lenders were unable to make some form of interest rate adjustments on long-term loans, they would have to make only short-term loans amortized over periods of less than ten years. Original borrowers would not be able to pay off their home purchases without having to refinance their indebtedness one or more times in the process. Short-term loans would also increase monthly payments and make the obtaining of such loans prohibitive to many people.

So the original borrower has the benefit of his bargain as long as he holds the property, and the lender has the benefit of his bargained-for right to increase the interest rate to current levels upon a sale or an encumbrance intended as a sale. This is a reasonable protection of a lender's justifiable interest and therefore does not constitute an invalid restraint on alienation.

As to requiring assumption by the purchaser, the court stated:

Having found the clause to be a reasonable restraint, and therefore valid, the agreement to forbear the exercise of the right to accelerate constituted adequate consideration for Malouff's undertaking to assume the unpaid indebtedness and to pay the increased interest rate.

*Malouff* builds directly on *Cherry*, recognizing that "due-on-sale" clauses have at least two legitimate functions and that one of these—

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54. The *Malouff* court quoted the language from *Cherry* which appears in the text accompanying note 18 supra.
raising interest rates—is an economic necessity operating without violence to the legal principles of unconscionability, restraint on alienation, or public policy.

This comment's final case, *Gunther v. White*,57 litigated as its central issue the question whether an acceleration provision is valid and enforceable where the admitted motive for exercising the option is to secure an increase in the rate of interest. It answered that question in the affirmative. Tennessee law does not view an acceleration option as a penalty or as a forfeiture which a court of equity should restrain:

[A] court of equity has the power to relieve a mortgagor from the effect of an operative acceleration clause in a mortgage where that condition making the option operative is the result of some unconscionable or inequitable conduct of the mortgagee. No case has been found however, which holds that the exercise of the option to gain the benefit of a current interest rate falls into these categories.58

*Cherry* was quoted extensively; then the court summarized its view thusly:

[T]he situation here is simply that [borrowers] can sell their property at a higher price if they can sell it at a lower interest rate. The [lenders] under their contract have the right to insist upon the repayment of their loan in the event of sale, so that they can relend the money at an increased interest rate, and so maintain their supply of lending money, at the level of their present cost of such money. . . . [E]quity should not depart from the law which requires it to enforce valid contracts and strike down the acceleration option simply because its exercise will let the [lender], not the borrower, make the profit on the interest rate occasioned by the increased cost of money.59

**IMPACT OF FEDERAL LAW**

The cases that have just been examined were selected because they best illustrated the course of development in their respective jurisdictions. Until very recently, this development was strictly a state matter. However the federal government, acting through the Federal Home Loan Bank Board (FHLBB), on March 19, 1974, published a regulation, T 56,60 binding upon all federally chartered savings and

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57. 489 S.W.2d 529 (Tenn. 1973).
58. Id. at 531.
59. Id. at 532.
60. T 56 Installment Loan: Restrictive proviso reads as follows:

Increases in mortgage interest rates by federally chartered associations which
loan associations. This regulation could have far reaching and potentially drastic effects upon the continued effectiveness of acceleration devices. Presently there are approximately 2,050 federally chartered savings and loan associations compared with 3,400 which are state chartered.

T 56’s major impact will be on loans given on or after April 10, 1972. In jurisdictions which enforce acceleration clauses (or “escalation clauses” as used in T 56) to increase interest rates, T 56 requires that any increase be enforced in such a way as will not increase monthly payments. In effect then, each monthly payment for loans on or after the cut-off date must remain equal to or less than the first payment. This means that savings and loan associations are only able to benefit from interest rate increases by extending the loan maturity date. Savings and loans are, however, restricted by law to certain maximum maturity limits and herein lies the problem.

The question arises: just what does T 56 mean by the phrase “may only extend the maturity of the loan up to the maximum term permissible for the type of loan involved”? Is the maximum period to be computed from the date of the original loan or from the date of assumption? In exploring the possible interpretations, a conventional home mortgage with its legal maximum maturity of thirty years will be used for illustration.

result from the exercise of rights for association under escalation clauses in loan contracts and other debt instruments have been questioned because of the proviso in the above regulation. Since April 10, 1972, the proviso has expressly prohibited any subsequent monthly payment of principal and interest on an installment loan from exceeding any such preceding payment.

It has been determined, with the concurrence of the Board, as to:

Loans made prior to April 10, 1972, that Federal associations may, within the original loan term, exercise their contractual right to increase the interest rate of a loan under an escalation clause contained in the loan contract or other debt instrument. In the alternative, the monthly payment may be increased and maturity of the loan may be extended up to the maximum term permissible for the type of loan involved to the extent necessary to absorb the increase in interest charged.

Loans made on or after April 10, 1972, the effective date of the most recent amendment of Section 541.14, that Federal associations exercising their rights under such clauses, may only extend the maturity of the loan up to the maximum term permissible for the type of loan involved to the extent necessary to absorb the increase in interest rate, provided that the monthly payment (of principal and interest) is not increased.


(a) Installment loan. The term “installment loan” means any loan repayable in regular periodic payments sufficient to retire the debt, interest and principal, within the loan term. However, no required payment after the first payment shall be more, but may be less, than any preceding payment.

62. For example there is a 30 year maximum maturity period for conventional home mortgages.
A. Maturity Extensions Figured from Date of Assumption

This possibility presents the fewest problems and gives both lenders and borrowers the greatest measure of freedom. With extensions computed from the date of the assumption the assumption agreement could be treated as if it were a new mortgage. For example; an original mortgage of $30,000 at 7.5% interest, with a twenty year maturity, would have monthly payments of $241.68. After six years the unpaid principal would be $24,129.39, so that an assumption at that point⁶³ could be made at 9% (assuming that was the current rate at the time of assumption), while keeping the monthly payment at $241.68 as required by T 56, but the new maturity period would now be fifteen years five months, instead of the fourteen years remaining under the original agreement. It might even be possible to reduce monthly payments upon assumption; an appealing prospect considering inflation-strained budgets. If the assuming vendee in the example above wished to assume at a lower monthly payment it could be done on the following terms: unpaid principal—still $24,129.39; hypothetical current interest rate—still 9%; maturity—extended to the maximum of thirty years; which yields a monthly payment of $194.15, compared to $241.68.

It must be noted however, that if the original maturity is close to the maximum allowed by law, the lender will be unable to raise interest rates appreciably until a substantial portion of the original debt is amortized. This is because nearly all the money paid on a mortgage in the first few years is applied to pay the accrued interest first leaving very little to be applied to reduce the principal.⁶⁴ Table 1 shows the maximum interest rate a lender could charge by extending maturities to the maximum thirty years, as a function of amortization. Data is based on an assumption of an original mortgage of $30,000.00 at 7.5% interest, for thirty years, which would yield a monthly payment of $209.76.

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⁶³ This and the following examples assume any appreciation in value will be absorbed in the down payment.

⁶⁴ For example in the illustration above of a $30,000 mortgage at 7.5% interest with a twenty year maturity, the total yearly payment will be $2,900.16. Of this sum $2,231.37 is allocated to payment of interest leaving only $668.79 to amortize the principle in the first year.
TABLE 1

<table>
<thead>
<tr>
<th>Number of Years Before Assumption</th>
<th>Unpaid Principal</th>
<th>Max. Rate Chargeable*</th>
<th>Yearly % Increase*</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$30,000.00</td>
<td>7.50%</td>
<td>.09%</td>
</tr>
<tr>
<td>1</td>
<td>29,747.35</td>
<td>7.59%</td>
<td>.10%</td>
</tr>
<tr>
<td>2</td>
<td>29,451.24</td>
<td>7.69%</td>
<td>.11%</td>
</tr>
<tr>
<td>3</td>
<td>29,123.16</td>
<td>7.80%</td>
<td>.13%</td>
</tr>
<tr>
<td>4</td>
<td>28,788.29</td>
<td>7.93%</td>
<td>.15%</td>
</tr>
<tr>
<td>5</td>
<td>28,417.72</td>
<td>8.06%</td>
<td>.17%</td>
</tr>
<tr>
<td>6</td>
<td>28,018.39</td>
<td>8.21%</td>
<td>.18%</td>
</tr>
<tr>
<td>7</td>
<td>27,588.06</td>
<td>8.38%</td>
<td>.21%</td>
</tr>
<tr>
<td>8</td>
<td>27,124.32</td>
<td>8.56%</td>
<td>.22%</td>
</tr>
<tr>
<td>9</td>
<td>26,624.57</td>
<td>8.77%</td>
<td>.25%</td>
</tr>
<tr>
<td>10</td>
<td>26,086.03</td>
<td>8.99%</td>
<td>.27%</td>
</tr>
<tr>
<td>11</td>
<td>25,505.68</td>
<td>9.26%</td>
<td>.29%</td>
</tr>
</tbody>
</table>

* Rounded to nearest .01%

In the example upon which the data in Table 1 is based, a federally chartered savings and loan association would be unable to boost interest rates to a current higher level (say 9%) unless sufficient amortization (at least ten years worth if lender wanted to charge 9%) had occurred, if the original maturity period were the maximum legal limit or close to it. This result could cause federally chartered savings and loans to give mortgages only with maturities somewhat less than the legal limit.

B. Maturity Extensions Figured from Date of Original Loan

A result of this interpretation would be an end to the thirty year mortgage from federal savings and loans, for no extension would be allowed on a loan whose original maturity period was the legal limit. Shorter loans would have built-in extension margins to the extent their maturities were below the maximum period allowed, but as a direct consequence, borrowers would have to make higher monthly payments, tending in turn to discourage borrowing.

Another pernicious side-effect of computing permissible T 56 extensions from the date of the original mortgage is the intra-industry competition generated between state chartered and federally chartered savings and loan associations. In the absence of similar state legislation, state chartered savings and loans will continue to be able not only to extend maturities, but also to continue to operate without restrictions limiting increases in monthly payments. By fostering unhealthy and unfair competition, the industry as a whole is weakened.

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65. The author gratefully acknowledges his indebtedness to Mike Baugh, a petroleum engineer, without whose patience and interest the data in this table and in the foregoing examples would have been much harder to have obtained, and to the Amerada Hess Corp. for the generous use of their computer facilities.

To the best of the author's knowledge, only one of the FHLBB's twelve district banks, has had a formal request for a T 56 clarification. In response to this request the FHLBB ruled that T 56 requires extensions to be computed from the date of the original mortgage. It is hard to imagine a decision less in keeping with the board's purposes—"to encourage thrift and economical home ownership. . ." This interpretation, by tightly restricting extension, denies to the lender the benefits of increased interest rates provided by acceleration clauses. Continuing unprofitability of unextendable loans (including those whose extension period is so short that no appreciable rate increase is possible) becomes a powerful impetus to lenders to compensate by charging new borrowers ever higher rates.

Any revision of the FHLBB's disappointing position must, however, await a formal challenge to its present interpretation. But it is hoped that when and if such a challenge occurs the board will reverse its ruling and take a stand in favor of the manifold advantages available to both lenders and borrowers in allowing extensions to be computed from the date of assumption.

CONCLUSION

This comment has traced the judicial treatment of the "due-on-sale" and "due-on-encumbrance" acceleration devices from their traditional purpose—protecting a lender's security—to their second and equally valid function—adjusting interest rates upward to the extent sales or encumbrances intended as sales occur. "Due-on" clauses were originally created during times of stable interest rates for the purpose of diminishing a lender's moral risks. Now, in a time of volatile interest rates, to deny them validity as economic safety valves because of their single-minded origin is to thwart the essential process of legal evolution. The law must be responsive to changing needs. Many sound legal and economic arguments, rooted in our recent and recurring economic instability, support the use of "due-on" clauses as rate adjusters. The formalistic approach of the minority rule requires over-rigid adherence to equity principles while ignoring economic imperatives. The majority rule balances economic necessity with preservation of the legal princi-

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66. The inquiry originated with First Federal Savings & Loan Ass'n of Little Rock, Ark. In the opinion of William O. Churchill, Associate Supervisor of the Federal Home Loan Bank at Little Rock, whom the author interviewed, this was the first request for a T 56 clarification to be received by any FHLBB district.

67. UNITED STATES GOV'T MANUAL at 452.
DUE-ON-SALE CLAUSES

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DUE-ON-SALE CLAUSES

(1) Some form of rate adjustment is an essential factor in holding down interest rates and in insuring the continued viability of long-term lenders;

(b) “due-on” clauses perform well the rate adjusting function;

(c) “due-on-sale” and “due-on-encumbrance” (when the encumbrance is intended as a sale) are valid and enforceable and are not restraints on alienation nor against public policy;

(d) A lender may accelerate solely to increase interest rates upon the happening of the triggering event without allegation or proof of waste or of depreciation; and

(e) “due-on-sale” clauses should be enforceable automatically, provided rates are not raised above current levels.

Acceleration clauses are not perfect. They can only upgrade a lending portfolio to the extent sales occur, but until they are replaced by some other rate adjusting device68 acceleration clauses must be accorded the validity and enforceability essential to their functioning.

It is vital therefore, for jurisdictions which have not yet litigated or are in the process of litigating the validity of “due-on” clauses,69 that their economic importance not be overlooked to the detriment of both lenders and new borrowers alike.

68. Of the alternative methods of rate adjustment the most popular and promising is the “variable rate mortgage” (VRM) which provides for periodic increases or decreases in mortgage rates as the cost of credit rises and falls.

69. The “due-on” issue is currently in the trial stage in Oklahoma. See Continental Fed. Sav. & Loan Ass’n v. Fetter, No. C-74-48, filed in Cleveland County District Court, State of Oklahoma.

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