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Mortgages - Due-On-Sale Clause: Restraint on Alienation - Enforceability [*Nichols v. Ann Arbor Federal Savings & Loan Association*, 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977)]

John L. Resor

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## MORTGAGES—DUE-ON-SALE CLAUSE: RESTRAINT ON ALIENATION—ENFORCEABILITY

EDITOR'S NOTE: A Michigan appellate Court has recently adopted a flexible approach for determining whether due-on-sale clauses in mortgage agreements are invalid and unenforceable as unreasonable restraints upon alienation. The first author, in submitting the decision to a traditional case analysis, concludes that embracing this approach was innovative and beneficial as a means of balancing the interests of mortgagor and lender. The contrasting piece more pessimistically suggests that the practical result of a flexible test may be a high degree of uncertainty, inconsistent treatment between federal and state institutions, and ultimately economic disadvantage borne primarily by the very borrower whom the approach was meant to assist.

*Nichols v. Ann Arbor Federal Savings & Loan Association*,  
73 Mich. App. 163, 250 N.W.2d 804,  
*appeal denied*, 400 Mich. 844 (1977).

In recent years, controversy has developed over the validity of mortgage due-on-sale provisions because they are claimed to unreasonably restrain alienation.<sup>1</sup> Such provisions typically provide that the mortgagee may declare the entire balance of the loan and its accrued interest due and payable immediately upon transfer or other change in the ownership of the mortgaged property. While these clauses operate to protect the interests of the mortgagee, they may also threaten the fundamental rights of the mortgagor-homeowner to freely alienate his property. *Nichols v. Ann Arbor Federal Savings & Loan Association*,<sup>2</sup> while adopting the general approach of viewing the due-on-sale clause as a restraint on alienation, applied a less conventional, "flexible"<sup>3</sup> test to determine whether the restraint involved was unreasonable, and thus unenforceable. In doing so, the Michigan Court

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1. See generally Annot., 69 A.L.R.3d 725 (1976). For a compilation of related secondary treatments, see *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 629, 224 S.E.2d 580, 586 (1976).

2. 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977).

3. *Id.* at 168, 250 N.W.2d at 806.

of Appeals took an important step toward a more logical and sensible approach to the judicial scrutiny of due-on-sale clauses.

The defendant in *Nichols* held a mortgage on property owned by Mr. and Mrs. Kempf. The mortgage contained a due-on-sale clause which provided for acceleration of the mortgage debt in the event of the transfer of the property by the mortgagors. The Kempfs entered into an installment land contract for the sale of the property to the Nichols, whereupon the defendant accelerated the mortgage indebtedness and commenced foreclosure proceedings when the entire loan was not repaid. Both parties to the land contract brought actions to permanently enjoin foreclosure, and, after consolidation for trial, were awarded summary judgment by the trial court. The court of appeals affirmed,<sup>4</sup> and the Michigan Supreme Court denied leave to appeal.<sup>5</sup>

Traditionally, judicial disdain for restraints on alienation has been applied exclusively to "direct restraints," classified into three major categories: disabling, forfeiture, and promissory.<sup>6</sup> The *Nichols* court properly recognized that the due-on-sale clause "[s]trictly speaking, . . . does not fit within the definition of a [direct] restraint on alienation,"<sup>7</sup> but agreed with a commentator's conclusion that it "is so closely akin to the promissory restraint as to justify designating it a direct restraint."<sup>8</sup> Even though a transfer of the property does not breach the mortgage agreement, the mortgagor's immediate obligation can be increased by the mortgagee from the amount of a periodic payment to the entire amount of the loan, a result not unlike a default on a covenant not to convey (a promissory restraint).<sup>9</sup>

In addition, when viewed on a practical level, a due-on-sale clause in a mortgage or deed of trust may restrict alienability by limiting the mortgagor to certain types of conveyances, or to a sale at a price significantly less than that which he would otherwise be able to obtain, and may permit the mortgagee to "effectively veto a proposed sale"<sup>10</sup> by exercising his power to accelerate whenever he disapproves of a

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4. *Id.* at 165, 250 N.W.2d at 805.

5. 400 Mich. 844 (1977).

6. RESTATEMENT OF PROPERTY § 404 (1944). See Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 752-53 (1973).

7. 73 Mich. App. at 165, 250 N.W.2d at 805.

8. Volkmer, *supra* note 6, at 773-74, quoted in *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 166, 250 N.W.2d 804, 806, *appeal denied*, 400 Mich. 844 (1977).

9. See Volkmer, *supra* note 6, at 774.

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

given transferee. This is especially true during periods of rising interest rates. If the purchaser is unable to gain the advantage of the lower interest rate in the original security agreement, he will probably offer the mortgagor-vendor less for the property to offset the higher interest payments which he will be forced to make pursuant to a new or amended financing agreement, often made with the mortgagee in exchange for a waiver of the right to accelerate the original obligation. Equally important, the mortgagor's options may be reduced to transfer by outright sale only, rather than by installment land contract or other financing method, as only the first will likely supply sufficient proceeds to pay off the entire original obligation.

Two of the cases cited by *Nichols* as representative of those jurisdictions which have held that the due-on-sale clause operates as a restraint on alienation, *Coast Bank v. Minderhout*<sup>11</sup> and *Baker v. Loves Park Savings & Loan Association*,<sup>12</sup> have been considered authorities for the per se approach. In each case the court held that the mortgagee's interest in protecting his security from waste and the risk of default in payment of the mortgage installments was a reasonable justification for the per se validity and enforcement of such restraints without regard to individual circumstances.<sup>13</sup>

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11. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

12. 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

13. See Comment, *supra* note 10, at 1121. The *Coast Bank* opinion, written by Justice Traynor, has been especially influential. The court held that:

The protection of several . . . interests has been recognized as justifying reasonable restraints on alienation. . . . In the present case it was not unreasonable for [the bank] to condition its continued extension of credit to the [mortgagors] on their retaining their interest in the property that stood as security for the debt.

61 Cal. 2d at 316-17, 392 P.2d at 268, 38 Cal. Rptr. at 508. The court did not, however, articulate precisely what interests of the mortgagee would justify the conceded restraint on alienation imposed by the due-on-sale clause. As a result, conflicting lines of authority have developed since the 1964 opinion. There are now widely differing explanations as to what kinds of circumstances would justify a finding that the restraint is reasonable. *Coast Bank* is frequently read as standing for the rule that a due-on-sale clause is "reasonable per se" absent a showing of fraud, duress, or other inequitable or unconscionable conduct on the part of the lender. *E.g.*, *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 629, 224 S.E.2d 580, 587 (1976).

A second line of post-*Coast Bank* cases maintains that the lender's interest in benefiting from rising interest rates justifies enforcement of the clause, thus permitting the lender to "take advantage of higher interest rates in the event his borrower transfers the security. This is merely one of the ways taken to minimize risks by sensible lenders." *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 301, 509 P.2d 1240, 1244 (1973). *Accord*, *Cherry v. Home Sav. & Loan Ass'n*, 276 Cal. App. 2d 574, 61 Cal. Rptr. 135 (1969) (lender's interest in maintaining favorable interest rates justifies enforcement of due-on-sale clause); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973) (exercise of due-on-sale clause held not unconscionable or inequitable, since it merely gave the benefit of increased interest rates to mortgagee rather than to mortgagor). See *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 545 P.2d 546 (1976) (provision in mortgage agreement giving mortgagee right to increase interest rate on loan upon trans-

In dismissing the per se approach to restraints on alienation,<sup>14</sup> the *Nichols* court adopted a flexible approach for determining the validity of due-on-sale clauses. Under this theory, the restraint "will not be enforced unless it is found to be reasonable in a particular case."<sup>15</sup> This rule had been fashioned in earlier cases involving the enforcement of nonassignment provisions in installment land contracts.<sup>16</sup> The *Nichols* court found "no appreciable difference" between nonassignment provisions and due-on-sale clauses.<sup>17</sup> Although the equitable title of the land contract vendee (derived from his equity of redemption) differs theoretically from the legal title of the real property mortgagor, there appears to be no logical basis for distinguishing the two interests in the context of restraints on alienation. Similarly, the protections afforded to the mortgagor from application of the clause should not depend upon whether the lien theory or title theory of mortgages is followed.<sup>18</sup>

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fer by original mortgagor held valid and enforceable). See also text accompanying notes 27, 42-44 *infra*. But see text accompanying note 37 *infra*. For a collection of additional cases following *Coast Bank*, see Annot., 69 A.L.R.3d 725 (1976).

*Baker* is representative of yet another interpretation of *Coast Bank*. *Baker* focused on the reasonableness of protecting the security interest of the lender rather than judging the equities of enforcing the lender's desire to maintain current, higher interest rates. The court held that: "It [is] completely justifiable . . . to prohibit the alienation, without the consent of the lender, of property which stands as security for the debt to a person whose personal and financial qualities are unknown to and were never considered by the lender in making the loan." 61 Ill. 2d at 125, 333 N.E.2d at 4. The *Baker* court was perhaps mistaken in its reliance upon *Coast Bank* for the determination that "the protection of the lender's security interest . . . must determine the validity of the restraint and not the circumstances of each particular case." *Id.* at 126, 333 N.E.2d at 5. While *Coast Bank* did not speak to particular circumstances in its holding, it did not dismiss them. In effect, *Baker* gives the lender absolute discretion to determine whether the particular transaction calls for enforcement of the due-on-sale clause. Such a result was expressly rejected in *La Sala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971) (enforceability of due-on-encumbrance clause depends upon circumstances of asserted threat to security). In *La Sala*, the California court refused to "rule upon the validity of a due-on-encumbrance clause in the abstract." *Id.* at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 860. See also *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); text accompanying notes 19-27 *infra*. The lender in *Nichols* did not assert waste or any threat to its security interest, either in the particular case, or "in the abstract." Thus, consideration of a possible threat to its security was precluded, leaving its interest in maintaining favorable, current interest rates as the sole justification proffered for enforcement of the clause.

14. 73 Mich. App. at 168-70, 250 N.W.2d at 806-07.

15. *Id.* at 168, 250 N.W.2d at 806.

16. *Id.* at 167, 250 N.W.2d at 806. See *Lemon v. Nicolai*, 33 Mich. App. 646, 190 N.W.2d 549 (1971); *Pellerito v. Weber*, 22 Mich. App. 242, 177 N.W.2d 236 (1970).

17. 73 Mich. App. at 167, 250 N.W.2d at 806.

18. See *Leipziger, The Mortgagee's Remedies for Waste*, 64 CALIF. L. REV. 1086, 1118 (1976).

The court embraced the California view, established in *Tucker v. Lassen Savings & Loan Association*.<sup>19</sup> *Tucker* involved plaintiff-mortgagors who entered into an installment land contract with a subsequent purchaser. When the defendant-mortgagee elected to enforce the due-on-sale provision in the mortgage agreement, the purchaser avoided a foreclosure sale by agreeing with the bank to assume the outstanding loan at a higher interest rate in consideration for a waiver of the mortgagee's right to enforce the clause. In addition, the mortgagors were obligated to execute a quitclaim deed.<sup>20</sup> On these facts, the California Supreme Court held the due-on-sale clause unenforceable, as an unreasonable restraint on alienation. In so doing, the court affirmed the award of damages in the amount of the difference between the balance due under the installment land contract and that remaining on the original mortgage obligation.<sup>21</sup> In applying the flexible approach, the court declared that to successfully enforce the due-on-sale clause, the mortgagee must:

demonstrate a threat to one of his legitimate interests sufficient to justify the restraint on alienation inherent in . . . [the due-on-sale clause's] enforcement. Such legitimate interests include not only that of preserving the security from waste or depreciation but also that of guarding against . . . the "moral risks" of having to resort to the security upon default.<sup>22</sup>

In *Nichols*, as in *Tucker*, the defendant made no allegations that his security was being wasted, impaired, or lost.<sup>23</sup> In addition, it seems likely that the Kempfs had not received payments from the purchaser sufficient to pay off the entire remaining obligation, since the land contract had been executed only six months after execution of the mortgage. The facts of *Nichols* parallel those of *Tucker*, which also involved the execution of an installment land contract within months of the initial mortgage.<sup>24</sup> Thus, in each case, the "*quantum of restraint*—that is, the actual practical effect upon alienation which would result from enforcement of the restraint"<sup>25</sup> upon the transfer by installment

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19. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

20. *Id.* at 632-33, 526 P.2d at 1170-71, 116 Cal. Rptr. at 634-35.

21. *Id.* at 635, 526 P.2d at 1172, 116 Cal. Rptr. at 634-35.

22. *Id.* at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639. The term "moral risks" here refers to the likelihood of having to retake the property, indicated by the poor credit of the borrower or the foreseeability of waste. Hetland, *Real Property and Real Property Security: The Well-Being of the Law*, 53 CALIF. L. REV. 151, 170 (1965).

23. *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 174, 250 N.W.2d 804, 809 (1977); *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 640, 526 P.2d 1169, 1176, 116 Cal. Rptr. 633, 640 (1974).

24. 12 Cal. 3d at 632-33, 526 P.2d at 1170-71, 116 Cal. Rptr. at 634-35.

25. *Id.* at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637 (emphasis original).

land contract—would be of “very considerable proportions.”<sup>26</sup>

It was on this basis that the *Nichols* court followed the California Supreme Court<sup>27</sup> in rejecting the “money market” rationale for enforcement of due-on-sale clauses.<sup>28</sup> Under this rationale, the mortgagee’s reasonable interest in maintaining his lending portfolio at current interest rates justifies the restraint imposed upon mortgagors. This practice is said to be justified because it accommodates the lender’s reasonable interest in profiting from changes in business conditions (so as to stabilize current mortgage rates for new borrowers), and because it creates the potential for higher returns which the mortgagee (typically a savings and loan association) can thereby afford to give to its investors.

Where a due-on-sale clause is coupled with a prepayment penalty, the money market justification is especially suspect. It is inconsistent for a defendant-mortgagee who claims that he has a legitimate interest in benefiting from a rise in interest rates to also claim that it is fair to enforce a prepayment penalty when interest rates fall. If it is reasonable for the mortgagee to protect his option to relend at higher rates, then it would seem equally reasonable for the mortgagor to pay off the loan in advance, and take a new mortgage available at lower interest rates. Thus, in *Crockett v. First Federal Savings & Loan Association*,<sup>29</sup> the court upheld enforcement of the due-on-sale clause as a reasonable restraint on alienation in part because of the lack of a prepayment penalty provision.<sup>30</sup>

In *Nichols*, on the other hand, the note did provide for a prepayment penalty. Although the court mentioned this fact in order to

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

27. 73 Mich. App. at 171-74, 250 N.W.2d at 808-09. In a footnote, the *Tucker* court had expressly overruled its earlier decision in *Cherry v. Home Sav. & Loan Ass’n*, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969), to the extent that *Cherry* had upheld the due-on-sale clause on the money market rationale. The court stated that:

Whatever cogency this argument may retain concerning the relatively mild restraint involved in the case of an outright sale . . . , it lacks all force in the case of the serious and extreme restraint which would result from the automatic enforcement of “due-on” clauses in the context of installment land contracts.

12 Cal. 3d at 639 n.10, 526 P.2d at 1175-76 n.10, 116 Cal. Rptr. at 639-40 n.10. Without impugning the logic of the money market rationale, the court stated that the unreasonableness of requiring full payment of the loan in the context of an installment land contract *outweighed* the reasonableness of the mortgagee’s interest in maintaining its portfolio: “To the degree that enforcement of the clause would result in an increased quantum of actual restraint on alienation *in the particular case*, a greater justification for such enforcement from the standpoint of the lender’s legitimate interests will be required in order to warrant enforcement.” *Id.* at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637 (emphasis added).

28. See Comment, *supra* note 10, at 1124.

29. 289 N.C. 620, 224 S.E.2d 580 (1976).

30. *Id.* at 626, 224 S.E.2d at 585.

distinguish *Crockett*, the *Nichols* court simply stated in its conclusion that "under the facts of the present case, we, as did the California Supreme Court in *Tucker*, find the money market argument unpersuasive."<sup>31</sup> Since *Tucker* did not discuss the effect of a prepayment penalty provision on the money market rationale, and the *Nichols* court considered the ability to prepay without penalty to be a "weak argument"<sup>32</sup> in any case, one might reasonably conclude that the provision for a prepayment penalty was unimportant to the court's decision. Nevertheless, this factual difference between *Nichols* and *Tucker* renders *Nichols* a stronger case for the invalidity of the due-on-sale clause.<sup>33</sup>

More significant than the factual distinctions in *Nichols*, is the remedy adopted by the court: a permanent injunction against foreclosure proceedings. In *Tucker*, and in the only post-*Tucker* case (aside from *Nichols*) which has held the due-on-sale clause to be an unreasonable restraint on alienation, *DeMey v. Joujon-Roche*,<sup>34</sup> damages were awarded. In the latter case, the defendant's attempt to enforce a due-on-sale clause in the deed of trust caused the plaintiffs' prospective sale to fail entirely. The court relied on *Tucker* in awarding the

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31. 73 Mich. App. at 174, 250 N.W.2d at 809.

32. *Id.* at 172, 250 N.W.2d at 808.

33. An additional factual difference between *Nichols* and *Tucker* is that the due-on-sale clause in *Tucker* began: "TO PROTECT THE SECURITY OF THIS DEED OF TRUST, TRUSTOR AGREES: . . . ." 12 Cal. 3d at 632 n.3, 526 P.2d at 1171 n.3, 116 Cal. Rptr. at 635 n.3. Additionally, plaintiffs executed a "Borrower's Statement of Understanding" which stated that:

We understand that your loan committee has approved this loan not only because they consider the property adequate security, but also because of our credit rating. Therefore, should we sell or transfer the property . . . the Association reserves the right to . . . declare the entire sum owing due and payable.

12 Cal. 3d at 632-33 n.3, 526 P.2d at 1171 n.3, 116 Cal. Rptr. at 635 n.3. Each of these phrases suggests that the purpose of the due-on-sale clause was to protect against waste or impairment of the security, or default by the particular trustor, and not against a rise in interest rates. The defendant's acceptance of the purchasers under the land contract as periodic tenants of the trustor for approximately ten months prior to their purchase indicates that it certainly did not consider that the transfer jeopardized its security. (The court here cites a memorandum of decision of the trial court which stated that: "[T]he provisions of [the 'due-on' clause] would certainly apply to leasing of the property." *Id.* at 631 n.4, 526 P.2d at 1171 n.4, 116 Cal. Rptr. at 635 n.4). Furthermore, legislation effective in California when *Tucker* was decided prohibited deficiency judgments against the mortgagor. CAL. CIV. PROC. CODE § 580b (West 1976). See Comment, *supra* note 10, at 1115. Thus, the financial worth of the particular mortgagor was irrelevant to the protection of the mortgagee's interests in the event of foreclosure.

In *Nichols*, not only were there no allegations of waste or of increase in the "moral risks" of having to foreclose, but there was no evidence which might support either of these allegations even if they had been made. Furthermore, there was no indication that enforcement of the due-on-sale clause was to be limited to special circumstances.

34. 133 Cal. Rptr. 570 (1976) (opinion omitted at 63 Cal. App. 3d 178).



plaintiffs damages in an amount equal to their expected profit from the sale. The *DeMey* court noted that the property was desert land, and thus not susceptible to waste. For this reason, it was unreasonable to enforce the clause upon what was essentially an installment sale, solely to maintain the defendant's lending portfolio.<sup>35</sup>

In *Tucker*, attempted enforcement of the due-on-sale clause forced an alternate method of sale, while in *DeMey*, the trustor's sale failed completely. Thus, damages was the only appropriate remedy in both cases, since the suits were brought after-the-fact. In *Nichols*, on the other hand, the plaintiffs brought suit seeking relief before the transaction was altered or abandoned. By virtue of the court's award of an injunction against foreclosure, this case was the first in which a court's finding that a due-on-sale clause constituted an unreasonable, and therefore invalid, restraint on alienation actually had the effect of preventing its enforcement. In granting equitable relief, the *Nichols* court did not require the plaintiffs to make any special showing of irreparable harm or inadequate legal remedy. Thus, the case may also stand for the proposition that in cases involving due-on-sale clauses, equitable relief will be available without any showing beyond what would be needed to support a claim for damages.

*Nichols* also addressed the contention that the due-on-sale clause can be justified as a disguised variable interest rate mortgage. Since a variable interest rate clause is generally a valid device for the lender automatically to take advantage of fluctuations in the money market structure,<sup>36</sup> it can be argued that the due-on-sale clause should be enforceable. The court distinguished the due-on-sale clause from the variable interest rate clause upheld in *Miller v. Pacific First Federal Savings & Loan Association*,<sup>37</sup> by stressing that the ordinary mortgagor would assume that the provision was intended only to protect the mortgagee's security, absent some effective disclosure to the contrary.<sup>38</sup> This criticism seems quite plausible and proper, and obviously adds to the unreasonableness of the restraint. It should also be noted that in a more recent Washington case, *Bellingham First Federal Savings & Loan Association v. Garrison*,<sup>39</sup> the court carefully distin-

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35. *Id.* at 572.

36. Comment, *supra* note 10, at 1125, 1130 & n.99. It should be noted, however, that such provisions are illegal in Michigan. MICH. COMP. LAWS § 438.31c(2) (Supp. 1976).

37. 86 Wash. 2d 401, 545 P.2d 546 (1976).

38. The court discussed the strong dissent in *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976), which pointed out that the clause's true purpose would not be apparent to the ordinary reader. 73 Mich. App. at 172-73, 250 N.W.2d at 808-09.

39. 87 Wash. 2d 437, 553 P.2d 1090 (1976).

guished between variable interest rate provisions and due-on-sale clauses, applying the *Tucker* rule of reasonableness to the latter.<sup>40</sup>

The element of disclosure would seem to be a major criterion in those jurisdictions which do not treat the due-on-sale clause as automatically invalid.<sup>41</sup> In *Gunther v. White*,<sup>42</sup> for example, the court found a change in interest rates to be a sufficient justification for acceleration,<sup>43</sup> but stated in dicta that inequitable conduct on the part of the mortgagee would relieve a borrower from operation of the clause.<sup>44</sup> In upholding the enforcement, the court, in the words of one commentator, notably "found sufficient evidence to infer intent on the part of the borrower to allow the lender to take advantage of the change in money-market conditions."<sup>45</sup> In addition, it has been suggested that a failure to inform the mortgagor at the time of the original transaction that the due-on-sale clause is to be used to extract a higher rate from a purchaser involves an element of unfair surprise.<sup>46</sup>

In jurisdictions accepting the *Nichols* (or *Tucker*) approach, the element of disclosure can be treated as simply another factor to be weighed in determining the reasonableness of enforcing the due-on-sale clause in the particular circumstances. That is, the flexible approach used in *Nichols* can incorporate the notice factor just as well as such factors as the existence of a prepayment penalty provision, the type of sale entered into by the mortgagor, the ratio of the outstanding indebtedness to the value of the secured property, the past credit record and job status of the mortgagor's vendee, and the general real estate market conditions.

The adoption of the flexible approach by other jurisdictions in the

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40. *Id.* at 440-41, 553 P.2d at 1091-92. The court upheld enforcement of the due-on-sale clause on the facts of the case, however, because the mortgagor's vendee was a poor credit risk. *Id.* at 442, 553 P.2d at 1092-93.

41. Some jurisdictions which do not view the due-on-sale clause as a restraint on alienation instead evaluate the clause under the penalty doctrine. This doctrine states that a court of equity will not enforce a penalty, i.e., an equity court will grant relief, "if the mortgagee's conduct indicates a waiver or amounts to bad faith, fraud, or unconscionable conduct. . . ." Volkmer, *supra* note 6, at 786. See e.g., *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972); *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 79, 486 P.2d 190 (1971), *rev. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. App. 1970). Utilization of the penalty doctrine to protect against enforcement of the due-on-sale clause is unnecessary, however, since "the restraints doctrine in this area would represent a natural development of the doctrine as expanded by *Minderhout* and refined by *Pellerito* and *Lemon*." Volkmer, *supra* note 6, at 803.

42. 489 S.W.2d 529 (Tenn. 1973).

43. *Id.* at 531.

44. *Id.*

45. Comment, *supra* note 10, at 1124.

46. *Id.* at 1127.

wake of *Nichols* seems likely. Michigan has been a prominent jurisdiction in the application of the restraints on alienation doctrine to real property security interests. *Sloman v. Cutler*,<sup>47</sup> the landmark case in upholding the validity of nonassignment provisions in land contracts, and the cases first adopting the flexible approach to restraints on alienation, *Pellerito v. Weber*<sup>48</sup> and *Lemon v. Nicolai*,<sup>49</sup> have all been Michigan decisions.

By its decision in *Nichols*, Michigan has become one of the few states to apply the flexible approach to restraints on alienation to the due-on-sale clause. The Michigan court was only the second to actually hold that the enforcement of a due-on-sale clause constituted an invalid restraint on alienation, and *Nichols* represents the first case in which the defendant-mortgagee was enjoined from foreclosure on the ground that enforcement of the clause would be an unreasonable restraint. *Nichols* provides support for the view that the mortgagee will be allowed to exercise the due-on-sale clause to his benefit only where a minimal quantum of restraint is imposed on the mortgagor's ability to alienate his land.

CLIFFORD M. WIENER

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47. 258 Mich. 372, 242 N.W. 735 (1932).

48. 22 Mich. App. 242, 177 N.W.2d 236 (1970).

49. 33 Mich. App. 646, 190 N.W.2d 549 (1971).

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Lending institutions have commonly included a provision in mortgage contracts allowing them to accelerate the maturity of a loan upon the alienation of the secured property.<sup>1</sup> Lenders use such due-on-sale clauses to adjust the overall yield of their loan portfolios toward the prevailing interest rates.<sup>2</sup> This practice may be severely limited because of recent state court decisions, including a Michigan Court of Appeals' decision in *Nichols v. Ann Arbor Federal Savings & Loan Association*.<sup>3</sup> The Michigan court held that the due-on-sale clause was unenforceable as an unreasonable restraint on the borrower's ability to alienate where the sole basis for enforcement was the lender's interest in maintaining his loan portfolio at current interest rates. Although the *Nichols* court emphasized its concern for the interests of the borrower, it is the contention of this writer that the court's decision will upset the conventional mortgage market at the expense of both lending institutions and home buyers.

In *Nichols*, the John Adams Mortgage Company held a mortgage, containing a due-on-sale clause, on certain real estate owned by Her-

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1. In 1970, the Federal Home Loan Mortgage Corporation conducted a survey of conventional mortgages (principally those used by savings and loan associations) and found that over two-thirds of such mortgages included due-on-sale clauses. Federal Home Loan Bank Bd. Adv. Op. No. 75-647, at 29 (July 30, 1975) (entered in Schott v. Mission Fed. Sav. & Loan Ass'n, No. 75-366 WMB (C.D. Cal., filed Feb. 4, 1975)).

2. Although some contend that the due-on-sale clause was originally used by lenders to protect their security interests, e.g., Valensi, *The Due on Sale Clause—A Dissenting Opinion* 45 L.A.B. BULL. 121 (1970), most authorities agree that it was conceived primarily to combat the rising interest rates of the 1960's. E.g., FEDERAL NATIONAL MORTGAGE ASSOCIATION, PUBLIC MEETING ON CONVENTIONAL MORTGAGE FORMS, S. DOC. NO. 92-21, 92d Cong., 1st Sess. 147 (1971) (Statement of Haydon M. Calvert, Senior Vice-President, Prudential Federal Savings & Loan Association, Salt Lake City, Utah) [hereinafter cited as FNMA PUBLIC MEETING].

3. 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977). The due-on-sale clause discussed in *Nichols* stated:

That the mortgage shall become due and payable forthwith at the option of the Mortgagee if there shall be any change in the ownership of the mortgaged property then and in such event, the aforesaid principal sum with accrued interest shall, at the option of the Mortgagee, become due and payable immediately . . . .

Brief for Appellant at Exhibit D-2, *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977).

For other state court decisions concerning due-on-sale clauses, see e.g., *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971), *rev. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972); *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal.3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); *accord*, *DeMey v. Joujon-Rouche*, 133 Cal. Rptr. 570 (1976) (opinion omitted at 63 Cal. App. 3d 178).

bert and Virginia Kempf.<sup>4</sup> The mortgage company assigned the mortgage to the defendant, the Ann Arbor Federal Savings & Loan Association (the Bank).<sup>5</sup> Approximately six months later, the Kempfs sold the property to Charles and Laverne Nichols on an installment land contract without the Bank's approval.<sup>6</sup> The Bank accelerated the mortgage debt,<sup>7</sup> and when the Kempfs did not pay off the loan, the Bank commenced foreclosure proceedings.<sup>8</sup>

The Kempfs and the Nichols filed independent suits seeking to enjoin the foreclosure and their actions were consolidated for trial.<sup>9</sup> The trial court granted the plaintiffs' motion for summary judgment and the court of appeals affirmed.<sup>10</sup> The Michigan Supreme Court denied leave to appeal.<sup>11</sup>

The court of appeals saw the problem presented by *Nichols* as twofold. First, was the due-on-sale clause a restraint on alienation? Second, if so, was it reasonable under the circumstances, so as to be enforceable under Michigan law?<sup>12</sup>

In answering the first question, the *Nichols* court noted that the due-on-sale clause does not fall within the Restatement of Property's definition<sup>13</sup> of a restraint on alienation. In spite of this, the court found that it "directly and fundamentally burdens a mortgagor's ability to alienate as surely and directly as the classical promissory restraint. As such, the due-on-sale clause is truly a direct restraint insofar as the

4. Brief for Appellant at 1, *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977).

5. *Id.*

6. 73 Mich. App. at 164, 250 N.W.2d at 805.

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

11. 400 Mich. 844 (1977).

12. 73 Mich. App. at 168, 250 N.W.2d at 806.

13. (1) A restraint on alienation, as that phrase is used in this Restatement is an attempt by an otherwise effective conveyance or contract to cause a later conveyance

(a) to be void; or

(b) to impose contractual liability on the one who makes the later conveyance when such liability results from a breach of an agreement not to convey; or

(c) to terminate or subject to termination all or a part of the property interest conveyed.

(2) If a restraint on alienation is of the type described in Subsection (1), Clause (a), it is a disabling restraint.

(3) If a restraint on alienation is of the type described in Subsection (1), Clause (b), it is a promissory restraint.

(4) If a restraint on alienation is of the type described in Subsection (1), Clause (c), it is a forfeiture restraint.

category of direct restraints can be articulated.”<sup>14</sup> For support, the court cited several cases from other jurisdictions which also adopted this position.<sup>15</sup>

In opposition to this conclusion, the Bank sought to distinguish the cases on which the court ultimately relied<sup>16</sup> by contending that the due-on-sale clause did not prohibit the Kempfs from alienating their property, but instead merely “furnish[ed] a measure of the duration of the loan contract between the mortgagor and the mortgagee.”<sup>17</sup> This argument is superficial and specious. Surely the mortgagor can alienate his property, but what is crucial here is not whether the clause expressly precludes the mortgagor from alienating, but whether it operates to inhibit him from doing so, and thus functions as a classic restraint on alienation.

In the case where a mortgagor transfers an interest in property which is the subject of a due-on-sale provision, the mortgagee may accelerate the mortgage debt, converting a long-term installment debt into one which is immediately due and payable in full. In this way, the due-on-sale clause is like a promissory restraint, where alienation constitutes a default on the agreement, entitling the mortgagee to full and immediate payment. In each case, the provision functions to restrain or deter alienation mainly because it causes the mortgagor to lose the principal benefit of the mortgage agreement—the ability to repay the loan on a deferred installment basis. Thus, where the mortgagee chooses to accelerate the mortgagor’s indebtedness, the practical effect of a due-on-sale clause is the same as a promissory restraint, and the court was proper in so treating it.

Normally, however, rather than incur the cost of a probable foreclosure proceeding and the delay of relending the proceeds, the mortgagee will waive his right to call the loan on the condition that the

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14. 73 Mich. App. at 166, 250 N.W.2d at 805 (quoting Volkmer, *The Application of the Restraint on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 774 (1973)).

15. Tucker v. Lassen Sav. & Loan Ass’n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); Coast Bank v. Minderhout, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964); Malouff v. Midland Fed. Sav. & Loan Ass’n, 181 Colo. 294, 509 P.2d 1240 (1973); Baker v. Loves Park Sav. & Loan Ass’n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

16. Lemon v. Nicolai, 33 Mich. App. 646, 190 N.W.2d 549 (1971); Pellerito v. Weber, 22 Mich. App. 242, 177 N.W.2d 236 (1970). Both *Lemon* and *Pellerito* involved installment land contracts containing clauses requiring the vendor’s written consent before the vendee could assign his interest. These provisions fell under the Restatement definition of a restraint on alienation. See RESTATEMENT OF PROPERTY § 404(1)(b), (c) (1944).

17. Brief for Appellant at 5, Nichols v. Ann Arbor Fed. Sav. & Loan Ass’n, 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977).

mortgagor or vendee accept an increase in the interest rate.<sup>18</sup> Since the elimination of the bargain rate will reduce the selling price of the property, the mortgagor will be less willing to alienate. Thus, even where the mortgagee does not enforce the due-on-sale clause but instead uses it as a means to obtain a higher interest rate, the court was justified in holding that the provision constituted a restraint on alienation.

The court decided the second issue, whether the due-on-sale clause was a *reasonable* restraint on alienation, by applying the rule it had developed in *Pellerito v. Weber*<sup>19</sup> and *Lemon v. Nicolai*.<sup>20</sup> These cases held that nonassignment provisions in land contracts<sup>21</sup> were unenforceable as unreasonable restraints on alienation unless the seller could demonstrate that the purchaser's transfer to a third party created a risk of waste, impairment, or loss of the security.<sup>22</sup> In *Nichols*, the Bank simply argued that its interest in maintaining its portfolio at the prevailing interest rates was sufficient to allow the enforcement of the provision.<sup>23</sup> The court rejected this argument and followed the *Pellerito-Lemon* rule, holding the due-on-sale clause unenforceable, absent a showing that the sale created a threat to the Bank's security.<sup>24</sup>

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18. Of course, if interest rates have declined, mortgagees, as a rule, will not call the loan. Under such circumstances, no restraint on alienation arises.

19. 22 Mich. App. 242, 177 N.W.2d 236 (1970).

20. 33 Mich. App. 646, 190 N.W.2d 549 (1971).

21. Until *Nichols*, Michigan courts had never addressed the question of the validity of restraints on alienation in mortgages. Thus the court of appeals had to rely on its former treatment of restraints on alienation in land contracts.

22. *Lemon v. Nicolai*, 33 Mich. App. 646, 649, 190 N.W.2d 549, 550 (1971); *Pellerito v. Weber*, 22 Mich. App. 242, 245, 177 N.W.2d 236, 238 (1970). See 73 Mich. App. at 167-68, 250 N.W.2d at 806.

23. Brief for Appellant at 7-19, *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977).

24. 73 Mich. App. at 173, 250 N.W.2d at 809. In dictum, the court expressed concern that a due-on-sale clause often does not reveal its purpose to the mortgagor. *Id.* at 172-73, 250 N.W.2d at 808-09. The Federal Loan Bank Board has shared this concern and as of July 31, 1976, it was the responsibility of every federally chartered savings and loan institution to ensure that the "rights and obligations of the contracting parties . . . [were] fully and specifically disclosed to borrowers." 12 C.F.R. § 556.9(a) (1977).

While some mortgagees may not adequately explain the workings of the due-on-sale clause to their mortgagors, this was not the case in *Nichols*. Herbert Kempf was a realtor who purported to purchase the loan for residential use, Brief for Appellant at Exhibit B-1, B-3, *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804, *appeal denied*, 400 Mich. 844 (1977), but apparently used it for commercial purposes. He bought the property for \$33,950, *id.* at Exhibit A-1, with a \$30,500 loan, acquired at an interest rate of 8%, to be paid back in monthly installments of \$223.80. *Id.* at Exhibit E-1. Approximately six months later, the Kempfs sold the property on an installment land contract to the Nichols for \$46,000 plus interest. The Nichols agreed to pay \$6,000 down and installments of \$223.00 per month at an interest rate of 8 1/2%,

To fully understand the significance of the case, it is necessary to examine why the Bank did not argue that the transfer to the Nichols impaired its security. The court would have then been faced with issues of both law and fact, and the Bank might well have prevailed on the latter.<sup>25</sup> Yet, the Bank did not wish to give the court an out and have the case resolved on a factual point. Thus, its strategy was to press the legal issue and attempt to establish a more useful precedent—a right to enforce a due-on-sale clause solely on the basis of the Bank's interest in upgrading its loan portfolio.<sup>26</sup>

This issue was one of first impression under Michigan law; however, courts of other jurisdictions had already faced the problem, with mixed results.<sup>27</sup> After considering several of these opinions, the *Nichols* court approved the reasoning of the California Supreme Court in *Tucker v. Lassen Savings & Loan Association*,<sup>28</sup> which stated that "the clause can be validly enforced only when the beneficiary-obligee can demonstrate a threat to one of his legitimate interests sufficient to justify the restraint on alienation inherent in its enforcement."<sup>29</sup> In a footnote, the California court had "reject[ed] the suggestion that a lender's interest in maintaining its portfolio at current interest rates justify[d] the restraint imposed by the exercise of a 'due-on' clause upon the execution of an installment land contract."<sup>30</sup> But the *Tucker*

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rising to 9 1/2% when and as often as the Nichols were in default. *Id.* at Exhibit F-1.

It is interesting to note that, in effect, the Nichols are leasing the property from the Kempfs. This is because the first month's interest (\$283.33) was greater than the monthly installment (\$223.00). Consequently, the amount of interest remaining due will be perpetually increasing. Unless the Nichols could afford to pay \$307.57 per month (the installment required to pay \$40,000 at 8 1/2% amortized over 30 years), they would default on the contract when its term expires. *Id.* at Exhibit F-1, F-2. Thus, at \$223.00 per month, the effect of the transaction is a lease rather than a sale.

25. Interview with Donald L. Bramlage, Jr., counsel for the Nichols (June 13, 1977); Interview with Alvin P. Lipnik, Vice-President and General Counsel for the Ann Arbor Federal Savings & Loan Association (June 14, 1977).

26. Interview with Alvin P. Lipnik, *supra* note 25.

27. For examples of cases opposing enforcement under these circumstances, see *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971), *rev. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972); *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

For examples of cases supporting enforceability in this setting, see *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 509 P.2d 1240 (1973); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973); *Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works*, 71 Wis. 2d 531, 239 N.W.2d 20 (1976). *Accord*, *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976); *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 545 P.2d 546 (1976).

28. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

29. *Id.* at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.

30. *Id.* at 639-40 n.10, 526 P.2d at 1175-76 n.10, 116 Cal. Rptr. at 639-40 n.10.



court only explained that a due-on-sale clause imposes a more severe restraint in the case of a transfer by installment land contract than in the case of an outright sale.<sup>31</sup> It did not evaluate the effect on the lender of preventing him from adjusting his portfolio to the current market rates to determine if it outweighed the harm from the restraint on alienation inflicted on the borrower. Such an analysis is crucial, but first it is important to examine the rule that *Nichols* adopted.

Certainty is traditionally recognized as a prime objective in fashioning rules of property law.<sup>32</sup> By requiring the mortgagee to demonstrate that the security has been impaired by a transfer of the property, the *Nichols* court violated this precept. Michigan real estate transactions are now clouded with questions as to when a mortgagee's security interest might be deemed to have been impaired. Two commentators have suggested that the security issue may be determined by a reasonableness test based on a loan-to-value ratio.<sup>33</sup> There are two problems inherent to such a test. First, it would be costly, since at least one recent appraisal of the security would be necessary. Moreover, it is likely that more than one would be commissioned, because valuation

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31. The court reasoned that in the case of an outright sale, the mortgagor-vendor receives full payment for his property at the time of the transfer and should be able to pay off his entire debt when the mortgagee enforces the due-on-sale clause. Thus, the restraint on alienation is slight. On the other hand, if an installment land contract is used, the mortgagor-vendor receives a relatively small down payment from the vendee and will therefore have little cash on hand from the transaction, when the mortgagee enforces the due-on-sale clause. When the amount due on the loan is substantial, the mortgagor's ability to alienate will be severely restrained.

The holding of *Tucker* applies only to situations where the secured property is transferred by installment land contract. The California court left open the question of whether "the relatively mild restraint involved in the case of an outright sale" would be justified by the lender's interest in maintaining its portfolio at current interest rates. *Id.* Since *Nichols* relied heavily on *Tucker*, it appears that *Nichols*, like *Tucker*, will apply only to cases of installment land contracts. Thus, until there is definitive case or statutory law to the contrary, Michigan lenders may succeed in enforcing due-on-sale clauses without a showing of waste or impairment of the security in situations where the secured property is transferred by outright sale.

32. See, e.g., *Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 126, 333 N.E.2d 1, 5 (1975). See also Manning, *The Development of Restraints on Alienation Since Gray*, 48 HARV. L. REV. 373, 405 (1935): "Although reasonableness may be a disguise for saying that the policy of the jurisdiction favors . . . restraints [on alienation], it is, nonetheless, a dangerous method of approach in a branch of the law where predictability of judicial result is of paramount importance . . . ."

33. Under this test, the mortgagee's security interest has been sufficiently impaired to justify enforcing a due-on-sale clause, when the ratio of the outstanding indebtedness to the current value of the secured property at the time of the sale by the mortgagor is substantially higher than the original ratio of the amount loaned to the value of the property at the inception of the loan. See Note, *Due on Sale and Due on Encumbrance Clauses in California*, 7 LOY. L.A.L. REV. 306, 315-19 (1974); Note, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1122-23 (1975).

would become a central issue, and each party will typically assert that its appraisal is the accurate one. Second, as with any reasonableness test, the results will likely turn on the peculiar facts and circumstances of each case, inviting more litigation and leaving less certainty in the marketplace. For these reasons, it is evident that the *Nichols* court has left Michigan with a burdensome rule for enforcing due-on-sale clauses.<sup>34</sup>

The *Nichols* decision may also create a lack of uniformity in the treatment of federal and state lending institutions. In 1976, the Federal Home Loan Bank Board amended its regulations, confirming the right of federally chartered savings and loan associations to include a due-on-sale clause in their loan contracts.<sup>35</sup> These clauses are to be governed exclusively by the terms of the loan agreement.<sup>36</sup> Thus, federal savings and loan associations need not show a threat to their security to enforce the clause.

Even if federal associations had this right when the *Nichols* litigation commenced, the Bank could not have raised it, since it had been assigned the mortgage by a state mortgage company, and an assignee generally can have no greater rights than its assignor.<sup>37</sup> But what is interesting to note is that the Bank may profit by losing its case. *Nichols* established a state common law rule prohibiting the enforcement of due-on-sale clauses absent a showing of waste or impairment of the security. At the same time, federal regulations now allow

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34. In Arkansas, which had earlier adopted a rule similar to *Nichols*, *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972), lenders have indicated that the current practice is to allow home buyers to assume existing mortgages rather than risk going to court over the security issue. Only in the rare situation where the transfer creates an egregious threat to the security is a lender likely to call the loan. Interview with David F. Menz of Wright, Lindsey & Jennings, counsel for the Pulaski Federal Savings & Loan Association (Oct. 13, 1977). It seems that Michigan lenders have now taken a similar stance. Interview with Alvin P. Lipnik, *supra* note 25 (Oct. 12, 1977). Thus, the effect of the *Nichols* rule appears to be substantially the same as if the due-on-sale clause had been wholly eliminated (except, as previously noted, in situations where the property has been transferred by outright sale, *see* note 31 *supra*).

35. *Due-on-sale clauses*. A Federal association continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instruments whereby the association may, at its option, declare immediately due and payable all of the sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent. . . . [E]xercise by an association of such an option (hereafter called a due-on-sale clause) shall be governed exclusively by the terms of the contract between the association and the borrower, and all rights and remedies of the association and borrower thereto shall be fixed and governed by said contract. 12 C.F.R. § 545.6-11(f) (1977).

36. *Id.*

37. *See, e.g.*, 4 A. CORBIN, CONTRACTS § 861 (1951 & Supp. 1971).

federally chartered savings and loan associations to enforce such clauses solely on the basis of the parties' agreement. Assuming that both rules may co-exist, the result in Michigan is that federal savings and loan institutions will be able to enforce due-on-sale clauses in situations where state chartered banks cannot. For this reason, Ann Arbor Federal Savings & Loan, as a federally chartered institution, would not be subject to the rule in *Nichols* and would accordingly enjoy an advantage of its state chartered competitors.

Whether this result will actually obtain, however, is not fully resolved. At present, federal savings and loan associations are awaiting the outcome of a California case<sup>38</sup> where the issue is whether the Federal Home Loan Bank Board can preempt state law concerning the enforceability of the due-on-sale clause. It is submitted that the Board should prevail, because "courts have upheld the authority of the Board on the basis that the plenary powers given to the Board in the HOLA [Home Owners' Loan Act] clearly evidence a Congressional intention to preempt the field, thus precluding any regulation of federal associations by state law."<sup>39</sup> If the Board does prevail, federal savings and loan associations may be expected to test the same issue in Michigan.<sup>40</sup> If one does and wins, state chartered lending institutions in Michigan will become second class citizens—at least until the *Nichols* rule is abolished. Should the above scenario occur, lenders will face a period of uncertainty and, in the end, the home buyer will suffer, because state regulated lenders will likely attempt to charge higher interest rates to compensate for the absence of a readily enforceable due-on-sale clause.<sup>41</sup>

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38. *People v. Glendale Fed. Sav. & Loan Ass'n*, No. 76-0162-HP (C.D. Cal., filed Jan. 14, 1976).

39. *Lyons Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 377 F. Supp. 11, 17 (N.D. Ill. 1974). *E.g.*, *Myers v. Beverly Hills Fed. Sav. & Loan Ass'n*, 499 F.2d 1145, 1147 (9th Cir. 1974); *People v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311, 319 (S.D. Cal. 1951).

40. Federal savings and loan associations in Michigan may be reluctant to test the preemption issue until they can get an accurate interpretation of 12 C.F.R. § 545.6-11(g)(1)(i) (1977) which states that a federal association may not invoke a due-on-sale clause because of the "creation of a lien or other encumbrance subordinate to the association's security instrument." Until such an interpretation, federal associations in Michigan may have to limit their use of the due-on-sale clause to the situation where the secured property is transferred by outright sale. The same regulation prevents a federally chartered lender from invoking the due-on-sale clause because of a "creation of a purchase money security interest for household appliances; [a] transfer by devise, descent, or by operation of law upon the death of a joint tenant; or [a] grant of any leasehold interest of three years or less not containing an option to purchase." 12 C.F.R. § 545.6-11(g)(1)(ii)-(iv) (1977). Furthermore, Board policy suggests that a federal association not exercise the provision when the transfer is made to immediate family or when the existing borrower faces extreme hardship. *Id.* at § 556.9(c).

41. See text accompanying note 54 *infra*.

Lending institutions commonly sell some of their mortgages in the secondary market

The most immediate effect of the *Nichols* decision is that it prevents Michigan lending institutions from using the due-on-sale clause to upgrade their loan portfolios. While some suggest that the use of variable rate mortgages may be a more equitable solution to the changing money market,<sup>42</sup> this practice is unlawful in Michigan.<sup>43</sup>

to generate additional funds for residential loans. Without a readily enforceable due-on-sale clause, Michigan mortgages will be less attractive to secondary loan purchasers than mortgages with a more viable due-on-sale provision. Thus, Michigan lenders will be at a competitive disadvantage in this secondary market, resulting in a reduction of new funds available for home loans in Michigan. See, e.g., Federal Home Loan Bank Bd. Adv. Op. No. 75-647, at 28-34 (July 30, 1975) (entered in *Schott v. Mission v. Fed. Sav. & Loan Ass'n*, No. 75-366 WMB (C.D. Cal., filed Feb. 4, 1975)). See also Pratt, *The Due on Sale Clause in California and Federally Chartered Savings and Loan Associations*, at 23-25 (submitted in *Schott v. Mission Fed. Sav. & Loan Ass'n*, No. 75-366 WMB (C.D. Cal., filed Feb. 4, 1975)).

42. See, e.g., FNMA PUBLIC MEETING, *supra* note 2, at 148; Note, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1130 (1975). See also Brief for Appellee at 9, *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 250 N.W.2d 804, appeal denied, 400 Mich. 844 (1977).

The advantage of variable rate mortgages is that the ability of the mortgagee to vary the interest rate (within prescribed statutory limits) throughout the duration of the loan permits him to offer a more competitive initial rate. In addition, because it allows for the possibility of interest rate reductions, borrowers may be more willing to accept a relatively high initial rate where they will be able to benefit from later downward movements in the prevailing rate without having to refinance the transaction. In periods of inflation, variable rate mortgages are well suited to borrowers who presently earn a modest income, but expect their income to increase thereby enabling them to afford subsequent increases in their mortgage rate. Of course, the variable rate mortgage is a death trap for someone on a fixed income.

Several states have proscribed variable rate mortgages. See, e.g. ILL. ANN. STAT. ch. 74, § 4(d)(Smith-Hurd Supp. 1977); MINN. STAT. ANN. § 334.01(1966); VT. STAT. ANN. tit. 9, § 41(a) (1970). Presumably, this is because their legislatures have decided that too often the mortgagor lacks the financial capacity to weather the interest obligations of a variable rate provision and the foresight or bargaining power to prevent its inclusion in his mortgage contract.

43. "[N]o . . . mortgage . . . shall provide that the rate of interest initially effective may be increased for any reason whatsoever." MICH. COMP. LAWS ANN. § 438.31c(2) (Supp. 1976). In addition, federally chartered savings and loan associations are prohibited from using variable rate mortgages by 12 C.F.R. § 541.14(a) (1977): "[N]o required payment after the first payment shall be more . . . than any preceding payment." When a mortgagee uses the due-on-sale clause in order to obtain a higher interest rate, he drafts a new mortgage agreement and thus circumvents § 438.31c(2) and § 541.14(a).

By prohibiting variable rate mortgages, Michigan, in effect, has mandated that its lending institutions insure their mortgagors against unexpected increases in interest rates. Savings and loan institutions generally acquire their funds from short-term sources (e.g. passbook savings and savings certificates) and invest them principally in long-term mortgages. Where variable rate mortgages are prohibited, the lender must determine the interest rate on the long-term loan by estimating what the interest rate will be for short-term capital over the life of the long-term loan. As a result, these lending institutions must depend on estimates of future interest rates and take the risk that these estimates may turn out to be too low. In compelling mortgagees to assume this risk, a prohibition of variable rate mortgages insures the mortgagor that the interest rate payable on his loan

Thus, by restricting the use of the due-on-sale clause, the *Nichols* court has left Michigan lenders without a means of adjusting their portfolios to the current market rates.

The effect of this situation on those subject to the *Nichols* rule depends upon the general movement of all interest rates. If mortgage rates decrease, the effect will be negligible. Under such conditions, home buyers will typically not assume existing mortgages, because they will be able to obtain financing elsewhere at lower rates. However, when mortgage rates are rising, home buyers will assume existing mortgages in order to retain the lower interest rate and, consequently, the average prepayment period (or life) of the mortgages in a bank's portfolio will increase.<sup>44</sup> As a result, lending institutions will have a greater number of low-interest loans than they would otherwise hold. The harm from this arises out of the fact that savings and loan institutions borrow on a short-term basis to support their long-term lending activities. Thus, during periods of rising interest rates, the cost of lending capital increases directly with the rise in short-term interest rates. Yet, at the same time, due to the greater number of low-yield loans in their mortgage loan portfolios, the institutions' overall yield will increase more slowly. The result is the reduction or elimination of earnings for the period of rising interest rates. In order to compensate for this, lenders must increase current mortgage rates more than would normally be required to offset their own increased costs.<sup>45</sup> In this way, present and future borrowers pay the added cost of preserving bargain rates for those home buyers who assume low-interest mortgages.<sup>46</sup>

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will not be affected by subsequent increases in the prevailing market rates. But, like any insurance, this protection against increasing interest rates comes only with a "premium," which in this case is the incremental percentage of the interest rate charged by the lender to compensate him for any unexpected rise in interest rates. Since, in the absence of § 438.31c(2) and § 541.14(a), rising interest rates would adversely affect all mortgagors, it seems equitable that all mortgagors pay a premium for the protection that the law provides. The same cannot be said for a statute (or case law) invalidating the due-on-sale clause. Such a statute would benefit only those mortgagors who attempt to alienate their property, yet all mortgagors would have to bear the cost of this insurance, since lending institutions would be forced to raise their interest rates on new loans to compensate for their inability to adjust their portfolios to the current rates. See text accompanying notes 47-49, *infra*.

44. Of course, the result will be the same, when the buyer takes subject to the existing mortgage. For example, in *Nichols*, the vendees purchased the property on an installment land contract, and the property remained subject to the Kempf mortgage.

45. See Opinion of the Office of Economic Research of the Federal Home Loan Bank Board on the Revocation of the "Due on Sale Clause" in the State of California, Federal Home Loan Bank Bd. Adv. Op. No. 75-647, Exhibit 1, at 3-5 (July 30, 1975) (entered in *Schott v. Mission Fed. Sav. & Loan Ass'n*, No. 75-366 WMB (C.D. Cal., filed Feb. 4, 1975)).

46. Although the buyer assumes the mortgage at a "bargain rate," it is normally the seller who benefits, since he can charge an inflated price for his property due to its low mortgage rate.

The following hypothetical may illustrate the problem more graphically.<sup>47</sup> Two \$10,000 mortgages, one with a due-on-sale clause and the other without, are closed the same day at an interest rate of 6% with a term of twenty-five years. When the properties are sold four years later, the loan having the due-on-sale clause is called and the interest rate is raised to 7%. Upon the sale of the properties three years hence, the due-on-sale clause is again invoked and the interest rate increased to 7 3/4%. After twenty-five years, the return from the loan with the due-on-sale clause would amount to \$21,535.80,<sup>48</sup> while the payments from the other loan would be \$19,329.00. To have generated that same \$21,535.80 from the loan without the due-on-sale clause, the mortgagee would have had to charge the original borrower an interest rate of approximately 7 1/4% instead of the 6% actually charged.<sup>49</sup>

Perhaps the simplest way to analyze the problem that *Nichols* raises is to ask: who should benefit from an increase in interest rates?<sup>50</sup> If the mortgagor is allowed to use his low interest rate to enhance the

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47. Pratt, *The Due on Sale Clause in California and Federally Chartered Savings and Loan Associations*, at 20-21 (submitted in *Schott v. Mission Fed. Sav. & Loan Ass'n.*, No. 75-366 WMB (C.D. Cal., filed Feb. 4, 1975)).

48. The Pratt study reports a different figure for the total amount generated by the due-on-sale clause. This is due to an apparent typographical error at one stage of the Pratt hypothetical. *Id.* at Table 4.

49. This increase does not take into account the risk factor. The above hypothetical illustrates with an after-the-fact analysis that the mortgagee would have to raise his interest rate approximately 1 1/4% to compensate for its inability to call the loan. As a practical matter, a mortgagee must set his interest rate *before* making a loan. To insure himself against losing money because of an estimate that is too low, the mortgagee will charge an increment to the expected interest rate. Thus, in the hypothetical, the mortgagee of the loan without the due-on-sale clause would charge an interest rate of 7 1/4% plus the increment.

50. Several courts have reasoned that a mortgagee should be able to take advantage of rising interest rates on the theory that a mortgagor has a like ability to profit from declining rates by paying off his loan and refinancing elsewhere at the lower rate. *E.g.*, *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 626-27, 224 S.E.2d 580, 585 (1976). The *Nichols* court rejected this argument. It reasoned that because the promissory note signed by the Kempfs included a prepayment penalty they were precluded from refinancing their mortgage. 73 Mich. App. at 172, 250 N.W.2d at 808. This is not necessarily so; it depends upon the size of both the prepayment penalty and the drop in interest rates. The mortgagor will likely be willing to pay off his loan and refinance elsewhere if the drop in interest rates is sufficient to offset the penalty and overcome the inertia to refinance. This might often happen in Michigan where prepayment fees are limited to 1% of the amount of the prepayment. Furthermore, no prepayment fee may be charged more than three years from the date of the loan. MICH. COMP. LAWS ANN. § 438.31c(2)(c) (Supp. 1976). For the Federal Home Loan Bank Board's limitation on prepayment penalties, see 12 C.F.R. § 545.6-12(b) (1977).

Most lenders admit that the purpose of the prepayment penalty is not to cover the cost of originating the loan, but to deter borrowers from refinancing elsewhere, when interest rates decline. *E.g.*, FNMA PUBLIC MEETING, *supra* note 2, at 196 (statement of Franklin Hardinge, Jr., California Savings and Loan League). Thus, it is suggested that the prepayment provision should be used to penalize only those borrowers who refinance and remain on the property, and not those who are forced to move.

marketability of the property, only he (and possibly the vendee) will profit.<sup>51</sup> On the other hand, if the mortgagee is permitted to accelerate the loan and relend at the prevailing rate, he presumably will be able to maintain lower interest rates on new loans, and the benefit will be spread among all home buyers.<sup>52</sup>

In general, most who argue against the due-on-sale clause seem to feel they are taking a pro-consumer stance.<sup>53</sup> The Federal Home Loan Bank Board disagrees. In an advisory opinion, it stated:

[the] invalidation of the "due-on-sale" clause will enable a certain class of sellers to make a fortuitous profit on the sale of homes with relatively recent low-interest loans (and to sell them more rapidly than other sellers in a tight money market). But it is the Board's firm conviction that such profits will be achieved only at the expense of the general home-buying public, because interest rates on new loans are most likely to be raised to offset the very substantial loss of savings and loan income flowing directly from elimination of the "due-on-sale" clause, and elimination of the "due-on-sale" clause will decrease the supply of housing funds which otherwise would be available. Therefore, viewing consumer interests from the broader perspective, it is the Board's opinion that elimination of the "due-on-sale" clause, at best, will have only a marginal overall consumer benefit, but undoubtedly will cause widespread hardship to the general home-buying public.<sup>54</sup>

Although the *Nichols* court only intended to restrict the due-on-sale clause, and not to eliminate it, the effect will be substantially the same as an absolute bar<sup>55</sup>—an increase in interest rates on new loans and a concomitant decrease in conventional mortgage funds. In addition, there will be less certainty as well as a potential lack of uniformity between state and federal lending practices. And, it is submitted that although lenders will suffer initially, the ultimate loss will be sustained primarily by the very home buyer whose interests the *Nichols* court sought to protect.

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51. Furthermore, such a policy may encourage borrowers to speculate.

52. One may contend that spreading rewards no one, since once the benefit is distributed, it is too insignificant to be meaningful, and that therefore, it is better to allow one person to receive a windfall. This argument ignores the fact that absent spreading, one marginal home buyer may be priced out of the housing market.

53. See, e.g., FNMA PUBLIC MEETING, *supra* note 2, at 116 (statement of John A. Spanogle, Jr., Public Interest Research Group); Note, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109 (1975).

54. Federal Home Loan Bank Bd. Adv. Op. No. 75-647, at 37 (July 30, 1975) (entered in Schott v. Mission Fed. Sav. & Loan Ass'n, No. 75-366 WMB (C.D. Cal., filed Feb. 4, 1975)).

55. See note 34 *supra*.