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THE DUE-ON-SALE CLAUSE: CURRENT LEGISLATIVE ACTIONS AND PROBABLE TRENDS

RICHARD W. THORNBURG

I. INTRODUCTION

The desire to own one's own home is deeply imbedded in the fabric of American life. The problems created by the inflation of housing prices, coupled with an even greater inflation in the price of mortgage funds, are cutting sharply into the ability to realize this goal. The higher interest rates for long-term mortgage money have raised monthly payments beyond the reach of all but the few who are able to advance a large down payment to reduce the amount financed.

Facing this problem, many home purchasers have looked to innovative financing techniques built around the assumption of an existing low interest rate mortgage. Second mortgages, wrap-around mortgages, and land contracts¹ are all based on transferring equitable title to property, but retaining the old loan with its lower payments.

Lenders, however, are caught in a bind between long-term assets and short-term liabilities, and are anxious to free themselves from these long-term, low-interest loans.² The device with which they seek to speed this conversion is the "due-on" clause. This comment will examine the due-on clause in terms of its history and current usage. It will then look at the issue of preemption of state law by federal regulations in those states which limit the use of due-on clauses. This comment will examine the nature and history of the due-on-sale clause, as well as some indications of congressional intent. It will examine the trend of events, attempt to predict future trends, and suggest some courses of action.

1. Land contracts, as used here, are contracts by which the seller takes a down-payment substantially equal to his equity, but continues to hold legal title to the property and make the mortgage payments from funds received from the buyer. Possession (equitable title) passes to the buyer immediately, but legal title passes only when the entire balance is paid. A wrap-around mortgage is a variation of this, where the seller takes a down-payment for substantially less than his equity, "wraps" a second mortgage "around" his current indebtedness, then pays both himself and the mortgage from the substantially higher payments made by the new owner.

2. Lenders in the "thrift industry", which finances most housing purchases, have portfolios made up of long term mortgages as assets, and short term deposits and certificates as liabilities. In periods of inflation they need to adjust this portfolio toward higher yield assets, as will be seen infra.

II. THE DUE-ON CLAUSE

A. Types of Due-on Clauses

"Due-on" clauses are contract provisions in financing documents which accelerate the balance due and call for the remaining principal to be paid. The event which triggers this call is provided by the clause. Due-on-sale clauses are triggered by the mortgagor/owner selling or otherwise transferring equitable title, and sometimes legal title, to another. Due-on-encumbrance clauses are triggered by the mortgagor/owner negotiating away any portion of his interest. Although these are the most common of the provisions, a contract can call for acceleration of the principal amount for any specified reason, such as the failure of the resident owner to maintain the property, the failure to purchase the required insurance, or any other action prejudicial to the interests of the mortgagee/lender.

While the due-on-encumbrance clause used to be common, the enforcement of this type of clause is suspect when the encumbrance is merely an obligation junior to the mortgage. The California Supreme Court first refused to enforce this type of contract provision in *LaSala v. American Savings & Loan Association*.³ The use of these clauses has receded and they are seldom the topic of litigation unless other equitable matters exist to justify their use.

Due-on-sale clauses, however, are present in nearly every new real property mortgage document.⁴ The predominant form is the one used by the Federal Home Loan Mortgage Corporation/ Federal National Mortgage Association, and commonly referred to as "paragraph 17":

17. Transfer of the Property; Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to this Mortgage, (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

3. 97 Cal. Rptr. 849 (1971). The court held that the risk to the mortgagee's interest in a junior lien situation did not justify the automatic exercise of due-on-encumbrance clause and foreclosure.

4. Memorandum from Wyatt T. Martin, Staff director to Committee on Commerce, Florida House of Representatives (Mar. 12, 1981). VA and FHA insured loans are still exempted from due-on-sale provisions.

leasehold interest of three years or less not 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. If Lender has waived the option to accelerate provided in this paragraph 17, and if Borrower's successor in interest has executed a written assumption agreement accepted in writing by Lender, Lender shall release Borrower from all obligations under this Mortgage and the Note.

If Lender exercises such option to accelerate, Lender shall mail Borrower notice of acceleration in accordance with paragraph 14 hereof. Such notice shall provide a period of not less than 30 days from the date the notice is mailed within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the expiration of such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 18 hereof.⁵

This provision provides for protection of the lender through his ability to (1) evaluate the creditworthiness of the prospective purchaser and (2) secure an agreement to increase the interest rate to his current rate. It protects the prospective purchaser by providing that the acceleration will not be exercised for the imposition of a junior lien, nor for a short-term lease, nor to prevent the property from passing to a surviving joint tenant. Other provisions further protect the borrower by prohibiting the invocation of any pre-payment penalty if the acceleration clause is exercised.⁶

While this provision is included in all mortgages written by federal savings and loan associations, with a similar provision for federal credit unions, it is not included in those loans insured by the Federal Housing Authority (FHA), nor in those guaranteed by the Veteran's Administration (VA). FHA and VA mortgages together accounted for approximately 20% of new single family mortgage loan originations in 1980.⁷ Although there have been proposals to

5. Paragraph 17, in compliance with 12 C.F.R. §§ 545.8-3(f) and (g)(1981), incorporates the provisos of those sections.

6. 12 C.F.R. § 545.8-3(g)(2)(1981).

7. Report, *An Economic Analysis of Due-On-Sale Clauses*, set forth in 1980 HOUSING AND COMMUNITY DEVELOPMENT CONFERENCE REPORT United States Department of Housing and Urban Development 19 (Apr. 21, 1981).

include a similar acceleration clause in the mortgages of those agencies, they are currently free of any contract provisions limiting assumption.⁸

B. History and Current Uses

The due-on-sale clause has been with us for a long time, becoming popular in some loan documents around the turn of the century. It was first brought into court in 1907, in the case of *Tidwell v. Wittmeier*,⁹ and was found to be enforceable. There was very little litigation on any aspect until the early 1960's. This renewed interest is explained in a recent Minnesota decision:

As interest rates began to rise in the mid-1960's, the due-on-sale clause became a vehicle, particularly in residential financing, to ensure the lender's position in the money market. The lender, faced with increasing costs of securing funds for new loans and the need to maintain reserves to back existing loans, began to use the due-on-sale clause to guarantee that its money was lent at existing rates. The due-on-sale clause provided the lender with the leverage to negotiate a higher rate of interest or, in the alternative, the ability to declare the entire balance due and owing, thereby obtaining the funds to lend at existing interest rates.¹⁰

The original purpose of the due-on-sale clause, the critics of its use contend, was to provide security for the lender's interest in the property. It did this by permitting the lender to evaluate the purchaser's credit rating and personal history to assure that the payments could be met and the property would not be allowed to deteriorate.¹¹ Any other use for such a provision was not foreseeable during the long years of stable interest rates when the difference between new financing and assumption of an existing mortgage was small and essentially a matter of administration fees. With the instability occasioned by inflation, however, the interest rate chargeable for a real estate loan became an important consideration in the purchase price of real property.¹² The mortgagor came

8. *Id.*

9. 43 So. 782 (Ala. 1907). An earlier similar case was *Coffing v. Taylor*, 16 Ill. 457 (1855), but no clause was included in the mortgage. 69 A.L.R. 3d 756 (1976).

10. *Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n*, 308 N.W. 2d 471, 481 (Minn. 1981).

11. Matis, *Due on Sale Clauses in MORTGAGES AND ALTERNATE MORTGAGE INSTRUMENTS*, 405 (Practicing Law Institute, 1981).

12. Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in Cali-*

to consider the low-interest loan to be a part of his property and sought to defeat the due-on-sale contract provision which said that it was not. Mortgagors sought relief in the courts to prevent enforcement of the due-on-sale provision. According to a recent survey, fourteen states have ruled in favor of enforcing due-on-sale clauses, while eight states have refused to enforce them.¹³

C. *The Dilemma of the Thrift Industry*

The rising interest rates have also been a great detriment to the lenders. Prior to 1978 the "thrift industry"—made up largely of state or federally chartered savings and loan associations or credit unions—was closely regulated concerning the amount of interest it could pay on deposits. Mortgage loans were generally offered at 2 ¼ % higher interest, which would cover the lender's operating costs.¹⁴ When the rate of interest paid on deposits was regulated at 5 ¼ % mortgage loans ranged from 7 ½ % to 8%.

By 1978, however, uncontrolled rates of interest on some other investments (i.e., money market certificates) had created a process known as "disintermediation," where people began to withdraw their savings from the thrift institutions in search of greater earning in the uncontrolled investments.¹⁵ In order to stem this outflow, the Federal Home Loan Bank Board changed the regulations governing the thrifts and allowed them to issue the high interest money market certificates. The problem with this "solution" was that most of the thrifts' assets were long-term fixed rate mortgages. They curtailed the outflow of funds only by fostering "internal disintermediation," the massive transfer of funds from pass-book savings to certificate savings. They had decontrolled their cost of money while their *income* remained tied to the low interest mortgages.¹⁶ In October 1978, the yield on the Federal National Mortgage Association (FNMA) portfolio was 8.31%, against an average cost of 7.80%—less than a traditional 2 ¼ %, but still respectable. In January 1981 these figures were 9.25% (yield) but funds were costing 10.01%.¹⁷ These costs have continued to rise, so

*for*nia in *Times of Fluctuating Interest Rates—Legal Issues and Alternatives* 6 U. S. F. L. Rev. 267, 309 (1972).

13. Martin, at 2.

14. Bomar, *Due on Sale. . . A Partial Solution*, FLORIDA SAVINGS AND LOAN LEAGUE RECORD 4 (Dec. 1979).

15. White *Strong Medicine for the S & Ls*, FLORIDA TREND 41, 43 (Aug. 1981).

16. *Id.* at 41.

17. *Economic Analysis*, *supra* note 7 at 9.

that FNMA's companion Federal Home Loan Mortgage Corporation's (FHLMC) weekly purchase of conventional mortgages for the week of September 4, 1981, was at a rate of 18.138%.¹⁸

A large portion of the mortgage money available to the buyer of a home or business property comes through the mechanism of the secondary mortgage market. This market exists because the small banks and thrift associations can obtain money to loan for more mortgages only if they sell their existing mortgages to others and gain additional cash to loan. While some private agencies participate in the market, the bulk of the long-term mortgage purchasing is done by three governmental agencies: the Federal Home Loan Mortgage Corporation (FHLMC—usually called "Freddie Mac"); the Federal National Mortgage Association (FNMA—usually called "Fanny Mae"); and the Government National Mortgage Association (GNMA—usually called "Ginnie Mae"). These agencies purchase approximately 10% of the mortgages held by the thrift institutions,¹⁹ making large amounts of money available for additional loans.²⁰

These secondary market agencies operate like huge national savings and loan associations. When the cost of obtaining funds exceeds revenue, they can no longer replace funds through purchases. In order to help protect themselves from this squeeze, they developed a standard due-on-sale clause ("paragraph 17") and will only purchase mortgage instruments containing this provision. In states that do not enforce due-on-sale provisions in mortgage contracts, these agencies will not purchase long-term contracts, but will only buy instruments callable after seven years.²¹ The states which normally rely heavily on the secondary mortgage market are those which experience high mobility in population, with the resultant high turnover of housing and mortgages.²² Two states which have this rapid turnover are California and Florida, neither of which permits enforcement of due-on-sale clauses to adjust interest rates. The effect is not only the loss of the secondary market in these states, but a restriction on the FNMA and FHLMC attempts to

18. Wall Street Journal, Sept. 4, 1981, at 24 col. 3.

19. Memorandum, *supra* note 4 at 11.

20. Wiggin, *Doing Business in the Secondary Mortgage Market*, 5 REAL ESTATE REV. 84 (Summer 1975), reprinted in A. AXELROD, C. BERGER AND Q. JOHNSTONE, LAND TRANSFER AND FINANCE 18 (1976 Supp.).

21. Wall St. J., Oct. 24, 1980, at 17, col. 3.

22. Comment, *The Due-On Clause: A Preemption Controversy*, 10 LOYOLA L. REV. (L.A.) 629, 638.

form a market of national scope.²³

E. The Issues in the Debate

1. Unreasonable Restraint on Alienation?

The primary issue in the debate over the enforceability of due-on-sale clauses is whether they constitute an unreasonable restraint on alienation. Both sides of the debate usually start with the section 404 of the American Law Institute's *Restatement of the Law of Property*,²⁴ but they often reach opposite conclusions from their reading. Both sides usually concede that the requirements of the due-on-sale clause do not clearly fit into any of the categories specifically set out, and both usually agree that if the due-on-sale clause occasions only an *indirect* restraint on alienation, it is enforceable. The disagreement surfaces when many writers find that *functionally*, the clause acts as a direct promissory restraint. In *Nichols v. Ann Arbor Federal Savings & Loan Association*,²⁵ the court found that the clause directly "burdens a mortgagor's ability to alienate as surely and directly as the classical promissory restraint," and "[a]s such, the due-on-sale clause is truly a direct restraint insofar as the category of direct restraints can be articulated."²⁶ Professor Ronald Volkmer, in his 1973 study, draws a parallel with the "fixed price preemption" and "quarter-sale" provisions, which the Restatement does find to be direct restraints, to state that the due-on-sale clause has effects which cannot be distinguished.²⁷

Simes and Smith, in their 1956 treatise, make an initial determination that, "[a]ny provision in a deed, will, contract, or other legal instrument which, if valid, would tend to impair the marketability of property, is a restraint on alienation."²⁸ They fail to specify

23. Report, *supra* note 7 at 6.

24. RESTATEMENT OF PROPERTY, § 404 (1944). This section, which is too long to reproduce here, describes the types of restraints on alienation.

25. 250 N.W. 2d 804 (Mich. Ct. App. 1977).

26. *Id.* at 805.

27. R. Volkmer, *The Application of the Restraint on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 800 (1973). He describes the price preemption provision as one which states that the "grantee is contractually bound not to sell his property without first offering to sell to some designated person at a fixed price." *Id.* the "quarter sale" provision is one where the "grantee is obligated to remit a certain percentage of the sale price to some designated person." *Id.* These concepts seem distinguishable from the practical effects of the due-on-sale clause.

28. L. SIMES, & A. SMITH, *THE LAW OF FUTURE INTERESTS*, § 1111 (2d ed. 1956).

what might "impair the marketability of property," however, and later state, "[z]oning ordinances might restrain marketability in some cases, though it would seem that, if properly applied, they should increase rather than decrease practical alienability."²⁹ Generally, Simes and Smith seem to acknowledge that the question is open for debate.

In recent years the debate has been taken up again, this time with more speculation that due-on-sale may not be a restraint of alienation of land, although it might restrain something else. Dunn and Nowinski point out that the restraint effects only the transferability of the debt contract, rather than real property.³⁰ They cite *Occidental Savings & Loan Association v. Venco Partnership*,³¹ where the court studies the Restatement and comes to the conclusion that the due-on clause "in no manner precludes the owner from conveying property."³² In his earlier study, Dunn pointed out:

That general economic conditions may restrain the market is quite possible, but these conditions are not restraints upon alienation. If transactional costs and interest rates create a condition of economic unfeasibility, certain buyers are naturally excluded from the market. By forbidding enforcement of the due-on clause as to existing loans, such a buyer has automatic financing when none is otherwise available. Whereas enforcement of the due-on acceleration places all buyers and all sellers on equal footing in such an economic climate, resulting in no *increased* restraint on alienation, the automatic right of assumption provides an *enhanced* ability to alienate.³³

Many of the decisions which approve the enforcement of a due-on-sale clause do so without reaching the issue of a possible restraint on alienation,³⁴ or decide that the clause is not a restraint.³⁵

29. *Id.*

30. Dunn & Nowinski, *Enforcement of Due-On-Transfer Clauses, An Update*, 16 REAL PROP., PROB. & TRUST J. 291, 311 (1981).

31. 293 N.W. 2d 843 (Neb. 1980).

32. *Id.* at 312.

33. *Enforcement of Due-on-Transfer Clauses*. 13 REAL PROP., PROB. & TRUST J. 891, 916 (1978). This study finds other applicable analogies in the Restatement. Analogies are made to § 410, which deals with restraints on assignments of possessory estates for years, and § 416, on consent-to-assignments requirements in land contracts. In the former they find no basis for a restraints on alienation determination. In the latter they find a justifiable promissory restraint. *Id.* at 900-01.

34. Examples are *Tierce v. APS Co.*, 382 So. 2d 485 (Ala. 1979) (*rehearing overruled* 1980); *Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works*, 239 N.W.2d 20 (Wis. 1976); *Stith v. Hudson City Sav. Inst.*, 313 N.Y.S. 804 (1970).

An interesting approach was taken in *Holiday Acres No.3*,³⁶ where the court stated that it was not a restraint on alienation in a case of investment property, but implied that it would be in a residential mortgage.

A variation on this position is the determination that the due-on-sale clause is a *reasonable* restraint on alienation which is enforceable because only *unreasonable* restraints are void. In *Coast Bank v. Minderhout*,³⁷ the court held that the exercise of the due-on-sale clause is a reasonable restraint designed to protect the lender's interest. Although some courts will find the adjustment of interest a reasonable business interest *per se*,³⁸ many others require an evaluation of the specific facts of each case.³⁹ It is necessary, therefore, to carefully read the actual provisions of the contract.

Prior to the standard use of paragraph 17, many of the due-on-sale clauses provided for acceleration of the notes at the lender's option, but made no mention of the lender's right to accelerate solely for the purpose of obtaining a higher rate of interest. Some courts have interpreted such a general statement to be a "hidden" provision, and have refused to allow acceleration when the sole reason was to increase interest.⁴⁰ The specific provision for agreement

35. A wide range of cases beginning with *Cherry v. Home Savings & Loan* 81 Cal. Rptr. 135 (1969) *overruled* 116 Cal. Rptr. 640 (1978) and continuing through *Williams v. First Federal Savings & Loan Association* (1981), 1981 Trade Cas P64,095 (4th Cir. 1981) rule that a due-on-sale clause does not constitute a restraint on alienation. Other examples are *Occidental Sav. & Loan Ass'n v. Venco*, 293 N.W.2d 843 (Neb. 1980); *Crockett v. First Fed. Sav. & Loan Ass'n*, 224 S.E.2d 580 (N.C. 1976); *Gunther v. White*, 489 S.W. 2d 529 (Tenn. 1973); *Sonny Arnold Inc. v. Sentry Sav. Ass'n*, 615 S.W.2d 333 (Tex. Civ. App. 1981); and the FHLBB Advisory Opinion No. 75-647, *Schott v. Mission Fed. Sav. & Loan Ass'n* (1975).

36. 308 N.W.2d at 484. This idea is also shown in VA. CODE § 6.1-2.5, which bars due-on-encumbrance clauses in one-to-four family residential dwelling units, but permits them in real estate of a more commercial nature. In *Medovi v. American Sav. & Loan Ass'n*, 152 Cal. Rptr. 572 (1979), the court distinguishes *Wellenkamp v. Bank of America*, 148 Cal. Rptr. 379 (1978) by limiting that decision to single family residences, holding it, therefore, not applicable to commercial properties.

37. 38 Cal. Rptr. 505 (1964) (modified by *Wellenkamp*).

38. *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 509 P.2d 1240 (Colo. 1973).

39. See *Von Ehrenkrook v. Midland Fed. Sav. & Loan Ass'n*, 585 P.2d 589 (Colo. 1978); *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 545 P.2d 546 (Wash. 1976); *Baker v. Loves Park Sav. & Loan Ass'n*, 333 N.E.2d 1 (Ill. 1975); *Peoples Sav. Ass'n v. Standard Industries, Inc.*, 257 N.E.2d 406 (Ohio Ct. App. 1970); *Century Fed. Sav. & Loan Ass'n v. Van Glahn*, 364 A.2d 558 (N.J. Super. Ct. Ch. Div. 1976); *Baltimore Life Ins. Co. v. Harn*, 486 P.2d 190, 193 (Ariz. Ct. App. 1971).

40. Examples of this may be found in *Baltimore Life Ins. Co. v. Harn*, 486 P.2d 190 (Ariz. Ct. App. 1971); *Lane v. Bisceglia*, 488 P.2d 474 (Ariz. 1971); *First Fed. Sav. & Loan Ass'n v. Lockwood*, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980); *Silver v. Rochester State Bank*, 424 N.Y.S. 2d 925 (1980); *Continental Fed. Sav. & Loan Ass'n v. Fetter*, 564 P.2d 1013

on a rate of interest was one of the prime improvements in the standard federal mortgage format. Many courts will consider the interest revision a proper reason for acceleration *if* it is specifically provided in the document.⁴¹

2. *Threat to Lender's Security Interest Required?*

There is no authority for declaring that a due-on-sale clause is *per se* unenforceable. The position least favorable to the exercise of a due-on-sale acceleration says only that a due-on-sale clause is an unreasonable restraint on alienation *unless* the lender can prove that his security is endangered. The degree of risk is determined on a case-by-case basis, but normally a lender who refuses assumption by someone who is totally uncreditworthy need not worry that his attempt to accelerate will be considered unreasonable.⁴²

The concept of threat to the security interest was first articulated in *LaSala v. American Savings & Loan*,⁴³ which curtailed California's tradition of automatic enforcement of due-on-sale clauses. Since *LaSala* decided that a junior lien did not endanger the lender's security, courts have added to the list of things that do not threaten the security interest. These decisions place a significant burden of proof upon the lender to establish that his security interest is endangered.⁴⁴ The provision in paragraph 17 which prohibits application in the case of junior encumbrances has been the source of litigation. Some mortgagors have attempted to sell the mortgaged property on a "land sales contract" or "wraparound

(Okla. 1977), *First Southern Fed. Sav. & Loan Ass'n v. Britton*, 345 So. 2d 300 (Ala. Ct. App. 1977); *Bellingham First Fed. Sav. & Loan Ass'n v. Garrison*, 553 P.2d 1090 (Wash. 1976).

41. *Bellingham Fed. Sav. & Loan Ass'n v. Garrison*, 553 P.2d 1090. The court seems to place weight on the mortgagee acting in good faith to protect its investment.

42. Provided, apparently, that this justification is made at the beginning of proceedings. In *Tucker v. Pulaski Federal Sav. & Loan Ass'n*, 481 S.W. 2d 725 (Ark. 1972), the lender did show that the assuming purchaser had a poor payment record on a previous mortgage and a poor credit report. The court seemed to feel, however, that these factors had not been considered *prior* to the rejection, and since the assuming purchaser was making regular deposits into the escrow account, the court refused to enforce the acceleration. 13 REAL PROP., PROB. & TRUST J. at 911.

43. 97 Cal. Rptr. 849.

44. See *Wellenkamp v. Bank of America*, 148 Cal. Rptr. 379 (1978); *Tucker v. Lassen Sav. & Loan Ass'n*, 116 Cal. Rptr. 633 (1974), *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 481 S.W. 2d 725 (Ark. 1972); *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 250 N.W. 2d 804 (Mich. Ct. App. 1977); *Baltimore Life Ins. Co. v. Harn*, 486 P.2d 190 (Ariz. Ct. App. 1971); *Home Fed. Sav. & Loan Ass'n v. English*, 249 So. 2d 707 (Fla. Dist. Ct. App. 1971); *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970); and *Pellerito v. Weber*, 177 N.W.2d 236 (Mich. Ct. App. 1970).

mortgage" concept. In these types of arrangements, legal title does not transfer until the transferee has paid off the contract, which usually includes the mortgagor's mortgage payment plus a payment for his/her equity. Since legal title remains with the mortgagor, many sellers have tried to classify this as a "junior lien" within the meaning of paragraph 17.⁴⁵

The lender, of course, points to the fact that the purchaser is in possession and that equitable title has been transferred. Despite the fact that great ingenuity has been used in developing the technical details, the courts have generally held that a transfer, within the meaning of paragraph 17, has taken place.⁴⁶

3. Unconscionable Contract Provision?

Some criticisms of the due-on-sale clause indicate that it may be considered an unconscionable contract provision. Early actions generally supported the contract as written, and did not consider the due-on-sale clause unconscionable. Some lenders, however, tried to exercise the due-on-sale clause against mortgagors who sold their homes in the early years of the mortgage, then demanded that the mortgagor also pay a pre-payment penalty. An example of this is *Hellbaum v. Lytton Savings & Loan Association*.⁴⁷ When the Hellbaums lost the sale because of the buyer's unwillingness to meet the lender's terms, the Hellbaums sued the lender for their equity. The court held that they did not have a cause of action, but seemed troubled by the inequity of applying both the due-on-sale and the prepayment clauses.⁴⁸

A case note on the Hellbaum decision⁴⁹ highlights the inequity and suggests that a court might take the position that the lender should be required to show why he should not be enjoined from foreclosing. To prove his case, he would have to show a clear danger to his security interest. In *Baltimore Life Insurance Co. v. Harn*,⁵⁰ where the lender tried to invoke both due-on-sale and prepayment penalty clauses, the court chose not to take a position on

45. See *Century Fed. Sav. & Loan Ass'n v. Van Glahn*, 364 A.2d 558 (N.J. Super. Ct. 1976). Cf. *Chopan v. Klinkman*, 330 So. 2d 154 (Fla. Dist. Ct. App. 1976).

46. One exception to this is *Chopan v. Klinkman*, 330 So. 2d 154 (Fla. Dist. Ct. App. 1976) (Installment land contract not a "sale"). For further background see, *Enforcement of Due-On-Transfer Clauses, an Update* 16 REAL PROP., PROB & TRUST J. 291, 300 (1981).

47. 79 Cal. Rptr. 9 (1969).

48. *Id.* at 11.

49. Note, *The Case for Relief from Due-on-Sale Provisions: A Note to Hellbaum v. Lytton Savings and Loan Association*, 22 HASTINGS L.J. 431 (1971).

50. 486 P. 2d 190 (Ariz. Ct. App. 1971).

the prepayment penalty, but refused to enforce the due-on-sale clause absent proof of default in payments or threat to the lender's security. Since this decision, the combination of prepayment clauses and due-on-sale clauses have become virtually unknown, and the standard FHLMC/FNMA mortgage specifically waives any prepayment provisions if the due-on-sale provision is exercised.⁵¹

Another theory advanced for the concept that due-on-sale clauses are unconscionable is that they can be seen as contracts of adhesion. Many cases lead to the conclusion that due-on-sale clauses are not *per se* unconscionable, but they may be applied unreasonably.⁵² In *Tierce v. APS*,⁵³ the court found the use of due-on-sale to meet rising interest rates a valid business purpose, but warned that a court of equity may refuse to foreclose if acceleration would have an inequitable or unjust result.⁵⁴ Perhaps the fear that acceleration was not within the contemplation of the parties, or at least of the borrower, would justify such refusal.⁵⁵ In *Holiday Acres No. 3*, the court made a strong argument for the proposition that due-on-sale clauses are contracts of adhesion:

In such a situation it is completely unrealistic to say that the homeowner and the moneylender were on equal footing in making the original contract and equally unrealistic to say that the homeowner can avoid the loss resulting from the threat to accelerate the due date of his note by paying off the mortgage or by refraining from selling his home. He has to sell and he cannot pay off the mortgage. This use of the acceleration clause to coerce an increase in the rate of interest is oppressive, extortionate and unconscionable.⁵⁶

In a similar manner, due-on-sale clauses may often be felt to be

51. 12 C.F.R. § 545.8-3 (g)(2).

52. See e.g. *Cherry v. Home Sav. & Loan Ass'n*, 81 Cal. Rptr. 135 (1969); *Coast Bank v. Minderhout*, 38 Cal. Rptr. 505 (1964); *Stith v. Hudson City Sav. Inst.*, 313 N.Y.S. 2d 804 (1970); *Tierce v. APS Co.*, 382 So. 2d 485 (Ala. 1979). See, also *Mortgages—A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485, 500 (1972).

53. 382 So. 2d 485 (Ala. 1980).

54. *Id.* at 487.

55. See, J. Henkel and G. Seltzer, *Acceleration Clauses in Mortgages: Misuse During Periods of Tight Money*, 17 AM. BUS. L.J. 441, 454 (1980).

56. 308 N.W.2d at 482. The due-on-sale clause is seen to meet the criteria for a contract of adhesion in a comment, *The Due-on Clause: A Preemption Controversy*, 10 LOYOLA L. REV. L.A. 629, 646 (1977). This position may have become less appropriate recently, due to the wide publicity that mortgage assumption has received, and the relatively high level of understanding of financing now common in the real estate industry.

unconscionable because of an unfair association with the concept of usury. In most cases the due-on-sale clause only requires re-negotiation of the interest rate to more nearly approximate the market rate, and no attempt is made by the lender to charge any rate in excess of the market rate. It is not usury to attempt to secure a lawful rate of interest, nor is it an unconscionable or inequitable act.⁵⁷ There are valid arguments for enforcement of the clauses as a matter of sanctity of contract.⁵⁸

4. *Equity in Due-On-Sale*

Traditionally, any transaction in land has been considered governed primarily by the principle of equity. In one summary it was said:

Mortgage foreclosure is an equity matter, and a court of equity may refuse to foreclose a mortgage when an acceleration of the due date would lead to inequitable or unjust results, or where the acceleration is the result of some unconscionable or inequitable conduct of the lender.⁵⁹

The most frequently cited recent Florida decision on this issue is *Clark v. Lachenmeier*.⁶⁰ Here the Second District Court of Appeals affirmed the dismissal of a complaint on the basis that it would be inequitable to foreclose solely because of a provision in the mortgage which required notice to and approval by the mortgagee, when no danger to the lender's security interest is shown. This case is the definitive law on the subject in Florida and was followed and expanded by *First Federal Savings and Loan Association v. Lockwood*.⁶¹ This recent decision reaffirmed the role of equity and determined that equity jurisdiction precludes preemption by fed-

57. See, *Advisory Opinion of the Federal Home Loan Bank Board*, Resolution No. 75-647, *Schott v. Mission Fed. Sav. & Loan Ass'n*, Civ-75-366 WMB (C.D. Cal. 1975) at 26.

58. R. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. LAW & ECON. 293, 315 (1975). In *Cherry v. Home Savings and Loan*, 81 Cal. Rptr 135, the court refused to "rewrite the contract," and upheld the due-on-sale clause. The court in *Stith v. Hudson City Savings Institution*, 313 N.Y.S. 2d 804 found the language of the due-on-sale clause "clear and unambiguous," and worthy of being enforced. The *Tidwell v. Wittmeier*, 43 So. 782 (Ala. 1907), due-on-sale clause was enforced primarily because it was part of the contract. *Tidwell* is declared to be still good law in *Tierce v. A.P.S. Co.*, 382 So. 2d 485, 487 (Ala. 1980). *Accord First Commercial Title, Inc. v. Holmes*, 550 P.2d 1271, 1272 (Nev. 1976).

59. Annot., 69 A.L.R. 3d 713 (1976).

60. 237 So. 2d 583 (Fla. 2d Dist. Ct. App. 1970).

61. 385 So. 2d 156 (Fla. 2d Dist. Ct. App. 1980).

eral law when the mortgagee is a federal savings and loan.⁶²

The *Lockwood* court has been criticized for confusing true equity considerations with substantive law.⁶³ While there is little doubt that equity applies to foreclosure actions, and that the traditional equitable defenses—waiver, estoppel, accord and satisfaction, and possibly laches⁶⁴—apply, it should also be noted that equity is a two-edged sword. As Nina Matis points out, “[B]etween mortgagor or mortgagee there is nothing inequitable or unconscionable about mortgagor enforcing its bargained for rights.”⁶⁵ When the *Lockwood* court ruled out preemption by federal law because foreclosure actions are solely within the province of equity, it failed to note that the federal courts also have equity powers. The United States Supreme Court, in *Stern v. South Chester Tube Co.*,⁶⁶ declared that if no other remedy was available, the federal courts have jurisdiction to grant relief under their traditional equity power.

Judge Higby, in discussing *Lockwood* in *First Federal Savings & Loan Association v. Peterson*, stated:

Both the court’s opinion and the defendant’s argument belabor a man of straw. In our federal system, courts of all 51 sovereigns apply the governing law regardless of the judicial forum utilized. Much federal litigation is governed by state law. State courts often apply the law of another state. An entire arcane body of learning called Conflict of Law has evolved to help state courts determine which state’s law applies. State courts likewise apply and enforce federal law. If they refuse to honor the supremacy of federal laws, federal courts can enforce them.⁶⁷

Equity seen from the federal point of view may be very different from that of the more parochially-oriented state court. In a jurisdiction where due-on-sale clauses are not enforced, the seller is “able to appropriate most of this gain [of selling the low interest

62. *Id.* at 160.

63. Dunn and Nowinski, note 30 *supra* at 297.

64. In *Mutual Fed. Sav. & Loan Ass’n v. Wisconsin Wire Works*, 205 N.W.2d 762 (Wis. 1973), the court held that laches would apply where appropriate, but that the mortgagee was not placed on constructive notice of a transfer by the recording of a land contract. The Recording Act was merely to give notice to subsequent purchasers, and recording could not affect the rights of the prior mortgagee.

65. N. Matis, *Due on Sale Clauses*, MORTGAGES AND ALTERNATE MORTGAGE INSTRUMENTS (Practising Law Institute, 1981).

66. 390 U.S. 606, 609 (1968).

67. 516 F. Supp. 732, 740-41 (1981).

loan with the house] by selling their houses at a higher price than sellers of houses without assumable mortgages."⁶⁸ While this wind-fall may be very good for sellers, it comes at a cost to prospective new borrowers who must pay higher interest to offset the outstanding low interest loans. If the lender must continue to carry the low-interest loan, he will charge even higher interest on new loans to compensate for the loss on the old loan. This particularly handicaps the young family in search of a home, since they typically have limited funds for a down-payment. Assumable loans tend to require a higher down-payment to cover the owner's equity, so young families must compete in a market where loans have even higher interest rates to compensate lenders for their cost in maintaining the assumed, low-interest loans. Requiring assumability of loans also has a significant adverse effect on the earnings of savings institutions and ultimately on their net worth.⁶⁹

As already noted, savings and loan associations and other thrift organizations have been at a severe disadvantage in a period of rising interest rates. Their only protection, before the recent authorization to use variable rate mortgages, was insertion of a due-on-sale clause in the mortgage contract. The FNMA/FHLMC Paragraph 17 is not a fine print, boiler plate provision. It quite clearly states the terms of the contract. Refusal to enforce it may be far more inequitable than enforcement.

The federal thrift organizations are bound by federal policies telling them to exercise due-on-sale clauses, and state policies which say the clauses cannot be enforced. This problem has caused many thrifts to look to the possibility of federal preemption of the issue.⁷⁰

68. HUD report, *supra* note 7 at 5.

69. 57% of a major Florida thrift's portfolio is composed of loans that yield an 8.9% return or less, as shown in Otis White, *Strong Medicine for the S&L's*, FLORIDA TREND 41, 42 (August 1981). Nationally, analysts predict industry losses that may total six to eight billion dollars. *Id.*

70. It is interesting that two states often considered leaders in real estate litigation, California and Florida, have decisions which disfavor the use of due-on-sale clauses to adjust to market-rate interest. See *Wellenkamp v. Bank of America*, 148 Cal. Rptr. 379 (1978); *Clark v. Lachenmeier*, 237 So. 2d at 583. These two states are also considered traditional leaders in the savings and loan field, with California having the largest S & L industry and Florida ranking second. See White, *supra* note 69, at 42.

III. FEDERAL PREEMPTION

A. *The Basis for Preemption*

The concept of federal preemption of state law lies in the United States Constitution. The supremacy clause⁷¹ requires that federal law overrule any state law on the same subject. The preemption doctrine strikes down all state laws in the area validly preempted.⁷² Preemption applies not only where federal and state law are in obvious and direct conflict, but also where Congress has indicated an intent that federal law occupy a field to the exclusion of state law.⁷³ The tests of congressional intent to displace state law are set out in *Rice v. Santa Fe Elevator Corp.*:

[Congressional] purpose may be evidenced in several ways. The scheme of federal regulation may be so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it. Or the Act of Congress may touch a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject. Likewise, the object sought to be obtained by the federal law and the character of obligations imposed by it may reveal the same purpose.⁷⁴

The first test in determining if intent to preempt is implied is whether the federal regulation is so pervasive as to leave no room for state regulation. Since the FHLBB Regulations deal specifically with the power of the federal thrift association to include the due-on-sale clause in the mortgage and indicate that the exercise by an association of such an acceleration clause shall be governed by the terms of the contract,⁷⁵ there is little doubt that the *regulation*

71. U.S. CONST. art. VI, cl. 2:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

72. See, *Pre-emption of Local Rent Control Laws by HUD Regulation*, 45 *FORDHAM L. REV.* 651, 652 (1976).

73. Dunn and Nowinski, 16 *REAL PROP., PROB & TRUST J.* at 292.

74. 331 U.S. 218, 230 (1947) (citations omitted).

75. 12 C.F.R. § 545.8-3(1981):

(f) *Due-on-sale clauses.* An association continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instrument whereby the association may, at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of

leaves no room for state regulation. The challenge to this argument is the contention that Congress did not, in the Home Owners' Loan Act of 1933 (HOLA),⁷⁶ provide the FHLBB the power to preempt due-on-sale laws of the states, but merely to regulate the internal affairs of the federal savings and loan associations. To show that state control is a congressional mandate, challengers cite provisions of HOLA section 1464 which specifically subject some federal savings and loans to more stringent state laws pertaining to neighborhood discrimination⁷⁷ and state taxation which does not exceed that levied on like organizations.⁷⁸ As support for its contention that broader state control is implied, the Minnesota Supreme Court has stated that "[d]espite the specificity with which the above issues were addressed, no mention of due-on-sale clauses is made."⁷⁹ This seems an interesting twist on the canon of statutory construction of *expressio unius est exclusio alterius*, that the expression of one thing excludes another.⁸⁰

An article that relies heavily on a perceived internal-external dichotomy purports to find basis for a distinction between internal and external authority in several of the cases which ultimately rule for preemption on the due-on-sale issue.⁸¹ This author is unable to find, in the sources cited, any clear rejection of the idea that federal authority is comprehensive on the issue of preemption.⁸²

The "pervasiveness" of the legislative scheme that calls for preemption is usually found in the extremely broad mandate that Congress gave the FHLBB to fashion the regulations under which congressional policy would be carried out. Section 1464 of the Home Owners Loan Act conferred on the FHLBB authority to regulate the operations of federally-chartered savings and loan as-

the real property securing the loan is sold or transferred by the borrower without the association's prior written consent. Except as provided in paragraph (g) of this section with respect to loans made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, exercise by the association of such option (hereafter called a due-on-sale clause) shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and the borrower shall be fixed and governed by that contract.

76. 12 U.S.C. §§ 1461-68 (1976).

77. 12 U.S.C. § 1464(a)(Supp. III, 1979).

78. *Id.* at § 1464(h) (1976).

79. 308 N.W. 2d at 476.

80. See, Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are To Be Construed*, 3 VANDERBILT L. REV. 395, 405 (1949).

81. Comment, *Due-on-Sale Clauses and Restraints on Alienation: Does Wellenkamp Apply to Federal Institutions?* 11 PAC. L. J. 1085, 1100 (1980).

82. Prime sources used on the subject are *Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n*, 499 F.2d 1145 (9th Cir. 1974) and the Advisory Opinion, *supra* note 57 at 18.

sociations.⁸³ Even the term "giving primary consideration to the best practices of local mutual thrift and home financing institutions in the United States," which is sometimes construed to imply local control,⁸⁴ seems instead to give the Board the choice of the best practices to form a national standard. Starting from the historic assumption that state police powers will not be superceded by federal law unless it is the "clear and manifest purpose" of Congress to do so,⁸⁵ the Ninth Circuit found in *Conference of Federal Savings & Loan Associations v. Stein*⁸⁶ that "the regulatory control of the Bank Board over federal savings and loan associations is so pervasive as to leave no room for state regulatory control."⁸⁷ The court is supported in this position by the statement in *Meyers v. Beverly Hills Federal Savings & Loan Association*,⁸⁸ that "pursuant to its valid statutory authority, the Federal Home Loan Bank Board has promulgated comprehensive regulations covering all aspects of every federal savings and loan association 'from its cradle to its corporate grave.'"⁸⁹ While unwilling to rule for preemption on such a wide scale, Judge Higby in *Peterson* found that preemption was required on the subject of due-on-sale enforcement.⁹⁰ This decision has been followed in the recent decision of *Price v. Florida Federal Savings & Loan Association*,⁹¹

The second test established in *Rice* is whether the subject is a field in which the federal interest is so dominant as to demand exclusive federal control. Generally, it is the national nature of the secondary mortgage market which makes this test seem applica-

83. HOLA, Section 5(a)(1) provides:

In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations" . . . and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States. 12 U.S.C. § 1464(a)(1).

84. *Id.* Cf. 10 LOYOLA L. REV. (L.A.) *supra* note 56, at 634. Note that this quote stops before completion of the sentence.

85. 331 U.S. at 230.

86. 604 F.2d 1256 (9th Cir. 1979), *aff'd* 445 U.S. 921 (1980).

87. *Id.* at 1260.

88. 499 F.2d 1145 (9th Cir. 1974).

89. *Id.* at 1146-47. Quoting *People v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311, 316 (S.D. Cal. 1951).

90. 516 F. Supp. at 741.

91. — F. Supp. — Case No. 79-974-Civ.-J.-M. (M.D. Fla., 1981).

ble.⁹² There are clear signs of a current intent to declare a federal interest in enforcing due-on-sale clauses in many federal lending areas.⁹³ Judge Higby, in *Peterson*, finds that the importance of a national secondary mortgage system has asserted a unique federal interest in due-on-sale clauses which is dominant.⁹⁴ This same notion was challenged in *Holiday Acres No. 3* by the contention that the federal due-on-sale provision is merely permissive and does not, therefore, achieve a dominant interest.⁹⁵ In view of the individual thrift's fiduciary duty to follow the FHLBB's interpretation of "best practices," one might question how voluntary the use of due-on-sale is, but this challenge will doubtless be asserted again.

The third test established in *Rice* deals with the underlying purpose of the regulation and whether preemption is necessary to accomplish that purpose. This is a test for *actual* conflict, regardless whether the semantics indicate a conflict. In cases where state authority would defeat the goals of federal regulation, the Supreme Court has been most specific. For example, in *Bethlehem Steel Co. v. New York State Labor Relations Board*, the Court stated: "[T]he power of the state may not so deal with matters left to its control as to stand 'as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" ⁹⁶ Moreover the Court states in *Hines v. Davidowitz* that the common expressions "conflicting; contrary to; . . . interference" are only yardsticks to determine if the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."⁹⁷ Concerning due-on-sale specifically, Judge Higby states, "Allowing Florida to refuse to enforce due-on-sale clauses when acceleration is to raise interest rates would thus frustrate the HOLA's purpose as implemented by the Board. Preemption is required to further that purpose because the association system calls for federal control of the securities marketed."⁹⁸ The Minnesota Supreme Court, in reaching an opposite result on this

92. See, *Due-On Clauses*, 10 LOYOLA L. REV. (L.A.) at 638. See notes 19 through 23 and accompanying text.

93. See, e.g. 46 Fed. Reg. 38676 (July 29, 1981) proposing enforcement of due-on-sale clauses in all documents of the National Credit Union Administration (NCUA), and 46 Fed. Reg. 18932 (March 27, 1981) showing intent to retain enforceable due-on-sale clauses in the new Adjustable Rate Mortgages.

94. 516 F. Supp. at 740.

95. 308 N.W. 2d at 479.

96. 330 U.S. 767, 773 (1947), quoting *Hill v. Florida*, 325 U.S. 538 (1945).

97. 312 U.S. 52, 67 (1941).

98. 516 F. Supp. at 740.

issue, stated, "[W]e can only say, with the Supreme Court of Oregon, 'we do not believe that preemption occurs simply because under some imaginable set of economic facts the application of state law could impede the efficient execution of a federal statutory purpose.'"⁹⁹ They do not find the secondary mortgage market problems a reason for preemption.

B. Preemption in Other Areas

An analogy to the question of due-on-sale preemption can be made to in the area of federal preemption in rent control controversies. Like mortgages, rent has traditionally been an area within the police powers of the states. Here, as in due-on-sale provisions, Congress does not expressly preempt state and local regulation. The National Housing Act (NHA) must be considered in conjunction with regulations of the Department of Housing and Urban Development (HUD) to determine if state or local rent control laws are nullified with respect to specific projects.¹⁰⁰ The question turns, in rent control, on the first and third tests established in *Rice*—pervasive federal interest and frustrating the intent of the program. Conflict arises when HUD establishes what it considers a minimum rent which will support the project, thereby preserving federal subsidies or federal (NHA or FHA) loan guarantees, and a local or state rent control board demands a lower rental than this minimum. This conflict creates a threat to the project's continued functioning which has usually, but not always, led to a determination that the HUD regulations preempt the local rent scheme.

In *Levin-Sagner-Orange v. Rent Leveling Board*,¹⁰¹ the court held that the HUD regulation, preempting the entire field of rent regulation, was a valid exercise of the Secretary's rule-making authority. In *515 Associates v. City of Newark*¹⁰² the court held that the National Housing Act authorizes the Secretary to formulate such regulations as necessary to implement the provisions of the Act, thereby defeating Tenth Amendment challenges. A wave of earlier cases reached contrary results based on the contention that the regulation only authorized the Department to regulate *maximum* rents. Consequently the regulation was re-worded to provide

99. 308 N.W. 2d at 479, quoting *Derenco, Inc. v. Benjamin Franklin Fed. Sav. & Loan Ass'n*, 577 P.2d 477, 483, *cert. denied*, 439 U.S. 1051 (1978).

100. Comment, *Pre-emption of Local Rent Control Laws by HUD Regulation*, 45 *FORDHAM L. REV.* 651, 662 (1976).

101. 316 A.2d 616 (N.J. Super. Ct. Law Div. 1976), *aff'd* 371 A.2d 302 (1976).

102. 424 F. Supp. 984 (D. N.J. 1977).

coverage of the minimum rent also.¹⁰³

C. *Other Signs of Current Congressional Intent*

Congress and the FHLBB have recently taken several steps which demonstrate their intention that the federal savings and loan associations survive and retain their fair share of the housing market financing. The first step was the 1978 authorization to issue six-month money market certificates with interest rates which could fluctuate with the rates on U.S. Treasury bills. As mentioned earlier, this was intended to stem the flood of depositors who were withdrawing their funds from the savings and loans in search of higher interest.

The money market certificates accomplished part of their goal—that of keeping deposits in the savings and loans. However, the money market certificates were so successful that they resulted in even greater withdrawals from the 5 ¼ % accounts.¹⁰⁴ The cost of savings and loan deposits jumped upward, while their assets were still tied up in long-term mortgages. The money market certificates were not themselves a mistake. The mistake was that it took too long to provide any flexibility on the other side of the equation.¹⁰⁵

In July of 1979, the thrifts were finally authorized to issue a Variable Rate Mortgage (VRM).¹⁰⁶ Otis White, staff writer for Florida Trend magazine, explains the concept:

Broadly stated, here's how the adjustable rate mortgage works: The homebuyer and his savings and loan agree upon a mortgage rate and a monthly payment for his home loan. The buyer pays the same monthly payment for an agreed-upon period, generally between two and five years. But even as the homebuyer makes his payments, his actual interest rate changes, fluctuating according to the movement of interest rates on one of several cost-of-funds indexes from which the S&Ls can choose.

At the end of the period, the homebuyer and the S&L must settle up. If the interest rate has declined since the mortgage was negotiated, the S&L will extend the mortgage at a lower interest rate to compensate for the changes. If the interest rate has increased, the homeowner will see his mortgage payments escalate

103. Comment, *supra* note 100 at 43.

104. White, *supra* note 15 at 43.

105. *Id.* See also, *An Economic Analysis*, *supra* note 7 at 8.

106. Henkel and Seltzer, *supra* note 55 at 456.

to pay for the increases.¹⁰⁷

While it was once hoped that the VRM would render moot the due-on-sale controversy, it is now obvious that it will not do so for several reasons: (1) federal regulation originally limited the investment in all alternative mortgage instruments to no more than 50% of an institution's portfolio,¹⁰⁸ (2) the interest rate on such mortgages cannot be increased more than 2 ½% over the term of the loan,¹⁰⁹ and (3) it will take years for long-term lenders to shift their portfolios into the new instruments.

The FHLBB proposed regulations on September 30, 1980, to permit the use of Shared-Appreciation Mortgages (SAM). In this type of mortgage the borrower agrees to share the property's appreciation with the lender in return for a mortgage rate below that on standard mortgages.¹¹⁰ "The borrower agrees to pay the lender a lump sum of 'contingent interest' that is dependent upon the appreciation of the property securing the loan and a prespecified share of that appreciation."¹¹¹ This transaction is fairly easy if the house is sold during the period prior to the "date of reckoning." The payment can then be made from the equity the borrower receives. It becomes more complicated if the borrower remains in possession because he must now come up with the funds for the contingent interest and appreciation based on a current appraisal of the property.¹¹²

Another device to prevent disintermediation and to lower the cost of money for the thrifts is the tax-sheltered "All-Savers' Certificate." With this the thrift should be able to limit its cost of money to the 12% range and yet attract funds seeking a real return near 17%.¹¹³ These instruments only became effective on October 1, 1981, so it is too early to see how they will be accepted. It is interesting to note, however, that they were authorized only af-

107. White *supra* note 15 at 43.

108. Martin, *supra* note 4 at 11. The Depository Institutions Deregulation and Monetary Control Act of 1980 has removed the ceiling, but instituted limitations on how much the rate can be adjusted at any interval of time. Dunn and Nowinski, *supra* note 30 at 313.

109. *Id.*

110. J. McKenzie, *A Comprehensive Look at Shared-Appreciation Mortgages*, 13 FHLBB J. 11 (1980).

111. *Id.* at 13.

112. *Id.* at 13.

113. The ability of the thrift to pay the lower rate (70% of the current rate for a 52 week Treasury Bill) and have greater effective yield is the tax exempt feature. A typical table of equivalent earnings is:

ter the Congress had severely limited the tax-exempt status of municipal mortgage subsidy bonds.¹¹⁴ The municipal mortgage subsidy bond had become a popular, tax-exempt method of gaining funds for housing construction or purchase. As such it undoubtedly contributed to disintermediation of the thrift industry. Although many feel that the real problems in housing finance could be handled more efficiently by these municipal bonds than by the All-Savers' Certificates,¹¹⁵ the fact that this technique was given to the thrift industry does show a definite congressional intent to assure the survival of the savings and loan associations.

The problem with these efforts is that, for the most part, they may be too little, too late.¹¹⁶ The need for enforcement of due-on-sale clauses remains as strong as ever.

D. Federal Court Decisions

California and Florida, with their high volumes of real estate turnover, their large real estate industries, and their correspondingly large thrift industries, are logical places for the controversy over preemption to be most severe. In California the state position is presented in *Wellenkamp*, which prohibits exercise of due-on-sale unless the lender's security is threatened. The federal decision in *Glendale Federal Savings & Loan Association v. Fox*¹¹⁷ clearly rules for preemption of federal law in due-on-sale clauses by federal thrift associations. This case has now been appealed to the Ninth Circuit. In Florida the state law is established by *Clark v. Lachenmeier*,¹¹⁸ and the state position on preemption by *Lock-*

GROSS INCOME Probable Tax Bracket*	\$20,000		\$30,000		\$40,000		\$50,000	
	Single 27%	Joint 19%	Single 35%	Joint 29%	Single 40%	Joint 33%	Single 50%	Joint 44%
TAX-FREE YIELDS	TAXABLE EQUIVALENT YIELDS:							
11.00%	15.07%	13.58%	16.92%	15.49%	18.33%	16.42%	22.00%	19.64%
11.50%	15.75%	14.20%	17.69%	16.20%	19.17%	17.16%	23.00%	20.54%
12.00%	16.44%	14.81%	18.46%	16.90%	20.00%	17.91%	24.00%	21.43%
12.50%	17.12%	15.43%	19.23%	17.61%	20.83%	18.66%	25.00%	22.32%

*Based on 1982 Tax Tables. Assumes 15% itemized deductions, plus standard exemptions.

Pamphlet, Flagship Bank Tallahassee, Fla. (1981) (on file with FSU Law Review).

114. J. Broadus, *The Mortgage Subsidy Bond Tax Act of 1980: A Step in the Wrong Direction*, 9 FLA. ST. U.L. REV. 469 (1981).

115. *Id.* at 470-71.

116. White, *supra* note 17 at 44. See also, Miami Herald, August 23, 1981 (J. Russell, Financial Editor).

117. 459 F. Supp. 903 (1978) (Partial summary judgment) and 481 F. Supp. 616 (1979) (summary judgment made final).

118. 237 So. 2d 583.

wood.¹¹⁹ The federal courts in Florida were initially hesitant to accept federal question jurisdiction, remanding several cases to state court, but finally accepting two for consideration.¹²⁰

The first complete consideration of preemption in the federal courts of Florida came in *First Federal Savings and Loan Association v. Peterson*, decided June 22, 1981.¹²¹ Judge Higby found basis for preemption under all of the tests enunciated in *Rice*, and stated that, on the issue of exercising due-on-sale clauses to obtain a higher interest rate, federal law preempts all state law. This decision was followed by the decision in the Middle District in September, 1981, in *Price v. Florida Federal Savings and Loan Association*.¹²² In this decision Judge Melton takes note of several federal court decisions that have opted for federal preemption of due-on-sale provisions and cites with approval the reasoning of *Peterson*.¹²³

E. Legislative Consideration

In an interesting parallel development, the Florida Legislature considered the issue of due-on-sale provisions in its 1981 session. Under strong lobbying from the savings and loan associations and with strong opposition from realtors' organizations, the Florida House of Representatives considered and passed House Bill 1052. This bill was essentially a legislative policy statement supporting the enforceability of acceleration clauses to raise interest rates or, in the alternative, to call such loans due pursuant to the terms of the mortgage.¹²⁴ The bill provided certain conditions such as a proviso that the right to provide increased interest is specifically included in the mortgage, and that no prepayment penalty could accompany the payment of the note following failure to agree on a

119. 385 So. 2d 156.

120. In May of 1980, the Middle District took up two cases, *Kirkland v. Fidelity Fed. Sav. & Loan Ass'n*, ___ F. Supp. ___, Case No. 79-859 (M.D. Fla. May 16, 1980); and *Price v. Florida Fed. Sav. & Loan Ass'n*, ___ F. Supp. ___, Case No. 79-974-Civ-J-M (M.D. Fla. May 23, 1980). The results were mixed—*Kirkland* was remanded to state court, while *Price* was retained on federal question jurisdiction. In January of 1981, the case of *Schultz v. Coral Gables Fed. Sav. & Loan Ass'n*, 505 F. Supp. 1003 (S.D. Fla. 1981) was removed to the Southern District federal court and was subsequently remanded to the state court on procedural grounds. Following the reasoning of *Gully v. First National Bank*, 299 U.S. 109 (1936), the court refused to rule that the invocation of the doctrine of federal preemption was adequate to establish federal question jurisdiction. *Id.* at 1011.

121. 516 F. Supp. 732.

122. Case No. 79-974-Civ.-J.-M. (M.D. Fla. 1981).

123. *Id.* slip op. at 5.

124. H.B. 1052, FLORIDA LEGISLATIVE REPORTERS (1981).

higher rate of interest.¹²⁵ In the Florida Senate the question was not reported out of committee prior to adjournment. It is not known whether this question will be considered in the 1982 Legislative session, but the possibility of federal preemption should encourage legislators to take steps to assure that state chartered thrift associations do not end up bound by restrictions that federal chartered associations can evade.

IV. CONCLUSION

It is clear from congressional acquiescence in FHLBB actions, and in their own actions in allied fields, that Congress intends to insure the survival and viability of the federal thrift association. Congress would probably require federal preemption in any case of conflict with that objective. It is probable, but less clear, that Congress would also intend preemption because of pervasive federal occupation of the field.

If a state wishes to retain some control over the area of mortgage operation and foreclosure, then, it would seem necessary to avoid direct conflict with the objectives of a program Congress considers vital. This may well be what Minnesota has been able to do through their decision in *Holiday Acres No. 3*. The Minnesota Supreme Court will undoubtedly face the problem again when a residential mortgage, rather than an investment property, is at issue. In the meantime they have some "breathing room" and an opportunity to avoid conflict in future cases. Certainly they will be less likely to cause a preemption mandate than a state that makes a claim that only state courts can enforce equity matters.

California cannot easily avoid this conflict. The obvious conflict of *Wellenkamp* and *Glendale* is too direct and the state statutes too clearly in conflict with the FHLBB position. Florida, however, is not so circumscribed. The issue has never been ruled on by the Florida Supreme Court. Given the right case, the court could choose a position which would avoid direct conflict and yet maintain state authority over this traditionally state-controlled area. The Florida Legislature also has the opportunity to relieve the source of this conflict and at the same time, assure that state-chartered thrift associations are not caught at a disadvantage.

All of the cases currently mandating preemption (*Glendale*, *Peterson* and *Pierce*) are on appeal to the federal appeals court for

125. *Id.* at 1.33-1.46.

their respective circuits. Even after a decision at this level for preemption, it would require a decision by the United States Supreme Court before the preemption decision would be mandatory on the states. Given the restraint of the current Court, it is doubtful that it would decide for preemption based on pervasive occupation of the field alone, so long as there were no clear conflicts with the intent of an important congressional program.

Due-on-sale clauses are not necessarily inequitable and appear to be an economic necessity. The question is no longer whether they will ultimately be approved, but by whom.