University of Michigan Journal of Law Reform

Volume 14

1981

Selected Problems in Wrap-Around Financing: Suggested Approaches to Due-on-Sale Clauses and Purchaser's Depreciable Basis

Sanford M. Guerin
University of Denver College of Law

Follow this and additional works at: https://repository.law.umich.edu/mjlr

Part of the Banking and Finance Law Commons, and the Property Law and Real Estate Commons

Recommended Citation

Sanford M. Guerin, *Selected Problems in Wrap-Around Financing: Suggested Approaches to Due-on-Sale Clauses and Purchaser's Depreciable Basis*, 14 U. MICH. J. L. REFORM 401 (1981).
Available at: https://repository.law.umich.edu/mjlr/vol14/iss3/3

This Article is brought to you for free and open access by the University of Michigan Journal of Law Reform at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in University of Michigan Journal of Law Reform by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

SELECTED PROBLEMS IN WRAP-AROUND FINANCING: SUGGESTED APPROACHES TO DUE-ON-SALE CLAUSES AND PURCHASER'S DEPRECIABLE BASIS

Sanford M. Guerin*

The wrap-around ("WA") mortgage has become in recent years a predominant force in real estate financing, despite a general misunderstanding of its unique financial characteristics among the judiciary, the Internal Revenue Service, and taxpayers seeking to utilize it.[1] This misunderstanding has resulted in an uncertain and inconsistent application of the law to a substantial number of wrap-around financed sales. Despite the uncertainty, however, increasing numbers of sellers employ wrap-around financing, either because of financial preference or economic necessity.

The WA-financed installment sale offers benefits to both purchaser and seller which are unavailable under conventional financing methods.[2] The purchaser benefits primarily from flex-

* Associate Professor, University of Denver College of Law. B.A., 1971, Boston University; J.D., 1974, University of San Francisco; L.L.M., 1975, New York University.

[1] A WA mortgage is a loan equal to the existing mortgage plus any additional cash advanced by the lender. A WA mortgage may be used as a purchase money loan or as a refinancing technique. The principle, however, is the same in both situations. When the borrower makes payments on the WA mortgage, the lender is required by the WA agreement to make payments on the first mortgage. This allows the borrower to obtain a loan below market rates while insuring an above-market return to the seller.

Consider the following example: A owns Blackacre, valued at $100,000, with an adjusted basis of $30,000, and encumbered by a first mortgage of $70,000 bearing interest at the rate of 9% per annum. B would like to buy Blackacre but he has no money for a down payment, and cannot afford the current 15% mortgage rate. A could offer B a WA mortgage for the full $100,000 at 12% per annum. A's investment in the property would be $30,000 (the actual amount of money loaned by A). For each year of the WA mortgage, A will receive interest income of $12,000 ($100,000 × 12%) while paying out $6,300 ($70,000 × 9%) on the first mortgage. This would give A a gain of $5,700 — a net return on his investment of 19%. *See* note 3 *infra*.

The original mortgagee in this example would understandably feel left out, because it is saddled with a 9% return. To avoid this result, it will attempt to call in the first mortgage through a "due-on-sale" acceleration claim in the original agreement. *See* pt. II *infra*.

[2] A review of the conventional options in a real estate disposition illustrates why real estate purchasers and sellers are finding WA-mortgage financing increasingly attractive, and at times essential. Using again the example presented in note 1 *supra*, the sale can

ibility in negotiating financing terms. Because the seller is not constrained by the statutory limits on borrowing applicable to commercial lenders, he can allow a purchaser to make a smaller cash downpayment and obtain a larger loan than the purchaser could obtain from an institutional lender. In addition, negotiating a loan with a life in excess of a conventional mortgage or with an increasing interest rate can decrease the amount of the purchaser's debt service in the early years. Use of a wrap-around also enables the purchaser to avoid paying "points," or other loan origination fees, customarily charged by institutional lenders. Moreover, in some situations, the WA mortgage may be the only financing available, either because of a tight money supply or because a purchaser's poor credit rating disqualifies him from obtaining conventional financing.

Comparable advantages accrue to the seller utilizing a WA mortgage arrangement. The seller can enhance the marketability of his property by tailoring the mortgage to suit the purchaser's needs. In addition, a WA mortgage may be the only means for a

---

be accomplished by one of three conventional methods.

First, the purchaser can pay cash for the entire purchase price, with the seller retiring the $70,000 mortgage with the proceeds. This arrangement may be disadvantageous to the seller, because he will be taxable in a single year on the $70,000 gain while only receiving $30,000 in cash. Assuming the purchaser utilizes his own funds, the transaction is financially undesirable from his viewpoint because it provides no leverage. If a WA mortgage were used, the seller would recognize as taxable gain only that amount of each monthly payment attributable to the $30,000 he actually advanced. This allows the seller to spread his taxable gain over a longer time period. The purchaser would benefit as well, because he still would have his money to use for other investments.

Second, the purchaser can pay a small percentage of the sales price to the seller, and borrow the balance from a third-party lending institution. The purchaser may encounter difficulty in qualifying for financing, or may be forced to pay an excessive interest rate. Moreover, as in the first alternative, the seller will have to report his entire taxable gain in the year of sale. In contrast, under a WA-financing scheme the purchaser would need only to satisfy the seller's qualifications, and upon satisfaction of those qualifications could obtain a loan at below the market interest rate.

Third, the sale can be structured as an installment sale under I.R.C. § 453, with the purchaser assuming the existing mortgage while paying cash and a note to the seller in exchange for his equity in the property. One obvious problem with this method would arise where the purchaser has insufficient cash to cover the seller's equity, necessitating secondary financing. This transaction nonetheless may be preferable to the above two alternatives because it permits the seller to report as income only a portion of each payment received, thus allowing him to spread his taxable gain over the years of payment on the note. The installment sale also provides the purchaser with increased leverage. Under this method of reporting gain, however, the assumption of the seller's indebtedness in excess of his adjusted basis is deemed a "constructive payment," thus being treated as a taxable payment in the year of sale even though no cash is received. Therefore, if the purchaser either assumes the seller's mortgage or takes the property subject to the mortgage, the amount in excess of basis, $40,000, constitutes a taxable payment in the year of sale. A WA mortgage, while still enabling the benefits of § 453 installment sales, would avoid this problem of constructive payment.

seller to avoid a large prepayment penalty, or to sell property encumbered by a "locked in" loan. Moreover, and perhaps most significantly, the leverage in the WA arrangement enables the seller to earn income from the interest rate based on the unadvanced funds — that portion of the WA mortgage which equals the unpaid balance on the senior mortgage — in addition to the interest income received on the equity advanced to the purchaser.[3] Finally, if the purchaser does not assume the existing mortgage or take the property subject to that mortgage, the WA mortgage may eliminate a constructive payment in the year of sale while decreasing the percentage of income to be reported by the seller on the receipt of each installment payment.

Although WA mortgage financing has reached near epidemic proportions, its use remains clouded by judicial uncertainty. For example, "due-on-sale" or "due-on-encumbrance" clauses, often employed by institutional lenders to prevent WA financing, have been inconsistently analyzed and enforced by the courts. Additionally, no cases or guidelines exist for evaluating whether a WA mortgage should be included in the purchaser's depreciable basis. Despite the obvious hazards,[4] however, and the fact that taxpayers cannot be assured of the results from a particular WA transaction, an increasing number of taxpayers have deemed the advantages, or perhaps the necessities, of employing WA financing as sufficiently attractive to justify the uncertainties.

This article will address two unresolved issues surrounding the WA transaction which result from the inherent flexibility available for negotiating financing terms in the absence of an institutional lender. Part I discusses the circumstances warranting exclusion of the WA loan from the purchaser's depreciable basis.

---

[3] This transaction creates financial leverage for the seller. Leverage arises when funds are borrowed at a given percentage and then loaned at a specified rate. When the cost of borrowing is less than the income earned by loaning the borrowed funds, there is "positive leverage." "Negative leverage" occurs when the cost of borrowing exceeds the return available for those dollars. Leverage thus describes the use of another's money to increase one's own return.

For instance, in the example set forth in note 1 *supra*, the seller is receiving 12% interest on the full $100,000 WA mortgage, while actually lending only $30,000. The remaining $70,000, the outstanding balance on the first mortgage, is subject only to a 9% interest rate. This combination creates an effective interest rate of 19% — the interest income of $12,000, less the interest payments of $6,300, produces a net interest income of $5,700, or a 19% earning on the $30,000 loan. Thus the seller enjoys positive leverage.

[4] A further difficulty may be presented when sellers fail to adhere meticulously to the Tax Court's uncertain guidelines, which could cause the purchaser to be treated as having "assumed" or taken the property "subject to" the existing mortgage. Either outcome could result in a constructive payment in the year of sale, and a modification to the seller's profit-reporting percentage.

Part II addresses whether, and when, a due-on-sale clause in the senior mortgage should negate the possibility of utilizing WA financing.

I. Inclusion of the Wrap-Around in the Purchaser's Basis

The law permits a depreciation deduction for property used in a trade or business, or held for investment.[5] Because depreciation can be taken only to the extent of the owner's basis in the property, it behooves the owner to maximize his basis. Thus, the WA-financed purchaser will seek to include the amount of the WA mortgage in his depreciable basis, in order to receive depreciation deductions exceeding his cash investment in the property. The flexibility available to parties negotiating WA-financing terms, however, engenders substantial uncertainty regarding the purchaser's ability to maximize his depreciable basis by including the WA mortgage. For example, no-money-down 100% WA financing[6] might prevent inclusion of the WA mortgage in the purchaser's depreciable basis. Furthermore, uncertainty exists regarding the significance of whether the purchase-money WA loan is nonrecourse, of whether the term of the loan exceeds the useful life of the property, and of whether the purchase price exceeds the fair market value of the property.[7]

Although no court has addressed these questions specifically with respect to WA financing, a line of cases dealing with purchase-money mortgages and sale-leaseback arrangements establish general principles for inclusion of a purchase-money loan in a purchaser's cost basis. These rules should also apply to

---

[5] I.R.C. § 167. Depreciation is not allowed for property used for personal purposes. Accordingly, the discussion in Part I is limited to WA mortgages employed for purchasing trade or business property, or property held for investment. This is not to imply, however, that WA financing is used more extensively in commercial, as opposed to noncommercial, purchases. The benefits of WA mortgages, *see* notes 2-3 and accompanying text *supra*, apply with equal force to purchasers of property intended for personal use.

[6] For an example of a 100% WA mortgage, *see* note 1 *supra*.

[7] This last device, if successful, would result in income tax savings to both purchaser and seller. A stated purchase price in excess of the fair market value of the property would provide the purchaser with a higher depreciable basis in the property — equal to the stated purchase price. The seller could report a portion of each payment received as capital gain, rather than ordinary income, by trading the higher purchase price for a lower interest rate on the mortgage. In such a case, however, the Internal Revenue Service could argue that the amount exceeding the fair market value of property represents a loan discount. Under this reasoning, the purchaser would be prevented from including the excess in his basis and would therefore amortize the discount amount over the term of the loan. The seller would then recognize ordinary income on each payment in an amount equal to the portion of each payment attributable to the discount.

purchase-money WA loans. There is no reason to distinguish between WA purchase-money mortgages and non-WA purchase-money mortgages in this context, because both represent the purchaser's cost for the property. Several unique aspects of WA-financing transactions must be viewed within the framework of these general rules, however, to determine if the WA mortgage presents any special problems for the purchaser. For example, the use of a land sale contract, under which title does not pass until the debt is satisfied in full, might affect the purchaser's ability to include the WA mortgage in his basis. Furthermore, inclusion of the WA mortgage in the purchaser's depreciable basis might be precluded where the combined face amount of the purchaser's WA mortgage and the seller's senior mortgage exceed the fair market value of the property. Analysis of the rationales underlying a purchaser's ability to include a mortgage in his basis provides answers to these concerns.

A. Rules Regarding Depreciable Basis

1. The Crane *rule—* Internal Revenue Code section 167(g) provides that, for purposes of depreciation, the basis of property is the adjusted basis set forth in section 1011 for determining gain or loss on the sale or disposition of such property.[8] Section 1011(a) provides that the basis of property is to be determined under section 1012,[9] which states that "[t]he basis of property shall be the cost of such property."[10] The regulations provide that, in general, the cost of property is the amount paid for the property in cash or other property.[11] Thus, a purchaser's depreciable basis in property is generally the amount paid for the property. A line of cases beginning with *Crane v. Commissioner*[12] establishes that the "amount paid" for property, for purposes of depreciation and for computing gain or loss on the sale of the property, includes the full amount of any debt "assumed or taken subject to."

In *Crane,* the taxpayer inherited real property encumbered by a mortgage equal to the fair market value of the property. The mortgage was never assumed by the taxpayer and remained outstanding until the taxpayer's subsequent sale of the property. In

---

[8] I.R.C. § 167(g).
[9] I.R.C. § 1011(a).
[10] I.R.C. § 1012.
[11] Treas. Reg. § 1.1012-1(a) (1957).
[12] 331 U.S. 1 (1947).

computing gain on the disposition of the property, the taxpayer used a zero valuation for her basis on the theory that, because the mortgage equaled the value of the property she inherited, she originally acquired no equity in the property. She paid tax on the amount reflecting the difference between her equity in the property at the time of the sale and her zero "basis" in the property. The Commissioner contended that the taxpayer's basis in the property, for purposes of computing gain or loss on the sale, should be the full value of the property, including the amount of the mortgage.[13] The Court upheld the Commissioner, finding that inclusion of the mortgage in the taxpayer's basis was offset by the fact that the taxpayer must also include the full mortgage amount in the amount realized on the sale of the property subject to the mortgage.[14]

The *Crane* rule may be justified most easily where the terms of the note and mortgage make the buyer personally liable for the debt amount, as the buyer will be required to pay the debt in the event of default and subsequent foreclosure.[15] The *Crane*

---

[13] In *Crane*, the taxpayer's method resulted in a computed gain of $2,500 (the taxpayer's sale price minus her zero basis), whereas the Commissioner's approach resulted in a computed gain of over $24,000. Under the Commissioner's approach, the taxpayer's adjusted basis was found to equal only the fair market value at the time of acquisition (which happened to equal the encumbrance on the property) less the allowable depreciation. To arrive at the gain realized, the adjusted basis was then subtracted from the sale price, which the Commissioner asserted was equal to the cash received by the taxpayer plus the outstanding balance of the encumbrance. The Commissioner and the Court reduced the taxpayer's basis by the allowable depreciation of approximately $25,000 (which, indeed, the taxpayer had claimed during her term of ownership) under the language of § 113(b)(1)(B) of the Revenue Act of 1938, then in effect, which provided that "proper adjustment in respect of the property *shall in all cases be made* . . . for exhaustion, wear and tear . . . to the extent allowed (*but not less than the amount allowable*). . . ." *Id.* at 11 (second emphasis added). (The Commissioner's computed gain was only $24,000 because additional interest on the outstanding encumbrance had accrued during the taxpayer's term of ownership.)

[14] In rejecting a definition of basis which included only the taxpayer's equity in the property, the Court noted the effect of such a construction on the allowance of depreciation deductions and corresponding adjustments to basis for wear and tear on the property. If depreciation is computed upon the taxpayer's equity basis, the taxpayer would be allowed only a portion of the actual wear and tear. On the other hand, if depreciation is computed on the full value of the property, but subtracted from the equity basis, the deductions might eventually yield a negative basis. Further, the use of an equity basis would require that the basis be altered with each mortgage payment, creating a tremendous accounting burden for both the Commissioner and the taxpayer. This led the Court to conclude that the basis in property must include the full amount of any mortgage thereon.

[15] Contrast this result to the situation where the buyer takes the property subject to the mortgage. In this latter situation, the buyer simply may walk away from the property in the event of default and incur no personal liability. Under these circumstances, it is more difficult to conceive the nonrecourse mortgage as part of the buyer's "cost" of the property.

court refused to distinguish between recourse and nonrecourse debt, however, reasoning that the tax result is the same upon ultimate sale of the property regardless of whether the seller is personally liable for the debt.[16]

2. *Nonrecourse loans*— Nineteen years after *Crane*, the Tax Court, in *Mayerson v. Commissioner*,[17] applied the *Crane* rule to nonrecourse purchase-money mortgages. In *Mayerson*, the taxpayer purchased depreciable real property for a minimal downpayment and a substantial nonrecourse purchase money mortgage. The term of the mortgage was ninety-nine years, with a specified amount of interest to be paid annually in fixed monthly installments. Under the terms of the mortgage, substantial reductions in the purchase price were offered in the event the buyer made full payment of the purchase price in either of the first two years following the sale, although repayment of principal was not required before the due date ninety-nine years hence. The taxpayer was not personally obligated under the note for any repayment of principal; in the event of default the seller could foreclose only against the property.

The taxpayer included the full amount of the mortgage in the property's basis and computed his depreciation deductions using that amount. The Commissioner argued that the lengthy term of the mortgage and the unusual nature of many of its provisions, especially its nonrecourse nature, indicated the taxpayer had made no capital investment in the property.[18] The Commissioner claimed that because the taxpayer was not personally liable for repayment of any principal amount of the mortgage, no debt was created — therefore the taxpayer should not be allowed to include the purported debt in calculating his depreciable basis. Further, the Commissioner argued that the obligation, if any, was too contingent or indefinite to be considered a part of the taxpayer's depreciable basis in the property, because the balance due on the mortgage could be one of three different

---

[16] The Court observed:

> We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged or as if a personal debt in an equal amount had been assumed by another.

Id. at 14 (footnote omitted).

[17] 47 T.C. 340 (1966), *acq.*, 1969-1 C.B. 21.

[18] *Id.* at 350. Furthermore, the Commissioner, in disallowing the depreciation deductions, claimed that the transaction was in fact a lease, and thus not a purchase. Accordingly, the Commissioner classified the downpayment as the cost of obtaining a lease with an option to purchase, with such cost to be amortized over the ninety-nine year term.

amounts depending upon when payment occurred.

The Tax Court held that a valid debt obligation was created by the purchase-money mortgage, despite the ninety-nine year term of the loan and the absence of personal obligation for repayment of the principal.[19] The court found the lack of personal liability in a nonrecourse debt not to be significant, given the common business practice to limit liability to the property involved.[20] Recognizing that the parties agreed at the time of sale upon a conversion as soon as practicable to institutional mortgage financing, the court concluded that the transaction was in fact a bona fide arm's length purchase. Furthermore, the court found the variable purchase price not to constitute a contingent or indefinite obligation[21] because the alternative prices were fixed in amount, merely representing an incentive for early repayment. That the purchaser and seller later settled the debt for an amount far less than the face amount was held not to affect

---

[19] The Court recognized that "[i]t is well accepted . . . that depreciation is not predicated upon ownership of property, but rather upon an investment in property." *Id.* This rule had been established earlier by two cases holding that a purchaser must make a capital investment in the property to acquire a depreciable interest. Bare legal title, without beneficial ownership, is not sufficient to support a depreciation deduction. *See* Weiss v. Weiner, 279 U.S. 333 (1929); *In re* Gladding Dry Goods Co., 2 B.T.A. 336 (1925). The basis for this requirement, expressed in Blake v. Commissioner, 20 T.C. 721 (1953), is that the benefit of the depreciation deduction should inure to one who suffers an economic loss as a result of wear and exhaustion of the business property.

[20] 47 T.C. at 351-52.

[21] *Id.* at 353-54. Various Tax Court decisions have established that the cost of property for purposes of determining its depreciable basis does not include any amount with respect to obligations which are contingent and indefinite in nature. *See* Columbus & G. Ry. v. Commissioner, 42 T.C. 834 (1964), *aff'd per curiam,* 358 F.2d 294 (5th Cir.), *cert. denied,* 385 U.S. 827 (1966); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), *aff'd per curiam,* 333 F.2d 653 (2d Cir. 1964); Redford v. Commissioner, 28 T.C. 773, *appeal dismissed per stipulation,* (4th Cir. Nov. 27, 1957). The court in *Mayerson* distinguished these cases on the ground that the underlying obligation in each of the other cases was by its terms contingent, so that there was no amount of fixed indebtedness for which the purchaser was liable. For example, in *Redford,* the face value of a note was excluded from the purchaser's basis because the note was payable only from profits and it was uncertain whether there would ever be profits. In *Albany Car Wheel,* the disallowed liability consisted of the purchaser's obligation to pay severance pay to its employees, where it was unknown at the time of the sale whether it would be necessary to satisfy any severance pay obligations. In *Columbus & Greenville Railway,* a mortgage was excluded from the taxpayer's basis where the taxpayer had by agreement been relieved of all liability under the mortgage and release and satisfaction of the mortgage had been issued by the mortgagee prior to the time taxpayer claimed inclusion of the mortgage in his depreciable basis. The court in *Mayerson* held these three cases inapplicable to the purchase-money mortgage situation where a variable purchase price based on optional discounts for early retirement of the mortgage is specified in dollar amounts. The court further held that the amount to be included in the purchaser's basis in this situation is the undiscounted amount, with a later adjustment of the basis of prepayment to be made under the terms of mortgage.

the allowable depreciation deduction in the years prior to settlement.

3. *Applying* Crane *and* Mayerson *to the WA mortgage purchaser*— The *Crane* and *Mayerson* decisions allow the WA mortgage purchaser to include the full amount of the WA mortgage in his depreciable basis. These cases afford the purchaser this treatment regardless of whether: (1) the WA mortgage is recourse or nonrecourse; or (2) the purchase price under the WA mortgage is fixed or varies with the time of repayment. The transaction between the parties must be at arm's length, however, and must evidence a valid purchase and a valid debt.[22]

In *Bolger v. Commissioner*,[23] the Tax Court, faced with an extreme set of facts, again upheld the inclusion of a nonrecourse purchase money obligation in the purchaser's depreciable basis. Ten separate transactions entered into by Bolger were challenged by the Commissioner. For each transaction Bolger had formed a corporation in which he was a shareholder. Each corporation negotiated to purchase real property under an agreement whereby the owner and user of the property conveyed title to the corporation, leasing back the property. The corporation then sold negotiable interest-bearing notes to an institutional lender, in face amounts equal to the purchase price,[24] and used the funds to purchase the property from the seller-lessee. To secure its obligation under the notes, the corporation executed a first mortgage on the property in favor of the lender and, in addition, assigned the lease to the lender.

After execution of the lease and mortgage agreements, the corporation conveyed each property to its shareholders for a token payment. As required by the mortgage agreement, the shareholders agreed to perform all obligations under the lease and mortgage agreements without, however, assuming personal liability, so that the corporation remained primarily liable. Bolger, as a shareholder-transferee, claimed his proportionate share of all income and deductions attributable to the properties transferred by the corporation. The primary issues before the court were whether Bolger, as a shareholder-transferee, acquired a de-

---

[22] The Service acquiesced to the Tax Court's determination in *Mayerson*, but also stated in Revenue Ruling 69-77, 1969-1 C.B. 59, that the acquiescence was

> based on the particular facts in the case and will not be relied upon in the disposition of other cases except in situations where it is clear that the property has been acquired at its fair market value in an arm's length transaction creating a bona fide purchase and a bona fide debt obligation.

[23] 59 T.C. 760 (1973), *acq.*, 1976-1 C.B. 1.

[24] The notes provided for full payment over a period equal to or less than the term of the lease.

preciable interest in the properties, and if so, whether the unpaid mortgages formed part of his depreciable basis.

The Commissioner contended that, in each transaction, Bolger acquired a mere reversionary interest in the properties insufficient to support a depreciation deduction. The court, however, found that the corporations acquired full legal and beneficial title to the properties at the outset, which they transferred to Bolger as a shareholder, with Bolger thereby acquiring a depreciable interest in the property.[25] The Commissioner argued alternatively that even if petitioner were the legal and beneficial owner of the properties, the fact that Bolger had assumed no personal liability under the mortgages precluded him from adding to his adjusted basis the amount of the nonrecourse debt encumbering the property. Because the actual cash flow was minimal and the properties were mortgaged to their fair market value, the Commissioner argued that Bolger had no reason to protect his property interests by making payments on the mortgages.

The court disagreed, citing *Crane v. Commissioner*,[26] *Blackstone Theatre Co. v. Commissioner*[27] and *Mayerson v. Commis-*

---

[25] In determining whether a depreciable interest in the properties was acquired, the court first examined the corporations to ascertain whether they constituted separate, viable entities. Relying on the test set forth in Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the court held that the corporations were formed to avoid state-law ceiling restrictions on loans to individuals and to limit personal liability of the shareholders, both valid business purposes under *Moline Properties*, so that the corporations were valid and separate entities. 59 T.C. at 767.

Having found that the corporations must be treated as separate entities from the transferee-shareholders, the court proceeded to examine the nature of the interests acquired by the corporations and the shareholders. Bolger argued that in each transaction he acquired from the corporation both legal title to, and full beneficial ownership of, the property. The Commissioner claimed that — due to the execution and assignment of the long term lease and the provision for payments directly from the lessee to the mortgagee — Bolger had acquired a mere reversionary interest in the property, upon which depreciation is not allowed. The court, however, found that the execution of the mortgages and the assignments of the leases to the mortgagees were for security purposes only. The assignments did not shift the responsibility away from the corporations for recognizing income from the rents, and accordingly did not rob the corporations of legal or beneficial ownership of the properties. *Id.* at 767-69.

[26] 331 U.S. 1 (1947).

[27] 12 T.C. 801 (1949), *acq.*, 1949-2 C.B. 1. The taxpayer in *Blackstone* purchased a building for approximately $37,000 cash, subject to outstanding tax liens of approximately $120,000 against the property for assessed and unpaid real estate taxes and penalties. Five years after purchase of the building, the taxpayer purchased the tax liens for approximately $50,000 at a public sale in connection with foreclosure of the liens. Beginning with its initial acquisition of the property, the taxpayer included the entire $120,000 of tax liens in its basis for depreciation. The Commisssioner contended that the taxpayer's basis should include only the $50,000 for which the taxpayer later purchased the liens, plus certain legal and title fees incurred by the taxpayer in acquiring the lien. The

sioner,[28] holding that Bolger did have incentive to satisfy the nonrecourse liabilities. Each lease payment amortizing the mortgages increased Bolger's equity interest in the properties, both for ultimate sale and potential refinancing purposes. Further, the Court noted that Bolger could hope to benefit from appreciation in market value of the properties only by protecting his interest. The court reached this result even though only a very small cash investment had been made, the property was mortgaged to its full value, and the rent payments from the leases were included in petitioner's income although the rents were assigned to the institutional lender.

B. *Limitations on Inclusion of Mortgages in the Depreciable Basis*

The preceeding discussion has demonstrated the general rule that purchase-money mortgages, including WA mortgages, are included in the buyer's depreciable basis. This rule, however, is not without limitations. Examination of the relevant case law indicates that exceptions to this rule exist where (1) the mortgage exceeds the fair market value of the property, (2) the seller retains significant control over the property transferred, or (3) the mortgage exceeds the useful life of the encumbered property.

1. *The fair market value limitation*— The court in *Bolger* made an express finding that, when the corporations transferred property to Bolger, the fair market value of each property equalled at least the remaining principal balance of the unassumed mortgage. In subsequent cases and rulings, this finding has become essential to inclusion of the nonrecourse mortgage in a purchaser's basis.[29]

For instance, in *Estate of Franklin v. Commissioner*,[30] the court took the sensible approach that the purchaser's failure to demonstrate that the purchase price of real property equalled at

---

court, citing *Crane*, held that the depreciable basis for the property included the full amount of the tax liens on the property at the time of purchase, even though the taxpayer was not personally liable on the liens and subsequently was able to purchase the liens for a lesser amount. The court held that the depreciable basis is to be determined upon conditions existing when the return is filed, and that to require retroactive adjustments to basis for subsequent events would result in administrative burdens which the *Crane* decision meant to avoid.

[28] 47 T.C. 340 (1966), *acq.*, 1969-1 C.B. 21.

[29] Rev. Rul. 69-77 states: "It is to be noted that the fair market value of the property was not put in issue in [*Mayerson*]." 1969-1 C.B. 59. Fair market value was not an issue in *Crane* either. 331 U.S. at 3.

[30] 544 F.2d 1045 (9th Cir. 1976), *aff'g*, 64 T.C. 752 (1975).

least approximately its fair market value was fatal to his attempt to include the mortgage in his depreciable basis. The taxpayer, a partner in a limited partnership, claimed his distributive share of depreciation and interest deductions with respect to a motel and related property purchased by the partnership.[31] The purchaser's obligation was nonrecourse. The sale was combined with a lease-back of the property to the sellers, with lease payments approximating closely the ten-year monthly payments, so that, except for the original prepaid interest payment, no cash would change hands between the sellers and the purchaser until a lump sum balloon payment ten years later. Because a net lease was involved, the sellers continued to be responsible for taxes, assessments, rents, utility costs, and all other charges against the property. In addition, the sellers were obligated for payments under the first and second mortgages until the balloon payment was made, and had the right to encumber further the property without the purchaser's consent.

The Tax Court held the transaction to be an option rather than a sale, and thus disallowed depreciation and interest deductions based upon inclusion of the mortgage in the taxpayer's basis in the property. The Tax Court relied on several factors in reaching its decision: (1) the debt was nonrecourse, enabling the partnership to walk away after ten years but lose only its $75,000 prepaid interest; (2) the deed was not recorded; (3) the benefits and burdens of ownership remained with the sellers throughout this period; and (4) the lease payments equalled the purchase-money mortgage payments.[32]

The Court of Appeals, although upholding the Tax Court, based its decision on entirely different grounds. Citing several cases, including *Mayerson,* the court stated that all indicia relied upon by the Tax Court to characterize the transaction as an option rather than sale could exist as well in a valid sale. The Court of Appeals found the fatal flaw in the transaction to be the lack of proof that the purchase price at least approximated the fair market value of the property.[33]

---

[31] The purchase price for the properties was $1,224,000. The terms of the purchase agreement provided for an initial payment of $75,000 of prepaid interest, monthly payments of approximately $9,000 for ten years, and a balloon payment of $975,000 at the end of the ten year term.

[32] 64 T.C. at 763-69.

[33] Comparing *Franklin* to prior cases allowing a deduction, the court stated:

> In none of these cases, however, did the taxpayer fail to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property. Just such a failure occurred here. The Tax Court explicitly found that on the basis of the facts before it the value of the property could not be

The court reasoned that when the purchase price exceeds a reasonable estimate of the fair market value of the property, payments on the purchase price do not yield any equity to the purchaser — therefore the purchaser makes no investment in the property. Following the reasoning of *Crane* and *Mayerson*, the court held that because depreciation is based upon an investment in property, absent personal liability a valid debt exists only where it is economically reasonable for the purchaser, from the date of purchase, to have an interest in making a capital investment in the amount of the unpaid purchase price. When the purchase price equals the fair market value of the property, the property owner reasonably can be expected to satisfy the debt to protect his equity interest, but when the purchase price exceeds the estimated fair market value of the property, a purchaser forfeits no equity interest in the property by abandoning his obligation. In the latter situation, it cannot be assumed that the purchaser ultimately will make a capital investment in the property in the absence of personal liability; such an assumption would include necessarily a parallel assumption of significant appreciation in value of the property prior to the investment. Thus, the court concluded that the purchaser should not be allowed to include the amount of any nonrecourse mortgage on the property in his depreciable basis when the purchase price exceeds the fair market value of the property.[34]

Under *Franklin*, an attempt to inflate the purchase price beyond the value of the property in a WA-mortgage transaction should be sufficient to deny the purchaser the benefits of a higher depreciable basis in the property. It might be argued that if, in a WA-financing transaction, the combined face amounts of the seller's senior mortgage and the purchaser's WA mortgage exceed the fair market value of the property, the transaction runs afoul of the rules established in *Franklin*. The *Franklin* decision, however, rests upon the premise that a purchaser is not likely to satisfy a nonrecourse debt exceeding the fair market value of property, because such payments do not increase his equity in the property. In the WA situation, though, the purchaser's payments on the WA mortgage do create an incentive to repay by increasing his equity in the property, thereby avoiding

estimated. . . . In our view this defect in the taxpayers' proof is fatal.

544 F.2d at 1048.

[34] In its decision, the court in *Franklin* makes reference to Rev. Rul. 69-77, 1969-1 C.B. 59, and states that "[e]mphasis on the fair market value of the property in relation to the apparent purchase price animates the spirit, if not the letter, of [that ruling]." 544 F.2d at 1049 n.6.

the situation contemplated by *Franklin*. Only if the WA purchaser has a purchase price exceeding the fair market value of the property should the liability be considered "contingent."

Two subsequent rulings, citing *Crane* and *Franklin*, disallowed inclusion of an obligation in the basis of the property for depreciation purposes because the purchaser failed to show that the value of the property approximated the value of the obligation.[35] Neither ruling qualified the magnitude of the disparity between purchase price and fair market value necessary to preclude inclusion of the subject property in the depreciable basis. *Franklin* indicates, however, that the rule applies only to cases in which the purchase price substantially exceeds the fair market value of the property.[36]

2. *Allocation of the benefits and burdens of ownership*— The appellate court in *Franklin* based its decision solely on the disparity between the purchase price and fair market value of the property, declining to rely upon the characteristics of the transaction emphasized by the Tax Court. A recent Supreme Court decision, *Frank Lyon Co. v. U.S.*,[37] however, indicates that

---

[35] Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 77-110, 1977-1 C.B. 58. In these rulings the taxpayer purchased property (film rights in the earlier ruling; patent rights in the later ruling) for a minimal downpayment and a nonrecourse note for the balance of the purchase price. In both, the taxpayer failed to demonstrate that the fair market value of the property at least approximately equaled the amount of the nonrecourse notes. In each situation the Internal Revenue Service (IRS) disallowed inclusion of the value of the note in the purchaser's basis in the property. In a more extreme example of the taxpayer's burden of proof in this area, Rev. Rul. 80-42, 1980-1 C.B. 182, the IRS limited the taxpayer's basis to a lower fair market value even though the actual cash paid by the taxpayer exceeded that amount. This Revenue Ruling indicates that in the Service's view, the taxpayer bears a heavy burden in this area to prove the fair market value of the property.

[36] *See* 544 F.2d at 1048 n.4, referring to strong evidence in the Tax Court findings indicating a substantial disparity between the fair market value and the purchase price in this case. In addition, the last paragraph of the decision expressly limits the holding "to transactions substantially similar to that now before us." *Id.* at 1049.

[37] 435 U.S. 561 (1978). In this sale-leaseback case, Lyon purchased a building under construction from a bank which had planned the construction to be its new offices, which it had hoped originally to finance and own. Due to federal regulations, the bank was unable to carry out its plans. The purchase price for the building was $7,640,000, with an initial investment by Lyon of $500,000, and a 25-year mortgage for the balance of the purchase price. As part of the same transaction, Lyon leased the building back to the bank for a 25-year term, with the rental payments under the lease equal to the payments due by Lyon under the mortgage. The bank retained an option to purchase the building after 15 years. The Commissioner attempted to reclassify the transaction as one in which Lyon loaned the bank the initial $500,000 investment, and acted as a mere conduit for the payments from the bank to the mortgagee, in order to deny Lyon depreciation deductions on the property.

The Court examined the economic realities of the transaction and noted that in situations of this type, the tax results will depend upon which party bears the economic benefits and burdens associated with the ownership of property. Finding that Lyon alone was

courts may focus upon the allocation of the "benefits and burdens of ownership" in highly leveraged transactions. Like the Tax Court's analysis in *Franklin,* this analytical focus may disallow depreciation deductions based on nonrecourse debt when the sellers retain the indicia of ownership.

The allocation of benefits and burdens among the parties to a WA mortgage therefore might influence the purchaser's ability to inflate his basis in the property. In a WA-financing transaction, the parties often employ a land sale contract which delays title passage until the entire purchase price has been satisfied, with the WA mortgagee remaining liable as mortgagor on the initial mortgage(s). Because the land sale contract merely postpones passage of legal title to the property in order to protect the seller against the purchaser's default on the contract, however, such a purchaser acquires all the usual indicia of ownership throughout the term of the WA mortgage. The seller's obligation on the original mortgage neither diminishes the purchaser's liability on the WA mortgage nor shifts the benefits and burdens of ownership with respect to the WA-financing transaction. These aspects of the WA-financing transaction thus should not deny the purchaser his cost basis under a benefits-and-burdens analysis.

3. The useful life limitation— A 1971 Tax Court memorandum decision, *Marcus v. Commissioner,*[38] placed another restriction upon the purchaser's ability to include nonrecourse indebtedness in his cost basis. *Marcus* involved myriad transactions in which the taxpayer acquired bowling alleys, lanes, and pinsetters for amounts greatly in excess of the original asking price. In each transaction the taxpayer made a small downpayment and executed a non-interest-bearing note for the balance of the purchase price. The term of the note in each transaction substantially exceeded the useful life of the property. In all but two transactions the notes were nonrecourse.

The court noted that the contract price in each transaction bore no relationship to the fair market value of the properties. In denying inclusion of the mortgage in the taxpayer's basis, however, the court relied upon the fact that each mortgage term greatly exceeded the useful life of the property. The Court reasoned that the purchaser is not likely to continue to make pay-

---

obligated for payments on the notes, and that it had disclosed this liability on its balance sheets, thereby decreasing its ability to obtain financing for other needs, the Court held that Lyon had a capital investment in the property for which it was entitled to claim depreciation.

[38] 30 T.C.M. 1263 (1971), *aff'd,* (3d Cir. Apr. 8, 1974).

ment on a nonrecourse obligation after the useful life of the property has expired.[39]

In *Marcus,* the court made no reference to its earlier decision in *Mayerson,* which upheld the validity of a ninety-nine year purchase-money mortgage on property with a useful life of twenty-five years.[40] The court in *Mayerson* found a valid debt despite its lengthy term because "a definite contractual obligation was created which would have had to be fulfilled by or before a definite date in the future."[41] Although the note in *Mayerson* was a nonrecourse obligation, the court did not analyze the result to the taxpayer if he failed to fulfill his obligations under the note after the property no longer had a useful life. This failure to examine the economic reality of such a situation seems contrary to the court's holding that nonrecourse debt should be included in a purchaser's basis.[42] Under the likelihood of repayment analysis, espoused by *Franklin* and adopted in *Marcus,* a nonrecourse purchase-money obligation with a term exceeding substantially the property's useful life poses the same problems as a nonrecourse obligation in excess of the fair market value of the property — because the purchaser can walk away from the property at some point during the term, without loss of investment or further liability, it is not reasonable to expect that the purchaser will pay the full contract price. Accordingly, the *Marcus* decision is correct; notwithstanding *Mayerson,* a mortgage should not be included in the buyer's basis to the extent that it exceeds the useful life of the encumbered property.

A purchaser commonly will claim a shorter useful life for depreciation than the term of the bank mortgage on the property. In states where nonrecourse financing is the primary vehicle for the financing of real property,[43] the *Marcus* reasoning might

---

[39] 30 T.C.M. at 1273.

[40] "Although this term does seem unusually long, after viewing the totality of the circumstances and all the evidence of record we have found and hold that a valid debt obligation was created by the purchase money mortgage in question." Mayerson v. Commissioner, 47 T.C. 340, 352 (1966), *acq.,* 1969-1 C.B. 21.

[41] *Id.* at 352.

[42] The court's failure to examine this issue in greater depth may have been due to the particular facts surrounding the purchase transaction. Although the stated term of the note was 99 years, the court noted several times that the 99-year term was never expected to run its course, because the parties had agreed Mayerson would get commercial financing as soon as possible. In addition, Mayerson did obtain conventional financing, retiring the 99-year mortgage six years after the purchase. Thus, the court may have been reluctant to bar inclusion of the debt in Mayerson's depreciable basis solely by reason of its 99-year term.

[43] For example, in California, purchase money debt for real estate is nonrecourse. *See* Braun v. Crew, 183 Cal. 728, 192 P. 531 (1920).

pose a threat to inclusion of the mortgage in the purchaser's depreciable basis where he claims a shorter useful life than the term of the bank loan. Closer examination, however, demonstrates that *Marcus* does not necessarily preclude inclusion of the mortgage in the depreciable basis where the bank loan's term exceeds the stipulated useful life.

The appropriate measure for calculating useful life on the taxpayer's property is the length of time during which it is economically profitable for him to use that asset in his particular business.[44] Thus, "taxable useful life" of a property may differ from the "economic useful life" of that property, which continues until the property is of no value regardless of its use or of the taxpayer involved. For example, assume the taxpayer purchases a building to be used as a manufacturing plant. After ten years, he might be forced to sell the building because expansion of the company and changes in technology require replacement of the building with a larger, more modern facility. Although, for that taxpayer, the appropriate useful tax life of the building is ten years, its economic useful life will be longer if the building remains of value to someone. Only when the building becomes worthless for all purposes does its economic useful life end.

To analyze inclusion of a nonrecourse obligation in a taxpayer's cost basis for depreciation, the economic useful life should govern. Only when an asset has no economic value to the taxpayer — so that the taxpayer can neither make productive use of the property nor realize a return on a sale of the property — does the likelihood of repayment diminish, creating a contingent liability. Accordingly, under the *Marcus* rationale, a nonrecourse liability should be excluded from a taxpayer's depreciable basis only when the term of liability exceeds the economic useful life of the encumbered property. A taxpayer claiming a tax useful life shorter than the mortgage term is not being inconsistent, and should not be threatened by the reasoning of *Marcus,* at least where the term of the loan does not exceed the economic useful life of the property.

C. Standards for Inclusion of the WA Mortgage in the Purchaser's Depreciable Basis

As *Crane* and *Mayerson* illustrate, the recourse or nonrecourse nature of a debt is not dispositive of whether that debt

---

[44] *See* Hertz Corp. v. United States, 364 U.S. 122 (1960); Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).

may be included in the purchaser's depreciable basis. The *Crane* and *Mayerson* test, measuring the contingency of an obligation by the economic incentive to repay, should be the primary consideration in analyzing WA mortgages with a substantial purchase-money nonrecourse debt.

Applicable case law provides guidance for inclusion of wraparounds in the purchaser's depreciable basis. *Bolger, Franklin,* and *Marcus* define the bounds within which a WA-financing transaction may be structured to permit inclusion of the WA mortgage in the purchaser's depreciable basis. *Bolger* and *Franklin* demonstrate that the parties to the transaction have flexibility in negotiating the financing terms of the WA mortgage, in allocating the burdens and benefits of ownership, and in limiting the purchaser's liability on the WA mortgage. *Franklin* correctly indicates, however, that failure to prove that the contract price does not exceed the property's fair market value should result in exclusion of nonrecourse debt from the purchaser's basis. Similarly, as indicated in *Marcus,* nonrecourse debt with a term in excess of the property's economic useful life should be excluded from the purchaser's basis.

Use of a land sales contract in a WA-financing transaction does not, per se, affect the purchaser's inclusion of the WA mortgage in his depreciable basis. Although legal title does not pass to the purchaser until the debt has been satisfied, the land sale contract purchaser shoulders the economic benefits and burdens of ownership. Thus, an examination of the "economic realities" of the transaction under *Lyon* would reveal a depreciable interest in the purchaser.

The fact that the combined face amounts of the purchaser's WA mortgage and the seller's senior mortgage exceed the fair market value of the property is not relevant in determining whether the WA mortgage should be included in the purchaser's basis, so long as the stated purchase price does not substantially exceed the fair market value of the property. If the purchase price is not in excess of the fair market value, and the payment period does not exceed the economic useful life of the property, the purchaser's payments on the WA mortgage increase his equity in the property, providing the purchaser with the necessary incentive to repay the mortgage.

II. DUE-ON-SALE CLAUSES

Due-on-sale clauses, and the closely related due-on-encum-

brance clauses, arose as a response of lending institutions to rising interest rates during the past two decades.[45] Buyers found it financially advantageous to assume the seller's lower fixed-rate-interest loan, particularly when interest rate differentials between currently available loans and older loans often ranged above five percent and conventional financing was sometimes unavailable at any reasonable price. Lending institutions correspondingly found it disadvantageous to permit such assumptions, and began utilizing due-on-sale and due-on-encumbrance clauses to escalate interest rates on loans otherwise assumable at lower rates. Some lenders justified use of such clauses on the ground that their security interests were impaired upon sale or further encumbrance of the property.

The availability of WA mortgages as an alternate financing method may, depending upon the jurisdiction in which the transaction occurs, be barred if a due-on-sale clause is contained within the seller's original mortgage. If due-on clauses were automatically enforced, they would eliminate the very cornerstone of purchase-money WA financing — preservation of the first mortgage at a favorable interest rate. Accordingly, any party contemplating a WA-financed sale must determine whether a due-on-sale clause is present, and if so, to what extent it is enforceable. Loans older than ten years and loans insured by the Veteran's Administration may not contain one of these clauses.[46] Even if a due-on clause is present, however, all may not be lost — many jurisdictions do not automatically enforce such clauses,

---

[45] A typical due-on clause is the following:

> Should Trustor sell, convey, transfer, dispose of or further encumber said property, or any part thereof, or any interest therein, or agree to do so, without the written consent of Beneficiary first being first obtained, then Beneficiary shall have the right, at its option, to declare all sums secured hereby forthwith due and payable.

See Comment, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1110 n.5 (1975). Not all due-on clauses are as broad as this one, which appears literally to permit the lender to accelerate the mortgage debt if the borrower rents his home for the summer. For example, regulations issued by the Federal Home Loan Bank Board (FHLBB) in 1976 governing federally chartered savings and loan institutions prohibit the exercise of a due-on clause simply because a second lien has been created or a leasehold interest of less than three years has been granted. *See* 12 C.F.R. § 545.8-3(f), (g) (1980); First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. App. 1980) (interpreting and discussing the FHLBB regulations). However, the FHLBB regulations permit, and most due-on-sale clauses allow, the mortgagee to accelerate the mortgage debt if the mortgagor "sells the secured real estate." 12 C.F.R. § 545.8-3(f) (1980). Moreover, the language of the due-on clause usually is broad enough to encompass installment sales where the seller retains title.

[46] *See* 38 C.F.R. § 36.4308(a) (1980).

primarily because they may constitute an unreasonable restraint upon alienation.[47] Because no court has confronted the issue of enforceability of due-on-sale clauses in WA-financed sales, one must proceed by analyzing case law involving first mortgage assumptions and creation of junior encumbrances. Some additional insight may be provided by drawing analogies between WA sales and cases involving installment land contracts, as many WA transactions utilize installment land contracts in lieu of deeds of trust.

A. *The Common Law Approach to Due-on-Sale Clauses*

The threshold question regarding the enforceability of a due-on-sale clause is whether such a clause would constitute an unreasonable restraint on alienation. A prohibition against such restraints exists in all states, either through case law or statute.[48]

1. The California experience— Examination of the California experience with due-on clauses necessarily must provide the starting point for analysis of this threshold question, for other jurisdictions essentially have adopted either end of California's evolving law in this area. Early California cases held that due-on-sale clauses were a reasonable restraint on alienation and therefore would be upheld.[49] By 1979, the California Supreme Court had swung full circle, finding such a clause to be generally unreasonable, justifiable only where the lender could show an impairment of its security.

The California Supreme Court first addressed this issue in *Coast Bank v. Minderhout*,[50] a 1964 case dealing with an unusual instrument held to constitute an equitable mortgage under California law. The seller-mortgagor had agreed in the instrument not to transfer or encumber the property without the lender's consent, until the loan was paid, but transferred the property in violation of the agreement. The court acknowledged

---

[47] *See, e.g.*, First Fed. Sav. & Loan v. Greenwald, 591 F.2d 417 (1st Cir. 1979); Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n, 499 F.2d 1145 (9th Cir. 1974); Williams v. Speedster, Inc., 175 Colo. 73, 485 P.2d 728 (1971).

[48] *See, e.g.*, CAL. CIV. CODE § 711 (West 1974), providing that "conditions restraining alienation, when repugnant to the interest created, are void."

[49] *See* Coast Bank v. Minderhout, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964), *overruled*, Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969), *disapproved in Wellenkamp*; Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

[50] 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964), *overruled*, Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

the permissibility of some restraints on alienation — noting that only unreasonable restraints on alienation were prohibited. The court proceeded to find reasonable a lender's conditioning the extension of credit on the mortgagor's retention of ownership of the property, holding that acceleration of the loan by the lender if the mortgagor should default was both reasonable and valid.[51]

In a subsequent California Court of Appeals decision, *Cherry v. Home Savings & Loan Association*,[52] the plaintiff attempted to avoid a due-on-sale acceleration by arguing that there was an important condition in the mortgage agreement that the lender would not withhold its consent to any transfer of the property unless it could show impairment of its security.[53] The court rejected this argument, finding that the lender merely was exercising its rights under the mortgage agreement. Because the due-on-sale clause was justified by business considerations, allowing the lender to take advantage of rising interest rates, the lender was not required to show impairment of its security as a condition precedent to enforcement of the clause.[54]

By 1969, therefore, the law was "settled" in California that due-on-sale clauses were not unreasonable restraints on alienation and would be enforced automatically, even if the lender's security were not impaired. Over the next ten years, however, the California courts slowly modified their view as to what constituted a reasonable restraint on alienation, gradually eroding and finally overruling *Coast Bank*.

The first step in this erosion occurred in *La Sala v. American Savings & Loan Association*,[55] where the California Supreme Court denied enforcement of a due-on-encumbrance clause. The court drew an important distinction between the enforceability of due-on-sale and due-on-encumbrance clauses. A due-on-sale clause does not preclude the seller-mortgagor from selling the property and paying off the first lien, but rather merely prohibits the seller-mortgagor from transferring the property with the transferee assuming the mortgage. In contrast, a due-on-encum-

---

[51] The court stated in dictum that a direct prohibition against selling the house would have been invalid. A due-on-sale clause, however, was only an indirect restraint. 61 Cal. 2d at 314, 392 P.2d at 268, 38 Cal. Rptr. at 508.

[52] 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969), *disapproved in* Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

[53] The due-on-sale clause in *Cherry*, as do most such clauses, held that the loan would be accelerated if the mortgagor transferred the property without the mortgagee's consent.

[54] 81 Cal. Rptr. at 137-38.

[55] 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

brance clause effectively precludes all refinancing, for a junior encumbrance rarely will produce funds sufficient to pay off the first lien. This led the court to find the due-on-encumbrance clause at issue to be an unreasonable restraint on alienation, enforceable only if the lender were able to show an impairment of its security.

In balancing the possible impairment to the lender's security against the degree of restraint upon alienation which the due-on-encumbrance clause created, the court concluded that enforcement of the due-on-encumbrance clause was not necessary to protect the lender's security interest.[56] The extent of the borrower's remaining interest was the crucial issue to the *La Sala* court. Because the borrower retained sufficient economic incentive to prevent waste or deterioration, no justification existed for accelerating the note. The court rejected the lender's argument that maintaining a portfolio of loans at current interest rates was a valid justification for enforcing the clause. After noting that due-on-encumbrance clauses are more restrictive than due-on-sale clauses, the court stated that a restraint on alienation is not reasonable merely by virtue of its profitability to the restrainor.[57]

The next step in *Coast Bank*'s demise came three years later, in *Tucker v. Lassen Savings & Loan Association*,[58] when the California Supreme Court refused to enforce a due-on-sale clause in an installment land contract sale. The court held that Tucker's entering into an executory contract to sell land did not justify automatic enforcement of the due-on-sale clause, because the lender's security interest was not significantly impaired. After first defining outright sales as all transactions "wherein the seller receives full payment from and transfers legal title to the buyer,"[59] the court observed that installment sales differ from outright sales in that an installment sale vendor rarely receives a cash down payment sufficient to satisfy the balance due on the note. Additionally, the court observed that the installment sale vendor retains legal title, so that his interest in maintaining the property and preventing waste is greater than that of an outright seller.

---

[56] 5 Cal. 3d at 880 n.17, 489 P.2d at 1123 n.17, 97 Cal. Rptr. at 859 n.17. This view was subsequently codified by the California legislature in a provision prohibiting acceleration of a due-on clause because of a junior encumbrance. CAL. CIV. CODE § 2949 (West 1974). *See also* VA. CODE § 6.1-2.5 (1975).

[57] 5 Cal. 3d at 880 n.17, 489 P.2d at 1123 n.17, 97 Cal. Rptr. at 859 n.17.

[58] 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

[59] *Id.* at 634 n.6, 526 P.2d at 1172 n.6, 116 Cal. Rptr. at 636 n.6.

The *Tucker* court articulated a standard for enforcement of due-on[60] clauses: "To the degree that enforcement of the [due-on] 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."[61] Such legitimate interests of the lender would include (a) preserving the security from depreciation or waste, and (b) guarding against the moral risks of having to resort to the security upon default.[62] The court expressly limited its holding to situations involving land sale contracts, specifically declining consideration of the test's application to an outright sale situation.

The landmark 1978 case of *Wellenkamp v. Bank of America*[63] rejected the distinction between outright sales and installment sales in non-commercial settings. Wellenkamp had paid the sellers an amount equal to their equity interest in the subject prop-

---

[60] Any subsequent discussion of due-on-sale clauses necessarily includes due-on-encumbrance clauses as well. Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978), establishes that both types of clauses will be evaluated by the same test: whether the amount of restraint upon alienation that the clause imposes can be justified by the lender's interest in protecting its investment. As *La Sala* indicates, however, the lender's justification must be higher to enforce a due-on-encumbrance clause, because such a clause imposes a higher degree of restraint on alienation. *See* notes 55-57 and accompanying text *supra*.

[61] 12 Cal. 3d at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637. The court compared outright sales with installment sales:

> [T]he contrast between an outright sale and an executory sale by installment land contract is striking. In the former . . . the automatic application of the "due-on" clause results in little if any restraint on alienation because the terms of the second sale usually provide for full payment of the prior trust deed. In other words, the trustor-vendor normally receives enough money through the financing of the second sale to pay off his note, and he is normally required to do so. Little if any restraint on alienation results through enforcement of the provision.
>
> In the case of the installment land contract, however, the matter is otherwise. The trustor-vendor normally receives a relatively small down payment upon execution of the contract, the remainder of the purchase price to be paid through monthly installments. This down payment, like the proceeds of the junior encumbrance involved in *La Sala*, "does not often provide the borrower with the means to discharge the balance secured by the trust deed." (Citation omitted) The result is that a conveyance by means of an installment land contract would essentially be precluded in all cases wherein the balance due on the trustor-vendor's note was substantial if the "due-on" clause were to be given automatic effect. Accordingly, although the trustor-vendor might be willing to accept a rate of interest lower than that currently offered by institutional lenders, the prospective purchaser would be compelled to resort to such lenders to finance the acquisition of the property. The result in terms of restraint on alienation is clear.

Id. at 637-38, 526 P.2d at 1174, 116 Cal. Rptr. at 638.

[62] *Id.* at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.

[63] 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

erty, and then assumed the balance outstanding on the sellers' mortgage. The California Supreme Court, in reversing the court of appeals, extended to the lender in all cases the burden of proving that enforcement of a due-on clause was reasonably necessary to prevent impairment of the security interest and to protect against default. Thus, due-on clauses no longer would be enforced automatically in California. Outright sales were redefined as any transfer of legal title,[64] with the court adopting the *Tucker* balancing test to determine if there had been an unreasonable restraint upon alienation.[65]

The *Wellenkamp* court determined that the mere fact of sale does not constitute justification for enforcement of a due-on clause; rather, some substantial actual risk of impairment to the security interest must be shown. The court advanced three reasons supporting its rejection of automatic enforcement upon the mere fact of sale: (1) automatic enforcement is not justified simply because there is a possibility that the purchaser may be uncreditworthy or wasteful; (2) in transactions in which either the seller or the buyer retains an equity interest in the property, there normally remains a sufficient incentive to prevent waste or default; and (3) a lender's commercial interest in maintaining its loan portfolio at current rates is not a justification for enforcement.[66]

---

[64] *Id.* at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

[65] One commentator has urged that the degree of restraint upon alienation, discussed in *Tucker* and *Wellenkamp*, should be measured by the seller's loss in equity occasioned by the due-on clause, rather than as suggested in *Wellenkamp*, the amount of loss caused by the seller's decision to forego the sale:

> Assume there are two homes, equally valued and equally encumbered by deeds of trust bearing interest at eight percent per annum. Home A, however, is saddled with a due-on-sale clause while home B is not. Current rates are ten and three-fourths percent per annum. When both homes are put up for sale, home A is placed at an obvious disadvantage to home B, due entirely to the due-on-sale clause. Homeowner A will have to reduce the sale price to compete with homeowner B. The resulting difference in price is the economic equivalent of the restraint on alienation.

Note, *Wellenkamp v. Bank of America: A Victory for the Consumer?* 31 HASTINGS L.J. 275, 285 (1979). This proposed analysis permits a court to determine accurately the actual restraint imposed by such a clause in any particular case, absent "an unnecessary variable—the borrower's mental processes." *Id.* at 286.

[66] 21 Cal. 3d at 951-53, 582 P.2d at 975-76, 148 Cal. Rptr. at 384-85. In addition, the court observed that the enactment of CAL. CIV. CODE § 1916.5 (West Supp. 1981), providing for utilization of variable rate mortgages, presented a viable and attractive alternative to lending institutions as a method of adjusting their loan portfolios. 21 Cal. 3d at 952 n.10, 582 P.2d at 976 n.10, 148 Cal. Rptr. at 385 n.10. One commentator observed, however, that the lender's interest in maintaining a current loan portfolio is not without merit, especially in inflationary times with increasing interest rates, because some borrowers tend to look upon variable rate mortgages with disfavor. Note, *supra* note 65, at 290-97. *See id.* at 295 (concluding that a standard fixed rate loan containing a due-on-

The court rejected the lender's current interest rate portfolio argument because, in its view, a restraint upon alienation of land is unreasonable when it serves solely as a hedge against inflation. Although the court limited its holding to institutional lenders, the commercial status of the lender should not be significant if the evil to be avoided is restraint upon alienation.[67]

California case law concerning the validity of due-on clauses has evolved considerably — from automatic enforcement of such clauses in *Coast Bank* and *Cherry* to the case-by-case reasonableness approach first advanced in *La Sala* and *Tucker* and later adopted in *Wellenkamp*. Other jurisdictions considering the validity of due-on clauses have essentially adopted either extreme of the California experience — some favor automatic enforcement, or at least a strong presumption of validity,[68] while

sale clause is a valuable option for buyers who anticipate keeping a house for a substantial length of time).

[67] A mortgagee's attempt to foreclose on a deed of trust on a service station was successfully enjoined in Sanders v. Hicks, 317 So. 2d 61 (Miss. 1975). The deed of trust required no payment of interest until maturity, but contained a due-on-sale clause. The buyers, who were of substantial means, agreed to take the property subject to the deed of trust in order to have the advantageous terms of this note. The Mississippi Supreme Court, in granting the injunction, stated that the restriction could not be enforced simply on the basis that a party of substantial means was taking unjust and inequitable advantage of a contractual concession. This justification was not a threat to the legitimate interests of the beneficiaries.

Sanders is significant because it involved a private lender and a commercial setting. Whereas the California Supreme Court in *Wellenkamp* had suggested that due-on-sale clauses in notes executed in favor of private lenders would be subject to automatic enforcement — absent unconscionable or inequitable conduct by the lender — the Mississippi Supreme Court held that a private lender would not be accorded an easier standard for enforcement than an institutional lender, at least when the transaction is within a commercial setting. *Wellenkamp*, in contrast, had indicated that a private lender should enjoy an easier burden for justifying enforcement of a due-on-sale clause.

The *Sanders* result perhaps is undesirable. Especially in an era of limited credit, private lenders, at least in Mississippi and those jurisdictions following its lead, undoubtedly will think twice before loaning funds secured by real property.

[68] These jurisdictions do not scrutinize carefully actions of the parties in deciding whether due-on-sale clauses should be enforced. Rather, absent a clear showing of unconscionable or inequitable conduct on the part of the mortgagee-lender, in general the clause will be presumed valid and automatically enforceable. Colorado upheld enforcement of a due-on clause in Malouff v. Midland Federal Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973). The Colorado Supreme Court relied heavily upon Justice Traynor's language in *Coast Bank:* "The view that the common-law rule against restraints on alienation prohibits all such restraints has been forcefully criticized on the ground that it loses sight of the purposes of the rule and needlessly invalidates reasonable restraints designed to protect justifiable interests of the parties." *Id.* at 300, 509 P.2d at 1243 (quoting 61 Cal. 2d at 314, 392 P.2d at 268, 38 Cal. Rptr. at 508). In light of this determination that a due-on clause was not an invalid restraint *per se*, the court observed:

> Both parties have the benefit of their original bargain during their continued creditor-debtor relationship. However, when the property is sold to a purchaser who desires to assume the existing loan, economic consideration may reasonably

others prefer the case-by-case reasonableness approach of *Wellenkamp*.[69] At least one jurisdiction attempted to resolve the issue of enforceability by constitutional amendment.[70]

2. *Applying* Wellenkamp *to WA financing*— No court has confronted squarely the issue of whether a due-on clause may be enforced when a WA-financing arrangement is present. The current California approach, embodied by *Wellenkamp*, should be applied to WA situations, thereby limiting the enforceability of due-on clauses. In *Wellenkamp* the court stated:

> justify the lender in raising the interest rate to or approaching one equal to the current market rate. We view the condition imposed for the non-exercise of the acceleration clause under such circumstances to be a reasonable protection of a justifiable interest and the operative effect of the clause does not therefore constitute an invalid restraint on alienation.

Id. at 303, 509 P.2d at 1245. *See also* Century Federal Sav. & Loan Ass'n v. Van Glahn, 144 N.J. Super. 48, 53, 364 A.2d 558, 562 (1976) (the necessity of protecting the lender from rising interest rates constitutes a valid justification for enforcing due-on clauses).

[69] The Supreme Court of Arkansas adopted the case-by-case reasonableness approach in the lending case of Tucker v. Pulaski Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972). The mortgagor-sellers had searched over a year for prospective purchasers, finally finding a buyer for their apartment house. The buyers tendered a $1,500 cash down payment and agreed to take subject to the mortgage in favor of Pulaski. Pursuant to the due-on-sale clause in the mortgage, Pulaski accelerated the note and brought a foreclosure action. The Arkansas court refused to allow the mortgagee, "simply on the basis of the quoted clause, [to] accelerate the note, declare the indebtedness due and payable, and foreclose upon the property. This procedure cannot be countenanced in a court of equity." *Id.* at 852, 481 S.W.2d at 728. The court held the burden for establishing justification for enforcement of the clause to be on the mortgagee, and that Pulaski had failed to meet this burden. Finally, the court noted that the buyers had never previously defaulted on any real estate notes held by Pulaski, and that the mortgagor-sellers still remained liable on the debt, so that the mortgagee necessarily would have to establish a strong justification for enforcement.

Similarly, in Fidelity Land Development Corp. v. Rieder & Sons Bldg. and Development Co., Inc., 151 N.J. Super. 502, 377 A.2d 691 (1977), acceleration of a note was rejected. The corporate mortgagor conveyed land to its principal stockholder but, upon realization that the mortgagee regarded the transfer as a justification for invoking the acceleration clause, the land was transferred back to the corporation. The New Jersey Superior Court held that the transfer was a mere paper change in title, and did not constitute a sufficient justification for accelerating the note.

[70] The following proposal for amending the Colorado Constitution was rejected in the November, 1980 general election:

> Shall Article XVIII of the Constitution of the State of Colorado be amended to provide that in order that all persons shall have the right to sell or transfer their Real Estate or any interest therein subject to existing financing, no person shall or lending institution with a security interest in the Real Estate shall accelerate or mature the indebtedness secured by such Real Estate or alter the terms and conditions of the indebtedness or security interest because of such sale or transfer, so long as the original debtor remains directly responsible for the indebtedness and the security for the indebtedness is not substantially impaired by the sale or transfer?

(On file with the *University of Michigan Journal of Law Reform*).

> When the seller does not receive the value of his equity in cash but takes back a second or "all-inclusive" deed of trust for a portion thereof, he of course retains an equity interest in the property which provides him with an incentive to prevent waste or default. In this case, then, both the buyer and the seller have an interest in preserving the security. The lender's position thus resembles that occupied by it in the context of an installment land sale contract.[71]

This favorable comparison with installment land contract sales, although dictum, suggests that a strong justification may have to be established by the lender to permit enforcement of due-on clauses in WA-financing arrangements, even in those jurisdictions not following *Wellenkamp*.[72] A jurisdiction that automatically enforces due-on-sale clauses in outright sales situations may be less willing to do so in a WA transaction. Such a transaction necessarily involves retention by the seller of a sufficient interest in the property vis-a-vis the senior mortgage, so that the incentive to prevent waste will undoubtedly be high. California's protection of *Wellenkamp*-type transactions (outright sales with assumption of the seller's mortgage) logically should encompass the WA situation as well — a WA arrangement assures the original lender of adequate protection of the underlying security, because of the seller's continuing interest in the property.

B. Proposal for Legislative Intervention

1. Drawbacks in the Wellenkamp *and automatic enforcement approaches*— The validity and propriety of due-on-sale clauses have been the subject of much litigation and debate. The state courts have either adopted the *Wellenkamp* balancing approach,

---

[71] 21 Cal. 3d at 951 n.8, 582 P.2d at 975 n.8, 148 Cal. Rptr. at 384 n.8.

[72] Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P.2d 190 (1971), for instance, involved a mortgagee's attempt in a jurisdiction following the *Wellenkamp* rule, to invoke the due-on-sale clause following the mortgagor's execution of an agreement to sell the subject property. After acknowledging that an agreement to sell was a conveyance within the meaning of a due-on-sale clause, the court refused enforcement simply upon allegation that the acceleration clause terms had been violated. Instead, the court would require "allegation that the purpose of the clause is . . . being circumvented or that the mortgagee's security is jeopardized . . . ." *Id.* at 81, 486 P.2d at 193. Because the mortgagee had failed to allege impairment of its security interest, the court refused to enforce the clause. In addition, the court noted that large pre-payment penalties were involved, so that enforcement of the due-on-sale clause "could be unconscionably harsh." *Id.*

or allowed automatic enforcement of the clauses.[73] From the standpoint of sound public policy, each approach has difficulties.[74]

The most obvious problem with the case-by-case approach of *Wellenkamp* is its generation of litigation without outlining clear standards for enforcement. *Wellenkamp* appears to be a consumer-oriented decision,[75] yet its benefits may prove illusory if lending institutions choose to litigate aggressively against homeowners unwilling or unable to resist. The mere threat of a lawsuit may restrain alienation as much as a due-on-sale clause. *Wellenkamp* also may result in increased costs of transferring

---

[73] However, the Illinois Supreme Court held that due-on clauses should be automatically enforced in Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975). The court noted that "stability of real estate titles is of paramount importance, [so that] it is necessary that the court follow a policy in construing restraints on alienation which will produce a reasonable degree of certainty." *Id.* at 126, 333 N.E.2d at 5. The court reasoned that a greater degree of certainty was required in the case of land titles, thus justifying automatic enforcement of these contractual agreements absent unconscionable or inequitable conduct. In the absence of such conduct, the clause would be presumed valid and automatically enforceable. *See, e.g.*, Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 313 N.Y.S.2d 804 (Sup. Ct. 1970); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976); Gunther v. White, 489 S.W.2d 529 (Tenn. 1973); Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 71 Wisc. 2d 531, 239 N.W.2d 20 (1976).

The Supreme Court of Nevada extended *Baker* even further, in First Commercial Title, Inc. v. Holmes, 92 Nev. 363, 550 P.2d 1271 (1976). The court held that a due-on clause is entitled to automatic enforcement whenever there has been an outright sale by the trustor. *Id.* at 366, 550 P.2d at 1272. The court expressed no opinion as to the enforceability of such clauses in an installment land contract setting. In addition, the court explicitly rejected the reasonableness approach, refusing to impose the burden upon the lender-beneficiary to establish justification for enforcement of the clause. Instead, the Nevada court, and other courts which tend toward automatic enforcement, would "burden the trustor with the responsibility of establishing grounds for unenforceability." *Id.* at 366, 550 P.2d at 1272.

[74] Not all jurisdictions, however, have fallen neatly into either category. Illustrative of the confusion are the seemingly conflicting positions taken by the Washington Supreme Court in two 1976 cases. The court first upheld a due-on-sale clause in Miller v. Pacific First Fed. Sav. & Loan Ass'n, 86 Wash. 2d 401, 545 P.2d 546 (1976), which specifically allowed an increase in the interest rate by the mortgagee upon sale of the subject property. While qualifying approval partially upon the absence of unconscionable or inequitable conduct, the court did recognize as legitimate the mortgagee's interest in being protected against rising interest rates. A few months later, the Washington Supreme Court seemed to adopt the case-by-case reasonableness approach, contrary to the virtually automatic enforcement approach of *Miller*, upholding a due-on clause in Bellingham First Fed. Sav. & Loan Ass'n v. Garrison because the mortgagee had met its burden of proof. 87 Wash. 2d 437, 553 P.2d 1090 (1976). *See* 12 GONZ. L. REV. 765 (1977). The court, after noting that due-on clauses were not invalid per se and then shifting the burden for justifying enforcement to the mortgagee, held in favor of the mortgagee because of the mortgagor's questionable credit rating and delinquencies in satisfying the mortgage debt.

[75] The enforcement of due-on-sale clauses occurs most often in consumer purchases of personal residences. In California, for example, the average house changes hands every four to five years. *See* Comment, *supra* note 45, at 1111 & n.6.

ownership in real property, regardless of whether a lawsuit arises, because homeowner-sellers, lenders, and buyers may incur additional legal fees in negotiating a compromise settlement to avoid litigation. Congress has already found real estate settlement charges to be "unnecessarily high"[76] in many parts of the country. Finally, *Wellenkamp* may penalize lending institutions subject to state law which are competing with federally chartered savings and loans able to enforce due-on clauses under FHLBB regulations.[77]

Automatic enforcement of due-on clauses also poses significant drawbacks. Automatic enforcement, at least in times of rising interest rates, likely does restrain alienation. The crucial question becomes the extent of this restraint. Homeowners who have the luxury of choosing when, and if, to sell may opt to rent, thus continuing to build equity at favorable interest rates. On the other hand, homeowners who must sell will do so regardless of the existence of a due-on-sale clause. Whether, then, due-on clauses significantly impair the free alienability of land is debatable; nonetheless it seems clear that automatic enforcement does, to some extent, restrict alienation.

Jurisdictions that automatically enforce due-on-sale clauses generally accept the lender's current interest rate portfolio argument or the lender's interest in protecting his security.[78] These arguments, however, are invalid in this context. Analysis of due-on clauses should not be concerned with whether the homeowner or lender is the proper party to benefit from the chosen judicial approach. In addition, courts expressing concern for the lender's interests have often routinely resolved issues of unconscionability and adhesion contracts in the lender's favor. This fails to recognize the possibilities for a lender with bargaining power to couple a due-on-sale clause with a hefty prepayment penalty.[79] A lender typically protects itself against homeowner refinancing

---

[76] *See* 12 U.S.C. § 2601(a) (1976).

[77] *See* 12 C.F.R. § 545.8-3(f) (1980). *But see* Panko v. Pan American Fed. Sav. & Loan Ass'n, 174 Cal. Rptr. 240 (1981), where the California Court of Appeals held that regardless of the FHLBB's stated intent to preempt state law, the regulation concerning due-on clauses would not preempt California law because neither of the two traditional measures of preemption were present. The court also stated that under all federally related loans the enforcement of the particular clause would normally rest upon conventional state contract and property law. The same result was reached one month later by the California Court of Appeals for the Fourth District, in de la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n, 50 U.S.L.W. 2041 (Cal. App. July 2, 1981).

[78] *See, e.g.*, Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973).

[79] *But see* 12 C.F.R. § 545.8-3(g) (1980).

at lower interest rates by imposing prepayment penalties.[80] If automatic enforcement is permitted, a lender can easily force the unsuspecting borrower to bargain himself into a position so precarious that a future sale becomes prohibitively expensive, regardless of the financing arrangement utilized. Many cases allowing automatic enforcement of due-on-sale clauses have stressed the importance of such clauses in protecting the lender's legitimate interest in its security.[81] In fact, automatic enforcement often allows lending institutions to use the clauses simply to increase their bargaining power with future borrowers.

2. *Proposed legislative response*— The significant competing interests involved and the extensive tax ramifications which may result suggest a need for legislative intervention. Any legislation should incorporate a two-step approach. First, in order to enforce any due-on clause, the lender would be required to show that its security would be impaired as a result of the transfer, either due to the uncreditworthiness of the transferee or some other relevant and objectively demonstrable factor. The legislation should include standards by which this determination would be made. If the lender were able to show impairment, it would be able to enforce the due-on clause and call the loan. Second, if the lender were unable to carry its burden, the lender would be required to consent to assumption or a continuation of the mortgage, but could raise the interest rate to a point halfway between the rate on the mortgage and the current rate for new loans.

---

[80] In First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300 (Ala. Civ. App. 1977), the mortgagee expressly conditioned approval of a buyer's assumption upon payment of a percentage finance charge or consent to an increased interest rate. The Alabama Court of Civil Appeals denied First Federal the right to use the acceleration clause as a means to impose these penalties upon the buyer, reasoning that "[t]he purpose of the clause was not being served by the threatened acceleration but the unrelated financial interest of the lender was the reason for the acceleration." *Id.* at 303. The court observed that exercising the acceleration right "is dependent upon the sale producing a threat to a legitimate interest of the mortgagee sought to be protected by the clause." *Id.* The Alabama court then suggested, as had the California court in *Tucker*, that protection of the security from waste and depreciation, and the possible necessity of having to resort to the security after default, were legitimate interests entitling the mortgagee to accelerate. The court noted finally that its decision did not invalidate such clauses whenever the offered justification for enforcement was the lender's financial interest; rather, the court would require only that such a purpose clearly be bargained for by both parties when the clause was executed. *See also* Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977) (holding a due-on clause to be an invalid restraint upon alienation when motivated solely by a mortgagee's desire to maintain its portfolio at current interest rates).

[81] *See, e.g.*, Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975).

This proposal would aid lenders by insuring protection of their security while allowing an increase in their interest rate portfolio. Borrowers would benefit as well, because their ability to offer assumption at below market interest rates would minimize the restraint on alienation. To be effective, such legislation would need to be at the federal level and apply to all banks. If enacted by the various states, each state could adopt its own version, preventing uniformity. More importantly, state legislation would have no effect on federally chartered banks, which hold the vast majority of mortgages.[82]

CONCLUSION

The WA mortgage is rapidly becoming a widely used financing technique for real estate. It is important for anyone using this technique to realize that the WA mortgage will be included in his depreciable basis. He must be aware, however, that the extent of its inclusion will be limited by the fair market value and economic useful life of the property, and by the allocation of the benefits and burdens of ownership.

A more general concern is the effect of a due-on-sale or due-on-encumbrance clause on a WA mortgage. The present state of the law provides little guidance either to lenders or borrower-sellers. The enactment of federal legislation would eliminate much of this uncertainty, benefiting lenders and borrower-sellers alike.

---

[82] The Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 (1976), would be a precedent for federal legislation in the real estate industry.