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THE CLOG ON THE EQUITY OF REDEMPTION AND ITS EFFECT ON MODERN REAL ESTATE FINANCE†

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I. BACKGROUND

Consider this not terribly hypothetical scenario. D, a commercial real estate developer, approaches L, an institutional lender, seeking a commitment for long-term financing of a proposed construction project. Negotiations are commenced with experienced attorneys representing both sides. L finally offers to provide the necessary funds in the form of a fixed interest rate mortgage loan, provided that D grants L an option to acquire a part ownership interest in the property upon completion of construction. D agrees and the deal is formally consummated. Construction proceeds to completion. L provides permanent financing as agreed. Now, L seeks to exercise the option, but D resists. Can L obtain specific performance?

If this were strictly a question of contract law, the answer would clearly be yes.[1] However, in view of the 345 year old rule against clogging the equity of redemption,[2] the considered response can only be "maybe."

The clogging doctrine was originally developed by English eq-

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[1] *See generally* 11 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1441B (3d ed. 1968) (examples of specific enforcement of options); 5A A. CORBIN, CORBIN ON CONTRACTS § 1197 (2d ed. 1964) (same).

[2] *See infra* note 16 and accompanying text. Despite the widely held view that the rule arose in 1639, two commentators have suggested that the doctrine's roots go back to a far earlier day. *See* Preble & Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, in STRUCTURING REAL ESTATE INVESTMENTS IN THE MID-EIGHTIES: TRANSACTIONS IN TRANSITION 497-98 (A.B.A. 1985); Preble & Cartwright, *Convertible and Shared Appreciation Loans: Unclogging The Equity Of Redemption*, 20 REAL PROP. PROB. & TR. J. 821, 825 (1985).

uity courts to prevent forfeitures by borrowers whose mortgage instruments contained clauses that indefeasibly vested title to their property in the mortgagee, if payment of the indebtedness was even one day later than required.[3] The doctrine, which denied specific performance of such clauses, was a necessary corollary to the very concept of an equity of redemption (the right in equity of a mortgagor in default to buy back the property by paying the debt).[4] Thus, agreements found in a mortgage instrument or executed contemporaneously with a mortgage, that purported to waive the mortgagor's right to redeem or that had the equivalent effect, were uniformly held to be void in equity.[5]

Undoubtedly, the rule was an innovative and highly enlightened development in seventeenth century jurisprudence. However, in England, the rule was often broadly stated and, therefore, seemingly invalidated any benefit granted to a secured lender other than interest.[6] American courts have generally applied the doctrine to achieve just results. Nonetheless, today the rule casts a cloud of uncertainty upon the legal status of innovative mortgage instruments and real estate financing transactions used by the most sophisticated institutions and developers.

This article examines the clogging doctrine's present contours and its potential impact upon modern real estate financing techniques in light of the rule's historical and ethical underpinnings. First, modern financing techniques will be briefly surveyed. Second, the policies underlying the clogging rule will be examined in their historical context, one in which usury laws were strict, the law of unconscionability was in its infancy, and mortgaged lending was predominantly the domain of unregulated individuals. Third, the present viability of the doctrine will be considered in view of the relaxation of usury laws, the development of UCC unconscionability concepts, and the dominant modern role of large institutional mortgage lenders. Finally, some practical approaches and proposed solutions to the problems created by the rule will be discussed.

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[3] *See* 4 AMERICAN LAW OF PROPERTY § 16.59 (1952).

[4] *Id.*

[5] *See* 4 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1193 (5th ed. 1941).

[6] *See, e.g.*, Jennings v. Ward, 23 Eng. Rep. 935 (1705).

II. THE RISE OF ALTERNATIVE REAL ESTATE FINANCING TECHNIQUES

During the past twenty years, as a result of increasing disillusionment with fixed-rate, long-term mortgages, financial institutions that have traditionally served as sources of so called "permanent" financing for residential and commercial real estate developments have resorted to more creative financing transactions. In general terms, the cause of this dissatisfaction has been the low rate of inflation adjusted return provided by mortgages during this period.[7] Consequently, substantial growth has taken place in the use of alternative real estate financing techniques.

A variety of additional factors has heightened the pressure upon these institutions—primarily banks, savings and loan associations, and life insurance companies—to generate alternative real estate investment vehicles.[8] For banks and savings and loan associations, the major additional pressure has been generated by *portfolio lag*, the inability of income from past long-term investments to cover the higher costs of money obtained at prevailing higher rates.

Life insurance companies have suffered from related pressures. Cash outflows from policy loans and a trend toward the purchase of term insurance rather than whole life policies have put life insurers in a position analogous to the bankers. The need to charge competitive term life premiums, like the banks' need to pay market rates to attract deposits, furnishes a strong motivation to find

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[7] For example, one article cites a Brookings Institute study indicating that CPI-adjusted interest actually earned on fixed rate, long-term mortgages declined from an average of 3.51 percent on loans made in the 1950's, to an average of 2.15 percent on loans made during the 1960's, to an average real return of 1.73 percent during the years 1970 through 1975. This occurred despite the dramatic rise in contract interest rates that occurred for these same instruments during the same time period: From 5.02 percent for loans made between 1951 and 1959, to 6.58 percent for loans made in the 1960's, to 9.34 percent for loans made from 1970 through 1975. Strum, *Long Term Fixed Rate Mortgages*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80'S 23 (A.B.A. 1981); *See generally*, Strum, *The Roles of Life Insurance Companies and Pension Funds in Financing Real Estate in the 80's*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80'S 1 (A.B.A. 1981). Of course, the high real interest rates and relatively low inflation rates that have typified the 1980's, so far, belies the notion that fixed rate, long-term loans are no longer good investments. Rather, it serves to illustrate that long-term lenders have historically borne the risk of inflation. And, as the apparent risk has increased, prudent lenders have naturally sought alternatives.

[8] *See* Roegge, Talbot & Zinman, *Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained*, 39 FORDHAM L. REV. 579, 579 (1971) [hereinafter Roegge].

higher yielding investments than the traditional fixed return mortgage.[9]

The increasing importance of pension fund money managed by financial institutions further heightens the pressure for alternative financing transactions. ERISA's diversification requirements and fiduciary standards are widely believed to open the door to the investment of some of these funds in real estate.[10] Considering the

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[9] *Id.* at 583-85.

[10] *See* ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1982). Section 404(a)(1) provides that:

> Subject to sections 1103(c) and (d), 1342, and 1334 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.

Id. Subparagraph (B)'s "prudent man" language is widely believed to create a reasonable expert standard. Read in conjunction with Subparagraph (C)'s diversification requirement, some have speculated that while real estate investments are certainly not a mandatory component of a pension fund investment portfolio, a prudent plan administrator would at least consider the possibility of some real estate investment. *See* Strum, *supra* note 7, at 3. The argument may be paraphrased as follows: A plan administrator is explicitly required by 29 U.S.C. § 1104 (a)(1)(C) to diversify for the purpose of reducing risk of large losses. Real estate investments are an even older and more traditional method of preserving wealth than the typical corporate debt and equity securities that form the bulk of the normal trust portfolio. Therefore, a prudent expert investor would naturally diversify some of his funds into some sort of real estate investment. *See* Strum, *supra* note 7, at 3. This argument is bolstered by ERISA's abandonment of the traditional approved investments list in favor of Section 404's more general approach. Further, the prudent expert standard seems to preclude the excuse of complexity as a reason for avoiding an investment. *See* Lanoff, *Impact of ERISA on Commercial Real Estate Investment by Employee Benefit Plans*, in PENSION TRUST INVESTMENTS IN REALTY: BANKS, INSURANCE COMPANIES, WALL STREET, DEVELOPERS 275 (P.L.I. 1981). *See also* McMahan, *Institutional Strategies for Real Estate Equity Investment*, in PENSION TRUST INVESTMENTS IN REALTY: BANKS, INSURANCE COMPANIES, WALL STREET, DEVELOPERS 107 (P.L.I. 1981). However, there is another side. The sheer size of required investments may make direct equity investments in real estate highly imprudent for a small plan. *Id.* at 116. Similarly, the inherent uncertainty of appraisal as a method of valuation, combined with the illiquidity that makes reliance upon appraisal frequently necessary, can detract from the attractiveness of a real estate investment. A pooled investment vehicle may mitigate these drawbacks.

inflationary history of the economy, and the particular objectives of most pension plans, such investments may well be part of a wise strategy quite apart from legal considerations of diversification. Pension plan benefits are typically defined in terms of the employees' salaries during the five years prior to career termination. Thus, effective hedging against inflation is critically important.[11]

While, with the exception of the very recent past, inflation adjusted yields on mortgages have been falling since the 1950's,[12] real estate property values have risen in real terms. Therefore, it is not surprising that traditional mortgage lenders have sought avenues for sharing in the inflation hedge and profit opportunities inhering to the equity side of real estate investment, as well as seeking to limit the risk of inflation-adjusted losses on fixed rate long-term loans.

In retail residential financing, the industry response has been to develop a variety of "alternative mortgage instruments." These are designed to meet two objectives. Some permit a more rapid response to changes in prevailing interest rates—by shortening the term of the loan, insertion of due-on-sale or due-on-encumbrance clauses, or actual indexing of interest rates. Other instruments, for example, Shared Appreciation Mortgages (SAMS), allow the

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[11] *See* Strum, *supra* note 7, at 5. *See also The Recession Proof Boom*, in The Economist, February 7, 1981, *reprinted in* PENSION TRUST INVESTMENTS IN REALTY: BANKS, INSURANCE COMPANIES, WALL STREET, DEVELOPERS 141, 145 (P.L.I. 1981). One paradoxical effect of inflation is to invert some traditional notions of investment safety. A "high quality" fixed interest debt instrument may be a low risk in terms of the debtor's creditworthiness, but if it is a long term indebtedness, it offers scant protection against inflation rates with no theoretical upper limit. In contrast, an investment in commercial real estate, although potentially at real risk to normal business cycles, can offer significant inflation protection through the use of indexed rent adjustment formulae or short lease terms. This apparent risk inversion is of particular concern to the pension fund. Since a fund's liabilities are usually linked to future wages, they are *real* (*i.e.*, effectively inflation indexed) liabilities and potentially unlimited in dollar amount. This is always a matter of relatively immediate concern to fund managers since any actuarial shortfalls in funding may trigger a requirement of additional contributions by plan sponsors under ERISA. *See* ERISA § 302(a)(6), 29 U.S.C. § 1082 (a)(b) (1982). *See also* Strum, *Pension Fund Investments in Real Estate*, in PENSION FUND INVESTMENTS IN REALTY: BANKS, INSURANCE COMPANIES, WALL STREET, DEVELOPERS 21, 31 (P.L.I. 1981). Further, this need to maintain adequate actuarial funding creates yet another concern for fund managers, since economic factors such as fluctuating interest rates will affect the market value of portfolio investment. It has been suggested that an appropriate commitment of investment funds to real estate may serve to reduce this undesirable volatility. *See* Weisz, *Investment Strategies and the Common Trust Fund*, in PENSION FUND INVESTMENTS IN REALTY: BANKS, INSURANCE COMPANIES, WALL STREET, DEVELOPERS 59, 64 (P.L.I. 1981).

[12] *See supra* note 7.

lender to share in the appreciation of the mortgaged property.[13]

On the commercial side, the industry response has been the rise of the large real estate joint venture. These transactions have been as diverse as the legal, financial and tax requirements of the

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[13] SAMs (Shared Appreciation Mortgages) are a class of loan instruments sharing several distinguishing elements: (1) a fixed rate of interest that is generally lower than the prevailing rate for a conventional mortgage; (2) a contingent interest provision that permits the lender to share in the appreciation of the property by charging interest equal to a portion of the increase in value of the property, at set time intervals or upon maturity of the note; (3) acceleration of the note upon sale, encumbrance or refinancing. Depending upon the particular instrument, the contingent interest charge may be based on periodic (*e.g.*, every five years) appraisals of the property throughout the life of a loan that is amortized over a long time period, or, alternatively, the interest may accrue only upon maturity of the note. If the interest accrues only upon maturity, the loan will typically have a short term (*e.g.*, no more than 10 years) but payments will be amortized over a longer time period (*e.g.*, 30-40 years). In the latter situation, a guaranteed refinancing provision may be part of the contract. In the periodic reappraisal type of SAM, provision may be made to amortize the contingent interest that accrues, either through a separate note or as part of the original instrument.

In a commercial setting, a SAM may be utilized to allocate one of the major benefits of equity ownership—the potential appreciation of the property—to the mortgagee. In a residential context, proponents advocate SAMs as a means of providing first-time home buyers with access to affordable financing.

A variety of legal pitfalls surround the design of these instruments. Potential problems include usury limits, unconscionability, arguable foreclosure problems (due to the uncertain status of the mortgagee), priority issues as to the lien securing the contingent interest, as well as the major focus of the discussion—clogging the equity of redemption. *See* Levin & Roberts, *Future Forms of Financing—Lending Devices Addressed to Inflation and Tight Money*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80'S 31 (A.B.A. 1981) [hereinafter Levin & Roberts] (overview of alternative mortgage instruments); Comment, *The Shared Appreciation Mortgage: A Clog on the Equity of Redemption*, 15 J. MAR. L. REV. 131, 150-54 (1982) (discussion of SAMs and clogging). A detailed treatment of the characteristics of the mortgage instruments primarily designed for borrowers with expectations of rising incomes (or a short period of ownership of the property) may be found in Levin & Roberts, *supra*. The instruments and programs treated by the authors include the Graduated Payment Mortgage (GPM), the Deferred Interest Mortgage (DIM), the Flexible Loan Insurance Program (FLIP) and the Tenants in Common Keeping Equity Plan (TICKET). *Id.* at 35-40. The simplest of these arrangements is the GPM, which couples a fixed interest rate loan to an individualized payment plan that may include negative amortization in the early years (when payments are low). DIMs are GPM variants—a portion of the interest charges for the first two years of the loan term are deferred and added to the outstanding balance. *Id.* The FLIP concept requires the borrower to deposit what might have been a down payment in an interest bearing account. The lender then furnishes what amounts to a GPM for the entire purchase price of the borrower's home. A schedule of deductions from the interest bearing account serves to reduce the early loan payments, until the account is exhausted. *Id.* at 39. The TICKET plan pairs a borrower who cannot obtain funds for a down payment with an investor who furnishes those funds in return for an undivided interest in the property as tenant in common. The borrower and investor agree to sell or refinance within five years, at which time the investor presumably takes his profit. *Id.* Variable rate mortgages (yet another "alternative mortgage" instrument) are discussed *infra* at note 151.

lenders and developers involved.[14] However, these transactions are distinguishable as a class by provision for an equity participation by the institutional lender. Participation by an institutional lender generally involves either an interest in the venture or in the underlying property dating from the inception of the deal or the completion of some phase of construction, options to acquire an interest at a later date, or both.[15] Thus, for example, a convertible mortgage may be employed as a component of a joint venture agreement. The convertible mortgage couples a mortgage loan with an option in favor of the mortgagee to purchase all or a portion of the secured property or the venture equity at some future date.

A common thread running through most modern real estate financing techniques is the grant of some additional benefit to the mortgage lender on top of interest. This additional interest to the institutional lender creates a potential conflict with an ancient rule that was originally directed at the excesses of unscrupulous individual lenders. This rule is the doctrine forbidding clogs on the equity of redemption.[16]

III. Historical Setting for the Development of the Clogging Doctrine

The origin of the rule against clogging is found in the evolution of the mortgage itself. In the fourteenth century, mortgages took the form of a conveyance of the mortgaged property to the

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[14] *See* Roegge, *supra* note 8, at 588-89, 636-39.

[15] A good illustration of the potential for diversity is found in an outline of some of the basic deal structures used by institutional investors, in Furnary & Simpson, *Real Estate Investments for Pension Funds*, in PENSION TRUST INVESTMENTS IN REALTY: BANKS, INSURANCE COMPANIES, WALL STREET, DEVELOPERS 73, 78-81 (P.L.I. 1981). As the authors indicate, the size of the institution's commitment may be to fund the gap between permanent financing and total project cost, or to fund the entire project. The leverage (and, consequently, the risk appreciation potential, and depreciation-related tax benefits) afforded to the developer may vary from little, or none in the case of a free and clear equity investment by the institutional investor, to the maximal leverage achieved in a land sale/leaseback with a leasehold mortgage. In this latter deal structure, the institutional investor purchases the land from and leases it back to the developer. The construction is then financed by a leasehold mortgage on the improvement, permitting the lender to foreclose on the entire interest of the developer in case of default on either rent or mortgage payments. The nature of the institution's interest may also be that of a traditional mortgagor, or hybridized through the use of a SAM, *see supra* note 13, or a convertible mortgage.

[16] The doctrine is generally said to date back at least to 1639. *See* Norstrand, *The Convertible Mortgage and the Equity of Redemption*, 26 B.B.J. 24, 25 (Sept. 1982). *See also* Bacon v. Bacon, 21 Eng. Rep. 146 (1639) (court relieved mortgage to the tenth generation even though purchaser did not have notice). *But see supra* note 2.

mortgagee subject to a condition subsequent. The condition subsequent, also known as a defeasance, provided that title would revert to the grantor if the grantor paid the indebtedness by the *law date*. If timely full payment was not made, the mortgagor lost his property. These conveyances were enforceable at common law. Considerable injustice could result, however, since the value of the forfeited land could be grossly disproportionate to the outstanding indebtedness.[17]

In the 1600's, equity courts began granting relief to defaulting mortgagors by holding that an *equity of redemption* arose upon default that gave the mortgagor the right to buy back the property by paying the indebtedness. This right inhered in the mortgagor notwithstanding the language of the instrument.[18] Lenders were quick to react by inserting waivers of the equity of redemption in the mortgage instruments. These waivers, however, were uniformly invalidated in equity on the theory that the equity of redemption could not be *clogged* by a contractual term.[19] From this beginning, the equity courts continued to make it utterly clear that the mortgagor's right to redeem after default could not be contracted away.[20] This principle is often phrased "*once a mortgage always a mortgage*"[21] even though, from a logical standpoint, the invalidation of a contractual clause that waives the equity of redemption is in some respects more akin to making a mortgage out of that which never was a mortgage.

The doctrine might have been easy to live with, were it not for the related doctrine that forbade mortgagees from taking *collateral advantages* which crept into the doctrines of equity in the eighteenth century. In its broadest form, the rule was phrased: "A man shall not have interest for his money on a mortgage, and a collateral advantage besides for the loan of it; or clog the equity redemption with any by-agreement. . ."[22]

One might conclude that the collateral advantage doctrine, as thus stated, is an entirely separate principle from that of clogging rather than a particular sub-genre of the general category of clogs.

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[17] G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 6 (1951).

[18] *Id.*

[19] *Id.* at § 97.

[20] *Id.*

[21] *Id.*

[22] Jennings v. Ward, 23 Eng. Rep. 935, 935 (1705).

Unfortunately, the reporter in *Jennings v. Ward*[23] chose to use the conjunction "or" in the language quoted above, which permits both interpretations.[24] From a grammatical standpoint, the leading British case of *Kreglinger v. New Patagonia Meat & Cold Storage Co.*,[25] discussed *infra*, could be said to stand for the proposition that the word "or" in *Jennings* should be read to mean "to wit." Therefore, a collateral advantage cannot be bad unless it also satisfies the definition of a clog on equity of redemption. Practitioners might rightly sigh in relief at this ruling, since if one were to read the conjunction to denote alternative doctrines, virtually all modern real estate financing would be suspect.

Even assuming that the collateral advantage doctrine was a separate restriction on mortgages from the clogging doctrine, it is not clear whether a collateral advantage that did not result in a total benefit to the mortgagee in excess of the usury limit would be proscribed.[26] However, the collateral advantage doctrine does not appear to be a factor in American cases, and, in any event, "the modern rule" is more clearly directed towards invalidating contractual clauses that prevent a mortgagor from redeeming after default. Nevertheless, room for disagreement exists as to what does or does not prevent redemption. The focal point of this argument today concerns the mortgagee's option to purchase real property securing the indebtedness. These options are integral parts of convertible mortgages, and are found as well as components of a variety of deal structures. The theory for invalidating the mortgagee's option is that if the mortgagee acquires an ownership interest in the mortgaged property (by exercising the option) the mortgagor could not possibly redeem. Convertible mortgages and options to purchase an interest in the secured property can provide the institutional lender with some of the long term benefits of a joint venture, while avoiding the duties and liabilities of partnership until exercise.[27] The developer in a joint venture may find the option or

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[23] *Id.*

[24] *See generally* 30 WORDS AND PHRASES 100-108, 135-137 (West 1972) and cases cited therein (illustrations of the word's versatility).

[25] 109 L.T.R. (n.s.) 802 (1914).

[26] *See, e.g., infra* note 43.

[27] *See* Nellis and Hastie, *Real Estate Joint Ventures in the 80's*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80'S, 201, 206 (A.B.A. 1981) (summary of serious potential legal problems associated with convertible mortgage). Problems associated with convertible mortgages include usury, clogging the equity of redemption, sufficiency as a tax tool, and the uncertain availability of specific performance of an option to purchase an interest in

the convertible mortgage to be a useful device for limiting the amount of pre-construction capital contributions by the co-venturers. This may help the developer to avoid the unfavorable tax consequences of being classified as a partner whose equity contribution is services.[28] By delaying the acquisition of an equity interest by the long term lender, the device may also serve to shift the tax benefits of early year losses to the venturer most able to utilize them, who is generally the developer. Of course, an option to buy an interest in a development after completion of construction can also be attractive in more straightforward terms—as a mechanism for allocating the entrepreneurial risks in the early phases of a construction project, or as a bargained-for "sweetener" to induce more favorable mortgage terms.[29]

Considering the utility of mortgagees' options in real estate finance, the clogging rule's effect upon their enforceability would be reason enough to be troubled. However, the logic underlying the clogging rule is quite open-ended. As a result, the rule casts a cloud of uncertainty over far more than the mortgagee's option and the convertible mortgage. It led Lord Mersey to observe, in *Kreglinger v. New Patagonia Meat & Cold Storage Co.*,[30] that the rule was "like an unruly dog, which, if not securely chained to its own kennel, is prone to wander into places where it ought not to be."[31]

Modern finance techniques further the societal goal of making mortgage money more available to borrowers. Yet, the clogging rule seemingly operates to frustrate this purpose. This is an odd consequence to flow from a doctrine designed to protect borrowers. A necessary conclusion, therefore, is that either the rule has outgrown its original purpose or the world of modern finance has out-

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a partnership. *Id.*

[28] To the extent permissible under section 704(a) of the Internal Revenue Code, 26 U.S.C. § 704(a)(1982), a developer will generally wish to maximize its own allocation of income in the partnership agreement, and minimize third-party contributions of capital, until contributing property of substantial value to the venture (typically, upon completion of a phase of construction). This will make it less likely that the third-party capital contributions will appear to be partial payment for the services contributed by the developer. If the developer is found to be a partner for services, its tax status will be unfortunate—the partnership interest will be recognized as immediate ordinary income, without generating any cash for payment of the resulting tax liability. *See* Abramson, *Tax Tools for Structuring Real Estate Investments in the Inflationary 80's*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80'S, 291, 294 (A.B.A. 1981).

[29] Nellis and Hastie, *supra* note 27, at 206.

[30] 109 L.T.R. (n.s.) 802 (1914)(Mersey, Lord, concurring).

[31] *Id.* at 808 (Mersey, Lord, concurring).

grown the rule.[32] An examination of the leading British and American cases will demonstrate, at minimum, that Lord Mersey's *unruly dog* has been wandering quite a bit.

IV. THE LEADING CASES

A. British Cases

It is generally agreed that the leading modern British case on the clogging doctrine is *Kreglinger v. New Patagonia Meat & Cold Storage Co.*[33] In *Kreglinger*, a firm of meat canners borrowed 10,000 pounds for a five year term at six percent interest, secured by a floating charge on "its undertaking, and all its property both present and future."[34] As part of the agreement, the company granted the secured parties, who were woolbrokers, a right of first refusal on all sheepskins they sold for five years, and promised to pay a one percent commission on any skins sold to others. The borrowers prepaid the loan but resisted enforcement of the "option." They argued that determining whom they did business with was an incident of ownership of their business. To allow a claim on this property right to outlive the debt clogged their right of redemption.[35] The House of Lords rejected the "clogging" argument. The court viewed the option as a separate and reasonable contract in substance despite its location in the loan agreement.[36] The *Kreglinger* court's decision is helpful, therefore, in that it makes clear that the form of an agreement will not control the result in a particular case.[37] The opinion offers little guidance, however, as to what in substance constitutes a clog on the equity of redemption.[38]

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[32] In this regard, it is worth noting that the typical modern mortgage lender is a large institution with a broad range of accountabilities that serve to motivate responsible behavior. Yet, as recently as the 1920's, most mortgagees were largely unregulated individuals. *See* Kratovil, *Mortgage Law Today*, 13 J. MAR. L. REV. 251, 251-52. (1980).

[33] 109 L.T.R. (n.s.) 802 (1914).

[34] *Id.* at 803.

[35] *Id.* at 803-04.

[36] *Id.* at 807, 808. In view of the fact that the woolbroker-lenders had a legitimate business interest in obtaining the skins, the transaction could reasonably be viewed as one whose primary purpose was to obtain a supply of sheepskins. However, the meat canners could argue with equal force that as far as they were concerned, the primary purpose of the deal was to obtain a loan. Here, the court might have reasonably concluded that the parties had different primary intents in entering into the contract. Perhaps this is part of the reason that the court found two separate contracts in one instrument. *Id.* at 807-08.

[37] *See* 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.58.

[38] We can be certain, at least, that any agreement by a mortgagor that directly deprives him of the right to redeem, or places time limits on redemption, or otherwise expressly

The cases preceding *Kreglinger* shed some light on the nature of this confusion.

In *Jennings v. Ward*,[39] defendant lent 16,000 pounds secured by a mortgage and a covenant to convey so much of the mortgaged estate as would equal the value of the indebtedness. Redemption was granted and the convenant invalidated:

> [B]ut the *Master* of the *Rolls* decreed a redemption, on payment of principal, interest and costs, without regard to that agreement; but set aside the same as unconscionable. A man shall not have interest for his money, and a collateral advantage besides for the loan of it, or clog the redemption with any by-agreement.[40]

Thus was born the so-called *collateral advantage* corollary of the clogging rule.

On its facts, *Jennings* would seem to be merely another case in which a covenant was invalidated because it would have made a mortgage irredeemable if enforced. However, undoubtedly due to the breadth of the language of the report, *Jennings* is cited for the proposition that any benefit given to a mortgagee in addition to interest is a collateral advantage and is, therefore, void.[41]

English courts retrospectively have interpreted the case as an effort by the equity courts to prevent evasion of the usury laws.[42] Thus, in 1889, the Chancery Division concluded that the *Jennings* collateral advantage doctrine had no viability since the repeal of the usury laws, at least when the parties had equal bargaining power.[43] Apparently, the collateral advantage, which once was bad

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limits the right, is absolutely void. *See, e.g.*, Price v. Perrie, 22 Eng. Rep. 1195, 1195 (1702) (mortgagee's option to buy equity of redemption after default is void); Howard v. Harris, 23 Eng. Rep. 406, 408 (1683) (mortgagor cannot restrict redemption to male heirs of his body); Jason v. Eyres, 22 Eng. Rep. 1064, 1065 (1681) (cannot forfeit redemption right on mortgagee's death); Newcombe v. Bonham, 22 Eng. Rep. 1063, 1064 (1681) (express waiver of redemption right is void). If the substance of a transaction is the creation of security, substance will win out over form. *See* Salt v. Northampton, 65 L.T.R. 765 (1892); Courtenay v. Wright, 66 Eng. Rep. 141, 147 (1860); Vernon v. Bethel, 28 Eng. Rep. 838, 839 (1762).

[39] 23 Eng. Rep. 935 (1705).

[40] *Id.*

[41] 4 AMERICAN LAW OF PROPERTY, *supra* note 3, §16.60, at 111-12.

[42] *See, e.g., Kreglinger*, 109 L.T.R. (n.s.) at 805.

[43] *See* Mainland v. Upjohn, 41 Ch. D. 126, 136, 144 (1889). *But see* James v. Kerr, 40 Ch. D. 449, 449-60 (1889), where the court stated that the rule against collateral advantages had more viability since the repeal of the usury laws, to protect against unfair results where the parties do not have equal bargaining power. The court in *James* concluded that even before the repeal of the usury laws, the doctrine had independent significance. *Id.* at 460. However, the supporting citations listed in both the *Mainland* and the *James* decisions are generally equivocal. One exception is French v. Baron, 2 Atk. 120, 26 Eng. Rep. 475 (1740),

because it was in the nature of extra interest, was on its way to becoming a respectable part of an arms-length deal.

This evolution continued in *Biggs v. Hoddinott*.[44] There, the brewer-plaintiff had taken a mortgage on the defendant's hotel. In return for an extension in the repayment terms, defendant agreed to serve only the plaintiff's beer for the term of the loan. The court observed that the provision was in no way oppressive and found it to be an acceptable collateral advantage.[45] The court also emphasized that *Jennings* stood only for the proposition that a collateral advantage should not prevent redemption, and such prevention was not present in this agreement.[46]

The clogging doctrine was further narrowed in *Santley v. Wilde*,[47] where a loan provision was upheld even though it provided for payment of both interest and one third of profits from rent on a ten year leasehold. The court was not disturbed that this provision could outlive repayment of the loan. Rather, it implied that the clogging doctrine was no substitute for usury laws:

> Any provision inserted to prevent redemption on payment or performance of the debt or obligation for which the security was given is what is meant by a clog or fetter on the equity of re-

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cited by the *James* court, *James*, 40 Ch. D. at 459, for the proposition that the rule against collateral advantages originated independently of the usury laws. In *French*, a mortgagor promised to pay the mortgagee for the mortgagee's expenses of collecting rents, in addition to interest on the indebtedness. *Id.*, 26 Eng. Rep. at 476. Since the amounts involved and the interest rate is not reported, one inference might be that the amounts were irrelevant and that usury was not a factor. Of course, an alternative interpretation could involve difficulties in transcription of the report.

[44] [1898] 2 Ch. 307.

[45] *Id.* at 311.

[46] *Id.* at 315-16. Was there ever a blanket prohibition of collateral advantages, or was the purported legal doctrine a result of unfortunate wordsmanship in *Jennings*? There do not seem to be any clogging cases in which contractual benefits are struck down solely because they represent non-interest benefits for the use of money. Rather, the issue in the clogging cases seems reduced to the issue of whether the suspect provision prevents redemption. Labelling the provision as a collateral advantage may be effective advocacy, but the rule against collateral advantages appears to add nothing of substance to the law. *See* Biggs v. Hoddinott, [1898] 2 Ch. 307, 317-18, where the court reviewed the progeny of *Jennings* and concluded that the rule of *Jennings* was at all times an overstatement. In fact, the court concluded, there is always either a clog on the equity of redemption or some overreaching in a bad collateral advantage. *James*, discussed *supra* note 43, is not contrary to this view. Interestingly, the *Biggs* court distinguished *French*, also discussed *supra* note 43, as involving a charge that had to be paid in order to redeem the property, rather than a collateral advantage. *See Biggs*, [1898] 2 Ch. at 315-16. On this basis, the *Biggs* court concluded, in effect, that there are no cases supporting the so-called *Jennings v. Ward* doctrine. *Id.* at 315.

[47] [1899] 2 Ch. 474.

> demption and is therefore void. It follows from this, that "once a mortgage always a mortgage"; but I do not understand that this principle involves the further proposition that the amount or nature of the further debt or obligation the payment or performance of which is to be secured is a clog or fetter within the rule. . .[48]

This was a significant development in the growing judicial approval of the collateral advantage, since the provision arguably prevented redemption for the ten year life of the covenant, and profits from rent would appear to be incidents of ownership of a leasehold. In fact, since the covenant lasted for the life of the leasehold, redemption was effectively impossible.[49]

However, in the subsequent decision of *Noakes & Co. v. Rice*,[50] we learn of at least one type of obligation that will constitute a clog. Plaintiff was a brewer who mortgaged his brewery and covenanted to serve the defendant-mortgagee's malt liquor on the premises exclusively. The covenant was worded by the parties so as to indicate their intent to create a charge upon the brewery that would "run with the land" and persist beyond the term of the debt.[51] This was held to be unenforceable beyond the term of the debt as a "fetter" on the brewer's right to redeem.[52] One may question whether *Noakes* is consistent with *Santley*.

Fortunately, *Bradley v. Carritt*[53] obviated this question by overruling *Santley*. Here, defendant in a breach of contract action had pledged his shares in a tea company to the plaintiff and covenanted to forever use the plaintiff as his tea broker. The trade custom was that brokers bought shares to get their business. Defendant paid his debt, sold the shares to another broker and refused to honor the covenant. The covenant was held invalid because it exceeded the term of the debt. *Biggs* was distinguished for this reason.[54]

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[48] *Id.* at 474-75.

[49] This is a good example of the logical openness of the rule, since this type of analysis could lead to the conclusion that any leasehold mortgage lasting for the term of the lease was a clog on the equity of redemption if pre-payment were penalized.

[50] [1902] App. Cas. 24, 86 L.T.R. (n.s.) 62 (1902).

[51] *Id.* The court expressed considerable doubt as to the effectiveness of this attempt to bind the brewer's successors in interest by the covenant. *Noakes*, [1902] App. Cas. at 32, 86 L.T.R. at 64. However, the issue was never reached, as it was not argued on appeal. *Id.* at 25-26, 86 L.T.R. at 62. Even if the covenant were strictly a personal obligation of the brewer, it was impliedly void for outliving the debt.

[52] *Id.* at 29-30, 86 L.T.R. at 64.

[53] [1903] App. Cas. 253.

[54] *Id. See also* Fairclough v. Swan Brewery Co., 106 L.T.R. 931 (1912) (covenant which

One year later, however, in *Samuel v. Jarrah Timber & Wood Paving Corp.*,[55] an obligation that did not extend beyond the term of the loan was voided as a clog on the mortgagor's equity of redemption. The contractual provision was an option to buy, at discount, the debenture stock of Jarrah, which had been pledged to Samuel, the optionee and mortgagee. The option was held to be void as a clog on Jarrah's right to redeem, emanating from the principle "once a mortgage always a mortgage."[56] The court analyzed the facts in this manner:

> The first question is, What is the true nature of this agreement? Is it a mortgage with an option to purchase, or is it a conditional sale? Or is it an agreement giving Samuel an option to hold the debenture stock as a mortgage or a purchase? It appears to me to be clearly a mortgage with an option to purchase.[57]

The court's finding was a mortgage was intended, implicating the equity of redemption doctrine. Thus, the option was void as an impairment of a redemption right, and "[a]ny bargain which has that effect is invalid. . ."[58]

Unfortunately, the court did not explain how it differentiated between a mortgage with an option to purchase and an option to hold the collateral as either a mortgage or a purchase. It would seem that these two possibilities are rather similar and probably only distinguishable by a most subtle inquiry into the intent of the

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discharges immediately before leasehold expires makes mortgage irredeemable); Morgan v. Jeffreys, [1910] 1 Ch.D. 620 (one-sided provisions which make mortgage irredeemable for twenty-eight years exceed "all reasonable limits" and not enforceable).

[55] [1904] App. Cas. 323, 325.

[56] *Id.* at 329. *Jarrah* illustrates just how unfortunate the phrase "once a mortgage always a mortgage" can be when taken out of its original context. It should mean that an equity of redemption is inseparably part of every mortgage. This meaning flows naturally when the principle is used to strike down a time limit on redemption, for example, since such a provision, if given effect, would change a mortgage into an absolute conveyance. *See* 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.59. However, in *Jarrah*, the court invalidated the mortgagee's option on an emanation from this principle. In effect, this is a different principle entirely. Further, a clause placing time limits on a redemption right may well take advantage of a borrower's optimism about his ability to repay his debt which is a basis for the rule. *See* Wyman, *The Clog on the Equity of Redemption*, 21 HARV. L. REV. 459, 460, 475 (1908). However, the knowing grantor of an option to buy property cannot possibly have any hope of realizing more than the option price on sale of the property. Thus, evolving from the protection of borrower hopes and perhaps their expectations in the earlier clogging holdings, the court clearly has made a transition in *Jarrah* toward protecting the borrower from its own view of a bad bargain.

[57] *Jarrah*, [1904] App. Cas. at 328.

[58] *Id.* at 329.

parties to the arrangement. Nor did it explain how any obligation in addition to interest could help but impair the right of redemption, if the borrower had difficulty meeting the obligation. *Kreglinger* clarified matters somewhat by holding that *Jennings'* notion, that all collateral advantages were bad, was simply obsolete considering the repeal of the English usury laws in 1854.[59] Thus, the only bad collateral advantages were those that were unconscionable and those that penalized or prevented the borrower from exercising a redemption right.[60]

However, the question remained: What type of collateral advantage interferes with the exercise of a redemption right? By endorsing *Jarrah*, Lord Parker's opinion in *Kreglinger* suggests that, at least when the option is for purchase at less than fair market value, an option to purchase the security is certainly a bad collateral advantage. Also, he accepted the result in *Noakes*, indicating that an exclusive obligation to serve the mortgagee's liquors was too much of an infringement upon the mortgagor's rights as a proprietor, after redeeming his premises.[61] Since Lord Parker rejects the notion that *Noakes* should turn on the persistence of the "tie" past the debt, the rule must be that a mortgagee's right of first refusal is acceptable based on the facts of *Kreglinger*, but an exclusive dealing agreement is beyond the pale.[62]

Despite some language in *Kreglinger* suggesting that the rule against clogging has no place in an ordinary business transaction,[63]

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[59] *Kreglinger*, 109 L.T.R. (n.s) at 811.

[60] *Id.* at 813.

[61] *Id.* at 812.

[62] This leaves two theoretical possibilities for distinguishing the "tie" in *Noakes* from the right of refusal in *Kreglinger*. First, a "tie" is a far more serious infringement upon an incident of ownership than a right of refusal, since a "tie" affects the mortgagor's daily use of the mortgaged property or the business enterprise. Second, the granting of a "tie" involves an arguably measurable loss to the grantor, since the value of the grantor's ownership interest is seemingly diminished. However, the granting of a right of refusal neither diminishes the value of the enterprise, nor does it impair freedom of action as seriously as a "tie".

Either of these theoretical approaches would consistently explain the result in *Jarrah*, since an option to purchase part of the collateral at a set price involves both a serious dimunition in the value of the grantor's incidents of ownership, and a potential loss in control of the collateral if the option is exercised. It is unfortunate that these two theoretical possibilities have not been more clearly distinguished in the case law, since the option to purchase at market value would seem to straddle the theories involving, on the one hand, a potential loss of control of the subject property, but entailing, by definition, no measurable decrease in the value of the optionor's interest.

[63] For example, the Lord Chancellor stated that the rule should not apply if the right of first refusal is not part of the mortgage, but rather a separate agreement in substance. But how did he conclude that there was a separate contract? "If there had been no mortgage

the subsequent English case of *Lewis v. Frank Love, Ltd.*[64] indicates otherwise. In *Lewis*, plaintiff owned a tract of residential land that was subject to a 6000 pound mortgage. He apparently was having difficulty meeting the obligation. When his creditors obtained a judgment on the note, he contacted a knowledgeable friend for some advice. Together, they decided to seek some interim financing in order to buy time. They apparently planned to use this time to convince the local authorities to remove certain restrictions on the use of their property, thereby increasing both the resale value and development potential. The defendant then agreed to pay off Lewis' creditors in exchange for a mortgage granting a two year option to buy a portion of the tract. In return, Lewis obtained defendant's promise not to demand payment of the note for an equivalent time period.

The deal deliberately was structured to avoid the clogging doctrine's reach by drafting separate instruments for the mortgage transfer and the grant of the option. Additionally, the defendant attempted to assume the role of transferee of a preexisting mortgage rather than a mortgagee. Despite this careful planning, the court focused on the substance of the deal and refused to enforce the option. Ironically, the court relied on the correspondence between the attorneys that expressed concern about avoiding the effects of the rule.[65]

Thus, the *Lewis* court's invalidation of this option is particu-

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such a contract . . . would have been an ordinary incident in such a business." *Kreglinger*, 109 L.T.R. (n.s.) at 806. Similarly, Lord Parker concluded his opinion with language suggesting that, although the rule still prevented mortgagees from contracting away their redemption rights, the court might well find something other than a mortgage in a business transaction, thereby circumventing the rule:

> I doubt whether, even before the repeal of the usury laws, this perfectly fair and businesslike transaction would have been considered a mortgage within any equitable rule or maxim relating to mortgages. It never was intended by the parties that if the defendant company exercised their right to pay off the loan they should get rid of the option.

Id. at 813. Interestingly, Lord Parker couched his opinion in terms of effectuating the parties' intent. He seemed to be saying that if the parties intend to clog the equity of redemption, then the court should not find a mortgage. The implication is that if a legitimate business deal is involved, the rule will not apply.

[64] [1961] 1 W.L.R. 261.

[65] The attorneys may well have acted in such a manner based upon Lord Chancellor's opinion in *Kreglinger:*"I cannot but think that the validity of the bargain in such cases as *Bradley v. Carritt* and *Santley v. Wilde* might have been made free from serious question if the parties had chosen to seek what would have been substantially the same result in a different form." *Kreglinger*, 109 L.T.R. (n.s.) at 807. However, the opinion of the *Lewis* court conspicuously failed to even mention *Kreglinger*.

larly important since there were no obvious elements of unconscionability[66] and the entire transaction was proposed by the mortgagor.

B. American Cases

The situation is no less confusing in the United States. For example, in *Humble Oil & Refining Co. v. Doerr*,[67] plaintiff, Humble, had approached the defendants and offered to assist them in financing the enlargement of their service station. The deal required the defendants to lease the land and building to Humble for fifteen years at a monthly rent of $272.30. Defendants then were able to obtain a $35,000 construction mortgage from a bank by assigning the lease as additional security. This mortgage subsequently was converted into a fifteen year "permanent" mortgage loan with monthly payments of $272.30. The final part of the transaction involved Humble leasing the station back to defendants, in a year to year lease, also for $272.30 per month. Thus, if the defendant-borrowers defaulted on the mortgage loan, the bank could foreclose on its security interest in the lease and look to Humble's rent payments to satisfy the mortgage debt since the term and monthly payments for mortgage and lease were identical. Further, since the monthly leaseback rent was for the same amount as the mortgage payments and rent under the lease to Humble, the practical import of this arrangement is much like that of a guarantee. Humble's credit is engaged, but in the absence of a default there is no net cash flow between Humble and the other parties. The result appeared to be a good deal for the defendants since, as a result of Humble's quasi-guarantee, they obtained more construction financing than they otherwise might have obtained on their own.

However, Humble also obtained an option to purchase the fee interest for $150,000 during the lifetime of the lease which it chose

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[66] The court did note one apparent element of unfairness in *Lewis* in that the plaintiff had sought a loan of 6,500 pounds, not 6,000 pounds, and clearly needed the additional sum to prepare his proposal for the town authorities. This sum was orally promised, but never paid. *Lewis*, [1961] 1 W.L.R. at 263, 265. Had the court grounded its ruling upon defendant's failure to perform, the case would be comprehensible as a variant of the unclean hands doctrine. But the court took pains to note that this occurrence merely established that plaintiff was not necessarily acting in bad faith by resisting the option. *See Lewis*, [1961] 1 W.L.R. at 267.

[67] 123 N.J. Super. 530, 303 A.2d 898 (Super. Ct. Ch. Div. 1973).

to exercise ten years later. The value of the land was found to be $240,000 at this time, compared to $85,000 when the option was granted.[68]

The *Humble* court held that the option was a clog on the defendant's equity of redemption. It observed that the option would have been enforceable but for the fact that it "was given in connection with a mortgage loan."[69] The court had little difficulty in concluding that the lease-leaseback transaction was in substance a mortgage. Unable to ascertain Humble's motives, the court maintained that the intent of both parties was to create a mortgage. The evidence considered was largely the substance of the transaction. Thus, Humble was not an ordinary guarantor, but, effectively, a secured guarantor. More importantly, though, Humble apparently had approached the defendants and presented the deal as a financing arrangement.

Having completed this small logical leap, the court then relied on Pomeroy's "classic statement of the rule":[70]

> *Once a Mortgage, Always a Mortgage; Collateral Agreements and Agreements Clogging the Equity of Redemption.*—In general, all persons able to contract are permitted to determine and control their own legal relations by any agreements which are not illegal, or opposed to good morals or to public policy; but the mortgage forms a marked exception to this principle. The doctrine has been firmly established from an early day that when the character of a mortgage has attached at the commencement of the transaction, so that the instrument, whatever be its form, is regarded in equity as a mortgage, that character of mortgage must and will always continue. If the instrument is in its essence a mortgage, the parties cannot by any stipulations, however express and positive, render it anything but a mortgage, or deprive it of the essential attributes belonging to a mortgage in equity. The debtor or mortgagor cannot, in the inception of the instrument, as a part of or collateral to its execution, in any manner deprive himself of his equitable right to come in after a default in paying the money at the stipulated time, and to pay the debt and inter-

[68] *Id.* at 543, 303 A.2d at 904. These valuations were made by Humble's expert witness and accepted by the court. *Id.* Since Humble was denied both specific performance and damages by the ruling, the precise figures were not terribly crucial. However, considering the nature of the appraisal process, it is worth observing that a high appraised value at time of exercise of the option or a low appraisal at the time of the grant of the option could make a bargain of this sort look far harsher than it really is.

[69] *Id.* at 544, 303 A.2d at 905.

[70] *Id.* at 544-45, 303 A.2d at 905.

> est, and thereby to redeem the land from the lien and encumbrance of the mortgage; the equitable right of redemption, after a default is preserved, remains in full force, and will be protected and enforced by a court of equity, no matter what stipulations the parties may have made in the original transaction purporting to cut off this right.[71]

The clogging holding in *Humble* then was bolstered by that court's determination that the option was unenforceable as part of an "unfair, inequitable and oppressive" transaction.[72] A fair transaction apparently would have granted the defendants a fifteen year sublease. Notably, both the clogging and unfair transaction holdings hinged on a preliminary finding that Humble was a mortgagee.

A situation similar to *Humble* arose in *Cunningham v. Esso Standard Oil Co.*,[73] where plaintiff Esso sought and was granted specific performance of an option to buy a service station. Defendant was assigned an option held by Esso to purchase land for $8,500 and the defendant put up $2,000 towards exercise of the option. Esso then arranged $6,500 in third party mortgage financing. In order to finance the construction of a station, Esso leased the land from defendant for a ten year term with five successive one year renewal options. Defendant then assigned the lease as security for a mortgage. As in *Humble*, the lease payments equaled the mortgage payments and defendant leased the station back on a year to year basis. Contrary to his attorney's advice, defendant granted Esso an option to buy the property for $20,000. The land was worth $18,000 when the agreement was entered but appreciated to $73,000 when Esso exercised its option. The Delaware court in granting specific performance of the option noted that the deal was not unconscionable when made, and a subsequent increase in value does not invalidate this option.[74]

The *Humble* court distinguished *Cunningham* because an attorney was present, but it implied that *Cunningham* would have

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[71] 4 J. POMEROY, *supra* note 5, at § 1193, *quoted in* Humble Oil & Ref. Co. v. Doerr, 123 N.J. Super. at 544-45, 303 A.2d at 905.

[72] *Humble*, 123 N.J. Super. at 559, 303 A.2d at 913. The court also attached importance to the fact that the option was "not a right of first refusal or one to pay current market value." *Id.* at 554, 303 A.2d at 911. But these contractual details were not accorded the importance attributed to Humble's dominant bargaining position in the transaction.

[73] 35 Del. Ch. 371, 118 A.2d 611 (1955).

[74] *Id.* at 379, 118 A.2d at 615.

gone the other way if the clogging issue had been raised.[75] This is a troublesome implication since the defendant in *Cunningham* was a newcomer to the deal and, in some respects, in a position similar to that of a joint venturer with Esso. Thus, so far, true joint venturers generally have escaped the clogging rule.[76]

MacArthur v. North Palm Beach Utilities, Inc.[77] came as close as any American case comes to explicitly holding a joint venture to be exempt from the clogging rule. However, it focused its decision instead on the purchase money aspects of the transaction. Nevertheless, the facts of the case lend some support to the notion that a joint venture should escape the reach of the clogging rule since the Florida court's conclusions emanated largely from the existence of a larger transaction of which the loan was but a part. Further, a real estate development joint venture in which mortgage financing is an integral part of a plan to construct improvements is akin to a purchase money arrangement to the extent that the financing is secured by "not previously owned" property. Here, plaintiff MacArthur had sold defendant a large amount of acreage for development. As part of the same transaction, MacArthur provided construction financing for a water supply and sewer system, secured by a first mortgage on the land involved. The agreement also granted plaintiff a five year option to buy the water supply and sewer system at a price equal to defendant's cost. The court granted specific performance of the option and rejected the argument that it was a clog on the defendant's equity of redemption: "This court is committed to the proposition that A can sell a tract of land to B and reserve an option to re-purchase a part of it."[78] The court then went on to state that it was illogical to invalidate this type of transaction merely because A also accommodated B with a mortgage loan.

The *MacArthur* court noted that the transaction was conducted at arms length and the buyer was "encumbered" from the outset. The court indicated that under these circumstances it

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[75] *See Humble*, 123 N.J. Super. at 563, 303 A.2d at 915.

[76] The author is unaware of any case in which joint venturers have been subjected to the clogging rule. The court in *Humble* speculated that different rules may apply to joint ventures, and cited MacArthur v. N. Palm Beach Util. 202 So. 2d 181 (Fla. 1967), as standing for this proposition. *Humble*, 123 N.J. Super. at 559-60, 303 A.2d at 913-14. However, although the parties in *MacArthur* appear to be possibly classifiable as joint venturers, the *MacArthur* court did not address this issue.

[77] 202 So. 2d 181 (Fla. 1967).

[78] *Id.* at 184.

would be inequitable to give defendant what he never actually had.[79]

Nearly three centuries ago the *Jennings* court sought to generalize a rule from particular inequitable circumstances, and seemed to conclude that all collateral advantages were bad. Yet, in *MacArthur*, the Florida court, applying a similar form of reasoning, reached a nearly opposite result.

Perhaps, *Humble*, *Cunningham* and *MacArthur* could be rationalized on the basis of the distinction between purchase money and non-purchase money mortgages. But this rationale fails when *Barr v. Granahan*[80] is considered. Defendant was a small businessman whose property had gone up in value as a result of his efforts to build a viable enterprise. Plaintiff was a mortgagee who held an option to buy the land and building. The option price was fair when the option was granted, and the mortgage was given to enable the defendant to purchase the property. Nevertheless, the court concluded that grant of specific performance would not be equitable under the circumstances.[81]

What we can glean from these cases is that considerable uncertainty exists as to the enforceability of mortgagee's options. More generally, some doubt exists as to the enforceability of any contractual benefit coupled to a mortgage.

V. Theories of the Clogging Doctrine

In *Jennings*, the court interpreted clogging as a form of "per se" unconscionability. Yet, the approach utilized by the *Barr* court, which examined a mortgagee's option in terms of its unfairness under the circumstances, seems indistinguishable. The problem is that the circumstances of *Barr* are nearly universal. An option holder only is going to exercise the option if the property value exceeds the option price. In this circumstance, it is always possible for a court to find a harsh bargain or forfeiture. Yet, this analysis would be more sensible if determined at the time the option is granted. However, as exemplified by the *Humble* court, some courts are creative in their search for forfeitures. Clearly then, a more precise theoretical basis is needed for the clogging rule. Two approaches are commonly employed: one based on the particular

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[79] *Id.*

[80] 255 Wis. 192, 38 N.W.2d 705 (1949).

[81] *Id.* at 194, 38 N.W.2d at 706.

property rights involved; the other, concerned with the underlying policy bases of the rule.

A. Property Based Distinctions: "The Three Rules"

Osborne[82] apparently adopted Lord Davey's classification[83] of the doctrine as encompassing the following three rules: "once a mortgage, always a mortgage," the rule against collateral advantages, and the rule against fetters.[84]

The first of these rules stands for the proposition that the equitable right of redemption is an inseparable incident of any mortgage.[85] Analytically, this provides a helpful starting point.[86] If we can define a mortgage, it should be straightforward enough to proceed to a definition of a redemption right. This was the approach taken by the court in *Batty v. Snook*.[87] In *Batty*, the court concluded that a conditional sales contract executed in connection with a pre-existing mortgage held by the vendor as mortgagee, coupled with a deed from the contract vendee to the contract vendor, which purportedly conveyed the property in satisfaction of the pre-existing mortgage indebtedness, was an equitable mortgage because the deed was intended as security. Therefore, a "time is of the essence" clause that resulted in a forfeiture was an invalid attempt to deprive the vendee of his equity of redemption:

> The mortgagor may release the equity of redemption to the mortgagee for a good and valuable consideration, when done voluntarily, and there is no fraud, and no undue influence brought to bear upon him for that purpose by the creditor. But it cannot be done by a cotemporaneous [sic] or subsequent executory contract, by which the equity of redemption is to be forfeited if the mortgage debt is not paid on the day stated in such contract, without an abandonment by the court of those equitable principles it has ever acted on in relieving against penalties and forfeitures.[88]

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[82] 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.58.

[83] *See* Noakes & Co. v. Rice, [1902] App. Cas. 24. *See also* 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.58.

[84] *See* Noakes & Co. v. Rice, [1902] App. Cas. 24.

[85] *See* 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.59.

[86] *But see supra* note 56. This rule was developed to invalidate clauses that waived the right of redemption, or that attempted to make time of the essence in the exercise of redemption. Thus, it becomes less helpful as it is applied to indirect clogs on the redemption right.

[87] 5 Mich. 231, 239-40 (1858).

[88] *Id.* at 239-40.

This reasoning typifies numerous American cases which, when ascertaining the intent of the parties and finding an intent to secure an indebtedness, have equated any attempt by the lender to avoid judicial foreclosure or create a forfeiture by the borrower as an attempt to deprive the borrower of the equity of redemption.[89] The problem with this analysis is that once a mortgage transaction is found, the remaining logic is inexorable. Since an indebtedness can only be an obligation to pay money plus interest,[90] it necessarily would follow that any other benefit must flow from the equity of redemption. This logic is worth pondering. Apparently, the lease-leaseback in *Humble* fell victim to this logic.

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[89] *See, e.g., In re* Ellis, 674 F.2d 1238, 1246-47 (9th Cir. 1982) (deed with disfeasance clause a redeemable mortgage); Merryweather v. Pendleton, 91 Ariz. 334, 344, 372 P.2d 335, 340 (1962) (sale of stock with repurchase option intended as mortgage to avoid foreclosure process); Bowling v. Duff, 272 S.W.2d 805, 806 (Ky. 1954) (deed with leaseback and repurchase option indicates intent of mortgage to secure a debt); Mills v. Reneau, 411 P.2d 516, 519 (Okla. 1965) (mineral deed in separate agreements given as security for debt and intended to be defeasible). *See generally* 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.59 (discussing cases where intent of parties determined equity redemption rights); cases cited in 4 J. POMEROY, *supra* note 5, at § 1193 (intent creates mortgage regardless of form and stipulations).

[90] This notion must have been considered an enlightened restriction on the activities of moneylenders, who have been viewed with suspicion for thousands of years. *See generally* Hershman, *Usury and the Tight Mortgage Market*, 22 BUS. LAW. 333 (1967) (discussing the unique combination of history and theology antedating usury laws). Yet it appears extraordinarily rigid when superimposed upon modern notions relating the value of money to the goods it can buy at the moment, rather than to some absolute standard. This is particularly true in the context of the institutionalized inflation that has typified much of the economics of the late twentieth century. The reasons for the apparent rigidity of this idea that indebtedness can only comprise principal plus a fixed rate of interest are also tied up in the modern conception of the time value of money. In the modern framework, interest may be viewed as having two components. One component is the payment for the use of money in recognition of the fact that capital is productive. The second component of interest is that portion of a payment for the use of money that compensates the lender for the erosion of principal caused by inflation. Underlying these two components of interest are implicit allocations of risk. The borrower assumes the risk of being unable to employ the funds borrowed so as to generate profits above the interest rate. The lender assumes the risk of the debtor's insolvency. This risk can be reduced if the loan is secured by sufficiently valuable collateral, although it will obviously remain a substantial risk to the extent that property values fluctuate. The financial risk represented by the prospect of debtor insolvency may well pale in comparison to the nearly unlimited risk represented by the prospect of runaway inflation. *See generally* P. SAMUELSON, ECONOMICS 598-619 (10th ed. 1976) (discussing reasons why this paradigm is oversimplistic for other purposes). *See also* Olwine v. Torrens, 236 Pa. Super. 51, 344 A.2d 665 (1975) (risk of dollar depreciating not eliminated by making loan repayment contingent on relative purchasing power). If creditors could obtain appropriate inflation hedges, a more rational risk allocation for inflationary times could result. But the idea that an indebtedness should be only an obligation to pay money plus interest forces the modern financier to work with antiquated tools.

Therefore, the key inquiry is in determining whether or not a mortgage exists. The rule is that if the conveyance is intended as security, an equitable mortgage will be found. If there is any doubt, the continued existence of a debt will favor the finding of a mortgage.[91]

In this framework, the collateral advantage has its usual meaning: a benefit given the lender in addition to interest as consideration for the loan. Fetters are a special type of collateral advantage that outlive the loan.[92]

Unfortunately, a number of cases do not fall neatly into these analytical categories. In *Hopping v. Baldridge*,[93] the Oklahoma Supreme Court used a clogging rationale to hold that a mortgagee's ten year option to buy a fifty percent interest in oil and mineral rights was extinguished when the mortgagor paid off the loan. It is not clear whether the option would have survived scrutiny in the absence of prepayment of the loan. A more liberal but equally uncategorizable approach is illustrated by *Smith v. Smith*,[94] in which the New Hampshire Supreme Court granted specific performance of a mortgagee's option to buy a house in the event of the mortgagor's death or sale of the premises. The court characterized the arrangement as a legitimate collateral advantage. However, the court may have been influenced by the fact that the mortgagee was the mortgagor's son.

The limited usefulness of the property-based distinction between a good collateral advantage and a clog on the equity of redemption or a "bad collateral advantage" becomes clear when we try to classify a non-assignable option to repurchase in the hands of an equitable mortgagor. This was the problem in *Hill v. Day*.[95] Brown deeded a farm worth $40,000 to Hill for $19,500 in cash, additional consideration worth $500 and a five year non-assignable option to repurchase the property for $20,000 plus interest. The agreement provided that any profits generated by the farm were to be credited to Brown's option price. Brown sold his interest to Day, who sought to "redeem" by exercising Brown's option. Since the profit arrangement was inconsistent with an intention for an outright sale, the court had no difficulty finding that the Brown-

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[91] 4 J. POMEROY, *supra* note 5, § 1195 at 577.

[92] 4 AMERICAN LAW OF PROPERTY, *supra* note 3, § 16.61 at 112-13.

[93] 130 Okla. 226, 232, 266 P. 469, 472 (1928).

[94] 82 N.H. 399, 135 A. 25 (1926).

[95] 231 Ark. 550, 331 S.W.2d 38 (1960).

Hill transaction was an equitable mortgage. This meant that Brown's option was in fact a redemption right. What, then, becomes of the non-assignability clause? It is void, the court said, because it has the effect of blocking a redemption right. Apparently, the court was not overly concerned that the non-assignability clause in no way prevented Brown from redeeming his property directly. Nor was the court concerned that, in substance, it was holding a non-assignable mortgage to be in violation of the clogging rule. This has been the problem with the post-*Jennings* effect-based holdings.[96]

The failure of property theory to delineate and define the clogging doctrine heightens the importance of policy-based analyses. Several approaches have been suggested.

B. Underlying Policy Supports for the Rule

The most often cited policy basis for the clogging doctrine is equity's abhorrence of forfeitures.[97] This is an adequate reason to invalidate a "time is of the essence" clause, but it is clearly inappropriate when dealing with a mortgagee's option that is a component of a legitimate business deal. Until a non-forfeitable equity of redemption is found, the mortgagor has no interest to forfeit. Thus, if an option is granted with an intent to evade foreclosure by conditioning exercise on the mortgagor's default, finding a forfeiture in the option's exercise protects the legitimate expectations of the parties. However, when a purchase option is granted to a mortgagee in the context of a fairly bargained commercial transaction, the mortgagor cannot have a legitimate expectation of an equity of redemption in the property subject to the option and no forfeiture should result from the option's exercise.

An eloquent alternative explanation, apparently based on protecting mortgagors from their own overconfidence, was phrased as follows: "[W]hen duress of circumstance and mistaken self-confidence combine they have won complete recognition in a rigid rule of nullification, while either of these elements standing alone has won but partial recognition, in the rule of particular equities."[98]

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[96] The problem, simply, is that any burden placed upon the debtor may have the effect of impeding redemption, although the effect may be remote.

[97] *See, e.g.*, Batty v. Snook, 5 Mich. 231, 240 (1858).

[98] Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646, 648-49 (1921).

This is an adequate basis for explaining cases that void attempts to circumvent foreclosure proceedings, but again fails to justify the invalidation of a mortgagee's option to purchase when granted in the context of an arms-length business deal. A mortgagee will exercise the option if there is a significant rise in the value of the property, assuming a fixed and fairly bargained exercise price which is hardly an unfortunate turn of events for the mortgagor.

A third viewpoint treats the clogging doctrine as an aspect of enlightened social policy. Thus, an early twentieth century commentator analyzed the rule as protection for the continuing existence of unrestricted alienation rights for property owners.[99] However, the author failed to recognize that an option is one method of effecting the alienation of property. The moral overtones lurked nearby: "[T]o the writer the doctrine against the clog on the equity of redemption seems one of the striking examples of the great truth that the ethical standard of our law is often higher than the average morality of the commercial community."[100] This viewpoint embraces the property-based distinction upon which the doctrine is founded and invests it with "righteousness." As an analytical prediction of case law it is a perfect tautology. However, as a guide to how the law will be or should be, it has limitations. Undoubtedly, the clogging rule was enlightened policy at the time of its birth, but with changed financing practices the morality of this rule discourages the availability of real property mortgages. Thus, it seems that the primary effect of the clogging rule today is to introduce uncertainty into the law of mortgages. It would be difficult to establish that the present utility of the rule serves its original purposes.

VI. Clogging, Usury and Unconscionability

Clearly, the doctrines of usury and unconscionability are closely related to each other. Both bear a close historical and doctrinal relationship to clogging, as well. In *Kreglinger*, it was suggested that the clogging doctrine as applied to collateral advantages was a result of the equity courts' enthusiasm for supple-

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[99] *See* Wyman, *supra* note 56, at 474, where the author states "[a]nd there is in the eye of equity a fetter upon his property if the covenant . . . will, after redemption, hamper [the owner's enjoyment of the property]. . .or hinder him in the disposition of it." *Id.*

[100] *Id.* at 475.

menting the usury laws.[101] As will be discussed, the relationship between unconscionability and clogging is even closer.

A. *Clogging and Usury: The Historical Link*

The chronology of the English usury laws lends credence to assertions found in *Kreglinger* that the rule against collateral advantages was an expression of equity's support for the enforcement of those statutes.[102] The harshness of this disapproval is probably as significant as the zealousness with which the laws were enforced. In the middle ages, any charge of interest was considered usury. Usurers were not only liable to church censure, but their chattels forfeited to the king and their lands escheated to the lord of the fee upon death.[103] An early English law book even lamented the fact that usurers were permitted to be buried in sanctuaries.[104]

The discovery of the New World either caused or coincided with a softening of this viewpoint.[105] Henry VIII legalized interest up to ten percent per annum in 1545.[106] This statute was repealed, however, in 1552[107] and then reinstated in 1570.[108] Complaints about this high rate[109] led to sequential reductions in the maximum rate, to eight percent in 1623,[110] then six percent in 1660,[111] and finally five percent in 1713 by the Statute of Anne.[112]

Maximum legal interest in England remained at five percent until 1854, when all usury laws were repealed.[113] Dating the birth

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[101] Kreglinger v. New Patagonia Meat & Cold Storage Co., 109 L.T.R. (n.s.) 802, 812. This is not surprising in view of the obvious potential for evasion of usury laws through the granting of collateral benefits to the lender. But modern courts will place a value on the benefit and then evaluate whether the total remuneration exceeds usury limits—thus obviating the need for a supplementary doctrine. *Cf.* Roegge, *supra* note 8, at 624, where the authors discuss the problems created by the modern approach.

[102] *Kreglinger*, 109 L.T.R. (n.s.) at 805.

[103] 66 C.J.S. *Usury* § 5 (1934).

[104] *See* Schlesinger v. State, 195 Wis. 366, 370, 218 N.W. 440, 442 (1928).

[105] Hershman, *Usury and the Tight Mortgage Market*, 22 BUS. LAW. 333, 335 (1967).

[106] A Bill Against Usury, 37 Hen. 8, ch. 9 (1545).

[107] 5 & 6 Edw. 6, ch. 20 (1552).

[108] An Act Against Usury, 13 Eliz., ch. 8 (1570).

[109] 66 C.J.S. *Usury* § 5 (1934).

[110] An Act Against Usury, 21 Jac., ch. 17 (1623).

[111] An Act for the Restraining the Taking of Excessive Usury, 12 Car. 2, ch. 13 (1660).

[112] An Act to Reduce the Rate of Interest, Without any Prejudice to Parliamentary Securities, 12 Anne stat. 2, ch. 16 (1713).

[113] An Act to Repeal the Laws Relating to Usury and to the Enrollment of Annuities, 17 & 18 Vict., ch. 90 (1854). For a general overview of the history of usury, see Union Savings Bank & Trust Co. v. Dottenheim, 107 Ga. 606, 610-16, 34 S.E. 217, 219-20 (1899); Plitt

of the clogging doctrine at 1639,[114] it is fair to conclude that the doctrine evolved during a period when the commercial need to permit the charging of interest was vying with public attitudes that kept a tight lid on permissible rates. By the late nineteenth century, English attitudes had become more accepting of free trade in money.[115] In that sense, the stage had been set for *Kreglinger*.

Until recently, the American legal attitude towards high rates of interest might be best characterized as ambivalent. Thus, in 1933, the North Carolina Supreme Court made its position perfectly clear: "There is nothing more obnoxious than usury. . ."[116] However, a New York trial court struggled, in 1905, with the inequity of its own judgment, in awarding principal as well as interest to plaintiff, under the usury law of the day: "All oppression . . . is immoral *per se* . . . but a charge of more than the lawful rate of interest, where there is no actual oppression, cannot be said to be in and of itself immoral."[117]

In the 1980s, it seems clear that interest rates are no longer a moral issue in the United States. Considering that usury laws are largely regulatory in the modern view, a realignment of the American clogging doctrine to reflect modern realities seems appropriate.

B. Policy and Theory: Similar Themes for Clogging and Usury

The policies underlying usury laws are almost identical to those that motivate the clogging doctrine: "There is no need, at this late date in the law of usury to discuss its rationale. Suffice to say that its purpose is to protect the necessitous borrower from extortion." (citations omitted)[118]

Further, the factual situations encountered often bear a resemblance to those in which the clogging doctrine has been applied. Thus, in *Kawauchi v. Tabata*,[119] plaintiff owned property worth between $300,000 and $400,000. It was sold to defendants for $90,000 and leased back with a three year repurchase option at

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v. Kaufman, 188 Md. 606, 610, 53 A.2d 673, 675 (1947); Dunham v. Gould, 16 Johns. 367, 376 (1819).

[114] *See* 4 AMERICAN LAW OF PROPERTY, *supra* note 3, at § 16.58.

[115] *See* National Bank of the Commonwealth v. Mechanics' Nat'l Bank, 94 U.S. 437, 438 (1876); Hershman, *supra* note 105.

[116] Dixon v. Osborne, 204 N.C. 480, 486, 168 S.E. 683, 686 (1933).

[117] Hagaman v. Reinach, 48 Misc. 206, 213, 96 N.Y.S. 719, 724 (Sup. Ct. N.Y. County 1905).

[118] Wilcox v. Moore, 354 Mich. 499, 504, 93 N.W.2d 288, 291 (1958).

[119] 49 Hawaii 160, 413 P.2d 221 (1966).

$117,000, with plaintiff remaining in possession. The court found this to be a loan, and usurious. Redemption was ordered for $90,00 plus one percent interest at the maximum rate allowable by law.[120] The court might have found that the sale-leaseback was an equitable mortgage and order redemption on the grounds that the limited life of the repurchase option transaction was an invalid attempt to preclude redemption. But the usury analysis is superior since it focuses on the true nature of the injustice—which is the amount of the enrichment going to the lender, not its underlying character as a property interest.

The theoretical analysis of a usury case begins at the same place as a clogging claim: Is there in fact a loan? This is determined by reference to the intent of the parties in light of the circumstances.[121]

However, once beyond this always uncertain analysis of intent, the logic of usury laws heads for solid ground by inquiring as to the amount of benefit accruing to the lender. This is an obviously superior approach to the clogging doctrine's examination of effects upon redemption rights since it introduces an element of certainty to the legal determination.

Further, a usury-based approach is unlikely to find a "forfeiture" of the *Humble* variety due to post-contract appreciation in value, assuming that the lender has fairly bargained for the benefit of this appreciation. The Arizona Supreme Court explained this succinctly: "The theory . . . is that where the lender risks the principal with the chance of . . . getting a greater return than the lawful interest rate . . . there is no usury, since '[u]sury laws do not forbid the taking of business chances in the employment of money.' "[122]

The theory implies rather directly that to the extent a mortgagee's option is a usurious benefit, the determination would have to be made as of the time the contract granting the option was made.[123]

Arguably, the relaxation of usury laws in recent years would

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[120] *Id.* at 190, 413 P.2d at 236.

[121] *See* Swallow Ranches, Inc. v. Bidart, 525 F.2d 995, 998 (9th Cir. 1975).

[122] Britz v. Kinsvater, 87 Ariz. 385, 392, 351 P.2d 986, 991 (1960) (quoting RESTATEMENT, CONTRACTS, § 527, comment a (1956); Owens v. Conelly, 77 Ariz. 349, 272 P.2d 345 (1954)).

[123] *Cf.* Roegge, *supra* note 8, at 626 (where concern is expressed that the courts might not follow this approach).

limit the effectiveness of the usury approach as a substitute for the clogging rule. However, this cuts both ways. We live in an era when relatively high interest rates are deliberately fostered in order to control inflation. It makes scant sense for an equitable doctrine largely developed to supplement usury laws to operate at cross purposes with the policy underlying the relaxation of the usury laws.

On balance, then, usury laws seem more capable than the clogging doctrine of controlling much of the lender overreaching.[124] However, since usury laws look to amount, rather than the form of benefit conferred, they would not be terribly helpful in preventing unwitting small property owners from signing away their ownership interests. However, this is the sort of situation for which unconscionability doctrines are designed.

C. Unconscionability and Clogging: Close Theoretical Relatives

The mere mention of the term "unconscionability" should trigger concern for definitions. When considering the overlap between the clogging doctrine and the law of unconscionability, this concern is doubly necessary. The concept of unconscionability is a major underpinning of most equitable doctrines.[125] This is obviously true with respect to the clogging doctrine.

It is useful to recognize that the term unconscionability is employed in two somewhat distinct senses.[126] First, it denotes the general ethical basis from which specific equitable doctrines have

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[124] Usury laws sensibly focus on the value of the economic benefit received by the lender. All benefits, including options, have value. Therefore, the usury approach should be capable of regulating options, except those options that are specifically designed to "thwart equity." Of course the "equity-thwarting" option will *never* be found in an arms-length business deal.

Some states recognize that lenders are adequately regulated through market forces. These states provide usury law exemptions for categories of transactions with minimal potential for lender overreaching. For example, in New York, corporations are prohibited from interposing a civil usury defense. N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1978). Further, loans for amounts exceeding $250,000 are exempt from civil usury restrictions. If the amount exceeds $2,500,000, criminal usury restrictions are removed as well. *Id.* at § 5-501(6) (McKinney Supp. 1984-1985). Illinois takes a slightly different approach. Loans to corporate borrowers are generally not subject to any interest rate regulation. ILL. ANN. STAT. ch. 74, § 4(a) (1966); Business purpose loans are similarly generally exempt from usury limits. *Id.* Why not create either a business purpose exemption or an amount-based exemption to the clogging rule? *See* discussion *infra*, Part IX, for a discussion of New York's recent legislation.

[125] J. CALAMARI & J. PERILLO, CONTRACTS 318 (1977).

[126] *Id.* at 320.

emerged and crystallized.[127] In this sense, it is entirely legitimate to view the clogging doctrine as a type of *per se* unconscionability.[128]

However, the term is more often used to denote the direct application of these ethical precepts to specific fact patterns. Viewed in this fashion, it seems somewhat disingenuous to bolster a clogging holding with an alternative holding of unconscionability, as was done in *Humble*. If a clog is found, it should follow as a logical point that the underlying contract is unconscionable. To present unconscionability as an alternative ground for the holding is to tacitly admit that the clogging rule has outstripped its ethical underpinnings.

Perhaps this goes to the heart of why the dog is unruly, in Lord Mersey's terms.[129] When the doctrine against clogging evolved, the sort of large arms-length transaction that occurred in *MacArthur* could not have been envisioned. It may have been very logical in an age of small individual mortgagees to crystallize a category of transactions and brand them as offensive.

The holding in *Humble* is an excellent illustration of how complete the overlap between clogging and unconscionability can be.[130] *Barr* is equally understood when considered as a general unconscionability holding-particularly since clogging was never mentioned.

D. *Modern Theories of Unconscionability*

A variety of theories have been proposed for the application of the unconscionability doctrine since it found its way into the UCC. Leff observed that "UCC unconscionability" is particularly appropriate to the mass market, since its emphasis on deviation from a norm was well suited to form contracts.[131] This was to be distin-

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[127] *Id.* at 319.

[128] This seems particularly apt when considered along with the cryptic language in *Jennings*, 23 Eng. Rep. at 935, discussed *supra* note 22 and accompanying text.

[129] Kreglinger v. New Patagonia Meat & Cold Storage, 109 L.T.R. (n.s.) 802, 808 (1914).

[130] This is not to say that the unconscionability holding in *Humble* is beyond criticism. In light of the court's conclusion that the defendant understood the nature of the option and even bargained over the option price to a limited extent, it seems debatable that the granting of a purchase option for 50% more than the value of the station at the time of entering into the contract is so harsh as to be unconscionable. Ostensibly, the holding turned upon the short term of the leaseback to the defendant. Yet, the deal obviously would not have been enforced were it not for the existence of the option.

[131] Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L.

guished from equitable unconscionability, which was, in his view, more appropriate for unique items such as real estate. He further subdivided the concept into procedural or bad conduct and substantive or bad result unconscionability.[132] While it is debatable whether courts accept this distinction,[133] it is useful for descriptive purposes. At a minimum this approach would seem to be theoretically suitable for preventing mortgagors from signing away their redemption rights without changing the result in cases, such as *MacArthur*, which did not involve bad conduct or bad result.

Ellinghaus suggested that in some circumstances the nature of the bargain itself, without reference to the behavior of the parties, could trigger a holding of unconscionability.[134] Unfortunately, this reasoning with its *per se* emphasis was probably responsible for the modern clogging confusion. But, even so, the facial analysis of a mortgage transaction for injustice is more rational than a property analysis in the clogging context, since it appears less likely to cause injustice.

Eisenberg proposed that the unconscionability doctrine should be applied to contracts in four situations, which he termed *distress, transactional incapacity, unfair persuasion* and *price ignorance*.[135] *Distress* would cover forms of virtual duress that do not include wrongful conduct by the plaintiff.[136] *Transactional incapacity* would include situations that stop far short of true contractual incapacity.[137] It typically would protect an ignorant party who entered a highly complex commercial transaction and was fleeced in the process. *Unfair persuasion* would protect victims of undue influence in the absence of a confidential relation.[138] His final category proposes that exploiting *price ignorance* in some circumstances might also be unconscionable.[139]

These categories paint a fairly comprehensive picture of the

REV. 485, 489 (1967).

[132] *Id.*

[133] *See* 1 A. CORBIN ON CONTRACTS § 128 (1951 and Supp. 1984).

[134] Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757, 789 (1969). *Compare In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 874 (E.D. Pa. 1966) (unfair conduct must be present) *with* Campbell Soup Co. v. Wertz, 172 F.2d 80, 84 (3d Cir. 1948) (a harsh bargain is enough).

[135] *See generally* Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 741 (1982).

[136] *Id.* at 754-55.

[137] *Id.* at 763-73.

[138] *Id.* at 773-78.

[139] *Id.* at 778-85.

directions we are likely to see in the future development of the law of unconscionability. As a gauge of the likely outer limits of the unconscionability doctrine, it is worth noting that the first three categories would seem capable of completely supplanting the clogging doctrine in situations involving a genuinely unfair sort of deal. However, unlike the clogging doctrine, this relatively activist approach to unconscionability appears to allow businessmen to continue to strike reasonable bargains.

E. Applying Unconscionability to Mortgages

Goldstein, after briefly touching upon much of the same material discussed *supra* at part VI D,[140] noted that *Humble's* unconscionability holding rests in part on a New Jersey Supreme Court case that applied UCC section 2-302.[141] Thus, he suggests that in a limited sense, UCC unconscionability has already crept into the law of clogs. This analysis concluded that there are three separate meanings ascribed to unconscionability:

1. Surprising and oppressive digressions from a norm in contract formation (the UCC concept).
2. Fair dealing in performance.
3. The traditional equity concept of not sanctioning a harsh result.[142]

In this framework, it should be clear that the modern law of unconscionability is well equipped to assume the burden of regulating those transactions that are truly unfair, without impeding legitimate activities. Unconscionability has been used to support the invalidation of an exorbitant interest charge.[143] This suggests that the doctrine might satisfactorily supplant any residual usury prevention aspects of the clogging rule.[144]

Case law applying an unconscionability rationale to redemption rights is nearly always done in tandem with inevitable prop-

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[140] *See generally* Goldstein, *Unconscionability: Some Reconsiderations with Particular Reference to New Type Mortgage Transactions*, 17 REAL PROP. PROB. & TR. J. 412 (1982) [hereinafter Goldstein]. Mr. Goldstein's article, cited herein, suggested some of the comparisons made in the text accompanying notes 132-40 *supra*.

[141] *Id.* at 416. *Humble* approvingly cites Ellsworth Dobbs, Inc. v. Johnson, 50 N.J. 528, 236 A.2d 843 (1967). *Id.*

[142] Goldstein, *supra* note 140, at 417.

[143] *See, e.g.*, American Home Improvement, Inc. v. MacIver, 105 N.H. 435, 201 A.2d 886 (1964).

[144] *See* Kane, *The Mortgagee's Option to Purchase Mortgaged Property*, in FINANCING REAL ESTATE DURING THE INFLATIONARY 80S 123, 126 (A.B.A. 1981)

erty analysis.[145] However, the reasoning of *Humble* certainly implies that the unconscionability doctrine is every bit as broad as a genuinely oppressed mortgagor might wish.

It is difficult to understand the survival of the clogging rule in light of the potential power of the unconscionability doctrine. Perhaps, it reflects the courts' reluctance to rule forthrightly based on unconscionability alone, which typified sale of goods transactions prior to UCC section 2-302.[146] This suggests that enactment of ULTA section 1-311,[147] which is similar to UCC section 2-302, might be a useful and appropriate adjunct to reform of the clogging rule.

VII. THE ENCROACHMENT OF THE CLOGGING DOCTRINE UPON MODERN TRANSACTIONS

Generally, despite the doctrine's broad language, American

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[145] *But see* Bunbury v. Winter, 37 Eng. Rep. 372, 375 (1820) (redemption denied because there was no unfairness in the arrangement). *See also* Bogerding Inv. Co. v. Larson, 284 Minn. 371, 170 N.W.2d 322 (1969) (apparent clog on the equity of redemption invalidated largely on unconscionability grounds).

[146] *See* J. CALAMARI & J. PERILLO, *supra* note 125, at 317.

[147] Unif. Land Transactions Act § 1-311, 13 U.L.A. 502 (1986). The section reads as follows:

> [Unconscionable Agreement or Term of Contract]
>
> (a) The court, upon finding as a matter of law that a contract or contract clause was unconscionable at the time the contract was made, may refuse to enforce the contract, enforce the remainder of the contract without the unconscionable clause, or limit the application of any unconscionable clause in order to avoid an unconscionable result.
>
> (b) Whenever it is claimed, or appears to the court, that a contract or any contract clause is or may be unconscionable, the parties, in order to aid the court in making the determination, shall be afforded a reasonable opportunity to present evidence as to:
>
> (1) the commercial setting of the negotiations;
>
> (2) whether a party has knowingly taken advantage of the inability of the other party reasonably to protect his interests by reason of physical or mental infirmity, illiteracy, or inability to understand the language of the agreement, or similar factors;
>
> (3) the effect and purpose of the contract or clause; and
>
> (4) if a sale, any gross disparity, at the time of contracting, between the amount charged for the real estate and the value of the real estate measured by the price at which similar real estate was readily obtainable in similar transactions, but a disparity between the contract price and the value of the real estate measured by the price at which similar real estate was readily obtainable in similar transactions does not, of itself, render the contract unconscionable.

Id.

courts have reached just results in given situations. However, arguments to extend the clogging doctrine into less appropriate transactions continue to surface.

In *Powell v. Bastian*,[148] plaintiff owned a home subject to approximately $13,000 in encumbrances. Facing foreclosure, she deeded the property to defendant for $16,000 and retained an option to repurchase it for $18,000 within 3 months. She found a buyer willing to pay $20,500, exercised the option, made a $2,500 profit on the deal, and sued for damages. Judgment was rightly for defendant, but a vigorous dissenting opinion maintained that the transaction was usurious, unconscionable and a clog on her equity of redemption.[149]

The rumblings extend quite far afield from sales with repurchase options. Concern exists that clogs might be found in the entire gamut of modern real estate financing techniques. Potential targets of attack include convertible mortgages, shared appreciation mortgages,[150] variable rate mortgages[151] and due-on-sale clauses.[152]

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[148] 541 P.2d 1127 (Utah 1975).

[149] *Id.* at 1132. (Maughan, C.J., dissenting). Here, the structure of the transaction (sale with repurchase option) invited the application of the clogging rule, since, if it was intended to be a loan, an equitable mortgage should have been found. *Id.* at 1130-1131 (Maughan, C.J., dissenting). However, distinguishing intent to make a loan from some other intent can be problematic. As the dissent demonstrates, once the loan intent is found, clogging, usury and unconscionability follow naturally. *Id.* at 1129-1132 (Maughan, C.J., dissenting).

[150] Convertible mortgages and shared appreciation mortgages have been described previously in the text. *See supra* note 13, and the discussion in Part II.

[151] Variable rate mortgages are a class of long term mortgage instruments in which the interest rate is tied to some index (typically, the index might be based on the prevailing market rate for funds or the institution's cost of funds). An initial interest rate is set, and periodic upward or downward adjustments are made according to an agreed schedule (more complex formulae are of course also possible). Like SAMs, the actual future payment amounts are unknown when the loan is consummated. Maximum limits on the size of adjustments may be included in the loan contract. Also, as in the case of SAMs, variable rate mortgages are often touted as inflation protection for the lender. However, unless the index employed is in fact related to the inflation rate, it is more precise to consider variable rate instruments as providing protection against fluctuations in the cost of money. This is an important distinction considering the recent past, in which high real interest rates have been associated with relatively low inflation rates. Aside from the clogging and unconscionability issues that may arise from large increases in payment amounts, these instruments must be examined for potential conflicts with usury ceilings, state and federal regulations of form and content, and possible restrictions on capitalization of interest. *See generally* Levin and Roberts, *supra* note 13.

[152] A mortgage may contain a due-on-sale clause, which gives the mortgagee the right to accelerate payment of the mortgage if the mortgagor sells or conveys the land without the written consent of the mortgagee. Such a clause simply allows the lender to accelerate ma-

However, the most worrisome transaction is the large real estate joint venture. Here, both mortgage and equity are intrinsic to the deal. When real estate joint ventures were in their infancy, the equity interest taken by the institutional investor may well have been viewed by developers as an inducement for a mortgage loan. Yet today, it is more realistic to treat the mortgage as an inducement for the developer to go into what is fundamentally an equity deal. Institutional investors bring expertise and expectations to the modern joint venture that reflect an interest in sharing profits, risk of loss, and the possibility of appreciation from the outset.[153] It makes little sense to apply the clogging rule here because the very structure of the deal argues against an inference of lender overreaching. Nevertheless, a typical joint venture is vulnerable to the logic of the clogging doctrine, since any equity interest obtained by a mortgagee would seem to be incompatible with the notion "once a mortgage, always a mortgage."[154]

One method by which a joint venture might avoid the reach of the clogging rule would be the use of corporate form,[155] but incorporation will generally be economically unacceptable to a real estate joint venture.[156] The only escape would appear to be the legitimate joint venture exception, occasionally alluded to,[157] but never

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turity if an unauthorized sale takes place. R. KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE § 125 (1972).

[153] *See* Roegge, *supra* note 8, at 597-98.

[154] *See* 4 J. POMEROY, *supra* note 5, at § 1193.

[155] As Norstrand points out, hybrid debt-equity financing is well accepted in corporate law because the instruments themselves are statutorily authorized, despite the fact that comparable real property mortgages might be found to be clogs on the equity of redemption. Norstrand, *supra* note 16 at 29. However, hybrid instruments would not necessarily be required to set up a real estate joint venture in corporate form—"garden variety" debt instruments, preferred and common stock would often suffice. It follows that these less exotic but no less statutorily authorized instruments would be similarly immune from clogging attack.

[156] *See* Roegge, *supra* note 8, at 597-98.

[157] The court in *Humble* suggested that such an exception would not be inconsistent with its own reasoning: "Different rules may also apply where an oil company is a true joint venturer with the owner-lessor or where it started out as the owner of the property." 123 N.J. Super. 530, 559, 303 A.2d 898, 913 (Super. Ct. Ch. Div. 1973).

In *Kreglinger*, there is dicta directly suggestive of such an exception to the rule. The Lord Chancellor took the position that the doctrine should not be a crystallized technical rule but should be applied with a view towards the policies underlying it. He stated that an arrangement "to take permanently into the firm a new partner as a condition of obtaining fresh capital in the form of a loan" was "plainly collateral" and therefore permissible. Kreglinger v. Patagonia Meat & Cold Storage Co., 109 L.T.R. (n.s.) 802, 806 (1914). Lord Parker, whose position was more technical than the Lord Chancellor's, felt that the rule was primarily designed to prevent penalties in mortgage transactions and, as such, was a rule of

directly ruled upon.

Some comfort can be taken from cases that have seemingly more or less exempted the joint venture from usury laws.[158] However, the case law does not go so far as to "exempt" loans executed in the context of a joint venture. Rather, the cases reiterate the propositions that usury laws only apply to loans, and a joint venture is not a loan.[159]

A student comment points out that there is an inherent clog in the shared appreciation mortgage, or SAM.[160] SAMs come in a variety of forms, but generally function so as to give the borrower a low initial rate of interest. This is accomplished by granting the lender a portion of the appreciation in value of the property which is called interest, and payable either upon sale or upon refinancing.[161] Unfortunately, if the property appreciates too much in value, this could be detrimental to the borrower. Upon refinancing the mortgage, the higher payments necessary to pay the bank its "appreciation" could force a forfeiture of sorts, since the borrower might be forced into sale or default. Even though the borrower would walk away from the foreclosure with cash from a proportionate share of the appreciation as well as any initial investment, it is difficult to predict how an equity court might respond to what seems like a combination of "duress of circumstance and mistaken self-confidence."[162] SAMs also have a theoretical problem because they grant a contingent interest contract right to the lender that behaves very much like an equity interest.

It has also been suggested that the due-on-sale clauses may violate the clogging rule.[163] The argument is that the borrower's

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intent effectuation. He hypothesized a person lending money to a firm secured by a mortgage on partnership property in return for an option to buy a partnership interest for the loan balance. This, he reasoned, was something "more complex" than a mortgage. *Id.* at 810. Therefore, the rule should not be applied. Thus, two leading authorities that otherwise appear irreconcilable would seem to leave room for agreement that a mortgagee's option to purchase a partnership interest that is granted as part of an arrangement to admit a new partner to the partnership *should not* be invalidated by the clogging rule.

[158] *See, e.g.*, Stark v. Bauer Cooperage Co., 3 F.2d 214 (6th Cir. 1925); Orvis v. Curtis, 157 N.Y. 657, 52 N.E. 690 (1899).

[159] "[I]t is not seen how such an arrangement as this is obnoxious . . . . It is . . . a joint adventure." *Stark*, 3 F.2d at 217; *see also Orvis*, 157 N.Y. 657, 52 N.E. 690 (1899) (joint venture not founded upon loan thus usury inapplicable as defense).

[160] Comment, *supra* note 13.

[161] *Id.* at 150. *See supra* note 13 for a more detailed discussion of these instruments.

[162] Note, *supra* note 98, at 648-49.

[163] Falk, *Due-On-Sale Clauses and Clogging the Equity of Redemption*, 36 WASH. & LEE L. REV. 1121, 1124 (1979).

ability to sell his equity of redemption is an incident of ownership and thus, any inhibition of that right is a forfeiture of sorts. This reasoning has not won court acceptance, but at least one dissenting opinion has embraced it.[164]

A due-on-sale clause does not prevent a borrower from tendering payment in foreclosure or from selling. However, the argument propounded is not a very large leap from *Hill v. Day*,[165] where non-assignability of an option was considered a clog. Thus, it would not be surprising if this theory resurfaces.

Overall, we are confronted with a state of the law that is fraught with uncertainty concerning the more innovative recent developments in real estate finance. Even the adjustable rate mortgage would seem to be subject to attack. Consider a recent comment by a specialist in the field: "They [adjustable rate mortgages] encourage people to over-commit and think they can manage something they can't."[166] This comment sounds like a policy argument for applying the rule against clogs.[167] However, the area of greatest concern to the real estate practitioner should be the enforceability of a mortgagee's option to buy an interest in the secured property.

VIII. Living With the Rule

Kane analyzed the American case law alongside *Kreglinger* and concluded there were two paths an investor might realistically follow to skirt the perimeters of the clogging doctrine.[168]

The first approach would apply to transactions where there is a genuine intent to sell and purchase with an incidental mortgage. In this scenario, the mortgagor might genuinely wish to sell his property at a later date for some sound reason, such as delaying recognition of a capital gain. Similarly, the mortgagee-purchaser may wish to delay purchase in order to observe the progress of a

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[164] Lincoln Mortgage Invs. v. Cook, 659 P.2d 925, 930 (Okla. 1982) (Opala, J., concurring in part and dissenting in part).

[165] 231 Ark. 550, 331 S.W.2d 38 (Ark. 1960).

[166] Jack Guttenberg, *quoted by* Brooks, *Talking Adjustables*, N.Y. Times, Nov. 20, 1983, § 8, at 12.

[167] In fact, the theory of the clog in the SAM applies with nearly the same force to the adjustable (variable) rate mortgage, since the attack in both instances is predicated on the large jump in monthly payments that might shatter a borrower's "mirage of hope." *See* Wyman, *supra* note 56, at 472.

[168] Kane, *supra* note 144, at 126-27.

development.[169] In these situations, where the mortgage is for purchase money and is intended to be incidental to an outright purchase, the suggested approach is to document the primary intent in the agreement and any ancillary communications.[170] This is a sound practice and would doubtless find considerable support in the case law, but it still runs squarely into some of the broader language of the clogging decisions.

If the sale and purchase approach simply doesn't prevent the application of the clogging doctrine, an alternative suggestion is to grant the mortgagor a right to negate the mortgagee's option by payment of a premium. Assuming no overreaching, this should be equitably sufficient.[171]

Preble and Cartwright[172] make clogging some detailed suggestions for "minimizing the application of the rule."[173] They suggest that the mortgage and option should be negotiated and documented as separate transactions. The option should be recorded and take priority over the mortgage. The option fee should be nominal, the exercise price should substantially equal fair market value at the time the option is granted and the exercise should not be permitted until a fixed time period has passed or some contingency occurs that is not related to default. Exercise of the option should cancel the indebtedness. In this approach, the borrower will also receive a right to "call" the optionee's interest for fair market value at the time of the call. If the option is for less than 100% of the borrower's interest in the property, the borrower may "put" the remainder to the optionee for fair market value at the time of exercise of the option.[174] Additionally, the use of a clogging estoppel certificate from the borrower and a favorable clogging opinion from borrower's counsel is recommended.[175]

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[169] *Id.*

[170] *Id.*

[171] *Id. But see* Biggs v. Hodinott, [1898] 2 Ch. 307, and its discussion of French v. Baron, 2 Atk. 120 (1740), which, as perhaps suggested by the discussion in note 46 *supra*, may be some (albeit ancient) authority for the notion that the "premium" suggested to undo the option may itself be considered a clog on the equity of redemption. Of course, if the premium is not unconscionable, this should not be the result.

[172] Preble and Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 REAL PROP. PROB. & TR. J. 821 (1985).

[173] *Id.* at 856.

[174] When a right in the nature of an option confers upon the holder thereof the right to buy certain property, it is often denominated a "call." If the holder receives the right to sell certain property, it will be called a "put." *See* BLACK'S LAW DICTIONARY 986 (5th ed. 1979).

[175] Preble and Cartwright, *supra* note 172, at 857-58. Messrs. Preble and Cartwright

It is apparent, though, that even in the highly circumscribed arrangements described above, a lender wishing to share in the appreciation of the secured property risks an adverse application of the clogging rule. This is a particularly difficult problem in situations where mortgagee's option to buy at a price below the current fair market value. There is little authority for sustaining the validity of even clearly "conscionable" transactions.

In the absence of clear case law guidance, it would seem that the broader implications of the rule may need to be accepted as a risk of doing business. In any transaction having the arguable indicia of an equitable mortgage the practitioner should beware that the clogging rule may become a factor.

IX. Legislative Solutions

Easy solutions seem elusive. Norstrand pointed out that the drafters of the UCC did not seem concerned about permitting waiver of redemption rights in UCC section 9-506.[176] This is somewhat glib since the waiver permitted in the Code is part of a comprehensive procedure for dealing with secured transactions. Further, it is subject to the Code's general obligations of good faith.[177]

It seems unlikely that the clogging doctrine could be legislatively abolished without encouraging the growth of the law of unconscionability in the most worrisome area—mixed debt and equity financing. Yet the growth of unconscionability law seems inevitable. The unconscionability doctrine is theoretically sounder than the clogging doctrine and inherently less likely to interfere with arms-length bargains fairly struck.

Recently, several significant legislative initiatives have been put forth in an effort to remove the mortgagee's option from the purview of the clogging doctrine. One initiative takes the form of Section 211 of the recently passed Uniform Land Security Interest Act ("ULSIA").[178] A second initiative is a recently enacted New

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provide helpful samples of the recommended estoppel certificate. *Id.* at 867-69. They wisely further suggest that such arrangements should never be entered into by lenders with unsophisticated borrowers. *Id.* at 859.

[176] Norstrand, *supra* note 16, at 29.

[177] *See* U.C.C. § 1-203 (1977).

[178] Unif. Land Security Interest Act § 211, 7A U.L.A. 31 (1986). The ULSIA was adopted by the National Conference of Commissioners on Uniform State Laws at its August 1985 meeting. It is derived from the Uniform Land Transactions Act ("ULTA") but deals only with secured transactions in real estate. Section 211 of the USLIA replaces ULTA Section 3-211, which read:

York State statute. Both seek to validate the mortgagee's option to purchase interests in property secured by the mortgage. However, their approaches and purported coverage differ.

The ULSIA Section, which replaces a relatively new provision of the Uniform Land Transactions Act, reads:

> Section 211. Secured Party's Equity in Collateral.
> Notwithstanding a rule denominated "fettering," clogging the equity of redemption," or "claiming a collateral advantage" or a rule of similar import:
> (1) a secured party may, without adversely affecting its security interest, may acquire from a debtor [other than a protected party] any direct or indirect present or future ownership interest in the collateral, including rights to any income, proceeds or increase in value derived from the collateral; and
> (2) an option granted by a debtor [other than a protected party] to a secured party to acquire an interest in the collateral takes priority as of the date of its recording and is effective according to its terms if the right to exercise the option is not dependent upon the occurrence of a default under the security agreement.[179]

This section would abrogate the application of the clogging doctrine to a mortgagee's option to purchase an interest in the collateral, provided that the option's exercise is not conditioned on default. Additionally, the priority of the option would be preserved by the recording. The bracketed words would give a state the option of complete abrogation of the rule with respect to mortgagee's options, or retention of the rule's protection for small residential borrowers.[180] The ULSIA provision goes further, however, and

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> Notwithstanding a rule denominated "fettering," "clogging the equity of redemption", or "claiming a collateral advantage" or a rule of similar import, an option granted by a debtor [other than a protected party] to a secured party to acquire an interest in the collateral takes priority as of the date of its recording and is effective according to its terms if the right to exercise the option is not dependent upon the occurrence of a default under the security agreement.

Unif. Land Transactions Act § 3-211, 13 U.L.A. 589 (1986). Unlike the current USLIA Section 211, this section does not protect hybrid debt-equity instruments and related arrangements from the purview of the clogging doctrine.

[179] Unif. Land Security Interest Act § 211, 7A U.L.A. 31 (1986). The author was furnished with an early draft of the as yet unpublished USLIA by Norman Geis, Esq., Chicago, Illinois. Mr. Geis, whose assistance the author gratefully acknowledges, represented the American College of Real Estate Lawyers on the Drafting Committee for the Act.

[180] ULSIA Section 113 defines a "protected party" as follows:

Section 113. Protected Party: Residential Real Estate.

(a) "Protected party" means:

broadly validates many of the alternative mortgage provisions that, ironically, may in some circumstances be more likely to be upheld in a residential context than in a commercial transaction. This is due to the federal preemption provisions of the Alternative Mortgage Transaction Parity Act of 1982.[181]

The New York statute adds a new section to the General Obligations Law:

> Section 5-334. Option or right to acquire interest in property.
> 1. An option or right to acquire an equity or other ownership interest in property or in a partnership, corporation, trust or other entity that owns property shall not be unenforceable because the owner of such interest grants such option or right to the holder of a mortgage which is a lien on such property or to the holder of a security interest in such property, simultaneously with or in connection with any loan or forbearance of money secured by such mortgage or security interest, if (a) the power to exercise such option or right is not dependent upon the occurrence of a default with respect to such loan, forbearance, mortgage or security interest, and (b) such loan or forbearance is for the principal sum of two million five hundred thousand dollars or more when the option or right is granted. Loans or forbearances aggregating two million five hundred thousand dollars or more which are to be made or advanced to any one borrower in one or more installments pursuant to a written agreement by one or more lenders shall be deemed a single loan or forbearance for the total amount which the lender or lenders have agreed to make or advance pursuant to such agreement.

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(1) an individual who gives a security interest in residential real estate all or a part of which the individual occupies or intends to occupy as a residence;

(2) a person obligated primarily or secondarily on an obligation secured by residential real estate if, at the time he [or she] becomes obligated, that person is related to an individual who occupies or intends to occupy all or a part of the real estate as a residence; or

(3) an individual who acquires residential real estate and assumes or takes subject to the obligation of a prior protected party under the real estate security agreement.

(b) "Residential real estate" means, in relation to a protected party, real estate, improved or to be improved, containing not more than [three] acres, not more than four dwelling units, and no nonresidential uses for which the protected party is a lessor. If a unit in a common interest community is otherwise "residential real estate," it remains so regardless of the size of, or the number of units in, the common interest community.

Unif. Land Security Act § 113, 7A U.L.A. 27 (1986). This irony was noted by Mr. Geis, *supra* note 179, in one of several helpful conversations with the author.

[181] 12 U.S.C. § 3804 (1982 and Supp. 1985).

> 2. This section shall not be construed to limit, impair or otherwise affect the power of the holder of any option or right to acquire an equity or other ownership interest in property or in a partnership, corporation, trust or other entity that owns property, if such option or right is or would be enforceable without reference to this section.
> 3. This section shall apply to all options or rights which are exercised on or after the effective date of this section, notwithstanding the date when such options or rights were granted.[182]

The New York approach provides that an option to purchase property in securing a debt shall not not be unenforceable because the option is granted to the lien holder. However, two conditions must be satisfied. First, the exercise of the option must not be conditioned upon occurrence of default. Second, the secured loan must equal or exceed two and one half million dollars when the option is granted, or be part of a written package of loan commitments that aggregate the same sum.[183]

The New York statute explicitly covers a mortgagee's option to purchase an interest in the entity owning the secured property. ULSIA section 211 should impliedly accomplish the same result, since it explicitly mentions the clogging rule. However, while New York retains the clogging rule for all transactions to which criminal usury laws are applicable, by virtue of the dollar amount threshold,[184] the ULSIA provision would completely abrogate the clogging rule, or alternatively retain it only for the far narrower class of protected parties.[185] Both initiatives preclude circumvention of normal foreclosure procedures by excluding from statutory coverage those options that are conditionally exercisable on default.

Perhaps the major difference between the two statutory sections lies not in the transactions covered but in the potential scope of their legal effect. The New York approach would seem to impliedly remove the unconscionability defense, as well as any other defense based on the optionee's status of mortgagee. However, ULSIA section 211 goes further since it explicitly validates the enforceability of the transactions it purports to cover.

The ULSIA provision is likely to provide a desirable degree of

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[182] N.Y. GEN. OBLIG. LAW § 5-334 (McKinney 1978 and Supp. 1986).

[183] *Id.*

[184] *See supra* note 124, for a description of New York's statutory usury scheme, which employs a parallel dollar threshold approach.

[185] *See supra* note 180.

certainty to the enforceability of sophisticated real estate financing agreements. The New York statute, while certainly an improvement over the existing state of law, may give rise to some troublesome implications since it fails to foreclose the re-emergence of the clogging doctrine in new settings such as the various hybrid debt-equity arrangements.[186] USLIA section 211 seems clearly preferable in this respect.

In seeking to protect the mortgagee's option from the clogging doctrine, the California legislature enacted the following Civil Code section in 1984:

> Section 2906. Secured party: Option to acquire interest in real property collateral; Priority; Validity. An option granted to a secured party by a debtor to acquire an interest in real property collateral takes priority as of its recording and is effective according to its terms if the right to exercise the option is not dependent upon the occurrence of a default with respect to the security agreement and, where the real property which is the subject of the option is other than residential real property containing four or fewer units, shall not be deemed invalid or ineffective on the basis that the secured party has impaired the debtor's equity of redemption in violation of common law or Section 2889. [Section 2889 invalidates "contracts for forfeiture of property subject to a lien, in satisfaction of the obligation secured thereby, and all contracts in restraint of the right of redemption from a lien."][187] This section shall not be construed to make valid or effective an otherwise unlawful option nor shall any inference be drawn from this section as to the validity or application of common law with respect to residential real property containing four or fewer units.[188]

This statute is similar to ULSIA section 211 to the extent that it abolishes the application of the clogging rule to purchase options granted to real property mortgagees outside the realm of small residential mortgages. It also incorporates the strongest part of the New York approach by affirming the enforceability of those options that it covers. Further, the last sentence of the California section takes a measured approach towards eliminating any undesirable implications through its attempt to restrain both the positive and negative implications of option enforceability. In this respect, the California approach may be preferable to New York's, however,

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[186] *See supra* note 182 and accompanying text.

[187] CAL. CIV. CODE § 2889 (West 1974).

[188] CAL. CIV. CODE § 2906 (West 1974 and Supp. 1986).

neither state has effected the kind of broad ranging rationalization of the law that is epitomized by the ULSIA provision.

X. The Clogging Rule Has Outlived Its Original Purpose

At the very least, the law of clogs on the equity of redemption is in a confused state. Language can be found in the leading cases that could either uphold or invalidate a substantial number of modern real estate financing techniques. To the extent that this uncertainty discourages the development of creative approaches to real estate finance, the rule's application contradicts modern economic thinking.

The development of the clogging doctrine was deeply rooted in the English usury laws of the seventeenth and eighteenth centuries. Ironically, the doctrine has persisted beyond its moral purpose.

Ultimately, clogging is a child of the equitable unconscionability concept. Yet, the parent seems far more modern than the child. While Lord Mersey's unruly dog wanders, unwanted, into the world of modern real estate finance, twentieth century unconscionability law has been maturing into a legal tool that appears better designed to regulate the original target of clogging.

Has the unruly dog become a dinosaur? Perhaps this question is overly metaphysical. But, clearly, the rule against clogging the equity of redemption has become a danger to the ordinary transaction of ordinary business deals. When unruly dogs become dangerous, we euphemistically speak of "putting them to sleep." After three and one half centuries in defense of impecunious landowners, the rule deserves a final resting place as well.