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increasing minors' access to efficient means of terminating unwanted pregnancies.

KATHLEEN MCGILVRAY

Wellenkamp v. Bank of America: Exercise of Due-on-Sale Clauses as an Unreasonable Restraint Upon Alienation

The author examines the history of due-on-sale clauses, tracing its treatment in the Supreme Court of California to its most recent pronouncement, where the court found the clause to be an unreasonable restraint on alienation absent proof from the institutional lender that enforcement was necessary to protect against risk of default or impairment of its security. The author concludes that the rationale of the court reasonably balances the common law rule against restraint on alienation and the lender's interest.

In July 1973, Birdie, Fred and Dorothy Mans purchased real property and obtained financing through defendant, Bank of America. The bank received a promissory note, secured by a deed of trust, which contained a standard due-on-sale clause. The clause provided, *inter alia*, that if the Manses sold the property, the defendant bank could, at its option, accelerate the maturity of the loan.¹

Two years later, the Manses sold the property to plaintiff, Cynthia Wellenkamp, for the amount of their equity in the property along with plaintiff's assumption of the outstanding balance on the Manses' loan from defendant. When the bank was notified of the transfer of title and received plaintiff's check for the monthly payment of the loan, it returned the check and notified plaintiff of its intention to accelerate the loan payment unless plaintiff agreed to accept a one and one-quarter percent increase per annum in the interest rate on the original loan. When the plaintiff would not agree to the higher interest rate, defendant elected to file a notice of default and sell the property under the deed of trust.

Plaintiff filed for an injunction against enforcement of the due-

1. *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 946, 582 P.2d 970, 972, 148 Cal. Rptr. 379, 381 (1978). The deed of trust provided that if the trustor (the Manses) sells, conveys, alienates . . . said property or any part thereof, or any interest therein . . . or becomes divested of [his] title or any interest therein . . . in any manner or way, whether voluntarily or involuntarily. . . . Beneficiary shall have the right at its option, to declare said note . . . secured hereby . . . immediately due and payable without notice.

on-sale clause and a declaration that such a clause could not be enforced without any demonstration that the sale of the property had impaired the defendant's security.² The superior court sustained defendant's demurrer on the ground that no cause of action for declaratory relief had been stated. The court of appeal affirmed the decision, finding that although a cause of action for declaratory relief had been stated, any declaration of rights on the merits would have been unfavorable to plaintiff and no benefit would have resulted from a reversal of the erroneous judgment.³ On appeal, the Supreme Court of California *held*, reversed: The exercise of a due-on-sale clause contained in a promissory note or deed of trust constitutes an unreasonable restraint on alienation of property in violation of California law unless the lender⁴ can show that enforcement is reasonably necessary to protect against the risk of default or impairment of its security. *Wellenkamp v. Bank of America*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

A due-on clause is a device used in real property security transactions to provide the lender with an option to declare the entire balance of the loan and its accrued interest due and payable immediately upon the occurrence of certain contingencies set out in the deed of trust or mortgage, in the note or bond secured thereby, or in both such instruments. Lending institutions commonly include due-on clauses in their contracts which are contingent upon some form of alienation of the secured property.⁵ While due-on-sale clauses operate to protect the lender's interests, they may infringe upon the borrower-seller's right of free alienation of his property.

There are two lines of cases which have developed in the United States to provide flexibility against the common law rule voiding all restraints on alienation.⁶ Under the "majority doctrine," restraints

2. *Id.* at 947, 582 P.2d at 972, 148 Cal. Rptr. at 381.

3. *Wellenkamp v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 68 Cal. App. 3d 835, 137 Cal. Rptr. 488 (Ct. App. 1977).

4. The court emphasized the fact that the party seeking enforcement of the due-on-sale clause in this case was an institutional lender and limited its holding accordingly. 21 Cal. 3d at 952 n.9, 582 P.2d at 976 n. 9, 148 Cal. Rptr. at 385 n.9.

5. 28 CASE W. RES. L. REV. 493, 503 (1978).

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

Id. at 503 n.1.

6. 47 Miss. L.J. 331, 333 (1976). The common law rule regards the right of alienation "as an inherent and inseparable quality of a fee estate, such that conveyance of title included the right of free and unlimited alienation." *Id.* at 333 (citing 61 AM. JUR. 2D *Perpetuities and Restraints on Alienation* § 94 (1972)).

against alienation⁷ are invalid per se unless the restraint falls within certain recognized exceptions.⁸ The specific classes of exceptions differ in various jurisdictions, but there is substantial agreement as to many.⁹ Under the "minority doctrine," adopted by the Supreme Court of California in *Coast Bank v. Minderhout*,¹⁰ the facts of each case are weighed on an ad hoc basis to determine whether the restraints on alienation are reasonable.¹¹ If the restraints are reason-

A more practical rationale supporting the rule is that restraints on alienation violate public policy. . . . Under this view the law against restraints is justified as a useful device avoiding grave economic and social consequences such as the removal of property from commerce, the concentration of wealth, the limitations of property improvements, and the impeding of debt collection. See *Baker v. Loves Park Sav. & Loan Ass'n*, 21 Ill. App. 3d 42, 44, 314 N.E.2d 306, 308 (1974); A. CASNER & W. LEACH, *CASES AND TEXT ON PROPERTY* 1008 (2d ed. 1960)

Id. at 334 n.13 (citations omitted).

7. A restraint on alienation, as that phrase is used in this note, is a direct restraint on the legal power of alienation. A direct restraint occurs when an instrument purports to prohibit or penalize alienation of the property. An indirect restraint occurs when an instrument attempts to accomplish some purpose other than the restraint of alienability, but its incidental effect is to so restrain. L. SIMES & A. SMITH, *THE LAW OF FUTURE INTERESTS* § 1112 (1956). Only direct restraints are treated as possible illegal restraints on alienation. *But see* Comment, *Debt Acceleration of Transfer of Mortgaged Property*, 29 U. MIAMI L. REV. 584, 596 (1975) (arguing that due-on-sale clause should be held invalid as unreasonable restraint on alienation).

There are three types of direct restraints: disabling, forfeiture and promissory restraints. 4 RESTATEMENT OF PROPERTY § 404 (1944). The due-on-sale clause does not fit perfectly into any of these categories, but it closely resembles a promissory restraint, which "refers to a covenant in an instrument of conveyance, or to a contract, in which the promisor agrees not to alienate the property." L. SIMES & A. SMITH, *supra* at § 1131. In fact, a court which found a due-on-sale clause to be a restraint on alienation noted that it "directly and fundamentally burdens a mortgagor's ability to alienate as surely and directly as the classical promissory restraint." *Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n*, 73 Mich. App. 163, 166, 250 N.W.2d 804, 805, *appeal denied*, 400 Mich. 844 (1977) (quoting Volkmer, *The Application of the Restraint on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747, 774 (1973)).

8. The major exceptions to the majority approach are: (1) the spendthrift trust and similar trust devices; (2) restraints on the power to partition (if it does not last too long a time); (3) restraints (particularly forfeiture) on alienation to a small group of persons classified other than by race or other social characteristics; (4) forfeiture restraints on a life or lesser estate; (5) promissory (and sometimes forfeiture) restraints in the form of a right of preemption; (6) restraints for protection of vendor in land sales contract; (7) reasonable provisions in articles of a business organization prohibiting transfer of shares; (8) restraints on gifts to charities. 47 MISS. L.J. 331, 334 n.21 (1976); *see* Bernhard, *The Minority Doctrine Concerning Direct Restraints on Alienation*, 57 MICH. L. REV. 1173, 1174-75 (1959).

9. Bernhard, *supra* note 8, at 1175; 47 MISS. L.J. 331, 334 (1976).

10. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1965); *see* Bernhard, *supra* note 8. In *Coast Bank*, the supreme court issued its landmark decision upholding, for the first time, a due-on clause which was being challenged as an illegal restraint on alienation. A California statute stated that "[c]onditions restraining alienation, when repugnant to the interest created, are void." CAL. CIV. CODE § 711 (West 1954). Justice Traynor, writing for the *Coast Bank* majority, however, recognized that this rule only forbade *unreasonable* restraints against alienation. *See* 21 Cal. 3d at 948, 582 P.2d at 973, 148 Cal. Rptr. at 382.

11. *See* Bernhard, *supra* note 8, at 1176; Volkmer, *supra* note 7, at 749 n.12.

able, they are valid and enforceable. "Theoretically, when the purpose behind the restraint outweighs its effect in hindering the alienability of property, the standard is satisfied."¹²

In the due-on-sale situation, the borrower-seller's right to alienate his property is balanced against the interests of the lender which are protected by the clause. One such interest of the lender is the protection of his security. If the transfer of the realty increases the risk of future default by the borrower or future waste to the property, it is reasonable for the lender to demand an increase in the interest rate on the loan as compensation for the additional risks, or to require that the maturity of the loan be accelerated. The due-on-sale clause traditionally has had the purpose of minimizing these special risks which face the lender when there is a subsequent transfer of the property.¹³ In recognition of the lender's justifiable concern over possible impairment of its security interest, courts have uniformly found that due-on-sale clauses are not invalid per se.¹⁴

Another interest of the lender, at least the institutional lender, is to maintain its loan portfolio at prevailing interest rates.¹⁵ There

12. 47 Miss. L.J. 331, 336 (1976). The adoption of the *justification versus quantum of restraint* test by the supreme court in *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633, (1974), is very similar.

13. See Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F. L. REV. 267, 271 (1972); Valensi, *The Due on Sale Clause—A Dissenting Opinion*, 45 L.A.B. BULL. 121, 121 (1970); Note, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1116 (1975); 47 Miss. L.J. 331, 338 (1976). But see 28 CASE W. RES. L. REV. 493, 503 n.2 (1978).

Although some contend that the due-on-sale clause was originally used by lenders to protect their security interests, . . . most authorities agree that it was conceived primarily to combat the rising interest rates of the 1960's. E.g., FEDERAL NATIONAL MORTGAGE ASSOCIATION, PUBLIC MEETING ON CONVENTIONAL MORTGAGE FORMS, S. DOC. NO. 92-21, 92d Cong., 1st Sess. 147 (1971) (statement of Haydon M. Calvert, Senior Vice-President, Prudential Federal Savings & Loan Association, Salt Lake City, Utah). . . .

Id. (citations omitted).

14. See Jacoway, *Mortgages—A Catalog and Critique on the Rule of Equity in the Enforcement of Modern Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485, 493, (1973); note 15 *infra*.

15. The reasons why a lender wishes to keep his loan portfolio in step with the current market rate of interest are fairly straightforward. Lenders, usually savings and loan associations, borrow money on a short-term basis from their depositors and lend it on a long-term basis in the form of mortgages. When the interest rate rises, the cost of borrowing money from their own depositors increases. At the same time, home buyers wish to assume existing mortgages to take advantage of the lower rates. Thus, the average life of mortgages in lenders' portfolios will increase, resulting in a greater than usual number of low-interest loans. 28 CASE W. RES. L. REV. 493, 512 (1978). If there is a decrease in the interest rate, the effects will be minimal since the buyer would not assume the mortgage when he could refinance it at a lower rate.

The court recognized these economic factors in *Wellenkamp*, but concluded that if, at a time of high interest rates, a lender was unwilling to allow assumption of an existing loan

is a distinct conflict in the various jurisdictions,¹⁶ as well as in the literature discussing this area of the law,¹⁷ as to whether a lender should be allowed to enforce a due-on-sale acceleration clause where impairment of his security is not threatened.

California has addressed the legal consequences of due-on clauses more often than any other state, and, although not always predictable, its decisions illustrate the various lines which other jurisdictions have followed. Since both the majority and dissenting opinions in *Wellenkamp* rested their conclusions on these prior cases, they will be discussed briefly.

Writing for the majority in *Coast Bank v. Minderhout*,¹⁸ Justice Traynor concluded that due-on-sale clauses were restraints on alien-

and elected instead to enforce its due-on clause, transfer of the property might be prohibited entirely, as it might be economically unfeasible for the buyer to acquire a new loan. In the alternative, the buyer could insist that the seller lower the purchase price, leaving the seller with the option of either complying and reducing his equity return or refusing to sell. In either case, the clause hampers alienation. 21 Cal. 3d at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84 (1978) (citing Note, *supra* note 13, at 1113).

16. See generally Annot., 69 A.L.R.3d 725 (1976). For examples of cases allowing automatic enforcement of due-on clauses, see *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 509 P.2d 1240 (1973); *Baker v. Loves Park Sav. & Loan Ass'n*, 61 Ill. 2d 119, 333 N.E.2d 1 (1975); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973); *Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works*, 71 Wis. 2d 531, 239 N.W.2d 20 (1976); accord, *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976); *Miller v. Pacific First Fed. Sav. & Loan Ass'n*, 86 Wash. 2d 401, 545 P.2d 546 (1976).

For examples of cases requiring that the lender show an impairment to its security, see *Patton v. First Fed. Sav. & Loan Ass'n*, 118 Ariz. 473, 578 P.2d 152 (1978); *Baltimore Life Ins. Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971), *rev. denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 481 S.W.2d 725 (1972); *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. 2d DCA 1970); *Sanders v. Hicks*, 317 So. 2d 61 (Miss. 1975); *Bellingham First Fed. Sav. & Loan Ass'n v. Garrison*, 87 Wash. 2d 437, 553 P.2d 1090 (1976).

17. For a good discussion of the opposing viewpoints, see 28 CASE W. RES. L. REV. 493 (1978), which contains two casenotes on the same case. Other secondary sources include *Bonanno, supra* note 13; *Volkmer, supra* note 7; Note, *Beyond Tucker v. Lassen: The Future of The Due-on-Sale Clause in California*, 27 HASTINGS L.J. 475 (1975); Note, *Mortgage Consent To Sale Clause: A Reasonable Restraint on Alienation?* 8 J. MAR. J. PRAC. & PROC. 513 (1975); Note, *Due On Sale and Due On Encumbrance Clauses in California*, 7 LOY. L.A. L. REV. 306 (1974); Note, *supra* note 13; Comment, *supra* note 7; 11 CAL. W. L. REV. 578 (1975); 22 HASTINGS L.J. 431 (1971); 47 MISS. L.J. 331 (1976); 7 U. W.L.A. L. REV. 258 (1975).

18. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964). In this case, the bank brought an action against landowners to foreclose an alleged equitable mortgage created by a security agreement not to encumber or transfer property in consideration of loans made to them by the bank. The instrument provided that upon default on the loans, the bank at its election could accelerate the debt. The borrowers sold the property without the knowledge or the consent of the bank. The defendants conceded actual knowledge of the agreement. The court held that the instrument did, in fact, create an equitable mortgage which could be foreclosed by the bank. While conceding that the instrument was a restraint on alienation, and that the common law rule makes any such restraint invalid, Justice Traynor concluded that since the instrument was a *reasonable* restraint, designed to protect the bank's justifiable interest, the court should not needlessly invalidate it.

ation, but he noted that only "unreasonable" restraints against alienation were unenforceable.¹⁹ The court failed, however, to articulate exactly which interests of the mortgagee would justify the restraint.²⁰

In the majority's interpretation of *Coast Bank* in the instant case, Justice Manuel stated one interest of the mortgagee that the court would consider. "In determining whether a due-on clause was unreasonable in *Coast Bank* we looked at whether the restraint was necessary to prevent impairment to the lender's security."²¹ In contrast, the dissent²² construed *Coast Bank* as standing for the rule that in an outright sale of property, a due-on-sale clause is reasonable per se.²³ The dissent's interpretation rests on the language of the *Coast Bank* decision which "held that it was reasonable for a lender to condition its continued extension of credit to borrowers 'on their retaining their interest in the property that stood as security for the debt.'"²⁴

*La Sala v. American Savings & Loan Association*²⁵ involved the exercise of a due-on-encumbrance clause after the borrower had

19. *Id.* at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508.

20. Although Justice Traynor identified several judicial decisions which had upheld reasonable restraints upon alienation, such as spendthrift trusts and restraints on assignments of leases, executory land contracts, life estates and corporate shares, *id.* at 316-17, 392 P.2d at 268, 38 Cal. Rptr. at 508, conflicting lines of authority have developed as to what kinds of circumstances would justify a finding that a restraint was reasonable.

Three lines of authority have developed since *Coast Bank*. One line construed *Coast Bank* as standing for the rule that due-on-sale clauses are reasonable per se. See, e.g., *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 629, 224 S.E.2d 580, 587 (1976).

Another line of authority supports a "money market" theory, thereby justifying enforcement of a due-on-sale clause in order for the lender to take advantage of higher interest rates if the borrower alienates the property. See *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 301, 509 P.2d 1240, 1244 (1973).

Still a third line of authority focuses upon the reasonableness of protecting the security interest of the lender without balancing the equities, a path taken by subsequent California cases discussed in notes 25-32 and accompanying text *infra*. 28 CASE W. RES. L. REV. 493, 495-96 n.13. See also Annot., 69 A.L.R.3d 725 (1976) (a collection of the cases following *Coast Bank*).

21. 21 Cal. 3d at 948, 582 P.2d at 973, 148 Cal. Rptr. at 382 (emphasis added).

22. Justice Clark was the lone dissenter on a panel of seven justices.

23. 21 Cal. 3d at 954-55, 582 P.2d at 977, 148 Cal. Rptr. at 386 (Clark, J., dissenting); see *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 629, 224 S.E.2d 580, 587 (1976).

24. 21 Cal. 3d at 955, 582 P.2d at 977, 148 Cal. Rptr. at 386 (quoting *Coast Bank*, 61 Cal. 2d at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508).

25. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

In *La Sala*, plaintiffs borrowed money from American Savings & Loan Association which utilized a form deed of trust containing a "due-on-encumbrance" provision. This clause provided that if the trustor should further encumber the property without the consent of American, then American had the right, at its option, to accelerate the sums due.

Plaintiffs did execute a note and second deed of trust, and American responded with a letter offering to waive its right to accelerate in return for payment of a sum of money and an increase in the rate of interest on the first deed of trust.

executed a junior encumbrance on the security. In determining whether the clause was an unreasonable restraint on alienation, the supreme court considered the possible impairment to the lender's security and the degree of restraint on alienation of the property. The court concluded that the degree of restraint on alienation was significant and that unless the lender could show that enforcement of the due-on-encumbrance clause was reasonably necessary to prevent impairment of the security, the clause would not be enforced.²⁶

Three years later in *Tucker v. Lassen Savings & Loan Association*,²⁷ the supreme court was again confronted with a due-on-sale clause, but this time it was in the context of a borrower selling the property by installment contract. The court clarified the test used in *La Sala*, pointing out that a decision as to whether a given restraint on alienation was unreasonable required a balancing of the "quantum of restraint" involved and the "justification" for so restraining alienation of the property.²⁸ In applying this test, the court concluded that the quantum of restraint was high and that the lender had not shown legitimate justifications for it.²⁹

Both *La Sala* and *Tucker* reaffirmed *Coast Bank* in their dicta. It was pointed out that the degree of restraint in an "outright" sale³⁰ was small when the seller received sufficient funds from the sale to pay off the lender, whereas usually there were not sufficient funds to pay off the outstanding mortgage in cases involving junior encumbrances or installment land contracts.³¹ On the other hand, dicta suggested that the justification for enforcing the restraint would be greater in an outright sale than in an encumbrance or installment contract situation. In the latter situations, the borrower still has a substantial interest in protecting the underlying security, while in the former situation the borrower is more divorced from the property.³²

In *Wellenkamp*, the Supreme Court of California refused to follow the dicta of *La Sala* and *Tucker* by denying the lender's contention that the transfer of an interest in real property made

26. Justice Clark agreed in his *Wellenkamp* dissent by stating: "[I]f particular circumstances indicated the lender's security was endangered" the enforcement of the clause may be reasonably necessary. 21 Cal. 3d at 955, 582 P.2d at 978, 148 Cal. Rptr. at 387.

27. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

28. *Id.* at 635-36, 526 P.2d at 1173, 116 Cal. Rptr. at 637.

29. *Id.* at 637-38, 526 P.2d at 1174-75, 116 Cal. Rptr. at 638-39.

30. The term "outright sale," as used by the court in *Wellenkamp*, refers to "any sale by the trustor of property wherein legal title (and usually possession) is transferred." 21 Cal. 3d at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

31. *Id.* at 949, 582 P.2d at 974, 148 Cal. Rptr. at 383.

32. *Id.* at 951-52, 582 P.2d at 975-76, 148 Cal. Rptr. at 384. Of course if the new buyer places a large down payment to pay off the seller's equity, he too has a substantial interest in the property. *Id.*

acceleration of the loan a *reasonable* restraint on alienation per se.³³ After reviewing its prior case law, the majority applied the quantum of restraint versus the justification for enforcement test, stating:

We first discuss the *quantum of restraint* imposed by enforcement of the due-on clause after transfer of the property by outright sale, for if as defendant contends, automatic exercise of the clause in these circumstances results in little, if any, restraint on alienation, we need not reach the question whether there exists justification sufficient to warrant enforcement.³⁴

Justice Manuel had no trouble finding that a considerable quantum of restraint existed. There are often times when "economic conditions are such that new financing is either unavailable or economically unfeasible, [in which case] the seller and buyer will normally agree to a form of financing arrangement wherein the buyer will assume the seller's loan."³⁵ In such an instance, if the lender elects to exercise his due-on-sale clause, the sale, in effect, will be prohibited because the "buyer will be unable to substitute a new loan for the loan being called due, and the seller will not receive

33. As noted earlier, the supreme court restricted its opinion to institutional lenders. *Id.* at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 384 n.9. This is not surprising given the court's tendency in this area of limiting its holdings to the specific facts before it. *E.g.*, *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974) (installment loan contract); *La Sala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971) (due-on-encumbrance clause). The quantum of restraint on the borrower-seller would be the same regardless of whether it was a private or institutional lender. The court noted, however, that the justification for enforcement of a due-on-sale clause may be so inherently greater in the case of a private lender that automatic enforcement would be in order. 21 Cal. 3d at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 384 n.9.

The inherent justification, if one exists, would be that the private lender, upon resale of the property by the borrower, faces greater risks of default or future waste than the institutional lender. Indeed, the money market theory would provide no justification since private lenders are not borrowing short and lending long while they try to maintain loan portfolios.

It may be more likely that private lenders set the rate of interest they charge in a manner which is more subjective and personalized to the particular borrowers than the rate set by institutional lenders. Once a lending institution determines that a potential borrower has passed a certain threshold level of credit worthiness, it will loan him money at the going interest rate. Another borrower whose credit may not be as good as the first, but who also passes the threshold level, will most likely receive a loan at the same rate of interest. A private lender, however, will not be greatly influenced by the threshold level of credit worthiness and the going market rate of interest.

The private lender may well use some calculus of objective and subjective factors to determine what rates he will charge as compensation for the risks he feels he is taking. This rate might be different for each borrower. Yet, this difference between loans made by private and institutional lenders does not change the fact that in reality "the buyer in such an outright sale may be at least as good, if not a better credit risk than the original borrower/seller." *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385. It seems, therefore, that there is no significant reason for treating private lenders any differently from institutional lenders regarding automatic enforcement of due-on-sale clauses.

34. 21 Cal. 3d at 949, 582 P.2d at 974, 148 Cal. Rptr. at 383.

35. *Id.* at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

an amount from the buyer sufficient to discharge that loan, particularly when the balance due is substantial."³⁶ Even if the lender offers to waive acceleration in return for the buyer's assumption of the existing loan at an increased rate of interest, the restraint on alienation is apparent.³⁷ With the less favorable interest rate, the cost of the property to the buyer is higher. Thus, the seller may be forced to lower the purchase price, absorbing the loss himself, or he may have to refuse to complete the sale and face diminished prospects of a sale at the same price in the future.³⁸

The defendant Bank of America offered two independent justifications for the quantum of restraint involved. First, the outright sale of property eliminates any incentive or ability for the borrower-seller to avoid impairment of the lender's security. Thus, the lender's risks increase. Second, the effort of the lender to maintain its loan portfolio at the current market rate of interest would benefit from the option to accelerate loans. The majority disposed of both of these arguments.³⁹

As noted earlier,⁴⁰ the lender's security may be impaired either by waste to the property or by default on the loan, with the consequent costs and delays of foreclosure. The court, however, properly noted that the new buyer in an outright sale will have to make a down payment on the purchase, which creates an equity interest in the buyer. Therefore, the buyer will normally have sufficient incentive not to create waste. Furthermore, the buyer "may be at least

36. *Id.*, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.

37. *Id.* at 950-51, 582 P.2d at 975, 148 Cal. Rptr. at 384.

38. *Id.* The dissent argued that it is not the due-on-sale clause which restrains alienation; rather, it is the very economic climate postulated by the majority. This argument appears similar to some type of proximate cause requirement. It does not take into account that given rising interest rates (which give the lender the motive to exercise the due-on clause), the borrower-seller would not be restrained from alienating his property but for the due-on-sale clause in his original agreement. *Id.* at 956, 582 P.2d at 978, 148 Cal. Rptr. at 387.

39. The defendant bank also argued that "inclusion of the due-on clause in the promissory note . . . would make that clause part of the debt itself and therefore automatically enforceable on that basis." *Id.* at 953 n.12, 582 P.2d at 976 n.12, 148 Cal. Rptr. at 385 n.12. This argument was apparently based upon a statutory requirement that the clause appear in both the deed of trust and the note. CAL. CIVIL CODE § 2924.5 (West 1978). The supreme court stated that the purpose of the statutory section was to provide the borrower with notice and not to allow automatic enforcement on either the deed of trust or the promissory note. *Id.*

In Florida, an appellate court has denied automatic enforcement of a due-on-sale clause in a mortgage while allowing it in a suit upon a promissory note. Compare *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. 2d DCA 1970) with *Stockman v. Burke*, 305 So. 2d 89 (Fla. 2d DCA 1974). In *Stockman*, the court distinguished between an action in equity, which required the lender to show impairment of his security, and an action at law. In light of the policy considerations regarding restraints on alienation of property, the distinction of the court can be questioned as putting form above substance.

40. See note 13 *supra* and accompanying text.

as good, if not a better credit risk than the original borrower/seller.”⁴¹ It is apparent that there are circumstances in which the security interest is not impaired by the outright sale of property and, therefore, *automatic* enforcement of the due-on clause is not justified on this basis.

In *Tucker*, the supreme court rejected the money market rationale with respect to installment land contracts. The court, however, expressly left open the question of whether this rationale, which recognizes a lender's interest in maintaining its portfolio at current interest rates, would provide sufficient justification for the restraint imposed by the exercise of a due-on clause in the case of an outright sale.⁴² Faced with this open question in *Wellenkamp*, the court rejected the money market rationale.⁴³

The reason of the court for rejecting this rationale was simple. The due-on clause was designed to protect the lender's security.⁴⁴ Protection against the business risk of fluctuating interest rates, which the lender undertakes in making any loan, does not further the purpose for which this restraint on alienation was designed. Therefore, it was not reasonable “to place the burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property.”⁴⁵

The underlying logic of the court is sound. There is no logical nexus between the sale of property (or the transfer of a “lesser” interest) and the lender's readjustment of its loan portfolio. As far as the lender is concerned, the sale is a fortuitous circumstance.⁴⁶ Depending upon the economic conditions, rather than on the characteristics of either the property, the borrower-seller or the new buyer, the lender will determine whether or not to exercise the due-on clause.

In support of the money market rationale, it has been argued that “present and future borrowers pay the added cost of preserving bargain rates for those home buyers who assume low-interest mortgages.”⁴⁷ Without the due-on-sale clause, lending institutions will have to raise interest rates to compensate themselves for the greater proportion of low-interest loans they would have in their portfolios

41. 21 Cal. 3d at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385 (emphasis added).

42. 12 Cal. 3d at 639 n.10, 526 P.2d at 1175 n.10, 116 Cal. Rptr. at 639 n.10.

43. 21 Cal. 3d at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

44. See notes 6-13 and accompanying text *supra*.

45. 21 Cal. 3d at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385.

46. Of course, a lending institution could estimate how often it would get the opportunity to exercise a due-on-sale clause, but it could not control or even anticipate when any *individual* borrower would act in such a manner as to activate the due-on clause.

47. 28 CASE W. RES. L. REV. 493, 512 (1978); see *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 301-03, 509 P.2d 1240, 1244-45 (1973).

due to home buyers assuming mortgages during periods of rising mortgage rates.⁴⁸ Thus, the question has been posed: "[W]ho should benefit from an increase in interest rates?"⁴⁹

In *Wellenkamp*, it appears the court implicitly answered this question when it recognized that "a restraint on alienation cannot be found reasonable merely because it is commercially beneficial to the restrainer. Otherwise, one could justify any restraint on alienation upon the ground that the lender could exact a valuable consideration in return for its waiver, and that sensible lenders find such devices profitable."⁵⁰ The lending institution incorporates its prediction of future rates into the current long-term rate it charges. If, in the future, the projections prove incorrect, the lender will not have as high a profit margin as anticipated. Without due-on-sale clauses to help the lender maintain its loan portfolio at the then current interest rate, it is possible that some of the loss will be made up by charging a higher interest rate on new loans.⁵¹ To some degree a lender's losses will always be passed on to the consumer, but this consequence alone cannot justify favoring the lender.

Alternatives to the due-on-sale clause exist in many jurisdictions. One of these is the variable interest rate mortgage.⁵² Another

48. See *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 301-03, 509 P.2d 1240, 1244-45 (1973).

Additionally, lending institutions assert that [due-on-sale clauses] serve a public need in supplying loan funds. Their contention is that uniform mortgage contracts with flexible provisions, such as [these clauses], facilitate the transfer of mortgages between lenders in various parts of the country. Thus, cash can more readily flow from areas with a surplus of funds to areas with an abundance of borrowers and a shortage of cash.

Comment, *supra* note 7, at 594.

49. 28 CASE W. RES. L. REV. 493, 513 (1978).

50. 21 Cal. 3d at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385 (quoting *La Sala*, 5 Cal. 3d at 880-81 n.17, 489 P.2d at 1124 n. 17, 97 Cal. Rptr. at 860 n.17).

51. This, of course, assumes that competition for borrowers amongst the various lending institutions will permit the lender to charge a higher rate.

52. For a discussion of the variable interest rate mortgage versus the due-on-sale clause, see *Malouff v. Midland Fed. Sav. & Loan Ass'n*, 181 Colo. 294, 509 P.2d 1240 (1973).

A variable interest rate mortgage gives the mortgagee the ability to charge an interest rate, within prescribed statutory limits, throughout the duration of the loan. The advantages of such mortgages is that they allow the mortgagee to offer a more competitive initial rate. Additionally, borrowers may be more willing to accept a higher initial rate because the type of mortgage also allows the possibility of interest rate reductions.

While variable rate mortgages may be good for those who expect their income to increase with time, it is undesirable for those on a fixed income.

Some states have statutes which specifically endorse or proscribe the variable interest rate mortgage, while other states allow it without any statutory enactment. *E.g.*, CAL. CIVIL CODE § 1916.5 (West 1978) (allowing variable interest rates); ILL. ANN. STAT. ch. 74, § 4(d) (Smith-Hurd Supp. 1977) (proscribing); MICH. COMP. LAWS ANN. § 438.31c(2) (Supp. 1976) (proscribing); MINN. STAT. ANN. § 334.01 (West 1966); VT. STAT. ANN. tit. 9, § 41(a) (1970) (proscribing). The use of the variable interest rate is also prohibited to federal savings and loan associations. 12 C.F.R. § 541.14(a) (1977).

alternative is making renegotiation of the interest rate part of the loan agreement. Neither of these alternatives would interfere with the borrower's right to alienate his property.

Finally, it should be noted that the borrower will not always refinance the loan if the interest rate falls.⁵³ One disadvantage to this is that many instruments have prepayment charges written into the loan agreement to discourage refinancing.⁵⁴ Another factor deterring refinancing is simply the fact of borrower inertia.

In conclusion, the Supreme Court of California has issued a well-reasoned opinion in *Wellenkamp* which will be influential in the many jurisdictions which have not yet addressed the validity and construction of a due-on-sale clause contained in a promissory note or deed of trust. The court has effectively placed the burden upon the lender to show that the enforcement of a due-on-sale clause is reasonably necessary to protect against impairment of its security through waste or increase in the risk of default, thereby justifying a restraint on the alienation of property. In so doing, the court has rejected the money market rationale and continued to protect the free alienability of property. By insisting that a due-on clause cannot be enforced upon the occurrence of an outright sale unless the lender can demonstrate the need for protection of its justifiable interests, the court has rejected any form of a per se rule and has equitably balanced the interests of lender and borrower.

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53. See Note, *supra* note 13, at 1126.

54. 28 CASE W. RES. L. REV. 493, 513 n.50 (1978).