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Due-on-Sale Clauses: Separating Social Interests from Individual Interests

Joseph Gibson, III

NOTE

Due-on-Sale Clauses: Separating Social Interests from Individual Interests

I. INTRODUCTION

For the past fifteen years mortgage markets in the United States have been characterized by a generally rising trend in mortgage interest rates and by increasingly precipitous swings in those rates.[1] Until recently, the almost exclusive vehicle for financing purchases of real property was the fixed rate mortgage with a term of twenty to thirty years. During the period between World War II and the Vietnam War, the institutions that made these loans garnered funds from sources that offered stable availability and cost. As interest rates rose during the 1970's these institutions were no longer able to secure funds at rates that did not exceed the average rates of their mortgage portfolios, and many began to experience losses.[2] In order to avoid or reduce those losses, institutional lenders have increasingly sought to enforce due-on-sale clauses—provisions in mortgage contracts that enable lenders to accelerate loans when the underlying property is sold.

Appellate courts in at least twenty-nine states have ruled on the enforceability of due-on-sale clauses.[3] Although a majority of

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1. *See* U.S. LEAGUE OF SAVINGS ASS'NS, '81 SAVINGS & LOAN SOURCEBOOK, table 25, at 27 (1981) [hereinafter cited as '81 SOURCEBOOK]; FED. HOME LOAN BANK BOARD, FED. HOME LOAN BANK BOARD J.: ANNUAL REPORT 1980, tables S.5.1-.3, at 110-11; *see also* U.S. DEP'T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES, ser. 477, at 1003 (1975) (interest rates on Moody's Aaa corporate bonds, 1919-1970).

2. Roessner & Nagle, *Asset-Liability Management for Savings and Loans*, FED. HOME BANK BOARD J., July 1981, at 25.

> Volatile interest rates have caused a dramatic shift in the deposit mix at the nation's S & Ls. As recently as May 1978, 97 percent of deposits at S & Ls were at fixed rates of 8 percent and below . . . . At that point, only 3 percent of deposits were in the form of market sensitive jumbo certificates. By April 1981, 6-month money market certificates and jumbos comprised 47 percent of all deposits, with another 12 percent in 30-month MMCs [money market certificates]. The passbook deposit share had fallen about half, from 37 percent to 21 percent of all deposits.

Id. at 26.

3. A recent compilation of these decisions appears in Dunn & Nowinski, *Enforcement of Due-on-Sale Clauses: An Update*, 16 REAL PROP. PROB. & TR. J. 291, 315-17 (1981). Since the appearance of the Dunn and Nowinski article, further decisions have been re-

courts have opted for "automatic" enforceability,[4] a substantial minority have concluded that unless a lender can demonstrate that the sale of the property will jeopardize the security of the lender's collateral, the clause will not be enforced.[5] Borrowers challenging the validity of due-on-sale clauses have often attempted to characterize the clauses as restraints on alienation.[6] Courts have responded in a variety of ways: some courts have concluded that the clauses are illegal restraints, others have found that they are legal restraints, and still others have held that the clauses are not restraints at all. Some jurisdictions have labelled due-on-sale clauses unfair and, under equitable principles, denied automatic enforcement. Other jurisdictions have considered automatic enforcement and have found no unfairness.[7] Recent commentary has suggested that in certain cases the clauses are appropriately viewed as contracts of adhesion,[8] an analysis that would permit a court to deny enforcement when the mortgagor is a consumer and the lender is an institution, but to uphold the clause when both lender and borrower are commercial enterprises or when the lender is an individual extending a purchase money mortgage. The list of appellate decisions will undoubtedly grow; as long as interest rates remain at current levels, the substantial financial benefit of avoiding the payment before maturity of a loan carrying a relatively low rate of

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ported. *See* Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910 (4th Cir. 1981) (applying Virginia law); Wilhite v. Callihan, 121 Cal. App. 3d 661, 175 Cal. Rptr. 507 (1981); Dawn Inv. Co. v. Superior Court, 116 Cal. App. 3d 439, 172 Cal. Rptr. 142 (1981); Damen Sav. & Loan Ass'n v. Heritage Standard Bank & Trust Co., 431 N.E.2d 34 (Ill. App. 1982); Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, 423 N.E.2d 998; Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981); Mills v. Nashua Fed. Sav. & Loan Ass'n, 433 A.2d 1312 (N.H. 1981); State *ex rel.* Bingaman v. Valley Sav. & Loan Ass'n, 636 P.2d 279 (N.M. 1981); Ceravolo v. Buckner, 444 N.Y.S.2d 861 (Sup. Ct. 1981); First Fed. Sav. & Loan Ass'n v. Jenkins, 109 Misc. 2d 715, 441 N.Y.S.2d 373 (Sup. Ct. 1981); Northwestern Fed. Sav. & Loan Ass'n v. Ternes, 315 N.W.2d 296 (N.D. 1982); First Fed. Sav. & Loan Ass'n v. Kelly, 312 N.W.2d 476 (S.D. 1981); Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816 (Tex. Civ. App. 1981); Lipps v. First Am. Serv. Corp., 286 S.E.2d 215 (Va. 1982); United Virginia Bank v. Best, 286 S.E.2d 221 (Va. 1982); *see also* Great N. Sav. Co. v. Ingarra, 66 Ohio St.2d 503, 423 N.E.2d 128 (1981) (reserving issue of automatic enforceahility of due-on-sale clauses).

4. As used in this Note, "automatic enforcement" means enforcement without the necessity of inquiry into the lender's motives. *See* Tierce v. APS Co., 382 So. 2d 485, 487 (Ala. 1979).

5. *See infra* notes 37-53 and accompanying text.

6. *See infra* notes 11-40 and accompanying text.

7. *See infra* notes 41-53 and accompanying text.

8. *See* Maxwell, *The Due-on-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 U.C.L.A. L. REV. 197 (1980); Note, *Due-on-Sale Clauses: A Suggested Approach For Dealing With Non-Institutional Lenders*, 8 WAYNE L. REV. 57 (1980).

interest assures that the mortagor's incentive to challenge enforcement of a due-on-sale clause will remain high.

The array of disparate arguments and conclusions that currently characterizes the law of due-on-sale clauses must necessarily be confusing for courts faced with the issue of enforceability. This Note suggests that courts have failed to articulate properly the relation of the due-on-sale clause to the legal doctrines under which it has been challenged. In particular, courts that have considered the clauses to be restraints on alienation have concentrated on the impact of enforcement or nonenforcement on the borrower, and have ignored almost completely the social interest in the free transferability of land, which has been the traditional rationale for the rule against restraints. Likewise, courts that have considered due-on-sale clauses under equitable principles frequently have failed to articulate whether the inequity arises from an attempt by one party to seek more than was contained in the contract, or because the due-on-sale clause is too harsh a term to be forced upon a weaker party. By failing to isolate the social policy goals that those doctrines seek to advance, courts have produced opinions in which different lines of argument are confused, with the result that these opinions are left vulnerable to the criticism that they are the instruments of result oriented "judicial legislation." Additionally, this confusion of argument has resulted in a tendency to approach the due-on-sale clause issue as a search for a single rule, and thus has limited a jurisdiction's flexibility to reach a contrary result in a case whose facts may warrant it. By seeking a clear definition of the policy goals that are implicated in the due-on-sale clause controversy, this Note suggests an appropriate analytical framework that a court may use to approach a due-on-sale clause issue in cases of first impression. Additionally, the Note considers the related issue of the due-on-encumbrance clause in terms of the suggested analysis and concludes that because of the different considerations which apply to the due-on-encumbrance clause, a judicial decision that due-on-sale clauses warrant automatic enforcement does not compel the same result with respect to due-on-encumbrance clauses.[9]

II. Due-On-Sale Clauses in the Courts

Judicial responses to the due-on-sale clause have employed di-

9. *See infra* part V.

verse rationales to justify or prohibit enforcement.[10] This diversity not only is the result of the courts' different views on the nature of the problem and their desires to reach particular results, but also is related to variety in the form of the acceleration device used and differences in the factual settings of the cases. In many of the opinions more than one mode of analysis is considered, and in some cases multiple justifications for the court's conclusion are stated without a clear indication of which one is determinative. The analyses fall into two main lines of argument. The first considers whether the due-on-sale clause is a restraint on alienation and consequently subject to invalidation under the rules relating to such restraints and the public policy against them. The second considers whether the enforcement of the clause would be equitable, with specific consideration given to the purpose for which the clause was included in the mortgage.

A. Due-on-Sale Clauses as Restraints on Alienation

In a majority of the recent due-on-sale clause cases the party seeking to prevent enforcement of the clause has alleged that it is unenforceable as an illegal restraint on alienation.[11] The courts that have addressed this allegation may be grouped according to the criteria that they have accepted as determinative of the result. Their reasoning may be abstracted as follows:

(1) The due-on-sale clause is not a restraint on alienation because the borrower has made no express promise not to convey the estate. The clause is enforceable.
(2) The due-on-sale clause is not a restraint on alienation because its enforcement produces no practical restraining effect. The clause is enforceable.

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10. *See generally* Report of Subcommittee on "Due-on" Clauses of the American Bar Association Committee on Real Estate Financing, *Enforcement of Due-on-Transfer Clauses*, 13 REAL PROP. PROB. & TR. J. 891 (1978) [hereinafter cited as *Enforcement*].

11. *See, e.g.*, Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, 423 N.E.2d 998; Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981). For summaries of the rule against restraints and its relation to the due-on-sale clause, see G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 5.21, at 297-99 (1979); Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 IOWA L. REV. 747 (1973); and *infra* note 67 and notes 105-13 and accompanying text. On the subject of restraints in general, see 6 AMERICAN LAW OF PROPERTY §§ 26.1-.132 (A.J. Casner ed. 1952); W. FRATCHER, PERPETUITIES AND OTHER RESTRAINTS 1-240 (1954); RESTATEMENT OF PROPERTY §§ 404-423 (1944); 3 L. SIMES & A. SMITH, THE LAW OF FUTURE INTERESTS §§ 1111-1172 (2d ed. 1956); Bernhard, *The Minority Doctrine Concerning Direct Restraints on Alienation*, 57 MICH. L. REV. 1173 (1959).

(3) The due-on-sale clause is a restraint on alienation, and such restraints will be enforced when reasonable. The lender may reasonably enforce the clause to gain an increased rate of interest. The clause is enforceable.

(4) The due-on-sale clause is a restraint on alienation, and such restraints will be enforced when reasonable. Enforcement is unreasonable unless the lender can show that his security will be impaired upon transfer. The clause is not automatically enforceable.

1. Clause Enforceable—No Express Promise Not to Convey

The due-on-sale clauses challenged in the reported decisions have been of two distinct types. The first type, which this Note designates a "consent-to-transfer clause," is a contractual covenant wherein the mortgagor promises not to convey without the consent of the lender.[12] This clause is normally coupled with a further provision that upon breach of a covenant the mortgagee may declare the note immediately payable, with the effect that by refusing consent the lender may force acceleration of the underlying obligation upon transfer of the property by the mortgagor. The second type, which this Note designates an "acceleration clause" requires no promise that the mortgagor will not convey without consent, but merely stipulates that the note becomes due upon conveyance.[13] In

12. *See, e.g.*, Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975). The disputed clause in *Baker* was of the consent-to-transfer type and contained the following language:

"A. THE MORTGAGOR COVENANTS DURING THE TERM OF THIS MORTGAGE

. . . .

(8) Not to suffer or permit without the written permission or consent of the mortgagee first had and obtained:

. . . .

(d) A sale, assigument, or transfer of any right, title or interest in and to said property or any portion thereof."

Id. at 121, 333 N.E.2d at 2.

13. *See, e.g.*, Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981). *Holiday Acres* considered the validity of an acceleration clause that contained the following language:

In the event that the mortgagors convey the title (legal, equitable, or both) to all or any portion of said premises or in the event that such title becomes vested in a person other than the mortgagors in any manner whatsoever except under the power of eminent domain, that in any such case the entire unpaid principal of the note secured hereby with all accrued interest thereon shall, at the option of the mortgagee at any time thereafter, become immediately due and payable without notice.

Id. at 474.

spite of the apparent similarity in effect of these two types of devices,[14] in many opinions this distinction appears to be material. For example, one court considering an acceleration clause stated, "[T]he right of the mortgagee to sell his equity is not involved. The acceleration provision recognizes this right. All it does, is to provide that when the mortgagor does this, the mortgagee has the right to demand payment of his debt in full."[15] Under this analysis, if the clause is not of the consent-to-transfer type, the inquiry into the nature of the clause as a restraint on alienation has ended, since any restraining effect is not the sort of which the law takes cognizance.[16] One court has suggested that the obverse might be true, that consent-to-transfer clauses are automatically unenforceable,[17] but no jurisdiction giving automatic enforcement to acceleration clauses has stated such a rule.

2. Clause Enforceable—No Practical Restraint

The opinions of some courts have acknowledged that if enforcement of an acceleration clause were to have the practical effect of restraining alienation, the clause might not be enforceable. After inquiry into the nature of the effect of such clauses on the transferability of property, however, these courts have concluded that no practical restraining effect exists. According to this view, the only disadvantage to the mortgagor resulting from enforcement of the clause is the inability to profit from the "sale" of a submarket rate mortgage—something for which he had not bargained in the first place.

This argument appeared in the dissenting opinion of Justice

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14. *See infra* text accompanying notes 61-64.

15. Gunther v. White, 489 S.W.2d 529, 531 (Tenn. 1973); *accord* First Fed. Sav. & Loan Ass'n v. Jenkins, 109 Misc. 2d 715, ___, 441 N.Y.S.2d 373, 379 (Sup. Ct. 1981); *cf.* Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 624-25, 224 S.E.2d 580, 584 (1976) (acceleration clause did not cause the same type of "direct restraint" as had been struck down in previous restraint cases).

16. *See* Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333, 339 (Tex. Civ. App. 1981) (acceleration clause creates no "direct" restraint); *cf.* Mills v. Nashua Fed. Sav. & Loan Ass'n, 433 A.2d 1312, 1314 (N.H. 1981) (acceleration clause not "per se unreasonable" restraint on alienation because it did not "in itself, result in the forfeiture of the owner's title and did not preclude the mortgagor from conveying the property"); Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 58 Wis. 2d 99, 108 n.1, 205 N.W.2d 762, 767-68 n.1 (1973) (restraints on alienation prohibited in Wisconsin constitution are "those employed under feudal property law to enforce the obligations of the tenant to his landlord").

17. *See* Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 925-26, 925 n.33 (4th Cir. 1981) (stating that lenders must "dot the 'i's and cross the 't's"); *see also* Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___ n.3, 423 N.E.2d 998, 999 n.3 (court's ruling on acceleration clause not to apply to consent-to-transfer clauses).

Clark in *Wellenkamp v. Bank of America*,[18] a case in which the California Supreme Court refused to permit automatic enforcement of due-on-sale clauses in mortgage loans made by institutional lenders. Justice Clark's reasoning has since been adopted by Nebraska in *Occidental Savings & Loan Association v. Venco Partnership*.[19] In *Occidental Savings* the court first noted that the acceleration clause under consideration did not fall within the definition of restraints on alienation provided by section 404 of the *Restatement of Property*.[20] The court then stated,

> It is true that the possibility of acceleration may impede the ability of an owner to sell his property as he wishes; nonetheless, not every impediment to sale is a restraint on alienation, let alone contrary to public policy. It is a fact that zoing restrictions, building restrictions, or public improvements may impede the sale and substantially affect the ability of the owner to realize a maximum price. . . . We are somewhat at a loss to understand how or why so

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18. 21 Cal. 3d 943, 957, 582 P.2d 970, 979, 148 Cal. Rptr. 379, 388 (1978) (Clark, J., dissenting).

> A seller possessing property and a buyer lacking sufficient funds can seldom do business if financing is unavailable. . . . If tbey can do business . . . it follows that the buyer must pay the going interest rate and the seller, as an incentive to the buyer, may be required to reduce the selling price. If a loan exists on the property with a due-on clause, no *increased* restraint on selling results if the lender cannot accept the proposed buyer, the situation then being the same as in the case of the unavailability of funds to the proposed buyer. If the lender will permit assumption but only at an increased interest rate, again no *increased* restraint results because without the existing loan the buyer would be required to pay the higher interest rate and the seller may be required to compromise his selling price. There is thus no increased restraint on alienation beyond that inherent in the economic conditions postulated by the majority. . . .
>
> [If the due-on-sale clause is not enforced], [b]ecause [the] seller has a marketable, sought-after asset in the form of a low-interest transferable loan—something he never bargained for—he can ask for and expect to get additional considerations from his buyer. . . . The loan has thus become not a restraint on alienation but a factor making salable what before could not be sold.

Id. at 956-57, 582 P.2d at 978-79, 148 Cal. Rptr. at 387-88 (emphasis in original).

19. 206 Neb. 469, 293 N.W.2d 843 (1980).

20. *Id.* at 472, 293 N.W. at 845. The RESTATEMENT OF PROPERTY, *supra* note 11, § 404, defines restraints on alienation as follows:

> (1) A restraint on alienation, as that phrase is used in this Restatement, is an attempt by an otherwise effective conveyance or contract to cause a later conveyance
>
> (a) to be void; or
>
> (b) to impose contractual liability on the one who makes the later conveyance when such liability results from a breach of an agreement not to convey; or
>
> (c) to terminate or subject to termination all or a part of the property interest conveyed.
>
> (2) If a restraint on alienation is of the type described in Subsection (1), Clause (a), it is a disabling restraint.
>
> (3) If a restraint on alienation is of the type described in Subsection (1), Clause (b), it is a promissory restraint.
>
> (4) If a restraint on alienation is of the type described in Subsection (1), Clause (c), it is a forfeiture restraint.

> many courts have been willing to describe a due-on-sale clause as a restraint on alienation and are unwilling to do so.[21]

The court concluded that the facts of the case under consideration demonstrated that an acceleration clause is not a practical restraint on alienation since title had been transferred with little difficulty.[22]

Two recent cases apparently adopted this same reasoning, but avoided an explicit holding that an acceleration clause is not a practical restraint on alienation by stating that if the clause constitutes any practical restraint at all, then it is a reasonable, and therefore enforceable, one. In *Williams v. First Federal Savings & Loan Association*[23] the Fourth Circuit Court of Appeals, applying Virginia law, indicated its skepticism that an acceleration clause created any practical restraining effect.

> The due-on-sale clause, standing by itself, can hardly be a restraint on alienation. In the first place, its effect is to remove a lien or encumbrance—namely the security deed of trust—and thereby render the parcel more alienable—not less. Moreover, and perhaps more importantly, the homeowner whose property is subject to a due-on-sale clause is as free to sell, and, in selling, to realize as much as a homeowner holding the same property free and clear of any encumbrance.[24]

The court then compared a mortgage loan containing a due-on-sale clause to a mortgage loan payable on demand from the outset and stated that because the latter could certainly not be termed a re-

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21. 206 Neb. at 472-73, 293 N.W.2d at 845.

22. *Id.* at 475, 293 N.W.2d at 846-47. Apparently in accord with *Occidental Savings* is Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816 (Tex. Civ. App. 1981). In *Crestview* the court found that the enforcement of a due-on-sale clause would not "result in any evil the rule against such restraints was designed to prevent" and that it was not a restraint on alienation. *Id.* at 826. Although no finding of reasonableness is necessary under such an analysis, the court went on to approve the clause as reasonable. *Id.* at 826-27. The court, however, admitted that such a clause could constitute an indirect restraint that "consists in the inhibiting effect such a clause has with respect to prospective purchasers and the owner, who may be compelled either to forego a . . . sale or arrange for immediate payment of a large sum of money." *Id.* at 823.

23. 651 F.2d 910 (4th Cir. 1981).

24. *Id.* at 923 n.29; *see also id.* at 923-24 ("Viewed in isolation [a due-on-sale clause] cannot be said to create a restraint on alienation, or if it does, it is one validated by the Virginia legislature.") (footnote omitted). The court cited VA. CODE § 6.1-330.34 (1979), which sets forth a form of notice that must be prominently displayed on deeds of trust containing due-on-sale clauses. 651 F.2d at 923. In a footnote the court quoted extensively from Occidential Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 293 N.W.2d 843 (1980), and from the dissent of Justice Clark in Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 148 Cal. Rptr. 379, 582 P.2d 970 (1978). The Fourth Circuit Court of Appeals termed the *Wellenkamp* majority's "attempted rebuttal" of Justice Clark's dissent a "combination of non sequitur and unsupported assumptions." 651 F.2d at 923 n.29; *see also* Lipps v. First Am. Serv. Corp., 286 S.E.2d 215, 219-20 (Va. 1982) (adopting reasoning of *Williams*).

straint on alienation, the former could not be a restraint since its terms were by far the more favorable.[25] The Massachusetts Supreme Judicial Court in *Dunham v. Ware Savings Bank*[26] followed the reasoning in *Williams* and concluded that if any practical restraining effect resulted from an acceleration clause it was a reasonable one.[27] The court noted that there was "substantial authority" that due-on-sale clauses were not restraints on alienation,[28] citing passages from *Occidental Savings* and *Williams*.

3. Due-on-Sale Clause as Reasonable Restraint

Some jurisdictions admit the restraining effect of the due-on-sale clause, but find the restraint to be reasonable. They find the due-on-sale clause to be a restraint either because it is in the form of a consent-to-transfer clause[29] or because an acceleration clause may produce an "indirect" or "practical" restraining effect on the ability to alienate.[30] Courts applying this rationale have taken the position that reasonable restraints on alienation are permissible, and that unreasonable restraints are not,[31] and have concluded that the lender's interest in maintaining his loan portfolio at a profitable average rate renders the restraint reasonable.[32] Specific

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25. 651 F.2d at 924 n.29.

26. 1981 Mass. Adv. Sh. 1607, 423 N.E.2d 998.

27. *Id.* at ___, 423 N.E.2d at 1000.

28. *Id.* at ___, 423 N.E.2d at 1000.

29. *See, e.g.*, Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 296, 509 P.2d 1240, 1241 (1973); Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 121, 333 N.E.2d 1, 2 (1975).

30. *See, e.g.*, Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 625, 224 S.E.2d 580, 584 (1976).

> [T]he practical effect of the due-on-sale clause when it is considered in isolation is that the owner is encouraged not to alienate his property *if* it would be more advantageous to enjoy a loan which has become favorable because of changed interest rates in the market. This is what may be termed a hindrance or an indirect restraint on alienation.

Id. (emphasis in original). This group of cases necessarily includes Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910 (4th Cir. 1981), and Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, 423 N.E.2d 998, opinions that have sidestepped the issue of the existence of a restraint by stating that if any restraint exists, it is a reasonable one. *See supra* text accompanying notes 23-28.

31. *See infra* text accompanying notes 105-10.

32. *See, e.g.*, Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 301, 509 P.2d 1240, 1244-45 (1973); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 627, 224 S.E.2d 580, 587 (1976). *But cf.* Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 125-28, 333 N.E.2d 1, 4-6 (1975) (consent-to-transfer clause held to be reasonable restraint; interest rate increase of 1% per annum held reasonable, but viewed as liquidated damages for breach of covenant); Provident Fed. Sav. & Loan Ass'n v. Realty Centre, Ltd., 428 N.E.2d 170, 174 (Ill. App. 1981) (Scott, P.J., dissenting) (suggesting that *Baker* did not address issue whether a due-on-sale clause might be enforced solely for purpose of increasing rate of

justifications for the conclusion that the clauses are reasonable include that the clauses are a "legitimate and reasonable business practice";[33] that they protect the lending institution's depositors;[34] that they represent an equitable adjustment of the rights of the borrower and lender;[35] and that they enable lenders to make long-term fixed rate loans.[36]

4. Due-on-Sale Clause as Unreasonable Restraint

A final group of cases follows the previous cases in their reasoning that due-on-sale clauses are restraints on alienation and that their nature as a restraint invokes a test of reasonableness.[37] These courts, however, have concluded that the due-on-sale clause is an unreasonble restraint.[38] Implicit in this finding is a rejection of the justifications that have been offered for the clauses. This group of courts, however, has not declared the clauses wholly unenforceable, but has instead applied a per se rule of unreasonableness when the party is not motivated by a "legitimate interest." Specifically, this view has held that the enforcement of the clause for the purpose of increasing loan yields is not among the legitimate interests of the lender,[39] whose proper interest is in protecting the se-

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lender's mortgage portfolio).

33. Century Fed. Sav. & Loan v. Van Glahn, 144 N.J. Super. 48, 54, 364 A.2d 558, 561 (Ch. Div. 1976).

34. *See, e.g.*, Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 302, 509 P.2d 1240, 1244-45 (1973); Dunham v. Ware Sav. Bank, 81 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1003.

35. *See* Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1002.

36. *See* Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 303, 509 P.2d 1240, 1245 (1973); Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816, 824 (Tex. Civ. App. 1981).

37. *See, e.g.*, Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 949-51, 582 P.2d 970, 973, 148 Cal. Rptr. 379, 382 (1978); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 165-67, 250 N.W.2d 804, 805-06 (1977); Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 87 Wash. 2d 437, 440-41, 553 P.2d 1090, 1091 (1976); *see also* Patton v. First Fed. Sav. & Loan Ass'n, 118 Ariz. 473, 477, 578 P.2d 152, 1656-59 (1978) (due-on-sale clause effects "very harsh restraint"; lender must show impairment of security to justify enforcement).

38. *See* Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 953, 582 P.2d 970, 975-76, 148 Cal. Rptr. 379, 384-86 (1978); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 174, 250 N.W.2d 804, 808-09 (1977); State *ex rel.* Bingaman v. Valley Sav. & Loan Ass'n, 636 P.2d 279 (N.M. 1981); Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 87 Wash. 2d 437, 441, 553 P.2d 1090, 1092 (1976).

39. *See, e.g.*, Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 954-55, 582 P.2d 970, 976, 148 Cal. Rptr. 379, 385 (1978); Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 87 Wash. 2d 437, 440-41, 553 P.2d 1090, 1092 (1976).

curity of its loan. Additionally, this view has maintained that forcing borrowers to shoulder the risk of a lender's inability to accurately project interest rates is unfair.[40]

B. *Due-on-Sale Clauses Under Equitable Principles*

In another major group of cases in which due-on-sale clauses have been successfully attacked, the clauses have been subjected to a test of reasonableness after the court's invocation of equitable powers in a foreclosure proceeding.[41] The restraints on alienation arguments set forth above either do not arise or are incorporated in the court's rejection of foreclosure as inequitable.[42] These courts, like the courts that follow the *Wellenkamp* majority's reasoning, permit enforcement when the lender demonstrates that his security may be impaired, but refuse enforcement as inequitable if the lender's purpose is to increase the loan's interest rate or to collect a transfer fee.[43]

Frequently, what the courts regard as the true source of the inequity cannot be determined from the opinions.[44] These courts simply state that enforcement is unreasonable because the only purpose of the clause is to protect the lender's security, not to pro-

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40. *See* Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 952-53, 582 P.2d 970, 976, 148 Cal. Rptr. 379, 385 (1978).

41. *See, e.g.*, Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 853, 481 S.W.2d 725, 728 (1972) (enforcement solely on basis of written clause "cannot be countenanced in a court of equity"); *see also* Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 186 P.2d 190 (1971); Clark v. Lachenmeier, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970); Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 P.2d 1013, 1019 (Okla. 1977). *See generally* Note, *Mortgages—A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485 (1973).

42. *See, e.g.*, Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 81, 486 P.2d 190, 193 (1971) (clause's effect as restraint on alienation held insufficient to justify absolute avoidance, but sufficient to impose reasonableness requirement; equity should not order foreclosure absent allegations that lender's security is jeopardized).

43. *See, e.g.*, Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 855, 481 S.W.2d 725, 729 (1972) ("arbitrary" disapproval of lender might force a sale "at great sacrifice"); Clark v. Lachenmeier, 237 So. 2d 583, 585 (Fla. Dist. Ct. App. 1970) (foreclosure unjust "where no harm has resulted to mortgagee from [the] conveyance"). Other courts have refused enforcement on equitable grounds when the conveyance was to a corporation of which the mortgagor was the sole principal, *see* Nichols v. Evans, 92 Misc. 2d 938, 401 N.Y.S.2d 426 (Dutchess County Ct. 1978), or to a principal, when the corporation was the original mortgagor. *See* Fidelity Land Dev. Corp. v. Rieder & Sons Bldg. & Dev. Co., 151 N.J. Super. 502, 377 A.2d 691 (App. Div. 1977). Such cases may also be explained in terms of the principles of contract interpretation, since it was probably not intended by the parties that the conveyance would trigger the due-on-sale clause. *See id.* at 510-11, 377 A.2d at 695. *But see* Damen Sav. & Loan Ass'n v. Heritage Standard Bank & Trust Co., 431 N.E.2d 34, 36-37 (Ill. App. 1982).

44. *See, e.g.*, Clark v. Lachenmeier, 237 So. 2d 583 (Fla. Dist. Ct. App. 1970).

vide a lever for increased profits. Whether the courts might allow the parties to agree contractually upon some other purpose, however, is unclear. For example, in the Oklahoma Supreme Court's decision in *Continental Federal Savings & Loan Association v. Fetter*[45] the court, after stating that "[a]cceleration clauses are bargained-for elements of mortgages and notes to protect the mortgagee,"[46] made the flat assertion that the "underlying rationale for an acceleration clause is to . . . afford the lender the right to be assured of the safety of his security."[47] The court, averring to the rule that agreements restricting the sale of property must be reasonable, noted that the mortgage did not contain reference to the transfer fee that the lender had attempted to impose and concluded that the foreclosure would not be granted "because neither the note nor the mortgage contained such a provision; it was not a bargained-for element of the note and mortgage; . . . and there was no jeopardizing of the mortgagee's security."[48] This case may be read as a simple instance of an interpretation of contract *contra proferentem*,[49] but the *a priori* assertion that the purpose of the due-on-sale clause is to protect the lender's security blurs the court's rationale.[50]

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45. 564 P.2d 1013 (Okla. 1977).

46. *Id.* at 1017.

47. *Id.*

48. *Id.* at 1019; *see also* First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156, 159 (Fla. Dist. Ct. App. 1980) (court noted statement in mortgage that "intent" of mortgage was to secure payment of note).

49. *See* RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981).

> Interpretation Against the Draftsman
>
> In choosing among the reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds.

Id.; *see also* A. CORBIN, CORBIN ON CONTRACTS § 559 (1960).

50. *Cf.* Silver v. Rochester Sav. Bank, 73 A.D.2d 81, 424 N.Y.S.2d 945 (1980). In *Silver* the court considered a mortgage agreement stipulating that the mortgagee's consent to assumption would not be withheld unreasonably. From the inclusion of the reasonableness requirement, and the circumstances of the case, the court concluded that the normal inference to be drawn from the clause was that the the lender's purpose in including it was concern about the security of the collateral. *Id.* at 86, 424 N.Y.S.2d at 948; *cf.* First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300 (Ala. Civ. App. 1977), *overruled*, Tierce v. APS Co., 382 So. 2d 485 (Ala. 1979).

> Since the purpose of any mortgage is to obtain security for the loan and thereafter minimize the risks in repayment, it may be said that the purpose of all clauses in the mortgage is to protect the security of the mortgagee.
>
> . . . .
>
> The terms of the clause give no indication that an interest of the mortgagee other than the protection of its security is [cause for acceleration]. . . .
>
> We do not say that the mortgagee may not specifically contract for the option to

Other courts have resisted the idea that inequity results when a lender is allowed to enforce a due-on-sale clause solely for his financial gain.[51] The reasons these courts have given are much the same as the reasons given by those courts which find that the clauses are reasonable restraints on alienation—that the seller of the property is only seeking the unbargained-for right to sell his loan and that lenders have a legitimate need to keep their portfolios responsive to the current market rates for mortgages.[52] Neither do these courts see any ambiguity in the typical acceleration clause that might permit a restricted interpretation of the clause; the assertion is frequently made that a court will not rewrite the parties' contract.[53]

III. An Analysis of the Due-on-Sale Clause as a Restraint on Alienation

Some of the differences in analysis and result in the cases summarized in part II can be attributed to variations in the phras-

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accelerate in the event of sale unless the purchaser agrees to . . . increased interest. 345 So. 2d at 303. *But cf.* Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816, 822-23 (Tex. Civ. App. 1981) (enforcement of clause equitable in spite of provision in deed of trust that lender would not unreasonably withhold consent to sale).

51. *See* Tierce v. APS Co., 382 So. 2d 485 (Ala. 1979); Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 313 N.Y.S.2d 804 (Sup. Ct. 1970); Ceravolo v. Buckner, 444 N.Y.S.2d 861 (Sup. Ct. 1981); Gunther v. White, 489 S.W.2d 529 (Tenn. 1973).

52. *See, e.g.*, Tierce v. APS Co., 382 So. 2d 485, 487 (Ala. 1979); Stith v. Hudson City Sav. Inst., 63 Misc. 2d 863, 867-68, 313 N.Y.S.2d 804, 808 (Sup. Ct. 1970); Ceravolo v. Buckner, 444 N.Y.S.2d 861, 863 (Sup. Ct. 1981) ("contractual rights of the mortgagee should be no less entitled to the recognition and protection of the court than those of the mortgagor"); Gunther v. White, 489 S.W.2d 529, 531-32 (Tenn. 1973). *But cf.* First Commercial Title, Inc. v. Holmes, 92 Nev. 363, 550 P.2d 1271 (1976). In *Holmes* the court placed the burden of establishing grounds for nonenforcement on the borrower, but added that "[a] lender has the right to be assured in his own mind of the safety of his security without the burden of showing at each transfer that his security is being impaired." *Id.* at 366, 550 P.2d at 1272.

Some jurisdictions note that equity will refuse enforcement if the borrower can prove that foreclosure would be unjust in the circumstance. In Mutual Fed. Sav. & Loan Ass'n v. Wisconsin Wire Works, 71 Wis. 2d 531, 539, 239 N.W.2d 20, 24 (1976), the court agreed with the lender that the adjustment of a mortgage portfolio to current rates would justify enforcement, but implied that equity might refuse enforcement if the lender demanded a rate above the current average. *See also* Mills v. Nashua Fed. Sav. & Loan Ass'n, 433 A.2d 1312, 1315-16 (N.H. 1981) (suggesting that equity might refuse to enforce due-on-sale clause in specific situations, giving as examples transfers to a spouse who becomes co-owner, transfers to a spouse upon dissolution of marriage, and transfer to an *inter vivos* trust of which the mortgagor is beneficiary).

53. *See, e.g.*, Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 630, 224 S.E.2d 580, 587 (1976); Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333, 339 (Tex. Civ. App. 1981).

ing or operation of the due-on-sale clause under consideration,[54] or to the nature of the proceeding as equitable or legal.[55] Even after these factors are taken into account, however, much remains unexplained. The general lack of clarity in the opinions that have refused automatic enforcement of the clauses leaves them vulnerable to the criticism that the courts have been prejudiced in favor of the consumer and have permitted an unwarranted dip into the lender's supposedly deep pocket.[56] Additionally, at least one opinion implies that under some circumstances a due-on-sale clause may be enforceable, but provides no clear indication why those circumstances demand a different result.[57] The cause of this confusion has been a failure both to segregate the interests of the individual parties to the mortgage contract and the interests of society at large, and to articulate the nature of those interests. The thrust of the rule against restraints on alienation is the protection of society's interest in the unfettered transferability of real property.[58] Courts whose findings of unreasonableness are based on the owner's difficulty in attempting to sell property subject to an automatically enforceable due-on-sale clause[59] have focused on the wrong interests. The counterargument that any disadvantage to the individual property owner is assumed to have been compensated for in the contract process is an effective one. Although defects in the contract process may also provide good grounds for nonenforcement, such defects should be remedied by application of contract law principles, not by application of the rule against restraints.

In light of the confused reasoning of cases that have invoked the rule against restraints to protect the individual, courts, not surprisingly, have expressed doubt whether due-on-sale clauses con-

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54. For example, the result may turn on whether the clause appears as a consent-to-transfer clause or an acceleration clause, *see supra* text accompanying notes 12-17, or the language of the clause may suggest that the lender's sole purpose for including the clause was the protection of his security, *see, e.g.*, Clark v. Lachenmeier, 237 So. 2d 583, 584 (Fla. Dist. Ct. App. 1970) (clause granting mortgagee "the right and privilege of accepting or rejecting, or passing on credit, etc. of such successor in ownership").

55. *See supra* text accompanying notes 41-43.

56. *See, e.g., Enforcement, supra* note 19, at 935-36.

57. *See, e.g.*, Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 952 n.9, 582 P.2d 970, 976 n.9, 148 Cal. Rptr. 379, 385 n.9 (1978) (holding limited to "institutional lenders").

58. *See* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, § 26.3; RESTATEMENT OF PROPERTY, *supra* note 11, §§ 404-423 introductory note.

59. *See, e.g.*, Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 949-51, 582 P.2d 970, 974-75, 148 Cal. Rptr. 379, 383-84 (1978); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471, 484 (Minn. 1981) ("The need of the borrower-occupier for quick and easy transfer of personal residence is greater than that of the investment borrower.").

stitute *any* restraint on alienation,[60] particularly when a clause does not contain a promise not to convey without consent. A comparison, however, of due-on-sale clauses with other contractual devices that have traditionally been regarded by courts and authorities as restraints on alienation exposes the nature of the restraint. Specifically, this comparison reveals that a legally cognizable restraint on alienation exists whenever a device imposes upon a property owner a loss or penalty that is triggered by sale. Moreover, an analysis of traditional restraints makes plain that an absolute prohibition on transfer or a consent requirement is not necessary to invoke the rule against restraints.

A. Effect of Form—Consent-to-Transfer or Acceleration Clause

Some courts state or suggest that the result in a given case will depend on whether the clause is of the "consent-to-transfer" or the "acceleration" variety.[61] Such a conclusion is difficult to support. Indeed, under almost any conceivable circumstance the practical operation of the two clauses is identical—each clause confers upon the lender the right to accelerate the loan upon conveyance of the property. The only potential for differing effect between the two clauses is that under a consent-to-transfer clause a lender could attempt to obtain specific performance or an injunction against the transfer.[62] Under such circumstances the restraining effect is clear, but the normal and proper course for the court is to refuse specific performance and merely allow a sale of the land to operate as a breach of a covenant or an "event of default," which in turn brings the acceleration provision into play.[63]

Identical treatment of the two forms of due-on-sale clauses is both equitable and logical.[64] If a court finds enforcement of the

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60. *See supra* text accompanying notes 18-28.

61. *See supra* text accompanying notes 12-17.

62. Of course, if an owner were to convey property in violation of a consent-to-transfer clause, a lender could theoretically recover for damages suffered as a result of the breach. Damages, however, will normally be limited to the amount of the debt plus interest, *see* 22 AM. JUR. 2D *Damages* § 64 (1965), which is the same amount that would be due under the typical acceleration clause.

63. This treatment has been suggested as the proper judicial response to the "negative pledge," or covenant not to transfer or encumber property. *See* G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 38.4, at 1017 (1965); G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 11, § 3.33, at 113 (1979).

64. Although its logic was flawed, the court in *In re* Bonder, 285 S.E.2d 615, 616 (N.C. App. 1982), opted for identical treatment. The court approved the automatic enforcement of a consent-to-transfer clause and stated that the North Carolina Supreme Court had construed consent-to-transfer clauses as equivalent to acceleration clauses in Crockett v. First

lender's purpose appropriate, surely that purpose should not be frustrated by setting a trap for the inept draftsman. Similarly, a court which believes that the form of the clause somehow eliminates the necessity to inquire into its practical effects as a restraint on alienation has elevated considerations of form over the appropriate inquiry—whether the enforcement of the clause runs counter to the social interests that the rule against restraints attempts to protect.

B. Practical Restraining Effect

Perhaps the most hotly disputed aspect of the due-on-sale clause controversy is whether a practical restraining effect results from enforcement of a due-on-sale clause that should subject it to scrutiny as a restraint on alienation.[65] Most discussions treating this issue begin by listing various classes and categories into which restraints have been divided in an attempt to find a place for the due-on-sale device, and, apparently, in search of an appropriate rule of law.[66] This approach risks entanglement in the semantic thicket[67] that has grown around the subject of restraints and, by

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Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976). The clause under scrutiny in *Crockett*, however, was an acceleration clause. *See id.* at 621-22, 224 S.E.2d at 582.

65. *See, e.g.*, Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 923 n.29 (4th Cir. 1981); Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1000-01 (1981); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471, 482-84 (Minn. 1981).

66. These courts are frequently concerned with whether the clause is a "direct" or an "indirect" restraint, since some authority maintains that the rule against restraints does not apply to "indirect" restraints. *See, e.g.*, Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 165-68, 250 N.W.2d 804, 805-06 (1977); Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 473-74, 293 N.W.2d 843, 846 (1980). *See generally* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 11, § 5.21, at 297-99; Volkmer, *supra* note 11, at 773-75.

67. The following categories of restraints on alienation, which have been identified or suggested by a variety of authorities, all apply to provisions contained both in deeds and in separate contracts:

Disabling/Forfeiture/Promissory. A disabling restraint is one that, if specifically enforced, would cause a future conveyance to be void. A forfeiture restraint is one that, if specifically enforced, would terminate or subject to termination all or part of the property interest conveyed. A promissory restraint would impose contractual liability on one who makes a later conveyance in breach of an agreement not to convey. *See* RESTATEMENT OF PROPERTY, *supra* note 11, § 404 (reproduced *supra* note 20).

Restraint on Practical Alienability/Restraint on Legal Power of Alienation. Commentators have defined the former as any provision "which, if valid, would tend to impair the marketability of property," and the latter as a provision that would render conveyance legally impossible. *See* 3 L. SIMES & A. SMITH, *supra* note 11, § 1111, at 4.

Direct/Indirect. Simes and Smith define a direct restraint as a provision "which, by its express terms, or by implication of fact, purports to prohibit or penalize . . . aliena-

placing the emphasis on categorization, usually neglects the central issue—the actual consequences of enforcement. By setting aside the categorization process and exploring the actual effects of the due-on-sale clause in a hypothetical situation, this Note demonstrates that the due-on-sale clause is almost identical in its opera-

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tion." *Id.* § 1112, at 5. An indirect restraint "arises when an attempt is made to accomplish some purpose other than . . . restraint . . . , but with the incidental result that the instrument, if valid, would restrain practical alienability." *Id.* This distinction is in the purpose of the restraint. "Indirect restraints" normally arise on the creation of future interests and of trusts, according to Simes and Smith. *Id.* One commentator stated that indirect restraints "do not directly nullify or penalize a transfer of property but . . . have the indirect effect of making alienation impossible, difficult, or improbable." W. FRATCHER, *supra* note 11, at 7. Fratcher considers virtually any division into separate present interests, or of a present interest into present and future interests, an indirect restraint. *See id.* at 7-9. Some writers limit "direct restraint" to a restraint that would restrict the legal power of alienability. *See* Volkmer, *supra* note 11, at 748; *see also* J.C. GRAY, RESTRAINTS ON ALIENATION § 8 (1895) ("speaking strictly, . . . a future interest is not a restraint . . . unless the contingency upon which the future interest depends is itself the alienation of the estate").

Restraints in Substance but Not in Form. The *American Law of Property* does not discuss promissory or indirect restraints, but includes in this "restraints in substance" group conditions restricting the use of land, preemptive provisions, restrictions on occupancy, and other conditions restricting the fee but not stipulating any legal disability or forfeiture. *See* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, §§ 26.63-.80.

Reasonable/Unreasonable Restraints. The majority doctrine of restraints on alienation has traditionally held that, as a general rule, restraints are per se invalid without regard to reasonable purpose or effect in the particular case, but that certain *classes* of restraints are enforceable where social interests justify enforcement. *See* Coast Bank v. Minderhout, 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964); Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 299-301, 509 P.2d 1240, 1243 (1973). Under the "minority doctrine" of restraints on alienation, any restraint may be enforced if it can be shown that, in the particular case, enforcement would be reasonable. *See generally* Bernhard, *supra* note 11; *infra* text accompanying notes 29-36.

The most serious source of confusion appears to be the idea that unless a restraint purports to restrict the legal power of alienation, it is "indirect" and, therefore, not traditionally subject to the rule against restraints. *See* Volkmer, *supra* note 11, at 748-49. Simes and Smith do not so severely limit the application of the rule against restraints. *See* 3 L. SIMES & A. SMITH, *supra* note 11, § 1112, at 5 ("while the classification of restraints as restraints on the power of alienation and restraints only on the fact of alienability corresponds in many instances to the classification as direct and indirect restraints, the two classifications are not coextensive"). Neither does the *Restatement of Property* thus limit its coverage. *See* RESTATEMENT OF PROPERTY, *supra* note 11, § 413 comments f, g (justifying rules against "quarter-sales" and fixed price preemptions because of their effect as producing a "hesitancy to sell" or "hindrance to alienation"); *id.* § 404 comment g (declaring that a promise to pay a part of sale proceeds to grantor or another "is a promise not to convey without so doing and hence is a promissory restraint"; *infra* text accompanying notes 92-93. The latest addition to the list of terms used to categorize restraints was contributed by the court in Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910 (4th Cir. 1981). The Fourth Circuit in *Williams* distinguished the nature of a consent-to-transfer clause from the nature of an acceleration clause, terming the former "a flat restraint on alienation." *Id.* at 925.

tion and effect to several other devices that have long been regarded as subject to the rules against restraints on alienation.

In a recent ruling on the enforceability of a due-on-sale clause,[68] a court estimated that a home which would sell unmortgaged for $100,000 if the market rate of interest for 30-year, fixed rate mortgages were 15% per annum, would sell for $115,000 if it carried an assumable $50,000 fixed rate mortgage at 10% with a remaining term of 27 years.[69] Some further effects associated with enforcement of due-on-sale clauses following a rise in the general level of mortgage rates may be understood by using as a basis the hypothetical as it appeared in the case,[70] and, in addition, assuming that in 1978 Smith and Jones, both Assistant Engineers at the U.S. Motors truck plant in state *A*, each purchased a residence identical to the one described above for $70,000. While Smith executed a $50,000 fixed rate mortgage containing a due-on-sale clause, Jones, who in 1978 believed that interest rates had reached a peak, chose to secure a variable rate mortgage. In 1982, when home prices and mortgage rates have risen to the higher figures stipulated above, a position as Senior Engineer becomes available in U.S. Motors' plant in state *B*. Although Smith is the firm's first choice for the job he refuses it. Smith realizes that since his mortgage is not assumable, if he is to sell his house in state *A* for $100,000 and pay off his sub-market rate mortgage, his current level of mortgage payments will support only a $35,000 mortgage at the prevailing 15% rate. Therefore, at his current level of payments he will only be able to replace his $100,000 house in state *A* with an $85,000 house in state *B*. Because Smith is "locked-in" to his current home by having chosen a fixed rate mortgage, he now lives in a house that he might not be able to afford if purchased

68. Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 915 n.8 (4th Cir. 1981).

69. *Id.* The monthly payment required to amortize a $50,000 mortgage at 10% per annum over a 27 year period is $447.05. *See* D. THORNDIKE, THORNDIKE ENCYCLOPEDIA OF BANKING AND FINANCIAL TABLES, table 5, at 5-76 (rev. ed. 1980). If the interest rate is 15% per annum, the same payments will amortize a mortgage of $35,124.98. *See id.* table 5, at 5-156. The hypothetical assumes that the buyer is indifferent about which mortgage he obtains as long as the monthly payment remains the same. In practice, the premium for such a home with an assumable mortgage will probably be less, since the assumption of the first mortgage may force the buyer to raise the rest of his purchase money by means less desirable than a market rate first mortgage—for example, through the advancement of additional cash, or the execution of a second mortgage, perhaps at a rate higher than the rate for first mortgages.

70. The court used the hypothetical to illustrate the advantage that accrues to a mortgagor when enforcement of a due-on-sale clause is denied. Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 915 n.8 (4th Cir. 1981).

under present conditions, but he may reap the benefit of his bargain only if he remains there. When Jones is offered the job, he takes it. Because of his mortgage's variable rate, he is making a higher payment than Smith, but will be able to secure approximately the same variable rate financing for a new home.[71] Because of a poor decision in 1978, Jones, unlike Smith, has no value inherent in his home financing arrangements that will be extinguished (or at least lost to him) upon sale of his home.

The courts which have held that due-on-sale clauses are in no way restraints on alienation would argue that the positions of both Smith and Jones would be unchanged following the sales of their homes.[72] This argument, however, fails to consider that before the sale Smith, as long as he remains in his home, is in a far better position than Jones, because of the lower payments on his fixed rate mortgage. More siguificantly, the argument ignores that because of Smith's disinclination to sacrifice that superior position, *the wrong man has gotten the job.* For this reason a welfare loss, external to the parties to the mortgage contract, is associated with the arrangement.[73]

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71. Of course, a variable rate mortgage may be structured in such a way that it imposes some disadvantage upon a mortgagor who prepays the mortgage on his existing residence and executes a new variable rate mortgage when he moves. This disadvantage, however, is generally far less than that faced by the mortgagor of a fixed rate mortgage. *See* Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471, 482 n.15 (Minn. 1981); Volkmer, *supra* note 11, at 801.

72. Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 923 n.29 (4th Cir. 1981). The due-on-sale clause, standing by itself, can hardly be a restraint on alienation. In the first place, its effect is to remove a lien or encumbrance—namely the security deed of trust—and thereby render the parcel more alienable—not less. Moreover, and perhaps more importantly, the homeowner whose property is subject to a due-on-sale clause is as free to sell, and, in selling, to realize as much as a homeowner holding the same property free and clear of any encumbrance.

Id. See also Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 956-57, 582 P.2d 970, 978-79, 148 Cal. Rptr. 379, 387-88 (1978) (Clark, J., dissenting); Occidental Sav. & Loan Ass'n v. Venco Partnership, 206 Neb. 469, 477-78, 293 N.W.2d 843, 847-48 (1980).

73. The welfare loss is the amount of lost production at the plant in state *B* caused by the assignment of the less effective employee to the Senior Engineer position. This loss exists without regard to the economic impact of enforcement upon the parties to the mortgage contract. That society may be injured when parties contract among themselves is a traditional concern of the common law. Closely analogous to the instant situation is the rule against unreasonable postemployment restraints. The test of reasonableness in evaluating these restraints has been described as "a problem of balancing the social detriment of restricting the promisor's activities and the social advantages of protecting the promisee in the legitimate interest given him by the contract and of enabling the covenantor advantageously to dispose of his business, practice, or property." Annot., 46 A.L.R. 2d 119, § 26, at 201 (1956). The "social detriments" of this arrangement include the potential that the restraint may "deprive the community of the benefit of the promisor's services and the benefit which

Courts opting for automatic enforcement might argue that if a court were to refuse to enforce the due-on-sale clause in Smith's mortgage and thereby allow him to sell his home for $115,000 instead of $100,000, he would be the beneficiary of a windfall.[74] This conclusion is undoubtedly valid, assuming that the clause was fully understood and bargained for and that Smith had no reason to expect to receive an extra $15,000 for his home. Moreover, the $15,000 has been taken from the pocket of the mortgagee, who might have immediately made another $50,000 loan at the market rate. Thus, evaluating the relative interests of only the mortgagor and the mortgagee, a court could reasonably be compelled out of a sense of fairness to enforce the clause. A benefit to society, however, results if the court rules Smith's 10% mortgage assumable, since such a decision would allow Smith to realize his $15,000 windfall and to make a larger downpayment on a home in state *B*. The extra cash available would offset the disadvantage of the smaller mortgage that he can afford at a 15% annual rate and would enable him to purchase a home that is the approximate equivalent of the one he left in state *A*.[75] Smith would thus be under no disincentive to move, and "the right man would get the job"—that is, resources would be allocated more appropriately.

C. *Effect of Traditional Restraints Compared*

The "lock-in" or penalty that results from the enforcement of due-on-sale clauses is essentially the same effect as that produced by several other devices that courts and authorities have tradition-

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his competition might offer to the general public." *Id.* One commentator has suggested that the balancing of burdens of the individual parties to a postemployment contract will adjust society's interest as well, since "the social cost of preventing an employee from going to a job at which he would be more productive is theoretically equal, given an efficient market, with the economic loss to the individual." Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625, 686-87 (1960). Clearly, however, the social cost equals zero only when the employee's economic loss equals zero, that is, when the postemployment restriction is eliminated.

74. *See, e.g.*, Great N. Sav. Co. v. Ingarra, 66 Ohio St. 2d 503, 513, 423 N.E.2d 128, 134 (1981) (Rutherford, J., dissenting).

75. If an exactly equivalent home in state *B* costs $100,000 and carries no assumable mortgage, Smith may purchase it by offering the $65,000 in cash received as proceeds from the sale of his state *A* residence, and borrow the $35,000 balance under a first mortgage. His monthly mortgage payment will remain essentially unchanged. (Smith will be more likely to secure a $35,000 mortgage at 15% for 30 years than the hypothetical $35,124.98 mortgage at 15% for 27 years, discussed *supra* note 69, which would have produced a monthly payment equivalent to that on the mortgage on his state *A* home. His payment will be reduced from $447.05 per month to $442.54 per month. *See* D. THORNDIKE, *supra* note 69, table 5, at 5-157.)

ally viewed as subject to the rules against restraints on alienation.[76] Three such devices are the penalty on alienation, the fractional sale, and the fixed price preemption.[77]

1. Penalty on Alienation

The most direct and obvious attempts to prevent alienation of property have taken the form of "disabling" or "forfeiture" restraints, which provide for either a legal inability to convey or a loss of the fee by reversion or gift over upon attempted conveyance.[78] Obviously, however, an enforceable contractual covenant stipulating the forfeiture of some other property upon alienation of the fee may also present an effective deterrent to alienation. The simplest provision of this sort would be the forfeiture of a sum of money or a bond following alienation of specified property. Although this device appears to have been used rarely, controversy over its effectiveness is of ancient origin. Lord Coke fired the opening salvo when, after stating that on a feoffment in fee a condition not to alienate is void, he asserted, "But if the feoffee be bound in a bond, that the feoffee or his heires shall not alien, this is good, for he may notwithstanding alien if he will forfeit his bond that he himself hath made."[79] Notwithstanding Coke's conclusion, when such bonds were given against the disentailment of fees by common recovery or fine, the English common-law courts disagreed on whether the bond was enforceable.[80] In the single American case to

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76. An understanding of the penalty imposed by the due-on-sale clause makes clear that an essential difference in effect exists between this sort of restraint and an "indirect restraint." *See supra* note 67. The imposition of an "indirect restraint" in the form of a future interest, trust, use restriction, or similar device may render property less valuable, but subsequent sale does not of itself alter that value, and the owner is not inhibited from selling. When sale itself triggers a loss of value, however, a reluctance to sell results that may be less severe than in the case of the forfeiture restraint (i.e., if the amount of the penalty is less than the value of the property) or, conceivably, greater than in the case of a forfeiture restraint (i.e., if the amount of the penalty exceeds the value of the property).

77. One commentator has previously drawn this analogy with respect to the percentage sale and the fixed price preemption. *See* Volkmer, *supra* note 11, at 799-800.

78. *See* cases cited *supra* note 34.

79. 2 E. COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND § 334, at 206b (1st Am. ed. Philadelphia 1812) (1st ed. London 1628).

80. *Compare* Freeman v. Freeman, 2 Vern. 233, 23 Eng. Rep. 751 (1691) (bond given upon promise not to bar fee tail held valid) *with* Jervis v. Bruton, 2 Vern. 251, 23 Eng. Rep. 762 (1691) (citing rule that recognizance conditioned upon tenant's promise not to bar fee tail is void as illegal perpetuity). The rule of enforcement of such a bond was disapproved by Gray. *See* J.C. GRAY, *supra* note 67, § 77, at 72; *cf.* Collins v. Plummer, 2 Vern. 635, 23 Eng. Rep. 1015 (1708) (relief denied in suit for specific performance of covenant not to bar fee tail; assertion by court that action for damages would lie).

decide the enforceability of such a provision, the court adopted the approach of Lord Coke, but its result has been criticized by the authorities.[81]

Of similar and perhaps indistinguishable practical effect would be a provision in a deed or contract that if tract *A* is alienated, the alienor will forfeit tract *B* by reversion, right of reentry, or gift over. Such a provision is not a restraint on the legal power of alienation and, perhaps for this reason, Coke took the same position with respect to its validity as he did to the validity of a bond.[82] In what is again a single American case presenting a close parallel with this situation, a court held such a forfeiture provision enforceable.[83] Commentators, however, have suggested that the character of the land, a burial plot, influenced the result, since otherwise illegal restraints have frequently been found permissible when a burial plot is the subject of the restraint.[84]

The greater the value of the penalty, the stronger will be the restraint—the owner's incentive to retain, rather than sell, his land. Courts and other authorities have perceived that severe penalties may result from the enforcement of contracts containing percentage sale provisions and fixed price preemptions because the seller forfeits value upon sale of his property.[85] This loss of value is the source of the restraining effect of the due-on-sale clause: the mortgagor, upon sale of his real property, forfeits a valuable con-

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81. The court's conclusion in Bliven v. Borden, 56 R.I. 283, 185 A. 239 (1936), is criticized in 6 AMERICAN LAW OF PROPERTY, *supra* note 11, § 26.71. The issue almost arose in Robinson v. Thurston, 23 Hawaii 777 (1917), *rev'd*, 248 F. 420 (9th Cir. 1918). In that case a mother and daughter had entered into an agreement that the daughter would forgive a debt on condition that the mother not sell certain land and that she not incur debt in an amount over $1,000. Although the claim that the mother had violated the agreement by conveying her land was abandoned, *id.* at 782, the Territorial Supreme Court held that the debt would not be reinstated since the provision against incurrence of debt was an illegal restraint of trade. *Id.* at 786-88. The Ninth Circuit reversed the case on this point. 248 F. at 422-24.

82. 2 E. COKE, *supra* note 79, § 360, at 223a. Lord Coke stated,

> If *A.* be seised of Black Acre in fee, and *B.* infeoffeth him of White Acre upon condition that *A.* shall not alien Black Acre, the condition is good, for the condition is annexed to other land, and ousteth not the feoffee of his power to alien the land whereof the feoffment is made, and so no repugnancy to the state passed by the feoffment; and so it is of gifts, or sales of chattels reals or personals.

Id.

83. Camp v. Cleary, 76 Va. 140 (1882).

84. *See* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, § 26.71. This treatise states that provisions stipulating the forfeiture of one tract upon alienation of another constitute a "serious impediment" to the alienation of the tract whose sale triggers the forfeiture, and should be void. *Id.* Gray questions whether Coke's approach was ever the law. J.C. GRAY, *supra* note 67, § 29b.

85. *See infra* notes 86-104 and accompanying text.

tract right—the right to enjoy the use of funds at a sub-market rate.

2. Percentage Sales

The "quarter-sale" provision typically has arisen in a deed containing a covenant that upon conveyance by the grantee, one fourth, or some other percentage, of the sale proceeds will be reserved for the original grantor.[86] From the seller's standpoint the provision is the same as if a fine is levied on the event of alienation, except that the amount of the penalty varies with the sale price and is payable from the proceeds. Although in this century deeds have rarely contained this device, it was apparently a common provision in grants of farmland in New York in the early nineteenth century.[87] The New York Court of Appeals declared these provisions invalid in the leading case of *De Peyster v. Michael,*[88] which now represents the majority rule in the United States.[89] Although the early cases relied on the ground that such reservations of interest were "repugnant" to a grant in fee simple,[90] a more recent case has recognized that important objectives of the rule are to promote the free transferability of property and to encourage improvements.[91]

The effect of such a provision as a deterrent to alienation can readily be seen. Upon sale the grantor realizes less than the full value of his property and is thus motivated to retain it rather than sacrifice some portion of the receipts. Percentage sale provisions do not fall within the literal definition of restraints on alienation provided in section 404 of the *Restatement of Property* since they contain no promise not to convey.[92] The *Restatement,* however, clearly rejects such a distinction as one of form over substance, stating in the comments that "a promise to pay the original grantor or some other person part of the resale price is a promise not to

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86. *See* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, § 26.68, at 512; RESTATEMENT OF PROPERTY, *supra* note 11, § 413(2)(b).

87. *See* Overbagh v. Patrie, 8 Barb. 28, 33 (N.Y. App. Div. 1850).

88. 6 N.Y. 467 (1852).

89. *See, e.g.,* White v. White, 105 N.J. Super. 184, 251 A.2d 470 (Ch. Div. 1969); Dunlop v. Dunlop's Ex'rs, 144 Va. 297, 132 S.E. 351 (1926); Annot., 123 A.L.R. 1474 (1939).

90. *See* De Peyster v. Michael, 6 N.Y. 467, 494-509 (1852); Overbagh v. Patrie, 8 Barb. 28, 37-40 (N.Y. App. Div. 1850); Dunlop v. Dunlop's Ex'rs, 144 Va. 297, 309-10, 132 S.E. 351, 354 (1926).

91. *See* White v. White, 105 N.J. Super. 184, 190-92, 251 A.2d 470, 473-74 (Ch. Div. 1969).

92. *See supra* note 20.

convey without so doing and hence is a promissory restraint."[93] Similarly, an acceleration clause, even though it contains no covenant not to convey without consent, must be recognized as a promissory restraint if the effect of acceleration is to impose a financial penalty on the transferor.[94] Percentage sale provisions can be distinguished in their effect from due-on-sale devices since the relative penalty for alienation imposed by a percentage sale remains constant, but the penalty imposed by an interest rate differential combined with a due-on-sale clause vanishes as the mortgage loan is repaid. Nevertheless, a period of effective restraint under a due-on-sale clause may extend for many years, and the "percentage" of net proceeds that must be sacrificed by the seller may be large. In the hypothetical set forth in section B above, if the due-on-sale clause is enforceable, the seller realizes an equity of $50,000, compared with a realization of $65,000 if he is able to " 'sell' " his mortgage. The reduction in net proceeds is almost one-fourth.

3. Preemptive Provisions

An owner of property who is bound by a preemptive provision in a deed or contract must, prior to selling his property in a general market, first offer to sell it to the holder of the preemption.[95] This provision should be distinguished from an option, under whose terms the option holder need not wait until the landowner desires to sell, but may demand sale under the option's terms.[96] Preemptive provisions have generally been treated as restraints on alienation.[97]

Recognizing that preemptive provisions may serve important

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93. RESTATEMENT OF PROPERTY, *supra* note 11, § 404 comment g (citation omitted).

94. *See supra* notes 61-64 and accompanying text. A recent case asserts that acceleration clauses do not fall within the provisions of the *Restatement of Property* because a promissory restraint must subject the contracting party to an action for damages or equitable relief following breach of a contractual duty, *see* Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816, 825-26 (Tex. Civ. App. 1981), and that "[i]n the context of promissory restraints, the 'duty' arises from the owner's promise not to convey his property without the consent of the other contracting party." *Id.* at 825. As the words of comment g to § 404 quoted in the text make clear, however, the relevant duty is the duty of payment following sale. Under the view that the relevant duty is the duty not to convey without consent, a bond or letter of credit to be forfeited upon conveyance would not be a promissory restraint. *See supra* text accompanying notes 78-81.

95. *See generally* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, §§ 26.64-.67; RESTATEMENT OF PROPERTY, *supra* note 11, § 413; 3 L. SIMES & A. SMITH, *supra* note 11, § 1154; Annot., 40 A.L.R.3d 920 (1971).

96. *See* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, § 26.64.

97. *See* authorities cited *supra* note 95.

social purposes, courts have allowed them to be enforced under some circumstances.[98] The *Restatement of Property* states that a preemptive provision is valid if it requires the preemption holder to meet the price of a third party offeror.[99] By contrast, if the price to be paid by the premption holder is fixed, the *Restatement* holds the preemption unenforceable.[100]

The *Restatement*'s dual rule for preemptive agreements is in harmony with an approach to restraints on alienation that would uphold or invalidate them according to their practical "lock-in" effect rather than their form. The authorities frequently have stated that when a preemption is at the offeror's price, little restraining effect results.[101] Likewise, a preemption at a fixed price will be unenforceable because, as is typical in the cases, when the preemption price is substantially below the market price the owner will not realize the full value of his property upon transfer, and he is thus deterred from selling.[102]

The restraining effect of the fixed price preemption frequently arises in much the same way as does the restraining effect of the due-on-sale clause. A price set in the agreement or deed appears fair to the party or parties at the time of its execution, but it becomes a severe deterrent to alienation following a substantial rise

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98. *See* Annot., 40 A.L.R.3d 920, 931 (1971).

99. RESTATEMENT OF PROPERTY, *supra* note 11, § 413(1).

100. *See id.*; *see also* Inglehart v. Phillips, 383 So. 2d 610 (Fla. 1980); Trecker v. Langel, 298 N.W.2d 289 (Iowa 1980); Kershner v. Hurlburt, 277 S.W.2d 619 (Mo. 1955); Tombari v. Blankenship-Dixon Co., 19 Wash. App. 145, 574 P.2d 401 (1978); authorities cited *supra* note 95.

101. *See* 6 AMERICAN LAW OF PROPERTY, *supra* note 11, § 26.66; 3 L. SIMES & A. SMITH, *supra* note § 1154, at 62. *But cf.* Annot., 40 A.L.R.3d 920, 927 (1971) (listing impediments to sale imposed by offeror's price preemptive provision).

102. At least two recent opinions state that under § 413 of the *Restatement of Property* fixed price preemptions are to be judged by a standard of reasonableness. *See* Tovrea v. Umphress, 27 Ariz. App. 513, 556 P.2d 814 (1976); Trecker v. Langel, 298 N.W.2d 289 (Iowa 1980). Sections 406-412 of the *Restatement of Property* (to which fixed price preemptions are referred by § 413), however, mandate that such preemptions be "governed by the general rules as to restraints on alienation of estates in fee simple." W. FRATCHER, *supra* note 11, at 87 (footnote omitted); *see* RESTATEMENT OF PROPERTY, *supra* note 11, §§ 406-413. Under the *Restatement*'s general rule, fixed-price preemptions are void without regard to reasonableness. The *Restatement* holds that in the case of indefeasible possessory estates in fee simple the rule of reasonableness has application only if "the restraint is qualified so as to permit alienation to some though not all possible alienees." RESTATEMENT OF PROPERTY, *supra* note 11, § 406(b). The drafters probably included this reasonableness exception as an accommodation to racially restrictive covenants, which were still common in many states at the time of the *Restatement*'s publication. *See id.* § 406 comments l, m. Clearly, a preemptive provision would be unreasonable under this test, since the number of persons to whom alienation is excluded is very large—normally, all persons except the preemption holder. *See id.* § 406 comments i, j, k.

in general property values over time. Similarily, following a rise in the market level of interest rates, a serious disincentive to alienation arises that was not present at the time of the execution of a fixed rate mortgage. Courts which adopt the rule that a due-on-sale clause is only enforceable when a lender's security is jeopardized[103] evidence a response that is analogous to the dual rule for preemptive provisions. Since, in general, prospective real property purchasers who will not jeopardize the lender's security interest greatly outnumber those who do represent such a threat, the approach taken by these courts represents no practical restraint on alienation.[104]

D. Integration of the Due-on-Sale Clause with the Doctrine of Restraints

If a court wishes to acknowledge that due-on-sale clauses should properly be considered restraints on alienation, it must integrate its holding—whether for or against enforcement—with the jurisdiction's case law concerning such restraints. Commentators have identified a majority doctrine and a minority doctrine of restraints on alienation.[105] The majority doctrine "takes the view that all restraints on alienation are void, unless they fall into recognized exception categories."[106] The minority doctrine, on the other hand, "holds that restraints on alienation of property are invalid only if unreasonable."[107] For many years the only jurisdiction in the United States to have adopted the minority doctrine was Kentucky.[108] Although the *Restatement of Property* has taken the majority position,[109] in recent years, a number of jurisdictions have expressly adopted the minority approach of "reasonableness" determined upon case-by-case inquiry.[110]

The tendency of some courts to keep separate an analysis of

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103. *See supra* notes 37-50 and accompanying text.

104. The rationale of this approach is the same as that which permits restraints against alienation of fee simple estates directed against a small group of persons, *see supra* note 102—"the curtailment of alienation is insignificant in relation to the power of alienation which is permitted." RESTATEMENT OF PROPERTY, *supra* note 11, § 406 comment j.

105. *See* Bernhard, *supra* note 11.

106. *Id.* at 1174.

107. *Id.*

108. *See id.* at 1177-78.

109. *See* RESTATEMENT OF PROPERTY, *supra* note 11, §§ 404, 406.

110. *See, e.g.*, Coast Bank v. Minderhout, 61 Cal. 2d 311, 315-17, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964); Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 299-301, 509 P.2d 1240, 1243 (1973).

the due-on-sale clause from the doctrine of restraints on alienation may result from a desire to avoid a shift from a "majority approach" to a "minority approach" when the court believes that the clause should be enforceable under certain circumstances, but not under others. In fact, both the majority and minority doctrines are inherently flexible enough to accommodate any ruling that a court sees fit to make.

One commentator has observed that in spite of the articulated differences in approach between the majority and minority jurisdictions, in practical operation they frequently function in much the same way.[111] In a minority jurisdiction, even though a case-by-case factual inquiry is permitted by doctrine in all instances, certain classes of restraints are so unreasonably restrictive that courts would be unable to sustain them. In practical effect, a per se rule would result for these classes of restraints.[112] Likewise, under the majority doctrine as applied, considerations of reasonableness have influenced not only the development of an extensive set of exception classes, but also the determination of an appropriate result within a given class of exceptions.[113]

When courts have acknowledged the restraining effect of the due-on-sale clause and nevertheless found enforcement to be appropriate, they have often termed the clause a "reasonable restraint."[114] In jurisdictions in which the majority doctrine prevailed at the time of the decision, courts have either tacitly created an additional class exception to the rule against restraints,[115] or they have taken the occasion to expressly adopt the minority rule for the jurisdiction.[116] No logical reason forecloses the creation of a new exception for due-on-sale clauses. The current exceptions are not bound together by any pervasive characteristic that might be wanting in the case of the due-on-sale clause. Instead, these excep-

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111. *See* Bernhard, *supra* note 11, at 1177-78.

112. *See id.* at 1178 (giving as an example a perpetual disabling restraint on a fee).

113. *See id.* at 1181-86.

114. *See* cases cited *supra* notes 29-36.

115. *See, e.g.*, Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1001 (alternative holding that if due-on-sale clause is a restraint, it is a reasonable one); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 628, 224 S.E.2d 580, 586 (1976) (citing as authority RESTATEMENT OF PROPERTY, *supra* note 11, § 410 comment a, but failing to note that the comment addresses reasonable classes of restraints, not particular reasonable restraints).

116. *See* Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 300, 509 P.2d 1240, 1243 (1973); *cf.* Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 921 n.25 (4th Cir. 1981) (applying Virginia law; referring to "doctrine outlawing unreasonable restraints" without distinguishing majority and minority doctrines).

tions are merely a collection of situations in which per se application of the rule would frustrate other worthwhile objectives.[117] That an exception for due-on-sale clauses has not been recognized previously is understandable, since until recently the lending environment had never been characterized by sharp swings in mortgage rates combined with the widespread use of the long-term fixed rate mortgage, the two conditions necessary for a serious restraining effect to arise.[118]

A number of jurisdictions have adopted the rule that a due-on-sale clause may be enforced only if the lender can demonstrate that enforcement is necessary to prevent impairment of the security for his loan.[119] In these jurisdictions, where the minority rule has been adopted, such a holding amounts to a rule that the lender's intention to protect his own financial interest through enforcement of the clause is unreasonable.[120] This rule at first glance is irreconcilable with a majority approach that prohibits case-by-case inquiry into the issue of reasonableness. The result, however, is consistent with the majority doctrine because a requirement that the grantee be creditworthy is not a significant restraint on alienation. No sacrifice is imposed on the seller by requiring that the mortgage be assumed by one who can afford to meet its terms.[121]

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117. This "class exception" approach was expressly adopted by the court in Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 125-27, 333 N.E.2d 1, 4-5 (1975) (importance of certainty and stability of real estate titles precludes case-by-case inquiry into reasonableness of consent-to-transfer clauses). *See also* Bakker v. Empire Sav., Bldg. & Loan Ass'n, 634 P.2d 1021 (Colo. App. 1981). The *Bakker* court, in effect, interpreted Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 509 P.2d 1240 (1973), to state that due-on-sale clauses were per se reasonable as restraints on alienation, by holding that *Malouff* permitted no case-by-case inquiry on the issue of reasonableness. *Bakker*, 634 P.2d at 1023.

118. The due-on-sale clause cases are numerous enough to have inspired a new topic in the Chapter dealing with restraints on alienation in Simes' and Smith's treatise on future interests: "Restraints for Protection of Mortgagees and Land Contract Vendors." 3 L. SIMES & A. SMITH, *supra* note 11, § 1164 (Supp. 1982).

119. *See supra* notes 37-50 and accompanying text.

120. *See, e.g.*, Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 952, 582 P.2d 970, 976, 148 Cal. Rptr. 379, 385 (1978); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 174. 250 N.W.2d 804, 808 (1977).

121. *See supra* note 104. If a lender wished to obtain an injunction against sale to an uncreditworthy buyer, a consent-to-transfer clause barring alienation to "the uncreditworthy" might well be found specifically enforceable under a recognized exception to the rule against restraints. This exception—that a restraint is permissible if alienation is prohibited to some but not all possible alienees—applies even to fee simple estates. *See* RESTATEMENT OF PROPERTY, *supra* note 11, § 406. Furthermore, the drafters of the *Restatement* added a "reasonableness" requirement to the class exception. *See* RESTATEMENT OF PROPERTY, *supra* note 11, § 406(c). An exception class of "restraints for the protection of mortgagees, where reasonable" would thus arguably be consistent with the approach of the *Restatement of Property*. *See also* Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816

This reasoning is in effect the response of the majority doctrine to the preemptive provision,[122] since by adopting a rule that only preemptions at the offeror's price are allowable, the doctrine limits the invocation of the majority rule to the class of cases in which restraining effect is possible—the preemption at a fixed price.

E. Economic Significance and Legality of Due-on-Sale Restraint

Once a court has recognized that the due-on-sale clause may act as a restraint on alienation, it must determine whether to allow enforcement in spite of that effect. The proper inquiry on this issue requires a balancing of the social welfare loss that results from the "lock-in" effect of the automatically enforceable clause against any social welfare loss that would result if the clause were not automatically enforceable. If a net welfare gain can be realized by declaring the device not automatically enforceable, a court should do so. This potential net welfare gain has been the justification for the rule against restraints on alienation.[123]

1. Traditional Objectives of the Rule Against Restraints

In justifying the rule against restraints most courts have focused on the social and economic consequences of the availability or unavailability of a particular device rather than on the effect upon the parties in the particular case under consideration. Paramount among the reasons that courts have offered for the rule against restraints is that restraints on alienability inhibit the free transferability of land and take property out of commerce.[124] One

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(Tex. Civ. App. 1981).

> If the clause in issue did constitute a restraint on alienation, we would nevertheless be required to enforce it in this case because it is expressly qualified by the requirement of reasonable conduct on the part of the noteholder, which implies that alienation is permitted to some though not all possible alienees.

Id. at 826-27 (citing RESTATEMENT OF PROPERTY, *supra* note 11, § 406). The court, however, failed to note that this argument can apply only to the clause as used to protect the lender against uncreditworthy transferees, unless the lender asserts that he would attempt to force escalation of a mortgage's interest rate to market levels only in the event of conveyance to a limited number of such transferees, and not transferees generally. Such an assertion would seem incredible.

122. *See supra* text accompanying notes 95-102.

123. *See supra* text accompanying notes 68-73.

124. Courts and commentators have also suggested that restraints on alienation are repugnant to a grant in fee simple, that they promote the concentration of wealth, that (in the form of spendthrift trusts) they allow the "survival of the least fit" by protecting persons from their own foolishness, that they may allow creditors to be abused, and that they

modern writer has further particularized the undesirable social effects of the clog on transferability:

> The undesirable effects on society potentially resulting from this include: (1) the unnatural increase in the market value of property which might result if restraints were widely employed in a particular locale; (2) the discouragement of improvements to the property, since it may be unprofitable to the owner to make such improvements while threatened with such restraint; (3) the hampering of the most effective use of property, if a prospective purchaser would be a more effective user than the present owners; and (4) the removal from trade of an increasing amount of the national capital.[125]

The *Restatement of Property* articulates an additional rationale for the rule that has frequently been offered and that may have relevance to a consideration of the due-on-sale device. The Restatement concludes that restraints on alienation of land prevent the ownership of property from being "responsive to the current exigencies of its . . . owners."[126] This concern may not reflect a strictly social objective since under certain circumstances society may benefit if a property owner is forced to sacrifice a future ability to profitably transfer his property for a benefit that accrues today. To the extent, however, that society has an interest in preventing at their inception bargains that, though legally enforceable, yield harsh results, this rationale may also be included in the list of desirable social welfare goals of the rule against restraints.

2. The Balancing Process

Measuring what social costs may attend the use of due-on-sale clauses is admittedly difficult. This difficulty may explain some courts' insistence on limiting their discussion to an inquiry of the effects enforcement would have on the parties to the mortgage contract.[127] Since, however, a decision for or against enforcement necessarily implies some judgment of the cost to society of the restraint, a considered inquiry should be made.[128]

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run counter to the policy against dead hand control. *See* Bernhard, *supra* note 11, at 1179-81.

125. *Id.* at 1179-80.

126. RESTATEMENT OF PROPERTY, *supra* note 11, §§ 404-423 introductory note.

127. *See, e.g.*, Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 923 n.29 (4th Cir. 1981); Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 950-51, 582 P.2d 970, 974-76, 148 Cal. Rptr. 379, 383-85 (1978).

128. Since the rule against restraints seeks to protect the general interest of society, the issue of the due-on-sale clause, and perhaps the issue of restraints on alienation in general, is arguably better left to legislative resolution. *See Enforcement, supra* note 10, at 935; Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816, 824 n.8 (Tex. Civ. App. 1981). The rule against restraints, however, has traditionally been developed as part of the common

(a) The Welfare Loss

The primary source of loss to society resulting from the widespread use of the due-on-sale device during times of rising interest rates is the tendency to "freeze" or "lock-in" resources with the resultant obstruction of commerce and productivity. The hypothetical proposed in part II of this Note[129] demonstrates that the reluctance of an individual to incur a financial loss upon sale of his home might prevent society from enjoying the benefits of increased productivity that would otherwise result from the free flow of human capital. The social importance of the mobility of human resources is evidenced by the large sums that corporations spend to move employees to the facilities where they are most needed. Equally important is a corresponding impediment to the free flow of property resources to their most efficient use. If a merchant who owns a shop on a given site is deterred from selling and building a new shop elsewhere while he "waits out" his mortgage, buyers in the prospective site are also forced to wait to be served by him.[130]

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law, and no compelling reasons exist to restrain courts from deciding the enforceability of due-on-sale clauses. Most legislative action to date has limited or forbidden enforcement of the clauses. *See, e.g.*, ARIZ. REV. STAT. ANN. § 33-806.01 (1974) (no transfer fee in excess of $100 or 1% of balance due upon transfer of interest by truster; no interest rate increase allowed when trustor remains liable on note; application of statute limited to residential property of 4 or fewer units); GA. CODE ANN. §§ 3301, 3002 (Supp. 1981) (interest rate increase upon transfer limited to 1%); IOWA CODE ANN. § 535.8(2)(C) (West Supp. 1981) (due-on-sale clauses void for one- or two-family dwellings unless security impaired); N.M. STAT. ANN. § 48-7-12 (Supp. 1981) (due-on-sale clauses void for four-unit and smaller residential housing unless security impaired). *But see* LA. REV. STAT. ANN. § 837A (West Supp. 1981) (granting lenders option to accelerate loan upon conveyance without reference to the inclusion of due-on-sale clause in mortgage agreement); *cf.* First Fed. Sav. & Loan Ass'n v. Kelly, 312 N.W.2d 476, 479 (S.D. 1981) (construing S.D. COMP. LAWS ANN. § 21-49-13(7) (Supp. 1981) as legislative mandate to enforce due-on-sale clauses).

129. *See supra* text accompanying notes 68-75.

130. The issue of enforcement of due-on-sale clauses as applied to commercial properties points up the importance of considering society's interests. Employment of an analysis that is designed to justify a particular result in one case, but that considers only private interests, may lead to inappropriate results in later cases when, although the social interests remain constant, the private interests that underlie the analysis have changed. In Dawn Inv. Co. v. Superior Court, 116 Cal. App. 3d 439, 172 Cal. Rptr. 142 (1981), the court held that "private" noninstitutional lenders could demand automatic enforcement of due-on-sale clauses. The court distinguished the *Dawn* situation from that in Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (holding that "institutional" lenders could not demand automatic enforcement of due-on-sale clauses), *see* 116 Cal. App. 3d at ___, 172 Cal. Rptr. at 143, since in *Dawn* the lenders were individuals, the property involved was an apartment building and not subject to "the public policy favoring the protection of equity in a person's home," and the parties were more equal in bargaining power. 116 Cal. App. 3d. at ___, 172 Cal. Rptr. at 145. None of these distinctions, however, bears on the social welfare interest of stimulating the efficient use of resources by promoting the free

The social losses related to such impediments are difficult to quantify, but they are certainly significant. The impediment to alienation imposed by the due-on-sale clause can be compared to another impediment that is triggered by the sale of property—the capital gains tax.[131] Although the losses associated with the imposition of a capital gains tax upon sale are probably no more quantifiable than those associated with due-on-sale clauses, the undesirable economic effects associated with the "lock-in" of assets caused by the capital gains tax have long been recognized,[132] and many commentators have suggested proposals for tax reforms that would eliminate "lock-in."[133]

Another social cost attributable to due-on-sale clauses is the vast effort that has been expended by individuals and corporations to avoid triggering them. When circumstances force an owner of property to vacate, and when, absent a sub-market rate mortgage with a due-on-sale clause, he would sell; in a substantial number of cases he will choose to lease rather than pay off the mortgage. To the extent that individuals and businesses are thus unwillingly forced to become landlords, due-on-sale clauses create another source of social waste manifested in the cost of setting up and maintaining the landlord-tenant relationship, frequently across

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transferability of property. This interest is endangered at least as much, and perhaps more, when valuable commercial properties are "locked-in" to their current ownership as when residential properties are similarly locked-in.

131. Under current income tax law, a property owner's income in the form of appreciation of property is not recognized and taxed until the sale of that property. *See* I.R.C. § 1001(c) (1976). The tax thus imposes a financial "penalty" upon a property owner that is triggered by sale. If gain is to be recognized upon sale, an owner of investment property will shift his investment only if the yield on the new investment is sufficiently higher than the yield on the old to compensate for the reduced amount of the new investment the owner will be able to purchase with the proceeds remaining after payment of the capital gains tax.

132. With respect to real property especially, the Internal Revenue Code seems to acknowledge these effects. The tax law contains a number of provisions that tend to reduce or eliminate this lock-in effect for various types of property transactions. *See, e.g.*, I.R.C. § 1031 (1976) (nonrecognition granted for like-kind exchange); *id.* § 1202 (Supp. III 1979 & West Supp. 1981) (deduction of part of capital gain from gross income); *id.* § 1304 (1976, Supp. III 1979 & West Supp. 1981) (rollover of gain upon sale of principal residence).

133. *See, e.g.*, Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 256-59 (1957); David, *Economic Effects of the Capital Gains Tax*, AM. ECON. REV., May 1964, at 288, 293; Holt & Shelton, *The Lock-In Effect of the Capital Gains Tax*, 15 NAT'L TAX J. 337, 352 (1962) (asserting that lock-in effect is "the principal basis for the attack on the capital gains tax"); Waggoner, *Eliminating the Capital Gains Preference. Part I: The Problems of Inflation, Bunching and Lock-In*, 48 U. COLO. L. REV. 313, 366-97 (1977). Among the solutions that have been suggested are (1) the income taxation of appreciation at the time of death, *see* Waggoner, *supra*, at 372-75; Holt & Shelton, *supra*, at 352; and (2) the taxation of gain without relation to sale, *see* Waggoner, *supra*, at 375-86.

long distances. The same sort of societal cost results when courts decide to enforce due-on-sale clauses with respect to outright sales, but not with respect to installment land sale transactions.[134] Little justification exists for artificially stimulating the use of this much criticized device[135] by granting special amnesty from the effect of the due-on-sale clause.

(b) Social Benefits of the Due-on-Sale Clause

The economic theory of contracts holds that a net economic gain is associated with any exchange of goods because each party to a contract is assumed to be better off after entering the contract than he was before.[136] Since the due-on-sale clause is one aspect of a mortgage contract, benefits presumptively accrue to both parties upon the mutually bargained for and assented to inclusion of such a clause, and hence a loss will be imposed on the parties to a mortgage contract if the law will not enforce the parties' bargain.[137] The sum of these losses must be weighed against society's potential welfare gain to determine whether society will receive a net gain if courts rule against automatic enforcement.

Many benefits fiow from use of the mortgage device. From a lender's standpoint real estate is among the most desirable forms of loan security because it is generally slow to decpreciate (and will more typically increase in value in step with inflation), the broad market for real property assures stability of market value, theft is difficult, destruction can be insured against, and title may be ascertained with a high degree of certainty. The mortgage, therefore, is an ideal vehicle for the lender who wishes to invest funds in large amounts and for long terms and thereby minimize the ratio of transaction cost to interest earned. From the borrower's standpoint the stable security value of real estate enables him to borrow funds at a high ratio of loan amount to property value and thus maximizes his ability to discount a future income stream and acquire in the present a commodity on which the typical individual

134. *See* Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

135. *See* Nelson & Whitman, *The Installment Land Contract—A National Viewpoint*, 1977 B.Y.U. L. REV. 541; Note, *Toward Abolishing Installment Land Sale Contracts*, 36 MONT. L. REV. 110, 118 (1975) (suggesting statutory system as substitute for installment land sale contract).

136. *See* A. KRONMAN & R. POSNER, THE ECONOMICS OF CONTRACT LAW 1-2 (1979).

137. The loss will be imposed on parties who desire to enter into mortgage contracts containing an automatically enforceable due-on-sale clause, but who will not enter such contracts if they know that courts will not enforce the clause.

desires to spend a very high percentage of his earnings—housing. The long-term fixed rate mortgage also permits the borrower to commit a high proportion of his earnings to housing, since he can predict its cost with a high degree of certainty.

Clearly these mutual advantages to borrower and lender do not all vanish upon the elimination of the due-on-sale clause. The automatically enforceable due-on-sale clause in a mortgage lending scheme does not alter the quality of real estate as loan security, but instead merely serves to decrease the length of time the average loan is outstanding, and thereby decrease the considerable interest rate risk that a lender undertakes when he extends a fixed rate loan of thirty years duration. The due-on-sale clause neither increases nor decreases the total amount of interest rate risk; rather, the clause simply serves to reallocate that risk between the lender and the borrower. Without the due-on-sale clause, however, the lender's risk can be allievated by some other means or be compensated through an increased rate of interest.

Some courts have suggested that without the due-on-sale device lenders would abandon the long-term fixed rate mortgage as too risky.[138] Even with strict judicial enforcement, however, the due-on-sale clause may not be a sufficiently protective device to guarantee the continued viability of the long-term fixed rate mortgage in the current interest rate environment. Since the borrower under a due-on-sale mortgage only activates the clause when he transfers the property, and since his decision to transfer the property cannot be compelled, the clause has an uncertain and haphazard effect as a risk reducer. Lenders have predicted the period that an "average" loan is expected to remain outstanding on the basis of past experience. In a market in which current long-term rates greatly exceed those contained in existing mortgages, large numbers of prospective sellers undoubtedly will lease properties rather than forego the economic advantage inherent in their current mortgages, and thereby will thwart the lender's purpose. Moreover, when interest rates fluctuate rapidly, the term-shortening effect of the due-on-sale clause will not be sufficient to reduce to a tolerable level the interest rate risk associated with the fixed rate mortgage.

To protect themselves against the increased level of risk associated with the current volatility of interest rates, lenders have de-

138. *See* Malouff v. Midland Fed. Sav. & Loan Ass'n, 181 Colo. 294, 303, 509 P.2d 1240, 1245 (1973); Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816, 824 (Tex. Civ. App. 1981).

veloped other risk-shifting means more effective than the due-on-sale clause. Some of these other devices, including the variable rate mortgage and the rollover mortgage,[139] shift the interest rate risk to the borrower. These devices are less attractive to the borrower, because he is less able to predict the future cost or availability of mortgage financing.[140] Although some lenders undoubtedly will continue to shoulder the entire risk, but will be compensated by an increased rate of interest,[141] neither the lender nor the borrower need absorb the interest rate risk. The replacement of payable-on-demand savings by long-term mortgage pool investment as a source of mortgage funds has proceeded at a rapid rate in the last several years.[142] Investors who for years have supplied funds to the long-term corporate and government bond markets, and who are increasingly providing those funds to the mortgage markets, are better able to shoulder the interest rate risk of long-term loan commitments than is the individual property owner. Moreover, savings institutions have increasingly been able to shift rate risk to third parties by moving away from payable-on-demand savings towards funding sources that more appropriately match their assets.[143]

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139. *See* Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471, 482 n.15 (Minn. 1981); Volkmer, *supra* note 11, at 799.

140. Whether the variable rate mortgage in fact imposes a significant burden on the mortgagor has been the subject of substantial debate. *See, e.g.*, Findlay & Capozza, *The Variable Rate Mortgage and Risk in the Mortgage Market: An Option Theory Perspective*, 9 J. MONEY, CREDIT & BANKING 356, 364 (1977) (suggesting that savings and loan associations could use variable rate mortgages to solve forecasting and pricing problems "with the possibility of no adverse effects on the consumer") and authorities cited therein.

141. *See The Business Struggles to Market the RRM*, SAV. & LOAN NEWS, July 1980, at 31.

> We're not anxious to sell mortgages with a 29-year fixed-rate any more than anyone else wants to sell a product for 29 years at a fixed price. . . . [Still], . . . we'll reinstate the fixed-rate mortgage if competitive pressures dictate we should, but maybe we'll offer it with an extra half point.

Id. at 32 (Comment of Rowland J. Bartow, Chairman, Bell Fed. Sav. & Loan Ass'n, Chicago).

142. *See* U.S. LEAGUE OF SAVINGS ASS'N, SAVINGS AND LOAN FACT BOOK '80 (1980). "In 1977, private institutions for the first time offered conventional mortgage-backed pass-through securities without the sponsorship of federal agencies. . . . By year-end 1979 the mortgage pools represented 12% of the total mortgage debt outstanding on one- to four-family housing and 5.2% of the mortgage debt on multi-family housing units." *Id.* at 35.

143. The savings and loan industry is in the process of vigorous exploration for new ways to reduce their interest rate risk exposure, many of which do not place this risk on the consumer's shoulders. *See* Bush, *Pension Funds Can Help Rescue Housing*, SAV. & LOAN NEWS, Sept. 1981, at 65; Frank, *Making Money in the New World Depends on Achieving the Proper Fit of Assets and Liabilities*, SAV. & LOAN NEWS, Aug. 1981, at 80; Frank, *Financial Futures: Major New Weapons to Combat Soaring Interest Rates*, SAV. & LOAN NEWS,

Courts that have upheld due-on-sale clauses have frequently cited fairness to lenders as grounds for enforcement.[144] These courts quite reasonably find that lenders who have relied on previous decisions in developing their lending policies and drawing their mortgage instruments should not be deprived of a contractual right in which they have a considerable investment. By limiting the application of a ruling striking down the due-on-sale clause to mortgages executed after the date of the decision, however, a willing court could avoid any unfairness to lenders. If such a decision amounts to the overruling of prior case law, a ruling that is only prospective in effect will normally be appropriate when parties have negotiated and accepted contract terms in justifiable reliance on precedential authority.[145]

If a jurisdiction were to decide to apply a ruling invalidating due-on-sale clauses both retrospectively and prospectively, some courts have suggested that a further social loss would result because future borrowers would have to bear the burden of artificially high interest rates as lenders "make up" for losses associated with the unenforceability of the clauses in their outstanding mortgages.[146] This argument, however, is not economically sound. A lender in a competitive market will make loans as long as a sufficient prospective spread exists between the anticipated interest cost of acquiring funds and the anticipated interest revenue to support the use of the capital required. Certainly a single lender whose "due-on-sale losses" were particularly heavy could not attract customers if it attempted to "catch up" by charging rates above the market. Neither will an entire industry be able to charge excessive rates and "catch up," absent collusion. The loss to lenders following a decision invalidating due-on-sale clauses will in fact be imposed on the owners of the lenders' capital,[147] and will be a one-time windfall loss. While future interest rates may be raised to some extent by the resulting depletion of the institutions' capital,

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July 1981, at 62.

144. *See, e.g., supra* note 18.

145. *See* Safarik v. Udall, 304 F.2d 944, 949-50 (D.C. Cir. 1962); Cascade Sec. Bank v. Butler, 22 Wash. 2d 777, 784-85, 567 P.2d 631, 635 (1977); Annot., 10 A.L.R.2d 1371, at § 5[b] (1966).

146. *See* Williams v. First Fed. Sav. & Loan Ass'n, 651 F.2d 910, 916-17 (4th Cir. 1981); Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1003-04.

147. This statement rests on the assumption that the institution remains solvent. If it does not, losses not insured by the government may be borne by depositors. That such an insolvency had been caused by the loss of the enforceable due-on-sale clause, however, would be difficult to demonstrate.

if the assumption is valid that such institutions will be able to operate profitably in the future after recovering from losses already inherent in loan portfolios, new capital for current loans should be attracted to the point of economic equilibrium with other investments.[148]

IV. Contract Law Limitations to Enforcement of Due-on-Sale Clauses

If a court concludes that automatically enforceable due-on-sale clauses should not be declared illegal as restraints on alienation, or if it decides that the application of a rule prohibiting their automatic enforcement should have only prospective effect, it should still refuse to enforce a clause if such enforcement would violate contract law principles. Two related doctrines are involved—the law of contract interpretation and the law of standardized agreements or adhesion contracts. Although the law of restraints on alienation does not and should not focus on the status and contracting behavior of the parties, a contract law analysis may logically lead a court to determine that different rules may be appropriate in different settings and enables the court to differentiate between the individual lender and the institutional lender, and between the consumer borrower and commercial borrower.

A. Interpretation of the Contract

In many of the due-on-sale clause decisions in which courts invoke the powers of equity and declare the clause unfair, the actual bases for such rulings appear to lie in the law of contract interpretation.[149] Courts, for example, often hold that enforcement would be inequitable when the lender's goal is to obtain an increased rate or a transfer fee because these adjustments do not further the "purpose" contemplated by the clause's inclusion in the mortgage contract. Such holdings are, in effect, declarations that as a matter of common understanding and usage, due-on-sale clauses

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148. *See generally* Kalish & McKenzie, *Portfolio Drag and Savings and Loan Lending Policy*, Q. Rev. of Econ. & Bus., Summer, 1979, at 77.

> The empirical results indicated that for the entire sample of savings and loan associations and for the subsample operating in nonconcentrated markets the past portfolio yield had no effect on the current mortgage rate. There was, however, a [statistically] significant relationship in the sample of associations operating in concentrated markets.

Id. at 77.

149. *See supra* notes 44-50 and accompanying text.

are employed by lenders only in order to provide themselves a veto over assumption of their mortgages by uncreditworthy persons. When it adopts this reasoning, a court implies that the mortgagor assented to the potential enforcement of the term for this purpose only. The wording of the clause itself may reinforce this conclusion,[150] or courts may derive this interpretation from the circumstances surrounding the execution of the contract.[151] Alternatively, the decision not to enforce may be explained as an interpretation of the contract *contra proferentem*—if the contract can reasonably be interpreted to give the lender only a right to protect his security, then this interpretation should be adopted, since it is the interpretation least favorable to its drafter, the lender.[152] Under either mode of analysis no resort need be made to the principles of adhesion contracts or unconscionability.

Insofar as the interpretation of a contract term is an attempt to ascertain its "meaning,"[153] that meaning must relate to the time when the parties entered into the contract.[154] Given the long-term nature of most mortgage contracts, courts must seek to determine the generally understood meaning and purpose of the due-on-sale clause at the time of its inception, and, importantly, give consideration to any traditional practices peculiar to a given jurisdiction.[155]

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150. *See, e.g.*, First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300, 301-02 (Ala. Civ. App. 1977) (upon mortgagee's consent to transfer, mortgagee might make "reasonable charge for services in effecting transfer"), *overruled*, Tierce v. APS Co., 382 So. 2d 485, 487 (Ala. 1980); Clark v. Lachenmeier, 237 So. 2d 583, 584 (Fla. Dist. Ct. App. 1970) (agreement gave mortgagee the "right and privilege of accepting or rejecting, or passing on credit, etc. of each successor in ownership").

151. Those courts that have asserted that the purpose of the due-on-sale clause is to assure the lender's security necessarily imply the existence of some usage of trade to that effect in the mortgage lending business. *See supra* notes 41-53 and accompanying text.

152. *See supra* note 49.

153. *See* RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 49, § 200.

154. *See, e.g.*, 3 A. CORBIN, *supra* note 49, § 535, at 16 n.14 (1960).

> Thus the term "Grand Coulee Dam" is a proper name and always has been; yet it could be used at one period and by certain persons to mean a proposed low dam across the Columbia River, not yet built; it could continue to be used with that meaning even after the government had determined upon the erection of a much higher dam, after the higher dam was under construction, and even after it had been completed. The court was quite right in holding that, at the time of making the contract, the meaning of the parties had shifted to the higher dam.

Id. (quoting Northern Pac. Ry. Co. v. United States, 70 F. Supp. 836 (D. Minn. 1946)).

155. Of course, the mortgage itself may state its purpose. Mortgage clauses that have appeared in the more recent cases have often stated the lender's purpose in relatively clear terms. *See, e.g.*, Patton v. First Fed. Sav. & Loan Ass'n, 118 Ariz. 473, 578 P.2d 152 (1978) (mortgage in issue gave the lender the option to accelerate upon transfer without consent, and the lender "shall have the contractual right to withhold its consent . . . where . . . the existing interest rate of this loan is less than the current interest rate"); First Fed. Sav. &

In the context of the consumer home mortgage, an "average" borrower in 1982 arguably would have reason to know that a lender might wish to enforce a due-on-sale clause in order to exact a higher interest charge.[156] By contrast, for mortgages executed prior to the onset of the extreme rate volatility in the early 1970's, a court might find more reasonable the assumption that borrowers would have been justifiably surprised to learn the mortgagor reserved an absolute right to refuse assumption, subject to any financial inducement that could be extracted.[157] In states that, at the mortgage's inception, had usury ceilings that severely limited the lender's ability to raise interest rates, a belief that mortgages are normally assumable might have been much more widespread than in states where the lender's right to charge what the market will bear was more readily acknowledged. That so many courts have determined as a matter of law that the purpose of the due-on-sale clause is to enhance the lender's security interest, rather than to mitigate the lender's interest rate risk,[158] should serve as strong evidence that their conclusion is at least an alternative reasonable meaning to be ascribed to the clause.[159] Since the contract

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Loan Ass'n v. Kelly, 312 N.W.2d 476, 477 (S.D. 1981) (mortgage in issue stipulated that assuming buyer must agree that "the interest payable . . . shall be at such rate as Lender shall request").

156. With interest rates at their present levels, the public has been increasingly exposed to financial and economic information. The concept of the money supply, once a concern of economists and bankers only, has now become a subject that warrants even television news coverage. Still, a large segment of potential mortgage borrowers probably would not anticipate a due-on-sale clause in a mortgage and would not comprehend the implications of such a clause.

157. *See, e.g.*, Tierce v. APS Co., 382 So. 2d 485 (Ala. 1980).

> The traditional and customary purpose of the "due on sale" clause has been to protect against impairment of the lender's security . . . . A majority of this Court has rewritten the agreement between the parties in the instant case and the meaning of the "due on sale" clause in many other existing agreements so that the clause may legally be used for the hidden purpose, not within the contemplation of the parties when they signed the agreement, of allowing the mortgagee upon default to condition his acceptance . . . upon the transferee's agreement to pay a higher rate of interest than the interest agreed to in the contract. . . . A majority of this Court would allow one party to a contract to . . . give new meanings to old terms with well settled meanings.

Id. at 488-89 (Torbert, J., dissenting).

158. *See supra* notes 41-53 and accompanying text.

159. *But see* Crestview, Ltd. v. Foremost Ins. Co., 621 S.W.2d 816 (Tex. Civ. App. 1981).

> The "due on sale clause" is broad but not ambiguous. There can be no reasonable doubt of its intended meaning. . . .
>
> The wording of the clause is singularly inapt to express a contractual intention that it be narrowly limited in its effect to one particular circumstance, that is, where a sale by the owner threatens to impair the security of the debt, and ineffective or inap-

is then to be construed against the drafter, the interpretation most favorable to the borrower must prevail.[160] If the lender has specifically provided that his intention is to raise the interest rate to market levels, the principles of contract law will, of course, produce the opposite result.[161] Similarly, the lender will prevail if the borrower drafted the agreement.

That a mortgage contract may be interpreted to preclude the enforcement of a due-on-sale clause for reasons not related to the lender's security does not mean that a court must engage in a case-by-case inquiry to determine whether the particular borrower knew or should have known that a lender might wish to enforce the clause to increase his return. Under the position taken by section 211 of the *Restatement (Second) of Contracts*, "Standardized Agreements" are to be interpreted "as treating alike all those similarly situated."[162] The comments add that "courts in construing and applying the standardized contract seek to effectuate the reasonable expectations of the average member of the public who accepts it. The result may be to give the advantage of a restrictive reading to some sophisticated customers who contracted with knowledge of an ambiguity or dispute."[163] The construction of standardized contracts in this fashion not only promotes judicial efficiency but also has the salutary effect of stimulating the issuers of such contracts to draft them in such a way that an average borrower can understand exactly what he is undertaking.[164]

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plicable with respect to all other sales.

Id. at 820. The parties originating the mortgage in *Crestview* were a partnership and an insurance company, and the property was an office building with a value of $1,000,000.

160. *See* RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 49, § 206. "In choosing among the reasonable meanings of a promise or agreement . . . , that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds." *Id.*

161. *Cf.* Provident Fed. Sav. & Loan Ass'n v. Realty Centre, Ltd., 428 N.E.2d 170, 173 (Ill. App. 1981) (dictum) (suggesting a rule that due-on-sale clauses should not be enforced for purpose of allowing interest rate increase unless such purpose is expressly stated).

162. RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 49, § 211(2).

163. *Id.* comment e. This approach is justified on the ground that the "sophisticated customer" has no more choice in acceptance or rejection of the term than does the unsophisticated customer. Murray, *The Parol Evidence Process and Standardized Agreements Under the Restatement (Second) of Contracts*, 123 U. PA. L. REV. 1342, 1387-89 (1975).

164. The resistance of lenders to drafting agreements that an average borrower can understand persists. In Squires, *A Comprehensible Due-on-Sale Clause (with form)*, 27 PRAC. LAW. 67 (April 15, 1981), *reprinted in* ALI-ABA CLE REV., Sept. 25, 1981, at 1, col. 1 (pt. 1), Oct. 2, 1981, at 6, col. 1 (pt. 2), the author argues that the due-on-sale language of the standard mortgage and deed of trust instrument of the Federal National Mortgage Association/Federal Home Loan Mortgage Corporation is "labyrinthine" and that it does little to advance the layman's understanding of what he is signing. *Id.* at 71, *reprinted in* ALI-ABA

An analogous issue of contract interpretation arises in lease contract terms relating to assignment or sublease.[165] Although section 15.2 of the *Restatement (Second) of Property* approaches this problem as an issue of restraints on alienation,[166] the solution takes the color of contract law: the landlord may not unreasonably refuse consent to an assignment or sublease "unless a freely negotiated provision in the lease gives the landlord an absolute right to withhold consent."[167] Although the section does not explicitly state that withholding consent to assignment for the purpose of obtaining a rent increase is unreasonable, some courts have stated such a rule.[168] Under this view, the *Restatement*'s position forces the conclusion that the lessor's refusal of consent for the purpose of demanding a rent increase is not inherently unreasonable, but that to interpret the contract to confer such a right would be unreasonable, absent an express contractual term providing for it. A rule for due-on-sale clauses that parallels the rule of section 15.2 of the *Restatement (Second) of Property* would mandate nonenforcement if the lender's purpose in refusing consent to assumption is to demand an increase in the interest rate, unless the lender has expressly reserved such a right in his contract.[169]

B. Unconscionability/Adhesion Analysis

An independent contract law basis for a ruling that a due-on-

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CLE REV., Sept. 25, 1981, at 5, col. 2. The comment of Michael H. Cardozo, Member, Committee on Legal Drafting, American Bar Association, which accompanies the reprint, suggests that "the seed of excessive litigation can be planted by 'lawyers language.' " ALI-ABA CLE REV., Sept. 25, 1981, at 1, col. 1.

165. This analogy was drawn in Comment, *Debtor-Selection Provisions Found in Trust Deeds and the Extent of Their Enforceability in the Courts*, 35 S. CAL. L. REV. 475, 487-90 (1962).

166. The *Restatement* states,

> Restraints on Alienation
>
> . . . .
>
> (2) A restraint on alienation without the consent of the landlord of the tenant's interest in the leased property is valid, but the landlord's consent to an alienation by the tenant cannot be withheld unreasonably, unless a freely negotiated provision in the lease gives the landlord an absolute right to withhold consent.

RESTATEMENT (SECOND) OF PROPERTY § 15.2 (1977).

167. *Id.*

168. *See, e.g.*, Homa-Goff Interiors, Inc. v. Cowden, 350 So. 2d 1035, 1037-38 (Ala. 1977); Ringwood Assocs., Ltd. v. Jack's of Route 23, Inc., 153 N.J. Super. 294, 303, 379 A.2d 508, 512 (Law Div. 1977). *Contra* B & R. Oil Co. v. Ray's Mobile Homes, Inc., 139 Vt. 122, 122-23, 422 A.2d 1267, 1267-68 (1980) (expressly rejecting position of the RESTATEMENT (SECOND) OF PROPERTY, *supra* note 166, § 15.2).

169. The court in Provident Fed. Sav. & Loan Ass'n v. Realty Centre, Ltd., 428 N.E.2d 170 (Ill. App. 1981), suggested the adoption of such a rule.

sale clause may not be enforced is that the clause is one of adhesion and that its enforcement would be unconscionable or unfair. The doctrine of adhesion contracts is premised on the idea that in some circumstances a court should refuse enforcement of a provision of a standardized form contract imposed by one of the parties even though enforcement would be granted if the parties had negotiated and prepared the writing together.[170] The typical homeowner/borrower mortgage contract, and probably many commercial mortgages, fall into this pattern.

The law of adhesion contracts is still at an early stage of development. The authorities disagree substantially over what should be the philosophical basis for specialized treatment[171] and in what ways courts should give effect to adhesion contracts and terms. This Note makes no attempt to summarize the law of adhesion contracts; it does attempt, however, to determine whether a court might conclude that the borrower would not reasonably expect to find such a clause in a mortgage contract—would be "surprised" by it—or that the due-on-sale clause is in some way "unfair." Either finding may serve to justify invalidation of the clause under an adhesion contract analysis.

1. Surprise

Signers of mutually negotiated contracts are not absolutely precluded from relief against unexpected terms. Nevertheless, in accordance with the "special effect"[172] that the law traditionally accords written agreements as formal "manifestations of assent,"[173] absent a showing of fraud, mistake, or some other major flaw in the contractual scheme, courts will not grant relief from the terms of a

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170. *See generally* 3 A. CORBIN, *supra* note 49, § 559; RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 49, § 211; Dugan, *Standardized Form Contracts—An Introduction*, 24 WAYNE L. REV. 1307 (1978); Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

171. *See, e.g.*, 3 A. CORBIN, *supra* note 49, §§ 559A-559I (Supp. 1980) (discussing adhesion contracts under topic "Interpretation"); J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 9-44 (2d ed. 1977) (discussing adhesion contracts under topic "Duty te Read"); J. MURRAY, MURRAY ON CONTRACTS § 350 (2d ed. 1974) (discussing adhesion contracts under topic "Unconscionability"); RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 49, § 211(3) & comment f (dealing with "standardized agreements" under topic "Effect of Adoption of a Writing" but suggesting that the rule is closely related to unconscionability and interpretation).

172. *See* RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 49, §§ 209-218 introductory note.

173. *See* J. MURRAY, *supra* note 171, § 19.

written contract.[174] The barriers to relief from an unexpected term in an adhesion contract are less formidable.

In an adhesion contract setting courts recognize that those who assent to such contracts do not normally read them.[175] Courts also recognize that as a matter of social policy it may not be desirable that adhesion contracts be read by those who sign them,[176] and that many who sign such contracts would be incapable of comprehending them even if they were to attempt a reading.[177] A court, therefore, should not allow a mortgagee to benefit from a standardized term incorporated in a mortgage contract that the borrower would not reasonably expect to find in such a contract.

Whether due-on-sale clauses are "reasonably expectable" in mortgages may vary according to the date and place that the contract was executed, and this inquiry parallels the inquiry into the proper interpretation of the contract. Interpretation, however, is not at issue in an adhesion analysis—the court may refuse to enforce the clause even though it clearly states that the lender intends to enforce the clause whenever possible for its own economic advantage and not merely as a device for security enhancement. Under an adhesion contract analysis the mortgagor should not be bound by the clause because he is not required to read the contract beyond its negotiated terms and would not reasonably have anticipated that the mortgage would contain such a clause.[178] When a lender includes in a mortgage contract a term that the borrower might find surprising, the term should, at the least, be called to the

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174. *See* J. CALAMARI & J. PERILLO, *supra* note 171, § 9-43.

175. *See, e.g.*, Weaver v. American Oil Co., 257 Ind. 458, 464, 276 N.E.2d 144, 147 (1971) (comparing adhesion contract to " 'a package' in printed form" and placing burden on drafter to show assent to "unusual or unconscionable terms").

176. For example, if all who entered into auto rental agreements read the full contract before turning the ignition, much of the commercial world might grind almost to a halt. *See* Kessler, *supra* note 170, at 632; Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 857 (1964).

177. *See, e.g.*, Weaver v. American Oil Co., 257 Ind. 458, 460-61, 276 N.E.2d 144, 145-46 (1971).

178. *See* J. CALAMARI & J. PERILLO, *supra* note 171, § 9-46, at 346; K. LLEWELLYN, THE COMMON LAW TRADITION 370 (1960). In a recent case, a California Court of Appeal refused to grant automatic enforcement to the beneficiary of a second trust deed under an adhesion contract theory, but specifically found that the clause was ambiguous. *See* Wilhite v. Callihan, 121 Cal. App. 3d 661, ___, 175 Cal. Rptr. 507, 512 (1981). Since the adhesion contract analysis was one of several "constellated reasons," *id.* at ___, 175 Cal. Rptr. at 512, that the court gave for its result, whether the court would have viewed the inclusion of an express term granting a right of automatic enforcement as "surprising" or otherwise unfair is not clear.

borrower's attention.[179] Even if the term is, in some general sense, "fair," the borrower should be given the opportunity to decide for himself whether an otherwise unexpected term is acceptable to him. When the objection to the term relates to its unexpected nature, a lender may insulate himself by "flagging" or separately negotiating the term. If borrowers are made aware of the clause's existence they will have an incentive to negotiate the clause or to shop for a mortgage that does not contain such a clause. Only if borrowers shop for mortgages will mortgagees be motivated to offer a mortgage without a due-on-sale clause.

2. Fairness

Courts ordinarily do not review mutually negotiated contracts to determine their substantive fairness.[180] If fairness is understood to relate to the bargain at the time of its inception, even courts of equity traditionally have not upset bargains unless the imbalance was extreme—a contract "such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other."[181] Particularly in recent years, however, courts have subjected standardized form, adhesion contracts to stricter scrutiny for substantive fairness.[182]

Most of the authoritative discussion of the ability of courts to review adhesion contracts for inherent fairness has been stated in terms of "substantive unconscionability."[183] Authorities have rec-

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179. The objection might be stated that if courts required the borrower to be completely informed of the terms of the mortgage, lenders might not be able to enforce the detailed provisions of foreclosure procedures since they were not "anticipated" by the borrower. Borrowers, however, can be held to an expectation that a mortgage will contain normal and customary security protection provisions. In today's interest rate environment the use of due-on-sale clauses to hedge interest rate risk may be normal and customary. In an earlier and calmer interest rate environment, however, such use may not have been customary as is evidenced by the number of due-on-sale clause opinions which state that it was not. Many mortgages executed during that period are still outstanding. *See supra* notes 155-59 and accompanying text.

180. *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965) ("Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain") (footnote omitted).

181. Earl of Chesterfield v. Janssen, 28 Eng. Rep. 82, 100 (Ch. 1750).

182. See 3 A. CORBIN, *supra* note 49, § 559A (Supp. 1980) and authorities cited therein; Dugan, *supra* note 88. *But see* Mills v. Nashua Fed. Sav. & Loan Ass'n, 433 A.2d 1312, 1315 (N.H. 1981) (approving concept of adhesion contract, but stating that "courts cannot . . . rewrite contacts merely because they might operate harshly or inequitably" and noting absence of evidence that contracts did not result from "a mutual meeting of the minds").

183. *See* Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757, 762-63, 773-

ognized that the reasons for not enforcing a contract relate either to the process of its formation or to its substantive content.[184] With respect to the due-on-sale clause the issue may be framed as follows: If a lender "flags" the clause, for example, by requiring a special initialing, and the clause is clearly brought to the borrower's attention, might a court still appropriately strike the clause as an unfair term in an adhesion contract? Put differently, when the deficiencies of notice related to adhesion contracts, as distinguished from mutually negotiated contracts, are eliminated, do distinctions remain that should invoke stricter scrutiny?

Some courts would answer these questions in the negative. These courts view the giving of notice as, in effect, transmuting an "adhesion term" into a "dickered term." Thus, they return to the *laissez-faire* standard of review applied to traditional contracts.[185] Other courts and writers, however, accept the proposition that when all who offer a given commodity have incorporated the same term in their contracts and will not negotiate it, or when the purchaser justifiably assumes that shopping for relief from an onerous term will only result in the substitution of equally onerous terms, no genuine assent to the term is possible, and the bargain's fairness remains reviewable.[186]

A court reviewing a due-on-sale clause for substantive fairness is in much the same position as a court deciding the reasonableness of a restraint on alienation, and the result will depend upon the court's concept of fairness. One judicial approach would be to engage in a weighing of the aggregate benefits accruing to the mortgagee and mortgagor. One court engaging in a restraint on alienation analysis of a due-on-sale clause concluded that such bargains are indeed fair exchanges—lenders are able to keep their mortgage portfolios in a profitable state and a corresponding benefit is received by borrowers in the form of more advantageous loan terms.[187] This court's approach is consistent with the doctrine that the contract must be inspected for unfairness or unconscionability at its inception—if it was fair at that time, then the borrower may not complain when he must fulfill his side of the bargain.

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803 (1969); Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 509-28 (1967).

184. *See* Ellinghaus, *supra* note 183, at 773-803; Leff, *supra* note 183, at 509-28.

185. *See supra* notes 180-82 and accompanying text.

186. *See* J. MURRAY, *supra* note 171, § 353, at 748.

187. *See, e.g.*, Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1001-02.

Such a finding, however, cannot be the end of an adhesion contract analysis. If fairness at inception were all that were required for a finding of overall fairness, virtually any contract provision could be justified on the theory that in a competitive environment the economic benefits of the clause's inclusion are passed on to the adherent in the form of a reduction in cost. Yet, allocation of detriment and benefit, even though fair in the aggregate, may be unfair in the particular. When an adhesion contract allocates risk to the class of adherents in such a way that the economic detriment falls on a sufficiently small proportion of that class, the result may be harsh in the individual instance and therefore unfair. The unfairness does not arise in the allocation of risk or detriment between the stronger party and the class of adherents, but in the way in which circumstances allocate the burden of the detriment among the adherents.[188]

Whether the burden imposed on an individual mortgagor by the enforcement of a due-on-sale clause amounts to harshness is certainly open to debate. Courts have repeatedly noted that the acceleration of a mortgage loan in an environment of rising interest rates imposes no loss on the mortgagor, but merely deprives him of a profit that he had no particular reason to anticipate.[189] Nevertheless, even though the exercise of the due-on-sale clause merely allows recoupment by the lender of the borrower's windfall, this Note has demonstrated that the typical borrower who is forced to prepay a sub-market rate mortgage is in a worse position than if interest rates had remained unchanged from their level at the time of the mortgage's inception.[190] If he desires to reinvest and if he

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188. *See* Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 403-04, 161 A.2d 69, 81 (1960). When the burdens of a contract are excessively harsh in particular cases, elements are present that might justify unenforceability as a matter of public policy. The implication is that public policy may be different in an adhesion contract setting than in a "dickered contract" setting. In *Henningsen* the court found that the statutory authorization of agreements between buyer and seller disclaiming warranties

> did not authorize the automobile manufacturer to use its grossly disproprotionate bargaining power to relieve itself from liability and to impose on the ordinary buyer, who in effect has no real freedom of choice, the grave danger of injury to himself and others that attends the sale of such a dangerous instrumentality as a defectively made automobile.

Id. at 404, 161 A.2d at 95.

189. *See, e.g.*, Dunham v. Ware Sav. Bank, 1981 Mass. Adv. Sh. 1607, ___, 423 N.E.2d 998, 1002; Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 627, 224 S.E.2d 580, 585 (1976); Gunther v. White, 489 S.W.2d 529, 532 (Teun. 1973) ("Finally analyzed, the situation here is simply that appellants can sell their property at a higher price if they can sell it at the lower interest rate.").

190. That is, he cannot sell his property and then purchase similar property without

must obtain financing, then he will be forced to borrow at the new higher rate. Furthermore, the high interest rate will exacerbate his financial disadvantage since the price he will receive for the property will undoubtedly be less than it would have been in a lower interest rate environment. Still, unless one imagines a market in which credit is simply unavailable, and perhaps even in such a market, the borrower's property will sell at some price, and the means will probably be available to provide for the mortgage's payment. Whether this amounts to harshness is of course subjective; the majority of the courts have concluded that it does not.

V. DUE-ON-ENCUMBRANCE CLAUSES

A term that has frequently appeared alongside a due-on-sale clause in a mortgage is the due-on-encumbrance clause. This clause contains the mortgagor's promise not to further encumber the property or provides that the mortgagee may accelerate the mortgage note upon such encumbrance. The single case to have ruled on the validity of such a clause in isolation is *La Sala v. American Savings & Loan Association.*[191] In *La Sala* the California Supreme Court held that the enforcement of a due-on-encumbrance clause was an unlawful restraint on alienation whenever the borrower's execution of a junior mortgage did not endanger the lender's security.[192] Even though other courts have not explored the validity of these clauses,[193] conclusions drawn from the preceding analysis suggest that even though a jurisdiction may opt for the general enforcement of the due-on-sale clause, the same result is not necessarily compelled in a due-on-encumbrance clause ruling.

A. Due-on-Encumbrance Clause as Restraint on Alienation

The court in *La Sala* assumed without discussion that a clause stipulating acceleration of the mortgage upon encumbrance was a sufficient interference with a property right to bring it within the

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incurring financial loss. *See supra* notes 65-75 and accompanying text.

191. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

192. *Id.* at 869, 489 P.2d at 1115, 97 Cal. Rptr. at 851. The same reasoning was later extended to the due-on-sale clause in Tucker v. Cassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974), and Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

193. This absence of case law may in part be the result of a reluctance on the part of lenders to demand enforcement of due-on-encumbrance clauses. In *La Sala* the lender attempted to have the borrowers' class action suit for declaratory judgment dismissed by waiving the clause as to the class representatives. 5 Cal. 3d at 873, 489 P.2d at 1117, 97 Cal. Rptr. at 853.

California statutory provision against restraints on alienation.[194] Under the historic concept of the mortgage as a conveyance of legal title subject to a condition subsequent, the mortgage was certainly "alienation" within the scope of the rule against restraints.[195] Under the modern "lien theory" of the mortgage,[196] the giving of property as security for a loan arguably is not "alienation" at all and, thus, not subject to the rule against restraints. In the courts, the determination of whether the mortgaging of land constitutes "alienation" has varied with the interest affected. Courts have held that the execution of a mortgage is not "alienation" in the context of a provision in an insurance policy that declared the policy void upon alienation of the property,[197] or a provision in a homestead act prohibiting alienation by an entryman before the issuance of a patent.[198] On the other hand, a court has held that a statute, which proscribed "alienation" of land held by a widow during a subsequent remarriage, prevented her from mortgaging the property.[199] The proper position is that restraints on encumbrance should be considered restraints on alienation if the asserted restraint produces effects that the rules against restraints on alienation are designed to prevent. The inability of an owner to mortgage his land may run afoul of the social interests in promoting the effective utilization of wealth, in keeping property responsive to the current exigencies of its owners, and in encouraging the improvement of property—all of which are interests protected by the rule against restraints.[200]

To the extent that a covenant or impediment against the mortgaging of property removes potential loan collateral from the marketplace, it is an impediment to the lending process itself.

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194. *See id.* at 877-78, 489 P.2d 1121-22, 97 Cal. Rptr. at 857-58.

195. The intermediate appeals court in *La Sala* viewed the encumbrance of the property as a reduction of the owner's interest, and in that sense an action on which a lender might condition his continued extension of credit. La Sala v. American Sav. & Loan Ass'n, 91 Cal. Rptr. 238, 242-43 (Cal. App. 1970), *rev'd*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

196. Under the lien theory the mortgagor holds legal title until there has been a foreclosure. *See* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 11, § 4.2, at 118.

197. *See* Smith v. Mutual Fire Ins. Co., 50 Me. 96, 97-98 (1863); *see also* Virginia Fire & Marine Ins. Co. v. Feagin Bros., 62 Ga. 515, 519 (1879) (mortgage not alienation within meaning of state insurance statute).

198. *See* Stark v. Morgan, 73 Kan. 453, 85 P. 567 (1906); Worthington v. Tipton, 24 N.M. 89, 92-94, 172 P. 1048, 1049-50 (1918).

199. *See* United States Sav. Fund & Inv. Co. v. Harris, 142 Ind. 226, 237-38, 40 N.E. 1072, 1075 (1895).

200. *See supra* text accompanying notes 125-26.

Credit arrangements may be the primary facilitant to capital formation in a capitalist economy. When a mortgagor is prevented from further borrowing against his property interest, this form of capital flow is clogged. The result is a welfare loss to society.

Whether society will realize a net gain if the due-on-encumbrance clause is declared an illegal restraint on alienation will depend on whether the sum of the individual benefits resulting from its inclusion in mortgage contracts are outweighed by the social benefit resulting from the elimination of its effects in restraining "alienation." As in the case of the due-on-sale clause, the mutual benefit accruing to mortgagee and mortgagor are probably impossible to measure accurately.[201] An intuitive analysis, however, leads to the conclusion that the due-on-encumbrance clause is probably of minimal importance to lenders as an inducement to the extension of the long-term fixed rate mortgage.[202] As a device to reduce interest rate risk, the due-on-encumbrance clause is almost certainly less effective than the due-on-sale clause. The circumstances that induce an owner to sell outright are frequently so compelling that even a major sacrifice imposed by the prepayment of a submarket rate mortgage must be endured and lenders, therefore, can predict property turnover with some degree of reliability for a given area. The decision whether or not to enter into a junior mortgage is probably more within the mortgagor's control—funds may be borrowed under other arrangements, or he may simply opt not to borrow at all.[203] Whether any rate risk premium that a mortgagee must charge to extend a fixed rate mortgage is significantly reduced in exchange for the borrower's willingness to enter into a due-on-encumbrance agreement is doubtful. Certainly the continued availability of the long-term fixed rate mortgage to con-

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201. *See supra* notes 136-38 and accompanying text.

202. Whether due-on-encumbrance clauses still exist in a majority of the mortgage instruments currently in use may be questioned. Current Federal Home Loan Bank Board regulations prohibit the associations that it governs from enforcing due-on-encumbrance clauses with respect to consumer mortgage loans made after July 31, 1976. 12 C.F.R. §§ 545.8-3(f), (g)(1) (1981). These regulations also declare that associations continue to have the power to include due-on-sale clauses in their mortgage contracts and that "the exercise of [due-on-sale clauses] shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and the borrower shall be fixed and governed by that contract." *Id.* § 545.8-3(f). Substantial litigation has ensued addressing the question whether these regulations preempt state law. *See* Dunn & Nowinski, *supra* note 3, at 292-300 and authorities cited therein.

203. Commentators have also noted that a property owner may more easily hide the second mortgage transaction from a first mortgagee than hide an outright sale. *See* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 11, § 5.21, at 297.

sumer homeowners will not hinge on the continued legality of the due-on-encumbrance device.

Particular instances may still exist in which significant benefits will accrue to a lender from the inclusion of a due-on-encumbrance clause in a mortgage. A court in a majority rule jurisdiction[204] must decide whether such benefits are important enough to warrant their inclusion in a class of "mortgagee's restraints" that will be allowed. In a minority rule jurisdiction[205] a court, upon proof of reasonableness by a lender, might allow the enforcement of the clause on a case-by-case basis. In the vast majority of cases, however, a general inclusion of the due-on-encumbrance clause within the class of illegal restraints upon alienation would result in a net benefit to society in terms of increased efficiency of resource allocation.[206]

B. Analysis of the Due-on-Encumbrance Clause and the Principles of Contract Law

A court may refuse to enforce a due-on-encumbrance clause as a matter of contract law. The analysis is similar to the contract law analysis of the due-on-sale clause—if under the circumstances the clause was not a part of the parties' bargain, or if enforcement would be an unfair use of a standardized form, enforcement should be refused.[207] Based on principles of contract interpretation, a refusal to enforce a due-on-encumbrance clause included as a device to exact increased rates of interest may be more difficult to justify than a similar refusal to enforce a due-on-sale clause. The case for invalidation of the due-on-encumbrance clause as an unconscionable adhesion contract, however, may be stronger than the case for a finding that the due-on-sale clause should be invalidated on this ground.[208]

1. Interpretation of the Due-on-Encumbrance Clause

The interpretation of the due-on-encumbrance term follows the same lines of analysis as the interpretation of the due-on-sale term. This Note has demonstrated that the potential double purpose of the due-on-sale clause may render the clause ambiguous.[209]

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204. *See supra* text accompanying notes 105-10.
205. *See id.*
206. *See supra* notes 129-35 and accompanying text.
207. *See supra* notes 149-90 and accompanying text.
208. *See supra* notes 170-90 and accompanying text.
209. *See supra* notes 149-52 and accompanying text.

This argument may have less force in the case of the due-on-encumbrance clause since the usefulness of the clause as a device to enhance the quality of the mortgagee's security is so speculative.[210] Nonetheless, if a court finds that at the time the contract was executed lenders customarily did not exact a penalty or interest rate increase in return for allowing a mortgagor to further encumber his land, the rule of interpretation of the contract most strongly against the drafter should prevail and the lender should be allowed to enforce only for the purpose of protecting his security.

2. Due-on-Encumbrance Clause as Contract of Adhesion

Adhesion contracts are subject to judicial review if their terms are unfair or if they result in surprise.[211] The argument that the due-on-encumbrance clause is substantively unfair is not as strong as the argument that the due-on-sale clause is unfair, since the mortgagor, in most circumstances, has more personal discretion to avoid giving a junior lien than he does to avoid the outright sale of property. The argument that due-on-encumbrance clauses are "surprising" to the borrower is much more persuasive because of the minimal impact of the clause as protection of the lender's security. The average consumer mortgagor is probably as surprised to find that he cannot further encumber without paying off the first mortgage, as he would be to find that the loan might be accelerated if he lost his job. Presumably either of these terms might be enforced if the parties knowingly bargained for and agreed to it. Neither term should be enforced when included without warning in a lengthy contract, the bulk of whose terms would be incomprehensible to the average consumer. Because a due-on-encumbrance clause is substantially more "surprising" than a due-on-sale clause, it should be correspondingly more vulnerable to invalidation under the law of standardized contracts.

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210. Although some commentators imply that the due-on-encumbrance clause enhances the lender's security by limiting the borrower's access to junior financing, *see* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 11, at 297; Volkmer, *supra* note 11, at 770, an honest appraisal of the mortgagee's position suggests that, at least with respect to completed residential properties, the lender's primary purpose in including the clause is the reduction of interest rate risk. The lender in *La Sala* candidly admitted that a purpose in including the clause was to insert a trigger, in addition to sale, that would allow acceleration of the note with the subsequent opportunity for the lender to maintain a more profitable mortgage portfolio. La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 889 n.17, 489 P.2d 1113, 1123 n.17, 97 Cal. Rptr. 849, 859 n.17 (1971).

211. *See supra* text accompanying notes 172-90.

VI. CONCLUSION

Due-on-sale clauses and due-on-encumbrance clauses are restraints on alienation, and their enforcement imposes costs upon society. As devices to shift interest rate risk from the mortgage lender to the borrower, their effectiveness is questionable, and, in an environment in which long-term mortgage rates have become increasingly unpredictable, whether the preservation of the devices will contribute meaningfully to the preservation of the thirty-year fixed rate mortgage is doubtful. A court which believes that the announcement of a rule of general unenforceability would unjustly injure the vested rights of lenders should invalidate the clauses through a rule of prospective application, rather than institutionalize a device whose social effects are harmful and whose purpose can be achieved by more benign means.

A jurisdiction which determines that automatically enforceable due-on-sale and due-on-encumbrance clauses are socially desirable should place the burden on lenders to ensure that any unfairness resulting from their enforcement is minimized. Its courts should insist that if either clause is to be enforced, the clause must clearly be brought to the attention of the borrower by means of an unambignous statement of the lender's purpose. Lenders should not be permitted to use standardized contracts and routine judicial enforcement to relieve themselves of risks that they were able to foresee but of which many or most of their customers were unaware at the time their mortgages were executed.

JOSEPH GIBSON, III