

Wellenkamp v. Bank of America:¹

Invalidation of Automatically Enforceable Due-on-Sale Clauses

The California Supreme Court held that an institutional lender may not automatically enforce a due-on-sale clause contained in a deed of trust upon sale of the encumbered property. The court found the clause, which allows the lender to accelerate the debt upon sale of the property, to be invalid as an unreasonable restraint on alienation, absent evidence showing impairment of the lender's security. This Note views *Wellenkamp* as the culmination of a series of cases challenging the validity of "due-on" clauses. Part I details the facts of the case. Part II relates the opinion to existing law. Part III sets out issues the court left unresolved. Part IV explores *Wellenkamp*'s impact on other provisions in real property instruments, such as lock-in clauses. Finally, Part V discusses *Wellenkamp*'s effect on current methods of financing. This Note first will argue that the court's holding is clearly applicable only where concerns about unequal bargaining power are present, as in the sale of residential owner-occupied property, and second will demonstrate that the court's failure to make these concerns explicit generated analytic lapses in the opinion which reduce its predictive value.

I

THE CASE

In July 1973, Birdie, Fred, and Dorothy Mans purchased a parcel of residential real property in Riverside County. They borrowed \$19,100 from the Bank of America against a promissory note secured by a first deed of trust on the real property. The deed of trust contained a standard due-on-sale clause which permitted the lender to accelerate the amount remaining due on the note following the trustor's sale or encumbrance of the property.² In July 1975, Cynthia Wellenkamp, the

1. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

2. The clause provided that if the trustor (the Mans) sells, conveys, alienates . . . said property or any part thereof, or any interest therein . . . or becomes divested of [his] title or any interest therein . . . in any manner or way, whether voluntarily or involuntarily, . . . Beneficiary shall have the right at its option, to declare said note . . . secured hereby . . . immediately due and payable without notice. . . .

plaintiff, purchased the property from the Mans. She paid them the difference between the total selling price and the balance outstanding on the Mans' loan and assumed the balance of the loan at the stated interest rate. The stated rate was below current market at the time of transfer (8% as opposed to the prevailing 9 1/4%).³ The Mans promptly notified the bank of the sale. The bank notified Wellenkamp of its intention to accelerate the debt, but offered to waive acceleration if she refinanced the Mans' loan at the interest rate it charged new customers (9 1/4%).⁴ When Wellenkamp refused, the bank served her with a "Notice of Default and Election to Sell the Property," arising from the power of sale provision in the deed of trust.

Wellenkamp sought an injunction against enforcement of the due-on-sale clause and a declaratory judgment that its exercise constituted an unreasonable restraint on alienation violating California law, absent a showing by the lender that the transfer jeopardized its security. The bank demurred, arguing that the case raised no question of fact and that automatic enforcement of the due-on-sale clause was valid under California law. The superior court sustained the bank's demurrer without leave to amend, and Wellenkamp appealed to the supreme court.⁵

The court determined that automatic exercise of the due-on-sale clause produced a restraint on alienation that outweighed the bank's justification for its enforcement.⁶ The court found that enforcement of the clause in a tight money market inhibited the borrower from selling her property.⁷ The bank had argued that the clause helped it lessen the risk of waste and maintain its loan portfolio at current rates. While admitting the factual accuracy of these arguments, the court found that the policy prohibiting restraints on alienation outweighed the bank's concerns. It reasoned that a lender may enforce a due-on-sale clause only when the lender demonstrates that the purchaser is likely to default and that such risk of default jeopardizes the lender's security interest. The court also found that use of the clause to exact higher

Id. at 946, 582 P.2d at 972, 148 Cal. Rptr. at 382 (ellipses as in court's opinion).

3. *Id.*

4. *Id.*

5. *Id.*

6. In so holding, the court overruled in part *Coast Bank v. Minderhout*, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964). 21 Cal. 3d at 953, 582 P.2d at 976, 148 Cal. Rptr. at 373.

7. 21 Cal. 3d at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84. In a tight money market, if the lender accelerates the seller's loan, sale to any buyer unable to find new financing would be impossible. Such a buyer could not provide the seller with enough cash to pay off the secured debt. Even if the lender waived acceleration and permitted assumption at an increased interest rate, the buyer must bear these costs. Thus, depending on the availability of new financing, the lender's enforcement of the clause could force the seller to either lower his purchase price, or forego sale. The court disregarded similar arguments in *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 169, 116 Cal. Rptr. 633 (1974).

interest charges through threats of acceleration is never justified.⁸ A lender can reduce the risk of rising interest rates by paying close attention to long range economic trends. If a lender desires to allocate the risk of rising interest rates between the parties, it can offer loans with a variable rate provision.⁹

II

PRIOR LAW

In *Coast Bank v. Minderhout*,¹⁰ the California Supreme Court upheld the validity of due-on-sale clauses. It determined that the statute prohibiting restraints on alienation applied only to "unreasonable" restraints and that a due-on-sale clause need not constitute an unreasonable restraint.¹¹ In *Coast Bank*, the bank sought to characterize its "Agreement Not to Encumber or Transfer Property" with the debtor as a mortgage that could be judicially foreclosed, thereby preventing the debtor's sale of the encumbered property to a third party. The court held the instrument to be an equitable mortgage. The buyer countered by arguing that even if the instrument were an equitable mortgage, it constituted an unreasonable restraint on alienation and was therefore unenforceable. The court, however, rejected this argument, finding that it was "not unreasonable for [the bank] to condition its continued extension of credit to the [borrowers] on their retaining their interest in the property that stood as security for the debt."¹²

In *La Sala v. American Savings and Loan Association*,¹³ the supreme court reevaluated the logic of *Coast Bank* and its progeny.¹⁴ In *La Sala*, the lender threatened to accelerate the plaintiff borrowers' loan under a standard form due-on-encumbrance provision after learning that they had encumbered the property. In return for waiving acceleration, the bank charged assumption fees and increased plaintiffs' interest rate from six to nine percent, the then prevailing rate. The court invalidated the vendor's acceleration, holding that enforcement of the due-on-encumbrance clause unlawfully restrains transfer whenever the encumbrance does not endanger the lender's security. It found that the lender's justification for enforcing the clause rested solely on

8. 21 Cal. 3d at 953 n.11, 582 P.2d at 976 n.11, 148 Cal. Rptr. at 385 n.11.

9. *Id.* at 953 n.10, 582 P.2d at 976 n.10, 148 Cal. Rptr. at 385 n.10.

10. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

11. California thereby embraced the "minority rule" regarding restraints on alienation. Comment, *The Demise of the Due-on-Sale Clause*, 64 CALIF. L. REV. 286, 573-601 (1976).

12. 61 Cal. 2d at 317, 392 P.2d at 269, 38 Cal. Rptr. at 509 (1964).

13. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

14. *Cherry v. Home Sav. & Loan Ass'n*, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (2d Dist. 1969), and *Hellbaum v. Lytton Sav. & Loan Ass'n*, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1st Dist. 1969), both disapproved by *Wellenkamp*, 21 Cal. 3d at 953, 582 P.2d at 976, 148 Cal. Rptr. at 373.

the lender's desire to realize gain.¹⁵

The court noted, however, that a lender could accelerate a loan upon the borrower's sale of encumbered property. Sale, unlike further encumbrance, divests the seller of his interest in the property, making the buyer responsible for its care and maintenance. Acceleration would thus provide lenders with "full protection." Yet it was unclear whether lenders were entitled to "full protection" in such a case. As the court noted in *La Sala*, "when [enforcement of the due-on clause] is not reasonably necessary to protect the security, the lender's use of the clause to exact collateral benefits must be held to be an unlawful restraint on alienation."¹⁶ The court's concern with the use of due-on clauses to attain "collateral benefits" like increased interest charges set the stage for *Tucker* and *Wellenkamp*.

In *Tucker v. Lassen Savings and Loan Association*,¹⁷ the court held that automatic enforcement of a due-on-sale clause following a sale of the encumbered property by installment land contract would constitute an "unreasonable" restraint on alienation.¹⁸ The court determined that whenever the quantum of restraint effected by the automatic exercise of the due-on-sale clause outweighed the lender's justification for its enforcement, use of the clause would unreasonably restrain the borrower's ability to transfer his property. There was no evidence in *Tucker* that the danger of depreciation or waste supported acceleration, since the lender had not even investigated the buyer's credit or moral responsibility before accelerating.¹⁹ Moreover, the lender failed to demonstrate how any installment sale contract, which left title in the

15. *Wellenkamp* disapproved *Cherry's* reasoning that restraints against encumbrances are necessary to enable lenders to maintain their loan portfolios at the current interest rate. 21 Cal. 3d at 953 n.11, 582 P.2d at 976 n.11, 148 Cal. Rptr. at 385 n.11. *La Sala* found that a restraint on alienation is not reasonable "merely because it is commercially beneficial to the restrainer." 5 Cal. 3d at 880 n.17, 489 P.2d at 1125 n.17, 97 Cal. Rptr. at 859 n.17. The court did not cite any extrastate authorities that have evaluated the efficacy of the lender's loan portfolio argument, preferring to rest its analysis on the reasoning advanced in *Tucker* and *La Sala*. 21 Cal. 3d at 949 n.3, 582 P.2d at 973 n.3, 148 Cal. Rptr. at 382 n.3. Had it done so it would have found itself advancing a minority view. See Comment, *supra* note 11, at 591.

16. 5 Cal. 3d at 882, 489 P.2d at 1125, 97 Cal. Rptr. at 859.

17. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974) (unanimous decision).

18. In *Tucker*, the borrowers did not intend to reside in the purchased property. At the time of the purchase, the bank knew that plaintiffs were real estate brokers or salesmen. *Id.* at 633, 526 P.2d at 1171, 116 Cal. Rptr. at 635. The court thus had no reason to determine whether the trustor's commercial interests in *Tucker* would justify acceleration of the due-on-sale clause. This hint of waiver by the bank militates against the possibility that the court wished to use this case to stress the identity of interest between commercial and residential borrowers with respect to execution of due-on-sale clauses by lenders.

19. Shifting the burden of proof forces the lender to bear the expense of investigating each new purchaser. In addition to these expenses, a lender who zealously enforces due-on-sale clauses would leave himself open to a class action suit by each borrower who challenges the lender's finding of impairment.

seller and passed possession to the buyer, could impair the lender's security interest in the property.²⁰

III

THE OPINION

A. Balancing Lender and Borrower Interests

In *Wellenkamp*, the court ruled that there is no significant difference between the degree of restraint effected by automatic enforcement of a due-on-sale clause in an installment sale and an outright sale. In the absence of facts making enforcement necessary to protect the lender's security, the restraint effected is unreasonable and automatic enforcement not justified. While many of the court's arguments for barring automatic due-on-sale enforceability in installment sales are equally applicable to all sales, *Tucker* reserved judgment on the lender's right to accelerate following a borrower's sale of property.²¹ Therefore, after *Tucker* it was unclear what kind of restraint would be sufficient to invalidate automatic enforcement of the due-on-sale clause,²² as well as what showing of impairment would permit the lender to accelerate.²³ *Wellenkamp* answered the first question by holding that the merely inhibitory effect on alienation produced by a combination of the clause's existence and unfavorable economic circumstances was sufficient.²⁴

In reaching this conclusion, the court relied on two assumptions derived from the facts of *Wellenkamp*. First, in a tight money market,²⁵ where interest rates are high and access to real estate financing is restricted, use of the clause to raise interest rates restrains alienation, since most buyers would rather refinance than assume the existing first deed of trust at current rates. Second, the due-on-sale clause is not a negotiated provision. It is, in most instances, an adhesive provision in a standard form instrument drafted by the lender and designed to secure

20. 12 Cal. 3d at 638, 526 P.2d at 1169, 116 Cal. Rptr. at 637.

21. *Id.*

22. Under the *Tucker* formula, the lender must justify enforcement of the due-on-sale clause. Economic arguments for exacting assumption fees cannot validate the use of a device designed to protect lenders against the likelihood of default and waste, which would jeopardize their security interest in the property. Whatever the threshold test for impairment becomes, the test must be individualized.

23. An important qualification was *Tucker's* limitation of an "outright sale" to cases where the buyer obtained new financing and made no attempt to assume the seller's loan. 12 Cal. 3d at 634 n.6, 526 P.2d at 1172 n.6, 116 Cal. Rptr. at 636 n.6, cited in *Wellenkamp*, 21 Cal. 3d at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

24. 21 Cal. 3d at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.

25. This is implicit in the court's mention of the interest differential between prevailing rates (8% to 9 1/4%) and explicit in the discussion of the effect of a due-on-sale clause where new financing is hard to obtain.

its interests.²⁶ In *Wellenkamp*, the Mans did receive notice of the due-on-sale clause's existence when they acquired the loan to finance their purchase,²⁷ but they did not realize that the due-on-sale clause might make the sale of their property more difficult.²⁸ Like most unsophisticated borrowers, they failed to consider the restraint on sale in calculating their total financing costs because they did not contemplate selling their property at the time of the purchase.

Armed with these insights, the court perceived two levels of restraint on alienation. First, where the lender intends to accelerate following sale,²⁹ no sale is possible, unless a buyer with outside financing³⁰ agrees to pay off the seller's loan upon purchasing the property.³¹ The court characterizes this situation as an absolute prohibition on transfer,³² and this is undoubtedly true as to a particular buyer. Second, where the lender waives acceleration following sale in return for the buyer's agreement to pay assumption fees³³ and current interest charges on the loan assumed, sale will be possible only where a buyer is willing to pay these fees. Such a buyer may insist that the seller lower his purchase price. The seller would then be forced to choose between absorbing the loss by lowering the purchase price or abandoning the sale. Aside from buyers who receive a discount in the purchase price, the only parties likely to assume an existing loan where the loan rate is as high as the cost of new financing will be (1) buyers unable to obtain financing, or (2) those unaware of the due-on-sale clause's effect. The former are likely to prove poor credit risks, while the latter may desire to breach the agreement as soon as the lender demands assumption and interest fees.

Based on these findings, the court determined that use of the due-on-sale clause to raise interest rates would inhibit the transfer of prop-

26. 21 Cal. 3d at 946, 582 P.2d at 972, 148 Cal. Rptr. at 382.

27. *Id.* at 953 n.12, 582 P.2d at 976 n.12, 148 Cal. Rptr. at 385 n.12.

28. This is implicit in the court's use of the doctrine of restraints against alienation to protect consumers who do not appear to be aware of the interests they are sacrificing by agreeing to clauses drafted by lenders to protect their interests. J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS §§ 3.12-3.13 (1974) (California Continuing Education of the Bar).

29. 12 Cal. 3d at 634, 526 P.2d at 1172, 116 Cal. Rptr. at 636.

30. 21 Cal. 3d at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

31. *See* H. MILLER & M. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 3:65 (1975).

32. 21 Cal. 3d at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.

33. Following transfer, most lenders seek a bonus called "assumption fees," an amount equivalent to the earnings lenders would receive if they resold the loan in the current market. Often this charge is referred to as "points." After *Wellenkamp*, the lender is not entitled to obtain any new profits on a transfer subject to the seller's loan, whether in the form of increased interest rates, points, assumption fees, etc., simply because there has been a transfer of an interest in the property. F. CRANE, REAL ESTATE LOAN TAKEOVERS: *WELLENKAMP V. BANK OF AMERICA* (1979).

erty.³⁴ Thus, the ultimate effect of *Wellenkamp*'s reformulation of the *Tucker* standard is to permit the borrower to maintain the loan, at the originally bargained for terms, after the sale of his property.³⁵

B. Implications of the Court's Holding

In an illuminating passage of *Wellenkamp*, the court characterized the premium realized by the seller on transfer of his loan as part of his "equity."³⁶ This characterization reveals much about the court's view of the conflicting interests in this case. By permitting the borrower to include the differential between his interest rate and the current market rate in his sale price, the court enables the borrower to sell his loan along with his secured property. While many borrowers may view this interest differential as part of their equity, since the loan does encumber their property, prior to *Wellenkamp* there had not been judicial recognition of this expectation. The interest rate on a real property loan arises from a contractual agreement that makes the borrower's real property security for that loan. Presumably, the due-on-sale clause limits the occasions when that loan may be transferred by providing for acceleration should the borrower sell the secured property. By treating this interest differential as "borrower's equity," the court determines that the borrower is entitled to the benefit of any increase in market interest rates demanded by lenders.³⁷

There is a policy motivating this determination, although it remains implicit throughout the court's opinion. Its central premise, aversion to adhesive agreements, is revealed most clearly by the court's decision to grant borrowers the benefit of interest increases rather than permitting lenders automatically to enforce due-on-sale clauses. That determination also implies that a mortgage with a separate provision permitting lenders to adjust loan charges to the prevailing market interest rate upon sale would also restrain alienation. A plainly written due-

34. Under *Wellenkamp*, a clause will only have a prohibitory effect on transfer if the lender acts against its self-interest. By accelerating the debt, the lender foregoes an increased interest charge in a tight money market. It must also bear the transaction costs of finding a new borrower for its available funds. However, if the lender acts in line with its self-interest, requiring assumption fees and higher interest payments, the court admits that the restraint is merely inhibitory.

35. 21 Cal. 3d at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84. To the extent that lenders refuse to permit assumption, even for additional fees, the clause acts as a nonassignment provision. When it is used to increase interest charges it becomes a disguised variable interest rate mortgage that springs into effect on the often fortuitous event of sale.

36. *Id.* While a borrower may come to view not just the amount of his loan but also the interest rate on it as a possession with a marketable value, there is no legal basis for this view.

37. In his concurring opinion on remand in *Medovoi v. American Sav. & Loan Ass'n*, 89 Cal. App. 3d 244, 152 Cal. Rptr. 572 (2d Dist. 1979), Judge Thompson remarked that *Wellenkamp* effectively says that "a contractual provision which denies the borrower profit on financing which subsequent events render highly advantageous is contrary to public policy." 89 Cal. App. 3d at 263, 152 Cal. Rptr. at 584 (Thompson, J., concurring).

on-sale clause would provide the borrower with notice of his potential liability for fees on sale or encumbrance, and would achieve the end it is stated to serve, adjusting interest rates. Yet if such an interest adjustment clause is to stand, it must be on its own merits as a separate contractual undertaking by the parties. Since all the lender may demand from its borrower are monthly payments and protection of its security interests against waste,³⁸ the clause appears suspect. It offers the borrower nothing and therefore suggests adhesion. Indeed, it operates like a wagering agreement where the lender always wins in a tight money market.³⁹ The point is that the due-on-sale clause should be unenforceable, because it is adhesive and discourages sale.

But what are the elements of adhesion to which the court looks in assessing the reasonableness of lender justifications for due-on-sale clause enforceability? These elements are not associated with fears that the lender will confiscate borrower "equity," but rather that they will use market leverage and superior bargaining ability to hamstring the borrower into a contract of their own making.⁴⁰ Merely providing the seller with notice that the due-on-sale clause will increase his costs in selling his property is not enough to validate the clause. Lack of market leverage may force the borrower to accept a contractual provision which is seriously disadvantageous to him. On the facts of *Wellenkamp* it appears that the Mans did not realize what effect the due-on-sale clause would have on their ability to sell their property. Therefore, whether the borrower signs an instrument with an automatically enforceable due-on-sale clause out of economic compulsion or ignorance,

38. The court's general reference to "due-on" clauses without singling out acceleration provisions means that the opinion may be applicable to all automatically enforceable due-on-sale clauses. *Id.* at 947, 582 P.2d at 972, 148 Cal. Rptr. at 381. Clauses requiring a credit report from the buyer or interest adjustment upon sale are arguably restricted by the court's ruling as well. However, the court had no occasion specifically to address this issue. Lenders have never used a due-on clause calling for an interest increase upon assumption, undoubtedly because it would present too clear a warning of their intended use of the provision. Perhaps the court's emphasis on impairment induced it to assume that available notice procedures were adequate. Or perhaps the court decided not to face the notice issue, since it appeared that Cynthia Wellenkamp knew of the due-on-sale clause. *Id.* at 953 n.12, 582 P. 2d at 976 n.12, 148 Cal. Rptr. at 385 n.12.

39. Such a clause would act as a variable rate mortgage which could only increase. This kind of device is specifically prohibited by California law. CAL. CIV. CODE § 1916.5 (West Supp. 1979). See Brunner, *Validity, Construction and Application of Clause Entitling Mortgagee to Acceleration of Balance Due in Case of Conveyance or Transfer of Mortgaged Property*, 69 A.L.R.3d 713 (1976).

40. The plaintiff's theory for invalidation of due-on-sale clauses in *Wellenkamp* was that notes and deeds of trust are lender documents. The note and deed of trust contain everything that the lender wants to protect himself—enforceable or not—and the laws of California contain rules that protect the borrower, including the buyer. Moreover, California mortgage and real property law primarily controls these provisions, not contract law. If no real property or mortgage law prohibits the activity, such as the trustee's power of sale provision, then its use is permitted to the extent controlled by the mortgage or real property law of California. F. CRANE, *supra* note 33, at 23. See *Garfinkle v. Wells Fargo Bank*, 21 Cal. 3d 268, 578 P.2d 925, 146 Cal. Rptr. 208 (1978).

the court will bar its application. This means that it is not intent but the relative bargaining power of the borrower and the lender that will determine the enforceability of restrictions on the right to sell property.

The court's specific citation of the state policy in favor of "protecting and conserving home equities"⁴¹ reveals another implicit policy concern which further delimits the scope of *Wellenkamp*. Automatically enforceable due-on-sale clauses that restrain sale of owner-occupied dwellings offer both a greater likelihood of lender leverage and lesser possibility of borrower knowledge regarding the due-on-sale clause's significance.⁴² Granting sellers an interest differential which would otherwise be a cost of selling their homes grants them flexibility in setting a purchase price that will maximize their return. Thus, the court uses the "preservation of home equities" argument more as a label than an analytical tool. While ambiguous, it highlights those policy concerns that form the nucleus of *Wellenkamp*.

C. *The Wellenkamp Dissent*

In his dissent, Justice Clark argued that the majority, in accommodating the interests of lenders and borrowers, overlooked third party rights. According to Justice Clark, the court's ruling placed holders of unencumbered property at a competitive disadvantage with owners of encumbered property in a tight money market since the former have no loan to sell at below market interest rates. In Clark's view, this failure to consider the plight of the unencumbered property owner underscores the shortsightedness of the court's position. The majority's response is that holders of unencumbered property are not directly affected by *Wellenkamp* since they owe no debt which can be accelerated by enforcement of a due-on-sale clause.⁴³ Such owners have already reaped the advantage of interest rate differentials by paying off their mortgages at the presumably lower interest rates prevailing on their original financing.⁴⁴ That some property owners have not chosen to sell their property should not restrict others from doing so.

41. CAL. HEALTH & SAFETY CODE § 50007 (West Supp. 1974-1978).

42. This will remain true only to the extent that a homeowner's financing of property does not involve legally sophisticated parties. In all other cases, the court's reliance on the protection of "home equities" imports a rule of law that makes home financing presumptively immune from the freedom of contract doctrines otherwise applicable to commercial transactions.

43. 21 Cal. 3d at 957, 582 P.2d at 979, 148 Cal. Rptr. at 387.

44. *Id.* at 951 n.7, 582 P.2d at 975 n.7, 148 Cal. Rptr. 384 n.7. Arguably, other benefits compensate owners of unencumbered property for the competitive disadvantage *Wellenkamp* effects. Although they have no first mortgage to use as leverage in sales transactions, they may still execute a first deed of trust, albeit at current interest rates. Since there is no loan to pay off on unencumbered property, buyers who wish to refinance need only place enough money down to secure the new financing. There is no need to pay off an existing loan and then come up with a down payment to secure a new first trust deed. Owners of encumbered property also retain an

To the extent that owners of unencumbered property are placed at a disadvantage by the court's opinion, the court dismissed the decision's indirect effect as a cost of changing the law. As the court remarked: "the only question before [us] is the sale of property subject to existing financing."⁴⁵ Although less than convincing analytically, this disposition appears empirically sound since few mortgages run to full term. However, the court's opinion offers little solace for those who chose to prepay their loans. They must now compete with holders of low rate mortgages in selling their property. In an era of rapidly increasing interest rates this factor could place them at a relative disadvantage.

D. Open Questions After Wellenkamp

1. Exemption of Private Lenders

Wellenkamp's analysis of lender opportunity to use leverage in tight money markets is limited to institutional lenders.⁴⁶ The court expressed no opinion as to whether private lenders might automatically enforce due-on-sale clauses upon resale. The outlines of this exemption are unclear since the court offered no policy to support it. Presumably, the court's reasoning was that institutional lenders can exert significant leverage over borrowers due to both their superior bargaining power and experience in negotiations.⁴⁷ Further, lenders with a large loan volume can adjust for varying risks. They need not suffer if one loan goes bad. Finally, they have access to data which permits them to anticipate interest rate changes.⁴⁸ While these factors amply justify the court's holding against institutional lenders, their absence does not supply a rationale for exempting private lenders.⁴⁹

advantage in raising capital because of their greater home equity. Moreover, they may use this advantage to improve the value of their property for purposes of resale.

45. *Id.*

46. *Id.* at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 385 n.9.

47. If this is the rationale, it reinforces the court's single-minded concern with residential transactions. However, it ignores the fact that legal counsel is often sought before execution of any loan in a commercial setting. And that, in a given case, a private lender may be as knowledgeable as an institutional one about the state of the financial market and the legal devices whose inclusion would best protect his interests.

48. Indeed, lenders tend to charge a higher interest rate on long-term loans to offset foreseeable interest increases. As of October 5, 1978, Wells Fargo Bank's long-term interest rate was 9.9%, while the rate on variable rate mortgages (which increase as the index rises) was 9.8%. On May 22, 1979, the rates had risen to 11.2% and 11.0% respectively for loans under \$150,000. Interview with Wells Fargo Bank officer (Berkeley, California).

49. Encouraging private parties to do their own financing increases the likelihood that more real estate financing transactions will proceed without legal counsel. While regulation of professional lenders lessens the possibility that they will use their expertise to take advantage of unwary consumers, shifting business to unsophisticated lenders unable to structure transactions to the benefit of either party seems a poor substitute. For instance, no down-payment-to-principal ratio

The private lender exemption makes sense only in a situation where the need to control loan assignability is paramount and the best method of assuring this control is automatic enforcement of a due-on-sale clause. Subjecting the private lender to the inhibitory restraint test of *Wellenkamp*, without first showing that the restraint arose from adhesive circumstances, is unwarranted. The private lender envisioned by the court will be unable to exert significant leverage over the borrower during negotiations, especially when the private lender is also the seller and participates in the buyer's financing. If the seller takes back a first trust deed or offers the buyer a second when the property is encumbered by a loan, it would alter the parties' negotiated agreement to place the burden of showing impairment on the lender. The contract is an agreement between two individuals. Its terms arise from a specific assessment of the buyer's credit potential and integrity. Permitting the due-on-sale clause to be automatically enforceable in these circumstances is similar to upholding a nonassignment provision in a sales contract.⁵⁰ When bargaining power is equal, both instruments should be enforceable.

It is arguable, however, that a private lender should only be able to use the clause to bar sales and not to raise interest rates. The private lender agreed to accept payment at the stated rate when he made the loan. Any change in loan terms made at the time of sale would be an alteration of this agreement. Moreover, as long as the borrower assigns the loan to an equally creditworthy party the lender will suffer no loss. If the parties desire to take interest rate fluctuations into account in fixing the loan rate, they should use a variable rate or roll-over mortgage, not a due-on-sale clause.

Yet this limitation may be unnecessary where the lender holds a thinly secured second trust deed. The threat of acceleration is only meaningful where the lender has sufficient priority to insure that he will recover his investment in a foreclosure sale following notice of default. Where the lender holds a second, his offer of a higher interest rate to the purchaser, in lieu of enforcing the nonassignment aspect of the due-on-sale clause, may be the only fair means of accommodating

regulations govern private lenders. Thus, their greater participation might encourage over-extension on shaky credit. See CAL. FIN. CODE § 7153.2 (West Supp. 1978) for provisions applicable to institutional lenders on residential and commercial transactions. In *DeMey v. Joujon-Roché*, 63 Cal. App. 3d 178, 133 Cal. Rptr. 570 (2d Dist. 1976), the court declared the defendant's acceleration under a due-on-sale clause "illegal and improper" where plaintiff trustor took back a second trust deed on subsequent sale of the secured property. The case is currently on remand to the Second District Court of Appeal, which recently decided *Medovoi*.

50. Pursuant to CAL. COM. CODE § 9311 (West 1964) "a provision in a security agreement making transfer a default is valid." This section was specifically added to the California version of the UNIFORM COMMERCIAL CODE (1962) (Official Text).

the lender's desire for security and the borrower's need to assign his obligation. Raising interest rates compensates for any greater credit risk posed by an assuming buyer. Use of the clause for acceleration need not lead to abuse since private lenders with a weak priority position will be encouraged to make the purchaser's creditworthiness the chief criterion in determining whether to permit loan assumption. Especially where the security is commercial property, secured primarily by soft assets like good will, the identity of the assuming party will be crucial to the lender. An insensitive new proprietor may seriously reduce the value of a popular franchise outlet. In these circumstances, the borrower could use his stronger bargaining position to assure that any concessions demanded by the lender on sale were reasonable.

2. *Application to Commercial Loans*

Throughout its opinion, the court failed to distinguish between commercial and residential property. *Wellenkamp* invalidated due-on-sale clauses in a sale of residential property to a private individual. In its finding of "inhibitory restraint," the court relied on a treatise that detailed policies applicable to the purchase of a home.⁵¹ However, while limiting the decision's impact to institutional lenders,⁵² the court did not specifically restrict the opinion's applicability to residential property. Evidently the court intended its decision to apply to both, did not think about the difference, or sought to limit the opinion to the facts of *Wellenkamp* without making that intention explicit.⁵³

The omission of such a distinction is in line with prior California case law in the due-on clause area. *Coast Bank* involved a commercial transaction, while *Tucker* offered a mix of considerations, with real estate brokers seeking to resell residential property to private parties. Although the kind of property in *Tucker* may have influenced the outcome, the *Tucker* court did not so indicate. Only *Wellenkamp* presented the most sympathetic case of one homebuyer selling to an-

51. H. MILLER & M. STARR, *supra* note 31, at 436.

52. 21 Cal. 3d at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 385 n.9.

53. In *Medovoi v. American Sav. & Loan Ass'n*, 89 Cal. App. 3d 244, 152 Cal. Rptr. 572 (2d Dist. 1979), the California Supreme Court directed the Second District Court of Appeal to dispose of *Medovoi* pursuant to the substantive principles announced in *Wellenkamp*. The court construed *Wellenkamp* as applying only to property transfers where an owner-trustor of a single-family residence engages in a voluntary transfer of his interest in the secured property to a prospective purchaser. The court concluded that *Wellenkamp* did not apply to commercial property such as a multi-unit apartment building. Although the court also relied on the argument that *Medovoi* was distinguishable since it involved an involuntary transfer, and by definition a restraint on alienation could only arise from a voluntary transfer, the first ground of distinction is clearly the stronger. However, the continued efficacy of this opinion seems in doubt. In an incredible footnote, the district court of appeal told the supreme court that it frankly preferred the dissent's view of the case and presumably would use any means to avoid following *Wellenkamp*. *Id.* at 261 n.1, 152 Cal. Rptr. at 583 n.1.

other. Indeed, a literal reading of *Wellenkamp* would limit the case's applicability to owner-occupied residential property.⁵⁴

When property, subject to a security agreement, is used for commercial purposes, different policies become relevant in making loans and enforcing their provisions. Although the quantum of restraint effected by the exercise of a due-on-sale clause in a commercial or residential setting is the same, a lender's justification for enforcement will be greater when the loan covers commercial property. The property upon which financing is sought is itself an investment whose success or failure may determine the borrower's ability to repay the loan. First, in a commercial transaction a lender must examine the buyer's credit and likelihood of success in the proposed enterprise.⁵⁵ Second, purchasers of commercial property tend to seek the advice of counsel and to consider financing costs in determining the contemplated enterprise's profitability. This enhances the likelihood of equal bargaining power between the parties. Third, projected uses of the property may require the cooperation of governmental entities such as zoning boards and state regulatory agencies.⁵⁶ The approval of governmental bodies may be just as important to insuring repayment as the buyer's personal or corporate credit. Fourth, the way the property will be managed or developed affects profitability and therefore likelihood of repayment.⁵⁷ Finally, California statutes tend to favor purchasers of residential property over purchasers of commercial property when determining who should be liable for deficiencies following default.⁵⁸ Where policies favoring home ownership are not at stake, the lender's interests in adequate security should be weighed more heavily. Given the greater likelihood of default in a commercial setting, as opposed to a residential setting, the balance should tip in favor of due-on-sale clause enforce-

54. *Id.* at 258-59, 152 Cal. Rptr. at 581.

If the presence of adhesive bargaining power is the crucial element, commercial development or speculative purchase of residential real property may well present circumstances that more readily justify acceleration under *Wellenkamp*. A per se exclusion of all but owner-occupied residential property would seem inappropriate due to the presumption against automatic due-on-sale enforceability, especially where the device is used to adjust interest rates.

55. *Hellbaum v. Lytton Sav. & Loan Ass'n*, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1st Dist. 1969).

56. Obtaining governmental approval requires more than favorable zoning. Increases in traffic, sewage, and power use arising from a proposed project may bar development despite substantial compliance with existing ordinances.

57. The identity of purchasers will also be important to commercial lenders. Just any hotel management company with good credit may not do for a reputation-conscious lender seeking Hilton Inns. Since the borrower may be unable to make payments if its business venture fails, the contemplated use of property is highly significant to commercial lenders.

58. CAL. CIV. PROC. CODE § 580(d) (West 1976).

ability in the typical commercial transaction.⁵⁹

In cases such as *Tucker* and *La Sala*, the court applied policies developed in commercial settings like *Coast Bank* to residential loans. Were it to clarify its position, the court could overrule or distinguish prior case law on a more principled basis and obviate litigation concerning *Wellenkamp*'s applicability to commercial transactions. A *per se* rule requiring any seller who is not a homeowner to demonstrate that a due-on-sale clause was not agreed to by the parties to protect the lender against forfeitures may be the best way to balance equities in this area of law.⁶⁰ However, it is a valid judicial approach to refuse to address an issue until it is squarely posed by a case. This may well be the path the court intends to follow in this area.

3. *Impairment of Security*

One of the principal deficiencies of the court's opinion is its failure to define an impairment of security. Although the court shifts the burden of proof to lenders, it does not indicate what showing of impairment would justify acceleration. As the court recognizes, the lender has a legitimate interest in preventing borrower default and deterioration in the value of its security. Thus the lender has an interest in determining the buyer's credit standing and "moral" responsibility.⁶¹

In *Tucker*, the court found that this interest did not justify acceleration in an installment sale because in such a transfer the seller retained title to the property.⁶² Presumably, this retention of title encouraged the seller to keep an eye on the property. The court found,

59. Where a purchaser occupies a residence, her ability to repay the loan will not depend on the profitability of the housing unit she plans to live in.

60. A possible approach to distinguishing residential from commercial transactions was suggested by the California Supreme Court in *Spangler v. Meinel*, 7 Cal. 3d 603, 498 P.2d 1055, 102 Cal. Rptr. 807 (1972). The court carved out an exception to CAL. CIV. PROC. CODE § 580(b) (West 1976), the purchase money anti-deficiency statute, for commercial property. It characterized such a case as a nonstandard purchase money situation. In the court's view, § 580(b)'s antideficiency bar need not apply to an automatic subordination clause in a commercial construction transaction where the lender sought to establish priority. The same reasoning could be used to validate a due-on-sale clause between commercial borrowers and institutional lenders.

For another jurisdiction's approach to the same problem, see *Crocket v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 224 S.E.2d 580 (1976), where the North Carolina Supreme Court held a lender's enforcement of a due-on-sale clause in a commercial property case not to be a restraint on alienation. The court noted that both the lender and the purchaser, who acquired three apartment buildings, were on equal footing in negotiating the due-on-sale provision. *Id.* at 630, 224 S.E. 2d at 587. The dissenting justice suggested that a different result should attend where an institutional lender dealt with a residential purchaser. *Id.* at 642-43, 224 S.E.2d at 594-95 (Lake, J., dissenting).

61. 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

62. *Tucker* found that as long as the trustor-vendor's equitable interest in the security remains significant, he retains a real incentive to prevent default. Therefore, the buyer's credit standing is irrelevant to a showing of impairment. 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 634.

however, that in an "outright sale," where the borrower paid off his loan with new financing, acceleration would be justified. According to the court, "[in an outright sale] the trustor-vendor normally receives enough money through the financing of the second sale to pay off his note, and he is normally required to do so. Little if any restraint on alienation results through enforcement of the provision."⁶³ *Wellenkamp* attacked this distinction, arguing that it was analytically unsound to make due-on-sale enforceability turn on the passing of title.⁶⁴ Moreover, if the buyer assumes the loan in an outright sale, the lender will be able to evaluate the buyer's credit before permitting him to assume the loan.⁶⁵ No such option is available in an installment sale. Where the purchase is "subject to" the seller's loan, the seller will remain liable to the lender. This is exactly what occurs in an installment sale. Thus, the risk of default and waste may actually be greater in an installment sale than in an outright sale.

Relying on this analysis, *Wellenkamp* modified *Tucker*⁶⁶ by holding that the passage of title and possession to the buyer in an outright sale did not justify automatic enforceability.⁶⁷ In *Tucker*, the court noted that "[a]s long as the trustor-vendor's equitable interest in the security remains significant, he retains a real incentive to prevent default."⁶⁸ *Wellenkamp* defined the circumstances in an outright sale that form the indicia of this "significant" interest. The court relied on two factors. First, any buyer seeking to acquire the seller's financing would have to make a large down payment to buy out the seller's equity. This investment would give him a significant stake in timely performance. Second, the credit of the buyer may be as good as or better than that of the original borrower-seller.⁶⁹

These arguments warrant closer consideration if the outlines of the court's nebulous impairment standard are to be discerned. As for the first proposition, even a large down payment may not guarantee the lender's security where the property is overvalued, or the equity does not rise significantly.⁷⁰ In either case, the loan-to-value ratio on the

63. *Id.* at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 638.

64. 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

65. *Id.* at 949, 582 P.2d at 974, 148 Cal. Rptr. at 382.

66. *Id.* at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

67. Numerous trial courts have held *Tucker* applicable to all sales, including "outright" ones. They refused to permit accelerations premised only on the lender's desire to increase interest charges. Lenders have generally not appealed these decisions, so that none have resulted in a published opinion. J. HETLAND, *supra* note 28, § 4.18 (Supp. 1977).

68. 12 Cal. 3d at 639, 526 P.2d at 1169, 116 Cal. Rptr. at 637.

69. 21 Cal. 3d at 952, 582 P.2d at 975-76, 148 Cal. Rptr. at 384-85.

70. Despite a general rise in property values, property in some neighborhoods will not appreciate. Urban blight, freeway construction, airport noise, and a host of other factors will make such areas virtually immune from inflationary trends.

purchased property may become so high that it decreases the amount a lender can realize through foreclosure.⁷¹ If the party in possession defaults on the payments or decides to abandon the property, a nonjudicial sale may not yield enough to make the lender whole. Moreover, the typical residential mortgage is purchase money and pursuant to statute⁷² the buyer will be protected from any deficiency judgments. Thus, the lender's interests would appear threatened by outright sale.⁷³

In practice, however, repayment of loan principal along with an adequate down payment will cushion the lender's loss should the buyer default or commit waste. Further, the phenomenal rise in housing values should protect lenders from losses following foreclosure of residential property. "When the seller does not receive the value of his equity in cash but takes back a second or 'all-inclusive' deed of trust for a portion thereof, he of course retains an equity interest in the property which provides him with an incentive to prevent waste or default."⁷⁴ Should none of these mitigating factors be present, a lender might argue that his security was impaired.

The other major lender risk following an outright sale is the buyer's creditworthiness. A new purchaser may be more likely to default than the original borrower who contracted with the lender. Yet in both *Wellenkamp* and *Tucker* the lender did not investigate the buyer's credit before accelerating.⁷⁵ Although in both cases the court recognized that lenders may include a due-on-sale clause to protect their security against a financially irresponsible buyer,⁷⁶ some finding of bad

71. If the loan-to-value ratio is in the 85-95% range at the outset and the property subsequently declines in value, the secured lender may be in a vulnerable position and wish to accelerate upon transfer regardless of how responsible the buyer is. See Comment, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1122 (1975).

72. CAL. CIV. PROC. CODE § 580(b) (West 1976). See Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again*, 22 U.C.L.A. L. REV. 755 (1975).

73. It is arguable that the test for impairment of security should differ where the buyer does not pay off the seller's equity. In a sale of property for \$100,000, where the borrower negotiates a first trust deed of \$80,000 (at 9 1/4%), sells the property five years later for \$125,000 (with \$75,000 remaining outstanding on the first trust deed), and the buyer assumes the seller's \$75,000 first (taking a \$45,000 second from the seller, toward the \$125,000 purchase price), the buyer need only place \$5,000 down on the property. While state regulations prohibit the lender from making a loan for less than 20% down on a residential transaction, CAL. FIN. CODE § 7153.2 (West Supp. 1978), this buyer need only put \$5,000 down. This is only one-fifth of the \$25,000 down the original lender would require to make the deal. Yet the lender must trust this new buyer not to default or allow the property to depreciate, where the buyer's only interest is the \$5,000 invested.

74. 21 Cal. 3d at 951 n.8, 582 P.2d at 976 n.8, 148 Cal. Rptr. at 384 n.8.

75. Upon receiving notice of the Mans' transfer and a check from Wellenkamp for the July payment on the Mans' loan, the bank returned Wellenkamp's check and notified her of its right to accelerate. *Id.* at 946, 582 P.2d at 972, 148 Cal. Rptr. at 381.

76. 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 385; 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 633.

credit is required before acceleration. Indeed, in *Tucker*, the court remarked that "the mere fact that the vendee under the installment land contract is not so good a credit risk as the trustor-vendor, while significant, would not be in itself determinative" of the decision to permit automatic enforceability.⁷⁷ One option might be inclusion of a clause in a trust deed requiring an assuming buyer to tender a credit report,⁷⁸ including job status and personal income at the time of sale.⁷⁹

After *Wellenkamp*, the buyer can acquire the property "subject to" the seller's existing loan.⁸⁰ Indeed, there is no longer a need for the buyer to assume the seller's trust deed.⁸¹ Although a "subject to" purchase leaves the seller liable on the original loan, the purchase money antideficiency statutes⁸² insulate the seller from any liability following a foreclosure sale triggered by a buyer default. While lenders may continue to insist on assumption fees after *Wellenkamp*,⁸³ they have no right to interfere with escrow instructions between the seller and buyer passing title to the buyer since the lender is not a party to this sale.⁸⁴ The only lender assistance needed to close escrow is a beneficiary statement of loan condition,⁸⁵ and this statement does not trigger any rights in the lender forbidding acquisition of the seller's loan.

This does not mean that the lender has no rights under its due-on-sale clause in a "subject to" transaction. Sale, not assumption, triggers the due-on-sale clause's applicability. Therefore, the lender may still accelerate following sale if he can show that the buyer's credit is so poor that it jeopardizes the lender's security. Where the buyer refuses

77. 12 Cal. 3d at 639 n.9, 526 P.2d at 1175 n.9, 116 Cal. Rptr. at 633 n.9.

78. Veterans Administration and Federal Housing Authority regulations which limit lender ability to deny loan requests based on review of the purchaser's credit might provide guidelines for judicial rulings based on the adequacy and stability of the buyer's income. 24 C.F.R. § 203.33 (1978). See Comment, *The Variable Interest Rate Clause and Its Use in California Real Estate Transactions*, 19 U.C.L.A. L. REV. 468 (1972), for factors differentiating the showing required in commercial as opposed to residential property, for purposes of antideficiency enforceability.

79. The lender might then investigate the property's appraised value, trends in the neighborhood, and general real estate market conditions.

80. 21 Cal. 3d at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383. See CAL. CIV. CODE §§ 2890, 2909, 2928 (West 1974). These sections underscore the fact that the lender may look only to the property to recover his loan. The personal obligation is severable.

81. The procedure is simple. A buyer wishing to purchase property "subject to," need only obtain a title insurance policy declaring him to be the owner of the fee, subject to the first trust deed of record and whatever is carried back by the seller. Fire insurance, impounds, if any, and all other interests which the seller held in the property are transferred to the buyer.

82. CAL. CIV. PROC. CODE §§ 580(b), 580(d) (West 1976).

83. CAL. FIN. CODE § 7153.2(d) (West Supp. 1978) requires that an association obtain "a written report on the credit standing of the borrower and the financial ability of such borrower to undertake and pay off the obligation involved in the loan" prior to approval of a loan to a borrower for use on property with a structure designed and used for a single-family home.

84. *Moss v. Minor Properties, Inc.*, 262 Cal. App. 2d 847, 69 Cal. Rptr. 341 (2d Dist. 1968).

85. CAL. CIV. CODE § 2943 (West 1978). The maximum fee permitted by this section for lender assistance in closing an escrow is \$15.00.

to tender credit information, the lender could argue that such refusal constitutes a *prima facie* showing of likelihood of impairment shifting the burden of proving creditworthiness to the buyer. Another approach would be to require that the buyer satisfy the same credit standards as the original borrower. Buyers with shaky credit could be required to produce a guarantor.⁸⁶

In formulating a set of procedures governing burdens of proof in establishing creditworthiness, it should be recognized that the question is not one of granting lenders air-tight guarantees but of accommodating the justifiable interests of lenders and borrowers.⁸⁷ Since institutional lenders are in the best position to adjust loan charges and interest rates,⁸⁸ the lender's ability to demand guarantees should be limited lest this power become a means of compelling buyer concessions that are not justified by the need to protect security.

4. *Preemption of State Law by Federal Savings and Loan Associations (S&L's)*

The most significant question left open after *Wellenkamp* is not within the California Supreme Court's power to address. In *Glendale Federal Savings and Loan Association v. Fox*,⁸⁹ United States District Judge Matthew Byrne, Jr., found that federal law preempted state regulation of "due-on-sale" clauses contained in loan instruments of federally chartered savings and loan associations. In granting Glendale Federal's motion for partial summary judgment, the court relied on specific regulations governing due-on-sale clauses promulgated by the Federal Home Loan Bank Board (FHLBB).⁹⁰ The FHLBB intervened as a cross-claimant⁹¹ in the suit between Glendale Federal and Fox, a

86. The parties entered into such an agreement in *In re Schott v. Mission Fed. Sav. & Loan Ass'n*, Advisory Opinion of Federal Home Loan Bank Board, Resolution No. 75-647 (1975).

87. In an era of rapidly increasing equity in residential property, an enforceable power of sale will assure the lender's recovery of his investment should default occur. Aside from the lender's cost of money, these charges need only compensate lenders for the costs incident to a default. *Baltimore Life Ins. Co. v. Horn*, 15 Ariz. App. 78, 81, 486 P.2d 190, 193, *petition denied*, 108 Ariz. 192, 494 P.2d 1322 (1972); *Tucker v. Pulaski Fed. Sav. & Loan Ass'n*, 252 Ark. 849, 854-55, 481 S.W.2d 725, 728-29 (1972).

88. For example, a court of equity may deny foreclosure if the result is inequitable, or if the sole reason for acceleration is the transferee's refusal to accept an increased interest rate, or pay an assumption fee not commensurate with the transaction costs of the transfer.

89. 459 F. Supp. 903 (C.D. Cal. 1978).

90. The FHLBB is responsible for regulating the activities of federal savings and loan associations. The scope of that regulatory authority is the issue in this case.

91. The court's limitation on the decision's applicability to post-June 8, 1976, loan instruments coincides with the effective date of FHLBB regulations. The Board intervened in an earlier action brought by the state attorney general against Glendale Federal, in *People v. Glendale Fed. Sav. & Loan Ass'n*, No. 76-0162 (C.D. Cal., Jan. 14, 1976). After it became a party, the Board issued proposed regulations relating to due-on-sale clauses and their use for interest escalation in support of its position as a defendant. 12 C.F.R. § 545.6-11(f), 41 Fed. Reg. 6286 (1976). On May

state official represented by the state attorney general.

This decision will excuse federal savings and loan associations from compliance with *Wellenkamp* for trust deeds executed on or after June 8, 1976, the effective date of the FHLBB's regulations concerning due-on-sale clauses. However, due-on-sale clauses in federal trust deeds issued before that date will be unenforceable, since the court did not reach the issue of whether the FHLBB's regulatory scheme prior to June 8, 1976, preempted state law.

The practical implications of this ruling are immense. As of December 31, 1977, seventy-four of California's 104 savings and loan associations were federals. Moreover, the federals had combined assets of over twenty-eight billion dollars, or slightly more than one-third of the combined total assets of 83.3 billion dollars. The great bulk of these assets arise from outstanding mortgage loans on California real estate.⁹²

The spectre of two rules with regard to due-on-sale clause enforceability is bound to confuse consumers. While sophisticated borrowers may benefit from the variety of financing devices, borrowers who consider stated interest rates the bottom line will be hurt.⁹³ Federal S&L's may be able to offer interest rates so attractive that they appear the only game in town. Then, by threatening to accelerate upon sale, they could exact higher interest charges than state S&L's without giving consumers effective notice of the reason for the due-on-sale clauses' inclusion.⁹⁴ Should federals not lower their stated rates, they could use this competitive advantage to strengthen their financial position vis-à-vis state S&L's.

Under *Glendale Federal*, federals are only responsible to the Federal Home Loan Bank Board, an administrative entity empowered by

3, 1976, the Board formally adopted a modified version of the proposed regulation and asserted for the first time in an introductory comment to those regulations that 12 C.F.R. § 545.6-11(f) was intended to preempt state law. 41 Fed. Reg. 18287 (1976). *People v. Glendale* is presently in the state court on remand. In the state action, the People sought summary judgment based on the state court rulings, including *Wellenkamp*, on the ground that their position was justified as a matter of law. The disposition by the court in *Glendale v. Fox* will lead to a dismissal of the suit in *People v. Glendale* barring a reversal of *Glendale v. Fox* on appeal.

92. J. HETLAND, *supra* note 28, § 4.18, at 32.

93. Buyers who work with real estate agents in purchasing property may receive notice of this rate disparity, since real estate agents are under a legal duty to disclose the purposes, effects, and handling of the due-on-sale clause by federal S&L's. Particularly, an agent must inform his client that a federal S&L will usually interfere with the transfer of ownership interests. *Pepitone v. Russo*, 64 Cal. App. 3d 685, 134 Cal. Rptr. 709 (1st Dist. 1976).

94. While the forms used by the Federal Home Loan Corp. contain a due-on-sale provision, the form states that it is subject to an interest rate adjustment on sale. No similar provision is contained in forms used by federally chartered S&L's in California. See *In re Schott v. Mission Sav. & Loan Ass'n*, Advisory Opinion of the Federal Home Loan Board, Resolution No. 75-647 (1974).

federal law to select guidelines and standards that meet "the best practices." Judged by their 1976 regulations⁹⁵ as upheld in *Glendale Federal*, these practices will impose far fewer restrictions on lenders than California law requires. Yet, no matter what practices federal S&L's follow,⁹⁶ California S&L's must follow California law. After *Wellenkamp* that means they will bear the burden of California's "consumer oriented" case law and legislation, including restrictions on the use of prepayment penalties as well as due-on-sale clauses. Although a further critique of *Glendale Federal* is beyond the scope of this note,⁹⁷ a refusal to reevaluate this case on appeal⁹⁸ will further complicate the California Supreme Court's job in adjusting borrower and lender interests in real estate finance transactions.

IV

BEYOND DUE-ON-SALE CLAUSES: LOCK-INS

The lock-in device merits present consideration because it is susceptible to invalidation under the "inhibitory" restraint doctrine of *Wellenkamp*. While the lock-in clause prohibits prepayment, the due-on clause compels it, and both protect the lender against its own inaccurate forecasts of market interest rates. Unlike due-on-sale clauses, however, lock-ins are supported by strong policy justifications. Thus, extension of *Wellenkamp* to this area of law, without close attention to the policies which shaped the restraint analysis in *Wellenkamp*, appears inadvisable.

Lock-in provisions bar prepayment by prohibiting any payments until performance is due under the loan. The borrower's privilege to prepay is thus withheld until he has made a determinate number of loan payments. The lock-in clause will not inhibit the borrower's ability to transfer the property where a buyer assumes the borrower's loan. If, however, the borrower seeks to prepay his loan before he sells the

95. 12 C.F.R. § 545.6-11(f), 41 Fed. Reg. 18287 (1976).

96. California Federal is currently refusing to accept "Reservation of Right" agreements. If a buyer refuses to assume the loan formally, California Federal starts foreclosure proceedings. Yet California Federal's own trust deed provides that it is to be construed according to California law.

97. Like federal S&L's, members of the National Banking Association used to claim federal privileges and exemptions. The United States Supreme Court struck down the bank's contention on June 17, 1977, in *Third Nat'l Bank of Nashville v. Impac Limited Inc.*, 432 U.S. 312 (1977). For a contrary view upholding the federal district court's action on the basis that the FHLBB was merely following "best practices" as permitted by its legislative mandate in promulgating the 1976 regulations, see Comment, *The Due-on-Sale Clause: A Preemption Controversy*, 10 LOY. L.A.L. REV. 629 (1976).

98. The court granted plaintiff lender's motion for partial summary judgment. The case is currently on appeal to the Ninth Circuit.

property, then the lock-in provision will effect an inhibitory restraint on alienation under *Wellenkamp*.

Straight application of the "inhibitory" restraint standard to the typical lock-in reveals both the flexibility of *Wellenkamp* and the dangers of its automatic application. A lock-in is likely to inhibit transfer in two instances. First, where the loan rate is sufficiently above market to make it unassumable as a practical matter, the seller will desire to pay off his loan before sale. The buyer could then seek new financing at lower rates to purchase the encumbered property. The above-market loan rate thus makes the property less saleable. Transfer is inhibited, and under a strict reading of *Wellenkamp* restraint on alienation results. Second, where the loan rate is below market, the loan will not be marketable unless the lender can find a buyer able to pay down to his loan. The high cost of secondary financing combined with the assumption of the first will deter many buyers from purchasing the property. Thus the borrower's inability to force a lender to refinance his loan, even at higher interest rates, may inhibit transfer by limiting the class of prospective purchasers.

A. Loan Rate Above Market

Although it is arguable that the first situation falls within *Wellenkamp*, it is not the lock-in which effects the restraint but the higher-than-market interest rate. Even without the lock-in clause, the borrower would have difficulty selling his property unless he discounted the sales price to account for the higher interest rate on his loan.⁹⁹ If the lock-in is declared to be unenforceable the lender will have no way of preventing the seller from refinancing the property, although the lender will be able to levy a penalty for prepayment. The lender's ability to sell the lock-in loan where the buyer refinances will protect the lender by compelling some buyer to make payments at the negotiated loan rate. Both the borrower and the lender assumed the risk of a change in the prevailing interest rate when they entered into the loan agreement. To deny enforceability because the borrower lost on the deal is unjustified.

More to the point, the borrower forfeited his right to prepay by agreeing to a lock-in. If the lock-in is to be invalidated, it must be because the clause was either not negotiated or hidden.¹⁰⁰ It is unlikely

99. Although a buyer could take "subject to" the borrower after *Wellenkamp*, few sellers would desire to remain liable on the underlying loan unless they were protected by antideficiency legislation from a judgment following the lender's exercise of a nonjudicial power of sale. CAL. CIV. CODE § 2924 (West 1978).

100. An example of a common lock-in clause reads: "The privilege is granted of making additional payments on the principal on payment dates after three years from the date of this note, subject to the payment of a prepayment fee equal to six months' advance interest on the amount of

that any rational borrower, aware of the lock-in's effect, would agree to its inclusion unless he could not otherwise obtain the loan, or could not obtain it at the terms agreed upon. Evidence of the kind of independent negotiations which attend sophisticated commercial or residential financing would support lock-in enforceability by negating any inference of adhesion. Conversely, the absence of lender concessions provides an independent ground for challenging the lock-in as adhesive. Under a proper reading of *Wellenkamp*, lock-ins that were the product of an unequal bargaining situation would be subject to attack as inhibitory restraints on transfer.

B. Below Market Loan Rate

The second case, where the loan rate is below market, presents a closer question. Although the lender bargained for the stated rate, its interest in prohibiting prepayment where the interest rate is below market is less obvious. The only benefit offered by such a lock-in would be a guaranteed rate of return, assuming the lender can recoup his losses by reloaning the money prepaid at higher rates. A recent case, *Hartford Life Insurance Co. v. Randall*,¹⁰¹ upheld a lock-in's enforceability in a joint venture where the lock-in was below market.¹⁰² The court held *Tucker's* restraint analysis inapplicable¹⁰³ to a case where the borrower sought to prepay his loan and the low ratio of his loan's value to that of the encumbered property restrained his ability to sell his property.¹⁰⁴ In the court's view, the lock-in clause did not prevent the defendants from selling their interests in the encumbered property. The borrower's inability to locate a buyer capable of cashing out his equity and assuming the loan was a consequence of the dramatic rise in housing values, not the lock-in's existence. This predicament was a risk defendants took in the "trade off of commercially beneficial interests which [they] knowingly made when they borrowed the money."¹⁰⁵

However, without the lock-in, the seller could refinance and es-

the principal so paid." The lock-in feature is at least partially "hidden" by the affirmative terminology. See Comment, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CALIF. L. REV. 923, 925 n.15 (1963).

101. 283 Or. 297, 583 P.2d 1126 (1978).

102. While the common law principles of freedom of contract support lock-in enforceability, there is little specific case law upholding the devices. In one case, a Maryland court denied purchasers in a sale of commercial property by installment land contract the right to make monthly payments before they were due. *Pierson v. Pyles*, 234 Md. 119, 197 A.2d 890 (1964).

103. Although the case does not indicate whether the property was residential or commercial, the borrowers admitted that they "sought to refinance the property so as to be able to use the equity contained in the property for other investments." 283 Or. at 298, 583 P.2d at 1127. It is therefore likely that the defendants purchased the property for use in a commercial venture.

104. *Id.* at 299, 583 P.2d at 1128.

105. *Id.* at 298, 583 P.2d at 1127.

cape this burden on marketability. The combined rise in equity and bar on refinancing led the lock-in to effect a restraint on alienation, just as in *Wellenkamp* the concurrence of tight money and the threat of acceleration inhibited sale. If the borrower is required to maintain a loan-to-equity ratio that will force most potential buyers to acquire secondary financing, the amount he can demand for his property is reduced. This effects a harsh restraint on transferability.

C. *Lock-ins as Restraints on Alienation*

Once the restraint is admitted, the problem is determining who should bear the risk of such an unmarketable loan. According to *Wellenkamp*, this decision should turn on the strength of the lender's justifications for enforcing the lock-in. Just as due-on-sale clause enforceability is permitted where the lender can demonstrate impairment of security, it is arguable that lock-ins should be allowed where they are used only to bar prepayment.

Under California case law,¹⁰⁶ the beneficiary of a locked-in loan may condition acceptance of early tender of performance on receipt of additional consideration from the trustor. Acceptance of such early tender alters the existing contract. This follows since the trustor has no right to extinguish his obligation, except in the manner authorized by the terms of his note.¹⁰⁷

The validity of this rationale depends on the legitimacy of the underlying agreement. Absent adhesive elements in forming the contract, lock-ins should be enforceable. This does not mean that where early tender is accepted the lender should be able to waive the lock-in for whatever compensation he can compel the borrower to pay. Such a use of the clause calls into question the contract's original validity. Where the amount demanded bears little relation to any expenses borne by the lender in transferring the funds loaned to a new borrower, the penalty charge may be separately assailable as unconscionable.¹⁰⁸ Still, if the lock-in was in both parties' perceived best interests when they con-

106. *McCarty v. Mellinkoff*, 118 Cal. App. 11, 4 P.2d 595 (2d Dist. 1931). Of course, the borrower may always liquidate the debt by paying principal and accrued interest up to the loan's full term. *La France Enterprises v. Van Der Linden*, 70 Cal. App. 3d 375, 383, 138 Cal. Rptr. 690, 694-95 (2d Dist. 1977).

107. CAL. CIV. CODE § 1490 (West 1968) provides that: "where an obligation fixes a time for performance, an offer of performance must be made at that time, within reasonable hours and not before or afterwards."

108. "There are indications that an exorbitant charge for prepayment would not be supported in judicial proceedings and that on one theory or another, yet undetermined, a person forced to sustain such a charge might have a remedy." *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 308, 99 Cal. Rptr. 417, 422 (2d Dist. 1971). The court relied on *Hellbaum v. Lytton Sav. & Loan Ass'n*, 274 Cal. App. 2d 456, 459, 79 Cal. Rptr. 9, 11 (1st Dist. 1969). See J. HETLAND, *supra* note 28, § 4.72, at 196.

tracted with one another, then it should not be subject to waiver when a sale, which both parties should have contemplated, arises.

Ideally, lenders who use lock-ins will be indifferent to movements in the interest rate. Lock-ins are typically found in large commercial loans, where the negotiation and binding effect of the loan are so important to the lender that he prohibits prepayment under any circumstances. Lenders with long-term income sources, like insurance companies,¹⁰⁹ need long-term commitments. To such institutions, a steady rate of return is paramount. Moreover, transaction costs on large commercial projects may exceed the returns from capitalizing on an advantageous shift in the interest rate.

The policies that support lock-in enforceability are inapplicable where the lender includes the clause as a matter of standard practice, and the borrower has inadequate notice of its effect. Recognizing that lock-ins are often hidden or unnegotiated, the California legislature ordered that any loan of \$100,000 or less must be subject to prepayment and that any restriction on the prepayment of such a loan is unenforceable.¹¹⁰ Since the consequences of lock-ins are so onerous to borrowers, they should be invalid after *Wellenkamp*, upon the borrower's showing that the provision was not independently negotiated. While this rule may eliminate lock-ins on most residential property, an agreement negotiated by a borrower who either obtained a significant discount for making the loan or would have otherwise been unable to obtain financing should remain enforceable. Moreover, the presence of an extra inducement to the making of a lock-in, like a break in the applicable interest rate, should charge the borrower with knowledge of the clause's negative effects.

V

IMPACT ON FINANCING DEVICES

A. *Variable Interest Rate Mortgages*

The ultimate impact of *Wellenkamp* on consumer interests may turn upon lender and borrower acceptance of variable rate mortgages (VRM's). *Wellenkamp* offered the VRM as a means of compensating

109. "Life insurance company holdings of nonfarm-nonresidential properties rose at a fairly steady pace in the 1950's and 1960's. Acquisitions increased rapidly in the early 1970's as the strong demand for these funds continued. . . . Holdings of nonfarm-nonresidential properties amounted to 24% in 1960, 35% in 1970 and 53% by 1976. Nonresidential properties increased by \$3.5 billion to total \$47.4 billion at the end of the year." AMERICAN COUNCIL OF LIFE INS., LIFE INSURANCE FACT BOOK '77, at 80 (1977).

110. CAL. CIV. CODE § 2954.9(a)(1) (West 1978) prohibits lock-ins on loans under \$100,000. This effectively limits the statute's protections to residential borrowers and constitutes, by implication, validation of lock-ins in commercial transactions where significant amounts of capital will be tied up.

lenders, who alleged they would suffer significant losses if unable to adjust their loan portfolios to current market rates.¹¹¹ The VRM permits interest charges to fluctuate with market rates, with the effect of dividing between the parties the "increment in equity" that *Wellenkamp* awarded to borrowers.

Although long-term mortgages are the accepted means of financing residential purchases,¹¹² lenders will not continue to offer them unless some method of tying loan rates to the lender's cost of money is developed. S&L's derive most of their funds from short-term savings deposits,¹¹³ while their mortgage lending takes the form of long-term home loans.¹¹⁴ VRM's offer S&L's an opportunity to gain an increased base for revenue without sacrificing intra-S&L competitiveness or forcing new borrowers to shoulder the entire burden of the prevailing cost of money.

One of the principal advantages of the VRM is that it permits lower initial charges, since there is no need for a built-in hedge against rising interest rates. Thus, they provide a means of avoiding an across-the-board interest increase on new loans. The absence of an interest adjustment mechanism, in periods of tight money, would discourage new financing and severely restrict economic expansion.¹¹⁵ VRM's will

111. Lenders have been able to keep up with current interest rates by using due-on-sale clauses, since real estate tends to be sold every seven to ten years. H. MILLER & M. STARR, *supra* note 31, § 3:74, at 460.

112. Home Owners' Loan Act of 1933, §§ 1 to 5(a), *as amended*, 12 U.S.C.A. §§ 1461-1464(a).

113. Indeed, "the volatility of residential credit generally reflects the volatility of deposit growth at thrift institutions. . . . The strong surges in loan growth in 1971-72 and 1976-77 can be partly attributed to the very high rates of savings growth in those years." U.S. LEAGUE OF SAVINGS ASSOCIATIONS, SAVINGS AND LOAN FACT BOOK '78 (1978).

However, to an ever-increasing extent traditional loan sources are being augmented by advances from the FHLBB. These medium- to long-term loan sources enable S&L's to correct the natural imbalance between short-term funds and long-term disbursements. Jallow, *Outlook for California's S&L's Industry*, CAL. BUS. 33 (Sept. 1978).

114. Approximately 90% of the income of S&L's is derived from interest on loans, while the interest paid to depositors forms their basic cost of money. See 40 Fed. Reg. 6870 (1975). S&L loans typically run for twenty- to thirty-year terms. See Comment, *Variable Rate Mortgages: The Transition Phase*, 61 MARQ. L. REV. 140, 141 (1977). Another alternative is the roll-over mortgage, a short-term loan with an option to renew. It is widely used in Canada and by the Bank of America. Luce, *The Real Message is VRM's*, J. CAL. S&L LEAGUE, Nov. 1978, at 24. These loans, however, are difficult for the lender to extend if the prevailing interest rate at the expiration date has decreased. Likewise, where it has increased, the lender will be reluctant to extend it. Bonanno, *Due-on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F. L. REV. 267, 306-09 (1972).

115. In negotiating loans, most consumers do not consider hidden costs like assumption and prepayment fees. Comment, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CALIF. L. REV. 923, 924 (1963). However, *Wellenkamp* may have the salutary effect of encouraging lenders to demonstrate to consumers that their new rates, although higher, are free of concealed charges that spring into effect on resale.

not find favor, however, with buyers who predict that their loan rate will move upward faster than their disposable income.

Moreover, from a lender's perspective, the VRM's currently available to finance home loans have several shortcomings. First, the California index applicable to residential loans¹¹⁶ is relatively slow-moving.¹¹⁷ It must advance a full point before a corresponding increase in the interest rate is permitted.¹¹⁸ Second, the interest rate may not change more than once during any semiannual period. Third, the borrower is not subject to prepayment penalties if he prepays within ninety days of notification of an increase in his interest rates.¹¹⁹

Generally, these lender disabilities become borrower benefits. However, in a period of decreasing interest rates, the slow-moving index could effectively trap the borrower into a higher-than-market rate. Although this scenario is unlikely to arise in this period of spiraling rates, critics charge that S&L's are able to manipulate mortgages to increase their profits. When interest rates are high, they push fixed-rate mortgages; when interest rates are low, they offer VRM's.¹²⁰ Thus, lender reluctance to accept VRM's in place of due-on-sale clauses

116. Pursuant to CAL. CIV. CODE § 1916.5 (West 1979), the State Savings and Loan Commissioner adopted the semiannual weighted average cost of savings, borrowings, and Federal Home Loan Board advances to members of the FHLB of San Francisco as the official index.

117. One critic has pointed out that between June 1970 and June 1971, the average cost of money rose five basis points (100 basis points = 1%) while the average effective rate on new loans fell 128 basis points over the same period. Thus, even though new loans were being made at 1 1/4% less in June 1971, those people who accepted variable rates in June 1970 would not have realized any benefit from the decline in rates. See Rand, *Negative Values of the Variable Interest Rates Mortgage*, 1972 SAVINGS AND LOAN ANNALS 132, 134-35; Comment, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1131 (1975). Of course, the slow-moving index also benefits borrowers in a period of rising interest rates by holding down their loan costs.

Some of the problems with the slow-moving index on residential variable mortgages may be cured by CAL. CIV. CODE § 1916.6 (West Supp. 1979). This section would permit notes and deeds of trust to provide that there will be no change in the interest rate until five years after execution of the document, and then not more frequently than every five years thereafter. In such cases, the change is not limited to one-fourth of one percent in a semiannual period, but all of the other provisions of CAL. CIV. CODE § 1916.5 (West 1979) are applicable.

118. CAL. CIV. CODE § 1916.5(a)(3) (West 1979) provides that "[t]he change in interest rate shall not exceed one-fourth of one percent in any semi-annual period, and shall not result in a rate more than 2.5 percentage points greater than the rate for the first loan payment due after the closing of the loan." The ceiling of 2.5 percentage points seems to run counter to the theory of the variable rate mortgage and can only be justified as an attempt to control interest rates despite significant fluctuations in the economy.

An additional limitation on the rate of actual payment has made variable rate mortgages even more attractive to borrowers. CAL. CIV. CODE § 1916.5(e) (West 1979) permits the borrower to maintain level instalment payments and extend the term of the loan to a maximum of 40 years where his interest rate is increased.

119. CAL. CIV. CODE § 1916.5(a)(5) (West 1979) permits the borrower to "prepay the loan in whole or in part without a prepayment charge within ninety days of notification of any increase in the rate of interest."

120. Wall St. J., Jan. 5, 1979, at 1, col. 6.

seems to arise from distaste for proconsumer variable legislation, rather than any intrinsic inequity in the concept of a variable rate.

Even with their shortcomings,¹²¹ VRM's seem far preferable to due-on-sale clauses as interest adjustment devices. Most important, their viability demonstrates that the consequence of severely restricting due-on-sale clause enforceability need not be a reduction in available financing and higher interest rates to new borrowers.¹²² Indeed, many lenders switched to VRM's after *Tucker* with no loss in profitability.¹²³

Thus far, most borrowers have accepted variables with only minor complaints. Residential borrowers have readily acceded to the modest increases under VRM's,¹²⁴ finding solace in the 1/4% break many lenders offered in VRM's, and in the provision allowing borrowers to extend the terms on mortgages up to forty years, making the real increase as little as 1/2 of 1% for each adjustment.¹²⁵ A continued climb in rates, however, could end borrower complacency.¹²⁶ At current rate levels, borrowers optimistic about an eventual rate decrease will prefer VRM's to fixed-rate mortgages.

Finally, borrowers who prefer fixed-rate mortgages may obtain them from federal savings and loan associations, who may enforce due-on-sale clauses, for the purpose of raising loan rates after *Glendale*.¹²⁷ Since federals may now offer VRM's also,¹²⁸ they are likely to gain a distinct competitive edge over state-regulated lenders.¹²⁹ State S&L's and banks are subject to more rigorous restrictions on the use of prepayment penalties¹³⁰ and due-on-sale clauses than federal S&L's.¹³¹

121. Most of the difficulties with VRM's rate lag arise in residential transactions due to the allegedly restrictive provisions of CAL. CIV. CODE § 1916.5 (West 1979).

122. Luce, *supra* note 114; Wall St. J., Oct. 14, 1975, at 2, col. 2.

123. Davis, *Some Background on Great Western's Decision to Adopt the VRM Loan*, J. CAL. S&L LEAGUE, Mar. 1975, at 21.

124. Wall St. J., Jan. 5, 1979, at 17, col. 5.

125. Comment, *supra* note 11, at 599 n.187.

126. One reason to anticipate a rise in variable rates is that treasury bill certificates of deposit, available since mid-1978, at a cost of 10% per year to S&L's, represent an increasing proportion of the savings deposits in California associations. Security analyst Glen Bottel, of Rhoades, Hornblower & Co., predicts that the index compiled by the San Francisco Bank Board will increase half a point this year, and perhaps more in April 1980. Wall St. J., Jan. 5, 1979, at 17, col. 5.

However, some of the sting of rate increases may be alleviated by adequate notice to consumers both at the time the loan is procured and before any increase. Pursuant to § 226.8(b)(8) of Regulation Z, lenders who extend credit to borrowers under certain open-end accounts secured by residential mortgages must disclose the impact on the number or amount of payments of a hypothetical rate increase of one fourth of one percent. 43 Fed. Reg. 60263 (1978).

127. *Glendale Fed. Sav. & Loan Ass'n v. Fox*, 459 F. Supp. 903 (C.D. Cal. 1978).

128. Wall St. J., Jan. 5, 1979, at 17, col. 5.

129. *Meyers v. Beverly Hills Fed. Sav. & Loan Ass'n*, 499 F.2d 1145 (9th Cir. 1974).

130. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379; CAL. CIV. CODE § 2924.6 (West Supp. 1979).

131. However, the federally regulated VRM is not subject to CAL. CIV. CODE § 1916.5 (West 1979) but nevertheless conforms with many of its guidelines. The federal VRM makes increases

Thus lenders subject to *Wellenkamp* who use fixed-rate mortgages will be at a competitive disadvantage against federal S&L's. Although an informed borrower might still opt for a VRM, continued rate increases in variables may drive many to the apparent safety of fixed-rate mortgages. Without adequate notice of the due-on-sale clause's use as an interest escalation device on sale or transfer of the secured property¹³² such borrowers may be misled. Even with such notice, the differing enforceability rights of federal and state lenders using VRM's¹³³ and due-on-sale clauses are bound to confuse unsophisticated borrowers.

B. *Wrap-Around Mortgages*

The fear that lenders will be unable to retire low interest rate loans without automatically enforceable due-on-sale provisions may be exaggerated. Given all the circumstances, it seems improbable that a large percentage of residential purchasers will seek to assume existing loans. Most private parties lack the ready cash to buy out a selling property owner's equity.¹³⁴ Thus, the bulk of new funding must come from institutional lenders.

In a typical case, the seller of residential property now valued at \$110,000 with a \$40,000 first mortgage, will ask \$10,000 down and offer his first trust deed for assumption. A buyer has several ways to obtain the remaining \$60,000. She can obtain a second mortgage for part of this sum, making up the rest by a larger down payment, or she can take a second covering the full amount from either an institutional lender or the seller. If she seeks to refinance the purchase price with the seller, she should be prepared to pay up to the cost of an institutional second. Whether this second takes the form of a straight loan or an installment land contract, the seller's compensation will be limited to monthly payments. Although a private lender-seller may be able to use an automatically enforceable due-on-sale clause,¹³⁵ he will be entering into a financing arrangement that professional lenders would not touch because, in their estimation, the risk would exceed the return.

One means of inducing a seller to take a second is to have the

optional and limits them to .5% every six months with a 2.5% ceiling. Increases or decreases could only be invoked in increments of .25% and without upward rounding. Terms on single-family dwellings could be extended up to 40 years in California. See Comment, *supra* note 114, at 159.

132. See Comment, *The Due-On-Sale Clause as a Reasonable Restraint on Alienation—A Proposal for Texas*, 8 ST. MARY'S L.J. 514, 528 (1976).

133. VRM's are specifically authorized by the FHLBB, but any adjustments in interest rate must be made in accordance with the approved FHLBB index. See 40 FED. REG. 6870 (1975) for text of approved rules. The new regulations amend and replace 12 C.F.R. §§ 541, 545 (1978).

134. This is due to a staggering increase in property values. The national average purchase price for a new home was \$67,000 in December 1978, up from \$65,000 a month before; California's rises have been steeper still. Wall St. J., Jan. 5, 1979, at 1, col. 6.

135. 21 Cal. 3d at 952 n.9, 582 P.2d at 976 n.9, 148 Cal. Rptr. at 385 n.9.

seller execute a wrap-around mortgage on the property. This device is a second trust deed that includes the unpaid balance of the seller's first trust deed. Instead of executing a second trust deed and only collecting interest on that obligation the seller uses his existing first to increase his total return. He realizes gain on the differential in interest from that portion of the second trust deed which overlaps the first trust deed.¹³⁶ The wrap-around mortgage permits him to offer his property at the market rate while profiting from the interest spread between the rate of his underlying obligation and the higher rate he charges on his wrap-around mortgage. A buyer will be interested in the deal as long as the wrap-around interest rate is sufficiently below market to make it more attractive than acquiring new financing. Wrap-arounds were cautiously used after *Tucker* as a form of installment land contract. They had to await *Wellenkamp* for specific validation,¹³⁷ subject to uncertain barriers erected by state usury laws.

The arrangement works well if the seller does not need to get his money out of the property. Where the seller needs cash, however, he has three choices. First, he can forego the advantages of a wrap-around and look for a purchaser with enough cash to assume his first trust deed. Second, he can sell his wrap-around to a third-party private lender.¹³⁸ Third, he can sell his wrap-around trust deed to an institutional lender.¹³⁹ This last alternative may be the most viable. Professional lenders, who are constitutionally exempt from usury laws, can

136. If the seller has a \$40,000 first at 8% on property valued at \$100,000, he might accept \$10,000 down and execute a second trust deed for \$90,000 at 9%. He would receive \$50,000 (\$90,000-\$40,000) at 9% plus \$40,000 at 1% (9%-8%).

137. 21 Cal. 3d at 950 n.5, 582 P.2d at 974 n.5, 148 Cal. Rptr. at 383 n.5. A serious obstacle to the use of wrap-around mortgages after *Wellenkamp* is the possibility that wrap-arounds will be found usurious. This is no obstacle for banks and S&L's specifically exempted from the usury laws under CAL. CONST. art. XXIII. Many residential sales will also be exempt since usury provisions are inapplicable to purchase money deeds of trust. Still, for those not exempt, the risk of a borrower's treble damages action would dissuade the use of wrap-arounds. However, in *Boerner v. Colwell Co.*, 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978), the court, speaking through Justice Manuel, the author of *Wellenkamp*, held that a bona fide credit sale is not subject to the usury law because it does not involve a "loan" or "forbearance" of money or other things of value. *Id.* at 45, 577 P.2d at 205, 145 Cal. Rptr. at 385. Moreover, the taking of a security interest in real property is inconsistent with a bona fide credit sale — at least in a case where the property which is the subject of the sale is to be affixed and made a part of the real property given as security for payment. *Id.* at 49, 577 P.2d at 207, 145 Cal. Rptr. at 387.

138. This alternative would require the seller to forego some of the profits he could have realized by collecting payments and interest from his new buyer, since the seller must discount his loan to attract a buyer.

139. Pursuant to CAL. FIN. CODE § 5255 (West 1978), the State Savings and Loan Commissioner has promulgated regulations regarding the treatment of "Wrap-Around Loans." The regulations treat a wrap-around as a first mortgage or first trust deed upon real property where certain conditions are met: (1) there must be no more than one preexisting loan on the property; (2) the wrap-around obligation to the savings and loan cannot be less than the sum disbursed to the borrower by the association and the balance due on the preexisting loan; and (3) the amount of the

step into the shoes of the private lender and realize an effective rate higher than that available on new financing.¹⁴⁰

CONCLUSION

Wellenkamp effects a reasonable change in the law by depriving lenders of an interest increase not negotiated with the borrower. It limits its use of a provision that purports to be a security device to protection of the lender's security interests. Yet the opinion is far more significant for what it failed to do than for what it accomplished. The court characterized the borrower's diminished ability to sell his property as an unreasonable restraint on alienation, but failed to tie this doctrine to the concerns over adhesion which motivated the decision. It determined that lenders could only accelerate upon a showing of impairment, but neglected to define the necessary standard. It cited the policy favoring preservation of home equities, but failed to draw any distinction between commercial and residential loans.

All these issues are ripe for litigation after *Wellenkamp*. However, the biggest problem with the decision is its formulation of the test for finding a restraint on alienation in terms of an "inhibitory" quantum. Taken literally, this standard could strike down any obstacle to transfer of property that could be paid off in cash. Such overly broad standards deprive practitioners of concrete guidance in determining the courts' likely approach to issues left unresolved by *Wellenkamp*.

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borrower's obligation on the wrap-around must not exceed applicable legal limitations (*i.e.*, 80% for most residential purchasers). CAL. FIN. CODE § 7153.2 (West Supp. 1978).

140. New forms of real estate investment encouraged by federal regulations may further spur the growth of a secondary market in residential mortgages. A proposal by the Department of Housing and Urban Development in 43 Fed. Reg. 60957 (1978) would establish a new mortgage-backed securities program that provides for the guaranty by the Government National Mortgage Association (GNMA) of securities based on and backed by pools of Graduated Payment Mortgages (GPM's). GPM loans are single-family mortgages, the monthly payments of which increase annually for a fixed number of years. In addition, banks are beginning to offer customers a new type of investment—an investment in an undivided interest in a "pool" of residential mortgage loans. The IRS has recently issued a ruling, Rev. Rul. 77-349, 1977-38 I.R.B. 7, explaining this new device. See Weinstein, *Tax Consequences of Residential Mortgage Loans*, 95 BANKING L. J. 265 (1978).

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