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Wellenkamp v. Bank of America: A De-Stabilizing Shift in California Real Estate Financing

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WELLENKAMP V. BANK OF AMERICA: A DE-STABILIZING SHIFT IN CALIFORNIA REAL ESTATE FINANCING

Of continuing interest to financial institutions loaning money on the security of liens encumbering real property, and to the buyers and sellers of such property, is the ability of the lender to exercise a due-on-sale clause[1] contained in the mortgage instrument. Originally conceived as a mechanism to protect a lender's security interest,[2] the due-on clause came to be used as an interest rate adjustment tool in times of rising interest rates.[3] The automatic enforcement of the due-on clause has been attacked by borrowers as constituting a restraint on alienation, a contention which has been examined by the California judiciary in a line of cases culminating in the decision rendered in

1. A due-on clause allows the mortgagee, upon the sale, transfer, or further encumbrancing of the secured property, to declare the remaining indebtedness immediately due and payable. A typical due-on-sale clause provides as follows:

> The mortgagor further covenants and agrees not to alienate nor to encumber to the prejudice of the mortgagee said real estate nor to commit, permit, or suffer any waste, impairment, or depreciation of said property and, in the event of any sale or transfer of title to the property herein described, such purchaser or new owner shall be deemed to have assumed and agreed to pay the indebtedness owing under the mortgage hereunder, whether or not the instrument evidencing such sale or transfer expressly so provides, and at any time after such sale or transfer, without limiting the foregoing, the mortgagee may, at its option, declare all of the remainder of the indebtedness immediately due and collectible, whether or not any default exists; this covenant shall run with said land and remain in full force and effect until said indebtedness is liquidated and the mortgagee may, without notice to the mortgagor, deal with such new owner or owners with reference to the debt secured hereby in the same manner as with the mortgagor, without in any way altering or discharging the mortgagor's liability hereunder upon the indebtedness hereby secured.

A. Arnold, Modern Real Estate and Mortgage Forms, Form 120.11, p.3-116 (1978).

2. *See* note 15 *infra* and accompanying text.

3. *See* note 22 *infra* and accompanying text.

Wellenkamp v. Bank of America.[4] This Note will explore the historical underpinnings of the due-on clause, the line of authority examining its current use, and its continuing vitality.

I. HISTORICAL BACKGROUND

A. The Due-On-Sale Clause

The due-on clause has its roots in the financial collapse accompanying the Great Depression.[5] Banks, faced with a flood of panicked depositors, found themselves with insufficient available capital to cover their obligations to depositors because of heavy investment in long term real estate mortgages, a condition known as illiquidity.[6] The few banks which reopened following the closure ordered by President Roosevelt in 1933[7] refused to commit funds to real estate mortgaging, and their lead was followed by those state building and loan associations which survived.[8] Because of rampant unemployment, two economic factors affected the lending market. First, many of the borrowers were unable to keep up mortgage payments due to their unemployment. Second, the investors who originally provided the capital to the lenders from which the loans were originally made found themselves in need of funds for living purposes, and sought to withdraw their investments. Due to the fact that lenders had neither new investors to draw upon, nor a constant flow of funds from their borrowers, the lenders could not meet withdrawal demands.[9]

Faced with the ominous prospect of a deepening unemployment crisis in the building trades, coupled with an acute housing shortage, a system of federal home loan banks was created to encourage the free flow of funding from lending institutions.[10]

4. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

5. *See generally,* Goddard, *Non-Assignment Provisions in Land Contracts,* 31 Mich. L. Rev. 1, 7-8 (1932).

6. 75 Cong. Rec. 12586-87 (1932).

7. 77 Cong. Rec. 45; Presidential Proclamation 2039, 48 Stat. 1689 (1933).

8. Kratovil, *A New Dilemma for Thrift Institutions: Judicial Emasculation of the Due-On-Sale Clause,* 12 J. Mar. J. Prac. & Proc. 299 (1979).

9. 75 Cong. Rec. 12586 (1932).

10. Federal Home Loan Bank Act, ch. 522, § 1, 47 Stat. 725 (1932) (codified at 12 U.S.C. §§ 1421 *et seq.* (1957)). This measure was intended as emergency legislation for the purpose of encouraging home ownership by giving home mortgage institutions an opportunity to borrow money on their assets. The loans were to be secured by advancements from the federal government. *See generally,* 75 Cong. Rec. 12585-629. The most

The principal means of encouragement under the plan was to provide a limited system of federally funded mortgage insurance.[11] The banks, still uneasy, resumed cautious lending. However, lending without governmental insurance was nonexistent. A system of federal savings and loan associations was created, which attracted depositors by insuring accounts through federal institutions. This insurance was also made available to deposits in state savings and loan associations.[12]

The lending institutions subsequently began a concerted effort to refine mortgage documentation. Among the refinements developed by the banks was the appearance of due-on-sale clauses in mortgage contracts. In its early form, the clause contained a covenant giving the lender a right to accelerate the remainder of the mortgage debt on sale of the security.[13] Presumably in response to increased judicial scrutiny of various objectionable aspects of the due-on-sale clause relating to restraints on alienation,[14] lenders began to segregate the due-on-sale provisions into separate articles within the mortgage contract. These versions became much more comprehensive[15] than

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important aspect of this type of financing arrangement was that a home loan bank could classify mortgages as assets, which provided the opportunity to borrow money against the bank's outstanding loans and thereby allowing for a free flow of capital. *See* 12 U.S.C. § 1435 (1957).

11. *Id.*

12. *See* Kratovil, *supra* note 8, at 299.

13. The early form of the due-on-sale clause existed as one of the many covenants contained in broad acceleration clauses covering breach of covenant in general. The typical clause was a covenant not to convey without the lender's consent. This type of format invited attack as a restraint upon alienation as evidenced by the Illinois Supreme Court's decision in Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill.2d 119, 333 N.E.2d 1 (1975). The early Federal Housing Administration (FHA) form incorporated the following language:

> If there shall be any change in the ownership of the premises covered hereby without the consent of the Grantee, the entire principal and all accrued interest shall become due and payable at the election of the Grantee, and foreclosure proceedings may be instituted thereon.

HOAGLAND, STONE & BRUEGGEMAN, REAL ESTATE FINANCE 14 (6th ed. 1977). This version originated in the FHA mortgage forms of Georgia, Puerto Rico, and Ohio in the 1930's and Oregon in 1940. Kratovil, *supra* note 8, at 302 n.7.

14. *See* Annot. 69 A.L.R.3d 722 (1976) (pointing out that there are few reported cases dealing with the due-on clause prior to 1964).

15. The Federal Home Loan Mortgage Corporation mortgage form provides as follows:

> 19. Transfers of the Property or Beneficial Interests in Borrower; Assumption. On sale or transfer of (i) all or any part of

the language previously used in these clauses and were tailored to specific types of situations that might trigger acceleration.[16] The economic philosophy underlying the due-on-sale clause was a practical one: lenders who had made loans to individuals based on a credit record were assured of credit-worthy replacements in the event of sale. Lenders were looking solely to the individual debtor, backed by his security, in making the acceleration decision; the sole consideration being protection of the loan principal.[17]

During the 1940's, 1950's and into the early 1960's—periods

> the Property, or any interest therein, or (ii) beneficial interests in Borrower (if Borrower is not a natural person or persons but is a corporation, partnership, trust or other legal entity), Lender may, at Lender's option, declare all of the sums secured by this Instrument to be immediately due and payable, and Lender may invoke any remedies permitted by paragraph 27 of this Instrument. This option shall not apply in case of
>
> (a) transfers by devise or descent or by operation of law upon the death of a joint tenant or partner;
>
> (b) sales or transfers when the transferee's credit-worthiness and management ability are satisfactory to Lender and the transferee has executed, prior to the sale or transfer, a written assumption agreement containing such terms as Lender may require, including, if required by Lender, an increase in the rate of interest payable under the Note;
>
> (c) the grant of a leasehold interest in a part of the Property of three years or less (or such longer lease term as Lender may permit by prior written approval) not containing an option to purchase (except any interest in the ground lease, if this Instrument is on a leasehold);
>
> (d) sales or transfers of beneficial interests in Borrower provided that such sales or transfers, together with any prior sales or transfers of beneficial interests in Borrower, but excluding sale or transfer under subparagraph (a) and (b) above, do not result in more than 49% of the beneficial interests in Borrower having been sold or transferred since commencement of amortization of the Note; and
>
> (e) sales or transfers of fixtures or any personal property pursuant to the first paragraph of paragraph 6 hereof.

FNMA-FHLMC General Counsels' Conference 148-49 (1977), *reprinted in* Kratovil, *supra* note 8, at 302 n.9.

16. Kratovil, *supra* note 8, at 309. Common clauses expressly provide for acceleration upon placing a junior encumbrance on the property, as in many corporate mortgages, or selling by means of an installment sales contract. *Id.*

17. *Id.* at 300.

of financial growth in which lending money was plentiful—little complaint was voiced with respect to inclusion of due-on-sale clauses in mortgage contracts.[18] In the late 1960's for the first time since the days before the Depression, interest rates began to rise significantly.[19] However, the lenders again found themselves in a position of illiquidity for two reasons. First, lenders acquire capital to lend principally from two sources. A major source of funds is the money deposited by investors in passbook or other types of savings accounts, which creates a cash reserve. The lender then uses this cash reserve, along with a variety of older outstanding loans, as security for borrowing funds that it then lends to new borrowers.[20] The lender thus must pay prevailing interest rates for the use of the money and hope to recapture the interest by charging a higher rate on money it lends. When the lender's loan portfolio contains a large amount of older low-yield loans in a period of escalating interest rates, the lender cannot afford to pay the difference between the proceeds of its old outstanding loans and the rates that will be charged for the use of new funds. This condition occurred in the late 1920's.[21] Second, when forms of investment which provide a higher yield than savings accounts become available, investors withdraw their funds from savings accounts in order to take advantage of investments with a higher return, a process called "disintermediation."[22] To put it simply, disintermediation is that point in time at which interest rates on government securities and municipal bonds rise to a level above the rates paid for passbook savings, resulting in a flow of capital from the savings institutions into government securities. This creates a situation not unlike that which banks faced during the Depression: banks are caught with long-term capital commitments and short-term obligations to depositors. The inevitable result is the unavaila-

18. *Id.*

19. Conventional mortgage rates rose from 6.29 percent in 1967 to 11 percent in 1977. *See generally* Boykin & Phillips, *The New Challenger: The Variable-Rate Mortgage,* 8 REAL EST. REV. 83, 84 (1978) and 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, 268 (1972).

20. *See* note 10 *supra* and accompanying text.

21. *See* note 19 *supra* and accompanying text.

22. *See generally* Kratovil, *supra* note 8. To illustrate the problem, the rates on ninety day U.S. Treasury Bills jumped from 3.27 percent in February, 1972 to 9.29 percent in August, 1974, a far greater return than could be realized from a passbook savings account. *See,* Boykin & Phillips, *supra* note 19 at 86.

bility of mortgage funds.[23]

In order to keep funds in the lending institutions and hence in the mortgage market, lenders must be able to offer depositors something that a depositor cannot get from government securities.[24] The lending institutions began to take a hard look at their investment portfolios with an eye towards converting those investments with low return on investment ratios to a more lucrative variety.[25] Among the mechanisms employed to free otherwise committed loan funds was the practice of automatically enforcing the due-on clause when the original borrower attempted to sell his home subject to an existing mortgage.[26]

In practice, the lenders did not call the note due upon sale of the property, but rather they would only consent to the sale on the condition that the purchaser pay an assumption or waiver fee and renegotiate the interest rate. In essence, the element of a former mortgage that the new buyer is most interested in—the interest rate—is thus removed, and there is subsequently little difference between "assuming" an existing mortgage and arranging for new financing.[27] The due-on clause, originally an instrument for the protection of the lenders' security from un-creditworthy transferees, became a tool for loan portfolio maintenance.[28] Not surprisingly, buyers resented the imposition of high interest rates and assumption charges. Sellers suffered derivatively because, when new financing was only available at a much higher interest rate and the existing mortgage could only be as-

23. See Kratovil, *supra* note 8, at 300.

24. Disintermediation affects savings and loan institutions to a greater extent than commercial banks. Savings and loans have traditionally been committed to long-term, and more secure, loan commitments. Commercial banks have dealt mainly in short-term notes which are tied to the current investment rates, and which, by their nature, quickly mature so the money can be reinvested at the prevailing rates. The commercial bank, therefore, can constantly adjust its loan portfolio to reflect current money market trends. The savings and loans, locked into long-term mortgage commitments, are unable to make this adjustment quite so easily. *See*, Comment, *Use of "Due-On" Clauses to Gain Collateral Benefits: A Common Sense Defense*, 10 TULSA L. J. 590, 592 (1975).

25. The commercial banks have attacked this problem by marketing services. Until very recently, the notion of banks being open on Saturdays or late in the evenings was unheard of, so much so that the term "banker's hours" has become a colloquialism in American society.

26. *See generally* note 24 *supra*.

27. *See, e.g.*, Tucker v. Lassen Sav. & Loan Ass'n., 12 Cal. 3d 629, 633, 526 P.2d 1169, 1171, 116 Cal. Rptr. 633, 635 (1974).

28. *See* Kratovil, *supra* note 8, at 299-300.

sumed if the old interest rate was adjusted to current levels, the seller had the alternatives of either reducing his selling price to induce the buyer to go forward with the transaction or of terminating the transaction and retaining the property.[29] A variety of devices were used to avoid the exercise of the due-on clause, most of which proved to be far from satisfactory.[30]

Inevitably, resort to the courts became necessary to resolve the basically economic dispute between the lending institutions and buyers or sellers. In each of the reported cases, frustrated buyers or sellers sought to invalidate exercise of the due-on clause by, among other things, attacking the clause as an invalid restraint on alienation.[31]

B. Restraints on Alienation

The earliest apparent event similar to the current due-on controversy took place in the 13th century. One of the cited Charters made at that time pledged the transferee not to mortgage or to sell the land, or to permit any of his freeholders to mortgage or sell, except to the Abbot of Gloucester,[32] the overlord. This enabled the overlord to maintain control over his vast holdings even after he had granted a freehold estate. The Chancery courts found this to be an impermissible social restriction, which would work a forfeiture, since the property would always revert to the Abbot. Consistent with its abhorrence of forfeitures, the Chancery court granted the mortgagee an equity of re-

29. Wellenkamp v. Bank of America, 21 Cal. 3d 943, 950-51, 582 P.2d 970, 975, 148 Cal. Rptr. 379, 384.

30. One such device entailed concealment of the transfer from the lender by not recording the sale agreement. For a more detailed discussion of devices employed, *see generally* Bonanno, *supra* note 19.

31. *See, e.g.*, Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971); Coast Bank v. Minderhout, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964); Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969); and Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969). For more detailed treatment of restraints on alienation in the real property secured transactions area, *see generally*, Volkmer, *The Application of the Restraints on Alienation Doctrine to Real Property Security Interests*, 58 Iowa L. Rev. 747 (1973), which also discusses a possible attack on the due-on clause as an unenforceable penalty, a topic beyond the scope of this article. *Id.* at 786. This contention was rejected in Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 459, 79 Cal. Rptr. 9, 11 (1969).

32. 4 Restatement of Property (Part II) Introductory Note 2373-74 (1944).

demption, notwithstanding his failure to perform the contract according to its terms,[33] because to hold otherwise would effectively make the property inalienable. The rule, therefore, was constructed to prevent the situation where an owner is absolutely precluded from transferring the property.[34] The rationale for the rule is that restraints remove the property from the stream of commerce resulting in "an undesirable increase in the market value of property, more particularly land. In some localities . . . such increase in the market price might be substantial. It may well be questioned whether an increase in marketable value so induced is of benefit to the public at large."[35]

II. THE CALIFORNIA COURT EXAMINES THE DUE-ON-SALE CLAUSE

The earliest reported case on the enforceability of the due-on-sale clause is *Coast Bank v. Minderhout.*[36] However, *Coast Bank* did not involve a mortgage agreement, but was the result of a property improvement loan which provided, in a separate agreement, that the borrowers would be precluded from transferring or further encumbering certain property as long as the loan remained in effect.[37] If the borrowers defaulted under the terms of the loan agreement, the bank could declare the remaining indebtedness immediately due. The borrowers conveyed the property to the Minderhouts, and the bank, upon discovery of the transaction, elected to accelerate the loan. When the bank could not collect the amount outstanding from the borrower, it instituted an action against the Minderhouts, seeking to fore-

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33. 4 RESTATMENT OF PROPERTY § 415, Comment a, Lien Theory versus title theory - Historical Background (1944).

34. The AMERICAN LAW OF PROPERTY explained the rule as follows:

> The rule against restraints upon alienation is directed primarily against attempts to make vested interests . . . inalienable. These attempts have taken two general forms. One method of restraint is the insertion in the conveyance of a provision that alienation shall cause a forfeiture of the conveyor's interest. This forfeiture provision usually assumes the form of a reservation by the conveyor of a power of termination (right of reentry) . . . . A second method of restraint is a provision which withholds from the conveyee the power to make a transfer.

6 AMERICAN LAW OF PROPERTY § 26.1 (A.J. Casner ed. 1952) (a right of reentry is analogous to the right of foreclosure clauses found in the due-on cases).

35. *Id.* § 26.3.

36. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

37. *Id.* at 313 n.2, 392 P.2d at 266, n.2, 38 Cal. Rptr. at 505 n.2.

close what the bank characterized as an equitable mortgage created by the separate agreement.[38] The Minderhouts further contended that even if the agreement created an equitable mortgage, the provision that the property could not be transferred represented an invalid restraint on alientation.[39] However, because of the manner in which *Coast Bank* reached the court, the bulk of the opinion dealt with issues collateral to the question concerning the due-on-sale provision.[40] In a very brief discussion, the court noted that only *unreasonable* restraints were prohibited, citing the California Civil Code section 711 in a footnote.[41] Although failing to resolve the restraint issue, the court hinted that it would have some real problems with the clause had it come up in another context.[42]

The next reported case, a Court of Appeal decision, was *Hellbaum v. Lytton Savings & Loan Association.*[43] In that case, the original borrowers executed a promissory note, secured by a deed of trust, which contained a due-on-transfer clause.[44] Hellbaum succeeded to the original borrowers' rights and obligations without triggering the due-on clause.[45] Hellbaum thereaf-

38. *Id.* at 312, 392 P.2d at 266, 38 Cal. Rptr. at 506.

39. *Id.* at 315, 392 P.2d at 267-68, 38 Cal. Rptr. at 507-08.

40. The Minderhouts' appeal was taken from a demurrer, and thus no evidence was taken at the trial court level. The primary contention on appeal was that the parties did not intend to create a security interest in the property. *Id.* at 315, 392 P.2d at 266, 38 Cal. Rptr. at 507.

41. *Id.* at 316 n.3, 392 P.2d at 268 n.3, 38 Cal. Rptr. at 508 n.3. The CAL. CIV. CODE § 711 (West 1977) provides: "[c]onditions restraining alienation, when repugnant to the interest created, are void."

42. The court stated as follows:

> Whether the promise not to transfer or encumber the property would be directly enforcible [sic] by injunction, specific performance, or an action for damages is another question. It is open to doubt whether such a promise would be a reasonable restraint when, as in this case, plaintiff had the additional protection of a security interest and the right to declare the entire debt due in the event of default. It is unnecessary, however, to decide this question now. Plaintiff is seeking not to enforce the Enrights' promise not to transfer the property but only to foreclose its security interest. The creation of that interest was a separate lawful object of the agreement.

61 Cal. 2d at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508-09.

43. 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969).

44. *Id.* at 457-58, 79 Cal. Rptr. at 10. A due-on-transfer clause is a refinement of the due-on-sale clause. Functionally equivalent, the due-on-transfer clause also encompasses other types of transfers, such as gifts.

45. How this came about is not clear from the case. The court merely states,

ter contracted to sell the property to other parties and applied to the bank for approval of an assumption by the prospective purchasers of the unpaid balance on the original note. The reason Hellbaum structured the transaction in this way, rather than having the prospective purchaser arrange for his own financing, was that the note also provided for a prepayment fee.[46] The amount of the prepayment fee combined with loan origination fees, normally imposed by any new lender, proved too expensive for the prospective purchaser, and assumption of the existing debt appeared to be the only way to salvage the sale.[47] Lytton Savings and Loan Association responded that it would only permit assumption without imposing acceleration and the attendant prepayment fee if the prospective purchaser would pay a five percent assumption fee. This, too, proved too expensive for the prospective purchasers, and ultimately they withdrew from the transaction. Eventually, Hellbaum defaulted in the loan payments and the property was sold at a trustee's sale.[48]

Hellbaum brought an action for damages, alleging, among other things, that the provision for a prepayment fee upon accelerated payment because of transfer of the property constituted an unreasonable restrain on alienation.[49] The court disposed of this claim by stating that "[i]t is settled that an agreement not to encumber or transfer property . . . is not an invalid restraint on alienation."[50] The court found the *Coast Bank* rationale compelling because the restraint was reasonably necessary to protect the creditor's justifiable interest in maintaining the direct responsibility of the parties on whose credit the loan was made.[51]

"[a]ppellants succeeded to the rights and obligations of the Thompsons through transactions not here material." *Id.* at 458, 79 Cal. Rptr. at 10.

46. The prepayment fee could also be imposed in the event the bank exercised its rights under the acceleration clause. *Id.* at 458, 79 Cal. Rptr. at 10.

47. *Id.* at 457-58, 79 Cal. Rptr. at 11.

48. *Id.* at 458, 79 Cal. Rptr. at 10.

49. *Id.*, 79 Cal. Rptr. at 11.

50. *Id.*

51. It should be recognized that Hellbaum's erstwhile purchasers had an aura of insolvency about them inasmuch as independent financing was something they could not afford. Even under Lytton's terms, the purchasers would have been required to obtain $44,440, which would have represented 15% of the purchase price. Even in 1969, a 15% buy-in price would normally be considered quite reasonable. Taken in this light, it would seem that Lytton's reluctance to permit assumption was well taken. Loans to insolvent debtors have an inherently greater risk of eventual foreclosure, and the attendant cost to the lender. On the other hand, the Hellbaums proved no more solvent than the prospective purchasers and, in fact, would have remained secondarily liable on the note had

The court reasoned that because a lender incurs administrative expenses in both issuing a loan and setting up servicing provisions, the lender may justifiably motivate its long-term debtor to refrain from early payment through the use of devices such as an acceleration clause.[52] However, the court's reasoning is puzzling, since, were it not thwarted by the bank's attempt to extract fees, the transaction would have accomplished precisely what the court perceived to be the lender's intent — avoidance of payment prior to maturity.[53]

In *Cherry v. Home Savings and Loan Association*,[54] decided three months after *Hellbaum*, the court took another cursory look at the application of Civil Code section 711 to the due-on-sale clause. In 1964, Orrin and Rosellen Wickershim executed a promissory note secured by a deed of trust on certain real property in favor of Home Savings. The deed of trust contained a due-on-sale clause.[55] In 1967, Tom Cherry offered to purchase the property from the Wickershims, subject to Home's security interest. The Wickershims were to remain primarily liable under the deed of trust for all indebtedness due Home. Thereafter, the Wickershims requested that Home give its consent to the proposed sale, which Home refused to do unless Cherry would agree to assume the mortgage at a higher rate of interest and pay an assumption fee of $471.00.[56] As in *Hellbaum*, the borrower's con-

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Lytton approved the assumption. Although the case does not reveal the reasons behind Hellbaum's eventual default, one might question Lytton's rationale in placing an obstacle in the path of obtaining a more solvent (or at least one more) obligor. Perhaps the answer lies in the fact that by proceeding as Lytton did, Lytton acquired an equity in the property, which represented $31,000, almost a 12% return on investment. *See id.*, 79 Cal. Rptr. at 10-11.

52. *Id.* at 459, 79 Cal. Rptr. at 11.

53. There are, however, some expenses connected with loan origination. The Mortgage Bankers Association reported that the expenses of originating a loan exceeded origination income by an average of $26.90 per loan. *See* 7 Hous. & Dev. Rep. (BNA) 135 (1979).

54. 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969).

55. Paragraph 12 of the deed of trust provided:

> That if the Trustor shall sell, convey, or alienate said property, or any part thereof, or any interest therein . . . without the written consent of the Beneficiary being first had and obtained, Beneficiary shall have the right, at its option, to declare any indebtedness or obligations secured hereby, irrespective of the maturity date specified in any note evidencing the same, immediately due and payable.

Id. at 576, 81 Cal. Rptr. at 136.

56. *Id.*

tention that the due-on clause constituted an invalid restraint was secondary.[57]

With almost no discussion, the court noted that the borrower's "contention [that the due-on clause constituted an invalid restraint on alienation] previously was answered adversely in Coast Bank v. Minderhout."[58] The court, however, added a new justification for its holding, observing that there is a risk that the security may depreciate or be destroyed.[59] The lender minimizes this risk in two ways. First, the lender knows his borrower. If the borrower is known to be conscientious, the lender can be reasonably assured that the borrower will perform adequate maintenance in order to prevent the security from falling into disrepair, will keep tax payments current, and otherwise protect the security. Second, the trust deed often requires that the borrower perform these functions. Thus, in the court's view the lender had an interest in keeping its original borrower in possession, and could decline to accept a substitute for any reason, or for no reason at all.[60] Again, the court's analysis seems to ignore the facts. The lender here had the best of all possible worlds; its original borrower remained primarily liable on the note, the new buyer had a strong incentive to keep the payments current, and the bank could foreclose on the property in the event of a de-

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57. The principal contention was that an unwritten, but implied term of the trust deed required the bank to act reasonably in withholding its consent to the transfer. *Id.* at 577, 81 Cal. Rptr. at 139.

58. *Id.* at 580, 81 Cal. Rptr. at 139.

59. *Id.* at 578, 81 Cal. Rptr. at 138.

60. The court stated:

> Lenders run the risk that security may be made to depreciate in value, or be totally destroyed. This risk of loss is reduced in the lender's viewpoint if the borrower is known to be conscientious, experienced and able. Often, as here, a trust deed requires the borrower to maintain property in good repair, secure and keep adequate insurance in force, satisfy liens, taxes and other encumbrances and in other ways to protect the security. If a borrower were able to sell the security without concern for the debt, he may take the proceeds of the sale, leaving for parts unknown, and the new owner of the property might permit it to run down and depreciate. Thus, the lender places some value on his belief that the person who takes out the loan is reliable and responsible. A lender may, indeed, be willing to loan money to some persons or entities at one rate of interest but to other less desirable risks, only at an increased interest rate.

Id. at 578-79, 81 Cal. Rptr. at 138.

fault.[61] Moreover, the court's reasoning is rather strained. Real property in California simply has not declined in value and, in fact, has become a major vehicle as a hedge against inflation.[62] The risk that property will depreciate is indeed small. That the court should accord major significance to this aspect of the housing market is to ignore the realities of California economics.

The *Cherry* court did, however, state the crux of the due-on issue: when interest rates drop, borrowers refinance the debt at the new, lower, rates leaving lenders money to lend at less favorable rates. When interest rates increase, borrowers do not refinance, and lenders are left holding long term loan commitments at rates below those which are then prevailing.[63] As one protection against this situation, the due-on clause is employed—permitting acceleration of the due date—so that the lender can take advantage of rising interest rates in the event his borrower transfers the security. The court noted that this is just one example of the methods used to minimize risks by sensible lenders.[64]

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61. Because the loan was for refinancing, and not a purchase money mortgage, the original borrower remained responsible even for a deficiency judgment. *See* CAL. CODE CIV. PRO. § 580(b), which provides in pertinent part:

> No deficiency judgment shall lie . . . under a deed of trust . . . given to the vendor to secure payment of the balance of the purchase price of real property . . . or . . . on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of such dwelling . . . .

CAL. CODE CIV. PRO. § 580(b) (West 1977).

62. The Census Bureau reports that the average sale price of a single family house increased 118 percent between 1966 and 1976. *See* 6 HOUS. & DEV. REP. (BNA) 827 (1979).

63. 276 Cal. App. 2d at 579, 81 Cal. Rptr. at 138.

64. The court stated:

> [l]oan agreements frequently permit a borrower to pay off a loan before it is due. When interest rates are high, a lender runs the risk they will drop and that the borrower will refinance his debt elsewhere at a lower rate and pay off the loan, leaving the lender with money to loan but at a less favorable interest rate. On the other hand, when money is loaned at low interest, the lender risks losing the benefit of a later increase in rates. As one protection against the foregoing contingency, a due-on-sale clause is employed permitting acceleration of the due date by the lender so that he may take advantage of rising interest rates in the event his borrower transfers the security. This is merely one example of ways taken to minimize risks by sensible lenders.

The application of California Civil Code section 711 to the enforceability of the due-on clause therefore became "settled law" without any serious inquiry by the courts as to whether the condition imposed by the due-on clause was really repugnant to the interest created by the deed of trust. However, the issue of whether the due-on clause really works a restraint at all was left open to question. In *Coast Bank* and *Cherry,* the point was raised by a disgruntled transferee, presenting the unique position of a successful buyer complaining of his sellers' inability to sell.[65] In *Hellbaum* the complaint was filed by a seller, on the verge of default, who had nothing better to offer than an insolvent buyer.[66] In all three cases, it was clear that the issue was not so much the *ability* of the transferor to alienate so much as the *consideration* the transferee would be required to pay.

Because of the *Cherry* court's language permitting the lender to act even "unreasonably" in its enforcement of the due-on clause, even for purely economic reasons, the California Supreme Court—in its first look at the due-on controversy since perhaps its inadvertent reference to Civil Code section 711 in *Coast Bank*—decided *La Sala v. American Savings & Loan Association.*[67] In 1963, the La Salas borrowed $20,700 from American Savings and Loan at six percent interest and executed a promissory note accompanied by a deed of trust which contained a due-on-encumbrance clause.[68] In 1969, the La Salas borrowed $3,800 from a third person and executed another note with a second deed of trust. Less than one month later, the bank notified the La Salas of its right to accelerate, but offered to waive its right in return for a payment of $150.00 and an in-

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> [The lender] had the power of free decision regarding use of its money by others, the right to determine in its own discretion whether it would exercise its option, and it had no obligation to act only in a manner which others might term 'reasonable.' Neither Cherry nor the Wickershims, all of whom were aware of the terms, can complain.

Id. at 579, 81 Cal. Rptr. at 138-39.

65. For *Coast Bank, see* note 37 *supra* and accompanying text. For *Cherry, see* note 54 *supra* and accompanying text.

66. *See* note 51 *supra* and accompanying text.

67. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

68. *Id.* at 869, 489 P.2d at 1115, 97 Cal. Rptr. at 851. A due-on-encumbrance clause permits the lender to accelerate if the borrower places a junior encumbrance on the secured property. *Id.* at n.2.

crease in the rate of interest to nine percent on the first deed of trust. The La Salas filed an action for declaratory relief, alleging that the due-on clause constituted an invalid restraint on alienation.[69]

The court focused on the interest of the lender to have its security free from the risk of devaluation or depreciation and injected the concept of reasonableness into the inquiry.[70] The court provided a two-prong test, asking first, what degree of restraint on alienation would result from enforcement of the clause, and second, whether the restraint was necessary to prevent impairment to the lender's security.[71] Thus, for the first time, the court looked to the original purpose of the clause rather than its new-found use as a portfolio adjustment tool. The court expressly rejected American's argument that portfolio adjustment made the restraint reasonable, stating:

> In any event a restraint on alienation cannot be found reasonable merely because it is commercially beneficial to the restrainor. Otherwise, one could justify any restraint on alienation on the grounds that the lender could exact a valuable consideration in return for its waiver, and that sensible lenders find such devices profitable.[72]

The court continued its analysis by illustrating one of the circumstances under which the lender's interest would be sufficiently jeopardized to justify acceleration. Where the property was over-encumbered by the new second loan, the borrower would have little or no equity and therefore little incentive either to protect the property from waste and depreciation, or to pay the loans.[73] Again, however, the applicability of Civil Code section 711 was not seriously examined. Presumably, its mention in the prior due-on-sale cases led the court to conclude that the section must apply since the court never explained how the property's alienability was affected.

In 1974, the California Supreme Court refined the *La Sala* two-prong test in *Tucker v. Lassen Savings & Loan Associa-*

69. *Id.* at 870, 489 P.2d at 1116, 97 Cal. Rptr. at 852.
70. *Id.* at 879-80, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
71. *Id.* at 879-82, 489 P.2d at 1122-24, 97 Cal. Rptr. at 858-61.
72. *Id.* at 880-81 n.17, 489 P.2d at 1124 n.17, 97 Cal. Rptr. at 859 n.17.
73. *Id.* at 881, 489 P.2d at 1124, 97 Cal. Rptr. at 860.

tion,[74] holding that a balancing test is to be employed. The greater the degree of restraint resulting from enforcement of an acceleration clause (the first prong of the *La Sala* test), the greater the justification for its enforcement must be (the second prong).[75] This refinement, then, represents a quantification of the same considerations employed in the *La Sala* test.

In 1969, the Tuckers purchased a parcel of improved property and financed part of the purchase price through a loan from Lassen Savings and Loan, giving Lassen a promissory note secured by a deed of trust on the property. Both the note and deed of trust contained due-on clauses providing that if the Tuckers transferred or further encumbered the property, Lassen could accelerate the loan balance.[76] Thereafter, the Tuckers entered into an installment contract of sale[77] by which the Tuckers

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74. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

75. *Id.* at 635, 526 P.2d at 1173, 116 Cal. Rptr. at 637.

76. The due-on clause, incorporated in the deed of trust, read in pertinent part:

> To Protect the Security of this Deed of Trust, Trustor Agrees: . . . (12) That if Trustor shall sell, convey, or alienate, or further encumber said property, or any part thereof, of any interest therein, or shall be divested of his title or any interest therein in any manner or way, whether voluntary or involuntary, all obligations secured hereby, irrespective of the maturity date expressed in any note evidencing the same, at the option of the Beneficiary and without demand or notice, shall immediately become due and payable.

Id. at 632-33 n.3, 526 P.2d at 1171 n.3, 116 Cal. Rptr. at 635 n.3. The Tuckers also executed a "Borrower's Statement of Understanding" which stated:

> We understand that your loan committee has approved this loan not only because they consider the property adequate security, but also because of our credit rating. Therefore, should we sell or transfer the property to some other person whose credit the loan committee has had no opportunity to examine, the Association reserves the right to either approve the new party or parties or declare the entire sum owing due and payable.

Id.

77. The installment contract of sale is a device for transferring the equitable interest in the property to the buyer while the seller retains bare legal title to the property. Legal title is retained by the seller until the entire purchase price is paid in accordance with the terms of the contract. One of the covenants provides that, upon payment of the purchase price, the seller must convey the retained legal title to the buyer. One of the drawbacks of this contract of sale mechanism is that there is no case law in California dealing with, much less approving, the use of a private power of foreclosure in a land sale contract. There is a body of law dealing with judicial elimination of a vendee's interest in real property upon default of the vendee. But, the case law which does exist deals exclusively with the principles of eliminating the interest of a *buyer* under a contract, rather than eliminating the interest of a *defaulting trustor* under a deed of trust. Although one

would retain legal title until the full purchase price was paid. Upon learning of the contract of sale, Lassen decided to enforce the due-on provision and demanded that the Tuckers pay the unpaid principal plus $230.00 in prepayment charges.[78] The Tuckers were unable to pay this amount, nor were they able to obtain substitute financing. Lassen then entered into an arrangement with the new purchasers, essentially allowing assumption of the existing loan at a higher interest rate. As a prerequisite to the arrangement, the Tuckers were required to execute a quitclaim deed. However, the Tuckers brought an action for damages, claiming, inter alia, that Lassen's exercise of the due-on clause constituted an unreasonable restraint on alienation.[79]

The court reasoned that the borrower-seller normally does not receive sufficient cash from the buyer to pay off the existing loan in this type of transaction,[80] and thus, a great deal of restraint would result from exercise of an acceleration clause. Further, the borrower-seller retained a substantial interest in the property by virtue of the fact that he retains legal title. Therefore, the larger the purchase money second mortgage (in the form of an installment sale contract), the more likely the borrower-seller is to assure payment of the senior loan.[81] The *Tucker* court, applying its newly announced balancing test, held that the "quantum of restraint" was so significant and the bank's interest so relatively unimpaired that enforcement of the

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title company has agreed to act as trustee under the form contract developed by the California Association of Realtors, apparently there have been no attempts at foreclosure under such a contract. The consensus among most major title insurance companies is that the only way to eliminate a defaulting vendee's interest is by judicial decree and, therefore, most will not issue a title insurance policy to the property after a private power of sale proceeding, held pursuant to the land sale contract, without making an exception to the possible interests of the vendee. In addition, one might question whether the legal title conveyed upon completion of the contract payments is free from delivery problems. *See* Sucher & Musa, *The California Supreme Court Accelerates the Demise of the "Due-On" Clause,* 6 ORANGE COUNTY B. J. 321, 338-39 n.26-27 (1979).

78. Lassen made no attempt to determine whether the new purchasers were good loan risks, whether they were allowing the property to depreciate, or whether the security was endangered in any respect by the contract of sale. Tucker v. Lassen Sav. & Loan Ass'n., 12 Cal. 3d at 640 n.11, 526 P.2d at 1176 n.11, 116 Cal. Rptr. at 640 n.11.

79. *Id.* at 633-34, 526 P.2d at 1171, 116 Cal. Rptr. at 635.

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

81. *Id.* at 638-39, 526 P.2d at 1175, 116 Cal. Rptr. at 639. (citing *La Sala,* at note 67 *supra*). It should be recognized that this was dicta in *La Sala,* as it was a due-on-encumbrance case. *See* note 68 *supra* and accompanying text.

due-on clause would unreasonably restrain the owner's ability to alienate in contravention of Civil Code section 711.[82] Once again, the real issue was not the Tucker's ability to sell the property, but rather what type of financing could be employed. The problem arose as a result of Lassen's attempt to exact an assumption fee and renegotiate the interest rate. Again, the court did not discuss how Civil Code section 711 fits into this financing scheme, but simply concluded that it does.[83]

A conflict arises between the holdings in *La Sala* and *Tucker*. In *La Sala,* the court held that a large equity, left in the original borrower with little or no secondary financing, was very secure, and therefore, the senior lender ran very little risk of impairment or default.[84] In *Tucker,* the court held that the larger the secondary financing held by the original buyer, the larger the incentive to prevent waste or default, so that the security would not be deemed to be impaired or the risk of non-payment increased.[85] The net result is that there is no way available under the two tests for the lender to justify acceleration because junior financing has been placed upon the property. If a small second mortgage is taken on the secured property, the *La Sala* logic would indicate that acceleration is not warranted, since the original borrower's large retained equity would compel him to prevent waste or default. On the other hand, if a large second mortgage is taken back by the original borrower, the *Tucker* logic indicates that acceleration is not warranted because the original borrower has a large incentive to protect his investment, and derivatively, the investment of the original lender. Given these two tests, it is doubtful that a due-on-encumbrance clause could be enforced under any circumstances other than a showing of specific facts concerning the new borrower's lack of credit-worthiness or reputation for letting property depreciate. In all but the rarest of cases, this information will be impossible to obtain. The lender is left with little guidance as to whether or not a loan may be accelerated in any given case. Additionally, the *La Sala* decision stated that the lender could automatically accelerate upon a sale.[86] The fact that the sale itself justified acceleration leaves

82. 12 Cal. 3d at 638-39, 526 P.2d at 1175, 116 Cal. Rptr. at 369.
83. *Id.* at 634, 526 P.2d at 1172, 116 Cal. Rptr. at 636.
84. *See* note 73 *supra* and accompanying text.
85. *See* note 80 *supra* and accompanying text.
86. 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859.

the due-on-sale clause available as a portfolio management tool.[87] In contrast, the *Tucker* court stated that whether or not the lender could automatically accelerate in the event of an outright sale was an open question which the court would resolve when the issue was properly before it.[88]

III. *WELLENKAMP V. BANK OF AMERICA*

Against the backdrop of a test impossible for the lender to meet and the apparent reopening of a formerly resolved issue, the court again examined the enforceability of the due-on-sale clause in the event of an outright sale in *Wellenkamp v. Bank of America*.[89] In 1973, Birdie, Fred, and Dorothy Mans financed the purchase of real estate through the Bank of America. Two years later, Cynthia Wellenkamp purchased this property in a "cash to the loan" sale agreeing to assume the balance of the outstanding loan.[90] When Ms. Wellenkamp tendered a loan payment to Bank of America, the bank refused to accept it. The Bank then instituted proceedings to enforce the due-on-sale clause.[91] Ms. Wellenkamp argued that enforcement of the clause was in contravention of the rule against restraints on alienation.

The California Supreme Court held that automatic enforcement of a due-on-sale clause constituted an unreasonable restraint on alienation.[92] The court applied the test announced in *Tucker*, balancing the quantum of restraint against the justification for the restraint.[93] The court found that in periods where the money supply was short, automatic enforcement of the due-on clause would work a substantial restraint on alienation due to the inability of the potential buyer to obtain financing.[94] The

87. *Id.* at 883, 489 P.2d at 1126, 97 Cal. Rptr. at 862.

88. 12 Cal. 3d at 635 n.7, 526 P.2d at 1172 n.7, 118 Cal. Rptr. at 636 n.7.

89. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

90. *Id.* at 946, 582 P.2d at 972, 148 Cal. Rptr. at 381. A "cash-to-the-loan" sale is one in which the new purchaser pays the original borrower the amount of equity accrued (i.e., the purchase price minus the balance of the outstanding loan) and assumes responsibility for payment of the loan. The seller, then, retains no interest whatsoever in the property since the lender's sole remedy in case of default (at least in the context of a purchase money mortgage which was the situation in *Wellenkamp*) is foreclosure. *Id.*

91. Actually, the bank offered to allow Ms. Wellenkamp to assume the Mans' loan at a rate of an additional one and one-quarter percent interest. *Id.* at 946, 582 P.2d at 972, 148 Cal. Rptr. at 381.

92. *Id.* at 947, 582 P.2d at 972, 148 Cal. Rptr. at 382.

93. *See* note 74, *supra* and accompanying text.

94. 21 Cal. 3d at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.

court also observed that the potential buyer, when faced with the prospect of renegotiating the interest rate or finding substitute financing, might well demand a lower purchase price, creating a situation where it would be economically unfeasible for the seller to dispose of the property.[95]

A. Analysis of the Case

The *Wellenkamp* court employed some anomalous reasoning in reaching the conclusion that the due-on clause constitutes an unreasonable restraint. The majority's discussion intimates that the use of the clause could well serve to lower the marketable value of property, a goal that the American Law of Property suggests would be of benefit to the public. This very result was one of the reasons used by the American Law of Property to explain the existence of the rule against restraints on alienation.[96]

Having found that a restraint existed, the court proceeded to weigh the justification for the restraint. The bank contended that the risk of waste and default is great in any outright sale, since both possession and legal title are transferred, thereby eliminating any incentive that the seller would have to prevent the risk from materializing.[97] The court dismissed this argument, pointing out that while the original borrower may not have such an incentive, the new purchaser, by virtue of his acquisition, would have sufficient incentive to prevent waste or depreciation.[98] Moreover, the new borrower may be as good, if not better, of a credit risk than the original borrower, placing the bank in an even more secure position than it was previously.[99] Even if the new buyer proved less credit-worthy than the original purchaser, the bank's position that this alone would justify accelera-

95. *Id.*

96. *See* note 36 *supra* and accompanying text.

97. 21 Cal. 3d at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

98. *Id.* at 952, 582 P.2d at 975, 148 Cal. Rptr. at 384.

99. *Id.*, 582 P.2d at 976, 148 Cal. Rptr. at 385. Historically, the risk of default in home mortgages was quite low. The reports of 956 savings and loan associations holding 50% of all savings and loan assets, disclose that those mortgages falling 60 or more days overdue represented only 0.71 to 0.79 percent of all loans outstanding between March and December 1978. The figures are reported monthly by the Bureau of National Affairs Housing and Development Reporter. A summary of these reports follows:

tion and foreclosure seems untenable.[100] There is no logical sense to be made of the contention that foreclosure must be allowed *now* because there is a greater risk of default and eventual foreclosure *sometime in the future*. The passage of a very brief period of time would effectively remove the guesswork inherent in this inquiry—if the new buyer is truly uncredit-worthy, his inability to make the installments will become obvious. If the lender is correct in its assessment of the new buyer's credit-worthiness the matter will quickly come to a head with a routine default, which would probably involve less time and legal expense than it would take to prove circumstances justifying exercise of the acceleration clause.

The risk of depreciation and waste is similarly small in terms of endangering the security for the loan. As a practical matter, lenders routinely require a margin of safety (the gap between the value of the security and the amount of the loan) of twenty to thirty percent.[101] It is highly unlikely that total inat-

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Month	Delinquency Rate
March	0.79
April	0.76
May	0.72
June	0.71
July	0.71
August	Not published
September	0.75
October	0.75
November	0.71
December	0.73

6 HOUS. DEV. REP. 36, 159, 273, 395, 699, & 877 (report for June 1978 - February 1979). The delinquency rates for 1979 have not been published. The rates for defaults and eventual foreclosures for nonpayment would naturally be smaller, since normally the borrower would become delinquent prior to the lender declaring a default and instituting foreclosure proceedings.

100. It should be noted that no evidence was produced in *Wellenkamp* that Ms. Wellenkamp was less credit-worthy than the Mans. 21 Cal.3d at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385. There was some indication in earlier decisions that this factor, as a matter of practice, was not being taken into account by the banks in any case. In *La Sala*, for example, the Attorney General, as amicus curiae, charged "as a matter of practice American Savings and Loan required waiver fees whenever a borrower makes a junior encumbrance." 5 Cal. 3d at 881, 489 P.2d at 1124, 97 Cal. Rptr. at 860.

101. Hetland, *After* Wellenkamp, CAL. REAL EST. Dec., 1978, at 42.

tention or lack of maintenance could result in a loss of twenty to thirty percent of the security. Even in a case where there is a reasonable danger that depreciation or waste would be committed to an extent likely to overcome the lender's margin of safety, the lender may well fare better by seeking the appointment of a receiver to prevent waste, a procedure available to the creditor even in the absence of monetary default.[102]

The bank's second contention in *Wellenkamp* was that the lender's interest in maintaining its loan portfolio at current interest rates justified acceleration. Although the court recognized the need for banks to provide depositors with a competitive return, it stated that the use of the due-on-sale clause to achieve this result was improper.[103] According to the court, it is up to the lender to take into account such factors as economic uncertainty and inflation in setting the interest rates on long-term loans. If this forecasting proves inaccurate "it would be unjust to place the burden of the lender's mistaken economic projections on property owners."[104] Clearly this result, and the analysis used by the court, were the logical conclusions of the reasoning em-

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102. *See, e.g.*, California Code of Civil Procedure § 564, which provides:

> A receiver may be appointed, in the manner provided in this chapter, by the court in which an action or proceeding is pending in any case in which such court is empowered by law to appoint a receiver.
>
> In superior courts a receiver may be appointed by the court in which an action or proceeding is pending, or by a judge thereof, in the following cases:
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> 1. In an action by a vendor to vacate a fraudulent purchase of property, or by a creditor to subject any property or fund to his claim, or between partners or other jointly owning or interested in any property or fund, on the application of the plaintiff, or of any party whose right to or interest in the property or fund is in danger of being lost, removed, or materially injured;
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> 2. In an action by a mortgagee for the foreclosure of his mortgage and sale of the mortgaged property, where it appears that the mortgaged property is in danger of being lost, removed, or materially injured, or that the condition of the mortgage has not been performed, and that the property is probably insufficient to discharge the mortgage debt;
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> . . . .
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> 7. In all other cases where receivers have heretofore been appointed by the usages of courts of equity.

CAL. CODE CIV. PROC., § 564 (West 1979).

103. 21 Cal. 3d at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

104. *Id.* at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385.

ployed in *La Sala* and *Tucker*. Both of the earlier cases illustrated that the court was unwilling to accept portfolio maintenance as a justification for acceleration.[105] In both cases, the court found that any action by the lender which tended to make the sale more difficult by increasing the price at which the property could be sold would be a restraint at least of sufficient magnitude to require the court to balance the quantity of restraint against the justification for its imposition.[106] When the justification offered is the lender's interest in maintaining its loan portfolio at current rates, there can be no other result than to disallow the use of the due-on clause since the court has found that portfolio maintenance constitutes no justification at all.[107] It is clear from the court's analyses in *La Sala* and *Tucker* that something further is required, and this appears to be some concrete showing of the new purchaser's reputation for letting property go to ruin or a reputation for uncreditworthiness.

In all of the due-on-sale cases, with the exception of *Hellbaum*, a transfer had in fact taken place.[108] Similarly, in all of the cases (*Hellbaum* included), the lender was more than willing to permit the transfer; it was simply seeking to exact consideration in exchange for its approval of the mortgage assumption.[109] This hardly seems to be a restraint on alienation, at least not within the definition supplied by the American Law of Property.[110] The real issue is that in these times of rising interest rates there are inherent risks involved in entering into a long-term lender-borrower relationship tied to fixed rates of return. The majority in *Wellenkamp* clearly allocates these risks to the

105. La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d at 880 n.17, 489 P.2d at 1123 n.17, 97 Cal. Rptr. at 859-60 n.17; Tucker v. Lassen Sav. & Loan Ass'n., 12 Cal.3d at 639 n.10, 526 P.2d at 1175 n.10, 116 Cal. Rptr. at 639 n.10.

106. For *La Sala, see* note 71 *supra* and accompanying text. For *Tucker, see* note 81 *supra* and accompanying text.

107. *See* note 105 *supra* and accompanying text.

108. Coast Bank v. Minderhout, 61 Cal. 2d at 312, 392 P.2d at 266, 38 Cal. Rptr. at 506; Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App. 2d at 576, 81 Cal. Rptr. at 136; and Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d at 633, 526 P.2d at 1171, 116 Cal. Rptr. at 635.

109. Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d at 458, 79 Cal. Rptr. at 10; Cherry v. Home Sav. & Loan Ass'n, 276 Cal. App.2d at 576, 81 Cal. Rptr. at 136; Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d at 633, 526 P.2d at 1171, 116 Cal. Rptr. at 635.

110. *See* note 4 *supra* and accompanying text.

lender,[111] whom one might expect to be better able to analyze the market. In addition, allocation of these risks to the commercial lender serves to diffuse the hardship of making errors in market projection, since the commercial lender will pass the effects of his mistakes on through to the public in the form of higher interest rates on new loans or lower returns on passbook savings accounts. The effect of a mistaken projection by an individual borrower would be devastating. In addition, other mortgage instruments are available which are better suited for utilization as a portfolio adjustment tool.[112]

B. The Due-on-Sale Clause as Unenforceably Adhesive

One commentator suggests that central to the dispute in *Wellenkamp* is the freedom to contract on the one hand versus the unenforceably adhesive contract on the other.[113] Looking at the loan agreement as of the time the parties enter into it, a combination of unequal bargaining power and unavailability of alternative terms (in this context, the universal inclusion of a due-on clause) are likely to result in a determination that the agreement was unenforceably adhesive at the time of its creation.[114] Institutional loans which do not contain a due-on clause are simply not available, and in fact, very few of the terms in institutional deeds of trust are open to negotiation.[115]

More is required than simple unavailability of alternative terms to make an agreement unenforceably adhesive. By the time *La Sala* was decided the doctrine of adhesion contracts had expanded to include the concept of "reasonableness as applied" as well as the indices of unequal bargaining power and unavailability of alternate terms.[116] Taken in this light, it is apparent

111. *See* note 104 *supra* and accompanying text.

112. *See* Wellenkamp v. Bank of America, 21 Cal. 3d at 952 n.10, 582 P.2d at 976 n.10, 148 Cal. Rptr. at 385 n.10. For a detailed discussion of various mortgage instruments available, and the application of each as a portfolio adjustment tool, see Kratovil, *supra* note 8 at 312.

113. Hetland, *supra* note 101.

114. *See generally* Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966); Steven v. Fidelity & Cas. Co., 58 Cal. 2d 862, 377 P.2d 284, 27 Cal. Rptr. 172 (1962); Schmidt v. Pac. Mut. Life Ins. Co., 268 Cal. App. 2d 735, 74 Cal. Rptr. 367 (1969).

115. The courts have held that deeds of trust of institutional lenders are adhesive. *See, e.g.*, Wilson v. San Francisco Fed. Sav. & Loan Ass'n., 62 Cal. App. 3d 1, 132 Cal. Rptr. 903 (1976).

116. As to the evolution of the adhesion contract doctrine, *see* Hetland, Secured

that these are the considerations the court has been employing in the due-on cases even though it has consistently framed its arguments in terms of restraints on alienation. The balancing approach employed since *Coast Bank,* and particularly the "reasonableness" approach announced in *La Sala,* point directly toward the concept of adhesion. In *La Sala,* the court acknowledged that the due-on clause might prove enforceable even though it had been adhesive at its creation.[117] The issue was whether or not the clause had been unreasonably, unconscionably, or abusively applied by the lender.[118]

IV. THE PRIVATE LENDER

The *Wellenkamp* court explicitly left open the question of the applicability of its holding to the private lender.[119] Since the prior cases were decided solely on the basis of the seller, and tended to treat the interests of the lender as secondary, *La Sala* and *Tucker* would seem to suggest that the same treatment should be afforded the private lender as is afforded the institutional lender. But the *Wellenkamp* court's specific refusal to comment on the application of its holding to the private lender points to an obvious belief that vastly different economic forces are at work in the private sector.

The private lender's involvement in the mortgage money market takes one of two forms.[120] First, because of phenomenal growth in the price of California housing, many first-time pur-

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REAL ESTATE TRANSACTIONS, 73-80 (CEB 1974).

117. La Sala v. American Sav. & Loan Ass'n, 5 Cal. 3d at 881-82, 489 P.2d at 1124, 97 Cal. Rptr. at 860.

118. *Id.*

119. The *Wellenkamp* court held:

> In the instant case the party seeking enforcement of the due-on clause is an institutional lender. We limit our holding accordingly. We express no present opinion on the question whether a private lender, including the vendor who takes back secondary financing, has interests which might inherently justify automatic enforcement of a due-on clause in his favor upon resale.

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

120. One form is a special purpose loan, such as an inter-family loan, or the situation where a seller loans part of the purchase price to the buyer and secures the transaction by means of a second deed of trust. Another form involves an individual investing in comparatively high-yield secured loans by supplying money to a loan broker. *See* Hetland, *supra* note 101; *see also* Comment, Wellenkamp v. Bank of America: *A Victory for the Consumer?* 31 HAST. L.J. 275, 300-02 (1979).

chasers are unable to raise sufficient capital for the down payment. Often, an intra-family loan is arranged, or the vendor will take back a less secure second mortgage. Both types of loans are subordinate to a senior loan held by a bank or federal savings and loan association.[121] Probably, the *Wellenkamp* court intended that such special purpose loans would be capable of acceleration. Among other considerations, if the senior loan is held by a federal savings and loan, the loan may be immune from California law through federal preemption (and thus, the effects of *Wellenkamp*) and could be accelerated upon sale for interest adjustment purposes.[122] In this situation it is likely that the holder of the junior mortgage would be able to accelerate in order to protect himself in the event of the senior loan's acceleration.

In addition, while the *Wellenkamp* court did not discuss the problem in terms of adhesion contracts, the analysis it used is entirely consistent with such an application. None of the overtones of the traditional adhesion contract exist in this type of arrangement since there is actual bargaining involved in arranging for the loan. The very uniqueness of such loans dictates that some special considerations exist and that these considerations must be examined by the court. An application of the *Tucker* two-prong balancing test would produce a result no different than that for the institutional lender, yet the prohibition on acceleration in this type of loan would be tantamount to defeating the very purpose of the loan.

The other form of private lender involvement is where an individual supplies capital for a broker-originated second deed of trust, a tax-exempt Clifford trust, or a small business pension plan by individuals.[123] In such circumstances the lender is an individual investing in comparatively high-yield, but generally safe, secured loans. Second deeds of trust are one example, offering rates of return much higher than passbook savings, but en-

121. *See* Hetland, *supra* note 101, at 42. *See generally* Goodman, *The* Wellenkamp *Decision: How it Will Affect Real Estate Financing,* 54 California State Bar Journal 34, 38.

122. *See generally,* Glendale Fed'l Sav. & Loan Ass'n v. Fox, 459 F. Supp. 903 (1978).

123. One might ask whether this type of loan arrangement is a contributing factor to disintermediation, one of the major causes of the due-on controversy. *See* note 19 *supra* and accompanying text.

tail far more security than personal loans. Typically, the lender is not personally engaged in the lending business at all, but rather, a loan broker puts the deal together.[124] The organized and highly professionalized nature of the loan brokerage business, together with the intent of the lender himself,[125] indicate that treatment of a private party as an institutional lender for purposes of the due-on clause would be appropriate in this situation.[126]

CONCLUSION

The function of the due-on clause has changed from a device to protect security to an interest rate adjustment tool. The policy issue underlying the due-on controversy is who should bear the risk of market fluctuation. The California Supreme Court clearly has resisted the attempts of institutional lenders to shift these risks to borrowers, but has done so under the doctrine of restraints on alienation. Reliance on this doctrine is clearly misplaced, and sidesteps the underlying issue of the inherent adhesiveness and unconscionability of the due-on clause with respect to its role as a portfolio adjustment tool.

The application of the doctrine of restraints on alienation to the due-on cases has led to the creation of largely unworkable tests, as well as confusion among borrowers and lenders alike. Reconsideration of the due-on controversy in terms of adhesiveness and unconscionability is long overdue and would lead to the establishment of meaningful standards for lenders and borrowers without sacrificing the underlying policy goals upon which the due-on cases were decided. A clarification of the status of this critical element of long-term lending would establish sorely needed stability to this most critical area of California housing.

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124. *See* Hetland, *supra* note 101 at 43.

125. The intent of this form of private lender differs from the first form in that here the whole object is to make money. In the first form, the object is generally to set up a family member in a house he could not otherwise afford. *Id.*

126. *See generally* Pas v. Hill, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1979), (applying *Wellenkamp* to private lender).