Half-Way Mark Reached in the Demise of the Inequitable Application of the “Due-On-Sale” Clause

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On October 10, 1974, the California Supreme Court filed its opinion in the matter of Tucker v. Lassen Savings and Loan Association,1 the third opinion2 written by the high court since 1964 dealing with the acceleration clause commonly known as the “due-on” clause.3 Though the Tucker opinion struck an important blow at the inequitable application of the “due-on-sale” clause, this article is primarily concerned with the fourth, yet unwritten opinion, which will concern the attempted exercise of a “due-on” clause upon outright sale4 by the trustor.

Coast Bank—“Due-on-Sale” Viewed in the Abstract

The first of the high court's three decisions, handed down in May,
1964, was *Coast Bank v. Minderhout*. This case involved a lender who made several unsecured loans to a borrower. The borrower executed an agreement not to transfer or encumber certain real property he owned without the lender's consent, until all of the indebtedness was paid. Contrary to the agreement, the borrower conveyed the property to defendant Minderhout without the lender's knowledge or consent. Minderhout admitted actual knowledge of the agreement.

Two questions faced the court: first, whether the agreement constituted an equitable mortgage and second, whether the agreement constituted an invalid restraint on alienation such that, even if an equitable mortgage had been created, it was void.

The court found some indication that the parties intended to create a security interest. That was sufficient to affirm the trial court's finding that an equitable mortgage had been created.

The court then found it was not unreasonable for the lender to condition its continued extension of credit to the borrowers on their retaining their interest in the property that stood as security for the loan. Inferentially, only unreasonable restraints on alienation were declared invalid. Thus, the court found that the lender validly provided that it might accelerate the due date, if the borrowers encumbered or transferred the property.

Based on the dicta in *Coast Bank*, three Court of Appeal decisions held that due-on-sale clauses in trust deeds do not constitute unlawful restraints on alienation. Yet, *Coast Bank* is almost unique in its factual setting; the decision may be distinguished easily from those cases which involve mortgages or deeds of trust containing due-on-sale clauses.

The *Coast Bank*, the defendant demurred and then failed to answer. The issue of the existence of an equitable mortgage

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5. 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).
6. Id. at 315, 392 P.2d at 267, 38 Cal. Rptr. at 507.
7. Id.
8. Id.
9. Id. at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508.
10. Id. at 316, 392 P.2d at 268, 38 Cal. Rptr. at 508.
11. Id. at 317, 392 P.2d at 268, 38 Cal. Rptr. at 508.
12. Id. The court stated that it was not unreasonable to condition continued extension of credit on the borrower retaining his interest in the property and that the lender validly provided it might accelerate the due date upon encumbrance or transfer of the property.
14. 61 Cal. 2d at 315, 392 P.2d at 267, 38 Cal. Rptr. at 507.
was never litigated. Instead, by demurring and failing to answer, the matter was deemed admitted if the agreement was susceptible of such an interpretation. The court found those minimum requirements had been met. Unfortunately for defendant Minderhout, by failing to answer, he also admitted knowledge of the existence of the equitable mortgage. Yet, in fact, he had no knowledge of anything but an agreement which gave the lender the right to accelerate his unsecured loans if the borrower chose to sell without his consent. Had the issue been litigated, it is extremely unlikely an equitable mortgage would have been found.\textsuperscript{15}

Under the actual circumstances of the case, where only a right to accelerate actually existed, the lender looked to the equity in the property for his security and not to the property itself. If that equity was disturbed by unauthorized sale or encumbrance of the property, it was reasonable that the lender should have the right to accelerate the due date to prevent the equity from being lost, dissipated or otherwise made unavailable to aid in repayment of the loan.

Where the lender holds a first mortgage or deed of trust securing his note, the situation is very different since a transfer or encumbrance of the property does not disturb the underlying security for the loan. The purchaser must take subject to the existing loan secured by the trust deed or mortgage. Any subsequent lender has a junior position and cannot affect the first lender's priority. In addition, the lender holding a mortgage or trust deed as security may have his position improved by a sale of the security or an additional encumbrance. In either case, there will be additional parties interested in maintaining the property and keeping the first lien current. The consideration received from the sale or proceeds from a loan, in the hands of a vendor-trustor, may aid in keeping loan payments current and provide additional funds to satisfy a deficiency judgment,\textsuperscript{16} if one were later granted. Yet, the lender's right to the full value of the property to satisfy the loan remains unimpaired.

The \textit{Coast Bank} decision may be a simple statement that the due-on-sale clause is not an illegal restraint on alienation in the

\textsuperscript{15} Id. at 314, 392 P.2d at 267, 38 Cal. Rptr. at 507.

abstract, such that a contract containing the clause would be void.\textsuperscript{17} The lender in \textit{Coast Bank} had not sought to foreclose because the borrower transferred the property without his permission, but rather because the borrower was in default in payment of his note.\textsuperscript{18} The court was observing the clause in the abstract. There was no application of the clause to be considered by the court. As noted in the next case to be considered, it is not so much the clause itself, but the lender's application of it that may effect an invalid restraint on the alienation of property.\textsuperscript{19}

\textbf{La Sala—A New Burden of Proof for Lenders}

The second of the high court's three decisions was \textit{La Sala v. American Savings and Loan Association},\textsuperscript{20} decided in October, 1971. In this case, properties of two named plaintiffs were subject to deeds of trust. The defendant was the beneficiary in each case. Each of the plaintiffs negotiated a junior encumbrance, secured by a second deed of trust, on his respective property. The defendant sent each a notice that it would waive its right to accelerate the due date for the note in exchange for a fee and a substantial increase in the interest rate on the note.

Plaintiffs' action was framed as a class action. After the suit was filed, the defendant offered to waive enforcement of the provision as to the two named plaintiffs. The trial court then dismissed the action, reasoning that there were no longer representatives of the class before the court. The Supreme Court reversed, holding that notice must be given to the class before dismissal.

The court proceeded further to discuss the due-on-encumbrance clause,\textsuperscript{21} which provided for acceleration of the due date of the note upon any further encumbrance of the property without the prior consent of the lender. The court reasoned that the due-on-encumbrance clause was not invalid in the abstract.\textsuperscript{22} In those instances in which enforcement is necessary to protect the lender's security, the restraint on alienation remains reasonable and lawful; however, when enforcement is unnecessary to protect the security but is used instead to exact collateral benefits, the clause must be held an unlawful restraint on alienation.\textsuperscript{23}

\begin{footnotesize}
\begin{enumerate}
\item Valensi, The Due on Sale Clause—a Dissenting Opinion, 45 L.A. BAR BULL. 121, 124 (Jan. 1970).
\item Id. at 123-24.
\item La Sala v. American Sav. & Loan Assn., 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).
\item Id.
\item Supra, note 3.
\item 5 Cal. 3d at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 860.
\item Id. at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 861.
\end{enumerate}
\end{footnotesize}
As a result, the burden of proof now lies with the lender who would accelerate upon authority of the due-on-encumbrance clause to show that the subsequent encumbrance endangers his security. This requires a case-by-case analysis, which this writer applauds. In concluding its opinion, the court inserted the following obiter dictum, dealing with the sale of encumbered property:

... [We] have concluded that the lender may insist upon the automatic performance of the due-on-sale clause [upon the sale of the property] because such a provision is necessary to the lender's security.24

This language is unfortunate, to the extent the court may be reluctant to change the position it has adopted, even though only dicta.

Tucker—Automatic Enforcement Denied?

Tucker v. Lassen Savings and Loan Association25 is the last of the three decisions of the California Supreme Court dealing with "due-on" clauses. The high court went half-way in reversing the dicta in La Sala, which authorized automatic enforcement of the due-on-sale clause.26 The facts were such that a compromise was easy. Four plaintiffs jointly purchased a parcel of improved land, borrowing part of the purchase price from the defendant, with the loan secured by a deed of trust with a due-on-sale provision. The plaintiffs rented the house to Joseph and Delia Noll on a month-to-month basis. Some months later, plaintiffs sold the house to the Nolls on a land sale contract which provided for a small down payment and monthly payments on the balance. Thus, the sale was to a vendee already in possession. The land contract was recorded.

When the lender-defendant learned of the sale, it sought to enforce its due-on-sale clause. Plaintiffs were unable to pay or to obtain substitute financing. The lender filed notice of default and election to sell under the deed of trust. The foreclosure sale did not take place because the Nolls agreed to assume the loan at 9.25 percent interest, 1.75 percent higher than the original loan to plaintiffs. As part of the arrangement, plaintiffs were required to execute a quit claim deed to the buyer. Plaintiffs sued for the

24. Id. at 883, 489 P.2d at 1126, 97 Cal. Rptr. at 862.
26. 5 Cal. 3d at 883, 489 P.2d at 1126, 97 Cal. Rptr. at 862.
difference between the amount outstanding on the land sale contract and the amount of the loan remaining outstanding. They won at the trial court level.

The high court characterized the transaction as falling within the phrase “sells, conveys, or alienates an interest in the property” and as “an installment land contract to sell,”\(^\text{27}\) as if differentiating in an important way the executory contract to sell and the executed sale of property by deed.

When applied to the sale of property by land contract, the court found the due-on-sale clause to be a substantial restraint on alienation, such that it would literally prevent the use of the land contract.\(^\text{28}\) The court reasoned that when property is sold by land contract, a small downpayment is usually accepted which does not provide sufficient funds to pay the encumbrance; the vendor retains legal title and usually retains a substantial equity in the property and thus has a strong motivation to continue to maintain the property.\(^\text{29}\) The court suggested that the propriety of invoking the clause and accelerating the loan may increase as the vendor’s equity decreases.\(^\text{30}\)

**Inaccurate Information May Lead to Faulty Reasoning**

The accuracy of certain statements and conclusions drawn from statements in both the La Sala and Tucker opinions are points of concern. The high court has apparently accepted certain statements and arguments based on those statements in support of the lender’s position presented by the lenders and amici curiae. Because the accuracy of certain of those statements may have an important bearing on the fourth, yet unwritten opinion dealing with the outright sale of property by the trustor, several of these statements will be reviewed.

In discussing the lender’s contention that acceleration was important to enable the lender to keep its portfolio at the current interest rates,\(^\text{31}\) the court in both Tucker and La Sala stated:

> This argument may be appealing as applied to a sale of the property. The borrower in such sales generally receives cash sufficient to pay off his obligation.\(^\text{32}\)

\(^\text{27}\) 12 Cal. 3d at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 638.
\(^\text{28}\) Id. at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 638.
\(^\text{29}\) Id. at 638, 526 P.2d at 1174, 116 Cal. Rptr. at 638.
\(^\text{30}\) Id. at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639 n. 9.
\(^\text{31}\) Id. at 635, 526 P.2d at 1173, 116 Cal. Rptr. at 637; La Sala, 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n. 17.
\(^\text{32}\) 12 Cal. 3d at 635, 526 P.2d at 1173, 116 Cal. Rptr. at 637; 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.11.
The fact is the borrower rarely receives cash sufficient to pay off his obligation. Worse, the borrower usually does not receive cash sufficient to cover his equity in the property. He often must retain an equitable interest in the form of a note secured by a purchase money deed of trust.

Not infrequently, the outright sale by the trustor is roughly equivalent to a sale by land contract. The equity retained and secured by a deed of trust is roughly equivalent to the equity retained by the vendor in a land contract. In such cases, the interests of the vendor and trustor in the maintenance of the property and in meeting the current obligations on the first deed of trust are conceptually equal.

The high court further stated the following, in both *Tucker* and *La Sala*:

Acceleration upon sale of the property, in other words, does not seriously restrict alienation because the sale terms can, and usually will, provide for payment of the prior trust deed. The fact is that when mortgage money is scarce, acceleration, or the threat of acceleration, may restrict alienation to the point of preventing any sale, particularly if the present lender is in a bind, is seeking to recover all cash possible and is unwilling to continue the loan, even at current interest rates, to a qualified buyer. Under the facts of *Tucker*, the plaintiffs were unable to secure another loan. Had an outright sale been contemplated, with plaintiffs securing their equity with a deed of trust rather than a land contract, the effect would have been precisely the same. The sale would have been prohibited unless the plaintiffs and Nolls agreed to whatever terms the lender chose to exact from them.

It is clear the lender's concern was not with the credit of the Nolls as potential borrowers, the existence of waste, the condition of the property or the value of the property as security for the loan. The lender extended the loan to the Nolls on the same property, in the same condition, without investigation of their credit, but after exacting a higher interest rate from them and

33. 12 Cal. 3d at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637; 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.17.
34. 12 Cal. 3d at 633, 526 P.2d at 1171, 116 Cal. Rptr. at 635.
35. See, 12 Cal. 3d at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637; 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.17.
requiring the plaintiffs to execute a quit claim deed. By requiring the plaintiffs to execute a quit claim deed, the lender cut off the interest of four additional parties who would have acted as additional security for the loan in order to protect the substantial equity they had remaining in the property.

The facts in Tucker clearly illustrate the immense disparity in bargaining power which may exist between borrower and lender, which often allows the lender to dictate almost any result the lender may choose. The Nolls were powerless to do anything other than accede to the lender's demand for higher interest. Because the foreclosure would have terminated both the Nolls' equitable interest and the plaintiff's security interest in the property, plaintiffs acceded to the lender's demand for a quit claim deed. Yet, by securing the quit claim deed, the lender was left with less security than before. Nevertheless, because the application of the due-on-sale clause was allowed as "automatic," under the dicta of La Sala, the lender apparently believed its arbitrary and inequitable actions were above scrutiny and review.

When the high court stated, as it did in both Tucker and La Sala, that "... the sale terms can, and usually will, provide for payment of the prior trust deed," it did not seem to recognize that the sale terms are usually formulated under the threat of enforcement of a due-on-sale clause. Few buyers and sellers would enter into a sales contract knowing that the lender could shortly accelerate the maturity date, exact new loan fees, higher interest rates and prepayment penalties, or foreclose the interest of both buyer and seller in the property.

Frequently, the lender will allow the proposed buyer to assume the loan, but only after payment of loan fees (points), an increase in the interest rate and exaction of prepayment penalties from the seller. This rather conclusively demonstrates that the lender has accepted the credit standing of the buyer and was satisfied with the security for the loan. Thus, the exactions are not required to protect the lender's security, but only to exact collateral benefits. In both Tucker and La Sala, the high court declared the exaction of collateral benefits an improper purpose of the "due-on" clause, resulting in an unlawful restraint on alienation. Further, as seen

36. 5 Cal. 3d at 883, 489 P.2d at 1126, 97 Cal. Rptr. at 862.
37. Id. at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.17; 12 Cal. 3d at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637.
38. 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.17; 12 Cal. 3d at 635, 526 P.2d at 1172, 116 Cal. Rptr. at 636.
39. 5 Cal. 3d at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 860; 12 Cal. 3d at 635, 526 P.2d at 1172, 116 Cal. Rptr. at 636.
below, the automatic right of acceleration can, and often does, result in the seller receiving less for his property than it is truly worth.

**COERCED HIGHER INTEREST ROBS BORROWER OF VESTED RIGHT**

In both *La Sala* and *Tucker*, the court reiterated the following statement:

> To permit the lender to accelerate ensures that all buyers of property must finance at the current interest rate, and that none obtain an advantage because of the fortuitous fact that his seller originally purchased during a period of low interest.\(^4\)

This language ignores the reality of the market place and assumes that the borrower was lucky to obtain a loan when interest rates were lower.

Two principal benefits inure to the borrower who wishes to sell property encumbered by a note with interest lower than the current rate: first, there is more than usual interest from potential buyers, which aids in obtaining a quick sale, often an important economic advantage, and second, and equally important, the seller receives a higher price for his property. A potential buyer is willing to pay more for property with a lower interest rate. To deprive the borrower-seller of the right to the benefit of his bargain is to deprive him of a vested interest. It is a mistaken notion to believe that the buyer alone benefits; it is the benefit which accrues to the seller, the person who has a right to the benefit and who frequently deliberately seeks the benefit, that the court must protect.

When the real property loan was first made, it likely was for a substantial period of time, typically 30 years. The lender has contractually agreed to the term of his loan for that period of time, though in fact, the amount actually loaned for the full term of the loan is miniscule, as the principle amount of the loan decreases with every mortgage payment. When the note, trust deed or both contain a due-on clause, the lender represents that the purpose of the clause is to protect his security. Thus, the borrower may reasonably believe that he has obtained a loan which will inure

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\(^4\) 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859 n.17; 12 Cal. 3d at 635-36, 526 P.2d at 1173, 116 Cal. Rptr. at 637.
to his benefit, provided he does not act in a way, with respect to
the property, that will endanger the lender's security. Thus, if a
borrower fortuitously or purposefully negotiated a loan during a
period of low interest rates, he should retain the benefits of his
bargain. It is a poor argument to say that because the institutional
lender will benefit, the seller should be deprived of the extra
marketability and value of his property, the benefit of his bargain.

**Most Sellers Retain Security Interest**

In the *La Sala* opinion, the court stated, "A sale of the property
usually divests the vendor of any interest in that property..."\(^{41}\)
As previously discussed, a buyer usually lacks sufficient cash to
purchase the vendor's entire equity. Usually the vendor takes a
note for a portion of his equity, secured by a second deed of trust.
Thus, in an ordinary sale of property, the vendor usually retains
an interest in the property, often substantially equivalent to that
of the vendor who sells by land contract.

In the *La Sala* opinion, the high court repeated the following
decidedly pro-lender language found in a court of appeals de-
cision:\(^{42}\)

> 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.\(^{43}\)

This statement ignores the fact that typically no deficiency
judgment will be allowed, under the prohibition of Code of Civil
Procedure § 580b.\(^ {44}\) Thus, in the majority of cases, the borrower's
concern is not for the debt, but for preservation of his remaining
equity and for securing payment for his equity through payment
of a land contract or note secured by a purchase money deed of
trust.

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\(^{41}\) 5 Cal. 3d at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
\(^{42}\) Cherry v. Home Sav. & Loan Assn., 276 Cal. App. 2d 574, 81 Cal.
Rptr. 135 (1969).
\(^{43}\) 5 Cal. 3d at 879-80, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
\(^{44}\) CAL. CODE OF CIV. PROC. § 580b (West 1975):
   No deficiency judgment shall lie in any event after any sale of
   real property for failure of the purchaser to complete his contract
   of sale, or under a deed of trust, or mortgage, given to the vendor
to secure payment of the balance of the purchase price of real prop-
erty, or under a deed of trust, or mortgage, 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 occupied, entirely or in part, by the pur-
chaser.
The statement also seems to ignore the fact that in this author's opinion most buyers are conscientious, responsible persons. Typically, the buyer is as concerned about his equity and the condition of the property as is the seller who retains some equitable interest, whether by land contract or purchase money deed of trust.

*Tucker* discusses the diminishing interest of the vendor in the maintenance of the property as the land contract is paid and the financial interest of the vendor decreases. This seems to ignore the fact that, as the vendor's financial interest decreases, the vendee's financial interest increases. Simultaneously, the amount of the first lien decreases through regular payments and often the value of the property increases, both adding to the vendee's equitable interest. Presently, in any sale of property in which the vendor maintains both legal title and an equitable interest sufficient to prevent acceleration of the due-on-sale clause by the reasoning of *Tucker*, the lender's security is usually being strengthened by a decreasing lien, increasing equity in the vendee through payments on the first lien, by the vendee acquiring the vendor's equity, and through increased value of the property. The same increasing security for the lender would obtain in the case of an outright sale with transfer of legal title, but nevertheless the lender presently appears to have an automatic right of acceleration.

**Highest Risk to Security is from Impoverished Borrower**

Finally, the *La Sala* and *Tucker* opinions convey the thought that when the borrower is in possession, the lender's position is more secure than when the borrower's vendee is in possession, and that the borrower's credit is better than that of his vendee. Yet, one of the worst situations for the lender, in terms of waste and depreciation of his security, is when the formerly conscientious borrower has fallen on hard times. The borrower will usually make every effort to continue his mortgage payments, but money normally allocated for repairs and preventive maintenance will not be spent. In

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45. 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639 n.9.
46. Id.
47. Id. at 634-35, 526 P.2d at 1172, 116 Cal. Rptr. at 636; 5 Cal. 3d at 879-80, 489 P.2d at 1123, 97 Cal Rptr. at 859.
48. 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639; 5 Cal. 3d at 879-80, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
such cases, almost any sale or transfer of the property may benefit the lender, as the vendee will likely have greater ability to maintain the property and prevent waste. Further, when the borrower is facing personal financial difficulties, the credit of the vendee will likely be a substantial improvement, providing greater security for the lender than his original borrower.

**Current Law Injures Needy Sellers**

Under the present California Supreme Court decisions, a borrower with personal financial difficulties faces undesirable alternatives if his property is encumbered by a trust deed which contains a due-on-sale clause. Under the authority of the *La Sala* opinion, the borrower could likely obtain a loan secured by a junior encumbrance without fear of acceleration of the primary obligation. This is so because the danger to the security already existed. The proceeds of the additional loan would enable the borrower to continue his payments, make necessary repairs, and introduce another party interested in maintaining both the property and the primary lien. However, at the very time a needy borrower's financial condition dictates he rid himself of obligations, this alternative saddles him with yet another obligation.

The *Tucker* opinion is authority for the proposition that acceleration should not take place if the needy borrower sold the property by land contract. Unfortunately, though the borrower may need all the cash he can raise, *Tucker* suggests that a substantial equity should be retained in the property by the vendor, such that the less equity retained, the greater the possibility of acceleration. Yet, irrespective of the size of the equity retained, the financially troubled borrower would have little financial ability either to protect the property from waste or to keep the mortgage payments current. The lender's security, in such a case, is improved through the sale by land contract, because of the addition of a vendee with better credit and financial ability to maintain the property and the loan than the needy borrower. Yet, the vendee's interest is not as great as if he had a greater equity and legal title, both seemingly prevented by present case law.

According to the *La Sala* opinion, if the needy borrower was fortunate to find a conscientious, able buyer who wished to buy

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50. 5 Cal. 3d at 862, 489 P.2d at 1124-25, 97 Cal. Rptr. at 860-61.
51. 12 Cal. 3d at 638-39, 526 P.2d at 1175, 116 Cal. Rptr. at 639.
52. Id. at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639 n.9.
outright and pay cash for the borrower’s entire equity, the lender would have the absolute and automatic right to accelerate the loan.\textsuperscript{53} This is true, in spite of the fact that the security was subject to waste and depreciation in the hands of the original borrower, that there was great danger of the risk of foreclosure, and that the proposed buyer was of demonstrated financial ability. Rather than endanger the lender’s security, such an outright sale would seem to greatly improve the lender’s position. Irrespective, lenders do accelerate, or threaten acceleration of their loans, in precisely the circumstances just described, in order to exact prepayment penalties from the needy seller and loan fees and higher interest rates from the buyer. The net result is often that the sale is never consumated. When it is, the net equity received by the needy seller is greatly reduced by prepayment penalties and a reduced selling price.

In the example just discussed, acceleration of the loan by authority of the due-on-sale clause, (by outright sale to an able, conscientious buyer from a seller-trustor fallen on hard times) cannot be to protect the security from waste or depreciation or to protect the lender from the “moral risk”\textsuperscript{54} of poor credit and having to retake the property. Rather, just the opposite is true. The only purpose can be to exact collateral benefits from the borrower and his vendee. The high court has properly observed that a restraint on alienation cannot be found reasonable because it is commercially beneficial to the restrainor.\textsuperscript{55}

**The Lender Has A Proper Concern For His Security**

When a lender is asked to make a loan on real property, four factors are evaluated which principally determine whether the loan will be granted. First is the availability of funds to loan. This factor is not pertinent at the time of acceleration under authority of the due-on-sale clause, as the money has already been loaned; no new funds are required. Second is whether the property meets

\textsuperscript{53} La Sala, 5 Cal. 3d at 883, 489 P.2d at 1128, 97 Cal. Rptr. at 862.

\textsuperscript{54} Id. at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 860 n.16; Tucker, 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.

\textsuperscript{55} La Sala, 5 Cal. 3d at 880-81, 489 P.2d at 1123-24, 97 Cal. Rptr. at 859-60; 12 Cal. 3d at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637; Hetland, Real Property and Real Property Security: The Well-Being of the Law 53 Calif. L. Rev. 151 (1965).
the lender's requirements as security for the loan. This is not rele-
vant to enforcement of the due-on-sale clause, as the lender made
that decision in the affirmative at the time the loan was originally
granted. No further consideration is pertinent.

The third factor is the credit and financial ability of the proposed
vendee. This factor is relevant. No lender should have to consent
to a sale of his security to a vendee who is obviously financially
incompetent to meet the mortgage payments and maintain the
security without danger of waste and depreciation. Most lenders
have established standards to ensure that their borrowers are finan-
cially able to meet their mortgage obligation and maintain the
security. Under usual circumstances, a lender should have the
right to measure the proposed vendee by the same criteria he would
use to evaluate an applicant for a new loan. There should be two
qualifications to that right, namely the evaluation should be made
as if under normal money conditions, irrespective of the actual
availability of mortgage funds, and relative to the terms of the
existing note and trust deed.

These two qualifications are important. A lender's criteria for
borrowers changes substantially with differing availability of
mortgage money. In tight money conditions, criteria are much
 stricter. In order to prevent arbitrary evaluations of credit and
financial ability, amounting in effect to an unlawful restraint on
alienation, the criteria used should be those applicable to times of
average availability of mortgage money. Also, because a borrower's
financial ability is measured against the monthly mortgage obliga-
tion, the vendee's ability to assume the loan should be measured
against the terms of the loan outstanding, not against higher cur-
rent rates which might disqualify the vendee.

The high court, in *Tucker*, suggests that even though the
vendee's credit is less than adequate, if the vendor has retained
sufficient equity to cause him to have a strong financial interest
in the maintenance of the mortgage and the property, acceleration
will not be proper until the vendor's equity diminishes to the point
where his interest in maintenance of the mortgage and the property
is so little as to constitute danger to the security.

The same reasoning should apply to the outright sale. When the
borrower retains a substantial interest in the property, acceleration
should be improper, even though the vendee's credit is less than
adequate. As the borrower's interest decreases, however, the ven-

56. 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639 n.9.
dee's financial capability should more closely approach the minimum standards the lender requires of his original borrowers. When the vendor's financial interest is so minimal as to constitute no effective protection of the security, the lender's minimum standards should apply to a proposed vendee, except as to average availability of mortgage money and application of the actual terms of the borrower's note and deed of trust. Once the vendee has met the lender's minimum requirements, no right of acceleration should exist based on lack of credit or financial ability of the vendee.

The fourth and final principal consideration of a lender is the financial interest of the proposed vendee in the property, which is usually measured by the amount of down payment. In the normal situation, where the property has not been subject to waste or depreciation, assuming a reasonable loan to value ratio existed at the time of the loan, a reasonable equity exists in the property, distributed in some fashion between the vendor and his vendee, depending upon the circumstances of the particular sale. Thus, together they have a substantial interest in maintaining the mortgage and the property. In *Tucker*, the high court already established that a small down payment, typical in the land sale contract, will not be sufficient to accelerate the loan.\(^\text{57}\) Neither should a small down payment allow acceleration in an outright sale with retention by the seller of a note secured by a purchase money deed of trust. In the case of a seller who is no longer a qualified borrower due to financial reversals, a larger down payment might well be appropriate, particularly if the seller would be financially unable to protect his equity by preventing waste or keeping the mortgage current. To substitute for the vendor's inability to protect his equity, it would be reasonable to require the vendee to have a greater financial interest. In any case involving an outright sale, or with or without equity retained by the vendor, the lender should be compelled to demonstrate danger or actual threat of danger to his security before accelerating the due date of a loan upon authority of the due-on-sale clause, exactly as the court has already required with respect to sale by land contract or subsequent encumbrance.\(^\text{58}\)

\(^{57}\) *Id.* at 637, 526 P.2d at 1174, 116 Cal. Rptr. at 638.

\(^{58}\) *Id.* at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639; *La Sala*, 5 Cal. 3d at 882, 884, 489 P.2d at 1125, 1126, 97 Cal. Rptr. at 861, 862.
Section 1208 of the California Uniform Commercial Code deals with acceleration clauses written into contracts which allow a party to accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure." The code simply states that under those circumstances, a party shall have the power to accelerate only if he, in good faith, believes that the prospect of payment or performance is impaired. This position is consistent with the high court's position to date with respect to subsequent encumbrances and sale by land sale contract. The only remaining step is to apply this principle to the outright sale of property.

The UCC seems inconsistent, in placing the burden of establishing lack of good faith on the party against whom it has been exercised. The high court has placed the burden on the lender who would accelerate upon authority of the "due-on" clause. The two positions can be reconciled, however, if in each case the burden is seen to be on the one with the easiest task of establishing his position. Under the UCC, the burdened party can show his financial circumstances have not deteriorated so that acceleration or demand for additional collateral would be inappropriate. Under the high court's decisions, the lender is the one who can show why a proposed vendee or proposed sale does not meet his standards and can easily state what those standards are.

Alternatives Are Available by Which Lenders Can Keep Their Loan Portfolios Near Current Interest Rates

Continuing concern over inequitable enforcement of due-on clauses is, in part, because of the unreasonable scope of the clause. The clause often allows acceleration of the due date of the loan for almost any act of an owner of property which affects any of his interests in his property. The clause is expressly said or implied to be for the purpose of protecting the security of the lender. Yet, lenders continue to enforce, or threaten to enforce the due-on-sale clause upon outright sale of the property, in order to exact collateral benefits, even though the lender's security may be greatly increased by the sale to a qualified, able buyer.

The financial strength and stability of those lenders who lend upon the security of real property is of great interest to the state of California, as is the free alienability of property and freedom

59. CAL. UNIF. COM. CODE § 1208 (West 1964).
from oppressive application of adhesion contracts. In both La Sala and Tucker, the lenders and amici curiae argued that automatic application of the due-on-clause was essential to allow the lenders to maintain their loan portfolios at current interest rates.\footnote{5} In both cases, the high court properly responded that mere benefit to the restrainor is not sufficient to validate an unlawful restraint on alienation.\footnote{6}

It has been suggested that lenders may enjoy current interest rates on notes secured by deeds of trust, without judicial intervention and negation, by employing the following technique: Offer the borrower a choice between a variable interest note,\footnote{2} and a fixed interest note. The lender could explain to the borrower that periodically the interest on the variable interest note would change to reflect changes in certain selected indices, presumably maintaining the interest rate at or near the current rate. Any time a sale of the property took place, a qualified buyer could merely assume the variable interest note. The rate of interest would already be at or near the current rate. As an alternative, the lender could offer the borrower a fixed interest note, in consideration for the lender's right to adjust the interest to the current rate, upon the divestiture of legal or equitable title.

The borrower's selection of a fixed interest note or a variable interest note would then represent a bargained-for provision, not the take-it-or-leave-it situation with usual provisions of an adhesion contract. In addition, legal consideration would have been given by the lender for the right to impose a current interest rate in those cases in which the borrower chose the fixed interest note. Finally, such a clause should not suffer from the infirmity of overbreadth or vagueness.

**Techniques Devised to Avoid Due-On Clause May Cause Further Jeopardy to Buyers and Sellers**

Since the due-on clause is presently used indiscriminately by
lenders to exact often unconscionable collateral benefits which frequently prevents the sale of property, the real estate industry has developed certain techniques which avoid application of the due-on-sale clause and allow sales to proceed. While these techniques may succeed in preventing acceleration of the loan, they tend to create new dangers to the parties' interests in the property.

One technique to avoid the due-on-sale clause is applied to what is otherwise an outright sale. An agreement to sell is created but not recorded. A trust deed is executed and recorded in favor of the buyer for the amount of the down payment. Grant deeds, reconveyances, etc. are executed and kept in open escrow, subject only to the direction of the buyer to record. Thus, the record continues to show the seller as a record owner. The principal loan appears unchanged. A second lien evidenced by a deed of trust is shown on the record, in favor of the buyer. There is no indication on the record that both equitable and legal title have passed. Some members of the real estate community have decided that such actions come under the apparent protection of the La Sala opinion and avoid automatic enforcement of the due-on-sale clause.

Unfortunately, this technique places the buyer in a tenuous position. His protection may be limited only to the extent of his downpayment secured by a second deed of trust. Should the buyer make substantial improvements to the property or the property appreciate, an unscrupulous seller could sell the property again, absconding with the consideration and leaving the buyer with only civil remedies against him. The seller could also place another lien against the property, secured by yet another deed of trust. Under California statute, a new buyer or lender, relying on the record, giving value and without notice of the prior transaction would have rights superior to those of the true owner. Thus, in an effort to avoid the substantial restraints on alienation imposed by automatic enforcement of the due-on clause, the buyer has lost the considerable protection afforded him by the recording system.

**Rules Evolved in La Sala and Tucker Opinions Need to be Applied to All Efforts to Enforce the Due-On Clause**

Within the La Sala and Tucker opinions are rules of general application with respect to enforcement of the "due-on" clause which are applicable to every attempted application and enforcement of the clause. There are no sound reasons why the rules

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63. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).
should not be applied to an outright sale of the security as well as to the sale by land contract and subsequent encumbrances.

In *Coast Bank*, the court stated that only unreasonable restraints on alienation were invalid. In *La Sala*, the court reasoned that the validity of the due-on-encumbrance clause could not be ruled upon in the abstract as it was not so much the clause itself as the lender's application that effects an invalid restraint on the alienation of property. The general rule was asserted as follows:

> When such 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 an unlawful restraint on alienation.

In *Tucker*, the court further refined the rule by stating as follows:

> To the degree that enforcement of the [due-on] clause would result in an increased quantum of actual restraint on alienation in the particular case, a greater justification for such enforcement from the standpoint of the lender's legitimate interests will be required in order to warrant enforcement.

More rules are not required. It is only necessary that the high court require the rules to apply to all areas in which the due-on clause purports to apply. Whenever the lender wishes to accelerate the due date of the loan for any reason, under any circumstances conceivably within the purview of the clause, it is reasonable that the lender be required to show danger to his security before enforcement is allowed; further, when the restraint is substantial, the danger to the security should likewise be more substantial before enforcement is allowed.

**Current Economic Conditions Make Reconsideration Urgent**

At this writing, the economic condition of the nation is described as a deepening recession, with threats of a depression. The auto industry is already in a depression, with hundreds of thousands of auto workers laid off. Nation-wide, millions are unemployed with government sources predicting the national unemployment rate will

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65. 6 Cal. 2d at 316, 392 P.2d at 268, 38 Cal. Rptr. at 508.
66. 5 Cal. 3d at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 860.
67. *Id.* at 882, 489 P.2d at 1125, 97 Cal. Rptr. at 861.
68. 12 Cal. 3d at 636, 528 P.2d at 1173, 116 Cal. Rptr. at 637.
reach eight and one-half percent by mid-1975. California already exceeds nine percent unemployed. The Dow Jones Industrial Average declined below 600 for the first time in many years.

As the ripple effect from distressed industries affects more and more related industries, many more occasions of forced sale of real property will arise due to personal economic misfortune. In many cases of forced sale, the equity in the property will be an important asset. Unwarranted restraint on alienation which would prevent realization of this equity to relieve personal financial hardship is unconscionable, but likely unavoidable if the court's present dicta, allowing automatic enforcement of the due-on clause in the ordinary sale, is allowed to stand.

In addition to the restraint imposed on the individual buyer and seller of real estate, the enforcement of the due-on-sale clause depresses the entire real estate industry. Real estate brokers, their salesmen, escrow companies and related industries will suffer from the inability to freely sell and transfer real property because of the inequitable application of the due-on clause. Only the lender benefits; rarely does he benefit from increased security for his loan, rather he benefits by the exaction of collateral financial benefits.

By extending the principles of La Sala69 and Tucker70 to the ordinary sale of real property, the seller will be able to more easily sell his property, to choose the method of sale most beneficial to him, and to realize the full value of his property. During periods of high interest rates and tight money conditions, buyers will be able to qualify for loans that might otherwise be unavailable to them. Full protection of the recording acts will be afforded to both buyers and sellers as techniques to avoid application of the due-on clause will no longer be needed. The real estate and affiliated industries will no longer be artificially depressed during periods of high interest and tight money conditions. These benefits are consistent with the interests and policies of the state of California.

Against these considerable benefits are balanced the changed situation for the lender. The lender may still properly invoke the clause whenever his security is threatened. The lender may create a variable interest note or bargain for the right to raise the interest rate upon divestiture of the legal or equitable title to the property and thus maintain his loan portfolio near the current interest rates. The only benefit denied the lender is the collateral financial benefit exacted from buyers and sellers in the absence of danger to the

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69. 5 Cal. 3d at 882, 489 P.2d at 1124, 97 Cal. Rptr. at 880.
70. 12 Cal. 3d at 639, 526 P.2d at 1175, 116 Cal. Rptr. at 639.
lender's security, a benefit already declared by the high court to be unreasonable\textsuperscript{71} and thus an invalid restraint on alienation.\textsuperscript{72}

\textbf{BERNARD J. KOERSELMAN*}

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\textsuperscript{71} Id. at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637; \textit{La Sala}, 5 Cal. 3d at 882, 489 P.2d at 1125, 97 Cal. Rptr. at 861.

\textsuperscript{72} \textit{Tucker}, 12 Cal. 3d at 640, 526 P.2d at 1176, 116 Cal. Rptr. at 640; \textit{La Sala}, 5 Cal. 3d at 882, 489 P.2d at 1124-25, 97 Cal. Rptr. at 860-61.

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