Due-on-Sale Clauses after Passage of the Garn Act: More Questions Than Answers?

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DUE-ON-SALE CLAUSES AFTER PASSAGE OF THE GARN ACT: MORE QUESTIONS THAN ANSWERS?

On October 15, 1982, the Garn-St. Germain Depository Institutions Act became law. This Comment surveys many unresolved issues remaining after passage of the Act. It particularly focuses upon the date the window period begins, the extent to which the window is abrogated by exceptions provided in the Act, the status of conversion loans, and the constitutionality of the retroactive application of the Act.

INTRODUCTION

The law regarding due-on-sale clauses has undergone major changes in the last decade, particularly in California. In 1978, the California Supreme Court held in Wellenkamp v. Bank of America1 that the clauses were not enforceable in an outright sale situation unless the lender's security was threatened. The impact of this holding was significantly magnified by its retroactive application,2 which was intended to shelter earlier purchasers from enforcement of these clauses. This decision provided only a short respite for consumers, because four years later two major restrictions were placed on Wellenkemp and its progeny.

The two major restrictions were Fidelity Federal Savings and Loan Association v. de la Cuesta3 and the Garn-St. Germain Depository Institutions Act of 1982 (Garn Act).4 In de la Cuesta, the

2. Two exceptions to a retroactive application of the decision were enunciated by the court. See infra note 39.

The Garn Act covers much more than due-on-sale clauses. Title III, part C, is the focus of this Comment. The Act consists of eight titles:

1. Deposit Insurance Flexibility
2. Net Worth Certificates
3. Thrift Institutions Restructuring
4. Provisions Relating to National and Member Banks

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United States Supreme Court held that due-on-sale clauses are enforceable when the mortgage is held by a federally-chartered savings and loan association. This decision disrupted the home loan industry, essentially placed all lenders at a disadvantage, and eventually prompted federal legislation. Under *de la Cuesta*, federally-chartered lenders could enforce due-on-sale clauses, and consequently, update their mortgage portfolios; however, this was an illusory advantage. Buyers subsequently preferred to deal with lenders who could not enforce these clauses. Lenders not affected by the *de la Cuesta* decision were also disadvantaged because they were in serious financial difficulties in the rising interest-rate market and could not update their mortgage portfolios. The Garn Act, signed into law October 15, 1932, was enacted in response to the perceived disarray and inequities in the home loan industry. With certain exceptions, the Act allows lenders to enforce the due-on-sale clauses. The Act places lenders on a more competitive footing, but it has also raised numerous questions. This Comment deals with unresolved issues concerning the commencement of the window period, and closely examines the constitutionality of the retroactive application of the Garn Act.

**History of Due-on-Sale Clauses**

Some background information on due-on-sale clauses will be helpful to an understanding of the recent changes in due-on-sale law. Prior to 1930, provisions restricting the owner's ability to transfer his interest in property without the lender's consent were rarely inserted in mortgages or deeds of trust. Due-on-sale

5. Amendments to the Federal Credit Union Act
6. Property, Casualty, Life Insurance Activities of Bank Holding Companies
7. Miscellaneous
8. Alternative Mortgage Transactions

5. *See infra* note 45 for a list of the transactions that do not trigger enforcement of the clause.
6. The window period provision precludes enforcement of due-on-sale clauses upon transfer during a specified time period. *See infra* note 52 for the text of the window period provision.
7. The purpose of this section is to provide only the minimal background necessary to an understanding of the Garn Act's impact. For a more comprehensive analysis of early due-on-sale clause decisions, see Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F.L. Rev. 267 (1972) [hereinafter cited as Bonanno]. For an excellent article that emphasizes the more recent *Wellenkamp* case and its impact, see Crane, *Wellenkamp v. Bank of America: A Victory for the Consumer?* 31 Hastings L.J. 275 (1979) [hereinafter cited as Crane].
clauses were originally inserted in notes and security instruments to provide “the lender . . . a choice of borrowers to guard against the moral risks, . . . usually waste or poor credit which increase the likelihood of having to retake the property.” Rarely were the early due-on-sale clauses enforced.\(^9\)

In the late 1960’s, interest rates began to rise,\(^11\) resulting in the extensive use of due-on-sale clauses.\(^12\) Savings and loan associations had made long-term, fixed-rate loans on real property at older, lower interest rates and when interest rates rose they were unable to update their long-term mortgage portfolios to higher, short-term interest rates on deposits. Thus savings and loan associations were unable to keep their portfolios at current interest rates, and they began losing money.\(^13\) Enforcement of the due-on-sale clause became vital to the survival of savings and loan associations.\(^14\) The clause, which was originally intended to protect the lender’s security, is now used as a means of extracting higher interest rates, large back-interest payments, and assumption fees commonly known as “points.”\(^15\)

**The Due-on Clause in California**

Lenders knew that unrestricted enforcement of the due-on-sale clause would bring a quick recovery to the ailing savings and loan industry, especially in California where the average turnover of...

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10. Even today, the clause generally is not enforced by requiring the borrower to pay off the balance of the loan; rather, the party acquiring the property agrees to pay a higher rate of interest in return for the bank’s agreement not to accelerate the loan. See Comment, *Due-on-Sale Clauses in Deeds of Trust: State Regulation or Preemption*, 1979 Ariz. St. L.J. 367, 368.

11. In April of 1987, the average residential mortgage yield was 6.29 percent. In February of 1970, the yield peaked at 9.29 percent and remained above 9 percent until October 1970. Bonanno, *supra* note 7, at 268 n.4.

12. Id. at 271.

13. In the first six months of 1982, savings and loan associations lost a record $3.3 billion. Overall losses for 1981 were $4.6 billion. In 1980, the savings and loan associations showed a profit. In the first half of 1982, 82 percent of federally-insured savings and loan associations lost money. In the first half of 1981, 70 percent lost money; in the last half of that year, 65 percent lost money. L.A. Times, Oct. 12, 1982, pt. IV, at 2, col. 1.

14. Enforcement of the clauses was also vital to the real estate industry, which relies on the availability of credit to finance most transactions. Bonanno, *supra* note 7, at 268-70.

15. See id. at 275.
homes occurs every seven years. As each home is sold, the loan is "recaptured" and updated to higher interest rates. The case of Coast Bank v. Minderhout, decided in 1964, was the first reported California case of an attempt to enforce a "due-on" clause. The borrowers had given no other security and agreed not to transfer or encumber their property without the lender's consent until they had repaid the money they owed the lender. The borrowers sold the property without the lender's consent. The lender chose to accelerate the debt and commenced a foreclosure action. The California Supreme Court concluded that only unreasonable restraints on alienation are forbidden by section 711 of the California Civil Code. The Court further stated that "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 debt." The due-on clause in Coast Bank was upheld, but the court's ultimate justification for the clause was not clear.

The Coast Bank decision was followed by Cherry v. Home Savings and Loan Association, in which the plaintiff sellers and buyers sought a declaratory judgment against the exercise of a due-on-sale clause. The appellate court held that a lender may enforce the provision to protect his security against risk of loss and to take advantage of rising interest rates. After Cherry, the law regarding due-on clauses began to change.

Three California Supreme Court cases decided in the 1970's have established the body of law in California with respect to the enforceability of due-on clauses. The first is La Sala v. American Savings and Loan Association, a 1971 decision in which the court began to limit the enforceability of due-on clauses. In 1963, the La Salas borrowed $20,700 from American Savings and Loan Association at six percent interest. They executed a note and a trust deed with a due-on-encumbrance clause and certified in writing that they would not give or execute any other lien or charge on the property. In June of 1969, they borrowed $3800, executing a note and second deed of trust as security for the loan. In

16. Crane, supra note 7, at 276.
18. 61 Cal. 2d at 316-17, 392 P.2d at 266, 38 Cal. Rptr. at 508. Section 711 states that “[c]onditions restraining alienation, when repugnant to the interest created, are void.” CAL. CIV. CODE § 711 (Deering 1982).
22. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).
July, American Savings and Loan Association notified the La Salas of its right to accelerate, but offered to waive the right if the La Salas would pay waiver fees of $150 and increase the rate of interest on the first deed of trust from six to nine percent.\textsuperscript{23} The court distinguished the due-on-sale clause from the due-on-encumbrance clause, noting that a junior encumbrance does not terminate a borrower’s interest in the property, but a sale generally does terminate that interest and might threaten the lender’s security.\textsuperscript{24} Because the court believed that the due-on-encumbrance clause involved less risk to the lender’s security, the court held that the due-on-encumbrance clause could be sustained only by finding that enforcement was reasonably necessary to protect the lender’s security.\textsuperscript{25}

In \textit{Tucker v. Lassen Savings and Loan Association},\textsuperscript{26} the California Supreme Court further limited the automatic enforcement of due-on-sale clauses. The Court, however, left open the question of whether due-on-sale clauses were enforceable in an outright sale (a sale in which title is transferred). The sale in Tucker was accomplished through an installment land contract (a transaction which gives the purchaser immediate possession but retains legal title in the seller as security until the purchase price is paid). The main issue was whether enforcement of the due-on-sale clause in this situation would be an unreasonable restraint on alienation. The court considered the quantum of restraint on alienation imposed by enforcement of the clause, as well as the justification for it.\textsuperscript{27} The court concluded that the lender’s desire to increase its interest rate is not a sufficient justification for the amount of restraint imposed by enforcement of the clause upon the execution of an installment land contract.\textsuperscript{28}

The third major California Supreme Court decision regarding due-on clauses was the 1978 decision of \textit{Wellenkamp v. Bank of

\begin{thebibliography}{9}
\bibitem{23} Id. at 869-70, 489 P.2d at 1115-16, 97 Cal. Rptr. at 851-52.
\bibitem{24} Id. at 880, 489 P.2d at 1123, 97 Cal. Rptr. at 859.
\bibitem{25} Id. at 883, 489 P.2d at 1126, 97 Cal. Rptr. at 862.
\bibitem{26} 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).
\bibitem{27} “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.” Id. at 636, 526 P.2d at 1173, 116 Cal. Rptr. at 637.
\bibitem{28} Id. at 639 n.10, 526 P.2d at 1175-76 n.10, 116 Cal. Rptr. at 639-40 n.10.
\end{thebibliography}
In 1975, Wellenkamp purchased a piece of real property from the Mans, paying them the amount of their equity in the property and agreeing to take the property subject to the balance of the existing loan with Bank of America. Bank of America refused Wellenkamp's payments. The bank told her it intended to accelerate unless she assumed the loan at an increased rate of interest. Wellenkamp sought an injunction and a declaration that the exercise of such a clause, without any showing that Bank of America's security had been impaired as a result of the sale to her, constituted an unreasonable restraint on alienation in violation of California law.

The trial court granted a preliminary injunction to restrain the foreclosure sale. The bank then demurred to Wellenkamp's complaint on the ground that automatic enforcement of the due-on-sale clause after a transfer of property in an outright sale is valid under California law, so the facts stated were not sufficient to constitute a cause of action for declaratory relief. The demurrer was sustained without leave to amend. The court of appeal affirmed. Wellenkamp appealed and was granted a hearing before the California Supreme Court. The key issue to be resolved was whether enforcement of a due-on-sale clause contained in a deed of trust securing real property constitutes an unreasonable restraint on alienation upon an outright sale of that property.

The court, using the test announced in Tucker, first considered the quantum of restraint on alienation imposed by enforcement of the clause in outright sale situations. Justice Manuel, writing for the 6-1 majority, redefined "outright sale" to include any sale by the borrower in which legal title is transferred. This was necessary to avoid dicta in Tucker and La Sala which suggested that restraint from an outright sale appeared to be de minimis. In Tucker and La Sala, "outright sale" referred to transactions in which the seller/trustor received full payment from the buyer (an "all cash to seller" sale). Outright sales, as redefined, include cases such as Wellenkamp's, known as "cash to loan" arrangements. These arrangements are made where new financing is unavailable or economically infeasible. The buyer pays the seller only the amount of the seller's equity, and assumes or takes "subject to" the existing deed of trust.

The court said that in "cash to loan" and other situations, a re-

30. Id. at 946-47, 582 P.2d at 972, 148 Cal. Rptr. at 381.
31. Id. at 947, 582 P.2d at 972, 148 Cal. Rptr. at 381.
32. Id. at 946, 582 P.2d at 971-72, 148 Cal. Rptr. at 380-81.
33. Id. at 950, 582 P.2d at 974, 148 Cal. Rptr. at 383.
34. Id. at 949-50, 582 P.2d at 974, 148 Cal. Rptr. at 383.
A restraint on alienation is possible if economic conditions are such that new financing is either unavailable or economically infeasible, and the lender is unwilling to permit assumption of the existing loan.\textsuperscript{35} Even if the lender is willing to allow the buyer to assume the loan at an increased rate, the court explained that an inhibitory effect on transfer might still result because the buyer might insist on a lower purchase price to compensate for increased interest costs, and the seller might then refuse to sell.\textsuperscript{36} "In either event," the court said, "the result in terms of a restraint on alienation is clear."\textsuperscript{37}

According to the Tucker test, once a restraint on alienation is found, the court must measure the justification. The Wellenkamp court did not find significant justification in Bank of America's contention that the lender's interest in maintaining its portfolio at current interest rates justifies the restraint imposed by the exercise of a due-on-sale clause upon transfer of title in an outright sale. The due-on-sale clause was designed to protect against impairment of the lender's security, not to protect lenders from business risks of inflation and a competitive money market. The court did not believe the property owner should bear the burden of the lender's mistaken economic projections.\textsuperscript{38}

The Wellenkamp court held that a due-on-sale clause in a promissory note or deed of trust cannot be enforced when an outright sale occurs unless the lender can demonstrate that enforcement is reasonably necessary to protect against impairment of its security or the risk of default. This holding overruled Coast Bank to the extent that opinion was inconsistent. Of particular importance, the court refused to limit its holding to a purely prospective effect.\textsuperscript{39} The lenders' expectations of economic benefit from enforcement of these clauses was insufficient justification to overcome the rule that a supreme court's decision overruling a former

\textsuperscript{35} Id. at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84. But see Comment, Due-on-Sale Clauses: The Economic and Legal Issues, 43 U. Pitt. L. Rev. 441 (1982).

\textsuperscript{36} 21 Cal. 3d at 950-51, 582 P.2d at 975, 148 Cal. Rptr. at 384.

\textsuperscript{37} Id. at 951, 582 P.2d at 975, 148 Cal. Rptr. at 384.

\textsuperscript{38} Id. at 952-53, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86.

\textsuperscript{39} The Wellenkamp holding applied retroactively before September 24, 1978, the date of the decision, with two exceptions: 1. where the lender had enforced the due-on-sale clause, resulting in sale by foreclosure or in discharge of the accelerated debt; 2. where the lender had waived enforcement of the clause in return for an agreement that modified the existing financing. Id. at 953-54, 582 P.2d at 976-77, 148 Cal. Rptr. at 385-86.
decision is retrospective. Thus, after Wellenkamp, due-on-sale clauses were of little effect in California.

de la Cuesta: The United States Supreme Court Speaks on Due-on-Sale Clauses

Wellenkamp was not, however, the final word on due-on-sale clauses. On June 28, 1982, the United States Supreme Court published its decision in *Fidelity Federal Savings and Loan Association v. de la Cuesta*. This decision states that federally-chartered savings and loan associations are unaffected by the Wellenkamp decision, thus upholding the enforceability of due-on-sale clauses in instruments held by those institutions. The de la Cuesta decision gives federally-chartered savings and loan associations the boost their troubled industry needed, but at the expense of consumers who may now be forced to renegotiate their loans and pay back-interest fees.

The Depository Institutions Act of 1982: Congress Speaks on Due-on-Sale Clauses

After de la Cuesta, savings and loan associations were in a state of disruption. Many state-chartered associations were converting to federal charters in order to enforce due-on-sale clauses and to take advantage of opportunities to acquire savings and loan associations in other states. It is still an open question, however, whether due-on-sale clauses in loans made before the institution converted to a federal charter will be enforceable under de la Cuesta. The Court in de la Cuesta expressly declined to rule on this issue.

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40. 102 S. Ct. 3014 (1982).
41. Certain exceptions are provided for in the Garn Act. See infra note 52.
43. 102 S. Ct. at 3031 n.24. An Orange County Superior Court judge has tentatively ruled that loans made by these institutions are assumable. In Bassett v. Fidelity Federal Savings and Loan Association, Judge Phillip A. Petty made a preliminary ruling that Robert Bassett could assume a thirty-year, fixed-rate mortgage on commercial property be bought in 1981. Civ. No. 366395 (Super. Ct. Orange County, Cal. Oct. 8, 1982). The loan Bassett assumed was made at 9.8 percent in 1977 (pre-Wellenkamp) by Mariners Savings and Loan Association, a state-chartered association which converted to a federal charter one month after the Wellenkamp decision, and was later purchased by Fidelity Federal Savings and Loan Association. Bassett sued Fidelity Federal for wrongful foreclosure when it tried to exercise the due-on-sale clause in his loan agreement to increase the interest rate. The lender argued that its action was proper under federal law. The decision, announced before passage of the Garn Act, was that Fidelity Federal “will be subject to the rule in Wellenkamp” and therefore, mortgages made under its state charter will be assumable. In another pre-Garn Act case, Bleeker Assoc. v. Astoria Fed. Sav. & Loan Ass'n, 544 F. Supp. 794 (S.D.N.Y. 1982), the court held
The beneficial effects of *de la Cuesta* on federal financial institutions were foreseeably limited. Consumers who became aware of the significance of the *de la Cuesta* holding understandably preferred to deal with state-chartered institutions for which due-on-sale clauses were still unenforceable. The Garn Act was passed to remedy the situation and “to place all lenders on a more competitive footing” by making due-on-sale clauses enforceable, except in certain specified instances.

Subsections (b) and (c) of section 341 of the Garn Act are of primary importance. Subsection 341(b)(1) essentially gives a lender the right to enter into or enforce a due-on-sale clause. that the Federal Home Loan Bank Board regulation, passed in 1976, did not purport to give federal associations the power to exercise due-on-sale clauses in loans originated by non-federal associations, when the state law was contrary.


45. Subsection 341(d) provides certain exceptions to the enforceability of the due-on-sale clause:

1. the creation of a lien or other encumbrance subordinate to the lender’s security instrument which does not relate to a transfer of rights of occupancy in the property;
2. the creation of a purchase money security interest for household appliances;
3. a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;
4. the granting of a leasehold interest of three years or less not containing an option to purchase;
5. a transfer to a relative resulting from the death of a borrower;
6. a transfer where the spouse or children of the borrower become an owner of the property;
7. a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;
8. a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or
9. any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board.


46. “Notwithstanding any provision of the constitution or laws (including judicial decisions) of any State to the contrary, a lender may, subject to subsection (c), enter into or enforce a contract containing a due-on-sale clause with respect to a real property loan.” *Id.* § 341(b)(1), 96 Stat. at 1505 (to be codified at 42 U.S.C. § 5402).

47. Subsection 341(a)(2) defines a lender as “a person or government agency making a real property loan or any assignee or transferee, in whole or in part, of such a person or agency.” *Id.* § 341(a)(2), 96 Stat. at 1505 (to be codified at 12 U.S.C. § 1701j-3).

48. Subsection 341(a)(1) defines a due-on-sale clause as “a contract provision which authorizes a lender, at its option, to declare due and payable sums secured
Subsection 341(b)(2)\textsuperscript{49} states that exercise of the due-on-sale clause is governed by the terms of the loan contract. The last part, subsection (b)(3) of section 341,\textsuperscript{50} encourages lenders to permit assumptions of real property loans at the existing rate or at a blended rate; that is, a rate between the contract and market rates.\textsuperscript{51}

The Garn Act successfully addressed the issue of disparity among lenders. Additionally, the Act dealt with the problem of loans in those states that had previously declared due-on-sale clauses unenforceable. By creating a grace period on enforceability to accommodate those states, the Act creates a myriad of issues concerning entitlement to this “window.”

**THE THREE-YEAR WINDOW**

For states that have restricted the enforcement of due-on-sale clauses, subsection (c) of section 341\textsuperscript{52} provides a three-year period by the lender's security instrument if all or any part of the property, or an interest therein, securing the real property loan is sold or transferred without the lender's prior written consent.” \textit{Id.} § 341(a)(1), 96 Stat. at 1505 (to be codified at 12 U.S.C. § 1701j-3).

49. Subsection 341(b)(2) reads:
   Except as otherwise provided in subsection (d), the exercise by the lender of its option pursuant to such a clause shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the lender and the borrower shall be fixed and governed by the contract.

50. Subsection 341(b)(3) reads:
   In the exercise of its option under a due-on-sale clause, a lender is encouraged to permit an assumption of a real property loan at the existing contract rate or at a rate which is at or below the average between the contract and market rates, and nothing in this section shall be interpreted to prohibit any such assumption.


52. Subsection 341(c)(1) reads:
   In the case of a contract involving a real property loan which was made or assumed, including a transfer of the liened property subject to the real property loan, during the period beginning on the date a State adopted a constitutional provision or statute prohibiting the exercise of due-on-sale clauses, or the date on which the highest court of such State has rendered a decision (or if the highest court has not so decided, the date on which the next highest appellate court has rendered a decision resulting in a final judgment if such decision applies State-wide) prohibiting such exercise, and ending on the date of enactment of this section, the provisions of subsection (b) shall apply only in the case of a transfer which occurs on or after the expiration of 3 years after the date of enactment of this Act, except that—
   (A) a State, by a State law enacted by the State legislature prior to the close of such 3-year period, with respect to real property loans originated in the State by lenders other than national banks, Federal
"window" during which certain due-on-sale clauses are not enforceable. The window applies to almost all lenders and individuals, except for federal savings and loan associations and federal savings banks.\(^{53}\) It began with the date of enactment of the Garn Act, October 15, 1982, and it ends three years later, October 15, 1985.\(^{54}\) After the window closes, specified due-on-sale clauses will be enforceable unless, during the three-year period, restrictions are imposed by: 1. a state legislature, with respect to real property loans originated by non-federal lenders; 2. the Comptroller of Currency, with respect to real property loans originated by national banks; or 3. the National Credit Union Administration Board with respect to real property loans originated by federal credit unions.\(^{55}\)

Loans originated or assumed during the time the state prohibited the exercise of the due-on clause are entitled to the three-year window. The Garn Act is ambiguous in its statement of when this "state prohibition period" begins. In California, the state prohibition period has at least four potential points of commencement. It could begin in 1971, with the La Sala decision, in 1974 with the Tucker decision, or in 1978 with the Wellenkamp decision because the due-on clause in each case was held unenforceable.\(^{56}\) The fourth potential beginning is the date of any state constitutional provision or statute that prohibits exercise of the clause. Thus, for California, the period could possibly have started as early as 1872, when section 711 of the California Civil Code first invalidated restraints on alienation. The following diagram clarifies the possible time sequences:\(^{57}\)
The general consensus seems to be that Wellenkamp marks the beginning of the window period in California. The Federal Home Loan Bank Board (FHLBB) has been placed in charge of interpreting the Garn Act, and one of its top legal advisors believes that in California the window begins with the August 25, 1978 Wellenkamp decision. Thomas Vartanian, general counsel of the FHLBB, said that when the rules regarding the Garn Act are published, no changes from the FHLBB’s initial reading given to the Act are likely; 1978 will probably be the operative date. Also, the legislative history indicates that the Committee on Banking, Housing, and Urban Affairs believes 1978 is the date on which the highest court in California placed a restriction on the enforcement of due-on-sale clauses. Finally, the United States Supreme Court indicated in a footnote to de la Cuesta, that Wellenkamp was the first California decision limiting a lender’s right to accelerate a loan in outright transfers where the security was unimpaired.

The date when the state prohibition period begins is crucial to consumers. If the 1978 Wellenkamp decision marks the beginning of the state prohibition period, then a due-on-sale clause in a contract made or assumed between 1978 and 1982 is enforceable only
in the case of a transfer occurring on or after three years from the enactment of the legislation, which would be 1985. If, however, La Sala is the first decision prohibiting enforcement, then the state prohibition period starts in 1971 and homebuyers who made or assumed real property loans from 1971 through 1977 would also receive the three-year window period. If the courts choose 1978 as the beginning of state prohibition against the clause, the issue of whether the clause may be retroactively enforced becomes vital to consumers who purchased real property in 1977 with a due-on-sale clause in the deed of trust.

Homeowners who purchased before the state prohibition period began are not the only persons concerned about receiving the benefit of the three-year window. Consumers whose loans were made during the state prohibition period by a state-chartered institution that later switched to a federal charter are also concerned that if de la Cuesta applies to them, they will not receive the three-year window. The Garn Act contains broad preemption language and could be viewed as supporting the ability of a federally-chartered savings and loan association to enforce a due-on-sale clause in a loan originated by non-federal lenders. The Senate Report, however, takes a different view: “The identity of the lender at the time the loan was originated determines whether or not a loan is subject to window period restrictions. For example, a loan originated by a state-chartered savings and loan association which subsequently converted to a federally chartered thrift institution will be subject to state due-on-sale restrictions for three years, unless state action provides other treatment for such loans.”

With passage of the Garn Act, many state-chartered savings and loan associations no longer find it

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62. A collateral problem of the Garn Act should also be noted. Subsection (c)(2)(B) states: “A lender may not exercise its option pursuant to a due-on-sale clause in the case of a transfer of a real property loan which is subject to this subsection where a transfer occurred prior to the date of enactment of this Act.” Pub. L. No. 97-320, § 341(c)(2)(B), 96 Stat. 1506 (1982) (to be codified at 42 U.S.C. § 5402) (emphasis added). Subsection (a)(3) defines the term “real property loan” as “a loan, mortgage, advance, or credit sale secured by a lien on real property . . . .” Id. § 341(a)(3), 96 Stat. 1505 (1982) (to be codified at 12 U.S.C. § 1701j-3). Thus, subsection (c)(2)(B) is ambiguous, but will probably be interpreted to mean the transfer of a piece of real property subject to a loan, not the loan itself.


necessary to switch to federal charters; in fact, some are even switching back.65

Another group of individuals whose loans were made during the state prohibition period may nevertheless find their due-on-sale clauses to be enforceable during the window period. Private individuals who made loans during the state prohibition period may also be able to enforce due-on-sale clauses because the Garn Act grants lenders the power to enforce a due-on-sale clause when a buyer fails to meet customary credit standards.66 The customary credit standards clause is a “sleeper” because, while it is not yet frequently enforced, it will probably be the subject of future intense litigation.

The importance of this clause is best explained by a hypothetical example. Assume that in 1979 A wishes to sell his home to B. At the time of the sale, A still owes money to a state-chartered savings and loan association on a promissory note secured by a first deed of trust. B agrees: to give A some cash as a down payment, to take subject to the existing first deed of trust, and to give A a promissory note secured by a second deed of trust. The second deed of trust and note contain a due-on-sale clause. In 1983, B has an opportunity to sell the house to C. Without telling A, B receives some cash from C, who takes subject to both the original first trust deed and A’s second trust deed, and C gives B a promissory note secured by a third trust deed.

One month later, A learns of B’s sale to C. A would like to have B pay off his note to A; the sleeper clause may make that possible. It states that “for any clause to which subsection (b) does not apply pursuant to this section, a lender [A, in this example] may declare a loan due and payable pursuant to the terms of the contract upon transfer to any successor or transferee [C, in this example] of the borrower [B, in this example] who fails to meet ... customary credit standards.”67 The term “customary credit standards” is not defined in the Garn Act. Savings and loan as-

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65. Additionally, California savings and loan associations will have expanded investment powers in 1983. As a result, one California institution, Central Federal Savings and Loan Association, has applied to switch from a federal charter to a state charter. L.A. Times, Nov. 23, 1982, pt. IV at 1, col. 4.

66. Under section 341(c)(2)(A) of the Garn Act:

For any contract to which subsection (b) does not apply pursuant to this subsection, a lender may require any successor or transferee of the borrower to meet customary credit standards applied to loans secured by similar property, and the lender may declare the loan due and payable pursuant to the terms of the contract upon transfer to any successor or transferee of the borrower who fails to meet such customary credit standards.


67. Id.
Associations generally have customary credit standards they apply to borrowers, but there are no standards for private individuals. Where, in addition to taking over a mortgage secured by a first trust deed, the buyer (C) takes over an additional obligation secured by a second trust deed and also gives a third trust deed, B may be able to assert very high credit standards for C. Thus, A can assert either: 1. C did not meet his standards and therefore the due-on-sale clause is enforceable; or 2. A did not have a chance to check C's credit and therefore the clause is enforceable. In failing to prescribe the meaning of "customary credit standards," the Garn Act creates an opportunity for state prohibition period lenders to enforce due-on-sale clauses during the window period.

**Retroactivity**

The due-on-sale dilemma involves two conflicting, retroactive laws. One is the *Wellenkamp* decision, and the other is the Garn Act. The California Supreme Court specifically stated in *Wellenkamp* that its decision was retroactive, despite pleas from lenders that the decision be given a purely prospective effect. It further stated that as a general rule, "a decision of a court of supreme jurisdiction overruling a former decision is retrospective in its operation . . . ." In all likelihood, the Garn Act was also intended to be retroactive because, when a transaction occurs, it affects preexisting loans. The retroactivity and constitutionality aspects of the Garn Act are important to consumers in determining their rights.

**Is the Garn Act a Retrospective Law?**

A retrospective law is defined as one that "affects the rights, obligations, acts, transactions and conditions which are performed or exist prior to the adoption of the statute." Legislative intent

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68. 21 Cal. 3d at 953, 582 P.2d at 977, 148 Cal. Rptr. at 386. Two exceptions to the retroactive effect, necessary to maintaining stability of real estate titles and interest, were noted earlier in the text. *See supra* note 39 and accompanying text.

69. 21 Cal. 3d at 954, 582 P.2d at 977, 148 Cal. Rptr. at 386 (quoting County of Los Angeles v. Faus, 48 Cal. 2d 672, 680-81, 312 P.2d 650, 685 (1957)).

70. The terms retroactive and retrospective, as applied to laws, have been held to be synonymous. American States Water Serv. Co. of Cal. v. Johnson, 31 Cal. App. 2d 606, 88 P.2d 770 (1939). Thus, the terms are used interchangeably in this Comment.

71. *Id.* at 613, 88 P.2d at 774.
is the key factor in deciding whether a law meets this definition.72 The intent is strictly construed in favor of prospectivity, such that the legislation "shall not be given retroactive effect unless such construction is required by explicit language or by necessary implication."73

An examination of the Garn Act and its legislative history indicate that the Act was probably intended to be retrospective. Section 341(b)(1) of the Garn Act reads: "[n]otwithstanding any provision of the constitution or laws (including the judicial decisions) of any State to the contrary, a lender may . . . enter into or enforce a contract containing a such clause with respect to a real property loan."74 Subsection (c)(1) abrogates the effect of subsection (b)(1) by carving out the state prohibition period exception. The Act does not, however, explicitly state that due-on-sale clauses in loans taken "subject to" before the commencement of the state prohibition period are enforceable. Had the Garn Act not carved out a state prohibition period exception which predates the legislation, and makes the legislation impliedly retroactive, a retroactive intent would not have been so easily discernible.

The legislation does, however, provide the state prohibition period, and is therefore impliedly retroactive. It would be illogical to carve out a state prohibition period for due-on-sale clauses in loans made after commencement of the state prohibition period and give them only a three-year window, when such clauses in loans made prior to that time are not enforceable. Theoretically, lenders who purchased after the state prohibition period should be entitled to more protection than those who purchased before it because the later purchasers had more reason to rely on the unenforceability of the clause. If any doubt remains concerning the legislature's intent, the Senate Report eliminates it: "[a] lender's right to enforce a due-on-sale clause, in any loan not subject to the window period restrictions, would be governed by the terms of the loan contract."75

Is Retroactive Application of the Garn Act Constitutional?

Two provisions of the United States Constitution allow condem-

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nation of retrospective civil statutes. The first is article I, section 10, which provides that states cannot pass laws which impair the obligation of contracts. The second is the fifth amendment, which provides that the federal government shall not deprive a person of property without due process of law. The application of these two provisions hinges on whether the legislation meets a standard of reasonableness and, ultimately, they become intertwined. However, the main concern is whether an unreasonable deprivation of property has occurred. The interaction between the contract clause and the due process clause has been described as follows:

Although there is no clause expressly forbidding the federal government to pass laws impairing the obligation of contracts, any federal law impairing them in a manner which the Supreme Court deemed unreasonable would doubtless be held to be a deprivation of property without due process . . . . [T]he results might be the same if the contract clause were dropped out of the Constitution, and the challenged statutes all judged as reasonable or unreasonable deprivations of property.

The main concern is the reasonableness of the law, rather than whether it results in a deprivation of property without due process or the impairment of a contract. An argument that contract rights are impaired under the Garn Act would be tenuous because the legislation actually enforces, rather than impairs, the literal terms of the contract. Because the argument that the Garn Act results in an unreasonable deprivation of property without due process seems to be a stronger argument, it will be covered more thoroughly in this Comment.

Assuming the Garn Act was intended to be retroactive and that Wellenkamp marks the commencement of the state prohibition period, pre-Wellenkamp and post-Wellenkamp purchasers may argue they are being unreasonably deprived of their property. The Garn Act, they might say, results in a “taking” of their property because a new purchaser can no longer take subject to the existing loan balance, so their property is worth less than it was before the enactment of the Garn Act. Additionally, some

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78. An argument frequently made by pre-Wellenkamp purchasers is the retroactive holding in Wellenkamp interpreting section 711 gave them a “vested right.” Even assuming this is true, there is no set formula for determining exactly what a vested right is and, once it vests, when that right can be taken away. See Smith, Retroactive Laws and Vested Rights, 5 TEX. L. REV. 231 (1927).
homeowners face foreclosure because they cannot afford higher monthly mortgage and back-interest payments. Although post-
Wellenkamp purchasers are provided a three-year grace period in which they can obtain new financing or sell their homes, their property has also been devalued. This, they may urge, is unreasonable because, at the time they entered into their contracts, the highest court in California had declared the clauses unenforceable.

Will Retroactive Application of the Garn Act Result in an Unreasonable Deprivation of Property Without Due Process?

These consumer arguments must be viewed in relation to the factors used in determining whether a retroactive law contravenes the due process clause. Two key factors are: 1. the nature and strength of the public interest served by the statute; and 2. the extent to which the statute modifies or abrogates the asserted preenactment right.79 These factors will be analyzed to determine whether the Garn Act causes an unreasonable deprivation of property without due process.

Nature and Strength of the Public Interest

The public is obviously interested in keeping the savings and loan industry in business, which is what the Garn Act was designed to do. Retroactive state legislation was used during the Great Depression to help financial institutions80 and mortgagors81 survive. The Garn Act however, reaches beyond the bounds of necessity. A purely prospective application of the Act would allow the savings and loan associations to recover as new loans are made.

Prospective application of the Act would yield a more equitable result, because consumers who purchased from 1982 forward would be on notice of the enforceability of due-on clauses. Lenders would eventually recover with a prospective application of the Act. A retrospective application however, carries the potential of irreparable harm to homeowners, particularly in foreclosure situations.

79. Hochman, supra note 76, at 697. A third factor the author discusses is the nature of the right which the retroactive statute alters. This factor is not addressed in this Comment. See id. at 717-26.
Extent of Change in Preenactment Right

If retroactive, the Garn Act will have a significant impact on rights previously acquired by the citizens of California. Consumers who purchased between 1971 and the 1978 Wellenkamp decision could sense a trend toward the nonenforceability of the clauses, in light of the La Sala and Tucker decisions. The retroactive holding of Wellenkamp, making the clauses unenforceable in California, confirmed the trend. Consumers who purchased in the period between the decision of Wellenkamp and enactment of the Garn Act entered into contracts with a reasonable expectation that the due-on-sale clause could only be enforced when a threat to the lender's collateral was present. Enforcement of these clauses upon a transfer of the property would reinstate the result Wellenkamp sought to avoid: it would force purchasers to bear the burden of the lender's mistaken economic projections.

The pre-enactment right against enforcement of due-on-sale clauses is not merely modified or abrogated by the Garn Act; it is completely destroyed. Complete destruction of the right is a significant factor because "the closer a retroactive statute comes to extinguishing the subincidents of that right, the less likely is the Court to sustain the application of the statute."82 Another consideration, according to W.B. Worthen Co. v. Kavanaugh,83 should be "whether the person asserting [the] right would have entered into the original transaction had he been able to foresee the subsequent legislation." Consumers might have purchased their homes even if they could have foreseen the legislation, but they probably would have sought a lower purchase price from the seller.

CONCLUSION

Economic conditions necessitated the passage of the Garn Act84 to assist the failing savings and loan industry. The constitutionality of a retrospective application of the Garn Act is still open to question. Unless interest rates decline significantly, savings and loan associations will continue to enforce the clauses to improve their economic condition. The courts must weigh the policy factors to determine whether retrospective application of the Act is an

82. Hochman, supra note 76, at 714.
83. 295 U.S. 56 (1935).
84. Hochman, supra note 76, at 715.
unreasonable deprivation of property without due process of law. The legislature assisted the savings and loan institutions in passing the Garn Act. The courts must now provide some assistance to the consumer. A prospective application of the act would not force the consumer to bear the burden of the lender's mistaken economic projections, and it would be more equitable to consumers.

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