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by Steve Lee

Almost every mortgage which is issued today by a private individual or by an institutional lender contains either a due-on-sale or due-on-encumbrance clause, or both. A due-on-sale clause is triggered whenever the property is sold or conveyed. A due-on-encumbrance clause is triggered whenever the property is further encumbered, e.g., a second mortgage. *See* Annot., 69 A.L.R. 3d 713 (1976). A typical due-on-sale clause would read as follows:

> If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, Lender may, at Lender's option declare all the sums secured by this Deed of Trust to be immediately due and payable.

This type of clause is intended to allow the lender to accelerate the remaining balance due under the mortgage upon the transfer of any interest in the property. The historical basis of such a clause was to protect the lender's security. In recent times, however, the clause has been used to increase the interest rate on outstanding mortgages in order to improve loan portfolios. This practice has focused a great deal of national attention and provoked a considerable amount of controversy. When used by lenders solely to increase interest rates, the courts try to determine whether the clauses are enforceable or whether the clauses impose an unreasonable restraint on alienation or violate some other public policy.

In *Wellenkamp v. Bank of America,* 21 Cal. 3d 943, 148 Cal. Rptr. 379, 582 P.2d 970 (1981), the court held that federal law did not expressly or impliedly pre-empt state law in this area; consequently the court limited the lender's right to utilize a due-on-sale clause to cases where the lender could demonstrate that the transfer of the property had impaired its security. Responding to the *Wellenkamp* decision, the U.S. Supreme Court held in *Fidelity Federal Savings & Loan Association v. De la Cuesta,* __U.S. __, 102 S. Ct. 3014 (1982), that the Federal Home Loan Bank Board's due-on-sale regulation, 12 C.F.R. § 545.8—3(f), (g) (1982), pre-empts conflicting state limitations on the due-on-sale practices of federally-chartered institutions. Specifically, 12 C.F.R. § 545.8—3(f) states:

> An association continues to have the power to include . . . a provision in its loan instrument whereby the association may, at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent.

The rule is further explained in 12 C.F.R. § 545.8—3(g):

> *Limitations on the exercise of due-on-sale clauses.* [A] Federal association: (1)Shall not exercise a due-on-sale clause because of (i) creation of a lien or other encumbrance subordinate to the association's security instrument; (ii) creation of a purchase money security interest for household appliances; (iii) transfer by devise, descent, or operation of law on the death of a joint tenant; or (iv) granting of a leasehold interest of three years or less not containing an option to purchase; (2) shall not impose a prepayment charge . . .; and (3) waives its option to exercise a due-on sale clause as to a specific transfer if, before the transfer, the association . . . agrees in writing that the person's credit is satisfactory to the association and that interest on sums secured by the association's security interest will be payable at a rate the association shall request. . . .

This regulation is applicable only to federally-chartered institutions. It has no binding effect on mortgages from state-chartered institutions or private lenders. Consequently, it is important for both lenders and borrowers to know the effect of a due-on-sale or due-on-encumbrance clause in their state.

The exact number of existing mortgages issued by state-chartered institutions and private lenders is not known, but it is thought to be a number greater than those issued by federally-chartered institutions. This may be inferred in Maryland because of the greater number of state-chartered institutions. As of June 30, 1982, in Maryland, there were forty-eight federally-chartered savings and loan institutions compared to one hundred and thirteen state-chartered savings and loan institutions, and twenty-seven federally-chartered banks compared to seventy state-chartered banks. The due-on-sale issue is, therefore, still relevant standing the *De la Cuesta* decision. The remainder of this article will pertain to the law as it exists in Maryland for both types of due-on clauses.

Maryland, unlike other states, has little authority regarding the due-on-sale clause. The only Maryland case to actually address the due-on-sale issue is *Chapman v. Ford,* 246 Md. 42, 227 A.2d 26 (1967). Other Maryland authority consists of two related Attorney General "letters of advice." 5 Nat'l Prop. L. Dig. 189 (April 28, 1980) (November 21, 1980) [hereinafter the April 1980 Letter]; 6 Nat'l Prop. L. Dig. 67 (November 21, 1980) [hereinafter the November 1980 Letter].

The letters from the Attorney General, Stephen Sachs, were in response to a problem raised by the Director of the Building, Savings and Loan Division of the Department of Licensing and Regulation. The issue presented to the Attorney General for consideration dealt primarily with the enforceability of a due-on-encumbrance clause in Maryland, and Attorney General Sachs limited his advice to the fact pattern which raised the issue.

The letters were not intended to address the proper use of either type of due-on clause by either a federally-chartered institution or a private lender, or the problem of applying the clauses to nonresidential property. The situation which precipitated the need for the Attorney General's letters centered around a state-chartered savings and loan association's attempts to enforce the due-on-encumbrance clause contained in their outstanding mortgages. The mortgagor in that case had obtained a second mortgage on the property without receiving the required prior permission from the mortgagee, the savings and loan. Historically, lenders have sought to enforce such a clause when the mortgagor's action impaired their security interests in the property, but in this case it appeared the lender sought only to improve its loan portfolio by relending the money at a higher interest rate. Attorney General Sachs concluded:

> [S]uch action would be against public policy, either because such exercise of a due-on-encumbrance clause would constitute an unreasonable restraint on alienation, [*La Sala v. American Savings and Loan Association*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971); *Pas v. Hill*, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978)], or because it might constitute an unconscionable use of a contract clause in violation of traditional notions of equity, [*Baltimore Life Insurance Co. v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971); *Tucker v. Pulaski Federal Savings and Loan Assn.*, 252 Ark. 849, 481 S.W. 2d 725 (1971); *Clark v. Lachenmeier*, 237 So. 2d 583 (Fla. App. 1970)].

November 1980 Letter, p. 68.

Attorney General Sachs agreed with decisions in other jurisdictions stating that due-on-clauses "are restraints on alienation, and therefore, subject to judicial scrutiny regarding the reasonableness of their exercise." November 1980 Letter, p. 71. He also indicated that a lender's attempt to accelerate a residential mortgage under a due-on-encumbrance clause solely for the purposes of bettering a loan portfolio would constitute an unreasonable, and therefore, an unlawful restraint on alienation.

In contrast, however, he thought the Maryland courts would be less likely to prevent the enforcement of a due-on-sale clause than of a due-on-encumbrance clause. In an outright sale the seller usually receives enough money to pay off the existing mortgage loan which terminates the seller's interest in the property. The lender, on the other hand, must have the ability to determine the creditworthiness of the assumptor in order to protect the security of its loan. Under these circumstances, the restraint on alienation would not be unreasonable and therefore the due-on-sale clause would be enforceable. *Chapman v. Ford*, 246 Md. 42, 227 A.2d 26 (1967) somewhat supports this rationale.

The pivotal issue in *Chapman* was determining *when* the "sale" took place for prepayment penalty purposes. The court concluded that a legal and binding sale of the property took place two weeks prior to a formalized written contract. The court ". . . found that the delay in entering into the written contract was only an attempt by the Chapmans to evade the penalty clause of their mortgage agreement with the Fords." *Chapman*, 246 Md. at 42, 227 A.2d at 32. *Chapman*, however, is more important for what it did not discuss than for what it did discuss. The court held the contract to be a contract at arm's length between consenting parties, and therefore, enforceable on its terms. The court in *Chapman* did not concern itself with whether the due-on-sale clause was invalid as an unreasonable restraint on alienation or against public policy; it chose instead to interpret the terms of the mortgage literally. Arguably, however, the court may have been intimating that an oral contract for the sale of real property is sufficient to trigger the prepayment penalty and, also, the due-on-sale clause. Attorney General Sachs distinguished the facts with which he was concerned from the facts found in *Chapman*. *Chapman* clearly involves a sale of property and the effect of a due-on-sale clause, whereas, Sachs was addressing the issue of a lien (second mortgage) and the effect of a due-on-encumbrance clause. Thus, *Chapman* is not analogous to Attorney General Sachs' factual situation.

Unfortunately, the law in Maryland as to the due-on-sale and due-on-encumbrance clause is unclear. Attorney General Sachs' conclusion is similar to the federal approach as stated in 12 C.F.R. § 545, 8–3(f) and (g). The Attorney General states:

> [A] due-on-encumbrance clause (although not necessarily a due-on-sale clause), when exercised by an institutional lender to accelerate a residential mortgage, would be an unlawful restraint on alienation, against public policy, and therefore, not enforceable in this State if the lender exercises the clause solely for the purpose of allowing the lender to relend money at a higher rate of interest and not for the purpose of protecting the lender's security in the loan.

November 1980 Letter, p. 72.

The Maryland Court of Appeals in *Chapman* did not discuss the possibility that the due-on-sale clause contained in the mortgage might constitute an unreasonable restraint on alienation or be unenforceable for other reasons. Nevertheless, one must question whether the case might be decided differently today or whether a slight change in the facts might provide a different result. The case law in many states dealing with this question has changed over the last six years. *See* Annot., 69 A.L.R. 3d 713 (1976). Most states have followed the approach taken by the California courts. This approach also seems to be the one that Attorney General Sachs would like the Maryland courts to follow.

A recent Maryland case deserving attention in light of the above discussion is *Daugharthy v. Monritt Associates*, 293 Md. 399, 444 A.2d 1030 (1982). *Daugharthy* deals with the "wrap-around" mortgage, a mortgage which wraps around, or is in addition to an existing mortgage. It would be entirely speculative to draw any conclusions from the *Daugharthy* case, but it does give some indication of how the Court of Appeals might view a due-on-sale or due-on-encumbrance case today.

In *Daugharthy*, the court held that a "wrap-around mortgage" was "subject to" the existing mortgage and not an assumption of that mortgage. The court's reasoning was based on language which expressly stated that it was taken "subject to" the existing mortgage. The existing mortgage included a clause stating:

> The parties agree that the said deferred purchase price shall be assumable by a later purchaser, should grantor herein sell the property to a third party, provided however that the note holders, or assignee or assignees, shall have the right to change the rate of interest to a prevailing rate of interest as of the time of such assumption.

Daugharthy, 293 Md. at 401, 444 A.2d at 1031.

This clause was intended to allow the mortgagee to raise the interest rate upon the sale of the property. The court, however, refused to allow the mortgagee to either accelerate the balance due or increase the interest rate, holding that Maryland law regarding assumptions is clear. Where there is an express contrary agreement to take "subject to" rather than assume liability, the existing mortgage is not assumed, and neither the acceleration clause nor the interest rate clause is triggered. *See Brice v. Griffin*, 269 Md. 558, 307 A.2d 660 (1973).

The *Daugharthy* case can be interpreted as either a strict-construction case or as a reluctance on the part of the court to allow lenders to increase mortgage interest rates upon the sale of property. The latter view is more likely. It does point out, however, that in Maryland both lenders and borrowers should be certain of the language contained in any due-on clause because a Maryland court will probably interpret it literally and strictly. If such a clause is required, a borrower should have it written as an assumable mortgage with an interest rate escalation clause upon sale. One can then follow the *Daugharthy* case closely, hopefully, in order to pass the low-interest mortgage on to the purchaser. A lender should be sure to include a due-on-sale clause similar to the example given at the beginning of this article. In the event of a sale or transfer of the property, a higher or blended interest rate can be offered if the language in the mortgage is clear and not open to judicial interpretation.

Presently, Maryland lenders and borrowers seem to be content to operate under the guidelines provided by Maryland Attorney General Sachs. Those guidelines basically follow the federal approach. Therefore, a due-on-sale clause in a mortgage is probably enforceable by the lender. A due-on-encumbrance clause is probably enforceable by the lender when it is exercised to protect the lender's security interest and unenforceable when it is exercised solely to improve its loan portfolio.