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Articles

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I. INTRODUCTION

In *Wellenkamp v. Bank of America*[1] the California Supreme Court

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1. 21 Cal.3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). The court in *Wellenkamp* was required to construe California Civil Code section 711 which states: "Conditions restraining alienation, when repugnant to the interest created, are void." *Wellenkamp* itself was the latest development in a recent series of California Supreme Court opinions restricting the use of due-on-sales clauses in various contexts. In *Wellenkamp* the Court was concerned with the effect of the clause in an outright sale, that is, "any sale by the trustor of property wherein legal title (and usually possession) is transferred." 21 Cal.3d at 950, 582 P.2d at 974, 138 Cal. Rptr. at 383.

In Coast Bank v. Minderhout, 61 Cal.2d 312, 392 P.2d 265, 38 Cal. Rptr. 505 (1964), there was an agreement against encumberance or transfer of the property. The Court recognized that such an agreement restrains alienation but held the restraint tolerable, so long as it was reasonable under the circumstances.

La Sala v. American Sav. & Loan Ass'n, 5 Cal.3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971), involved a different restriction— that of a due-on-encumbrance clause. This type of provision gives the lender the right to accelerate the loan balance not simply because of sale, but due to further encumbrancing of the property. The Court allowed this form of restraint only as long as it was necessary to protect the lender's security. *La Sala* provoked legislation speaking to the problem, CAL. CIV. CODE §2949. This section prevents acceleration of loan obligations on further encumbrance; section 2924.6 applied the same concept to residential dwellings of from one to four units.

Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal.3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974), was the most clear signal of the imminency of *Wellenkamp* and was the case that sparked FHLBB action on due-on-sales clauses. *Tucker* involved an installment land sale contract. There the court held that the restraints caused by acceleration were unreasonable. In so doing it fashioned

effectively prohibited real property lenders from using the due-on-sales clause,[2] a provision commonly found in lending instruments,[3] as a device to rid investment portfolios of unprofitable loans. *Wellenkamp* appeared in 1978, just when savings and loan associations began to feel the economic squeeze created by rising interest rates and keen competition among lenders for investment dollars.[4] Prior to *Wellenkamp*, lenders had begun to use the due-on-sales clause to ease this pressure by retiring or forcing the renegotiation of old loans made below the prevailing market rate. The California Supreme Court blocked this strategy by limiting the ability of lenders to accelerate loan balances on transfer or encumbrance of property to rare situations; thus, easy assumption of existing loans by new buyers became the public policy of the state.[5]

Eventually, powerful interest groups—realtors, consumers and lenders—were pitted against each other in the federal and state legislative arenas over the issue.[6] The controversy and consternation provoked by

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the test later to be used in *Wellenkamp* to determine the validity of due-on clauses in particular circumstances, that is, whether the quantum of restraint resulting through discretionary use of the clause, and the resulting "chill" on alienation, is justified by the lender's need to protect its security.

2. The "due-on-sales" clause is a provision allowing acceleration of the outstanding balance due on a loan. As the Court defined it in *Wellenkamp*:

> "A due-on clause is a device commonly used in real property security transactions to provide at the option of the lender, for acceleration of the maturity of the loan upon the sale, alienation or further encumbering of the real property security."

Wellenkamp, 21 Cal.3d at 946 n.1, 582 P.2d at 971, 148 Cal. Rptr. at 380.

3. Section 17 of the uniform mortgage instrument of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association is used in many loan agreements and reads in pertinent part:

> 17. Transfer of the Property; Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien of encumbrance subordinate to this Deed of Trust, (b) the creation of a purchase money security interest for household appliances, (c) transfer by devise, descent or by operation of law upon the death of a joint tenant or (d) the grant of any leasehold interest of three years or less not containing an option to purchase, *Lender may, at Lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable*. Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the Property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender *and that the interest payable on the sums secured by this Deed of Trust shall be at such rate as Lender shall request*. (Emphasis added.)

The option to accelerate the balance due on an original loan where resale is contemplated allows the lender to force the pay off of the old loan balance, or to negotiate a new, higher rate on the loan with new buyers. In either case, the lender has rid itself of an old loan at obsolete rates.

4. California Association of Realtors, Acceleration Upon Sale of Residential Property (statement of opposition to Assembly Bill 2158, May 4, 1981) [hereinafter referred to as Opposition Statement of May 4, 1981] (copy on file at the *Pacific Law Journal*).

5. *See Wellenkamp*, 21 Cal.3d at 953, 582 P.2d at 976, 148 Cal. Rptr. at 385; Dawn Investment Co. v. Superior Court, 30 Cal.3d 695, 703-04, 639 P.2d 974, 978, 180 Cal. Rptr. 335, 336 (1982).

6. In California, legislation sponsored by lenders was immediately introduced to overturn *Wellenkamp* after the case appeared. *See* A.B. 848, Cal. Leg., 1978-79 Regular Sess.; A.B. 790, Cal. Leg., 1980-81 Regular Sess.; A.B. 2158, Cal. Leg., 1980-81 Regular Sess. In 1981, federal legislation to preempt the issue for all lenders was introduced. *See* S. 1720, 97th Cong., 1st Sess. (1981). None of this proposed legislation has been enacted. Assembly Bills 848 and 790 did not reach the Assembly floor for a vote; Assembly Bill 2158 never came out of policy committee.

Wellenkamp were exacerbated by the important questions it left open.[7] The most significant of these, and one which may have sparked a revolution in the system of state and federal savings and loans and banks, was that of *Wellenkamp's* applicability to federally chartered institutions.[8] On June 28, 1982, the United States Supreme Court addressed this question in *Fidelity Federal Savings and Loan Association v. Reginald de la Cuesta*[9] establishing that California's restriction on the use of due-on-sales clauses, as well as those of numerous other states following a similar policy[10] had been preempted by federal agency regulation.[11]

The most immediate impact of *De la Cuesta* was to increase the flight of state savings and loan associations to the federal system.[12] This has resulted in further stagnation of the home sales market due to the un-

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Senate Bill 1720 was put out of the Senate Banking Committee after significant amendment on August 19, 1982, and further action on it is expected in the fall of this year.

7. *See Wellenkamp*, 21 Cal.3d at 953, 582 P.2d at 976-77, 198 Cal. Rptr. at 385-86. *See generally* Crane, *Wellenkamp v. Bank of America: A Victory for the Consumer*, 31 HASTINGS L.J. 275, 299-305 (1979); Musacchio, *A Case for Preemption: Wellenkamp v. Bank of America is Inapplicable to Federal Savings and Loans*, 20 SANTA CLARA L. REV. 219, 221 (1980).

8. *See generally* Crane, *supra* note 7; telephone interview with Robert Wolfe, California Department of Savings and Loans on September 1, 1982 [hereinafter referred to as conversation with Robert Wolfe] (according to information gathered by Mr. Wolfe's staff, since 1981, 32 California savings and loan associations have gone to federal charter or have merged with federal associations); 46 Fed. Reg. 46,964 (1981) (to be codified at 12 C.F.R. pt. 30) (proposed September 23, 1981) (by this proposed regulation, national banks as well as federal savings and loans will have the right to accelerate loans through due-on clauses without regard to state law).

9. 50 U.S.L.W. 4916 (U.S. June 28, 1982). *De la Cuesta* was the first of a number of cases involving due-on clauses to reach the United States Supreme Court for review, though the issue had already been addressed by some federal district courts. Most of these lower courts concluded that state law had been preempted by the FHLBB regulation. *See* Price v. Florida Federal Sav. & Loan Ass'n, 524 F. Supp. 175, 178 (ND Fla. 1981); First Federal Sav. & Loan Ass'n v. Peterson, 516 F. Supp. 732, 740 (ND Fla. 1981); Dantus v. First Federal Sav. & Loan Ass'n., 502 F. Supp. 658, 661 (Colo. 1980); Bailey v. First Federal Sav. and Loan Ass'n., 467 F. Supp. 1139, 1141 (CD Ill. 1979). *But see*, Holiday Acres No. 3 v. Midwest Federal Sav. & Loan Ass'n., 308 N.W.2d 471, 475-78 (Minn. 1981).

In *De la Cuesta*, appellees purchased property from various borrowers of Fidelity Federal Savings and Loan Association [hereinafter referred to as Fidelity]. The original borrowers had given as security for their loans deeds of trust on the properties that contained due-on-sales clauses. When Fidelity learned of each transfer, it gave notice of its intention to enforce the due-on-sales clauses, but offered, alternatively, to consent to the transfers and waive acceleration rights if the new buyers would agree to a higher interest rate on the loans. They refused, the accelerated loans were not paid and foreclosure proceedings were instituted. Each new buyer filed a suit in the Superior Court of California for Orange County seeking a declaration that *Wellenkamp* prevented acceleration, and injunctive relief against foreclosure and damages. The Superior Court consolidated the actions and then granted summary judgment for Fidelity on the ground that federal law had preempted California's due-on-sales restrictions. The California Court of Appeal, Fourth Appellate District reversed, petition for hearing in the California Supreme Court was denied and the United States Supreme Court then noted probable jurisdiction.

10. For instance, at the time of the decision, the following states had joined in an Amicus brief of the State of Michigan in support of appellees: Arkansas, Arizona, Colorado, Connecticut, Illinois, Indiana, Kansas, Maine, Minnesota, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, South Carolina, Vermont, Washington and Wisconsin. Amicus Curiae Brief of the State of Michigan, *De La Cuesta*; [hereinafter referred to as Brief of Michigan] (copy on file at the *Pacific Law Journal*).

11. *De la Cuesta*, 50 U.S.L.W. at 4920.

12. Telephone conversation with Ron Kingston, California Association of Realtors (September 2, 1982).

certainty created by these newly "federal" institutions claiming that they may exercise due-on-sales clauses in transactions entered into after *Wellenkamp* but *before* their metamorphosis.[13] A protracted round of litigation over this issue, ending again in United States Supreme Court resolution, is expected.[14] Not surprisingly, strong pressure on the California Legislature to provide "parity" to state lenders by legislatively overruling *Wellenkamp* has increased.[15]

De la Cuesta, however, has far greater significance than its immediate effect on the housing market and the legislative stalemate over assumptions. The rights of home owners and lenders affected by the due-on-sales clause in a lending agreement can be most accurately characterized as individual contract and property rights. These rights involve substantive law issues which generally have been reserved to the states for resolution.[16] Nonetheless, the Supreme Court in *De la Cuesta* found that California's substantive law determining the proper use of the due-on-sales clause has been preempted by a regulation of the Federal Home Loan Bank Board (hereinafter referred to as the FHLBB) that was issued in 1976 and that only ambiguously establishes the federal policy in this area.[17] Thus, *De la Cuesta* might fairly be described

13. *See* San Francisco Chronicle, July 15, 1982, at 29, col. 4; *see also*, California Board of Realtors, Proposed Legislation to Reverse California Law on Mortgage Loan Assumability (statement of opposition, July 13, 1982) sec. III. K. [hereinafter referred to as Opposition Statement of July 13] (copy on file at the *Pacific Law Journal*).

14. For two recent California cases disputing the right of converted associations to exercise due-on clauses, see Arnstein v. World Sav. Ass'n., No. Civ. 506095 (Santa Clara Co. Sup. Ct. filed August 18, 1982) and Halter v. World Sav. Ass'n., No. C418533 (Los Angeles Co. Sup. Ct. filed July 20, 1982).

15. *See generally* Opposition Statement of July 13, *supra* note 13; Tentative Proposal: Loan Assumability of July 28, 1982 [hereinafter referred to as Tentative Proposal] (copy on file with *Pacific Law Journal*). This proposed settlement provided the basis for discussions between representatives of lenders and realtors and was hoped to result in compromise legislation emanating from the just ended 1981-82 California legislative session. "Settlement" discussions broke down and no legislation resulted.

16. *See* Aronson v. Quick Point Pencil Co., 440 U.S. 257, 262 (1979); Butner v. United States, 440 U.S. 48, 55 (1979); *cf.*, Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 479-493 (1973).

17. 12 C.F.R. §545.8-3(f) (1981). This regulation originally appeared as 12 C.F.R. §564.6-11(f). *See* 44 Fed. Reg. 39108, 39149 (1979). The text of the regulation is as follows:

> (f) Due-on-sale clauses. An association continues to have the power to include, as a matter of contract between it and the borrower, 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. Except as provided in paragraph (g) of this section with respect to loans made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, exercise by the association of such option (hereafter called a due-on-sale clause) shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract.
> (g) Limitations on the exercise of due-on-sale clauses. With respect to any loan made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, 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

as a striking intrusion on state prerogatives. Certainly it gives added impetus to current Congressional efforts to enact national due-on-sales legislation that will apply to all real property lenders, state or federal.

Thus, *De la Cuesta* is important for several reasons: (1) by creating a dichotomy between state and federal savings and loans on the due-on-sale issue it intensifies pressure at the state level for legislators to create parity between state and federal institutions and to experiment with real property finance; (2) due to the economic uncertainty created by this dichotomy, *De la Cuesta* may have elevated an issue of serious local concern to one of national importance, thus buttressing the legal basis for federal legislation in the area; and finally, (3) *De la Cuesta* may be the harbinger of increased federal encroachment on individual contract and property rights through the vehicle of the preemption doctrine. This article will discuss the legal framework giving rise to the *De la Cuesta* opinion and its economic context. It will then describe in more detail the practical impact of the decision. Throughout, it will focus on the implications of *De la Cuesta* and related cases for the continued vitality of the preemption principle.

II. PREEMPTION—THE LEGAL FRAMEWORK OF *DE LA CUESTA*

State law pertaining to matters generally within the sovereign power of states (for example, property law and family law) may still be invalidated by the preemption doctrine if it conflicts with or frustrates the purpose of federal law validly made.[18] However, before state law must

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(iv) granting of a leasehold interest of three years or less not containing an option to purchase; (2) shall not impose a prepayment charge or equivalent fee for acceleration of the loan by exercise of a due-on-sale clause; and (3) *waives its option to exercise a due-on-sale clause as to a specific transfer if, before the transfer, the association and the person to whom the property is to be sold or transferred* (the existing borrower's successor in interest) *agree 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*. Upon such agreement and resultant waiver the association shall release the existing borrower from all obligations under the loan instruments, and the association is deemed to have made a new loan to the existing borrower's successor in interest. (emphasis added).

18. *See* Free v. Bland, 369 U.S. 663, 666 (1962) ("The relative importance to the State of its own law is not material when there is a conflict with a valid federal law, for the Framers of our Constitution provided that the federal law must prevail."); *see also*, McCarty v. McCarty, 453 U.S. 210, 232-33 (1981), Ridgway v. Ridgway, 454 U.S. 46, 54-55, (1981).

Constitutional authority for the preemption doctrine derives from the supremacy clause, U.S. CONST. art. VI, cl. 2, which provides:

> This Constitution and the law of the United States which shall be made in pursuance thereof; and all Treaties made, or which shall be made under the Authority of the United States, shall be the Supreme Law of the Land.

For federal law to have preemptive force it must derive from the constitutionally permissable exercise of federal power. Theoretically, the federal government is one of enumerated and, therefore, limited powers. *See, U.S. Const.* art. I, sec. 8. The Tenth Amendment to the Constitution recognizes this principle and reserves to the States powers not specifically allocated to the federal sphere. *See, U.S. Const.* amend. X. Nonetheless, countless Supreme Court opinions have established "beyond peradventure" that the commerce clause by itself is a "grant of plenary authority

give way to federal law in the face of the supremacy clause, a 'clear manifestation' of intent to preempt must be found.[19] Clear Congressional authorization to preempt is especially important where the law to be displaced falls traditionally within the main province of the state. As of this writing[20] there is no federal legislation prohibiting state restriction on the use of due-on-sales clauses. Thus, proponents of the preemption analysis have been forced to rely on less clear manifestations of federal purpose.

The system of federally chartered savings and loan associations was created by the Home Owner's Loan Act of 1933 (hereinafter referred to

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to Congress," National League of Cities v. Usery, 426 U.S. 833, 840 (1976), while the tenth amendment has been described as a "truism," stating merely that all is retained which has not been surrendered. United States v. Darby, 312 U.S. 100, 124 (1941). Accordingly, the sole constitutional grounds for invalidating federal law based on the clause have been findings that (1) there was no rational basis for the congressional determination that regulated activity affected interstate commerce, or (2) that there was no reasonable relation between the regulatory means chosen and the avowed federal purpose. Heart of Atlanta Motel, Inc. v. United States, 379 U.S. 241, 262, 268 (1964). Nonetheless, the United States Supreme Court's recent opinions in National League of Cities v. Usery, 426 U.S. 833 (1976) and Hodel v. Indiana, 452 U.S. 314 (1980), have made the constitutionally mandated division of state and federal power somewhat uncertain.

By a bare majority, the Court in *Usery* apparently transformed the tenth amendment from a truism to a potential curb on federal power. Justice Rehnquist's opinion for the Court did so by suggesting that where federal law is so intrusive as to undermine the States as sovereign entities, it may be prohibited by the tenth amendment, even if it otherwise properly rests on the "plenary" power of the Commerce Clause, 426 U.S. at 842-845. In a vigorous dissent Justice Brennan charged the majority with a "patent usurpation of the role reserved for the political process by their discovery in the Constitution of a restraint derived from sovereignty of the States." *Id.* at 858 (Brennan, J., dissenting).

Later and notwithstanding this "discovery," the Court in *Hodel* sustained the federal government's power, to regulate the very use of land within a state's borders, a matter obviously affecting the States' sovereign powers. 452 U.S. at 324. Surprisingly, Justice Rehnquist concurred in the result without referring to the Court's previous decision in *Usery*. *Id.* at 307-13. *Usery* left undescribed the various "attributes" of state sovereignty which might be insulated from federal regulation by the tenth amendment. 426 U.S. at 845. Read broadly, *Usery* could stand for the proposition that matters within the police power of the States may be entitled to tenth amendment protection wherever conflicting federal law impacts upon the states as sovereign entities. In contrast, *Hodel* approved federal law intruding on the power of states to determine the use of land within their boundaries, a matter seriously affecting the states' viability as sovereign entities themselves. While it is certainly possible to distinguish *Hodel* from *Usery* on the facts, the implications of both leave the exact division of power between the state and federal spheres in doubt where state police powers are involved. Should the Garn legislation be enacted insofar as it purports to directly preempt state due-on-sales law applying to state chartered savings and loans and banks, this division may be again examined.

19. Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947) ("historic police powers are not superseded by the federal act unless that is the clear and manifest purpose of Congress"). *See also*, Florida Lime & Avocado Growers v. Paul, 373 U.S. 132, 142 (1963) ("The principle to be derived from [the Supreme Court's] decisions is that federal regulation of a field of commerce should not be deemed preemptive of state regulatory power in the absence of persuasive reasons").

20. No provision of the Homeowner's Loan Act of 1933, 12 U.S.C. §§1461-1470 (1976 & Supp. V 1981) [hereinafter referred to as HOLA] speaks to the issue of due-on-sales clauses. Senate Bill 1720, known as the "Depository and Institutions Insurance Act of 1981," contains language preempting state law on due-on-sales for all commercial lenders. *See* S.1720, 97th Cong. 1st Sess. §141 (1981) (amending 12 U.S.C. §1735f-7. Senate Bill 1720 must still find its way through various committees and be passed on affirmatively by the House.

as HOLA)[21] in the midst of the Depression to provide a response to a state system of savings and loan rendered inadequate by dire economic conditions.[22] At that time, the FHLBB, which had been created by a section of the earlier Federal Home Loan Bank Act[23] (hereinafter referred to as FHLBA) was charged with the responsibility, "under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation and regulation" of federal savings and loan associations by section 5(a) of HOLA.[24] The congressional grant of agency authority to the FHLBB through HOLA was broad and vague. Aside from the power to promulgate rules and regulations necessary to effectuate the creation, operation and regulation of federal savings and loans, the Board was generally charged with the mandate, in so doing, to give, "primary consideration to the best practices of local mutual thrift and home financing institutions in the United States."[25] Thus, the original Congressional grant of authority might have been broad enough to authorize agency regulations pertaining to federal savings and loans that promote the economic good health and continued existence of such institutions. After this grant of authority, the FHLBB proceeded to adopt various rules and regulations for the administration of federal associations that have been characterized as regulating these institutions from "cradle" to "corporate grave".[26] Nonetheless, in all the years since HOLA's enactment, and even in the face of the economic hard times suffered by savings and loans due to a tight money supply and deregulation of the money market, Congress has not created legislation prohibiting the states from restricting the use of the due-on-sales clause by federal lenders.

In 1976, shortly after the appearance of *Tucker v. Lassen Savings & Loan Association*[27] and before *Wellenkamp*,[28] the FHLBB promulgated a regulation explicitly giving federal savings and loans the authorization to include due-on-sales clauses in their standard loan agreements.[29] By its literal terms, the regulation was permissive only and did not express any policy regarding the actual exercise of the clause. However, the preamble to the regulation[30] (an interpretive regulation

21. 12 U.S.C. §§1461-1470 (1976).
22. *De la Cuesta*, 50 U.S.L.W. at 4922 & n.18.
23. 12 U.S.C. §1437 (1976).
24. 12 U.S.C. §1464(a) (1976).
25. *Id.*
26. People v. Coast Fed. Sav. & Loan Ass'n, 98 F. Supp. 311, 316 (S.D. Cal. 1951).
27. 12 Cal.3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974). *Tucker* prohibited the discretionary exercise of due-on encumbrance clauses and formulated the test for unreasonable restraints on alienation further articulated in *Wellenkamp*. For a more detailed discussion of the case, see note 1, *supra*.
28. *See* Crane, *supra* note 7, at 304.
29. 12 C.F.R. 545.8-3(f). For the full text of the regulation, see note 17, *supra*.
30. 41 Fed. Reg. 18,286, 18,287 (1976).

at most[31]) proclaimed that it was the intent of the FHLBB in creating the rule that the exercise of due-on-sales clauses be governed by federal law without regard to state restrictions. This regulation and its preamble are central to the lenders' preemption argument in *De la Cuesta*.

An agency regulation may serve to preempt state law, just as federal legislation does.[32] However, the regulation must be within the scope of power delegated to the agency by Congress[33] and must reasonably relate to the purpose of the statute it serves.[34] In turn, the original Congressional action on which the regulation rests must have been constitutionally permissible.[35] The power of the FHLBB due-on-sales regulation to preempt state law in *De la Cuesta* depends on its relationship to HOLA, the original act creating the system of federal savings and loans, and inferences that can be drawn about Congressional purposes in creating it in 1933.

Preemption may be either express or implied.[36] And, a "preemptive regulation's force does not depend on express congressional authorization to displace state law."[37] If the scheme of legislation is so pervasive that Congress left no room for state supplementation in the area, or if the federal purpose is so dominant, "that the federal system will be assumed to preclude enforcement of state laws on the same subject," then the state law must fall.[38] Similarly, even where the federal legislative framework fails to occupy the entire field, state law will be invalidated when it "actually conflicts" with federal law.[39] Actual conflict is present when compliance with both state and federal law is impossible,[40] or when state law frustrates the purposes of federal law.[41] Clearly, HOLA provides no explicit authorization for preemption of state law relating to due-on-sales clauses—the specific issue had no occasion to arise in the enactment of the statute in 1933.[42] Preemption here must rest on a more ambiguous ground, namely, the general purpose of HOLA and the scope of authority to regulate originally delegated to the FHLBB.

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31. Chrysler Corp. v. Brown, 441 U.S. 281, 315-316 (1979).
32. *See*, Blum v. Bacon, 50 U.S.L.W. 4634, 4636-37 (U.S. June 14, 1982); *Free v. Bland*, 369 U.S. 663, 668 (1962).
33. United States v. Shimer, 367 U.S. 374, 381-382 (1961).
34. *Id.*
35. *See generally* Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1209 (1824); note 18, *supra*.
36. *See* Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977).
37. *De la Cuesta*, 50 U.S.L.W. at 4919; *see also* 367 U.S. at 381-83.
38. Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).
39. *See* McDermott v. Wisconsin, 228 U.S. 115, 132 (1913); Florida Lime & Avocado Growers, 373 U.S. at 142, 141-42 (dictum).
40. *Id.*
41. Hines v. Davidowitz, 312 U.S. 52, 67 (1941); *see also* Nash v. Florida Indust. Comm., 389 U.S. 235, 239 (1967); Jones v. Rath Packing, 430 U.S. at 526.
42. *See generally* 12 U.S.C. §§1461-1470.

Proponents of the preemption argument assert that HOLA granted the broadest plenary power to the FHLBB and that the dominant purpose of the statute was to establish a system of federal savings and loans to supplement beleaguered state associations in economic distress.[43] This broad characterization of HOLA may lead to the conclusion that *any* regulation promoting the economic health of federal associations accomplishes the federal purpose.[44] But does such a broad interpretation of HOLA also lead inexorably to the conclusion that it authorizes serious intrusions into matters of special state concern so as long as the intruding agency regulation can be reasonably related to this vague, changing and essentially economic standard?

The mere presence of a federal regulatory agency with substantial authority does not, without more, establish Congressional intent to preempt state law.[45] The exercise of state power may touch upon matters of such local concern that it can coexist with an extensive federal regulatory framework.[46] This has been particularly true where the state law at issue emanates from the historical common law categories and is concerned with adjusting the rights and liabilities of individuals rather than creating a competing state regulatory scheme.[47] There was ample evidence before the Court in *De la Cuesta* that it was *not* the purpose of Congress, when it authorized the chartering of federal savings and loan associations, to also insulate them from state contract and property law, thereby establishing a self-contained, segregated system dependent on yet to be developed federal common law.

A different characterization of the original purpose of HOLA is justifiable, that is, that federal savings and loans were created to provide a quick and effective means to halt home foreclosures by the acquisition and refinance of home loans. This required an infusion of mortgage capital and a system similar to the bank federal reserve system for thrift associations.[48] The number of state associations was simply not sufficient to accomplish this purpose.[49] No evidence indicates that HOLA was enacted to displace the state associations or to oust state law and practices regarding savings and loans. In fact, the federal system of

43. *See generally* Jurisdictional Statement of Appellants at 13-24, *De La Cuesta* 50 U.S.L.W. 4916; Musacchio, *supra* note 7, at 231-233.

44. *De la Cuesta*, 50 U.S.L.W. at 4923 ("Congress delegated power to the Board expressly for the purpose of creating and regulating savings and loans as to ensure that they would remain financially sound institutions.")

45. L. TRIBE, AMERICAN CONSTITUTIONAL LAW, 386-90 (1978).

46. *See, e.g.*, Head v. New Mexico Board of Examiners in Optometry, 374 U.S. 424 (1963).

47. *See* Linn v. United Plant Guard Workers Local 114, 383 U.S. 53, 61 (1966). *But cf.*, San Diego Building and Trades Council v. Garmon, 359 U.S. 236, 242 (1959).

48. *See generally* Brief of Michigan, *supra* note 10; 12 U.S.C. §1463 (repealed); 77 Cong. Rec. 2486 (April 27, 1933) (remarks of Representative Goldsborough).

49. *See, e.g.*, 77 Cong. Rec. 4987 (June 5, 1933) (remarks of Senator Buckley); 77 Cong. Rec. 2487 (April 27, 1933) (remarks of Representative Reilly).

national banks served as the model for the federal system of savings and loans. And, at the time HOLA was enacted it was clear that the contract rights of national banks were to be governed by state law.[50] In the light of the application of state law to national banks, it is doubtful that Congress meant to deviate from this fundamental notion in the creation of federal savings and loan associations. It is suggestive that the Comptroller of the Currency has yet to promulgate a regulation similar to the FHLBB rule for banks (though after *De la Cuesta*, such a regulation is imminent) and that no federal preemption argument was made in *Wellenkamp*, though the defendant Bank of America is a national bank.[51]

Prior to *De la Cuesta*, dualistic governance of federal savings and loan associations prevailed.[52] Matters directly relating to the chartering, organization and internal regulation of these associations were within the sole ambit of federal power and were established by myriad FHLBB regulations.[53] With respect to other matters, however, matters that some courts and commentators have characterized as relating to the external operation of these institutions, state law governed.[54] Before the appearance of *De la Cuesta*[55] and in the absence of direct Congressional direction, no one would have seriously suggested that the federal charter of a savings and loan association rendered it immune from state property taxes, zoning requirements and the like.[56] State law was deemed to govern the contract and property rights of these entities in their individual and "external" business transactions with the citizens of a particular state, as well.[57] Section 8 of the FHLBA, HOLA's precursor, seemed to acknowledge this.[58]

Notwithstanding the important state concerns involved and the generalized federal purpose embodied in HOLA, the Supreme Court had

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50. First National Bank of Louisville v. Kentucky, 76 U.S. 353, 362 (1870).

51. *But see* 46 Fed. Reg. 46, 964 (1981) (to be codified at 12 C.F.R. §30) (proposed September 23, 1981).

52. *See generally* 12 U.S.C. §1464(a) (Supp. II 1978); Musacchio, *supra* note 7, at 226.

53. *See* Gulf Federal Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 651 F.2d 259, 266 (5th Cir. 1981) *cert. pending*, No. 81-1744; Holiday Acres No. 3 v. Midwest Federal Sav. & Loan Ass'n, 308 N.W.2d 471, 478 (Minn. 1981).

54. *See* Brief of Michigan, *supra* note 10, at 15-20; Gulf Federal Sav. & Loan Ass'n., 651 F.2d 259; Holiday Acres No. 3, 308 N.W.2d 471. *But cf.*, Conference of Federal Sav. and Loan Associations v. Stein, 604 F.2d 1259 (9th Cir. 1979) *aff'd*, 445 U.S. 921 (1980).

55. *See De la Cuesta*, 50 U.S.L.W. at 4924 (O'Connor, J., concurring).

56. *Id.* at 4926.

57. Butner v. United States, 440 U.S. 48, 54-55 (1979).

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently. . . . The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee.

Id.

58. 12 U.S.C. §1437.

little problem in concluding that state restrictions on the "flexible"[59] FHLBB approach to due-on-sales clauses actually conflict with federal law by frustrating its objective and purpose.[60] Along with *McCarty v. McCarty*[61] and *Ridgway v. Ridgway*,[62] *De la Cuesta* is another instance of the Court's continued willingness to intrude on the police powers of the states and to retreat from the development of a stricter preemption standard where these state powers are involved.

Prior to the appearance of *McCarty* and *Ridgway*, a narrower preemption test had been applied by the Court when state law regarding domestic relationships was subject to a preemption claim.[63] In those sorts of cases the Court demanded a showing that Congress had "positively required by direct enactment" that state law be preempted and, secondly, that the state law in question "must do major damage" to the "clear and substantial" federal interest involved.[64] An equally narrow standard might be justifiable when contract and property rights other than those emanating from the marital estate are involved.

Though the Court in *McCarty* and *Ridgway* couched its approach in the rubric of this two-part test, its actual analysis in each demonstrated a retreat from these requirements and signaled an increased enthusiasm for the use of the preemption docrine even where the state police power is concerned.[65] Similarly in *De la Cuesta* no special consideration for state prerogatives was evinced because the state law at issue involved matters within the state's ambit of control.[66] It was enough for the proponents of preemption to logically link the most general characterization of HOLA's original purpose in 1933 to the FHLBB regulation made in 1976 and then to show a reasonable relation between the two. If this is to be the Court's approach, particularly where the source of preemption is attenuated from the direct expression of Congressional will, what are the limits of encroachment on state perogatives through preemption?

The issue to be resolved in *De la Cuesta* divided the Court.[67] Justices

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59. 50 U.S.L.W. at 4919.

60. *Id.*, at 4920 n. 13.

61. 453 U.S. 210, 211 (1981). *McCarty* held California's community property law to be impliedly preempted by the federal system of military retirement benefits. The issue has since been directly addressed by Congress by legislation giving the military spouse an interest in retirement benefits H.R. 749, 97th Cong., 2d Sess., 128 CONG. REC. H5957 (daily ed. Aug. 16, 1982).

62. 454 U.S. 46 (1981). *Ridgway* held that Maine's power to impose a constructive trust on insurance proceeds pursuant to a final decree of dissolution incorporating a property settlement agreement was impliedly preempted by the federal system of military insurance. *Id.* at 60.

63. Hisquierdo v. Hisquierdo, 439 U.S. 572, 581 (1979) (citing United States v. Yazell, 382 U.S. 341, 352 (1966)).

64. *Id.*

65. Bierman & Hershberger, *Federal Preemption of State Family Property Law: The Marriage of* McCarty *and* Ridgeway, 14 PAC. L.J. 27 (1982).

66. *De La Cuesta*, 50 U.S.L.W. at 4919 ("These principles [preemption] are not inapplicable here simply because real property is a matter of special concern to the States").

67. The majority opinion was written by Justice Blackmun. Justice Powell took no part in

Rehnquist and Stevens dissented from the majority.[68] In his dissent Justice Rehnquist acknowledged that the FHLBB did have the authority to promulgate regulations regarding due-on-sales clauses for federally chartered savings and loans,[69] but for him, the recognition of this authority, and its relation to HOLA, did not also require a conclusion that state law was preempted: "there is no indication in the FHLBA that the Board may, by promulgating regulations, preempt those state laws that are deemed to be economically unsound," and "there is no indication in HOLA itself, or in its legislative history, that Congress has empowered the Board to determine whether and when federal law shall govern the enforceability of particular provisions contained in mortgages."[70]

Justice O'Connor, while joining in the majority result, felt constrained to concur.[71] It was her concern that the majority's approach might be interpreted to open the way for unlimited intrusion on state power through preemption:

> Nothing in the language of . . . HOLA . . . remotely suggests that Congress intended to permit the Board to displace local laws . . . not directly related to savings and loan practices. Accordingly, in my view, nothing in the Court's opinion should be read to the contrary.[72]

But the question remains: If no special showing of Congressional intent to preempt or no real demonstration of the state law's actual negative impact on the federal objective need be made, what practical limitations on federal power through preemption exist, other than those emanating from the fundamental concept of enumerated powers itself? A brief analysis of the economic context of *De la Cuesta* indicates that the deleterious effect of state restrictions on due-on-sales clauses would have been difficult to demonstrate if "major damage" to the federal purpose had to be shown before preemption could occur.

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the decision. Justice O'Connor wrote a short, concurring opinion. Justice Rehnquist authored a dissent in which Justice Stevens joined.

68. *De la Cuesta*, 50 U.S.L.W. at 4924-25.

69. *Id.* at 4925.

> In declaring the due-on-sale clause enforceable as a matter of federal law . . . the Board has departed from the approach contemplated by Congress. Although Congress has authorized the Board to regulate the lending activities of federal savings and loan associations, there is no indication in HOLA itself, or in its legislative history, that Congress has empowered the Board to determine whether and when federal law shall govern the enforceability of particular provisions contained in mortgages concluded by federal savings and loan associations. If anything, section 8 of the FHLBA indicates that it was Congress' understanding in 1932 that the enforceability of provisions in mortgages is a matter of state law.

70. *Id.*

71. *Id.* at 4924.

72. *Id.*

III. THE ECONOMIC CONTEXT OF *DE LA CUESTA.*

Critics of the *Wellenkamp* decision have accused the California Supreme Court of misapprehending the economic purpose and effect of the due-on-sales clause in reaching its result.[73] This charge is understood in the context of *Wellenkamp*'s specific facts.

In 1973 the Mans purchased property in Riverside county. $19,100 of the purchase price was financed through the Bank of America by the Mans' promissory note in that amount secured by a deed of trust on the property. The interest rate on the loan was 8%. In 1975 Cynthia Wellenkamp bought the property and financed her purchase by paying the Mans their equity in the property and agreeing to assume the balance of their loan with the Bank of America. A grant deed reflecting the purchase was properly recorded and the bank was notified of the assumption. Wellenkamp commenced making payments on the loan, but the bank returned her first payment, and notified her that it would waive its right to accelerate the outstanding balance due on the loan only if she agreed to assume the loan at an increased interest rate. Wellenkamp refused to accede to the increased rate. The Bank of America instituted foreclosure proceedings and Wellenkamp then filed an action in which she sought an injunction against enforcement of the due-on-sales provision of the deed of trust and a declaration that the Bank's exercise of the provision was an unreasonable restraint on alienation absent a showing that the Bank's security had been impaired as a result of the sale to her. The trial court sustained Bank of America's general demurrer for failure to state a claim for relief on the ground that automatic enforcement of the due-on-sales clause was valid under California law. On appeal, the California Supreme Court reversed.[74]

Extending its holding in *Tucker*, the court in *Wellenkamp* required a lender to demonstrate that the transfer of property will impair its security before the due-on-sales clause may be enforced.[75] And, the court made it clear that a showing of "impairment of security" could be generally satisfied only by proof of a transaction likely to cause physical waste to the subject property or depreciation in its value.[76] In reflecting on this standard, commentators have observed that it makes exercise of the due-on-sales clause almost impossible in all but the most unique

73. *See generally*, Crane, *supra* note 7; Musacchio, *supra* note 7; Pratt Report, *The Due on Sale Clause in California and Federally Chartered Savings and Loan Associations* (copy on file with the *Pacific Law Journal*) (cited in Crane, *supra* note 7, *passim*); Federal Home Loan Bank Board, Due-on-Sale Task Force Report (1982); Position Paper of California Banker's Association (copy on file at the *Pacific Law Journal*).

74. *Wellenkamp*, 21 Cal.3d at 946-947, 582 P.2d at 971-72, 148 Cal. Rptr. at 380-81.

75. *Id.* at 953, 582 P.2d at 976-77, 148 Cal. Rptr. at 384-85.

76. *Id.* at 951-953, 582 P.2d at 975-76, 148 Cal. Rptr. at 385-86.

circumstances.[77] The court rejected outright the argument that the lender's generalized interest in maintaining its loan portfolio at current interest rates justified the restraint occasioned by resort to the clause:

> Although . . . we recognize that lenders face increasing costs of doing business and must pay increasing amounts to depositors for the use of their funds in making long term real estate loans as a result of inflation and a competitive money market, we believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against a lender's impairment of security.[78]

The "business risk" that the Court referred to seemed to entail only the risk that inflation would cause a significant gap between the amount of money being earned by lenders from interest paid on older loans and the amount of money being paid out to depositors at current interest rates. The court did not focus on the effect of sustained high interest rates for new loan money on the average life expectancy of long term loans made at earlier and more attractive rates.[79] This omission coupled with the Court's brief treatment of the actual economic reality of real estate lending in California has led to much of the criticism of *Wellenkamp*. A clearer picture of the economics involved in the decision emerges from the following information gathered from various sources engaged in the general dispute.

In a position paper on the alleged effects of *Wellenkamp* submitted to the California Legislature (hereinafter referred to as "Banker's paper"), the California Banker's Association[80] asserted that prior to the sustained upward spiral in interest rates, the real life of a fixed rate long term loan, of for instance thirty years, was actually only 7.5 years in California.[81] Thus, lenders could make long term funds available at more attractive rates because they could rely on the estimate that 12% of the population would move annually and that a concomitant termination of a significant percentage of their outstanding loans would take place as new buyers opted for affordable new financing.[82] One might say that the average life expectancy of long term loans at 7.5 years was a fundamental assumption of lenders willing to make "long term"

77. Goodman, *The* Wellenkamp *Decision: How Will It Affect Real Estate Financing*, 54 CAL. ST. B.J. 34, 38 (1979).

78. *Wellenkamp*, 21 Cal.3d at 951-53, 582 P.2d at 975-76, 148 Cal. Rptr. at 385-86.

79. *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

80. California Banker's Association, The Wellenkamp Decision Position Paper (submitted by the California Banker's Association in 1981 to members of the California Assembly in support of Assembly Bill 2158) [hereinafter referred to as the Banker's Paper] (copy on file at the *Pacific Law Journal*).

81. Id. *passim*.

82. *See id.* at 3.

loans available to borrowers at attractive pre-spiral rates.[83] Exercise of the due-on-sales clause, then, could be viewed as a means to allow this fundamental assumption to operate when extraordinary increase in interests rates have made new buyers deviate from pre-spiral behavior.

In a report prepared by the Office of Policy Development and Research of the U.S. Department of Housing and Urban Development in 1980, (hereinafter referred to as the Housing Conference Report of 1980)[84] the Office concluded that, "a mortgage with a fixed interest rate and a due-on-sales clause is equivalent to a renegotiable rate mortgage with the provision that the rate will not change as long as the borrower owns the house."[85] If interest rates increase beyond fundamental expectations, the value of the mortgage asset declines. This decline may be characterized as a capital loss.[86] This loss is further exacerbated if changes in state law render the exercise of the due-on-sales clause invalid, even on the transfer of the property, because the expected life of the loan will be extended.[87] It has been estimated that the "losses" resulting from the frustration of the expectation of actual loan life span may rise as high as 600 to 800 million dollars annually for federal associations and up to 1.0 to 1.3 billion dollars for state and federal associations combined.[88]

Losses of this magnitude may be difficult for the savings and loan industry to absorb. The Housing Conference Report of 1980 marshals statistics concerning the yield to debt ratio of the Federal National Mortgage Association (hereinafter referred to as FNMA) as evidence for the declining economic health of the thrift industry caused by *Wellenkamp*. The Report asserts that in October of 1981 the yield on FNMA's mortgage portfolio was 8.31%, while its average cost of debt was 7.8%.[89] By January of 1982 the yield was 9.25%, while cost of debt was allegedly 10.01%.[90] The Banker's paper asserts that this type of trend should be especially sharp in the case of state associations which have not been able to elude *Wellenkamp*.[91]

Prior to *Wellenkamp* the difference between the average maturity

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83. *See generally* U.C.C. §2-615 and Official Comments (1977). *See also* Appleton, Kennon & Pasternak, *Wellenkamp v. Bank of America: Boon or Bane to the Consumer?*, Los Angeles Daily Journal, June 19, 1981, at 3, col. 1.

84. *An Economic Analysis of Due-on-Sale Clauses, A Report Prepared by the Office of Policy Development and Research, U.S. Department of Housing and Urban Development at the Request of the 1980 Housing and Community Development Conference Report* (1980) [hereinafter referred to as the Housing Conference Report] (copy on file at the *Pacific Law Journal*).

85. *Id.* at 7.

86. *Id.*

87. *Id.*

88. *See* Federal Home Loan Bank Board, Due-on-Sale Task Force Report (1982) at 15 [hereinafter referred to as Due-on-Sale Report].

89. The Housing Conference Report of 1980, *supra* note 84, at 9.

90. *Id.*

91. *See* The Banker's Paper, *supra* note 80, at 12.

rates of loans originated by state and federal associations was approximately 8½ months.[92] Since 1977 (and due to *Wellenkamp*, the Banker's paper asserts) the difference is 8.9 years to the *disadvantage* of state associations.[93] But, a simple comparison of the yield to debt ratios of real property loans and inferences about the *possible* impact of *Wellenkamp*-like restrictions on those relationships does not really give an accurate picture of the economic condition of savings and loans. Such analyses, based on linked steps of logical, but empirically unproven inferences, have not established that state due-on-sales restrictions have a major impact on the federal objective of fiscally stable associations.

The effect of *Wellenkamp* is difficult, if not impossible, to isolate from the effects of inflation and deregulation of the money market in general. Some believe that it is the strategy of federal associations to exert leverage for advantageous due-on-sales legislation by threatening to pull out of the real estate lending market altogether.[94] The overall good health of savings and loans is suggested by the California Realtors Association, which points to a Merrill Lynch Market Letter of July 12, 1982, reporting that savings and loan stocks as a class increased 4.4% in value in the second quarter of 1982, while the Dow Jones Industrials suffered a 1.3% decline.[95]

While rising interest rates may have an uncertain impact on the overall condition of savings and loans, they have a stark effect on consumers and the housing market. Rising interest rates create an economic climate in which prospective home buyers, especially new buyers, may not be able to purchase a home at all without the option of loan assumption. If the due-on-sales clause were allowed to be automatically enforced in the face of this reality, a generalized restraint on alienation of property might obtain. It was this part of the economic picture with which the court in *Wellenkamp* was especially concerned.[96]

The California Board of Realtors estimates that approximately 80% of the almost 5 million owner occupied homes in California are subject to a mortgage that is assumable under California law.[97] In 1980, about 75% of all sales depended on some form of assumption.[98] The position of realtors and consumers seems to be that the fixed rate loan itself is an asset which belongs to the original buyer, an asset of great value in the current economy that can justifiably be sold along with the property

92. *Id.*
93. *Id.*
94. Opposition Statement of July 13, 1982, *supra* note 13, sec. II.F.
95. *Id.*, sec. II. J.
96. *Wellenkamp*, 21 Cal.3d at 950-951; 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.
97. Opposition Statement of May 4, 1981, *supra* note 4, at 1.
98. *Id.*, at 4.

itself.[99]

It has been asserted that certain standard provisions in loan agreements function in the nature of option contracts that, depending on the particular provision, may benefit the original buyer or lender.[100] One example of an option "embedded" within the loan agreement itself, is the prepayment provision which allows the original debtor to prepay the loan before it is due to avoid interest. This "option" allows the borrower to exercise the prepayment alternative so that it functions as a call option.[101] If interest rates fall, the borrower may prepay or, in effect, buy the loan for the principle outstanding balance and take advantage of lower interest rates that might be available with new financing.

The assumability of a loan may also be treated as an asset in the nature of an option where the lender is prevented from exercising the due-on-sales clause on transfer or further encumbrance of the property. If the original buyer may transfer the property to a new owner and the lender nevertheless may not call the loan due, then the homeowner has a put option and, in effect, is forcing sale of the loan (by forcing its extension beyond its natural life) to the lender at the original interest rate. Were the due-on-sales provision enforceable, the lender, rather than the borrower would possess the option and it too would be in the nature of a put option, forcing the sale of the mortgage to the original homeowner at the price of the original outstanding balance.[102]

The value of the assumability "option" in the hands of the home owner has been estimated to equal about 10% of the selling price of a similar home without such financing.[103] The real value of the option may be incalculable, if the presence of an assumable loan determines whether the home owner can sell his home at all. Realtors assert that in the current depressed housing market, sales are necessitatious—transactions are initiated because of job transfers, dissolutions of marriage, deaths, and the like.[104] Nonetheless, half of the 500,000 homes currently on the market will not sell at all.[105] According to market analyses conducted by the California Association of Realtors, further restrictions on loan assumptions may reduce already depressed sales by 25%.[106]

Aside from the impact on the 110,000 families who could neither buy

99. *See generally* Opposition Statement of July 13, 1981 *supra* note 13; Opposition Statement of May 4, 1981, *supra* note 4.
100. The Housing Conference Report, *supra* note 84, at 10-15.
101. *Id.* at 10-11.
102. *Id.* 12-15.
103. Banker's Paper, *supra* note 80, at 13.
104. Opposition Statement of July 13, *supra* note 13, sec. II.B.
105. *Id.*
106. *Id.*, sec. IV.D.

nor sell property due to this decline in possible home sales,[107] substantial revenue loss to the state may occur as well. Realtors assert that the aggregate value of one resale of an existing housing unit in 1981 was approximately $22,666.[108] This figure is derived from direct expenditures, transaction costs and use of retained equity.[109] Even without the presence of a multiplier factor added to the hard economic value of the transaction, the decline in sales caused by acceleration is estimated to deprive the state economy of about 1 billion dollars annually with a loss in government revenue of more than 600 million dollars per year.[110] If these figures even remotely indicate the true picture, the state has a clear economic interest beyond the concerns voiced in *Wellenkamp* in having its own law prevail.

In opposition to these consumer oriented arguments regarding the "ownership" of the option, lenders charge that prohibitions on due-on-sales clauses will have an impact on the secondary money market that has and will continue to shrink the amount of loan funds made available for California housing. Thus, they assert that the *Wellenkamp* case and similar results, in the long run, will actually harm consumers by causing sources of financing to become unavailable.

Put very simply, money for housing acquisition depends on a recurrent supply, or influx, of loan money from the secondary money markets.[111] The continuing interest payments of debtors to lenders can not alone regenerate funds necessary for new loan money. Thus, differential long-term mortgages are discounted to institutions in the secondary market in multi-million dollar blocks to generate a new supply of money; the institutions in turn sell interests in them to investors.[112] One obvious effect of prohibitions against exercise of due-on-sales clauses is to make loan documents sold on the secondary market from states following some form of *Wellenkamp* policy nonstandard. Aside from the impact on uniformity of loan instruments, lenders argue with some force that mortgages and deeds of trust that do not contain exercisable due-on-sales clauses simply won't be attractive items for sale on the secondary market.[113] The two institutions that mediate between lenders seeking to sell mortgages and investors wishing to buy them are the FHMA and the Federal Home Loan Mortgage Corporation (FHLMC).

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107. *Id.*, sec. II.D.
108. *Id.*
109. *Id.*
110. *Id.*, sec. IV.D.
111. *See generally* The Pratt Report, *supra* note 73; the Banker's Paper, *supra* note 80 at 7-10.
112. The Banker's Paper, *supra* note 80 at 7-10.
113. *See* Advisory Opinion of the FHLBB, Resolution No. 75-647, in Schott v. Mission Federal Sav. & Loan Ass'n, No. Civ.-75-366, at 30 (CD Cal., July 30, 1975). The FHLBB, in published statements concerning the proposed rule stated: "elimination of the due-on-sale clause will restrict and impair the ability of Federal associations to sell their home loans in the secondary mortgage market." 41 Fed. Reg. 6283, 6285 (1976).

California is heavily dependent on an inflow of mortage money from the secondary market to fuel its higher than average demand for home financing, because it is a state with a growing population and a housing shortage.[114] The Banker's paper asserts that since 1977, the FHLMC alone has "imported" into California more than 10 billion dollars of loan funds.[115] And, the association posits that California's diminishing sales of loans to the secondary market (approximately 15%) since 1977 is primarily attributable to *Wellenkamp*.[116] The Bankers' partial survey of savings and loan associations indicates that perhaps as much as 1 billion dollars of needed loan monies which could have emanated from the secondary market were diverted to other sources in the two years following *Wellenkamp*.[117]

One of the greatest problems stemming from the controversy about the effect of due-on-sales clauses is that no really reliable economic information is available to determine the true effect of prohibitions on the exercise of the clause on the health of the savings and loan industry and generally on the supply of loan funds.[118] This is true because it is difficult to isolate the effect of *Wellenkamp* from the overall impact of strict monetary policies that have driven up interest rates. Deregulation of the money market alone is an additional factor which would have had a significant impact on the health of the industry, absent *Wellenkamp*.[119] Consumers and realtors argue that there is simply a smaller volume of available mortgage money coming from the secondary market due to tight monetary policy and investor movement into other, more profitable activities.[120] Thus, a simple decline in mortgages sold on the secondary market establishes little or nothing about the real impact of *Wellenkamp* on the loan supply.

Further, while the FHMA and the FHLMC currently oppose prohibitions on the exercise of due-on-sales clauses,[121] it is questionable that these two dominating and government supported mediating institutions could or would pull out of *Wellenkamp* jurisdictions altogether. Currently, about 35% of FHLMC's portfolio is held in California.[122] These institutions are dependent on these sources of loans to sell to a great extent and can not exhibit perfect market behavior in the face of arguably less appealing loan paper. What may be true is that

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114. The Banker's Paper, *supra* note 80, at 8-9.
115. *Id.* at 7.
116. *Id.* at 8.
117. *Id.*, at 9.
118. The Housing Conference Report, *supra* note 84, at 9, 14 n.10.
119. *See generally*, Opposition Statement of July 13, 1981, *supra* note 13, sec. II.F.; Opposition Statement of May 4, 1981, *supra* note 4, at 6.
120. *Id.*
121. *See* July 2, 1982 Announcement of the FHLMC sent to Mortgage Corporation Seller Services [hereinafter referred to as July FHLMC Announcement].
122. Peninsula Times Tribune, July 18, 1981, at E1, col. 3.

the extent to which the amount of available loan money from the secondary market in California, and in other jurisdictions following a *Wellenkamp* result, has declined in excess of the national average, the decline may be partially attributable to the prohibitions against the due-on-sales clause. Concomitantly, the current condition of the savings and loan industry is probably exacerbated by the inability of some associations from some jurisdictions to limit the life span of long term loans through the mechanism of the due-on-sales clause. This uncertainty about the actual effect of the due-on-sales clause is especially problematic because a clear showing of such effect and its real impact on federal objectives should be demonstrated before the contract and property law of the States is displaced by federal policy.

IV. *De la Cuesta*—The Aftermath

During the pendency of *De la Cuesta* intense political activity over the due-on-sales controversy occurred on both state and federal levels. The actual appearance of the case intensified this activity and its result added a new dimension to the drama. What follows is a brief description of recent events surrounding the issue.

A. The California Experience

By its appearance in June, the *De la Cuesta* opinion contributed to a further stagnation of the housing market in California.[123] It also increased pressure on the legislative and executive branches of state government to provide state savings and loans parity with federal associations over the due-on-sales issues. While efforts by the California State Commissioner of Savings and Loans to achieve parity by simple regulation appear blocked,[124] *De la Cuesta* may break the legislative stalemate over the assumption issue that has existed in California since shortly after *Wellenkamp's* appearance.

As early as 1979, a bill sponsored by the California Savings and Loan League was introduced in the legislature, Assembly Bill 848, to reverse both *Wellenkamp*, and its precursor, *Tucker*. Consumer and realtor opposition was intense and the bill never came to a vote on the Assembly floor. In 1980-81, two attempts were made to legislatively overrule *Wellenkamp*. Assembly Bill 2158, sponsored by the California Banker's Association, was given extensive scrutiny in committee, but no final action was ever taken in the face of fierce opposition to it by consumers and realtors.

With the appearance of *De la Cuesta*, efforts to achieve a legislative

123. Conversation with Staff, California Association of Realtors, September 7, 1982.
124. 703 Op. Att'y Gen. 6 (1982). [Hereinafter Op. Att'y Gen.].

solution to the state/federal distinction over due-on-sales clauses were again renewed. This time, the interested factions engaged in "settlement" negotiations designed to result in a bill that would be acceptable to all.[125] The basis of these discussions revolved around the so-called "blended rate" approach. A blended rate involves the adjustment of interest rate on funds to be used to finance a home purchase that reflects a "blend" of the interest rate on the original obligation with prevailing interest rates for new loan money.[126] Realtors and lenders were unable to agree on what amount of the financed purchase would be subject to the blended rate,[127] that is, whether all of the amount financed would be subject to the mix up to 80% of the new purchase price, or whether the blend would apply only to the amount of the original loan, with full market rates obtaining for new financing. As a result of this impasse, no legislation emerged from the just ended 1981-82 session; it is expected that even more sustained efforts will be made in the next session to achieve a legislative compromise on the issue.[128]

De la Cuesta may have helped to intensify the movement of state chartered savings and loans to the federal system. Since 1981, 32 California state savings and loans have transferred to the federal system or merged with federal associations.[129] In 1979, section (a) of HOLA was amended to permit state associations to convert to federal charter.[130] While the disparity between state and federal savings and loans over due-on-sales clauses increases the attractiveness of federal conversion, the major impetus for the trend may be the ability of state associations to make interstate acquisitions.[131] Nonetheless, shortly after *De la Cuesta's* appearance, Linda Tsao Yang, the California State Commissioner of Savings and Loans, sought to issue a regulation that would have had the effect of immunizing state associations from *Wellenkamp*.[132] On August 17, 1982, the California State Attorney General's Office issued its opinion asserting that the Commissioner lacked the power to establish parity by regulation.[133] Because the opinion was

125. Tentative Proposal, *supra* note 15.
126. *Id.*
127. Telephone conversations with staffs of California Assemblyman Jim Costa and the California Association of Realtors, September 1, 1982.
128. *Id.*
129. Conversation with Robert Wolfe, *supra* note 8.
130. Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. 95-630, 92 Stat. 3641.
131. Conversation with Robert Wolfe, *supra* note 8.
132. *See generally* OP. ATT'Y GEN., *supra* note 124. The then Commissioner asserted her ability to grant parity pursuant to California Finance Code section 5500.5, which provides in pertinent part:

> Whenever by statute or regulation there is extended to federal institutions doing business in this state . . . any right, power, privilege, or duty not authorized herein to domestic associations, the commissioner may by regulation extend to domestic associations such right, power, privilege, or duty.

133. OP. ATT'Y GEN., *supra* note 124, at 4-6.

limited to the interpretation of the powers of the Commissioner given by the particular statute, intriguing state constitutional questions regarding separation of powers were never reached.[134] As will be discussed below, the California Supreme Court has continued to judicially extend *Wellenkamp* notwithstanding the pendency of *De la Cuesta* in the United States Supreme Court or the feverish activity the controversy has engendered in the state legislative and executive branches.[135]

B. Dawn Investment Co.

In early February 1982, the California Supreme Court made its first major decision concerning the due-on-sales controversy since *Wellenkamp*.[136] Notwithstanding the terrific controversy *Wellenkamp* has created, the pendency of *De la Cuesta*, or the legislative attempts to overturn *Wellenkamp* (and similar policies followed by other states), the California Supreme Court responded to questions left open by the original decision and extended *Wellenkamp* to new situations.[137] From a judicial perspective, easy assumability is still the public policy of the state.

Wellenkamp was limited by the Court's holding to its specific facts, that is, a transfer of residential property. The issues of prohibition against exercise of the due-on-sales clause for commercial property or non-institutional lenders were left unanswered. *Dawn Investment* specifically involved the exercise of the due-on-sales clause in a second deed of trust in the sale of a 16 unit apartment house.[138] When the property was resold, the holders of the second deed of trust refused to accept installment payments made by the new buyers and proceeded to accelerate the balance due through the due-on-sales clause. The new buyers sought injunctive relief to prevent the sale of the property after their refusal to pay the accelerated loan balance. The trial court granted the injunction and the private lenders petitioned for a writ of mandate to compel vacation of the injunction. The California Supreme Court denied the writ and made it clear that the policy of *Wellenkamp* is to obtain generally in California.[139]

In reaching this result the Court surveyed *Wellenkamp* and related cases. In so doing it again rejected outright the economic argument of lenders that the need to maintain a sound investment portfolio justifies resort to the clause. In stark contrast, the economic impact on federal

134. *Id.*
135. *See generally* Dawn Investment Co. v. Superior Ct., 30 Cal.3d 695, 639 P.2d 979, 180 Cal. Rptr. 332 (1982).
136. *Id.*
137. *Id.*, at 700-02; 639 P.2d at 976-78, 180 Cal. Rptr. at 334-35.
138. *Id.*, at 697; 639 P.2d at 974-75, 180 Cal. Rptr. at 332.
139. *See id.* at 699-704 639 P.2d at 975-79, 180 Cal. Rptr. at 333-37.

savings and loans of restrictions on acceleration was a key part of the federal *De la Cuesta* litigation.

The private lenders in *Dawn* argued that their situation differed from that of the Bank of America in *Wellenkamp* for a number of reasons.[140] First, they asserted that private lenders lack the resources necessary to establish impairment of security as required to be shown by *Wellenkamp*. Next, petitioners argued that since private lending is normally short term, the quantum of restraint occasioned by resort to the due-on-sales clause would be slight. The court found that this argument cut both ways—the "temporary" nature of this type of financing also reduced the need of the lender to accelerate and so reduced the interest to be balanced against the restraint created. In addition, the court brushed aside the petitioner's argument that their inability to spread the loss of a bad transaction should give them a greater interest in acceleration on transfer. The court summarily rejected petitioner's argument concerning their need to use the due-on clause to make reliable projections of economic status, an argument similar to the one made by institutional lenders in *Wellenkamp* and in *De la Cuesta*.[141]

When faced with the question of applying *Wellenkamp* to commercial sales of property, the court used an almost identical analysis of the issue as had been made in *Wellenkamp* itself to justify extension of the rule.[142] Ironically, in so doing, the court approved the disposition of the *De la Cuesta* case made previously by a California intermediate appellate court; this disposition was later overturned by the United States Supreme Court. Thus, after *De la Cuesta* and in the absence of any state legislative overruling of *Wellenkamp* or *Dawn*, a chaotic situation exists in California. Private lenders and the savings and loans that remain in the state system will be prevented from exercising due-on-sales clauses, whereas federal lenders protected by *De la Cuesta* will be free to accelerate on transfer. If federal legislation is enacted preempting state law regarding due-on-sales clauses for all institutional lenders, only private persons will be prevented from accelerating loan obligations on their purchaser's resale to another buyer.

C. The Garn Legislation, Converted Associations and Impairment of Contract Rights

In 1981, Senator Garn of Utah introduced a massive and controversial omnibus bill affecting various aspects of the financial industry.[143] Among its many sections Senate Bill 1720 contains a provision pre-

140. *Id.* at 700-02, 639 P.2d at 976-78, 180 Cal. Rptr. at 334-35.
141. *Id.* at 701-02, 639 P.2d at 977, 180 Cal. Rptr. at 335.
142. *Id.* at 702-04, 639 P.2d at 978-79, 180 Cal. Rptr. at 335-37.
143. S. 1720, 97th Cong., 1st Sess., §141 (1981).

empting state law on due-on-sales clauses.[144] Testimony was first taken on the bill in October of 1981. On August 19, 1982, it was passed out of the Senate Banking Committee after extensive amendment but with a due-on-sales provision still intact. This proposed legislation must still be acted on by various committees and then be passed on affirmatively by the House.[145]

Senate Bill 1720 attempts a compromise on the due-on-sales issue and a finesse of the constitutional issue raised by federal legislation affecting state and federal lenders. It provides that due-on-sales clauses may be exercised by state lenders notwithstanding state restrictions, but not until January of 1986 so that a "window" period is provided.[146] If during this window period the various state legislatures do not overtly adopt restrictions on the use of due-on-sale provisions, they are deemed to have acquiesced in the exertion of federal power. No window applies to federal associations—they are treated as having had the right to accelerate without regard to state restrictions at least as long as the FHLBB's 1976 regulation and perhaps before that.[147] In this way, the Garn Legislation anticipated the outcome of *De la Cuesta*.

If Senate Bill 1720 does become law, the status of converted associations will still be in doubt. Are they to be treated as state institutions and subject to the window or not? Of course, with respect to loans made after their conversion, these newly created "federal" associations claim that as federal savings and loans they are not subject to state restrictions on due-on-sales clauses. Even more startlingly, they have announced their intention to exercise rights under due-on-sales clauses in loan agreements executed while under state charter.[148] The problem of converted associations has already found its way into the California courts in what may be the test case on the subject. *Arnstein et. al. v. World Savings and Loan*,[149] an action seeking declaratory and injunctive relief and damages for interference with contract, with prospective economic advantage and for slander of title was filed in the California Superior Court, on August 18, 1982. In this case, plaintiff homeowners allege that the June 1982 resale of their home was frustrated when World Savings and Loan Association ("hereinafter "World") notified the new buyers of its intention to accelerate the balance due on the original loan unless they agreed to assume the loan at a higher interest rate.[150] The buyers terminated the transaction and the property re-

144. *Id.*
145. *Id.*
146. *Id.*
147. See generally note 13, *supra*.
148. *See*, Opposition Statement of July 13, 1981, *supra* note 13.
149. No. Civ. 506095 (Santa Clara Co. Sup. Ct. filed August 18, 1982).
150. Plaintiffs Complaint, *Arnstein* at 3-4.

mains unsold.[151]

In *Arnstein*, the loan at issue had been made in 1978 when World was still a California state association. In 1981 it converted to a federal charter.[152] Apparently, it wasn't until *De la Cuesta* appeared that World notified the parties of its intention to exercise the due-on-sales clause. By that time, the contract for sale had been executed and escrow had opened on the sale.[153] The success of the plaintiffs' claims for relief in *Arnstein* will depend on whether or not the court determines that World's current federal status, and thus its claim to the protection of *De la Cuesta*, operates to insulate it from state law relevant to loans made prior to its conversion. Because the exercise of federal power is not restricted by the limitations of the contract clause of the United States Constitution,[154] any legal impediment to absolute federal protection is unclear. Without this protection, however, World's refusal to accede to the transaction and its threat to exercise the due-on-sales clause might provide the basis for the related causes of action plead. The California Realtors Association is concerned that the FHLBB will facilitate this effort by issuing an advisory opinion that converted associations can apply *De la Cuesta* to all mortgages in their portfolios without regard to status of the association at their origin.[155]

The FHLMC jumped into the controversy adding its own leverage by announcing a change in its due-on-sales policy on July 2, 1982 that would have prohibited the future assumability of all mortgages owned in whole or in part by the corporation, subject to applicable state law.[156] Thus, all loans held by FHLMC that originated from federal lenders (and presumably converted associations) would have been subject to automatic acceleration by FHLMC on transfer "with no option for rate increase unless the Seller elects to repurchase the loan from the corporation".[157] The effective date of this proposed change has been delayed to January 1983, in anticipation of S. 1720.[158] If converted savings and loan associations are allowed to accelerate loan obligations made during their state status, or if some version of the Garn legislation emerges from Congress preempting state law on the issue for all commercial lenders, is there a basis for preserving the contract and property rights of individual debtors on these loans?

As mentioned above, the *federal* government is not prevented by the

151. *See id.*
152. *Id.* at 2, 4.
153. *See id.* at 4, 5.
154. U.S. CONST. art. I, sec. 10.
155. *See*, Opposition Statement of July 13, 1981, *supra* note 13.
156. July FHLMC Announcement, *supra* note 121.
157. *Id.*
158. Conversation with Ron Kingston, California Association of Realtors on September 2, 1982.

Contract Clause[159] from impairing contract rights. This is a provision that has served to limit the power of states in relation to their citizens.[160] Nonetheless, arguments against federal intrusion on contract rights have been made through the medium of substantive due process.[161] The characterization by realtors and consumers of the due-on-sales clause as a put option and one that ought to be the property of the home owner, supports these sorts of arguments in resistance to the federal trend. The California Realtors Association estimates that the asset "transfer" to lenders from owners occasioned by free exercise of due-on-sales clauses in California may rise as high as 1 billion dollars in the next few years.[162] Thus, the focus of the due-on-sales controversy has again shifted—this time the issues will involve some novel approaches to constitutional law.

V. CONCLUSION

Though the federal legislation involved in *De la Cuesta* and the specific basis of the preemption claim—an agency regulation—are not identical to those found in *McCarty* and *Ridgway*, the opinion still stands with recent Supreme Court cases effectuating preemption of state law involving the police power.

Along with decisions like *McCarty* and *Ridgway*, *De la Cuesta* stands as another inroad to state prerogatives and a demonstration of the vitality of the preemption doctrine in the hands of the Burger Court. While the Garn legislation, if passed, may make the specific issue of *De la Cuesta* old news, the opinion will remain important for its implications regarding the changing relationship between the state and federal spheres of influence.

De la Cuesta is a practical "landmark" as well. It contributes to the transformation of the dual system of state and federal savings and loan associations to a unitary one. When HOLA was enacted in 1933, savings and loan associations were solely state phenomena. HOLA created the alternative system of federal associations. It is ironical that now, in 1982, as it has been used to rationalize the preemption result of *De la Cuesta*, HOLA may be the destructive mechanism of state savings and loans. At the least, hindsight will show that *De la Cuesta* had a great effect on state and federal legislative innovations in real property finance. Most importantly, in its approach to preemption *De la Cuesta* raises serious questions about the limits of federal power exerted through the supremacy clause.

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159. U.S. CONST., art. I, sec. 10 ("No State shall . . . pass any law impairing the Obligation of Contracts").

160. *See* TRIBE, *supra* note 45, 464 n.1 (1978).

161. *Id.*; *Accord* Perry v. United States, 294 U.S. 330, 353-54 (1935); *see*, Lynch v. United States, 292 U.S. 571 (1934). *See Generally*, B. WRIGHT, THE CONTRACT CLAUSE OF THE CONSTITUTION (1938).

162. Opposition Statement of July 13, 1981, *supra* note 13, at 5.