

DUE-ON-SALE CLAUSES: CAN THEY STILL BE CHALLENGED?

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Introduction

The Garn-St Germain Depository Institutions Act of 1982, 12 U.S.C. sec. 1701j-3, *et seq.* (1982) (the "Act"), provides for the federal preemption of any limitations on the exercise of due-on-sale clauses imposed by state law. Since the passage of the Act, mortgage lenders generally have assumed that they no longer need to concern themselves with potential legal challenges to the validity or enforceability of such clauses in their mortgage loan documents. However, this complacency may be misplaced. This article will discuss and analyze those situations where mortgagors may still attempt to challenge -- and perhaps limit or even avoid -- the applicability, validity, or enforceability of due-on-sale provisions.

Land Contract vs. Outright Transfer

Occasionally, "clever" borrowers (and their counsel) have attempted to utilize land-contract transfers as a purported method of avoiding due-on-sale clauses in effect in existing mortgages on the subject property. This ploy again may become popular if interest rates continue to rise. *See* Mark E. Roszkowski, *Drafting Around Mortgage Due-on-Sale Clauses: The Dangers of Playing Hide and Seek*, 21 Real Prop. Prob. & Tr.J. 27, 29 (1986).

Fortunately (at least for lenders) the law is settled that a land-contract transfer constitutes a violation of a due-on-sale clause. The final regulations issued in connection with the Act define a "sale or transfer" as the conveyance of real property "or any right, title or interest therein, whether legal or equitable . . .," which includes outright sales, deeds, installment sales, land contracts, contract for deed and any other method of conveyance of real property interests. 12 CFR Part 591 (1983), sec. 591.2(b). The final regulations also provide that the creation of a vendor's or vendee's interest in a contract for deed does not fall within the exceptions contained in sec. 1701(j)(3)(d) of the Act, i.e., the limitation contained in sec. 1701(j)(3)(d) on the exercise of a due-on-sale clause in a residential real estate contract in the event of the creation of a secondary lien or encumbrance does not include a transfer of the property pursuant to a contract for deed. Sec. 591(b)(1)(i).

The Federal Home Loan Bank Board ("Board") felt that this clarification was necessary for the reason that if a transfer by contract for deed were considered to be a subordinate lien or encumbrance under this section, a loophole might be created enabling sellers of residential property to avoid the enforcement of due-on-sale clauses by use of a contract for deed to sell the property instead of an outright conveyance. Section 1701(j)(3)(d) of the Act provides that a lender may not exercise its option pursuant to a due-

on-sale clause upon the creation of a subordinate lien or encumbrance "which does not relate to a transfer of rights of occupancy in the property."

In the normal contract-for-deed situation, the right to occupancy of the property would be granted to the purchaser at the time the contract was executed. Apparently the Board was concerned about the situation where, e.g., the borrower transfers all or part of the property to a purchaser by use of a contract for deed and the original borrower retains occupancy until the contract for deed is paid off, or agrees to transfer occupancy of the property upon the fulfillment by the purchaser of certain conditions, such as the receipt of a stipulated portion of the payments due. The Board apparently also was concerned that a transfer of an interest in the property in this manner could be construed as a secondary lien or encumbrance and not as a transfer that would trigger enforcement of the due-on-sale clause. Therefore, the final regulations clarified that transfers by contract for deed do not create secondary liens or encumbrances entitled to the protection of sec. 701(j)(3)(d) of the Act, and that a conveyance by a borrower of all or a portion of the property by contract for deed constitutes a "sale or transfer" that would enable a lender to exercise its rights under a contractual due-on-sale clause.

For a good case-law discussion of this issue, see *Darr v. First Federal Sav. & Loan Ass'n. of Detroit*, 426 Mich. 11, 393 N.W.2d 152 (1986). In this case, the Michigan Supreme Court reversed the Michigan Court of Appeals and held that a land contract sale did not create a "lien or encumbrance subordinate to the mortgage" within the exclusion provision of the applicable due-on-sale clause in the standard FNMA/FHLMC agreement, and therefore such a sale was subject to the clause. The court noted that the fact that the land contract constituted a sale of the security was not disputed, and that even though an encumbrance may be adverse to the interest of the landowner when created in connection with a conveyance of real property, it does not conflict with his conveyance of the land in fee. The court also stated that the "lien or encumbrance" exception to the due-on-sale provision does not include liens that are created only as a result of the execution of a land contract that has as its primary purpose the transfer or sale of the secured property. Although the land-contract vendees in this case did not immediately assume the vendor's mortgage, this was only because the lender threatened to, and did, enforce the due-on-sale clause, and the land contract was in fact the instrument that created the obligation to assume the mortgage. Subsequent to this decision, in 1985, Michigan enacted a statute that provides that, with respect to a residential mortgage, any licensed professional who "aids or assists a person in evading the enforcement of a due-on-sale clause . . . shall be liable for a civil fine not to exceed \$5,000.00 for each offense and shall be subject to revocation of his or her license." MCLA 445.1628.

In another interesting decision, *Community Title Co. v. Roosevelt Federal Sav. & Loan Assoc.*, 796 S.W.2d 369 (Sup. Ct. of Missouri 1990), the court held that the mortgagee could not be held liable for tortious interference with a contract by rejecting title insurance from a title insurance company that encourages the use of contracts for deed in order to avoid the enforcement of due-on-sale clauses. The court found that the mortgagee, as the beneficial party to the title insurance policy, had an economic interest

in the proposed policy, and an economic interest in identifying those who sold or transferred an interest in property upon which the mortgagee held a deed in trust containing a due-on-sale clause.

Due-on-Sale and Prepayment

A frequently litigated issue involves whether the mortgagee may charge a prepayment premium if it accelerates the loan as the result of the mortgagor's violation of the due-on-sale provision in the loan documents. The regulations that were issued in connection with the Act state that "[a] lender may not impose a prepayment penalty or equivalent fee when the lender or party acting on behalf of the lender . . . declares by written notice that the loan is due pursuant to a due-on-sale clause." 12 C.F.R. § 591.5(b)(2)(i); 48 F.R. 32160-32162. Although the introductory comments to the regulations seem to make this language applicable to all loans, the revision was placed in the section of the regulations limiting the enforcement of due-on-sale clauses only "[w]ith respect to any loan on the security of a home occupied or to be occupied by the borrower." 12 C.F.R. § 591.5(b).

This federal prohibition with respect to prepayment penalties would not appear to apply with respect to commercial loans, but mortgage lenders nonetheless must still be careful to draft their prepayment-premium provisions to specifically state that the premium will be payable if the loan is accelerated by the mortgagee as a result of the mortgagor's default under any of the provisions of the loan documents (including violation of the due-on-sale clause).

If the prepayment provision does not specifically provide that the mortgagee may collect a prepayment premium upon acceleration of the loan, a court may not permit the mortgagee to collect this charge. For example, in *Slevin Container Corp. v. Provident Federal Savings & Loan Association*, 98 Ill. App 3d 646, 648-50, 424 N.E. 2d 939, 940-42 (2nd Dist. 1981), the Illinois appellate court held that in the context of a commercial loan, no prepayment penalty may be imposed when a loan is accelerated for violation of a due-on-sale clause. Similarly, in *McCausland v. Bankers Life Ins. Co.*, 110 Wash.2d 716, 721-22, 757 P.2d 941, 946 (1988) the court held, in a case involving acceleration of the debt as the result of the mortgagor's violation of the due-on-sale clause, that "[i]t is only fair that the lender be prohibited from demanding prepayment fees upon acceleration of the debt since . . . it is the lender who is insisting on prepayment"). See also N.Y. Real Property Law § 254-a (McKinney Supp. 1998) (prohibiting a prepayment fee upon the lender's exercise of a due-on-sale clause in connection with a residential mortgage); Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 Cornell L. Rev. 288, 343 n. 187 (January 1987); Gavin L. Phillips, *Validity and Construction of Provision of Mortgage or Other Real-Estate Financing Contract Prohibiting Prepayment for a Fixed Period of Time*, 81 A.L.R. 4th 423 (1991).

On the other hand, a comprehensively drafted due-on-sale clause should enable the mortgage lender to avoid this issue (at least in a commercial loan). For example, in *Eyde v. Empire of America Fed. Sav. Bank*, 701 F.Supp 126 (E.D. Mich. 1988), the mortgagors argued that the mortgagee had accelerated the debt not because of a default in the payment of principal and interest, but as the result of the mortgagors' alleged violation of

the due-on-sale provision in the loan documents. The court held that it was immaterial whether the loan had been accelerated for either reason, because the "clear intent" of the parties, as expressed in the prepayment-premium provision in the mortgage note, was that the mortgagee had the right to collect a prepayment charge in the event the debt was accelerated for any reason. The court found that the prepayment-premium provision was valid and enforceable because the parties had contractually agreed to allow the mortgagee to collect a prepayment penalty in the event of any acceleration. of the debt upon default by the mortgagor.

Federal associations may, in any event, include prepayment penalty clauses in commercial loan documents and enforce such clauses according to their terms regardless of any state law to the contrary (including equitable principles) because C.F.R. §§ 545.2 and 545.34(c), as amended at 49 F.R. 43044, authorize a Federal association to include a prepayment penalty clause in any loan it makes and to enforce such a clause in accordance with its terms regardless of any state law - including equitable principles in a foreclosure action - which purports to prohibit the collection of a prepayment penalty under certain circumstances. The preemptive effect of these regulations applicable to Federal associations is subject only to the limitations with respect to loans secured by borrower-occupied homes found or referred to in 12 C.F.R. 545.34(c) (governing disclosure and the imposition of a prepayment penalty after notice of an adjustment of an adjustable-rate mortgage) and the final rule regarding prepayment penalties with respect to residential property set forth in 12 C.F.R. 501(b). However, other federal legislation has limited or prohibited prepayment premiums or fees in connection with FHA loans (12 C.F.R. § 545.6-12(b); Veterans' Administration loans (24 C.F.R. § 207.253(a)); certain "high cost loans" (12 C.F.R. § 226.32), certain manufactured home loans (12 C.F.R. 590); and loans made by lenders subject to Federal Home Loan Bank Board regulations (38 C.F.R. § 36.4310).

The Alternative Mortgage Transactions Parity Act of 1982 (12 U.S.C. 3801), which regulates residential loans made by "housing creditors," permits covered lenders to preempt state law restrictions on prepayment penalties and provides for the insertion and enforcement of prepayment penalties in "alternative mortgage" instruments such as adjustable-rate and balloon mortgages. At the time of enactment, states were allowed to opt out of the preemption, but only six have done so: Arizona (in part); Maine; Massachusetts; New York; South Carolina; and Wisconsin (in part).

Mortgage lenders that are not subject to specific Federal regulations regarding prepayment premiums should consult applicable state statutory and case law with respect to the enforceability of a prepayment-premium provision in connection with the breach by the borrower of a due-on-sale clause. Under the Act, the lender should be able to impose a prepayment charge if the mortgagor violates the due-on-sale clause, unless it is clear that neither the contractual provision providing for a prepayment premium nor the due-on-sale provision in the loan documents can be construed to contemplate the payment of a premium in such an event. Federally regulated lenders (pursuant to statutes and regulations too numerous and detailed to mention in this article) should also enjoy similar protection with respect to commercial loans.

Agreement Not to “Unreasonably” Withhold Consent

The enforcement of a due-on-sale clause is always subject to contractual limitations contained in the mortgage provision. There is an area where tinkering with the contractual language that otherwise prohibits outright any unauthorized conveyance or transfer can get a mortgage lender in trouble, i.e., where the provision contains language that the mortgagee will not "unreasonably" withhold its consent. Does the use of such language prohibit the mortgagee from charging a transfer fee or an increase in the loan interest rate as a condition to giving its consent, or from withholding consent for a reason other than impairment of the security or failure of the proposed purchaser to meet the lender's creditworthiness standards?

The cases are divided as to whether the addition of language to the due-on sale clause providing that the mortgagee's consent will not be unreasonably withheld prohibits the mortgagee from imposing such additional requirements if they are not specifically stated in the provision. In *Torgerson-Forstrom H.I. of Wilmar, Inc. v. Olmstead Federal Savings. & Loan Association*, 339 N.W.2d 901 (Minn. Sup. Ct. 1983), the due-on-sale clause contained language that the mortgagee's consent to a transfer of the property would not be "unreasonably withheld." The mortgagee conditioned its consent to a proposed transfer on a two-percent increase in the interest rate to the current market rate. The mortgagor alleged that the proposed purchaser was creditworthy, and that the proposed rate increase constituted a breach of contract and tortious interference with contract. The mortgagor conceded, however, that the interest-rate increase would cause the interest rate for the loan to equal the current market rate for similar loans. The court held that under the circumstances, the required increase in the interest rate was not an "unreasonable" condition to the mortgagee's consent to the transfer. The court, relying on a prior decision, *Holiday Acres No. 3 v. Midwest Federal Savings & Loan Association*, 308 N.W.2d 471 (Minn. 1981), found that it was a fact of life that mortgage lenders raise interest rates upon the transfer of the mortgagor's interest in the property. Other cases have also held that the language in the due-on-sale clause that the mortgagee's consent "shall not be unreasonably withheld" did not preclude the mortgagee from withholding consent for a reason other than impairment of the mortgage security. *See, e.g., Crestview, Ltd. v. Foremost Insurance Co.*, 621 S.W.2d 816, 822-23 (Tex. Civ. App. 1981); *Western Life Insurance. Co. v. McPherson K.M.P.*, 702 F.Supp. 836, 842 (D.Kan.1988); *Rubin v.*

Centerbanc Federal Savings & Loan Association, 487 So.2d 1193, 1194-95 (Fla. 2nd DCA 1986).

However, other cases have held that where the due-on-sale clause provides that consent shall not be unreasonably withheld, the mortgagee may not raise the interest rate or charge a transfer fee in the absence of specific language permitting the mortgagee to do so. For example, in *Newman v. Troy Savings Bank*, 664 F.2d 52, (5th Cir. 1981), the court held that it was unreasonable for the mortgagee to exact a transfer fee of one percent where consent was not to be unreasonably withheld or denied and there was no language in the mortgage providing for the payment of a fee. Similarly, in; *Fogel v. S.S.R. Realty Ass'n*, 190 N. J. Super 47, 51-52, 461 A.2d 1190, 1192-93 (1983), the court found that, based on the language in the contract requiring that the mortgagee's consent not be unreasonably withheld, it was unreasonable for the mortgagee to require an increase in the interest rate as a condition to the conveyance of the secured property. *See also Destin Savings Bank v. Summerhouse of FWB, Inc.* 579 So.2d 232, 237 (Fla. 1st DCA 1991) ("in cases where the agreements contain in the due on sale clause language to the effect that consent to assumption will not be unreasonably withheld, court decisions have frequently construed such a provision as authorizing the trial court to test the withholding of consent against a standard of 'reasonableness' ").

The cases cited above that specifically prohibit an increase in the interest rate were decided before the effective date of the Act, or else did not consider the effect of the Act. It is arguable that the Act has totally preempted this area and that charging a fee or raising the interest rate is clearly reasonable and permissible under the Act, at least where the contract language does not otherwise restrict or limit enforcement of the due-on-sale provision.

The obvious solution to avoid a legal challenge is to draft the clause so that the "unreasonably withheld" language does not prohibit the mortgagee from raising the rate, charging a fee, or conditioning its consent on the approval of certain factors other than, or in addition to, the proposed purchaser's creditworthiness. For a drastic example of what can happen to a mortgagee when a due-on-sale clause contains only an agreement by the mortgagee not to "unreasonably" withhold its consent to an assignment and nothing more, *see Patel v. Gingrey*, 196 Ga. App. 203, 205-06, 395 S.E.2d 595, 597 (1990). In this case, the court held that an agreement by the lender merely not to "unreasonably" withhold its consent in the future with respect to a sale of the property was so uncertain, indefinite, and vague that it did not constitute an enforceable contract. *See also Annot., Validity and Enforceability of Due-on-Sale Real-Estate Mortgage Provisions*, 61 A.L.R.4th 1070 (1988); *Annot., What Transfers Justify Acceleration Under "Due-on-Sale" Clause of Real Estate Mortgage*, 22 A.L.R.4th 1266 (1983).

Change in Entity Ownership or Control

Although most mortgage lenders do not choose to deliberately restrict or limit the application of a due-on-sale-or-encumbrance clause in a mortgage, these clauses are sometimes negotiated - especially in connection with commercial loans - to exempt

certain conveyances, such as estate-planning transfers, leases or easements, or to permit certain "one time only" transfers or encumbrances (usually for a stipulated fee).

Furthermore, with the advent of securitized and conduit financing and the use of bankruptcy-remote borrowing entities to comply with rating-agency requirements, it has become more common for mortgage due-on-sale clauses to contain a "change of control" provision, i.e., a prohibition against certain "direct or indirect" changes in the equity ownership, control or management structure of the mortgagor (usually a limited partnership or limited liability company). This provision usually provides that if certain principal individuals or entities at any time own less than a specified percentage of the management, ownership, membership, general partnership, or voting interests of the borrowing entity, or if the borrowing entity sells, conveys, or assigns more than a specified percentage of such interests, a default will have occurred under the loan documents and the mortgagee may accelerate the loan. The parties of course heavily negotiate permitted transfers. Assuming that a senior mortgage note is securitized, rating agency affirmation may be required, even for permitted conveyances and transfers. Also, the lender on a junior note in a securitized transaction may want a separate approval right.

Provisions that prohibit or limit the change in ownership or control of the debtor have been enforced in the leasehold context. For example, in *In re Washington Capital Aviation & Leasing*, 156 B.R. 167 (Bankr. E.D.Va. 1993) the court held that language in the lease requiring the lessee-debtor's principal to control the lessee-debtor prevented a sale of stock in the debtor-lessee as a method of transferring its interest in the lease. Courts also will generally uphold an anti-assignment provision in a lease (or other agreement) where the language can be construed to apply to subsequent entity mergers and transfers "by operation of law." See, e.g., *Parks v. CAI Wireless Systems, Inc.*, 85 F. Supp. 2d 549, 555 (D. Md. 2000) ("under appropriate circumstances a corporate merger can result in the violation of an anti-assignment provision contained in a contract"); *The Citizens Bank & Trust Co. of Maryland v. The Barlow Corp.*, 295 Md. 472, 474, 456 A. 2d 1283, 1283 (1983) (holding that merger of corporate tenant under commercial lease into another corporation violated non-assignment clause that expressly excluded assignments by operation of law). See also Brent C. Shaffer, *Handling Assignment Clauses in an Age of Chameleon Entities (Part 1)*, 15 *The Practical Real Estate Lawyer* 61 (September 1999); Brent C. Shaffer, *Handling Assignment Clauses in an Age of Chameleon Entities (Part 2)*, 15 *The Practical Real Estate Lawyer* 45 (November 1999); Kathleen Hopkins and Cynthia Thomas, *Alligators in Commercial Leases: Transfers and Rights of First Refusal*, 16 *The Practical Real Estate Lawyer* 43 (March 2000).

If the mortgage lender does not draft the due-on-sale clause specifically to include these types of equity and control transfers, a court likely will determine that such transfers do not constitute a violation of the clause. For example, in *Fidelity Trust Co. v. BVD Associates*, 196 Conn. 270, 491 A.2d 180 (1985), the court held that a change of membership occasioned by the withdrawal of general partners of a limited partnership, which was a distinct legal entity and remained so after the change in the general partnership interests, was not sufficient to constitute a "sale or conveyance" under the applicable due-on-sale clause. In *Hodges v. DMS Co.*, 652 S.W.2d 762 (Tenn.App. 1982), the court held that in the absence of express language covering such a transfer, the

withdrawal of two of the partners of the partnership mortgagor, while the business was continued in lieu of liquidation, did not amount to a sale or transfer of the secured property even though the entity had changed by operation of law, and did not activate the due-on-sale clause.

Enforceability Against Non-Assuming Transferees

In recent years, transferees who obtained title to the mortgaged property pursuant to a deed whereby the conveyance was made subject to the existing mortgage, with no assumption of the underlying debt or the mortgage by the transferee, have occasionally challenged the ability of the mortgagee to enforce the due-on-sale provision against them. They argue that because they did not assume any of the obligations or liabilities under the original mortgage, they cannot be personally responsible for any violation of the clause or any debt deficiency.

In deciding this issue, the courts have considered whether a due-on-sale clause is a mortgage covenant that runs with (or “touches and concerns”) the land, or whether it is instead a condition that grants the mortgagee the option to accelerate the loan upon any unpermitted transfer. If the due-on-sale clause is determined to be a condition (as most such clauses are drafted) and not a covenant, then this provision cannot be “assumed” by the transferee. However, most commercial mortgages contain a “boilerplate” provision stating that each provision of the mortgage is binding upon the parties’ respective successors and assigns. This language would seem to favor the continued applicability of each of the mortgage provisions (including the due-on-sale clause) in the event of a transfer subject to the mortgage. *See Esplendido Apartments v. Metropolitan Condominium Association of Arizona II*, 161 Ariz. 325, 328, 778 P.2d 1221, 1224 (1989) (due-on-sale clause runs with the land and binds nonassuming grantee; mortgagee’s remedy is acceleration and foreclosure, not damages against the grantee). *But see In re Ormond Beach Associates Limited Partnership*, 184 F.3d 143, 157 (2nd Cir. 1999) (mortgage due-on-sale clause did not run with the land under Florida law; mortgagor’s grantee, which did not assume the existing mortgage when it acquired the property, was therefore not bound by, and did not breach, the clause).

Section 1701j-3(c) of the Act provides that a lender may enter into or enforce a contract containing a due-on-sale clause with respect to a real property loan “notwithstanding any provision of the constitution or laws (including the judicial decisions) of any State to the contrary.” The Act does not provide examples of what “laws to the contrary” are preempted. However, Section 591.5(a) of the Regulations states that “due-on-sale practices of Federal associations and other lenders shall be governed exclusively by the Office’s regulations, in preemption of and without regard to any limitations imposed by state law on either their inclusion or exercise including, without limitation, state law prohibitions against restraints on alienation, prohibitions against penalties and forfeitures, equitable restrictions and state law dealing with equitable transfers.” It is likely that this preemption provision of the Act would not apply in connection with transfers to nonassuming grantees of the mortgaged property, because the mortgagee would not in any event be prevented from accelerating the loan as a result

of the unpermitted transfer; it would simply be prohibited (as in the cases cited above) from obtaining a personal deficiency judgment against the transferee.

Modification or Elimination of Due-on-Sale Clause in Bankruptcy

A bankrupt debtor subject to mortgage containing a due-on-sale clause may file a Chapter 11 bankruptcy plan that seeks, pursuant to section 1123(a)(5) of the Bankruptcy Code (“Code”) to modify or delete the due-on-sale clause. Section 1123(a)(5) lists several means available to a debtor for plan implementation, including waiving of any default, extension of the maturity date or a change in the interest rate. However, section 1123(a)(5) does not provide for the modification of non-monetary terms of a secured creditor’s loan documents.

Because the deletion of the due-on-sale clause alters the legal, equitable and contractual rights to which the mortgagee is entitled under the mortgage, such deletion most likely renders the mortgagee’s class impaired under the Code (assuming, as is customary in single-asset bankruptcy cases, that the mortgagee’s claim is placed in a separate class by itself). The primary consequence of such a determination is that the mortgagee will be entitled to vote on behalf of such class to accept or reject the plan. 11 U.S.C. secs. 1123(a)(2), (3), (b)(1), 1126(c). *See, e.g., In re Barrington Oaks General Partnership*, 15 B.R. 952 (Bankr. D.Utah 1981). Pursuant to the debtor’s Chapter 11 bankruptcy plan in this case, the property was to be sold to a third party in violation of the due-on-sale clause. The bankruptcy court concluded that the mortgagee bank was impaired under section 1124 of the Code, stating “The bank is impaired because the sale to [the third party], even without a due on restriction, changes obligors and therefore alters rights under the instruments memorializing the loan.” *Id.* at 956. *Accord, In re Otero Mills, Inc.*, 31 B.R. 185, 187 (Bankr. D.N.M. 1983) (citing *In re Barrington Oaks General Partnership, supra*, with approval); *In re Real Pro Financial Services, Inc.*, 120 B.R. 216, 217-18 (Bankr. M.D.Fla. 1990); *In re Coastal Equities, Inc.*, 33 B.R. 898, 906-07 (Bankr. S.D.Cal. 1983).

Although the mortgagee’s class may be impaired for purposes of cramdown under the Code, bankruptcy courts have allowed the modification of loan documents, including the deletion of due-on-sale clauses. For example, in *In re Real Pro Financial Services, Inc., supra*, 120 B.R. at 219, the court found that the creditor’s argument that the court had no power to modify or alter a mortgage with a due-on-sale clause to be “wholly without merit. *See also In re Coastal Equities, Inc., supra*, 33 B.R. at 905 (“a due-on-sale clause is not something so sacrosanct that it is immune from modification in a bankruptcy setting”); *In re Western Real Estate Fund, Inc.*, 75 B.R. 580, 586-87 (Bankr. W.D.Okla. 1987); *In re P.J. Keating Co.*, 168 B.R. 464, 473 (Bankr. D.Mass. 1994); Jerald I. Ancel, Marlene Reich, and Gregory J. Seketa, *Are the Secured Creditor’s Loan Documents Inviolable?*, 13-Aug Am. Bankr. Inst. J. 22 (1994).

Under section 1111(b)(2) of the Code, an undercollateralized secured creditor is permitted to continue to be treated as a fully secured creditor under a plan that provides for the debtor’s retention of the collateral. The election is advantageous in those

situations where a creditor does not wish to incur an immediate loss and has confidence in the success of the debtor's reorganization or believes that its collateral will increase in value with the passage of time. A creditor making the election should attempt to assure that the restructured note and loan documents contain a due-on-sale clause providing for accelerated payment of the claim if the collateral is subsequently sold. The right to include a due-on-sale clause in the restructured agreement is enhanced if such a clause was contained in the original note and mortgage. Alternatively, the mortgagee can argue that a due-on-sale clause is a customary provision intended to promote the liquidity of institutional lenders.

Special Relief for Mortgagees

A mortgagor that ignores a violation of the due-on-sale clause may do so at its peril. In *Travelers Ins. Co. v. Corporex Properties, Inc.*, 798 F.Supp. 423 (E.D.Ky. 1992), the court expressly upheld a pre-negotiation agreement entered into between the mortgagor and the mortgagee in connection with the workout of a nonrecourse commercial mortgage loan on an office building. Because the mortgagor had conveyed the property during the negotiation discussions to a corporation controlled by it in violation of the due-on-sale clause in the mortgage, to better position the mortgagor for a "new debtor" bankruptcy, to avoid negative publicity, and to put the mortgagor, in its own words, "in a better position to negotiate on an even basis," the court, in an unusual form of relief awarded to the mortgagee, ordered a reconveyance of the property to the mortgagor. The mortgagor appealed the court's decision to the U.S Sixth Circuit Court of Appeals based solely on the court's order of reconveyance, but the mortgagor and the mortgagee subsequently reached a settlement providing for the conveyance of the property to the mortgagee by a deed in lieu of foreclosure, and the appeal was dismissed with prejudice.

Conclusion

It still may be possible to legally avoid the enforcement of a due-on-sale clause in certain limited instances, albeit almost always in those situations where the clause contains ambiguous limitations or has not been carefully and comprehensively drafted by the lender. Many courts would still prefer to construe due-on-sale clauses as illegal restraints on alienation notwithstanding federal law to the contrary. Mortgage lenders and their counsel should not give them the opportunity to do so by virtue of sloppy or inadequately drafted contractual language. The due-on-sale clause should be comprehensive and cover all conceivable forms of transfer and encumbrance. It also may be prudent for the mortgagor to specifically acknowledge that the due-on-sale provision is a bargained-for inducement for the mortgagee to make the loan, and to further acknowledge that the clause is reasonable and clearly understood. Where the mortgagee has agreed to permit certain transfers or encumbrances, or that its consent will not be unreasonably withheld, the clause should clearly set forth the terms and conditions under which its consent which will be granted in such situations. A sample of a negotiated due-on-sale clause, with certain permitted carveouts, is attached hereto as **Appendix A**. A sample of a due-on-sale clause for use in connection with a securitized mortgage-loan transaction is attached hereto as **Appendix B**.

APPENDIX A

Section _____. Unpermitted Transfers: For the purpose of protecting Mortgagee's security, keeping the Mortgaged Premises free from subordinate financing liens and/or permitting Mortgagee to raise the rate of interest due on the Note and to collect assumption fees, Mortgagor agrees that any sale, conveyance, further encumbrance or other transfer of title to the Mortgaged Premises, or any interest therein (whether voluntary or by operation of law), without Mortgagor's prior written consent, shall be deemed to be an unpermitted transfer ("Unpermitted Transfer") and, therefore, an Event of Default, which Unpermitted Transfers shall include but shall not be limited to:

- a.) any sale, conveyance, assignment or other transfer of, or the grant of a security interest in, all or any part of the legal and equitable title to the Mortgaged Premises, the Beneficial Interest, [or the beneficial interest in any land trust holding title to the Mortgaged Premises];
- b.) any sale, conveyance, assignment or other transfer of, or the grant of a security interest in, any share of stock of any corporation which (1) holds title to the Mortgaged Premises (other than the stock of a corporate trustee or a corporation whose stock is publicly traded) or the Beneficial Interest, or (2) constitutes a general partner of [Mortgagor] [the Beneficiary]; or the failure at any time of the Guarantors, collectively, to be the true and lawful owners of the unencumbered title to 100%, in the aggregate, of all classes of capital stock of _____, a _____ corporation (the "General Partner").
- c.) Any sale, conveyance, assignment or other transfer of, or the grant of a security interest in, a general partner's interest in any general partnership or limited partnership that holds title to the Mortgaged Premises or the Beneficial Interest, or the General Partner otherwise ceases to be the sole general partner of [Mortgagor] [the Beneficiary];
- d.) The failure at any time of the General Partner and the Guarantors, collectively, to be the true and lawful owners of the unencumbered rights, title and interest in and to at least 51%, in the aggregate, of the partnership interest, general and limited, in Mortgagor [the Beneficiary];
- e.) Any lease of all or any portion of the Mortgaged Premises other than _____.

Notwithstanding the foregoing:

- i.) Mortgagee may condition its consent to an Unpermitted Transfer upon the payment of a fee to Mortgagee and/or an increase in the rate of interest due on the Note; and
- ii.) in the event of a consent by Mortgagee to an Unpermitted Transfer or a waiver of a default by reason thereof, the same shall not constitute a consent to or waiver of any right, remedy or power accruing to Mortgagee by reason of any subsequent Unpermitted Transfer.

In the event of an Unpermitted Transfer, Mortgagee may declare the Maturity Date (as such term is defined in the Note) accelerated, and may declare the Indebtedness immediately due and payable in full, together with Additional Interest (as such term is defined in the Note) accelerated, and may declare the Maturity Date accelerated. Any consent by Mortgagee permitting a transaction otherwise prohibited under this Section ___ shall not constitute a consent to or waiver of any right, remedy or power of Mortgagee to withhold its consent on a subsequent occasion to a transaction not otherwise permitted by the provisions of this Section ___, and notwithstanding the giving of such consent, Mortgagor shall not engage in any “prohibited transaction” with any “party in interest,” as such terms are defined in the Employee Retirement Income Security Act of 1974, as amended from time to time.

No such consent shall be considered by Mortgagee unless the appropriate service fees and legal fees are paid in advance and no such consent shall be given unless Mortgagor agrees, in addition to any other conditions to such consent imposed by Mortgagee, that immediately upon closing of the subject sale or transfer, Mortgagor will provide Mortgagee with a copy of the deed or other instrument of conveyance and, if applicable, with an affidavit and agreement of indemnification regarding Internal Revenue Code Sections 1445 and 7701 in form and substance satisfactory to Mortgagee executed by the transferee under oath.

Section ___ Permitted Transfers. Mortgagee, for itself and its successors and assigns, agrees that, notwithstanding Unpermitted Transfers, the following transfers or assignments, upon written notice to Mortgagee, will be permitted without Mortgagee’s consent (collectively “Permitted Transfers”):

- a.) transfers by the Guarantors of a part of their respective interests in the General Partner to each other, or to themselves, as trustees, by inter vivos transfer in trust for the benefit of themselves or members of their immediate families (a spouse, lineal descendant or any spouse of a lineal descendant), PROVIDED THAT, following such transfers, Guarantors (or any family members or conservators thereof described in clause d below) shall remain the sole shareholders of the General Partner and shall be the

owners, for themselves or in trust for the benefit of themselves or members of their respective immediate families, of not less than one hundred percent (100%) of all classes of capital stock of the General Partner;

- b.) transfers by the Guarantors of a part of their respective interests in the General Partner to third party trustees, by inter vivos transfer in trust for the benefit of themselves or members of their immediate families, PROVIDED THAT, following such transfers, Guarantors (or any family members or conservators thereof described in clause d below) shall remain the sole shareholders of the General Partner and shall be the owners, for themselves or in trust for the benefit of themselves or members of their respective immediate families (as described in clause a above), of not less than one hundred percent (100%) of all classes of capital stock of the General Partner;
- c.) transfers by the limited partners of Mortgagor [Beneficiary of their respective interests in Mortgagor [Beneficiary], PROVIDED THAT (i) General Partner shall remain the sole general partner of Mortgagor [Beneficiary] and (ii) the General Partner and the Guarantors (or any family members or conservators of the Guarantors described in clause d below), together, shall be the owners, for themselves or (in the case of the Guarantors) in trust for the benefit of themselves or members of their respective immediate families (as described in clause a above), of not less than fifty-one percent (51%) of the partnership interest of [Mortgagor] [Beneficiary];
- d.) testamentary disposition or intestate distribution to members of the immediate families of the Guarantors or to conservators pursuant to court order, upon the disability of the Guarantors;
- e.) any sale, conveyance or other transfer of the Mortgaged Premises where the Indebtedness evidenced by the Note is paid off in full pursuant to the provisions of the Note;

PROVIDED, HOWEVER, that Permitted Transfers are not intended to circumvent the restrictions against Unpermitted Transfers set forth hereinabove; PROVIDED, FURTHER, that Permitted Transfers shall not effect in any way the obligations of _____ and _____ under the _____ Guaranty.

Notwithstanding anything herein to the contrary (i) [Mortgagor] [Beneficiary] shall notify Mortgagee ten (10) days before any such Permitted Transfer (other than a Permitted Transfer under clause (d) above) and (ii) no such Permitted Transfer (other than a Permitted Transfer under clause (d) above) shall be effective as to Mortgagee and General Partner shall remain as General Partner vis a vis Mortgagee for all purposes; and,

further provided that as an additional and independent source of recovery for Mortgagee, and as a condition to the effectiveness of such transfer as to any persons other than Mortgagee, the General Partner shall execute a guaranty of its recourse liability to Mortgagee under the Loan Documents, which guaranty shall be in form and substance satisfactory to Mortgagee. The failure of the General Partner to deliver such guaranty shall be an Event of Default hereunder.

APPENDIX B

Paragraph _____. Transfer or Encumbrance of the Property.

(a) Reliance on Borrower. Borrower acknowledges that Lender has examined and relied on the creditworthiness and experience of Borrower in owning and operating properties such as the Property in agreeing to make the Loan, and that Lender will continue to rely on Borrower's ownership of the Property as a means of maintaining the value of the Property as security for repayment of the Debt. Borrower acknowledges that Lender has a valid interest in maintaining the value of the Property so as to ensure that, should Borrower default in the repayment of the Debt, Lender can recover the Debt by a sale of the Property. Borrower shall not, without the prior written consent of Lender, sell, convey, alienate, mortgage, encumber, pledge or otherwise Transfer (as defined below) the Property or any part thereof, or permit the Property or any part thereof to be sold, conveyed, alienated, mortgaged, encumbered, pledged or otherwise Transferred.

(b) Definitions. A "**Transfer**" within the meaning of this Paragraph ____, shall mean any sale, conveyance, alienation, mortgage, encumbrance, pledge or transfer of the Property or any interest therein, or any change in the control of Borrower or any person who controls Borrower, and shall be deemed to include: (i) an installment sales agreement wherein Borrower agrees to sell the Property or any part thereof for a price to be paid in installments; (ii) an agreement by Borrower leasing all or a substantial part of the Property for other than actual occupancy by a space tenant thereunder or a sale, assignment or other transfer of, or the grant of a security interest in, Borrower's right, title and interest in and to any Leases or any Rents; (iii) if Borrower, any Guarantor, or any managing partner, general partner, member or manager of Borrower or Guarantor is a corporation, partnership, limited partnership, joint venture or limited liability company (an "**Entity**"), the voluntary or involuntary sale, conveyance or transfer of such Entity's stock, general or limited partnership interests, membership interests or other indicia of ownership (the "**Interests**") (or the interests of any Entity directly or indirectly controlling such Entity by operation of law or otherwise) or the creation or issuance of new interests, in one or a series of transactions by which an aggregate of more than 10% of such Entity's interests shall be vested in a party or parties who are not now stockholders, partners, general partners, limited partners, joint venturers or members, or there shall occur a change in control of such Entity; and (iv) if Borrower, any Guarantor or any general partner, managing partner, manager or joint venturer of Borrower or any Guarantor is a limited or general partnership, joint venture or limited liability company, the change, removal, resignation or addition of a general partner, managing partner, limited partner, manager, joint venturer or member, or the transfer of the interest of any general partner, managing partner, limited partner, or manager, or the transfer of the Interest of any joint venturer or member. As used herein, the term "**control**" means the possession by an individual or Entities or group of individuals or Entities, directly or indirectly, of the right, by virtue of any partnership agreement, articles of incorporation, by-laws, articles of organization, operating agreement or any other agreement, with or without taking any formative action, to cause Borrower to take some action or prevent,

restrict or impede Borrower from taking some action which, in either case, Borrower could take or could remain from taking were it not for the rights of such individuals.

(c) Risk or Impairment. Lender shall not be required to demonstrate any actual impairment of its security or any increased risk of default hereunder in order to declare the Debt immediately due and payable upon any Transfer which occurs without Lender's consent. This provision shall apply to every Transfer regardless of whether voluntary or not, or whether or not Lender has consented to any previous Transfer.

(d) No Waiver. Lender's consent to one proposed Transfer shall not be deemed to be a waiver of Lender's right to require such consent to any future occurrence of same. Any Transfer made in contravention of this paragraph shall be null and void and of no force and effect.

(e) Reimbursement of Related Expenses. Borrower agrees to bear and shall pay or reimburse Lender on demand for all reasonable expenses (including, without limitation, reasonable attorney's fees and disbursements, title search costs and title insurance endorsement premiums) incurred by Lender in connection with the review, approval and documentation of any such proposed Transfer.

(f) Permitted Transfers. Notwithstanding anything to the contrary contained in this Paragraph __, the following Transfers shall be "***Permitted Transfers***", which may occur without Lender's consent, provided that (i) Borrower gives Lender written notice of such Transfer together with copies of all related instruments at least ten (10) days prior to the date of the Transfer, and (ii) each such proposed Transfer complies with and/or satisfies all of the following requirements:

- (i) Investor Interests. "***Interest Holders***" in Borrower (i.e., limited partners, members in a limited liability company, or shareholders) as of the date of this [Mortgage] [Deed of Trust] shall have the right to Transfer their Interests, provided, however, that, after taking into account any prior Transfers of any nature after the date of this [Mortgage] [Deed of Trust].
 - (a) Aggregate Limitation. There shall not occur a cumulative Transfer of more than 49% of Borrower's Interests (including directly, indirectly or beneficially and including through one or more entities or trusts) as of the date hereof; and
 - (b) Individual Limitation. The proposed Transfer shall not result in that Transferee owning in the aggregate, together with all "***Immediate Family Members***" (i.e., the spouse and children of any Interest Holder) or any affiliates thereof or a trust established for the benefit of one or more Immediate Family Members, more than 20% of the Interests in Borrower (directly, indirectly, or beneficially and including through one or more entities or trusts), unless (1) approved in writing by Lender (an "***Approved Interest***

Holder”), or (2) the Transfer occurs to or for the benefit of an Immediate Family Member of an Interest by inheritance, devise or bequest or by operation of law upon the death of a natural person who was an approved Interest Holder.

- (ii) No Change in Control/No Default. No such Transfer shall result in a change of control of Borrower or the day-to-day operations of the Property, and no Event of Default or event which with the giving of notice or the passage of time would constitute an Event of Default shall have occurred and remain uncured, and in any event _____ shall be the person who shall exclusively hold and exercise control of Borrower and in that capacity shall be responsible for and in effective control of Borrower, the Property and Borrower’s day-to-day operations.
- (iii) Bankruptcy Remoteness. The legal and financial structure of Borrower after that Transfer and its shareholders, partners, or members and the single-purpose nature and bankruptcy remoteness of Borrower and its shareholders, partners or members satisfies Lender’s then current applicable underwriting criteria and requirements to the same extent Borrower would have satisfied those requirements without the proposed Transfer. At Lender’s request, Borrower shall deliver to Lender written confirmations from the Rating Agencies that such Transfer or series of Transfers will not result in a qualification, downgrade or withdrawal of any rating initially assigned or to be assigned in a Secondary Market Transaction.
- (iv) Reimbursement of Costs. Lender shall have been reimbursed for all reasonable expenses incurred by Lender in connection with the review and, if approved the approval and documentation of the proposed Transfer.

For purposes of the foregoing provision and limitations, (1) a change of control of Borrower shall be deemed to have occurred if there is any change in the identity of the individual or Entities or group of individuals or Entities who have the right, by virtue of any partnership agreement, articles of incorporation, by-laws, articles of organization, operating agreement or any other agreement, with or without taking any formative action, to cause Borrower to take some action or prevent, restrict, or impede Borrower from taking some action which, in either case, Borrower could take or could refrain from taking were it not for the rights of such individuals; and (2) an “*Immediate Family Member*” shall mean a spouse or a child of any Interest Holder.

(g) The following shall not be considered Transfers subject to the foregoing provisions and requirements:

- (i) The sale or other disposition of obsolete or worn out personal property that is contemporaneously replaced by comparable personal property of equal or greater value that is free and clear of liens, encumbrances and security

interests other than those created by this [Mortgage] [Deed of Trust] or the other Loan Documents.

- (ii) The grant of an easement, if prior to the granting of the easement Borrower causes to be submitted to Lender all information required by Lender to evaluate the easement, and if Lender, in its sole discretion, determines that the easement will not materially affect the operation of the Property or Lender's interest in the Property and Borrower pays to Lender, on demand, all costs and expenses incurred by Lender in connection with considering and reviewing Borrower's request.