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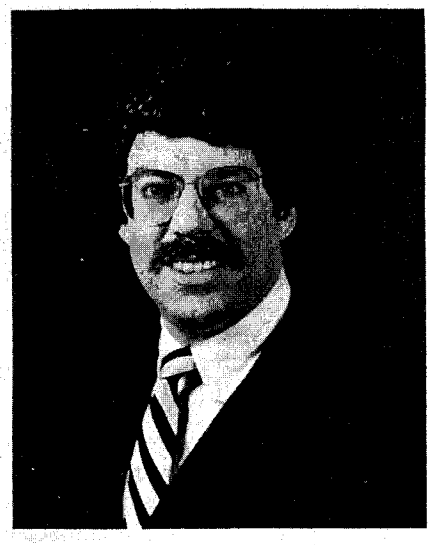
Due on Sale in New York: Clearer with Time?



Introduction

The April 1977 issue of the *New York State Bar Journal* contained an erudite and later oft - cited article on the subject of the due on sale clause in New York by Professor Leon Wein. At the time, there was but one case on this concept in the State[1] and the professor was surprised at the paucity of local litigation in an apparently vital area.

In addition to reviewing the limited case law, the article recognized the equities on both sides of the issue and recommended remedial legislation. That legislation has not been forthcoming. What has emerged, however, is some additional case law. Where the new decisions leave the status of the law is not as lucid as perhaps it should be, although we do have some guidance.

One of the modes of protection given a lender in a mortgage is the acceleration clause. This presents to the lender, or mortgagee, the *option* to declare the entire mortgage principal and interest immediately due and payable upon the happening of certain enumerated events.[2] An obvious such event is failure to make a mortgage payment, which has been treated with considerable strictness in New York,[3] although subject to

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[1] *Stith* v. *Hudson City Savings Institution*, 63 Misc. 2d 863, 313 N.Y.S. 2d 804 (1970)

[2] See Bergman, "Representing the Mortgagor: Can the Mortgage Be Saved? Part I" 55 *New York State Bar Journal 14* (February 1983) and Part II, 55 *New York State Bar Journal 26* (April 1983)

[3] *Graf* v. *Hope Building Corp.*, 254 N.Y. 1 (1930) *Ferlazzo* v. *Riley*, 278 N.Y. 289 (1938); *Albertina Realty Co.* v. *Rosbro Realty Corp.* 258 N.Y. 472 (1932); *Armstrong* v. *Rogdon Holding Corp.*, 39 Misc. 549, 247 N.Y. Supp. 682 (1930); *Mariash* v. *Bastianich*, 452 N.Y.S. 2d 190 (1st Dept. 1982); *Logue* v. *Young*, 463 N.Y.S. 2d 120 (3rd Dept. 1983)

some limited exceptions.[4] Less harshness is associated with other types of defaults such as failure to pay taxes,[5] alterations without consent,[6] among a number of others.[7]

The due on sale clause, also sometimes referred to as a due on transfer clause, is a part of an acceleration provision. In essence, it is a contractual agreement allowing a mortgagee to declare the entire loan balance immediately due and payable if the property securing the loan is sold or otherwise conveyed. That, at least, is the recognized *intention*. Significantly, precisely how the clause is drawn will affect its enforceability.

Why the Due on Sale?

The subject of the due on sale clause is of relatively recent vintage, which helps explain the dearth of reported decisions in existence at the time of the earlier mentioned article in 1977. Indeed, the clause has never been a part of the standard form of mortgage in New York. Employment of the clause, however, is common with lending institutions and skilled drafters of mortgage instruments.

Prior to the late 1960's, when interest rates were stable, lenders were not often concerned with assumptions of mortgages since the rate of return was not fluctuating. But when interest rates began to rise, older long term mortgages at below market interest rates became less economical for lenders bound to pay higher interest rates to depositors. As a consequence, both the use of the due on sale clause and its enforcement became important when previously it had either been nonexistent or inconsequential.

Because the very purpose of the clause is often an issue in decisions, the courts' view of its purpose should be examined:

- The financial security and stability of lenders could be endangered if the mortgaged property is transferred to one whose ability to repay the loan and/or maintain the property was inadequate.[8]
- Failure to use the clause would cause reduction of the cash flow and net income of lenders, in turn causing higher interest rates and loan charges on home loans generally.[9]
- Failure to use the clause will restrict and impair the ability of lenders to sell home loans in the secondary mortgage market, rendering them either unsalable or less valuable, in turn restricting new funds otherwise available for home loans.[10]
- It is the practice of banks to borrow short and lend long, which is obtaining funds on a short-term basis and investing them in long term real estate loans. Rising interest rates means the funds cost more. Exercising the due on sale clause allows the bank to alleviate the dilemma by replacing long term, low yield loans with those at prevailing rates.[11]
- Denial of the right to exercise the due on sale clause jeopardizes the solvency of institutional lenders.[12]
- Allowing lenders to have control over their funds through enforcement of the due on sale benefits the mortgage market.[13]
- The due on sale device encourages potential investors to place their funds in the mortgage market since there can be some adjustment to changing market conditions.[14]

Why a lender would wish to engage the due on sale clause is thus obvious. It is just as apparent why a mortgagor or his assignee would resist enforcement. When and under what circumstances the courts will support the exercise of the clause will vary with the language of the provision and the particular facts of each case.

Due on Sale Enforced

As a general proposition, the due on sale clause is enforced in New York State and the majority of decisions have so ruled.[15] The first time this question was raised in New York was in 1970.[16] The mortgage contained a typical due on sale clause permitting the mortgagee to declare the entire principal and interest immediately due and payable if the mortgagor sold or conveyed the property and if mortgagee did not consent to an assumption.

The property was sold with the mortgagee conditioning its consent upon an increase in the interest rate from 6% to 7%. When the purchaser declined to pay the higher interest, both mortgagor and purchaser sued for a declaration that mortgagor had a right to sell and purchaser had a right to buy the security and assume payment of the existing terms. The mortgagee counterclaimed for foreclosure.

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[4] *Nassau Trust Co.* v. *Montrose*, 56 N.Y. 2d 175, 451 N.Y.S. 2d 663 (1982); *Battim Associates* v. *L. & L. Estates*, 58 N.Y.S. 2d 96 (1945); *Manufacturers and Trades Trust Co.* v. *Cottrell*, 71 A.D. 2d 538, 422 N.Y.S. 2d 990 (4th Dept. 1979).

[5] *Noyes* v.*Anderson*, 124 N.Y. 175 (1881); *Bowery Savings Bank* v. *Corner Bay Shore Associates*, 46 Misc. 2d 788, 260 N.Y.S. 2d 457 (1965); *Ver Planck* v. *Godfrey*, 42 App. Div. 16 (1st Dept. 1899)

[6] *Loughery* v. *Catalano*, 117 Misc. Rep. 393, 191 N.Y. Supp. 436 (1921)

[7] *Rockaway Park Series Corp.* v. *Hollis Automotive Corp.*, 206 Misc. 955, 135 N.Y.S. 2d 588 (1954)

[8] *Fidelity Federal Savings and Loan Association* v. *de la Cuesta*, 73 L. Ed. 2d 664, 102 S. Ct. 3014 (1982)

[9] *Fidelity Federal Savings and Loan Association* v. *de la Cuesta, supra.*

[10] *Fidelity Federal Savings and Loan Association* v. *de la Cuesta, supra.*

[11] *Fidelity Federal Savings and Loan Association* v. *de la Cuesta, supra.*

[12] *Fidelity Federal Savings and Loan Association* v. *de la Cuesta, supra.*

[13] *Ceravolo* v. *Buckner*, 111 Misc. 2d 676, 444 N.Y.S. 2d 861 (1981)

[14] *Ceravolo* v. *Buckner, supra.*

[15] *Stith* v. *Hudson City Savings Institution, supra.; Mutual Real Estate Investment Trust* v. *Buffalo Savings Bank*, 90 Misc. 2d 675; *First Federal Savings & Loan Association of Rochester* v. *Jenkins*, 109 Misc. 2d 715, 441 N.Y.S. 2d 373 (1981); *Ceravolo* v.*Buckner, supra.; Neuburgh Savings Bank* v. *Grossman*, 118 Misc. 2d 1036, 462 N.Y.S. 2d 92 (1982); *Beacon Federal Savings and Loan Association* v. *Marks*, 91 A.D. 2d 1010 (2nd Dept. 1983); *Bonady Apartments* v. *Columbia Banking*, 119 Misc. 2d 923, 465 N.Y.S. 2d 150 (1983)

[16] *Stith* v. *Hudson City Savings Institution, supra.*

In upholding the due on sale, which was part of the acceleration clause, the court considered the language clear and unambiguous with its intent and purpose directly and intelligibly stated. The provision was held to be designed for the protection of the mortgagee and to make the security more effective.

In further support was the idea that lenders by using the due on sale reserve to themselves the right to determine whom they wish to accept as a debtor and to reappraise the desirability of the loan from the vantage point of its present value and condition in the interest marketplace. Significantly, the court reaffirmed the principle normally applied to defaults for principal and interest[17] that the acceleration clause was one which the parties to the mortgage agreed in a fair and legal contract and did not constitute a forefeiture or penalty.[18]

The next reported consideration of the due on sale clause came in 1977.[19] In the presence of such a clause, the mortgagor contracted to sell the property to a third party whose financial condition was *superior* to that of the mortgagor. When the mortgagee would not accept assumption by the third party, an action was instituted to declare the refusal - and the exercise of the due on sale - to be unreasonable under the circumstances.

The chagrined mortgagor alleged, but could not prove, certain nefarious reasons for the lender's refusal to permit assumption of the mortgage. While the court obliquely indicated that *proof* on this point may have been sufficient to invoke equity powers, nevertheless, the ruling was that refusal to consent to a sale to a financially responsible purchaser did not, in and of itself, constitute an unconscionable or inequitable exercise of the acceleration pursuant to the due on sale clause.

In addition to the unconscionability argument advanced by mortgagors, another claim is that the due on sale clause is a restraint upon alienation. However, the courts have rejected this and ruled that the due on sale clause is *not* an illegal restraint upon alienation.[20] The clause neither prohibits nor restricts a mortgagor's right to sell property. A sale by the mortgagor without the consent of the mortgagee only triggers the option of the mortgage to accelerate payment.[21]

Couched in somewhat different terms is the issue of a mortgagee's *motive* in enforcing the due on sale clause. In this area there has been some divergence of opinion. As to those decisions where motive was upheld, one court ruled that seeking enforcement of a due on sale clause to accommodate market conditions is a legitimate and reasonable business practice; thus not an unlawful or improper motive.[22]

Similarly, another case held that a lender's decision to condition its consent to transfer upon payment of a higher rate of interest approaching or meeting current market interest rates is legitimate and not violative of the standards of good faith and fair dealing.[23]

With a carefully drafted due on sale clause, an actual sale of property burdened by a mortgage will in most instances give rise to the mortgagee's option to accelerate. This has lead ultimately to questions as to when a conveyance runs afoul of the clause.

One such issue was raised in two cases where a land contract or installment sale contract was entered into.[24] In the earlier of the two, the due on sale clause provided that:

> "This mortgage shall be all due and payable upon transfer of part of (sic) all of the subject premises and shall not be assumable without the prior written consent of the mortgagee."

The mortgagor executed a land contract with purchaser to which lender did not consent. The court considered the issue to be whether the land contract was a "transfer of all or part" of the mortgaged premises. First, the court noted that the contract shifted equitable title to the purchaser, even though legal title remained in the mortgagor.[25]

Further, the Court held, the transfer of equitable ownership is a transfer of an interest in the property. Therefore, an equitable interest in the property amounting to real ownership is a transfer of at least part of the premises as contemplated by the parties.[26]

If, as a matter of law transfer of equitable title is a "conveyance," then presumably that concept should have been the basis of the case. While it was a factor, the court relied even more strongly upon the words of the due on sale clause which was comprehensive enough to include a transfer of an equitable interest. So we have the first indication that enforcement of the clause may in some situations rest upon the breadth of the drafter's work product.

In the second case on this subject, the due on sale clause was somewhat different, providing;

> "That the whole of the said principal sum shall become due at the option of the mor-

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[17] *Graf* v. *Hope Building Corp., supra,; Albertina Realty Co.* v.*Rosbro Realty Corp., supra.*

[18] *Stith* v. *Hudson City Savings Institution, supra.* (See also, *Mutual Real Estate Investment Trust* v. *Buffalo Savings Bank, supra.; First Federal Savings & Loan Association of Rochester* v. *Jenkins, supra.*)

[19] *Mutual Real Estate Investment Trust* v. *Buffalo Savings Bank, supra.*

[20] *First Federal Savings & Loan Association of Rochester* v. *Jenkins, supra.; Ceravolo* v. *Buckner, supra.*

[21] *First Federal Savings & Loan Association of Rochester* v. *Jenkins, supra.; Williams* v. *First Federal Savings & Loan Association of Arlington,* 651 F.2d 910

[22] *Ceravolo* v. *Buckner, supra.*

[23] Bonady Apartments v. *Columbia Banking, supra.*

[24] *Ceravolo* v. *Buckner, supra.; Newburgh Savings Bank* v. *Grossman, supra.*

[25] Citing as authority, *Elterman* v. *Hyman,* 192 N.Y. 113; *Williams* v. *Haddock,* 145 N.Y. 144; *Sloan* v. *Pinafore Homes,* 38 A.D. 2d 718; *Occidential Realty Co.* v. *Palmer,* 117 App. Div. 505, aff'd 192 N.Y. 588; *Marine Midland Bank — N.Y.* v. *Batson,* 70 Misc. 2D 8; *Van Curler Dev. Corp.* v. *City of Schenectady,* 59 Misc. 2d 621; *Charles* v. *Scheibel,* 128 Misc. 275, aff'd 221 App. Div. 816

[26] *Ceravolo* v. *Bucker, supra.*

tgagee in the event of a sale or conveyance of the premises hereinbefore described."

Mortgagor signed an installment sales contract with purchaser, creating the issue as to whether an installment contract constituted a "sale or conveyance of the premises" activating the option to accelerate. The Court ruled that it did. The agreement to sell conveyed full equitable title to the property to the purchaser even though technical legal title remained in the mortgagor.[27]

Still another permutation was a transfer of property arising out of a corporate dissolution, emphasizing anew the importance of the precise langauge of the due on sale clause.[28] The mortgagor was a corporation with all the stock owned by a husband and wife, which stock was ultimately owned by their daughter.

The mortgage clause recited:

"This mortgage shall become immediately due and payable if the mortgagor shall convey said premises without the written consent of the mortgagee herein."

When the daughter desired to dissolve the corporation, with distribution of the mortgaged property to herself, the lender declined to consent without an increase in the interest rate. In the resultant action by the daughter, she argued that the dissolution of the corporation and the distribution of the real property to her was not a "sale" within the meaning of mortgage. But the Court observed that the operative word in the clause was "convey", not "sell". Since the distribution of the property would require a transfer of title, the Court ruled the proposed transfer to be the type of conveyance contemplated by the due on sale clause, thus allowing acceleration by the lender.[29]

Tacit recognition of the legitimacy of the due on sale clause is found in Real Property Law § 254-a enacted in 1972 and amended in 1974.[30] That statute seems to accept the validity and enforceability of the clause by acknowledging it, but precluding collection of a prepayment penalty upon its invocation.

Federal law also plays a role in this area. Section 5(a) of the Home Owners' Loan Act of 1933 (HOLA) empowers the Federal Home Loan Bank Board (Board) to prescribe regulations governing federally chartered savings and loan associations. One of the Board's regulations empowers a federal savings and loan to include due on sale clauses in its mortgages.

The courts have therefore ruled that pursuant to the supremacy clause of the United States Constitution, state law with reference to due on sale clauses in conflict with Federal law has been pre-empted by the latter.[31]

Due on Sale Denied

Notwithstanding the general proposition that the due on sale clause is enforceable in New York, under unusual circumstances the courts may, and have on occasion refused to enforce.

One leading example involved a due on sale clause which, unlike all others previously reviewed, provided that the lender's consent to assumption of the mortgage would not be unreasonably withheld. Armed with such qualifying language, the Court noted that since the bank prepared the document, if there was an ambiguity, it would be resolved against the bank.[32] More important, the ruling concluded that the intention of the clause requiring the bank's approval of the purchaser was to give the bank only approval of the character and financial ability of the buyer but not an authorization to change the mortgage by increasing the interest rate.[33]

Equity was the basis to deny enforcement of the due on sale clause in a case where individual mortgagors had transferred the mortgaged property to their own corporation. Mortgage payments continued to be made by the individuals for almost a year after the conveyance. When the lender finally sought acceleration, the mortgagors even offered to have the property reconveyed to them. Under such circumstances, the ruling was that foreclosure would be inequitable without a showing of jeopardy to the lender's security.[34]

A similar result arose from a case where a corporate mortgagor conveyed to its individual principal one day after execution of the mortgage, although the deed was not recorded for some three years thereafter. Two years after the first transfer, the principal conveyed to himself and another as tenants in common.

With a typical due on sale clause in the mortgage, the lender accelerated based upon the transfers.

[27] *Newburgh Savings Bank* v. *Grossman, supra.*

[28] *Bonady Apartments* v. *Columbia Banking, supra.*

[29] Citing: *In re Loes Will*, 55 N.Y. 2d 723 (1945); *Mutual Federal Savings & Loan Association* v. *Wisconsin Wire Works*, 58 Wis. 2d 99, 205 N.W. 2d 762 (1973); RPL §§ 240, 290

[30] "If a bond or note, or the mortgage on real property, improved by a one to six family residence occupied by the owner, securing the payment of same, contains (1) a provision whereby the mortgagee retains the right to accelerate the due date for payment of the balance of principal upon a transfer or sale of such real property or by alienation of title of such real property due to an act or operation of law, and (2) a provision for payment of any charge, however denominated, in the nature of a prepayment fee and if a mortgagor sells or transfers his property or if title to the mortgaged property is transferred by act or operation of law and the purchaser requests permission to assume the mortgage or take the mortgaged premises subject to the mortgage, but the mortgagee does not consent to such request and thereby necessitates prepayment of the mortgage, the mortgagee shall not levy a prepayment fee; provided, however, that the provisions of this section shall not apply to the extent such provisions are inconsistent with any Federal law or regulation."

[31] *First Federal Savings & Loan Association of Rochester* v. *Jenkins, supra.; Fidelity Federal Savings and Loan Association* v. *de la Cuesta, supra.*

[32] Citing: *67 Wall St. Co.* v. *Franklin National Bank*, 37 N.Y. 2d 245, 371 N.Y.S. 2d 915; 4 Williston Contracts (3rd ed.) § 621; 10 N.Y. Jur., Contracts, § 223

[33] *Silver* v. *Rochester Savings Bank*, 73 A.D. 2d 81, 424 N.Y.S. 2d 945 (4th Dept. 1980)

[34] *Nicholas* v. *Evans*, 92 Misc. 2d 938, 401 N.Y.S. 2d 426 (1978)

Defendant countered that the lender knew or should have known that the principal was in fact the property owner and had to be in order to take advantage of certain individual tax deductions. Further, defendant asserted, title was placed in the corporate name at plaintiff's insistence to accommodate a higher rate of interest, with that corporate title having but one days's duration.

Relying upon equitable principles under these circumstances, the holding was that the lender sustained no damage, nor was its security impaired. Defendants had offered to reconvey the property and if the due on sale were enforced the impact would be harsh.[35]

Another example of language beyond the usual in the due on sale clause affecting the outcome was a case where an amendment added a provision that upon sale, acceleration must be based upon reasons not arbitrary or unreasonable. Upon sale, the lender demanded the usual increase in interest as a condition of consent.

Finding the language different than found in cases upholding the due on sale, the court reasoned that the clause in question afforded purchasers an economic benefit and was therefore part of the consideration for the mortgage as amended. If the lender had wished to preserve the right to demand higher interest from a purchaser, it would have stated so in some form. Given language which must be construed against the drafter, with a purchaser shown to be financially stable, due on sale would not be enforced.[36]

When a due on sale clause narrowly provided for acceleration solely upon "sale" of the property, sale of the stock of the corporate mortgagor was held not to be a sale of the property.[37] In so ruling, the court cited the analogy of a lease where landlords may choose to treat a stock sale as an assignment. Here, the reasoning was that the mortgagee could have provided that a stock sale would be deemed a sale of the property. This was not done. Moreover, such a term cannot be implied and the document must be construed against the drafter.

Conclusion

The lender wishing to benefit from the due on sale clause may do so with some degree of assurance that it will be upheld. Such is likely to be so if the clause is skillfully drawn and further if there are no unusual circumstances compelling a Court in invoke equity. But such an aphorism, while helpful, begs the question and requires more specifics.

To be as immune from assault as possible, the lender's clause must be as expansive as possible. For example, the clause should grant the acceleration option upon any sale or conveyance, legal or equitable, of all or any part of the secured property, including any sale of stock if the transferor is a corporation. Moreover, there cannot be any qualifying language as to reasonableness of lender's consent or any factors the lender is to consider.

It is clear that the courts recognize the need for and legitimacy of the due on sale clause. If lenders wish to use the power to maintain market returns on mortgage portfolios, the decisions have accepted that as a valid basis to enforce. At the same time, there is also a thread of distaste for use of the clause if somehow the result appears unfair. If the court has this sense of an unfair result, it may do one of two things, or both.

First, it will seek any ambiguity in the due on sale clause so that the circumstances can be said to fall

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[35] *Home Savings Bank of Upstate New York* v. *Baer Properties*, 92 A.D. 2d 98, 460 N.Y.S. 2d 833 (3rd Dept. 1983)

[36] *Iris* v. *Marine Midland Bank*, 114 Misc. 2d 251, 450 N.Y.S. 2d 997 (1982)

[37] *Gasparre* v. *88-36 Elmhurst Ave. Realty Corp.*, 119 Misc. 2d 628, 464 N.Y.S. 2d 106 (1983)