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Property

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PROPERTY

E.F. Roberts*

I. INTRODUCTION

In recent years it has become fashionable to discuss law and economics as if no transactional costs were involved.[1] To a lawyer dealing in real property, such discussion is rather odd because "land agents, surveyors, attorneys and other market middlemen also acquire a vested interest in landed property. 'Transaction costs' are like sand in the gears of perfect exchange. They eat into ownership and aggregate into a middleman's interest, which takes on the attributes of a species of property."[2] In light of this new property interest, it behooves lawyers to know who is making the law of real property. That is the subject of this article.

II. MORTGAGES

The assets of savings and loan associations are largely invested in residential mortgage loans. These associations are, in fact, hostage to the mortgage market. Roughly half of these associations are federally chartered and subject to regulation by the Federal Home Loan Bank Board. The other half hold state charters and are regulated by state agencies. All of the federal associations and most of the state chartered associations have their deposits insured by the Federal Savings and Loan Insurance Corporation.[3]

At one time, a mortgage lending institution collected six percent on its loans to homebuyers while paying out only three percent to its depositors for the use of their savings. The lender's loans were secure because the mortgaged homes were posted as collateral. The depositors were also secure because the collateral equalled the sum of their deposits. The lender could wind up its affairs easily by selling its outstanding loans to anyone interested

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1. Easy access into this literature may be had through Hoffman & Spitzer, *The Coase Theorem: Some Experimental Tests*, 25 J.L. & ECON. 73, 73 n.2 (1982).

2. A. OFFER, PROPERTY AND POLITICS 1870-1914, at 2 (1981).

3. THE PRESIDENT'S COMMISSION ON HOUSING, FINANCING THE HOUSING NEEDS OF THE 1980's, at 20 (1982) (Preliminary Report on Housing Finance).

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in a steady six percent return on investments. The collateral did not have to be re-assayed because the imprimatur of title insurance made mortgage portfolios negotiable nationwide. The only danger was the possibility of a run on the lending institution, with all of the depositors demanding cash on the barrelhead at once. The notion that deposits were insured, however, served to sedate depositors and prevented panics.

Then came a time when depositors threatened to discontinue depositing their money with lenders unless they were paid interest at nine percent. Because the institutional money was already lent long-term at six percent, the lending of money at a three percent differential became unprofitable for the lender. Although the use of the amortized mortgage enabled the lender to realize a slow return of the collective principal from the homeowners, there was no way that these modest sums could be loaned out again at a rate of interest high enough to offset the increase in interest on depositors' accounts. Because of a limit on what homebuyers could afford to pay to borrow money, the lender might have done well to obtain eighteen percent on its new loans. Thus, winding up the institution's affairs appeared propitious.[4]

The trouble was that the institution's loans no longer approached in total value the sum of the deposits. No one would buy a mortgage portfolio earning six percent when money earned at least eighteen percent. The lender might actually be insolvent, surviving by drawing down its own reserve funds. Should depositors have discerned that this plight was common to the whole industry, a much larger crisis would have loomed. The insurance scheme calculated to protect depositors had been financed on the theory that, like the Salem witch craze, a bank failure would be a local, rare, and damnably odd event. In terms of cover for all deposits in all mortgage lending institutions, the insurance fund might prove useless.[5]

Between 1962 and 1982, the environment in which mortgage banking was conducted went through a transition from the first to the second of the scenarios described above. New loan mechanisms were devised to take the place of the fixed-rate, long-term mort-

4. *See id.* at 24-25; Seiders, *Changing Patterns of Housing Finance*, 67 FED. RESERVE BULL. 461, 469 (1981).

5. *See* N.Y. Times, June 18, 1981, at D1, col. 3; *id.*, Mar. 24, 1981, at D6, col. 5.

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gage and to ease the transition. Although the transition did not occur overnight, it did occur rapidly enough to embarrass financially a number of savings and loan institutions. A general crisis in confidence might have occurred had not the authorities acted as midwives, overseeing mergers out of which new, stronger associations were created and weaker institutions "saved" in the process.[6]

Lending institutions, quick to discern the changing economic atmosphere, began to modify the terms of their long-term and fixed-rate home loans by adding a due-on-sale clause. A due-on-sale clause provides that the outstanding balance of a loan becomes payable upon the lender's call if the realty in question is sold or otherwise transferred. This clause neatly interrupted the consummation of home transfers in which the buyer paid to the seller only the value of the equity and undertook to pay off the seller's mortgage loan month by month according to the original time scale. The buyer then had to negotiate with the seller's lender a new and more current market interest rate on the outstanding balance in order to be entitled to discharge the mortgage in accordance with its other original terms.

Inflation creates its own values. For example, a homeowner who can entice a buyer to take over an outstanding mortgage loan at an old and fixed low rate of interest has, all other things being equal, a house worth more than one subject to a due-on-sale clause. If the equity is still modest in size, a larger class of buyers can afford the initial cash outlay and the monthly payments. The owner, therefore, has a more affordable house to sell than his neighbor whose mortgage was paid off years ago. Thus, in effect, the enforcement of a due-on-sale clause is a restraint on alienation.

Whether a court will refuse to enforce a due-on-sale clause depends upon whether the clause is perceived to be an "unreasonable" restraint on alienation. In more stable economic times, during which buyers regularly took over their sellers' mortgages, some courts looked askance at the idea that a lender should have the blanket authority to say "nyet" to any such takeover. These courts would not enforce the clause unless the lender produced specific

6. *See* Bartlett, Weeks & Wiorski, *Savings Association Legislation and Litigation—1981*, 47 LEGAL BULL. 329, 351-52 (1981); N.Y. Times, Jan. 4, 1983, at A1, col. 3; *id.*, Jan. 9, 1981, at D1, col. 1.

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evidence that in this particular instance its security would be put at risk.[7] As a question of local property law, a decision concerning restraint on alienation seemed to be of no great moment on the national scene.

If these same courts refused to recognize runaway inflation as a new ground justifying the invocation of the due-on-sale clause, some lenders hostage to the home mortgage market might have found themselves in financial difficulty. Whatever the wisdom of a particular state high court's decision, the question still seemed to be one of local property law. Reflection might implicate the invention of title insurance and development of a secondary mortgage market as indicia that there was a nationwide commerce in mortgage investments. Further reflection might generate skepticism concerning whether local failures of thrift institutions would be ignored by depositors elsewhere. This might tend to suggest that the due-on-sale question was not one of local property law but one of some ill-defined body of federal commercial law.

The spirit of *Swift v. Tyson*[8] reappeared in the guise of the Federal Home Loan Bank Board's authority to regulate the federally chartered savings and loan associations. In 1976, the Board purported to federalize the law pertaining to due-on-sale clauses and to validate the clauses nationwide.[9] The Board did not bark out their order in the authoritarian manner of a regimental sergeant-major, but instead released into the jurisprudential atmosphere, mandarin-style, a suggestion of their decision. The regulation confirmed the power of a federal association to include a due-on-sale clause "as a matter of contract" between the association and the original homebuyer. At the same time, the Board developed a standard enunciating that mortgages were to be governed by the law of the state in which the property was situated.[10] Only by recourse to the preamble of the promulgated regulation could anyone find a clear statement evidencing the Board's intention that due-on-sale clauses were to be governed "exclusively by fed-

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7. *See, e.g.,* Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

8. 41 U.S. (16 Pet.) 1 (1842). *See generally* G. GILMORE, THE AGES OF AMERICAN LAW 30-35 (1977).

9. *See* 41 Fed. Reg. 18,286, 18,287 (1976), *discussed in* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 102 S. Ct. 3014, 3019 (1982).

10. 102 S. Ct. at 3019 n.5.

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eral law."[11]

Arguably, the Board, regardless of its original intent, had preempted the field by enunciating an exclusive federal rule governing this aspect of the business of federal associations. Even if a rule had been articulated, the standard form arguably called for the use of "pure" state law without implicating any federal law otherwise locally applicable through the supremacy clause. In New York, an argument could be made that, given a completely new economic environment and the interpolation into property law of the commercial law notion of unconscionability, the question whether due-on-sale clauses were automatically enforcable was open for probing, in-depth review.

First Federal Savings & Loan Association v. Jenkins[12] put to rest all three arguments, despite an absolute dearth of New York authority pertinent to due-on-sale clauses in their federal context. Cases evidencing a majority trend were marshalled by Justice Bryant to uphold federal preemption and to negate the use of the standard clause as an exemption device. According to Justice Bryant, there was nothing unconscionable about a savings and loan association insisting upon its rights under a due-on-sale clause given "the prevailing economic conditions."[13]

> Long-term mortgages with fixed interest rates may be an endangered species of legal documents. Plaintiff, like other thrift institutions, are short-term borrowers and long-term lenders. The cost of deposits accelerates faster than the return on long-term mortgage loans. The "due-on-sale" clause is one authorized contractual provision to mitigate this problem for the lender.[14]

Thus, Justice Bryant based his opinion on the economic postulate that the association was not behaving unconscionably at all, but was simply "exercising a business judgment in an effort to remain a viable institution in the face of accelerating inflation and increasing interest rates."[15]

This nisi prius opinion was quickly cataloged in a thrift industry trade journal as *the* New York position.[16] It was also deemed

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11. *See* 41 Fed. Reg. at 18,287.
12. 109 Misc. 2d 715, 441 N.Y.S.2d 373 (Sup. Ct., Tompkins Co. 1981).
13. *Id.* at 728, 441 N.Y.S.2d at 381.
14. *Id.* at 726, 441 N.Y.S.2d at 380-81.
15. *Id.* at 726, 441 N.Y.S.2d at 380.
16. *See* 47 LEGAL BULL. 275 (1981).

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noteworthy as an illustration of how judges arrive at results "not only by the use of legal logic, but by a surprising understanding of economic realities."[17] In a very real sense, the nationwide validity of due-on-sale clauses employed by federal associations was coming to rest upon a pragmatic sanction.

The decision to use a due-on-sale clause is a business decision. Assuming that the Board was created to oversee the business decisions of federal associations, there does not appear to be any great principle at stake in giving the Board the benefit of the doubt when reading their regulations. Actual enforcement of the clause does, however, implicate local property and mortgage law. Indeed, the federal associations "have always used and been governed by state real property and mortgage law in respect to such matters as title, conveyancing, recording, priority of liens, proceedings for foreclosure, and deficiency judgments."[18] Preemption is possible, of course, but there is a serious question whether state property law ought to be displaced by a less than clear pronouncement of an administrative agency rather than by an express command of Congress. Thus, a California court perceived that a question of principle was involved: "The decision whether to displace state law is a fundamental one going to the very fabric of federalism; thus, the decision is one to be made by the people through their elected representatives in Congress rather than by agencies or tribunals insulated from democratic pressures."[19] These California judges refused to allow their property law to be displaced in an intrastate mortgage transaction even though the lender was a federal savings and loan association.

The Supreme Court of the United States, however, removed any doubt as to whether the Board had intended to preempt and had in fact preempted the field pursuant to the requisite authority granted by Congress.[20] In 1933, Congress gave the Board the power to regulate the operations of the federal associations. How associations operate, in the sense of how they conduct their affairs, does not immediately suggest that the overseer of their operations has the power to displace the property law of a state in which the as-

17. 48 LEGAL BULL. 34, 36-37 (1982).

18. de la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n, 121 Cal. App. 3d 328, 337, 175 Cal. Rptr. 467, 472 (1981), *rev'd*, 102 S. Ct. 3014 (1982).

19. 121 Cal. App. 3d at 339-40, 175 Cal. Rptr. at 474.

20. *See* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 102 S. Ct. 3014, 3025 (1982).

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sociations operate. Congress intended the Board to control the associations "so as to ensure that they would remain financially sound institutions."[21] The Board's task force had advised them that the elimination of the due-on-sale clause would adversely affect the "financial stability of Federal associations."[22] Thus, with the very existence of some institutions possibly at stake, authority over their operations necessarily included the power to displace state law that adversely affected the mortgage lending practices of federal associations.

Pragmatism, compelled by economic considerations, ultimately guided five members of the Court. Justice Rehnquist, with whom Justice Stevens joined, was unable to make the logical leap from the Board's duty to look after the financial stability of its charges to the Board's power to displace state law: "Discharge of its mission to ensure the soundness of federal savings and loans does not authorize the Federal Home Loan Bank Board to intrude into the domain of state property and contract law that Congress has left to the States."[23] The economic need to expedite the elimination of unprofitable mortgages from certain portfolios simply could not justify this insult to the principles of federalism.

Justice O'Connor sought to salvage principle while conceding the pragmatic necessity for the Board to act in this case under the rubric of maintaining the associations' financial stability.[24] The same rationale could not, however, be stretched "to permit the Board to displace local laws, such as tax statutes and zoning ordinances, not directly related to savings and loan practices."[25] Peculiarly enough, the majority had already provided the materials for just such a bridging operation by linking the purpose of assuring financially sound savings and loan institutions with the congressional concern of promoting home construction and purchase.[26]

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21. *Id.* at 3029-30.

22. *Id.* at 3030 (quoting Federal Home Loan Bank Board, Advisory Opinion No. 75-647, at 2, 17-18 (July 30, 1976)).

23. *Id.* at 3033 (Rehnquist, J., dissenting).

24. *See id.* at 3032 (O'Connor, J., concurring).

25. *Id.* The nexus between the cost of housing and the local tax and zoning structure has become a staple of the land use planning scene.

26. *See id.* at 3029-30.

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III. The Parameters of Ownership

New York sought to expedite access to cable television by apartment dwellers by requiring landlords to make space available on their buildings for cable installation.[27] A landlord was entitled to a one dollar fee unless the installation was shown to have caused actual damages.[28] The scheme was upheld by the New York Court of Appeals despite a landlord's complaint that the practice was an uncompensated taking of property, even though the landlord had no real use for the space occupied by the cable.[29] Absent a showing that the landlord was deprived of a reasonable return on his investment in the building, the New York practice was treated as a reasonable police power calculated to encourage the development of what was seen, oddly enough, as an important educational communications medium.

The Supreme Court overturned the New York opinion in *Loretto v. Teleprompter Manhattan CATV Corp.*[30] Reasonableness of return and the use of the police power were considered irrelevant. "[W]hen the 'character of the governmental action' . . . is a permanent physical occupation of property, our cases uniformly have found a taking to the extent of the occupation, without regard to whether the action achieves an important public benefit or has only minimal economic impact on the owner."[31] Justice Blackmun commented critically on this "curiously anachronistic decision," which "constructs a rigid *per se* takings rule."[32]

Readers of this *Survey* may recall that several years ago Justice Rehnquist suggested that, with respect to the scope of the just compensation clause, "the United States, as opposed to the several States, [is not] possessed of residual authority that enables it to define 'property' in the first instance."[33] Possibly, *Loretto* will establish a federal minimum of property defined in terms of a right

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27. *See* Act of May 24, 1972, ch. 466, 1972 N.Y. Laws 1779, 1791 (codified as amended at N.Y. Exec. Law § 828 (McKinney 1982)).

28. *See* Loretto v. Teleprompter Manhattan CATV Corp., 102 S. Ct. 3164, 3170 (1982).

29. *See* Loretto v. Teleprompter Manhattan CATV Corp., 53 N.Y.2d 124, 149, 423 N.E.2d 320, 333, 440 N.Y.S.2d 843, 856 (1981).

30. 102 S. Ct. 3164 (1982).

31. *Id.* at 3175-76 (citation omitted).

32. *Id.* at 3180 (Blackmun, J., dissenting).

33. Pruneyard Shopping Center v. Robins, 447 U.S. 74, 84 (1980), *quoted in* Roberts, *Property, 1980 Survey of N.Y. Law,* 32 Syracuse L. Rev. 455, 464 (1981).

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to exclude. The states, outside of that, may be free to regulate the use of property to an extent which in the past would have caused the federal courts to invoke the taking clause. Ironically, Justice Rehnquist could now achieve his original result by invoking Justice Blackmun's view that "new social circumstances can justify legislative modification of a property owner's common-law rights, without compensation, if the legislative action serves sufficiently important public interests."[34]

IV. Portends

The poet warns us that time past and present may both be present in time future. The same may be true of the law of real property. The future, if this society is to develop, will be bottomed on credit. The mechanisms of credit have become increasingly homogenized, as evidenced by the thrift institutions taking on some functions previously performed by commercial banks. The mechanisms of credit increasingly have become components of the national money market and, year by year, this *Survey* has witnessed the increasing federalization of property law practices.

A lesson may be learned from the due-on-sale clause controversy. No matter how much some industrialists of philosophy may regret law-making through pragmatic incrementalism, no secular principle can interfere with the workings of the evolving national money market for long. The regulatory apparatus of this market will not be determined by our present consciousness, and our future consciousness has yet to be determined by a full realization of the economy of a post-industrial society. People who inhabit the real world are condemned, so long as democratic notions prevail, to do the best they can pragmatically.

In a federally orchestrated economy, some regions of the country may be left to lie fallow as delightful spots to visit, not unlike, for example, the Adirondacks. The poet suggests that none of us can stand too much truth. To what extent is the increasing amount of state level preservation and environmental law a mechanism by which we convince ourselves that we desire underdevelopment by immersing ourselves in it? That is to say, to what extent does the norm ease the path toward the normative? The taking cases, which may yet endorse extraordinary restraints on land use at state level

34. 102 S. Ct. at 3186 (Blackmun, J., dissenting) (citation omitted).

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and outside federal development areas, bear watching because they contain the potential for a preemptive federal rule in development areas beyond which, at state level, almost anything might go. Thus, in this secular society, the law as a cohesive instrument expedites the necessary opiate.

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