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CONTRACTS - ILLEGALITY - COLLATERAL AGREEMENTS UNDER HOME OWNERS' LOAN ACT

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COMMENTS

CONTRACTS — ILLEGALITY — COLLATERAL AGREEMENTS UNDER HOME OWNERS' LOAN ACT — In transactions under the Home Owners' Loan Act[1] it is customary for the holder of the mortgage on the property on which a new loan is sought to agree with the H. O. L. C. to accept in full settlement of his claim bonds of the H. O. L. C. of a face value often times less than the amount of the obligation secured by the old mortgage. However, not infrequently the mortgagee also exacts from the home owner a collateral agreement under which the home owner gives him a new second mortgage on the property as

[1] 48 Stat. L. 128 (1933), as amended by 48 Stat. L. 648 (1934); 49 Stat. L. 296 (1935), 53 Stat. L. 1403 (1939); 12 U. S. C. (1934), § 1461-1468 and supplements.

security for an undertaking to pay the balance of the old obligation or some part thereof or to cover the difference between the face value and the market value of the bonds received. Whether he may lawfully do this is a question that has been presented for decision to the courts of at least fifteen states.[2] Of interest, therefore, is the decision of the Supreme Court of California in the case of *McAllister v. Drapeau*,[3] in which the court, by reversing the decision of the district court of appeals,[4] erases from the judicial slate the single dissent from the proposition that such collateral agreements are unenforceable unless there is proper disclosure to the H. O. L. C. of the existence of the agreement. The writer wishes to consider (1) the bases for holding that such collateral agreements are unenforceable; (2) whether the home owner can sue for affirmative relief in regard to the collateral agreement; and (3) the effect of disclosure to the H. O. L. C. of the existence of the collateral agreement.

I.

The purpose of these collateral agreements is to indemnify the lienholder against possible losses as a result of taking the H. O. L. C. bonds in satisfaction of the original mortgage.[5] As suggested above,

[2] Jessewich v. Abbene, 154 Misc. 768, 277 N. Y. S. 599 (1935); First Citizens Bank & Trust Co. v. Speaker, 159 Misc. 427, 287 N. Y. S. 831 (1936); Chaves County Bldg. & Loan Assn. v. Hodges, 40 N. M. 326, 59 P. (2d) 671 (1936); Stager v. Junker, 14 N. J. Misc. 913, 188 A. 440 (1936); Cook v. Donner, 145 Kan. 674, 66 P. (2d) 587 (1937); Pye v. Grunert, 201 Minn. 191, 275 N. W. 615, 276 N. W. 221 (1937); Meek v. Wilson, 283 Mich. 679, 278 N. W. 731 (1938); Anderson v. Horst, 132 Pa. Super. 140, 200 A. 721 (1938); Heath v. Huffman, (Tenn. App. 1938) 127 S. W. (2d) 282; Hays v. Commerce Union Bank, (Tenn. App. Nashville) (not reported) cited by Payne, "Enforceability of Agreements between Mortgagors of the Home Owners' Loan Corporation and Third Parties," 45 W. VA. L. Q. 332 at 333, note 7 (1939); McAllister v. Drapeau, (Cal. 1939) 92 P. (2d) 911, reversing (Cal. App. 1938) 85 P. (2d) 523; Markowitz v. Berg, 125 N. J. Eq. 56, 4 A. (2d) 410 (1939); Home Owners' Loan Corp. v. Aiello, (R. I. 1939) 5 A. (2d) 649; Keystone Bank of Spangler v. Booth, 334 Pa. 545, 6 A. (2d) 417 (1939); Council v. Cohen, (Mass. 1939) 21 N. E. (2d) 967; Sirman v. Sloss Realty Co., (Ark. 1939) 129 S. W. (2d) 602; McCrory v. Smeltzer, (Tex. Comm. App. 1939) 124 S. W. (2d) 336 (involves the same problem with the Federal Farm Mortgage Corporation); Dayton Mtg. & Inv. Co. v. Theis, (Ohio App. 1939) 23 N. E. (2d) 511, cited in McAllister v. Drapeau, supra, 92 P. (2d) at 916; Johnson v. Matthews, (Ill. App. 1939) 22 N. E. (2d) 772.

[3] (Cal. 1939) 92 P. (2d) 911.

[4] (Cal. App. 1938) 85 P. (2d) 523.

[5] Since the H. O. L. C. will only allow a new mortgage up to 80% of the appraised value of the property, there are many instances in which the H. O. L. C. bonds do not equal the balance of the original mortgage. See Wallace, "Survey of Federal Legislation Affecting Private Home Financing Since 1932," 5 LAW & CONTEM. PROB. 481 at 489 ff. (1938).

the sum necessary for such indemnity is usually computed on the basis of the amount of the original mortgage less the amount of the bonds to be given or already given to the mortgagee, but in some cases it is measured by the difference between the par value of the bonds and their present cash value. If it is the latter, there is no difficulty in holding the collateral agreements illegal and void, for section 8(e) of the Home Owners' Loan Act[6] provides that "No person . . . shall . . . contract for . . . payment of any difference which may exist between the market value and the par value of the bonds of the Home Owners' Loan Corporation," and makes violation of this provision a penal offense.

But where the collateral agreement is to make up the unpaid balance of the original mortgage, the solution is not so easy. There is nothing in the Home Owners' Loan Act itself which specifically prohibits this type of agreement. The declared purpose of the act is of no assistance, for it simply states that the act was passed:

> "to provide emergency relief with respect to home mortgage indebtedness to refinance home mortgages, to extend relief to the owners of homes occupied by them and who are unable to amortize their debt elsewhere. . . ."[7]

However, some of the courts have seized upon section 8 (a)[8] as a basis for declaring the collateral agreement illegal and void. This section provides:

> "Whoever makes any statement, knowing it to be false . . . for the purpose of influencing in any way the action of the Home Owners' Loan Corporation . . . shall be punished by a fine . . . or imprisonment . . . or both."

The false statement, according to the courts, is the promise in the "bond consent"[9] submitted to the H. O. L. C. by the lienholder, to

[6] This clause was added by 49 Stat. L. 298 (1935), 12 U. S. C. (Supp. 1938), § 1467 (e).

[7] Title of act, 48 Stat. L. 128 (1933).

[8] 48 Stat. L. 134, 12 U. S. C. (1934), § 1467 (a).

[9] "Bond consent" refers to the mortgagee's consent to take bonds, the legal significance of which will be explained infra. In the "bond consent" form used until 1935 there was no specific reference to second mortgages, but after January 31, 1935, at which time the larger portion of the lending had been consummated, the "bond consent" contained the following provision: "The undersigned represents that he will not require of the applicant any second mortgage or other instrument evidencing any portion of the aforesaid obligation or the payment of any money or other additional consideration except only as follows. . . ." This provision should certainly strengthen the case for the home owner. The form of the bond consent is set out in full in Payne, "Enforceability of Agreements Between Mortgagors of the Home Owners' Loan Corporation and Third Parties," 45 W. VA. L. Q. 332 at 338 (1939).

accept in "full settlement" of his claim the bonds of the H. O. L. C. and to release *all* of his claims against the property of the home owner. This promise is made despite the fact that a collateral agreement for a second lien on the land has already been executed or is contemplated. This immediately raises the question whether a *promise* of future performance made with a present intention not to perform comes within the scope of a "*false statement*" as used in the statute.[10] But, even assuming that such a promise can be regarded as a "false statement," how can the fact that there was a false statement made in violation of the statute affect the validity of the collateral agreement? The statute simply prohibits and punishes for false statements made to the H. O. L. C. regarding such matters as collateral agreements, value of home, amount of the mortgage, etc. However the statute in no way prohibits the *existence* of collateral agreements. Consequently, to hold a collateral agreement void as a violation of section 8 (a) seems a bit tenuous.

Another approach often used by the courts is suggested by section 4 (k) [11] which empowers the board to:

> "make such bylaws, rules and regulations, not inconsistent with the provisions in this section, as may be necessary for the proper conduct of the affairs of the Corporation."

In accordance with this rule-making power the board has passed several resolutions dealing with collateral agreements for second mortgages on the home owner's property.[12] They provide, in substance, that second mortgages for excess indebtedness over and above that which the corporation can refund are permitted only in limited cases and then only on a basis which assures a reasonable probability that the home owner will be able to pay his full obligation to the corporation and also meet the terms of the second mortgage indebtedness. While these resolutions do not prohibit collateral agreements, courts feel that a full disclosure of the amount and the terms of the proposed second lien is impliedly required by the H. O. L. C. so that it can determine whether the second mortgage complies with the regulations. Since these regulations are considered to have the force and effect of the statute itself,[13] it is

[10] A large number of modern cases have allowed damages in deceit or rescission where promises of future performance have been made with a present intention not to perform. Cases are collected in 51 A. L. R. 46 (1927); 68 A. L. R. 635 (1930); 91 A. L. R. 1295 (1934).

[11] 48 Stat. L. 132 (1933), 12 U. S. C. (1935), § 1463 (k).

[12] See resolutions quoted in McAllister v. Drapeau, (Cal. 1939) 92 P. (2d) 911 at 914. Since there have been several resolutions by the board on this question, the provisions of each of which are slightly different, it is well to note which resolutions were in effect at the time of the execution of the agreement between the H. O. L. C. and the lienholder.

[13] McAllister v. Drapeau, (Cal. 1939) 92 P. (2d) 911.

thought that the execution of a second lien without such disclosure is a violation of the letter and spirit of the statute. But is disclosure impliedly necessary under the regulations of the board? It seems reasonable to believe that the board would have specifically required disclosure had it desired it. Perhaps the board felt that it was really the function of the courts to decide whether the collateral agreements complied with its regulations when litigation arose over the validity of such agreements. Certainly the interests of the H. O. L. C. would be adequately protected in such a case, for if the court decided that the second lien conformed to the regulations, the H. O. L. C. could not be prejudiced thereby, and if it did not conform thereto, the second lien would be illegal and void as a violation of the terms of the statute.

Though there is no express recital in the act itself of the underlying legislative policy,[14] most of the courts buttress their decisions by reference to what they feel is the general public policy behind the act. The theory is that the act was intended solely for the benefit of home owners who were in financial difficulties.[15] From this it is argued that to allow the exaction of a secret second lien would "interfere by trickery with this corporation [H. O. L. C.]'s collecting its bonds, and the government's financial assistance would merely delay the inevitable foreclosure suit which it meant to prevent."[16] The second mortgagee would thereby receive benefits never intended for him; i.e., although he has received guaranteed tax exempt bonds in discharge of the original mortgage, yet by foreclosure of the second mortgage he may obtain the property of the mortgagor, subject only to the very favorable first mortgage held by the H. O. L. C.

On the other hand, one might suggest that although the purpose of the act was to assist the home owner, it was not intended to exonerate him completely from his just debts at the expense of his creditors; that the act was simply intended to enable the home owner to refund his debt and to place the first lien on his property in the hands of the H. O. L. C. The fact that neither the act nor the regulations absolutely prohibits second liens adds weight to this suggestion.[17]

Turning now from the act itself as a basis for decision to the nature of the relationship between the parties arising out of the promise of the

[14] The writer has reference here to such express declarations of policy as are set forth in the Norris-LaGuardia Act, 47 Stat. L. 70 (1932), and the National Labor Relations Act, 49 Stat. L. 449 (1935). Of course, an inkling as to the policy of the H. O. L. C. might be obtained from the declared purpose as set out in the act. See supra, at note 7.

[15] Meek v. Wilson, 283 Mich. 679, 278 N. W. 731 (1938).

[16] Jessewich v. Abbene, 154 Misc. 768 at 770, 277 N. Y. S. 599 (1935).

[17] For other arguments of the same tenor, see McAllister v. Drapeau, (Cal. App. 1938) 85 P. (2d) 523, revd. 92 P. (2d) 911.

lienholder to the H. O. L. C., it seems that the home owner could be relieved from the collateral agreement by reference to the law of contracts relating to third party beneficiaries.[18] Undoubtedly the lienholder by the "bond consent" is properly to be regarded as making an offer to the H. O. L. C. This offer calls for an act as acceptance on the part of the H. O. L. C. The offer, which also constitutes the consideration for the contract,[19] consists of a promise by the lienholder to the H. O. L. C. to accept its bonds and to give a full release of his claim against the property of the home owner in return for the act of the H. O. L. C. in giving him its bonds. But in these cases involving collateral agreements, the bonds of the H. O. L. C. often times are not sufficient to pay off the original claim of the lienholder. In view of the rule of law in most states to the effect that the payment of a smaller sum in satisfaction of a larger sum is not a good discharge of a debt,[20] is there actually consideration? Apparently so, for the payment here is by a third party with an understanding by the parties that it should be in full satisfaction of the obligation of the home owner, and is thus equivalent to an accord and satisfaction.[21] Also, the medium of payment is different from that contemplated in the original obligation, i.e., it consists of bonds of the H. O. L. C. Hence there is an enforceable contract between the H. O. L. C. and the original lienholder for the benefit of the home owner. In other words, the home owner is a third party beneficiary of the contract and in most states he can enforce this contract for his benefit.[22]

Therefore, by asserting his rights as a third party beneficiary of the contract between the H. O. L. C. and the lienholder in which the latter has agreed to release all claims against his property, the home owner is relieved of the collateral agreement.

However, when the collateral agreement is made *after* rather than *before* the above transaction is completed, there might be some question as to whether the home owner has not renounced his rights as a con-

[18] None of the courts, however, have utilized this theory, which seems like a simple and sound basis for decision. Some courts have referred to this three-cornered transaction as a novation. See Anderson v. Horst, 132 Pa. Super. 140, 200 A. 721 (1938). Others have referred to it as a release. See Cook v. Donner, 145 Kan. 674, 66 P. (2d) 587 (1937).

[19] 1 CONTRACTS RESTATEMENT, § 75 (1932). Also, 1 WILLISTON, CONTRACTS, rev. ed., § 102 (1936).

[20] ANSON, CONTRACTS, § 140 (1930).

[21] ANSON, CONTRACTS 148, note 3 (1930); 1 WILLISTON, CONTRACTS, rev. ed., §§ 121, 125 (1936); 2 CONTRACTS RESTATEMENT, § 421 (1932); Jessewich v. Abbene, 154 Misc. 768, 277 N. Y. S. 599 (1935); McAllister v. Drapeau, (Cal. 1939) 92 P. (2d) 911.

[22] ANSON, CONTRACTS, § 284 (1930); 2 WILLISTON, CONTRACTS, rev. ed., § 356 (1936).

tract beneficiary[23] and therefore is not relieved from the collateral agreement.

2.

Though the courts agree that where the lienholder sues on the collateral agreement the home owner can set up the defense of illegality, there is some doubt as to whether the home owner has any right to affirmative relief against the collateral agreement. In *Anderson v. Horst*[24] the home owner was denied the right to recover money paid under the collateral agreement on the theory that he was in pari delicto with the lienholder as regards the illegal collateral agreement. But in the same case the home owner was granted affirmative relief as to the setting aside of the illegal agreement. In *McAllister v. Drapeau*[25] and *Meek v. Wilson*,[26] the court allowed recovery of the money paid under the collateral agreement on the theory that the parties were not in pari delicto. The question whether the home owner was in pari delicto with the lienholder in executing the collateral agreement becomes important, therefore, in cases where the home owner is seeking affirmative relief; e.g., asking to have his notes surrendered and cancelled and the lien securing them removed from the records, seeking to recover money paid under the void agreement, suing to enjoin enforcement of or to cancel the collateral agreements, etc. Looking at the circumstances surrounding the execution of these collateral agreements, it does not seem that the parties are actually in pari delicto.[27] Usually the lienholder has started or is threatening foreclosure proceedings, thus forcing the home owner either to enter into the collateral agreement or lose his home. This amounts to a form of undue influence[28] which should be sufficient to negative the idea of pari delicto.

3.

In at least two[29] of the states where *secret* collateral agreements have been held illegal and void, the court has enforced the collateral agreement where there was a *disclosure* to the H. O. L. C. of its exist-

[23] For a complete discussion of the contractual elements involved, see Payne, "Enforceability of Agreements between Mortgagors of the Home Owners' Loan Corporation and Third Parties," 45 W. VA. L. Q. 332 (1939).

[24] 132 Pa. Super. 140, 200 A. 721 (1938).

[25] (Cal. 1939) 92 P. (2d) 911.

[26] 283 Mich. 679, 278 N. W. 731 (1938).

[27] Council v. Cohen, (Mass. 1939) 21 N. E. (2d) 967.

[28] In general, see Wallace, "Survey of Federal Legislation Affecting Private Home Financing Since 1932," 5 LAW & CONTEM. PROB. 481 at 489 (1938).

[29] Ridge Investment Corp. v. Nicolosi, 15 N. J. Misc. 569, 193 A. 710 (1937); Bay City Bank v. White, 283 Mich. 267, 277 N. W. 888 (1938). See also, Sirman v. Sloss Realty Co., (Ark. 1939) 129 S. W. (2d) 602, to the same effect, though there

ence. The theory is that if the H. O. L. C. knew of the collateral agreement at the time of its agreement with the lienholder it has accepted the collateral agreement as a part of the whole transaction. The question of disclosure is therefore an important consideration in determining the validity of these agreements. The requirement of disclosure is a concomitant of the theory of the courts that the taking a second mortgage by the lienholder is not a matter of right, but one of privilege to be granted by the H. O. L. C.[30] There are a number of possible ways in which this disclosure may be attempted. One method is simply to note on the "bond consent" the fact that a second mortgage has been or is to be taken by the lienholder. This was held to be a sufficient disclosure to the H. O. L. C. in *Sirman v. Sloss Realty Co.*[31] The disclosure might be made to the officials or employees of the H. O. L. C., in which case the question of the authority of the agent notified becomes important since disclosure to an agent with limited authority is not attributable to the principal where the limited authority does not extend to the matter disclosed.[32] Or the disclosure may be to the fee attorney (closing attorney) of the H. O. L. C. In *Ridge Investment Corp. v. Nicolosi*[33] the collateral agreement was held valid because it was prepared in the office of the closing attorney, a circumstance deemed sufficient to spell out notice to the H. O. L. C. But in *Markowitz v. Berg*[34] and *Council v. Cohen*[35] such disclosure was held not to constitute proper notice.[36] Disclosure might also take the form of a written document in the H. O. L. C. file of the home owner. Such disclosure was held to be notice to the H. O. L. C. in *Bay City Bank v. White.*[37]

What would otherwise be adequate disclosure to validate the collateral agreement may be inoperative because not made at the proper *time.* The time of disclosure is important in every case because of the

have been no decisions in the jurisdiction as to the effect if the second mortgage were kept secret.

[30] McAllister v. Drapeau, (Cal. 1939) 92 P. (2d) 911.

[31] (Ark. 1939) 129 S. W. (2d) 602.

[32] MECHEM, AGENCY, 3d ed., § 488 (1923); Trentor v. Pothen, 46 Minn. 298, 49 N. W. 129 (1891).

[33] 15 N. J. Misc. 569, 193 A. 710 (1937).

[34] 125 N. J. Eq. 56, 4 A. (2d) 410 (1939).

[35] (Mass. 1939) 21 N. E. (2d) 967.

[36] In view of the fact that the HOME OWNERS' LOAN CORPORATION, MANUAL OF RULES AND REGULATIONS, c. 6, § 1-d (2), specifies that "Fee attorneys are not employees of this corporation and shall be paid on a fee basis," that all officials of the H. O. L. C. with authority to pass on a loan are on a salary basis and, that the duties of the fee attorney include only the examination of titles, preparation of title reports and closing of loans, this seems to be the sounder view. The section of the Manual is quoted by Payne, "Enforceability of Agreements between the Home Owners' Loan Corporation and Third Parties," 45 W. VA. L. Q. 332 at 349, note 85 (1939).

[37] 283 Mich. 267, 277 N. W. 888 (1938).

peculiar circumstances surrounding the formation of the contract between the lienholder and the H. O. L. C. As we have already seen, when the lienholder submits his "bond consent" to the H. O. L. C. "consenting" to release all claims against the home owner's property, it is in the nature of an offer, and, as such, it can be varied in any way before acceptance. This means that if the lienholder properly discloses his intent to take a second mortgage before the H. O. L. C.'s act of acceptance, the terms of the offer ("bond consent") are altered so as to allow the second mortgage. So when the H. O. L. C. later accepts the offer it accepts it in the altered form. When the "bond consent" (offer) is submitted to the H. O. L. C., it is always necessary for the officers to investigate the home owner's status in order to determine his right to relief. As a consequence, it is usual to include in the "bond consent" (offer) an additional promise in terms to keep the offer open for a specific period as a safeguard to the H. O. L. C. once it starts to investigate in reliance on the offer. As soon as the H. O. L. C. has started the investigation leading to acceptance, it is arguable that there is a consideration for this promise and, as a result, there is an option.[38] This means that the offer cannot be withdrawn once the H. O. L. C. has started to act, and since the offer cannot be *withdrawn*, it cannot be *changed*.[39] So disclosure of the collateral agreement during this period has no effect on the terms of the offer. But if the option expires without acceptance then disclosure will be effective.[40]

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[38] 1 WILLISTON, CONTRACTS, rev. ed., §§ 61, 112, 139, 140 (1936); 1 CONTRACTS RESTATEMENT, § 90 (1932).

[39] ANSON, CONTRACTS 55, note 2 (1930). See also Chaves County Bldg. & Loan Assn. v. Hodges, 40 N. M. 326, 59 P. (2d) 671 (1936), in which the court refused to allow parol evidence to show that agents of the H. O. L. C. were notified as to the collateral agreement. Thus the parol evidence rule may provoke added difficulties.

[40] 1 WILLISTON, CONTRACTS, rev. ed., § 72 (1936).