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Prepayment Provisions in Bankruptcy: Premiums or Penalties?

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Practice Area: Restructuring and Insolvency & Banking and Commercial Finance

Commercial loan documents frequently provide for a prepayment premium. Often termed a "yield maintenance clause," "exit fee," or "prepayment penalty," these provisions are claimed by lenders and disputed by borrowers in and outside of bankruptcy proceedings.

These prepayment premiums may be a percentage of the outstanding indebtedness, a fixed fee, or a calculation based upon the difference between the contract rate of interest and the market rate of interest at the time of the prepayment.

Prepayment premiums come into effect not only when the borrower has *elected* to prepay the debt before its maturity date but also following the borrower's default and the lender's acceleration of the obligations. Prepayment premiums may be claimed in addition to late fees, interest, default interest, attorneys fees, and other costs of collection.

Lenders assert that the recovery of a prepayment premium is bargained for consideration and is due pursuant to the loan agreement. They further argue that the rates and fees included in the contract are agreed upon by sophisticated parties who are often represented by counsel. Lenders assert that prepayment premiums cover damages lenders incur in the event of prepayment by the borrower and are designed to ensure that the lender receives the benefit of its bargain. They contend that, absent enforcement of prepayment provisions, lenders are unable to protect themselves from the inherent risks of lending, especially changes in market conditions which are unforeseeable at the time that the loan is made.

Facing millions of dollars in prepayment penalties, borrowers argue that a lender waives its right to a prepayment premium when it accelerates its note, and that prepayment premiums are unreasonable penalties which bear no relation to a lender's alleged damages. Borrowers assert that these prepayment premiums are unenforceable.

Increasingly, courts are addressing the enforceability of these provisions, both under state law and in bankruptcy.

Unenforceability of Prepayment Premiums Upon Acceleration: Current Law in the Seventh Circuit

The Seventh Circuit has held that a lender is not entitled to a prepayment premium following its acceleration of the loan.[1] "This is so because acceleration, by definition, advances the maturity of the debt so that payment thereafter is not prepayment but instead is payment made after maturity." [2] Prepayment resulting from acceleration is not the voluntary act of the borrower. Moreover, acceleration is a voluntary waiver by the lender of the unpaid interest in "exchange for accelerated payment of the remaining principal." [3] Therefore, the "lender, by its [acceleration], may establish that it prefers accelerated payment to the opportunity to earn interest over a period of years." [4]

The court in *In re LHD Realty Corp. ("LHD")* found that when a lender shows an unmistakable intention to accelerate, then the lender forfeits its right to a prepayment premium. [5] In this case, the debtor executed a note which was secured by a mortgage on an office building. The note provided for a prepayment premium if the loan was paid before maturity. The debtor filed a voluntary petition under Chapter 11, started to make late payments on its loan, and eventually ceased making payments altogether. National Life Insurance Company ("National"), the assignee of the note, filed a request for relief from the automatic stay to allow it to foreclose on the office building which secured the note. The court denied the request and instead allowed the debtor to sell the building in bankruptcy.

Recognizing that reasonable prepayment premiums are enforceable and serve a valid purpose, the court noted that a lender's rights under prepayment premiums have certain limitations. One such limitation is that a lender loses its right to a prepayment premium when it accelerates the payment of the debt. By exercising this option, National advanced the maturity date of the debt. Accordingly, the court held that the payment was not a prepayment because by demanding payment, the lender caused the payment to be due.

Contracting for Prepayment Premiums: Enforceability Under State Law

In *LHD*, the court states: "These exceptions [to the enforceability of a prepayment premium] have been read into contracts by courts and could presumably be modified by the parties through appropriate contractual provisions." [6] Courts have more recently reviewed modified contract language and held that the lender may be entitled to its contractual prepayment premium, even after acceleration.

In *In re AE Hotel Venture*, the District Court for the Northern District of Illinois enforced a prepayment premium in connection with sale of property in the borrower's chapter 11 bankruptcy proceeding where the loan documents provided that the prepayment premium would be due after default and prior to a foreclosure sale of the property. [7] In this case, the lender accelerated the debt and filed a foreclosure action after the borrower defaulted on its loan. The borrower then filed a chapter 11 bankruptcy proceeding and, shortly thereafter, the borrower conducted a bankruptcy auction sale of the property.

The lender filed a proof of claim seeking: (1) a late payment charge equal to 5% of the unpaid balance of the loan, (2) default interest at the rate of 14.72% (a 5% increase over the contract rate of 9.72%), and (3) a prepayment premium of $1,248,290.91 (more than 18% of the loan balance).

The borrower contested the lender's request for the prepayment premium. The borrower asserted that the prepayment premium was unenforceable because of the lender's acceleration, and that the prepayment premium constituted an unenforceable penalty.

The court found that, although the prepayment premium did not specifically address payment after acceleration, it provided that payment of the debt after default *would be deemed to be a voluntary prepayment* as long as the prepayment occurred "before a foreclosure sale or some other sale resulting from [the lender's exercise of its] remedies under the mortgage." [8] Thus, the prepayment provision was enforceable even though the lender had accelerated the debt because the language of the contract so provided.

Next, the court analyzed Illinois law, which employs the law of liquidated damages to determine whether a prepayment premium is a penalty. Enforceability of prepayment clauses under Illinois law "depends on whether the premium is meant to liquidate damages or impose a penalty."[9] Three elements must be met for a liquidated damages clause to be enforceable: (1) the amount of damages was reasonable at the time of contracting in that they bear some relation to the damages which might have been sustained; (2) the amount of actual damages from a breach would be uncertain and difficult to prove at the time of contracting, and (3) the parties intended to agree in advance to the settlement of damages that might arise from a breach. [10]

The court found that the burden of proving that the prepayment premium imposed a penalty rests with the party resisting its enforcement, and further found that the borrower failed to meet its burden of proof. The court noted that the relevant question is not the size of the liquidated damages amount, standing alone, but the relationship between that amount and the actual projected loss. [11] Prepayment premiums, as liquidated damages provisions, must be a reasonable forecast of and bear some relationship to the lender's loss. [12]

Treatment of Prepayment Premiums in Bankruptcy

Section 506(b) of the Bankruptcy Code permits an oversecured creditor to receive interest on its claim and reasonable fees, costs, and charges pursuant to an agreement between the creditor and the debtor. [13] For a lender whose contract provides for prepayment premium to actually receive its prepayment premium as a reasonable post-petition charge pursuant to section 506(b) of the Code, the prepayment premium must meet a twopronged requirement.[14] First, the prepayment premium must be enforceable under state law. Second, the prepayment provision must be reasonable under section 506(b) of the Code.

The determination of whether a prepayment premium is "reasonable" for purposes of section 506(b) requires a detailed analysis.

"Reasonableness" for Purposes of Section 506(b)

Bankruptcy courts have generally adopted two different approaches when determining what it means for a prepayment provision to be a "reasonable" charge. "Most courts require that a prepayment premium reflect the actual damage the lender suffered from the prepayment. In addition, these courts often (though not always) examine the equities of awarding the premium." [15]

However, in addition to the standard approaches, other courts evaluate prepayment premiums as liquidated damage clauses. [16] For instance, in *Noonan v. Fremont Financial*, [17] Judge McGarity, writing for the Bankruptcy Court for the Eastern District of Wisconsin, applying Illinois law, evaluated the enforceability of a prepayment premium included in a loan agreement for a line of credit. The trustee contended that the prepayment premium of $225,000 (3% of the advance limit) was unreasonable and unenforceable as a liquidated damages clause. The court looked to whether the amount of the prepayment penalty was a reasonable estimate of the damages caused by the borrower's breach of the loan agreement, determined that actual damages for breach were impossible to determine, and held that the prepayment fee was enforceable under Illinois law.

Next, the court looked to whether the prepayment premium was "reasonable" under section 506(b) of the Code. In doing so, the court evaluated the prepayment premium as a liquidated damage clause. The court paid particular attention to the language of the contract itself, noting that the relevant clause in the loan agreement was drafted specifically as a liquidated damages provision, and stated that payment of the prepayment charge was deemed to be a "reasonable calculation" of the lender's lost profits and damages as the result of early termination and that the charge was agreed to "[i]n view of the impracticality and extreme difficulty of ascertaining actual damages and by mutual agreement of the parties."[18] Further, the court recognized that borrower and lender: were sophisticated parties and [were] represented by competent counsel. The transaction was entered into voluntarily and at arm's length. This formula is a reasonable calculation of liquidated damages for early termination, the creditor is entitled to the benefit of its bargain. [19]

Accordingly, the court awarded the lender recovery of its prepayment premium.

However, a different question arises when the prepayment premium is shown to be something other than a reasonable calculation of damages for early termination. In *River East Plaza, LLC v. The Variable Annuity Life Company*, the District Court for the Northern District of Illinois was called upon to determine whether a prepayment fee provision in a commercial loan was an unenforceable penalty. [20] After reviewing the evidence presented at trial, the court determined that the amount provided in the prepayment provision of the note was not reasonable at the time of contracting, and did not bear some relation to the damages which might have been sustained by prepayment. [21] Therefore, part of the prepayment provision, which was based on a yield maintenance clause, was found to be a penalty, and unenforceable. [22] The court distinguished *Lappin* by noting that the prepayment penalty in *Lappin* bore some relationship to the damages sustained by the lender as a result of the prepayment.[23]

In support of its conclusion, the court in *River East Plaza* cited *In re Kroh Brothers Development Corp.*,[24] which also found that where no rational relationship exists between the claimed prepayment premium and the damages foreseeably sustainable by the lender, the premium will be treated as a penalty and will not be enforced.[25]

Developing Trend: Enforcement of Prepayment Premiums
Increasingly, courts are holding that a lender may collect its contracted-for prepayment premium upon the debtor's default and the lender's acceleration, provided that the agreement provides for such payment in the event of acceleration, and that the premium bears a rational relationship to the lender's loss. To be enforceable, prepayment premium provisions should: (1) make clear that the borrower is obligated to pay in the event of default and acceleration; (2) state that damages for early termination are not easily ascertainable, and (3) make clear that the provision is intended to compensate the lender for the actual loss sustained as a result of the prepayment, and is not a penalty to punish the borrower for its default or early payment.

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[1] See *In the Matter of LHD Realty Corp.*, 726 F.2d 327, 330 (7th Cir. 1984).

[2] *Id.*; *see also Slevin Container Corp. Container Corp. v. Provident Fed. Sav. & Loan Ass'n*, 424 N.E. 2d 939, 941 (Ill. App. Ct. 1981) ("[T]he exercise of the election [to accelerate] renders the payment made pursuant to the election one made after maturity and by definition not prepayment.").

[3] *In the Matter of LHD Realty Corp.*, 726 F.2d at 331.

[4] *Id.*

[5] *Id.*

[6] *Id.* at 331 n.5.

[7] *In re AE Hotel Venture*, 321 B.R. 209, 216 (Bankr. N.D. Ill. 2005), *aff'd* 2006 U.S. Dist. LEXIS 2040 (N.D. Ill. Jan. 20, 2006).

[8] *Id.* at 219.

[9] *Id.* at 220.

[10] *See River East Plaza, L.L.C. v. The Variable Annuity Life Co.*, 2006 U.S. Dist. LEXIS 73317, at *24 (N.D. Ill. Sept. 22, 2006).

[11] *In re AE Hotel Venture*, 321 B.R. at 220 (*citing Jameson Realty Group v. Kostner*, 813 N.E.2d 1124, 1130 (Ill. App. Ct. 2004)).

[12] *Id.* at 221.

[13] "To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose." 11 U.S.C. § 506(a) (2005).

[14] *See Noonan v. Fremont Fin.* (*In re Lappin Electric Co.*), 245 B.R. 326, 329 (Bankr. E.D. Wis. 2000).

[15] *Id.* at 217 (citing *Sachs Elec. Co. v. Bridge Info. Sys., Inc.* (*In re Bridge Info. Sys., Inc.*), 288 B.R. 556, 564 (E.D. Mo. 2002); *In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. 823, 828 (Bankr. E.D. La 2001); *In re Outdoor Sports Headquarters*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993); *In re 433 S. Beverly*, 117 B.R. 563, 569 (Bankr. C.D. Cal. 1990).

[16] *See id*. (citing *In re A.J. Lane & Co.*, 113 B.R. 821, 827-28 (Bankr. D. Mass. 1990); *Connecticut Gen. Life Ins. Co. v. Schaumburg Hotel Owner Ltd. P'ship* (*In re Schaumburg Hotel Owner Ltd. P'ship*), 97 B.R. 943, 953-54 (Bankr. N.D. Ill. 1989)).

[17] *Noonan v. Fremont Financial* (*In re Lappin Electric Co.*), 245 B.R. 326 (Bankr. E.D. Wis. 2000).

[18] *Id.* at 328.

[19] *Id.*

[20] 2006 U.S. Dist. LEXIS 73317 (N.D. Ill. Sept. 22, 2006).

[21] *Id.* at *36-7 (*citation omitted*).

[22] *Id.*

[23] *Id.* at *31.

[24] *In re Kroh Bros. Dev. Co.*, 88 B.R. 997 (W.D. Mo. 1988).

[25] *River East Plaza, L.L.C.*, 2006 U.S. Dist. LEXIS 73317, at *29-30.

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