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ARTICLES

MORTGAGE PREPAYMENT CLAUSES: AN ECONOMIC AND LEGAL ANALYSIS

Dale A. Whitman*

Most mortgages on income-producing real estate (as distinct from owner-occupied housing) contain clauses restricting early payment of the loan. These clauses are highly controversial, and borrowers often resist their enforcement. While other writers have discussed prepayment clauses in the recent legal literature,1 my objectives in this Article are to advance this discussion in three respects: first, to provide an economic perspective on mortgage prepayment as support for a set of legal recommendations; second, to

* Guy Anderson Professor of Law, J. Reuben Clark Law School, Brigham Young University. The author gratefully acknowledges the helpful discussions and comments on earlier drafts of this paper by Frank S. Alexander, Robert S. Cooter, James D. Gordon III, Herbert Hovenkamp, James Kearl, Grant S. Nelson, and Chester S. Spatt. All faults and errors are, of course, attributable to the author rather than these generous colleagues.


Earlier articles include Jack F. Bonanno, Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives, 6 U.S.F. L. REV. 267 (1972); Ellis J. Harmon, Comment, Secured Real Estate Loan Prepayment and the Prepayment Penalty, 51 CAL. L. REV. 923 (1963).

See also GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 6.1-.5 (2d ed. 1985) for a general discussion of prepayment clauses.
consider whether the bankruptcy of the mortgagor should affect enforceability of a prepayment fee clause; and third, to analyze the cumulative effect of the presence in the same mortgage documents of both a clause imposing a fee upon prepayment of the loan and a clause accelerating the loan in the event of default, sale, eminent domain taking, or hazard insurance payoff.

I. INTRODUCTION

A. The Due-on-Sale Background

By using prepayment restrictions, lenders attempt to protect themselves against the vagaries of interest rate cycles. When rates fall, borrowers are inclined to prepay, depriving lenders on fixed-rate mortgage loans of the benefit of the existing contract rate. Prepayment restrictions seek to mitigate or prevent that deprivation. When rates rise, on the other hand, lenders on fixed-rate loans desire prepayment. The due-on-sale clause permits the lender to demand early payment if the real estate is transferred. Prepayment restrictions and due-on-sale clauses are thus opposite sides of a coin, the former significant in a falling rate market and the latter in a rising rate market. Because the economic history of the last twenty-five years is primarily one of extremely volatile and generally rising rates, due-on-sale clauses have been the subject of much more intense scrutiny in the courts and legislatures than prepayment clauses. It is helpful to review this controversy in setting the stage for a consideration of prepayment clauses.

In the 1970s and early 1980s, the enforceability of due-on-sale clauses was the subject of an intense legal battle waged for enormous stakes between lenders and borrowers. During much of that time, portfolio lenders—savings and loan associations and others that typically retain loans in portfolio rather than sell them in the secondary market—held large quantities of real estate loans made

2. It is really more than just loss at the contract rate. The lender has typically funded the loan by borrowing, matching the term of its borrowings against its expectations under the term of the mortgage. The lender doesn’t have attractive investment opportunities once the loan prepays because it has funded the original loan at high rates and now only has lower rate investment opportunities.

in earlier periods which bore interest yields considerably lower than current mortgage rates.\textsuperscript{4} Mortgages that contain enforceable due-on-sale clauses permit lenders to accelerate their loans when the real estate is sold and to compel a payoff, so that in a rising interest market the funds can be relent at the higher current rates. Alternatively, a lender can employ the clause as leverage to persuade the purchaser of the real estate to agree to an increase in the interest rate or the payment of a substantial "assumption fee" as the price of the lender's waiver of its right to accelerate. In either scenario, the clause allows the lender to increase the interest yield on its portfolio when a sale of the secured real estate occurs. In effect, the clause converts the fixed-rate mortgage loan into a partially effective but nonetheless highly useful adjustable rate mortgage.\textsuperscript{5}

The due-on-sale clause has a second function as well. It permits lenders to evaluate the credit history, income, and other characteristics of prospective purchasers of the real estate and to refuse to finance those whose characteristics are unsatisfactory under the lender's loan underwriting criteria. This function is by no means of trivial importance; in many situations it is crucial that the lender be able to avoid the increased risk of default that an uncreditworthy

\textsuperscript{4} In November 1981, at the peak of the rate cycle, the effective contract interest rate on new mortgage loans made by all major lenders on previously-occupied houses was 16.38\%. \textit{See Federal Home Loan Bank Bd., Savings \\& Home Financing Source Book 66 (1982).} Yet for FSLIC-insured savings associations, the average return on mortgage portfolios for the second half of 1981 was only 10.07\%. \textit{Id.} at 58. As the title to an article published during this era in the savings industry press suggested, \textit{Old Loans Never Die, They Just Eat Up Profits. Savings \\& Loan News, Jan. 1982, at 108.}

\textsuperscript{5} \textit{See} Kenneth B. Dunn & Chester S. Spatt, \textit{An Analysis of Mortgage Contracting: Prepayment Penalties and the Due-on-Sale Clause,} 40 J. Fin. 293, 294 (1985) ("[A]\nadjustable-rate loan or hedging in the financial market provides the lender with better protection from interest rate risk than a due-on-sale clause."). Dunn and Spatt regard the due-on-sale clause as imposing a form of prepayment penalty; the clause both compels prepayment when the real estate is sold and also requires the borrower to pay at par (\textit{i.e.}, the face amount of the loan balance) when in reality the loan may have a considerably lower market value because of increases in market interest rate. The difference between the loan's market value and the amount the lender requires to discharge it is, in effect, a prepayment penalty. Lenders do not always require payment at par, despite the fact that the due-on-sale clause gives them the right to do so; they may accept payment at a discount, which is frequently reflected in the lender's willingness to refinance the loan at a "blended" rate that is somewhat below current market rates. Dunn and Spatt provide an economic rationale for this practice by lenders. \textit{Id.}

While this sort of payment in excess of the loan's market value may be regarded as a prepayment penalty in an economic sense, it is not the principal focus of this Article, which is mainly concerned with explicit prepayment fees. Such fees are sometimes exacted by lenders in conjunction with the exercise of due-on-sale clauses. \textit{See infra} text accompanying notes 162-163.
Nevertheless, in periods of rising interest rates, the due-on-sale clause's rate adjustment function, described above, is far more significant economically than its credit-risk avoidance function.

Portfolio lenders were under severe financial pressure during the 1979–1981 period. They were obliged to pay extremely high interest rates on savings deposits and other sources of funds, while the yields on their portfolios of fixed-rate mortgage loans rose only gradually. The dangers of funding long-term lending with short-term borrowing became starkly clear to them. Many lenders regretted that they had not been making adjustable-rate loans during the previous decade. From their viewpoint, the due-on-sale clause was the only bright spot in an exceedingly bleak landscape. They were understandably disheartened when courts and legislatures in about a dozen states held that such clauses were unenforceable except when the credit or other personal characteristics of the proposed purchaser of the real estate were objectively unacceptable.

6. In the second half of 1981, while the average return on mortgage portfolio to insured savings associations was 10.07%, the average cost of funds (primarily savings deposits) to those same institutions was 11.53%. See Federal Home Loan Bank Bd., supra note 4, at 56, 58. Thus most institutions were losing net worth every day they were open for business! As one economist summarized the situation:

When short-term interest rates rose from approximately seven percent in 1978 to sixteen percent in 1981, SLAs faced a run off of deposits ($25 billion in 1981 and $6 billion in 1982) while they still held mortgages paying an average of nine to ten percent. Further, while Congress began to deregulate deposit interest rates in 1980, which helped stem the outflow of depositors' funds, this served to increase the thrifts' cost of funds to the point where interest margins often were negative.


7. As one savings association president put it, "We should have forced the government to come up with adjustable mortgage loans 10 years ago." See Beth M. Linnen & John N. Frank, Battered, the Business Hangs on in a Horrid Year, SAVINGS & LOAN NEWS, Apr. 1982, at 36, 37.

8. For a review of the state cases and other judicial decisions restricting due-on-sale enforcement, see NELSON & WHITMAN, supra note 1, § 5.22.

For economic analyses of the importance of the due-on-sale issue to the thrift industry, see FREDERICK E. BALDERSTON, THRIFTS IN CRISIS: STRUCTURAL TRANSFORMATION OF THE SAVINGS AND LOAN INDUSTRY 42–53 (1985); J. Kimball Dietrich et al., The Economic Effects of Due-on-Sale Clause Invalidation, 2 HOUSING FIN. REV. 19 (1983). The latter work estimates that the decision of the California Supreme Court in Wellenkamp v. Bank of America, 582 P.2d 970, 976–77 (Cal. 1978), which held due-on-sale clauses unenforceable unless the lender's security or risk position was impaired, caused a loss of 45% in value of the mortgages held by state-chartered thrift institutions in California. See also Mark Meador, The Effects on Mortgage Repayments of Restrictions on the Enforcement of Due-on-Sale Clauses: The California Experience, 10 AM. REAL. EST. & URB. ECON. ASS'N J. 465, 471 (1983) (estimating that the Wellenkamp
In response, they appealed to Congress to preempt these state statutes and decisions and to authorize all lenders in the nation to enforce due-on-sale clauses, even in cases where a lender's sole motivation was to increase the yield on its portfolio.

Congress acceded to the lenders' wishes by enacting section 341 of the Garn-St. Germain Depository Institutions Act of 1982. The "Garn Act" gave the lenders nearly everything they wanted. It declared due-on-sale clauses enforceable as a matter of national policy, preempting contrary state law. At the same time, in an ingenious political compromise, it protected borrowers in states that had legal restrictions on due-on-sale enforceability. By suspending the imposition of federal law for three years in these states, the Garn Act protected borrowers who might thus have obtained loans under the impression that these restrictions would apply to them. It also exempted a set of "minor" transfers of real estate (transfers to family members, passage of title at death, and the like) because Congress considered due-on-sale enforcement to be unfair in such situations. These sorts of transfers were declared not to trigger due-on-sale clause enforcement, at least on one-to-four-family case seriously reduced mortgage repayments to state-chartered savings associations during 1981, resulting in a loss to those institutions of $58 million to $170 million); Larry Ozanne, The Financial Stakes in Due-On-Sale: The Case of California's State-Chartered Savings and Loans, 12 Am. Real Est. & Urb. Econ. Ass'n J. 473 (1984).
homes, and that declaration was also made preemptive of state law.13

B. Prepayment Clauses in the Market

While the Garn Act settled the principal debate over due-on-sale clause enforceability, it dealt effectively with only half of the underlying problem of interest rate volatility. Due-on-sale clauses are designed to protect lenders by permitting them to adjust their portfolios' yields upward when interest rates have risen after the loan was made. Thus, they approximate the effect of an adjustable rate mortgage (ARM) loan, permitting the interest to be adjusted upward as the underlying real estate is transferred. But lenders also have a serious concern about the other side of the interest rate cycle. When rates fall, borrowers frequently wish to prepay their mortgage loans by obtaining new and cheaper financing from other sources.14 Lenders naturally wish to maintain the yields on their portfolios in such periods—to have "call protection," in bond market terms—and hence have developed various mortgage clauses to restrict prepayment or to permit it only upon the payment of an additional fee.

As a practical matter, these clauses have virtually disappeared in loans secured by single-family homes and are of interest primarily in income-producing real estate such as apartment buildings, offices, and shopping centers or other retail space. A number of states have sharply restricted their use in the home loan setting by statute.15 More importantly, both the Federal National Mortgage As-

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13. The original 1982 version of the Act exempted these sorts of transfers even with respect to mortgages on commercial property, but an amendment, effective November 30, 1983, provided that they are insulated from acceleration only if the mortgaged real estate contains "less than five dwelling units." Supplemental Appropriations Act of 1984, Pub. L. No. 98-181, § 473, 97 Stat. 1153, 1237 (1983). The Federal Home Loan Bank Board's original regulation interpreting the Act had attempted to limit these exemptions to loans secured by borrower-occupied homes, see 48 Fed. Reg. 21,562 (1983) (codified at 12 C.F.R. § 591.5(b) (1992)), but it is doubtful whether the Board was within its authority in doing so. For further analysis of this issue, see Nelson & Whiting, supra note 1, § 5.24.

14. The relationship between market rates and the probability of prepayment of existing mortgages is demonstrated empirically in Jerry Green & John B. Shoven, The Effects of Interest Rates on Mortgage Prepayments, 18 J. Money, Credit, & Banking 41 (1986).

15. States imposing such restrictions include California, Illinois, Kansas, Massachusetts, Michigan, Mississippi, Missouri, New Jersey, New York, North Carolina, Pennsylvania, and West Virginia. Statutory references are found in Nelson & Whiting, supra note 1, § 6.4 and Baldwin, supra note 1, at 430-34. See Resolution Trust Corp. v. Minassian, 777 F. Supp. 385, 390 n.1 (D.N.J. 1991) (discussing New Jersey statute); Donahue v. LeVesque, 215 Cal. Rptr. 388 (Ct. App. 1985) (statutory privilege of free prepayment applies even to a purchase-money mortgage given to a land vendor,
association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), the two principal federally sponsored entities purchasing mortgages on the secondary market, announced that beginning in 1980 they would no longer accept home mortgage loans containing prepayment fee clauses. Since the vast majority of home loans in the nation are written on the standard FNMA-FHLMC mortgage and note forms, and since these forms now insist upon free prepayment, the legal issues surrounding prepayment are of little current importance in home lending. While a few institutional home lenders and individuals (e.g., sellers of houses who take

where prepayment is made after the calendar year of the sale); Skyles v. Burge, 789 S.W.2d 116 (Mo. Ct. App. 1990); Weinstein v. Investors Sav. & Loan Ass'n, 381 A.2d 53 (N.J. Super. Ct. App. Div. 1977) (statutory restrictions on prepayment fees apply only to mortgages entered into after legislation's effective date); see also OR. REV. STAT. §§ 82.160–170 (1987) (requiring a prominent notice in the loan agreement of a lock-in or prepayment fee, and not limited to residential mortgages); Schnitzer v. State Farm Life Ins. Co., 773 P.2d 387 (Or. Ct. App. 1989).


17. Professor Frank Alexander, in his thorough 1987 analysis of the prepayment issue, suggested that prepayment penalties would be reintroduced into residential loan documents in response to the needs of the secondary mortgage market, and the demands of the holders of securities collateralized by mortgages, for greater predictability of loan prepayment. See Alexander, supra note 1, at 328–34. Thus far, however, the interests of consumerism seem to have prevailed over the needs of mortgage investors, and his prediction has not come to pass.

It should be noted that while residential lenders rarely impose prepayment restrictions or fees, they in effect compensate themselves for the risk of prepayment by charging “discount points” when residential loans are originated. For example, if one “discount point” (one percent of the amount of the loan) is charged on a loan with a face amount of $100,000, the lender will in fact disburse only $99,000 to the borrower. Nevertheless, if the borrower elects to prepay the loan before any amortization of the principal has occurred, the amount necessary to prepay is the $100,000 face amount. Thus the “points” have two effects: they increase the effective interest yield to the lender, and they produce additional revenue to the lender if prepayment occurs. See John M. Harris, Jr. & G. Stacy Sirmans, Discount Points, Effective Yields, and Mortgage Prepayments, 2 J. REAL EST. RES., Winter 1987, at 97.
purchase-money mortgages) may still employ prepayment restrictions, the focus of the remaining analysis here is on commercial or income-property lending.\textsuperscript{18}

C. \textit{An Introduction to the Law of Prepayment}

A summary of the traditional rules of mortgage prepayment will provide a helpful starting point. First, American law has presumed that in the absence of a clause permitting prepayment, the lender is under no duty to accept it.\textsuperscript{19} Hence, a mortgage loan whose documents are entirely silent on the subject is not prepayable as a matter of right. This standard doctrine seems contrary to common expectation, and several courts have recently announced that

\textsuperscript{18} A very limited form of prepayment fee is currently charged by lenders on FHA mortgage loans insured after August 2, 1985. On these loans the lender may charge interest for the entire month during which prepayment is made, even if the prepayment occurs before the last day of the month. In effect, borrowers who prepay before the last day of the month thus pay an unearned partial month's interest. The amounts involved are often several hundred dollars. See Cranston-Gonzalez National Affordable Housing Act of 1990 § 329, 12 U.S.C. § 4101 (Supp. III 1991) (requiring that borrower be given notice of this practice); 56 Fed. Reg. 18,951 (1991) (HUD regulation implementing this act); Carollo v. Financial Fed. Sav. & Loan Ass'n, 538 N.E.2d 884 (Ill. App. Ct. 1989) (upholding the practice). Note that no language authorizing this practice appears in the standard FNMA/FHLMC residential conventional mortgage form, and a lender's attempt to charge more than a per diem interest under that form is probably improper.

\textsuperscript{19} This rule of "perfect tender in time" is usually dated from Abbe v. Goodwin, 7 Conn. 377 (1829) and Brown v. Cole, 60 Eng. Rep. 424 (Ch. 1845). Professor Frank Alexander has argued vigorously and cogently that these decisions misunderstood pre-existing law and reached a result contrary to common sense. See Alexander, \textit{supra} note 1, at 298–308.


Language that obligates the lender to accept prepayment does not necessarily use the term "prepayment." For example, if the promissory note or bond's statement of the amount of regular installments due describes that sum as "$X or more," the latter phrase is sufficient to authorize the payment of any amount "more," including the full balance. Similarly, a promise to pay a sum "on or before" a maturity date will permit free payment prior to that date. See Garner v. Sisson Properties, 31 S.E.2d 400 (Ga. 1944).

For a discussion of the few cases which depart from the rule of "perfect tender in time" and permit prepayment when the mortgage is silent on the point, see \textit{infra} notes 43–49 and accompanying text.
they will no longer follow it.\textsuperscript{20} Without doubt the standard rule ought to be reversed. Surely it is not too much to expect lenders who want to restrict prepayment to say so in the mortgage. But the issue is currently of little consequence, since most modern mortgage forms (and virtually all forms prepared for use in income-property lending) deal explicitly with prepayments.

A second issue is the enforceability of prepayment fees which are provided for in the relevant note or mortgage. The general reaction of state courts has been to enforce them routinely, notwithstanding arguments that they are usurious,\textsuperscript{21} are unconscionable,\textsuperscript{22} constitute restraints on alienation,\textsuperscript{23} or amount to invalid liquidated damages clauses.\textsuperscript{24} While some case authority indicates that grossly excessive fees might not be permitted,\textsuperscript{25} one court approved a fee of fifty percent of the balance being prepaid where there was some evidence that the payment could have caused the lender damages approximating that amount.\textsuperscript{26} Where the borrower is in bankruptcy,\textsuperscript{27} or where the prepayment is regarded as involuntary,\textsuperscript{28} a very different picture, one much less favorable to lenders,

\begin{itemize}
\item \textsuperscript{20} See Spillman v. Spillman, 509 So. 2d 442 (La. Ct. App. 1987); Hatcher v. Rose, 407 S.E.2d 172 (N.C. 1991); Mahoney v. Furches, 468 A.2d 458 (Pa. 1983); \textit{see also} FLA. STAT. ANN. § 697.06 (West 1988) ("Any note which is silent as to the right of the obligor to prepay the note in advance of the stated maturity date may be prepaid in full by the obligor or his successor in interest without penalty."); MacIntyre v. Hark, 528 So. 2d 1276 (Fla. Dist. Ct. App. 1988).
\item \textsuperscript{22} See Aronoff v. Western Fed. Sav. & Loan Ass'n, 470 P.2d 889 (Colo. Ct. App. 1970).
\item \textsuperscript{24} See Meyers v. Home Sav. & Loan Ass'n, 113 Cal. Rptr. 358 (Ct. App. 1974); \textit{Lazzareschi Inv. Co.}, 99 Cal. Rptr. 417. \textit{But see infra} text accompanying notes 92–95 (arguing that such decisions are incorrect and that the prepayment fee clause is a species of liquidated damage clause).
\item \textsuperscript{25} See \textit{Lazzareschi Inv. Co.}, 99 Cal. Rptr. at 420.
\item \textsuperscript{26} See Williams v. Fassler, 167 Cal. Rptr. 545 (Ct. App. 1980); \textit{see also} Century Fed. Sav. & Loan Ass'n v. Madorsky, 353 So. 2d 868 (Fla. Dist. Ct. App. 1977) (approving a fee equal to 12 months' interest).
\item \textsuperscript{27} See \textit{infra} text accompanying notes 98–137.
\item \textsuperscript{28} See \textit{infra} text accompanying notes 138–189.
\end{itemize}
emerges. But in the absence of these two factors, legal attacks by borrowers nearly always fail.

D. The Financial Impact of Prepayment on Mortgage Lenders

From the lender's viewpoint, what function do prepayment restrictions and fees serve? Both lender and borrower recognize at the time of contracting that in the event the borrower pays the loan prior to maturity, the lender may suffer damage as a consequence. The predominant element of that damage is, of course, the lender's loss of an advantageous interest rate in a market in which rates may have declined since the loan was made. The lender may also incur some transaction cost in relending the funds, and in some cases an additional tax liability.

Prepayment raises the possibility of gain as well as loss to the lender. If the prepayment occurs at a time when market rates have risen, the lender will be able to relend the funds more profitably than under the old loan and will experience a gain. However, voluntary prepayments under such circumstances are relatively uncommon, since from the borrower's viewpoint a prepayment "at par" (that is, for the face amount of the loan's balance rather than at a discount) on these facts simply throws away the benefit of an advantageous contract. Still, such prepayments do occur sometimes. If the property is being sold, for example, the new owner may prefer a different monthly payment structure, perhaps with lower payments, even at the same interest rate. The mortgage may contain nonfinancial covenants from which the new owner wishes to escape, such as those dealing with the business operation of the property. Individuals who guaranteed the original loan may wish to get out of their liability. Any of these factors and others may induce the mortgagor to seek repayment of the loan even if no inter-

29. Of course, the lender may negotiate with a borrower a prepayment at a discount under these circumstances. If the discount is deep enough it may benefit the borrower sufficiently to equal the present value of the low interest rate on the loan being prepaid. For example, during 1986 and 1987 several federal government agencies that operate loan programs began accepting prepayments from the borrowers, in some cases at substantial discounts. See U.S. GEN. ACCOUNTING OFFICE, BORROWER LOAN PREPAYMENTS: OMB GUIDELINES NEED TO BE STRENGTHENED 19-29 (1989) (criticizing the basis on which some of the agencies computed discounted prepayment amounts as too generous to borrowers and as resulting in unnecessary losses to the government).

30. The borrower may sell the real estate to a corporation which has large quantities of cash or equity financing available to it, and which for accounting purposes wishes to hold the property debt-free; or the borrower may die, and his or her personal representative may be under a legal obligation to pay the decedent's debts. The debt may also be reduced by payment to the lender of the proceeds of casualty insurance policies
est rate savings will result. But whatever the borrower's motivation for prepaying, the payment raises a risk of damage to the lender primarily because of the risk that the funds must be relent at a lower interest rate.

An illustration using specific amounts will show how the lender's damage can be quantified. Assume that a mortgage loan has a remaining term of ten years, an interest rate of twelve percent, and an outstanding balance of $1 million. (The original loan may have been at a higher balance and for a longer term, but the foregoing assumptions reflect the loan's status at the time it is prepaid.)\(^{31}\) Assume also that the loan requires equal monthly payments which are sufficient to fully amortize the balance over the remaining term. Those payments will be $14,347 per month.

Now suppose a complete prepayment of the loan is made at a time when current mortgage interest rates (on similar types of loans) have fallen to ten percent. If we disregard transaction costs and assume that the lender in fact relends the $1 million at ten percent interest for a ten year term, the lender will receive a monthly payment of $13,215 per month; the loss in monthly payments to the lender as a result of the prepayment and relending will thus be $14,347 minus $13,215, or $1,132 per month. The present value of this monthly loss, discounted at the current interest rate of ten percent, is $85,736.\(^{32}\)

Some further elements of damage to the lender may exist. The borrower generally pays virtually all out-of-pocket transaction costs in commercial loan transactions: title, survey, credit report, appraisal, inspection, and other fees. In addition, lenders typically charge a general "loan fee" or "origination fee," which may cover part or all of their internal costs. But to the extent that any costs of relending are not thus covered, the lender may have a legitimate claim of further damage. Of course, the lender would eventually have incurred relending costs even if the loan had been paid on schedule rather than prior to maturity. Hence, it would be reasonable to "amortize" the relending costs, reducing the lender's claim

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\(^{31}\) For example, the loan might have been made five years earlier for a total term of 15 years. Under this assumption, the original loan amount would have been $1,195,500 and the balance would have been reduced to $1 million by five years of regular monthly payments. This information is not essential to the illustration in the text.

\(^{32}\) The current mortgage rate is an appropriate discount rate, since it reflects the current value of money in the relevant market.
of damages over time as prepayment occurs later in the original loan's term.

Moreover, the lender may be required to wait for some period until another suitable mortgage lending opportunity presents itself. Of course, the lender will not hide the money in a mattress in the interim; it will be invested in short-term commercial paper, short-maturity United States government obligations, or similar cash-equivalent instruments. These investments will typically carry interest rates a bit lower than commercial mortgage rates—perhaps two to three percent lower.33 Hence there may be an additional short-term loss beyond that estimated above. But its impact is apt to be quite small; the loss of even three percent interest on a $1 million principal sum for a month is only about $2,500. In general, then, the estimate of the lender's damages presented above must be regarded as both easy to derive and accurate.

A prepayment also raises the possibility of greater income tax liability to the lender, at least if the lender is also the seller of the real estate and is reporting the gain from that sale on the installment basis.34 Prepayment may accelerate to the current year a tax liability that would have accrued only in future years under the original payment schedule. Consequently, the seller/lender may suffer economically both from having to pay the taxes earlier and possibly from having to pay them at a higher marginal rate.

The borrower and lender have the right to allocate the risk of the lender's loss of an advantageous rate in any way they choose. One possibility, represented by the FNMA/FHLMC home mortgage form, is free prepayment: the lender bears the entire risk of interest rate declines. At the other extreme, the agreement may provide that the loan is "locked in," so that prepayment is not permissible; thus the borrower bears the full risk. One may also imag-

33. See, e.g., Loan Demand Weak, While Interest Rates Inch Up, REAL EST. FIN. TODAY, Apr. 26, 1989, at 14 (reporting income-property mortgage yields of about 100–105 basis points (a basis point is 1/100 of 1%) above U.S. Treasury obligations of similar maturity (e.g., 5 to 10 years), but with larger spreads of 125–150 basis points on smaller loans below $5 million).

Relating these rates to those on short-term (e.g., 90-day) Treasury yields is more complex, since short-term yields are "normally" significantly below medium-term yields (e.g., 150–200 basis points lower), but sometimes rise to or above medium-term yields during periods in which investors expect rates to rise generally. This phenomenon is known as an inversion of the "yield curve."

The statement in the text is thus a reasonable estimate of the typical differential between income-property mortgage rates and short-term Treasury rates, but that differential is quite variable.

ine any number of possible arrangements permitting partial prepayment, or full prepayment with various sorts of fee structures, and thus accomplishing a sharing of risk between borrower and lender.

II. LOCKED-IN MORTGAGE LOANS

A. The Economics of Mortgage Lock-Ins

Loans on commercial real estate commonly contain clauses known as “lock-ins” which prohibit all prepayments for the first five to ten years of the loan term. These clauses are designed to protect the lender’s investment in situations in which market rates have fallen at the time of a proposed prepayment; if rates have risen instead, the lender will normally be eager to waive the prohibition and accept the prepayment. Even if rates have fallen, so that the prepayment will produce loss to the lender, the lender may well be amenable to accepting prepayment during this period but may negotiate a sizeable fee as the price of doing so.\textsuperscript{35} As the Fifth Circuit Court of Appeals, upholding the results of such a negotiation, stated: “Having a good investment that did not require acceptance of prepayment, [the lender] could use market tactics to exact a profit.”\textsuperscript{36}

As noted above, in the absence of mortgage language on the point, the common law presumed that the lender had no obligation to accept prepayment.\textsuperscript{37} A fortiori, when the documents expressly prohibit early payment, the courts usually enforce these lock-in clauses, sustaining the lender’s right to refuse all prepayments for the period specified.\textsuperscript{38} This result is surprising, and wholly out of

\textsuperscript{35} See, e.g., Houston N. Hosp. Properties v. Telco Leasing, Inc., 680 F.2d 19, 22–23 (5th Cir.), aff’d on reh’g, 688 F.2d 408 (5th Cir. 1982); Tyler v. Equitable Life Assur. Soc’y, 512 So. 2d 55 (Ala. 1987). In each of the cases cited infra in note 52, the lender indicated a willingness to negotiate a fee which would permit prepayment during the lock-in period.

\textsuperscript{36} Houston N. Hosp. Properties, 680 F.2d at 22–23.

\textsuperscript{37} See supra note 19 and accompanying text. Several states have enacted statutes in recent years granting a right to prepay, but they are usually limited to mortgages on owner-occupied homes. See, e.g., 41 Pa. Cons. Stat. Ann. §§ 101, 405 (1992); see also Nelson & Whitman, supra note 1, § 6:1 n.3.

character with general contract law. A prepayment is in essence a breach by the borrower of the loan contract, requiring the borrower to repay the loan funds only in accordance with a prearranged schedule. In general it is unusual for the courts to compel a contracting party actually to perform; this result usually occurs only in cases in which the performance is unique or cannot fairly be compensated by money damages.\textsuperscript{39} In all other cases a contracting party is regarded as having the choice to perform or to pay damages for the breach. Since the payment of a mortgage loan as agreed (rather than via prepayment) is obviously not a unique sort of performance, and since its failure can easily be compensated by money damages, it is not clear why courts have been willing to enforce lock-in clauses literally.

Economic theory argues strongly for nonenforcement of the lock-in clause. The basis of this argument is the concept of the efficient breach. As Professor Hirsch has explained, this concept holds that:

[I]f one party determines that breach is in its self-interest, actual breach is efficient, as long as the other party is not harmed. The rule of financial [sic] equivalent performance ensures such an outcome by giving the nonbreacher the value of his deal; it releases the breaching party from an actual performance that he believes would be more expensive for him than payment of damages. Thus, the party best able to evaluate the cost of actual performance versus the payment of financial equivalent damages is given the power to decide. The nonbreacher is given his full financial equivalent for performance of the deal and may purchase conforming performance on the market.\textsuperscript{40}

The case of mortgage prepayment is an ideal one for application of this concept. The lender who receives an unwanted prepay-

\textsuperscript{39} See \textit{RESTATEMENT (SECOND) OF CONTRACTS} §§ 359–60 (1979) (specific performance or an injunction will not be ordered if damages are an adequate remedy; adequacy of damages is decided with reference to the difficulty of proof, the difficulty of purchasing a suitable substitute performance, and the likelihood of collecting damages if awarded).

MORTGAGE PREPAYMENT CLAUSES

ment, but who is also given the full economic value of the damages caused by the prepayment, simply has nothing to complain about; the lender may proceed to relend the funds, perhaps at a lower rate, but will have been fully compensated for the loss of income. The borrower who wishes to prepay, and who concludes that prepayment will be advantageous even though he or she must pay full damages as well, should be permitted to do so. If the borrower’s calculation of advantage is correct (and nobody is in a better position to judge it), an efficient result will ensue, and society as a whole will be better off.

Of course, in most cases the borrower will experience no direct economic advantage from prepayment under a legal rule that requires payment of full damages. In general, the borrower may refinance at a lower rate of interest and save considerable money over time, but the damages that must be paid to the old lender as the price of the prepayment will precisely equal the present value of those savings. Further, if the borrower plans to refinance by obtaining another conventional mortgage loan, he or she will usually incur significant transaction costs (title, legal, recording, appraisal, and similar expenses) in originating that new loan; hence, the prospect of refinancing and paying the old lender’s full damages becomes unattractive.

But for some borrowers in unusual situations, prepayment accompanied by the payment of actual damages may be advantageous. Several illustrations can be suggested. One possibility is a temporary market disequilibrium, allowing the borrower to find conventional financing elsewhere at lower rates than the existing lender can demand. But the financial markets of the United States have developed to a point of very high efficiency, and such a differential in rates is unlikely to be appreciable in size or to exist for long.

The following more probable situations offer examples in which prepayment is advantageous despite the borrower’s obligation to pay damages: (1) the real estate is being acquired by a governmental body or other entity that is cash rich or has access to below-market funds through tax-exempt borrowing; (2) the bor-

41. This point is nicely illustrated in John Tung, The Cost of the Loan Prepayment Privilege, REAL EST. REV., Spring 1989, at 87, 88–90. The borrower may obtain some forms of indirect advantages by refinancing, even if the lender’s full damages must be paid. For example, the new financing may have a longer term and lower monthly payments than the old loan, and thus may be easier to cover with the project’s cash flow. If the transaction cost of refinancing is not too great, it may be worthwhile to the borrower.
borrower has qualified for financing through industrial development
bonds, state housing finance agency bonds, or other state or local
governmental debt, again at a below-market, tax-exempt interest
rate; (3) the borrower has been awarded a governmental loan guar-
antee which enhances his or her credit substantially, allowing the
borrowing of conventional funds at lower rates than would nor-
mally be available; or (4) the borrower “goes public” or proposes to
sell the real estate to a public corporation that can raise funds in the
bond or equity markets with great economies of scale and, hence, at
a lower rate than would prevail in the mortgage market.

In each of these cases, the borrower either no longer needs debt
financing or can procure it advantageously from other sources.
Whether, in the case of tax-exempt financing, the borrowing vehicle
is itself efficient in a macroeconomic sense is another question and
well beyond the scope of the present discussion, but from the
viewpoint of the law of mortgage prepayments, it seems indispu-
table that the proposed prepayment (or breach) should be permitted if
the borrower will pay full damages.

B. Locked-In Mortgages in the Courts

A few courts in recent years appear to have come around to
this view. Perhaps the best illustration is the opinion of the Penn-
sylvania Supreme Court in Mahoney v. Furches. In Mahoney the
court created a presumption under Pennsylvania law contrary to
the common law presumption: that a right to prepayment exists if
the note is silent as to that right.

Of greater significance, however, was the court’s discussion of
an offer that the borrower had made to give the lender a bank letter
of credit or guarantee of payment in return for the lender’s release
of the land as security for the loan. The court observed in dictum
that

even where the mortgage explicitly states there is no right to pre-
pay the note, if the mortgagor can provide the mortgagee with
the benefit of his bargain under the terms of the note, he will be
allowed to have a release of his land following the substitution of
security or other arrangement.44

42. See generally David C. Beck, Rethinking Tax-Exempt Financing for State and
Zimmerman, The Intergovernmental Struggle over Tax-Exempt Bond Reform, in 7 Re-
43. 468 A.2d 458 (Pa. 1983); see also Spillman v. Spillman, 509 So. 2d 442, 444
44. Mahoney, 468 A.2d at 461 n.1.
The borrower can often provide this sort of substituted security, and Professor Frank Alexander has argued forcefully that the Pennsylvania court was correct in suggesting that the lender should be required to accept it as a matter of law. Economic analysis of such transactions justifies the court’s result. A substitution typically provides the lender with a better deal than it originally struck. The cash flow it receives will be identical to that agreed in the underlying mortgage note, yet the lender has obtained greater security.

Nevertheless, a substitution of security should not be the borrower’s only choice. The Pennsylvania Superior Court’s opinion in the Mahoney case suggests a broader view. That court declared that it would violate public policy “if we were to preclude the satisfaction of this mortgage once the mortgagor has provided for a method of prepayment that enables the mortgagee to reap all the benefits of the bargain including, of course, insulation of the mortgagor from such adverse tax consequences as may follow the prepayment.” Under this expansive statement, the “benefit of the bargain” owed to the lender might quite conceivably take the form, not of a substitution of security, but of a cash payment of the lender’s damages. Of course, the substitution of security approach has the advantage of circumventing the need to measure damages, since the lender literally suffers none. Nonetheless, if the borrower is willing to pay actual damages, there is authority (albeit dictum) in the superior court’s opinion in the Mahoney case for a right to do so.

45. An approach even less objectionable to the lender can sometimes be worked out. See Harris Ominsky, Creative Financing: How to Refinance Your Property in the Face of Lock-In Devices, A.B.A. REAL EST. FIN. NEWSL., Feb. 15, 1989, at 19, 22. Ominsky describes a technique in which the borrower places on deposit with a title insurer a sum of money equal to the balance on the existing mortgage. The borrower then obtains a new mortgage loan (at a lower interest rate) which the title company is willing to insure as a first lien since the company has the funds on deposit to fully pay off the prior lien. The title company invests these funds in accordance with standards agreed to by the borrower, and uses the investment earnings to service the preexisting loan. Id. Of course, if the investment earnings are not sufficient to cover the full debt service, the borrower will have to supplement the difference.

46. Alexander, supra note 1, at 337 n.240.

47. Obviously the lender is entitled to quibble if the financial strength of the institution issuing the guarantee or letter of credit is not at least the reasonable equivalent of the real estate security being released. But if the institution issuing the letter of credit is strong, “[t]he lender will usually go along with this. It can then continue to collect the contracted interest rates, and the credit enhancement will give it almost a bonded loan at no extra cost.” Ominsky, supra note 45, at 22.

The rationale of the superior court’s Mahoney decision (as well as that of the Pennsylvania Supreme Court) did not rely on the previously mentioned policy favoring efficient breach. Rather, the courts’ opinions were based on the view that prohibitions on prepayment unreasonably restrain the alienation of land. In most cases, however, this rationale is doubtful. Where a prepayment prohibition is present, the purchaser of the land may assume or take subject to the mortgage. If the mortgage loan carries an above-market rate, the purchaser of the land will insist on a discount against the purchase price to compensate him or her for taking over such disadvantageous financing. But this is merely another way of saying that the market value of the seller’s financing has declined as a result of falling market interest rates. The discount the seller must absorb (if the market in land is perfectly efficient) will be the equivalent of the damages which would be owed to the lender if the loan were prepaid. In reality, alienation is not restrained at all; the seller is merely haggling about the price. The same is usually true of the other terms included in the mortgage—term, outstanding balance, payment schedule, and need for additional collateral. These terms may not be ideal to the purchaser, but at some price-point, they will be acceptable.

On the precise facts of the Mahoney case, however, one can make a persuasive argument that the lender’s refusal to accept prepayment or substituted security caused an actual restraint on alienation. In Mahoney, the borrower proposed to sell the land as a subdivision rather than as a single tract. While there is no legal objection to the lot purchasers taking their titles subject to the preexisting “blanket” mortgage on the entire subdivision, there are serious practical problems with such an arrangement. In principle, it is possible to allocate payments on the blanket mortgage loan among the various lot buyers. The difficulties stem from the (reasonable) unwillingness of a given lot buyer to depend on the other owners making their prorata payments on the underlying mortgage. The situation requires undue and unacceptable mutual dependency: if Buyer 1 makes the required pro rata payments on the mortgage but Buyer 2 does not, Buyer 1 is subject to the risk of losing his or her land to foreclosure. Hence, to subdivide the land successfully

49. The doctrine of marshaling of assets might provide some purchasers consolation in this situation, requiring that the seller’s retained land be foreclosed first, and that the lots sold then be foreclosed in the inverse order of their sale. This might make the earlier lot buyers feel relatively secure, but the later buyers would face an increasingly unacceptable level of risk. Moreover, marshaling is a concept fraught with uncertainty.
it is probably essential that the seller procure its release from the mortgage first.

Outside the subdivision context, however, it is most doubtful that prepayment prohibitions per se restrain the marketing of real estate. Occasionally, there may be a purchaser whose preference for alternate financing is so strong that the inability to pay off the existing mortgage interferes with a sale. For example, a corporate buyer may, for accounting reasons, prefer to fund its purchase of the land with equity financing rather than mortgage debt. This is, however, an unusual situation.

In most cases, the lock-in provision of the existing mortgage does not kill sales. Rather, it reduces the seller's revenue upon sale as a result of the seller's having agreed to an interest rate that turns out to be high by the standards of the market at the time the sale of the land occurs. This is the very risk that the seller assumed by entering into a long-term, nonprepayable loan, and it can hardly be considered to restrain alienation. Thus, the restraint on alienation doctrine usually provides at best a weak rationale for a court's refusal to enforce a lock-in clause literally. The principle of efficient breach, presented above, has far broader application and is thus more appealing. For that reason, rather than the reason which the court gave, the Mahoney result is correct. The common law presumption that mortgage loans are nonprepayable should be reversed, and it should be legally impossible to "lock in" a mortgage loan.

III. ENFORCEMENT OF PREPAYMENT FEES OUTSIDE BANKRUPTCY

A. A Taxonomy of Prepayment Fee Clauses

We turn now from the lock-in problem to a consideration of prepayment fees. To begin, an examination of the kinds of fees in common use in the United States in recent decades is useful. The material which follows is not based on any broad-gauge survey of lenders or borrowers. Rather, it is anecdotal in nature, derived from reading the cases, examining numerous forms, and discussing the matter with lenders. Nevertheless, I believe it accurately depicts the evolution of the prepayment fee clause in modern mortgages.

and highly subject to litigation; few land buyers would wish to rely on it. See generally Nelson & Whitman, supra note 1, § 10.10.
We may begin with a clause that we will call Type I. In essence, it is a clause fixing a flat fee, either in dollar terms or as a percentage of the loan balance, as the price of prepayment. The prototype of this clause was found in the original FNMA/FHLMC home mortgage form, developed in 1971. It permitted the borrower to prepay up to twenty percent of the original balance in any twelve month period without charge, and levied a fee of six months' interest on all prepayments in excess of the twenty percent level. For a time this formula was enshrined in the Federal Home Loan Bank Board's regulations governing federal savings and loan associations, and it has been cited by at least one court as prima facie reasonable.

Over the last decade, commercial mortgage documents have used a different sort of clause, termed here Type II. The Type II clause permits prepayment if the borrower also pays an accompanying fee, defined as a declining percentage of the loan balance over time. Often this sort of clause will also "lock in" the loan, prohibit-

50. The regulation provided:

A borrower on a loan secured by a home or a combination of home or business property may prepay the loan without penalty unless the loan contract expressly provides for a prepayment penalty. The prepayment penalty for a loan secured by [an owner-occupied home] shall not be more than 6 months' advance interest on that part of the aggregate amount of all prepayments made on such loan in any 12 month period which exceeds 20 percent of the original principal amount of the loan. 12 C.F.R. § 545.8-5(b) (1981).


51. The clause involved in Lazzareschi Inv. Co. v. San Francisco Sav. & Loan Ass'n, 99 Cal. Rptr. 417, 418 (Ct. App. 1971), read as follows:

Privilege is reserved to make additional payments on the principal of this indebtedness at any time without penalty, except that as to any such payments made which exceed twenty percentum (20%) of the original principal amount of this loan during any successive twelve (12) month period beginning with the date of this promissory note, the undersigned agrees to pay, as consideration for the acceptance of such prepayment, six (6) months advance interest on that part of the aggregate amount of all prepayments in excess of such twenty percentum (20%).
ing all prepayment for a limited period, such as the first five years, seven years, or ten years of the loan's life. For example, the loan might be "locked in" for ten years, a prepayment fee of five percent might be imposed during year eleven, four percent during year twelve, and so on, with a one percent fee payable in year fifteen and thereafter.\textsuperscript{52} This clause is similar to the Type I clause described above. Only the lock-in period and the fact that the fee declines much more rapidly over time once the lock-in period has expired distinguish the two clauses.

A third type of clause has come into common use since the early 1980s. Rather than computing the fee as a predefined percentage of the balance being prepaid, the Type III clause attempts to measure, or at least to approximate, the lender's actual damage flowing from the prepayment. Because they seem designed to give the lender the economic equivalent of the yield it would have earned if the loan had remained in place for its full term, these clauses are sometimes referred to as "yield maintenance" clauses. To accomplish this, Type III clauses must take into account market interest rates at the time of prepayment. Such clauses can become complex, but a rudimentary version might fix the fee as the difference between the loan interest rate and the then-current yield on U.S. Treasury notes closest in maturity to the remaining loan term, multiplied by the loan balance and then by the number of years remaining on the loan term.\textsuperscript{53} As we shall see, the accuracy of this method of measuring the lender's loss may be open to serious criticism; but it does approximate that loss, at least in rough terms.

B. The Economics of Prepayment Fees

Essentially, prepayment fees are nothing more than liquidated damages clauses. The lender has committed itself to leave its funds outstanding for a fixed period at a given interest yield, and to suffer the market rate risk inherent in this position. If rates rise after the loan has been made, the value of the loan to the lender will fall accordingly. This risk is inherent in the role of a fixed-interest lender, and it is only partially mitigated by the inclusion of a due-on-sale clause. In return for absorbing the risk of rising rates, the


lender wants "call protection": some assurance that if market rates fall, the borrower will not merely prepay the loan and refinance at a lower rate.\textsuperscript{54} From the lender's viewpoint, a prepayment is a derogation of the right to earn the agreed yield for the full term even if extrinsic rates drop. In other words, the borrower breaches its obligation to keep the loan in effect for its full term.

If the lender demands (and has the bargaining power to insist) that the borrower absorb the risk of loss that results from falling interest rates, the borrower may seek to limit its exposure. Under these circumstances it is plausible for the lender to offer to insure the borrower, agreeing for a fee to limit the borrower's exposure in the event of a severe drop in interest rates. This is the effect of a \textit{Type I} or \textit{Type II} prepayment fee: the lender stipulates that the fee will be deemed to cover the lender's loss, whether the actual loss turns out to be greater or smaller.

The highly volatile nature of interest rates in recent years emphasizes the plausibility of this sort of insuring arrangement. At the time of contracting, the amount or even the existence of the loss that may eventuate from prepayment is virtually impossible to estimate. Even the most venturesome prognosticator is unlikely to make guesses about interest rates more than a year or so into the future. Their behavior seems essentially random over more than a very short period, and trends are easy to spot only after they have run their course. For example, the thirteen percent rates that mortgage lenders were demanding in 1980 seemed unprecedented and might have been viewed as the peak of the cycle until they were eclipsed by the fifteen percent rates of 1981.\textsuperscript{55} Similarly, an eight percent rate may appear relatively low unless rates a few years later fall to five percent. It is reasonable to expect borrowers to be less inclined than institutional lenders to attempt to manage this sort of risk. Most institutional lenders are in the mortgage market more or less continuously, while most borrowers, even if they own large income-producing projects, enter the market only at infrequent inter-

\textsuperscript{54} See First Nat'l Bank v. Philadelphia Nat'l Bank, No. 87-2829, 1989 WL 79789 (E.D. Pa. July 10, 1989), aff'd, 897 F.2d 521 (3d Cir. 1990), in which the borrower was given an explicit choice of an adjustable rate mortgage or a fixed rate with a large prepayment fee.

\textsuperscript{55} The average contract interest rate on conventional mortgage loans made by FSLIC-insured institutions on one-to-four-family homes rose steadily during 1978 and 1979, finally reaching 13.74\% in May 1980. It then fell slowly for three months before beginning another upswing which peaked in November 1981 at 15.80\%. These data, supplied by the Federal Home Loan Bank Board, were reprinted in \textit{REAL EST. FIN. TODAY}, Sept. 30, 1988, at 10.
vals. They probably have no special expertise in its intricacies and no familiarity with the tools generally employed by lenders to hedge the risks of rate fluctuations.

Like other types of liquidated damages clauses, the prepayment fee can be viewed as a form of insurance, in this case purchased by the borrower qua insured from the lender qua insurer. The insurance “premium” is the prepayment fee itself. Unlike most forms of conventional insurance, in which the premium is paid at the time of the contract or on a monthly or annual basis, the “premium” here is payable only if and when the event that gives rise to the risk of loss—prepayment as a result of the borrower’s actions—occurs. The “payout” of the insurance proceeds occurs by virtue of the lender’s absorption of whatever loss results from the prepayment.

Traditional economic theory suggests that such a bargain, if freely and knowledgeably entered into, should be sustained by the courts. There are several reasons for this. First, the parties to the contract are best positioned to evaluate their own aversion to risk and to allocate it between themselves. The prepayment fee clause permits the borrower to place a ceiling on the liability that will ensue from a prepayment. In effect, the fee buys certainty for the borrower, and the lender is rewarded financially for absorbing the risk of market rate fluctuation. There is plainly an economic efficiency in permitting parties who are not equally averse to risk to shift that risk between themselves.

The prepayment fee clause has the further advantage of eliminating the need for an actual (and possibly costly) measurement of the lender’s actual damages if and when prepayment occurs. I argue in this Article that the core of the damage that lenders suffer from prepayment—the loss of an advantageous interest rate—is easy to measure. But the peripheral elements, such as the cost of relending the funds and the impact on the lender’s tax liability, may be much more difficult to assess. Only after an expensive and time-consuming trial can a jury be expected to determine these damages. It is entirely rational for the parties to use the prepayment fee clause as a device for avoiding such a trial. The clause also avoids the


57. This is an important point. It is prepayment caused by the borrower that the parties intend to insure against. If a prepayment results from the lender’s acts rather than those of the borrower, no “insurance premium” should be due. The distinction is critical in the analysis of so-called “involuntary” prepayments. See infra Part V.
uncertainties of trial, such as the risk that a particular jury may be biased against lenders or real estate entrepreneurs, causing it to render a verdict that to some degree fails reasonably to view the evidence before it.

The prepayment fee clause enables the borrower to decide whether breach (in the form of prepayment) is efficient.\textsuperscript{58} I have argued above that a breach by the borrower is efficient if it saves the borrower more than the lender's full damages.\textsuperscript{59} But if the borrower is uncertain about the amount of damages that he or she must pay, and if that amount can be determined only by litigation, the decision to breach by prepaying is difficult to make and the borrower may not make it accurately. The inaccuracy may be great enough to produce economic inefficiency if, for example, the borrower refrains from prepaying the loan because he or she believes the resulting liability would exceed the benefits of refinancing, when in fact the liability would be less than that amount.

Of course, it is possible that in a particular transaction the insurance premium to which the borrower agrees (in the form of a prepayment fee) may either exceed or be exceeded by the actual loss. A borrower who agrees to a large fee, and who then prepay the loan when rates have fallen only slightly or not at all, may feel that she or he has overpaid. This attitude is perhaps human nature, like that of an automobile driver who pays collision insurance premiums for thirty years and makes a claim only once for a minor fender-bender. But if the contract was freely and knowledgeably made, it must be regarded as efficient and should be upheld, absent some persuasive countervailing argument.\textsuperscript{60} The borrower received

\textsuperscript{58} See James A. Weisfield, Note, "Keep the Changel": A Critique of the No Actual Injury Defense to Liquidated Damages, 65 WASH. L. REV. 977, 990–91 (1990). It can be argued that liquidated damages clauses which produce awards in excess of actual damages may introduce inefficiencies, since a contracting party who might breach and pay actual damages might not be willing to breach and pay the higher liquidated sum. See Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) (Posner, J.). But it seems more probable that the party with the opportunity to engage in an efficient breach will do so, after renegotiating the damages clause with the other party to share the financial benefits of the breach with him or her. See Debora L. Threedy, Liquidated and Limited Damages and the Revision of Article 2: An Opportunity to Re-think the U.C.C.'s Treatment of Agreed Remedies, 27 IDAHO L. REV. 427, 447–48 nn. 93–95 (1990).

\textsuperscript{59} See supra text accompanying notes 41–42.

\textsuperscript{60} See ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 293–96 (1988); A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW & ECONOMICS 61–63 (1983); Weisfield, supra note 58, at 978–80. Indeed, Richard Posner has remarked that the courts' reluctance to enforce agreed damages clauses is "a major unexplained puzzle
the certainty that the fee provided, and for which the borrower had bargained.

To pursue further the efficiency implications of prepayment fees, let us return to the numerical example of the lender's loss from prepayment presented earlier in this Article. We saw there that when the borrower prepaid a $1 million loan with a ten-year remaining term and a twelve percent interest rate and when prevailing mortgage rates were ten percent at the time of prepayment, the lender suffered damage of $85,736. This amount represented the present value of the lender's loss in revenue resulting from the prepayment. Of course, this figure also represents the value to the borrower of the right to prepay the loan; assuming that the borrower can refinance the $1 million principal at ten percent (the prevailing mortgage rate), the present value of the savings that the borrower will experience will be precisely $85,736.

The mortgage may contain a prepayment fee clause which imposes a charge that is less than, equal to, or greater than the lender's damage figure. Let us assume that the clause is legally enforceable and consider its impact on borrower and lender behavior in each of these three cases, all of which provide the borrower an opportunity to refinance at current interest rates (ten percent in the illustration above). First, suppose the fee is less than the lender's damages (and the borrower's gain from prepayment). In such a case, if other transaction costs are ignored, it is plainly to the borrower's advantage to refinance, and we can expect him or her to do so.

If prepayment occurs in this setting, the lender obviously suffers some degree of uncompensated loss. This is the risk that the lender voluntarily assumed by agreeing to the prepayment fee clause when the loan was originally negotiated. The effect of the transaction is to transfer some income from the lender to the borrower, but there is no obvious public policy reason for the legal system to interfere with such a transfer. The insurance arrangement between borrower and lender should be permitted to play itself out.


61. See supra text accompanying notes 31–32.

62. As noted already, there is a further disincentive to the borrower’s prepaying and refinancing the loan: he or she will probably have to pay quite significant transaction costs—perhaps in the order of 3% to 5% of the loan amount—to procure the new loan. Hence, refinancing is likely to occur only if the prepayment fee is lower than the lender’s damage figure by an amount somewhat greater than the transaction costs.
The second case for consideration here is that in which the prepayment fee is equal to the lender’s damage figure. Ordinarily, a borrower who wished to refinance to take advantage of lower interest rates but who, under applicable legal rules, could do so only by covering the lender’s actual damage would simply decide not to engage in the transaction, since it would be a “wash” from the borrower’s viewpoint. The borrower would pay the lender $85,736 in the illustration above, and would experience a present value savings of exactly the same amount. When we consider the transaction costs of obtaining substitute financing, it is all the more clear that no voluntary refinancing will occur.

In the third case, the prepayment fee is higher than the lender’s damage figure. From the discussion above, it is clear a fortiori that the borrower will decline to refinance. It makes no difference whether the fee is only a little higher than the lender’s damages or is astronomically higher. In this setting, the size of the fee is irrelevant; a rational person will be just as disdainful of the opportunity to spend $1.10 to save $1 as to spend $2 to achieve the same savings. Since current market interest rates establish the value of the prepayment privilege, the borrower can always limit his or her loss to that amount simply by refraining from prepaying. The irresistible implication of this argument is that, so far as voluntary prepayments are concerned, there is no economic difference, and hence there should be no legal difference, between prepayment fees that are merely fully compensatory to the lender and those that are grossly overcompensatory because no borrower is going to pay an overcompensatory fee.

However, occasionally a borrower may have access to refinancing at below-market interest rates. In other words, a situation may arise in which the privilege of prepayment to the borrower has a higher value than the amount of the lender’s damages. This is a fairly rare circumstance for owners of commercial real estate, but it may arise in several ways, already enumerated above.

For whatever reason, let us assume that the borrower in our numerical example above can refinance the loan at only eight percent interest despite the fact that the existing lender would be able to relend the prepaid funds at ten percent. It is simple to calculate the value of prepayment to the borrower in this setting. The borrower’s monthly payments on the new eight-percent loan for a ten-

63. See Tung, supra note 41.
64. See supra text accompanying notes 41–42.
year term will be $12,133. Since payments on the old twelve percent loan are $14,348, the borrower will save $2,215 per month by refinancing. Discounting this savings to a present value (using the borrower's interest rate of eight percent as a discount rate) produces a saving to the borrower of $182,564—more than twice the lender's damages of $85,736.

What will be the borrower's reaction to an enforceable prepayment fee clause in this setting? Plainly the borrower will be willing to refinance and suffer the prepayment fee, even though it is larger than the lender's damages, if it is smaller than the $182,564 savings (less the transaction cost of refinancing). But suppose the fee is larger than that amount; indeed, suppose it is vastly larger—say, fifty percent of the amount being prepaid, or $500,000 in our example. On cursory examination, one might suppose that such a huge fee will inhibit the borrower's prepayment of the loan. Thus, the borrower will lose the opportunity to take advantage of the below-market-rate financing.

But further analysis suggests that this is an unlikely result. Rather, the borrower is likely to approach the lender and renegotiate the fee, thus satisfying both parties' interests. Recall that we are discussing voluntary prepayment; the borrower is under no compulsion, legal or economic, to refinance. We can imagine a conversation between borrower and lender along these lines:

*Borrower:* I've been thinking about paying off our loan. Of course, you know very well that I have no intention of giving you an additional half-million dollars as a prepayment fee, and if you insist on receiving it, there simply won't be a prepayment. I estimate that your actual damages from prepayment in today's interest market environment will be about $85,000. I'm prepared to offer you an additional $50,000, or a total of $135,000, as a fee. If you accept my offer, you'll make a tidy profit. If you don't, I'll just keep paying on the existing loan.

*Lender:* We may have some difference of opinion about the size of my damages, but I must admit that your estimate is pretty close. I want to negotiate a bit about the exact amount of the fee, but I think we can work out a deal along the general lines you have suggested.

This negotiation fully compensates the lender for its damages and achieves a division between borrower and lender of the present value of the borrower's access to below-market-rate financing. If the $135,000 fee represents the parties' final agreement, the lender has gained about $50,000 over and above its damages, while the borrower has gained nearly $50,000 as well. This transaction has transferred some income from the borrower to the lender, but this
outcome neither produces any apparent economic inefficiency nor violates public policy. Obviously, the borrower will never concede to the lender any more than the borrower’s total savings from the refinancing; there would be no incentive for the borrower to do so. Observe that the size of the contractual prepayment fee (assuming that it is greater than the borrower’s total savings less the transaction costs of refinancing) is entirely irrelevant.

Will such a negotiation actually occur and will it lead to the sort of settlement described above? The reader may have noticed that the bargaining scenario we have described is based on the Coase Theorem, first introduced in Professor Ronald Coase’s famous article, The Problem of Social Cost.\textsuperscript{65} The Coase Theorem can be understood at several different levels,\textsuperscript{66} but no extended discussion of them is necessary for our purposes. Placed in the present context, the Theorem states that in the absence of transaction costs or other legal impediments to bargaining, a party who can realize external economic benefits only with concurrence of another party will bargain with that party and reach an agreement under which the two of them will share the benefits. Such a result is economically efficient because it allows the realization of a benefit that would otherwise be wasted.

Professor Robert Cooter has suggested, however, that the Coase Theorem may be unduly optimistic and that a bargain may not always be struck despite the fact that it is in the self-interest of both parties to strike it.\textsuperscript{67} One possible explanation for bargaining failure might be high transaction costs. In the mortgage prepayment context, such costs obviously exist, but they hardly seem prohibitive. Fortunately, there is only one party on each side of the table. Thus, unlike several of Coase’s original illustrations involving groups of farmers or other landowners, there are no costs involved in bringing together groups of people on each side of the transaction and getting them to reach consensus on bargaining position. In addition, the cost of information about the current state of the market is low; indeed, the lender probably possesses that information (assuming that it is still in the mortgage lending business). By making a few phone calls to mortgage bankers and brokers the borrower can effectively learn enough to bargain. Negotiation also requires time and effort, both for the parties and perhaps for their

\textsuperscript{65} J.L. & Econ. 1 (1960).
attorneys as well. But because the question under discussion ("How much will you accept to let me out of this loan?") is not particularly complex, the parties should be able to find a satisfactory resolution without a large investment of time or resources. Moreover, as Professor Herbert Hovenkamp has observed, transaction costs in a Coasian bargain are a two-edged sword. If they are excessive, they may discourage or stultify negotiation. If they are only moderate, however, they may actually encourage a quick resolution as the parties attempt to reach a consensus without "running the meter" unnecessarily.68

Cooter has suggested that bargaining may fail for a different reason, applicable even if the negotiation process is costless. Specifically, bargaining will fail if there is no institutional mechanism, such as the market, to dictate the terms of the contract. The borrower and lender must negotiate, not in a competitive market, but in a bilateral monopoly relationship. This is to say that they can deal only with each other; their contractual relationship binds them together, and each of them can escape it only by reaching agreement with the other. There are no alternative parties to whom they can turn. In the example above, in which refinancing produces a surplus of $182,564, the lender may be satisfied with $1, with the entire $182,564, or with any amount in between. Of course the parties will not likely achieve these polar extremes since each party must spend at least a modest amount to document the severance of their relationship, and each will presumably insist on retaining a bit more of the surplus than the cost of doing so. Nonetheless, there is a very wide range of possible outcomes, and no mechanism—neither market nor custom nor governmental regulator—exists to narrow that range. In these circumstances, either or both of the parties will possibly assume "hard" bargaining positions, refusing to relent from them in time to save the process from failure.

Nonetheless, the nature of mortgagor-mortgagee relationship suggests that the parties will achieve a successful outcome through negotiation. Because the parties are sophisticated and well-informed about the other's costs and opportunities, they will be less susceptible to having advantage taken of them. When negotiating with an experienced commercial developer, a lender will not take the position that it might take against an inexperienced consumer (e.g., "as a matter of policy, we never negotiate our prepayment fees"). Additionally, because the parties have or expect to have

68. Hovenkamp, supra note 66, at 300 n.29.
other business relationships with each other and because each belongs to a relatively small fraternity of players who periodically communicate with each other spreading reputational information about the opposing party, neither the lender nor the borrower will serve his or her own interest by being obdurate and unreasonable.

Given these facts, most prepayment negotiations between borrower and lender will result in a deal. Doubtless some bargaining failures do and will occur, but since the Coasian model reflects reality with sufficient regularity, it provides a fully acceptable working assumption for further analysis.

Its implications are surprising. When a borrower contemplates a voluntary prepayment, even grossly excessive prepayment fees have no significance in terms of economic efficiency. They do not force the borrower to forego obtaining more efficient financing but merely compel the borrower to negotiate with the lender to share the savings that result from that financing. Hence, they involve nothing more than a transfer of income from borrower to lender, and as shown above, the amount of that transfer will not exceed the savings that the borrower realizes from the refinancing, however expensive the stated prepayment fee may be.69

This scenario is equitable. Since we have postulated that knowledgeable parties freely entered the arrangement, there is no basis to attack it. In a sense, the borrower’s costs on the original loan include the potential obligation to transfer this income to the lender. If there were no prepayment fee clauses, the market would presumably drive up interest rates or front-end loan fees to compensate lenders in the aggregate by producing for them the same income as if the clause had been present.

In summary, two distinct economic arguments favor the enforcement of prepayment fee clauses when a voluntary prepayment occurs. First, the clause represents a form of insurance that a less risk-averse lender offers to a more risk-averse borrower; it permits the borrower to limit the amount owed the lender if the borrower prepays. Such voluntary shifting of risk enhances economic efficiency and should be encouraged. Second, even when resulting in a stated fee far in excess of the lender’s loss, the prepayment clause does not discourage the borrower from searching for and obtaining more efficient financing but merely compels him or her to share

69. I am indebted to the author of Note, Economic Analysis, supra note 40, at 1077–79, for pointing this out, although in a different context.
with the lender the financial benefits of the new financing. Hence, the clause introduces neither inefficiency nor inequity.

C. Economic Arguments Against Enforceability

Some factors in the mortgage prepayment environment may militate against the conclusions just stated. To examine this question, we can turn to more general economic analyses of liquidated damage clauses and critiques of their enforceability. As noted above, economists have usually regarded enforcement of these clauses as efficient and hence appropriate. However, contrary arguments can be made in some circumstances.

One such circumstance is a contract in which the party that has the benefit of the liquidated damages clause can influence the other party to commit a breach. This situation often exists, for example, in construction contracts in which the parties must, as a practical matter, cooperate with one another continuously on matters such as review of plans and specifications, and inspection of work in progress. Assume that in a contract to construct a house, the parties agree that the builder must pay the landowner $100 for each day that completion of construction is delayed beyond the agreed time. If the landowner discovers that, for personal reasons, she will be unable to occupy the house for several months after the completion date, she will have a strong incentive to encourage delay in completion. By doing so, she may realize a windfall under the clause even though she suffers no actual damage. To create this delay she may begin to “nit-pick” the quality of the builder’s work, become unavailable for scheduled inspections, and bog down the construction process in other ways. Obviously these activities are inefficient; they contribute nothing to the production of useful goods or services. The landowner’s actions will prevent the builder’s equipment and personnel from moving on to another project according to schedule. Moreover, the builder may engage in costly activity in an attempt to discover and prove that the landowner is being dilatory or acting in bad faith. This activity, too, is wasteful.

The case described above is one in which the nonbreaching party suffers no damages, but the analysis is the same when the nonbreaching party recognizes that the actual damages (including the cost of any breach-inducing activity) will be less costly than the liquidated damages provision. Hence, refusing to enforce an agreed damages clause is rational in any case in which the nonbreaching
party is willing to induce breach because the clause will produce a recovery that significantly exceeds actual damages.  

While this argument is convincing in the house construction context described above, it has no application to prepayment in the lender-borrower relationship because the lender has no breach-inducing activity available. While the lender may recognize that a prepayment (and collection of the concomitant fee) would be to its advantage, the lender cannot encourage a prepayment. We might expect lenders in such an environment (i.e., where rates have remained stable or fallen only a little since the loan was made, and where the prepayment fee greatly exceeds the amount necessary to cover the lender's actual damages) to be especially strict in dealing with defaults in payment by the borrower, but if the borrower is punctilious in performing his or her obligations, the lender can do little more.

Public policy also militates against the enforcement of agreed damages clauses because they may amount to gambling contracts. But such a policy is inapplicable in the context of prepayment fee clauses. As Professors Clarkson, Miller and Muris have pointed out, a contract is a wager only if it is unreasonable when it is entered into. If it is reasonably conceivable at that time that the non-breaching party's actual damages will be as high as the stipulated

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71. Clarkson et al., supra note 70, at 387, recognize this fact explicitly. They discuss some apparently contrary cases in which courts have refused to enforce agreed damage clauses between borrowers and lenders in cases of default (not simple prepayment), and suggest that these courts may be motivated by concepts of usury or excessive interest. They correctly point out that clauses providing for forfeiture of mortgage loan commitment fees when the borrower fails to complete the loan and borrow the funds are routinely upheld. Id.; see Woodbridge Place Apartments v. Washington Square Capital, Inc., 965 F.2d 1429 (7th Cir. 1992); Nelson & Whitman, supra note 1, § 12.3 n.26.

72. There is evidence that lenders display less lenient attitudes toward default when interest rates have risen and the loan is insured by a governmental or private mortgage insurance agency, so that default and foreclosure are virtually costless or actually profitable to the lender. See J. Harold Mulherin & Walter J. Muller, III, Volatile Interest Rates and the Divergence of Incentives in Mortgage Contracts, 3 J.L. ECON. & ORGANIZATION 99, 101–02 (1987). The existence of a prepayment fee clause which is enforceable upon default and acceleration will obviously have, to some degree, the same effect as a contract of mortgage insurance, since the prepayment fee will tend to offset the costs of foreclosure and any inadequacy in the value of the real estate as security for the loan. As to whether the courts do or should permit collection of prepayment fees when the prepayment is a result of default and acceleration of the loan, see infra notes 176–189.

73. See Note, Economic Analysis, supra note 40, at 1091–93.
amount, the clause is in essence insurance rather than a bet. In the case of mortgage loan prepayment, as I have suggested above, an advance estimate of damages is no more than a guess since the interest markets are intrinsically volatile; hence, only the most extreme prepayment fee imaginable could be regarded as a gambling contract.

Fairness and conscionability considerations may argue against enforcement of a liquidated damages clause. Nonenforcement may be appropriate if the borrower did not understand the clause or if the parties had such drastically disparate bargaining power that the borrower was virtually compelled to sign the lender's form. Such arguments are compelling when the borrower is an unsophisticated consumer borrowing a relatively small amount and the loan is documented on preprinted forms. But because prepayment restrictions have disappeared from home loan documents, nearly all borrowers who deal with such restrictions today are sophisticated in real estate transactions, represented by counsel, and entirely capable of carrying on effective negotiations with lenders. Borrowers will not always or usually get their way; if that were so, the final loan documents would rarely contain prepayment restrictions. But there are no industry-wide "standard" prepayment clauses. Each lender has its own approaches and preferences, and at least some lenders do indeed modify prepayment clauses in response to borrower negotiations, and perhaps in response to a borrower's willingness to pay a higher price for the loan. Most borrowers, in turn, shop the market, knowing what to look for. The market is not perfect, but

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74. See Clarkson et al., supra note 70, at 365 n.48.

One of the most attractive taxonomies of "unconscionable" contracts is set out in Melvin A. Eisenberg, The Bargain Principle and Its Limits, 95 HARV. L. REV. 741, 754–85 (1982). Eisenberg suggests four contexts in which the courts should refuse enforcement of contracts on unconscionability grounds: distress, in which a party's survival or fundamental needs compel him or her to contract; transactional incapacity, in which a party lacks sufficient experience, training, or specialized knowledge to appreciate the significance of a contract term; unfair persuasion, in which a party contracts while in a weakened or debilitated condition and is unable to fend off the other party's importunings; and price ignorance, in which a party is unfamiliar with market prices and is misled into believing the contract price fairly represents the market. It is significant that none of these four conditions is likely to exist in a commercial real estate loan negotiation. Borrowers are rarely under great pressure to make a deal with a particular lender, and they (or their counsel) generally have a high degree of experience with and information about the mortgage market, prices, and contract terms.
neither is it characterized by the sort of uninformed behavior by borrowers that traditionally leads courts and legislatures to intervene and declare contractual clauses unenforceable.

As the preceding discussion reveals, the nature of this situation determines whether the “terms of adhesion” argument should and should not be available. Several recent model and federal statutes and regulations adopt consumer protection measures that are limited to loans for “personal, family, or household purposes.” This bright-line test is convenient, and probably necessary for a statutory formulation. It coincides well with realities in the mortgage market, in which prepayment fees and restrictions have largely disappeared in financings for “personal, family, or household purposes.”

But when a court, unaided by statute, is asked to determine whether concepts of adhesion contracts should bar enforcement of a prepayment fee or restriction, it ought not to answer that question by noting that the borrower’s residence is the security or that the borrower is a “consumer.” Rather, the court should consider whether the borrower fully understood and had the opportunity to bargain over the clause, either with the assistance of counsel or by virtue of the borrower’s own experience and expertise. Phrases such as “personal, family, or household purposes” or “owner-occupied home” are mere proxies for the underlying issue of borrower understanding and bargaining opportunity. I employ the phrase “bargaining opportunity” here merely to indicate that the borrower was fully aware of the impact of the prepayment clause and that he or she at least considered raising it in the negotiation process. A knowledgeable borrower might reasonably review a proposed clause, understand its significance, and conclude that it is acceptable in the overall context of the proposed transaction. Thus, although no overt discussion of the clause between lender and borrower might occur, “bargaining opportunity” exists. Actual, explicit bargaining is a useful indicator that the borrower consciously and fully understood the clause, but it is not the only possible evidence of that fact.

MORTGAGE PREPAYMENT CLAUSES

Most commercial loan mortgagors probably satisfy the understanding and bargaining opportunity test, but there may be exceptions. On the other hand, many borrowers on owner-occupied homes probably would not meet this test, although occasionally one may do so. A court may well be warranted in refusing to enforce a prepayment restriction clause if the borrower lacked the necessary understanding and bargaining opportunity, whether the loan was commercial or residential in nature. But if understanding and bargaining opportunity were present, as is the case with most prepayment clauses today, the court need not intervene on the basis of the "term of adhesion" concept.\textsuperscript{77}

D. Legal Arguments Against Enforceability

I have argued above that a prepayment fee clause is a form of a liquidated damage provision. However, virtually all of the state court decisions treat prepayment fees without reference to the law of liquidated damages. This is perplexing, but it may be explained by the badly muddled condition of the law of liquidated damages. Perhaps the most commonly cited statement of the law dealing with liquidated damage clauses is that found in the first Restatement of Contracts, which holds such clauses unenforceable unless:

(a) [t]he amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and

(b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation.\textsuperscript{78}

The difficulties with this formulation are legion. First, it seems self-contradictory: a valid clause is one which makes a reasonable estimate of something that cannot reasonably be estimated. Moreover, as numerous commentators have remarked,\textsuperscript{79} the formula is seri-

\textsuperscript{77} Even where the borrower is sophisticated, the usual range of contract defenses—such as fraud, mistake, duress, and undue influence—might still be present. For example, the borrower may well have a defense to enforcement of the restrictions if the borrower accepts a loan commitment that mentions no prepayment restrictions or only very minor restrictions, and the lender at closing substitutes documents adopting different and more onerous restrictions, while either failing to point out the change to the borrower or pointing it out in circumstances in which the borrower has made other commitments and has no practical choice but to close. Cf. Frame v. Boatmen's Bank, 824 S.W.2d 491 (Mo. Ct. App. 1992) (lender issued mortgage commitment to commercial borrower without advising him that approval of another lender, which was expected to participate in the loan, was essential; first lender held liable for negligent misrepresentation).

\textsuperscript{78} Restatement (First) of Contracts § 339 (1932).

\textsuperscript{79} See Susan V. Ferris, Note, Liquidated Damages Recovery Under the Restatement (Second) of Contracts, 67 Cornell L. Rev. 862, 868 (1982); William S. Harwood, Comment, Liquidated Damages: A Comparison of the Common Law and the
ously defective because of its failure to specify the time-frame within which its tests are to be made. Is the “reasonable forecast” to be judged as of the date of contracting (an \textit{ex ante} test) or the date of breach (an \textit{ex post} test)? There is little consistency in the case results, and ample authority can be found for viewing reasonableness as of either date,\textsuperscript{80} or requiring reasonableness at either\textsuperscript{81} or both times.\textsuperscript{82} Often it is impossible to determine which test a court has employed.

The second fork of the \textit{Restatement}'s formula is equally ambiguous: must the harm be difficult to estimate as of the date of the


See E. ALLAN FARNSWORTH, \textit{Contracts} § 12.18 (1990) (asserting that the majority view tests reasonableness as of the date of contracting).

\textsuperscript{81} Decisions accepting a liquidation of damages which was reasonable at either time may be based on or influenced by U.C.C. § 2-718(1), which approves liquidations “at an amount which is reasonable in the light of the anticipated or actual harm.” U.C.C. § 2-718(i) (1988) (emphasis added). See, e.g., Stock Shop, Inc. v. Bozell & Jacobs, Inc., 481 N.Y.S.2d 269, 270–71 (Sup. Ct. 1984); Illingworth v. Bushong, 688 P.2d 379, 389–90 (Or. 1984).


The English courts have had little more success than the American courts in clarifying the time at which reasonableness is to be measured. The classic statement is that of Lord Dunedin in Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co., 1915 App. Cas. 79, 87 (appeal taken from Eng.) (citation omitted):

(a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss which could conceivably be proved to have followed from the breach [apparently an \textit{ex ante} test].

(b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid [apparently an \textit{ex post} test].

contract or the date of breach? Here the decisions have been equally inconsistent, sometimes upholding clauses on this point if the harm was difficult to predict when the contract was negotiated, and in other cases scrutinizing the difficulty of measuring damages at the time of the breach.

The Restatement (Second) does not clarify the matter. It retains, but in a more obscure form, the twin requirements of reasonableness of amount and difficulty of proof. They are now described as interrelated, so that greater difficulty of proof will justify greater departure from reasonableness. The text of the Restatement states that reasonableness may be tested either ex post or ex ante, suggesting that the test is made "in light of the anticipated or actual loss caused by the breach." Under this reading, a reasonable figure from either perspective would sustain the clause. Yet of the four illustrations given, only one involves a case in which the clause produces a damage figure that is reasonable at one time and unreasonable at the other, and in that instance the illustration indicates that the courts should reject the clause.

With regard to the second test, the difficulty of estimation of actual damages, the Restatement (Second) is even more cryptic. The text makes no reference to the issue of timing. The Reporter's Note states that "the difficulties of proof of loss are to be determined at the time the contract is made, not at the time of the breach," yet two of the four illustrations plainly test difficulty of proof as of the date of breach.

86. Id. cmt. b.
87. Id. § 356(1) (emphasis added).
88. The case is one in which a contract for construction of a racetrack provides for liquidated damages of $1000 for each day of delay beyond the agreed date of completion. The contractor delays, but because of difficulty in obtaining governmental approval to operate, the racetrack owner is not damaged at all. The agreed damages were presumably reasonable ex ante but obviously unreasonable ex post; the illustration states that enforcement should be denied. Id. cmt. b, illus. 4.
89. Id. cmt. b, Reporter's Note (citation omitted).
90. Illustration 4, described supra note 88, proceeds on the premise that "the actual loss to [the race track owner] is not difficult to prove." Id. cmt. b, illus. 4. Similar language is found in id. cmt. b, illus. 2.
In the context of prepayment fee clauses, the debate about the timing of the reasonableness and difficulty-of-estimation tests is significant, since the damages that a lender suffers as a result of prepayment are incapable of accurate estimation in advance but are easy to compute when the prepayment occurs. Consequently, almost any estimate may be considered reasonable at the time the loan is made, but such an estimate will often turn out, in the actual event, to miss the mark widely.

On the whole, this body of law hardly represents the finest achievement of American jurisprudence. Because the "rules" are so fuzzy, case outcomes are unpredictable. As Professor Debora Threedy recently put it, "the cases remain awash in contradictory results and analyses."91 The state of the law can be defended only if one believes that courts should have virtually unfettered ad hoc discretion to enforce or reject liquidated damages clauses.

As mentioned above, state courts have ignored the law of liquidated damages (perhaps appropriately) when faced with the issue of the validity of prepayment fee clauses. The California Court of Appeal's opinion in the Lazzareschi case illustrates this attitude:

In the instant case, there has been no breach. The borrower had the option, clearly spelled out in the promissory note, of making one or more prepayments. He . . . availed himself of the option. This is not a situation of liquidated damages. Although the word "penalty" is used . . . there is no penalty in the sense of retribution for breach of an agreement, nor is there provision for liquidated damages because of [the difficulty of] ascertaining what the damages for such breach may be.92

Thus the Lazzareschi court avoided application of the rules concerning liquidated damages by the expedient of declaring the prepayment fee clause to be an alternative mode of performance rather than a stipulation of damages for breach. This is inaccurate, of course. The difference between a clause providing liquidated damages for breach and an optional mode of performance, at least in the context of mortgage loan prepayment, is entirely illusory. Any skilled drafter can modify a contract so that a breach becomes an optional performance.93 A clause providing for liquidated dam-

91. Threedy, supra note 58, at 441.
93. This point is nicely dealt with in In re A.J. Lane & Co., 113 B.R. 821 (Bankr. D. Mass. 1990). Of course there is a technical difference between payment of liquidated damages and an alternative performance; as Professor Corbin observed, when one's performance is a condition to some return performance by the other party, one may earn
ages for breach of the promise not to prepay does not practically differ from a clause providing for performance by paying a prepayment fee.

Shortly after the Lazzareschi decision, in Garrett v. Coast & Southern Federal Savings & Loan Ass'n 94 the California Supreme Court recognized the fatuous nature of the "alternative performance" argument. The case was a class action by some 32,000 mortgage borrowers who attacked the validity of a "late charge" clause obligating them to pay additional interest at the rate of two percent per annum of the loan balance during the period that any installment payment was delinquent. The lender characterized the clause as merely calling for alternative performances, but the court gave this argument no credence, analyzing it instead as a liquidation of damages.

The mere fact that an agreement may be construed . . . to vest in one party an option to perform in a manner which, if it were not so construed, would result in a penalty does not validate the agreement . . . .

. . . . We recognized, of course, the validity of provisions varying the acceptable performance under a contract upon the happening of a contingency. We cannot, however, so subvert the substance of a contract to form that we lose sight of the bargained-for performance. Thus when it is manifest that a contract expressed to be performed in the alternative is in fact a contract contemplating but a single, definite performance with an additional charge contingent on the breach of that performance, the provision cannot escape examination in light of pertinent rules relative to the liquidation of damages. 95

The prepayment clause is closely analogous and should be treated similarly. Two facts in the prepayment context lead inexorably to-

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95. Id. at 1200-01 (footnotes omitted); see also Sybron Corp. v. Clark Hosp. Supply Corp., 143 Cal. Rptr. 306, 308-09 (Ct. App. 1978); Willis v. Community Developers, Inc., 563 S.W.2d 104, 108 (Mo. Ct. App. 1978) (late fee charged to borrower was an invalid penalty).
ward this conclusion: first, it is payment on time, rather than early payment with a fee, that the lender primarily desires and for which the lender bargains; and second, prepayment may cause the lender substantial damage, and the fee’s obvious purpose is to compensate for that damage. A prepayment is simply a breach of the borrower’s primary promise—to pay the loan on schedule—and a court ought not permit the drafter of the documents to disguise that fact. In this sense, the Lazzareschi opinion was wrong.

Nevertheless, Lazzareschi’s result was correct. Under the economic analysis already discussed, a freely-bargained prepayment fee clause ought to be enforced against the borrower who makes a voluntary prepayment, irrespective of the amount of money that the lender’s clause demands. The Lazzareschi court can be forgiven for its reluctance to apply the botched-up law of liquidated damages to the prepayment clause before it. Nevertheless, the court should have recognized the clause for what it was—a liquidation of damages. The court could then have disregarded the confusing pastiche of liquidated damage clause precedent and upheld it. This conclusion is consistent with the view of most modern commentators that courts should enforce liquidated damages clauses in fairly bargained contracts without regard to the supposed tests of reasonableness and difficulty of estimating damages. It is also consistent with nearly all of the nonbankruptcy cases involving voluntary prepayments.

IV. ENFORCEMENT OF PREPAYMENT FEES IN BANKRUPTCY

During the past decade a number of bankruptcy cases have rejected the Lazzareschi approach and considered the validity of prepayment fees under a liquidated damages analysis. The results have been of mixed merit, in part because of the crude state of the law of liquidated damages. Nonetheless, these cases are significant since they represent a departure from long-standing legal doctrine. They also provide an opportunity for a fresh look at the policy implications of the economic analysis presented above.

The earliest of these cases (and one which involves no mortgage security) is In re United Merchants & Manufacturers. Two lenders made large unsecured loans to the debtor, United. When

96. See, e.g., Hirsch, supra note 40; Sweet, supra note 75; Threedy, supra note 58; Weisfield, supra note 58; Note, supra note 40.
United entered Chapter 11 bankruptcy and defaulted on the loans, the lenders filed claims which included the outstanding principal and prepetition interest, various collection costs, and prepayment fees. Express language in the loan agreements provided that the prepayment fees were due even if the prepayment resulted from default and acceleration rather than the debtor's voluntary payment. The clauses under which the prepayment fees were claimed were apparently similar to the Type II clause described above, and produced fees of about eight percent of the loan balances.

The debtor in possession argued that the fees were unenforceable as excessive and invalid liquidated damages. But the court applied New York law, which it found to approve liquidated damages clauses if the actual damages were difficult to determine and the liquidated sum was not plainly disproportionate to the possible loss, both of these factors being assessed at the time of contracting rather than the time of breach. Applying this test, the court found that damages were difficult to predict. Since the court considered the fees to be not "plainly disproportionate," it upheld the clause. The opinion offered no detailed discussion of either prong of the test, but its conclusion is correct if one accepts the premise that the test is to be applied prospectively as of the date of the agreement.

Although it upheld the prepayment fee in full, *United Merchants* is a highly significant case because it marks the first time that a court recognized that a prepayment fee clause is a form of liquidated damages. That it arose from a prepayment incident to default and acceleration rather than the borrower's decision to prepay, and that the loan was unsecured, eased the court's break from the strictures of *Lazzareschi*, enabling it to deal with the fee clause as a species of liquidated damages.

In *In re Schaumburg Hotel Owner Limited Partnership*, which involved similar facts except that the loan was secured by a mortgage on real estate, the court followed *United Merchants*. The

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99. *Id.* at 142–43. As authority for its view of New York law, the court cited its own opinion in Walter E. Heller & Co. v. American Flyers Airline Corp., 459 F.2d 896 (2d Cir. 1972). While the court observed that *Heller* was "remarkably similar" to the instant case, *Heller* involved not a prepayment or loan default, but rather a borrower's failure to consummate a loan transaction despite a firm contractual obligation to do so. *Id.* The court in *United Merchants* cited no prior case in which a prepayment fee had been analyzed as a form of liquidation of damages.

100. The court also held that the lenders' collection of the fees violated no principle of bankruptcy law or policy, although it implied that it might have found such a violation if the debtor had been able to show that the lenders suffered no damage at all from the prepayment. *United Merchants*, 674 F.2d at 143–44.

Schaumburg court adopted an identical rationale and result. In Schaumburg the clause provided for a flat fee of ten percent of the amount prepaid. While the court employed a “time-of-contracting” analysis of the liquidated damage argument, it also placed some emphasis on the secured lender’s testimony that the prepayment clause produced an amount that was significantly less than the lender’s actual damages; hence, the lender received no windfall.

Far more significantly, United Merchants has given rise to a cluster of bankruptcy cases that apply a liquidated damages analysis to strike down or severely limit prepayment fee clauses. While some of these decisions discuss whether, as a preliminary matter, the fee is enforceable under state law, all of them focus primarily on whether the fee is allowable as a secured claim against the real estate. That question is governed by section 506(b) of the Bankruptcy Code, which recognizes such claims for “reasonable fees, costs, or charges” provided for in the agreement.102 Allowance as a secured claim is often of paramount importance to the mortgage lender, since if the fee is unsecured it will take its place pro rata with the other general debts of the bankrupt, and will usually be satisfied only in small part or not at all. For the court to allow the fee, the lender must satisfy the “reasonableness” test of section 506(b).

The earliest of these cases is In re American Metals Corp.,103 in which a loan secured by personal property provided for a “termination charge” of $20,000 per month for each remaining month of the loan term. When the debtor filed bankruptcy (which constituted a default under the loan agreement), the lender filed a claim that included both the loan balance and the “termination charge.” The security was more than adequate to cover the balance owing on the debt, and the court was therefore called upon to decide whether the prepayment fee should also be allowed as a secured claim under section 506(b).

The court distinguished the United Merchants case on two grounds. First, United Merchants had merely involved the validity of the claim for the fee and not its secured status, and thus had not required application of section 506(b). Second, the American Metals court found (with little detailed analysis) that the fee was unreasonable and disproportionate to the lender’s actual damages resulting from prepayment, and further that those damages were readily susceptible to estimation. Thus the court adopted typical

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state law terminology distinguishing valid liquidated damages from invalid penalties, employed a "time of breach" approach, and found unreasonableness under section 506(b) on the facts.\textsuperscript{104}

Attempting to reconcile \textit{United Merchants} with \textit{American Metals} starkly reflects the difficulties inherent in state law on liquidated damages clauses. \textit{United Merchants} applied the twin criteria of reasonability and difficulty of estimation as of the date of the contract, while \textit{American Metals} tested them as of the date of the breach.\textsuperscript{105} If the former approach is employed, prepayment fees in \textit{Type I} or \textit{Type II} clauses (in which the amount of the fee is fixed as a percentage of the amount being prepaid) will nearly always be upheld, since the future vagaries of the interest market are wholly unpredictable and nearly any fee may be considered reasonable. If the latter view is taken, however, any fee that exceeds the lender's actual damage will be struck down. Both of these decisions are unsatisfactory; they fail to provide any clear-cut rationale for the timing of the tests, and their application of the tests to the facts is almost wholly conclusory. Nonetheless, they break important ground, suggesting that the uniform state court practice of upholding prepayment fees will not necessarily prevail in the bankruptcy courts.

Several more recent bankruptcy cases recognize that to be enforceable as a secured claim, a prepayment clause must satisfy both the state law of liquidated damages and section 506(b). Both of these legal regimens may demand reasonableness. As we have already seen, state law is exceptionally variable and unpredictable, and may require the clause to be tested as of the date of contracting or the date of the prepayment; most of the bankruptcy decisions adopt the former view.\textsuperscript{106} Under section 506(b), on the other hand, both the context of the statute and the cases plainly require reasonableness of the fee at the time of prepayment\textsuperscript{107} although the courts

\textsuperscript{104} Id.

\textsuperscript{105} The \textit{American Metals} approach was also employed in \textit{In re} Imperial Coronado Partners, 96 B.R. 997, 1000-01 (Bankr. 9th Cir. 1989), in which the court held that under § 506(b) the prepayment fee must be tested for reasonableness as of the time of payment; the case was remanded for findings of fact on this issue.


\textsuperscript{107} \textit{In re} 433 South Beverly Drive, 117 B.R. 563, 569 (Bankr. C.D. Cal. 1990); \textit{Imperial Coronado}, 96 B.R. at 1001; \textit{Morse Tool}, 87 B.R. at 750; \textit{American Metals}, 31 B.R. at 237. Arguably contra, although the opinion is ambiguous on the point, is \textit{Schaumburg Hotel}, 97 B.R. at 953; see also \textit{Kroh Bros.}, 88 B.R. at 1001 (clause is inher-
sometimes appropriate state law liquidated damage concepts, such as ease of estimation, in assessing reasonableness. In terms of outcome, the two theories are conceptually different: a denial of enforceability under state law leads to a total rejection of the claim, while a denial under section 506(b) leads only to disallowance as a secured claim. But in many cases this distinction has no practical importance because there are so many unsecured creditors pursuing so few assets after the mortgagee has largely exhausted the reality.

Most of these cases deal with (and reject) clauses similar to Type I or Type II discussed above: a fee of $20,000 multiplied by the number of months remaining in the loan term;\(^{108}\) a fee of one percent of the prepayment amount, times the number of years remaining in the term;\(^{109}\) a three-year loan with a fee of five percent of the balance in the first year, four percent in the second year, and three percent in the third year;\(^{110}\) and a fee of six-months' interest on the amount being prepaid.\(^{111}\) All of these fee structures have a sort of arbitrariness about them that seems to irritate bankruptcy judges, particularly in light of the ease with which the lender's actual loss can be computed. As one bankruptcy judge stated, "[a]ny prepayment charge should be wholly or largely dependent upon such a calculation [of actual loss]."\(^{112}\) Several of the decisions simply hold that under section 506(b), the lender can never recover more than its actual loss;\(^{113}\) under this view, the mortgage clause fixes a ceiling, but not a floor, for the recovery. Hence the usual judicial technique is to hold the clause unenforceable only in part, and to enforce it to the extent of the lender's actual loss, if any.

What, then, should the courts do with a Type III clause—that is, one that purports to base the prepayment fee on actual conditions in the mortgage market at the time of the prepayment? In In

\(^{108}\) American Metals, 31 B.R. at 236.


\(^{110}\) Morse Tool, 87 B.R. at 747.

\(^{111}\) Imperial Coronado, 96 B.R. at 999.

\(^{112}\) A.J. Lane, 113 B.R. at 829.

\(^{113}\) Imperial Coronado, 96 B.R. at 1001 ("[A] lender is entitled, under section 506(b), to collect only the difference between (1) the market rate of interest on the prepayment date, and (2) the contract rate . . . ."); Morse Tool, 87 B.R. at 750 ("[S]ection 506(b) requires that the clause be enforced, but only to the extent that the secured party suffered actual and necessary damages."); In re American Metals Corp., 31 B.R. 229, 237 (Bankr. D. Kan. 1983) ("[S]ection 506(b) is limited to actual costs, charges or damages.").
re Skyler Ridge, the court dealt with a prepayment fee claimed by Travelers Insurance Co. in a mortgage loan on an apartment complex. The specific clause in that case provided the following procedure for computing the fee: First, an interest rate differential was to be calculated by subtracting the yield rate on 1995 U.S. Treasury notes from the mortgage note rate. The actual differential thus calculated on the facts was about two percent. This interest differential was then multiplied by the number of years remaining on the loan and then by the principal amount being prepaid. The clause also imposed a "floor" fee of one percent of the principal, even if the interest rate differential formula produced a lower fee or none at all.

The parties stipulated that this should be regarded as a liquidated damage clause, and the court accepted that characterization. It analyzed the validity of the clause under the law of Kansas, where the loan was made. Under Kansas liquidated damages law, the court concluded that the time of contracting was the relevant date for analysis of the clause's validity. The court had no trouble agreeing with the lender that predicting its damages at that date would have been difficult indeed. However, it found that the other prong of the standard test—reasonableness—was not satisfied.

The court raised several specific objections to the reasonableness of the fee. First, it noted that the use of the yield on U.S. Treasury notes as a reference point for determining the lender's loss was unrealistic. A life insurance underwriter, the lender was in the business of making long-term mortgage loans and would not ordinarily invest in long-term Treasury notes except on a temporary basis. Since the market regards Treasury notes as having extremely low risk, they carry commensurately low returns. The yield on mortgage loans is systematically higher by 1.3% to 2%, according to the court's estimate. Hence, the use of Treasury note yield as a reinvestment rate, rather than some index of current commercial mortgage loan yields, would consistently overcompensate the lender.

Second, the court observed that the prepayment fee formula in the mortgage made no attempt to discount the lender's lost interest to its present value. Awarding the lender the present value of the differential in interest yields differs vastly from awarding it the gross amount of that differential. Since the lender who receives prepay-
ment receives the money immediately rather than over a number of future years as provided in the original loan contract, and since it will immediately put those funds to work by relending them, it is overcompensated if the interest differential is not discounted to present value.\textsuperscript{117}

A third form of overcompensation to the lender, not mentioned by the court, is built into the Travelers' clause. The clause uses the full amount being prepaid as the principal on which the prepayment fee is to be computed. But most mortgage loans (including this one) provide for some regular amortization of principal by monthly or other periodic payments.\textsuperscript{118} In many cases the loan payments are “fully amortizing,” meaning that by the time of the final monthly payment the loan's principal will be reduced to zero. Thus the lender is expecting to receive all or a significant amount of principal prior to final maturity of the loan even in the absence of a prepayment. These scheduled payments force the lender to assume the burden of reinvesting the funds, possibly at a lower interest rate. Hence, it is unrealistic to assume, as the Travelers clause did, that upon receipt of prepayment the lender will lose the interest rate differential on the full principal for the full remaining term.

The court's final objection to the clause centered on the one percent “floor” fee, which would have produced $150,000. Although Travelers' actual damages rather clearly exceeded this level, thus making it a moot point, the court unnecessarily criticized the whole concept of a “floor.” Travelers attempted to justify the one percent fee by arguing that its transaction costs in originating a loan of this magnitude were about $150,000. But the court found this argument implausible since the clause made no provision for amortizing the origination costs over the loan's ten-year life; the one percent floor applied whether prepayment occurred in year two or in year nine.

Travelers also argued that the $150,000 “floor” was designed to compensate for its loss of earnings during the period necessary to place the funds in a suitable reinvestment. Again the court was

\textsuperscript{117} To use the illustration given supra in the text at notes 31–32, if the loss of future benefits to the lender were not discounted to present value, that loss would be $135,960 rather than $85,736.

\textsuperscript{118} Perhaps the reason the court did not focus on this issue was that the scheduled principal payments on the loan in question were minimal. The original loan balance was $15 million; only interest payments were required for the first five years, and thereafter only sufficient amortization payments to reduce the loan balance by $250,000 by the end of the tenth year, at which time a “balloon payment” of the entire remaining balance was to have been made. See 80 B.R. at 502.
unimpressed. As mentioned above, it noted that the lender who is prepaid will doubtless “park” the funds temporarily in commercial paper or other short-term obligations which will bear interest at rates not too far below the commercial mortgage rate. Moreover, the prepayment clause in this case required the borrower to give a thirty-day advance notice of intent to prepay, allowing Travelers considerable time to locate a longer-term reinvestment opportunity.

Because of these faults, the clause failed the state law test; it would always give the lender a fee substantially in excess of actual damages, and hence could not be regarded as a reasonable estimate of actual damages, even if judged prospectively. We might call the clause in Skyler Ridge a Type III-plus clause, with the “plus” signifying that the clause is designed to overcompensate the lender’s actual loss in all cases. Since the clause was unenforceable under state law, the court did not reach the question of allowability of the fee as a secured claim in bankruptcy under section 506(b). However, it indicated that under that section, the test of allowability would be actual (rather than prospective) reasonableness, and that obviously the clause before it would fail that test as well.

Under the Skyler Ridge court’s analysis, a Type I or Type II clause providing for a fee that was prospectively reasonable (and thus acceptable under state law) could still produce too large an actual figure and hence fail the section 506(b) test. Ironically, however, the court’s reasoning could not lead to this result under the Type III clause of the sort at issue in the case. Since such a clause attempts to measure the lender’s damages by a formula which refers to interest rates at the time of the prepayment, it is always possible to make the formula a reasonable one. The instant formula failed, but a formula that employed a realistic reference rate and accounted for the time value of money and the scheduled payments of principal under the loan would presumably have been acceptable both under state law and section 506(b). And since the lender could have employed a reasonable version of the formula, the instant less-than-reasonable version was unacceptable in the court’s view.

Moreover, the consequence of unenforceability in Skyler Ridge was draconian: the court treated the mortgage documents as if they contained no prepayment fee clause at all.\textsuperscript{119} This element of the Skyler Ridge decision is unjustifiable. A lender that employs an overbearing clause need not be penalized by denial of all compensa-

\textsuperscript{119} A bankruptcy judge who had handled a similar case observed to the author that this is an example of the “hog” theory: being half a hog may get you something, while being a total hog gets you nothing at all!
tion for its prepayment loss. The court explained that the common law of liquidated damages "requires the entire disallowance of the fees sought on the grounds that they are a penalty"; nevertheless, the common law does not proceed to deny actual damages as well.

While Skyler Ridge and several of the other cases described above purport to apply state law as an initial tool for determining the enforceability of prepayment clauses, they really apply the judges' suppositions about unknown state law. With the exception of the California bankruptcy cases, all of them were decided in jurisdictions in which no state court had ever considered a prepayment fee clause of the type before the bankruptcy court. The point is not such an important one, however, since bankruptcy judges can always fall back on section 506(b), concluding that the prepayment clause must be disallowed as a secured claim even if a state court's approach is unknown.

Debra Stark, an attorney who represents secured lenders, has criticized Skyler Ridge on the ground that it holds lenders to an unrealistic standard. Stark concedes that the Skyler Ridge court's insistence on discounting the lender's lost stream of interest to present value is justified, but she disagrees sharply with the court's objection to the use of the Treasury note rate as an index. She points out that every commercial mortgage loan is unique; that there is no "standard" published index of commercial mortgage loan rates; that the lender may require considerable time to find an investment comparable to the loan being prepaid; and that finding an essentially identical loan, in terms of maturity, risk, and other characteristics may be impossible. These criticisms are valid but not significant. Skyler Ridge does not, as Stark suggests, demand that the lender's clause employ a "perfect measure of damages."

Rather, it merely requires a reasonable measure. The difficulty with the use of the Treasury note index is simply that it invariably overstates the lender's loss. There could be no objection under Skyler Ridge, 80 B.R. at 507.

See, e.g., Gary Outdoor Advertising Co. v. Sun Lodge, Inc., 650 P.2d 1222, 1225 (Ariz. 1982); Idevco, Inc. v. Hobaugh, 571 So. 2d 488, 490 (Fla. Dist. Ct. App. 1990); A-Z Servicenter, Inc. v. Segall, 138 N.E.2d 266, 268 (Mass. 1956) ("Where the actual damages are easily ascertainable and the stipulated sum is unreasonably and grossly disproportionate to the real damages from a breach, or is unconscionably excessive, the court will award the aggrieved party no more than his actual damages.").

120. Skyler Ridge, 80 B.R. at 507.
121. Id. at 196.
Ridge if the lender, for example, constructed its own internal index—say, a weighted average of interest rates on all commercial mortgage loans within some range of maturities that it had made during the most recent calendar month—and based its prepayment fees on that index. Another possibility would be to determine the difference between the contract rate and some published rate (such as ten-year Treasury bonds) as of the date the loan was made, and to add that difference to the same published rate on the date of the prepayment. The mechanical problems of applying Skyler Ridge are not very hard to solve.

Two more recent bankruptcy cases deal with Type III yield maintenance clauses. The first, In re Kroh Brothers Development Co., precisely tracks Skyler Ridge's facts and conclusions. It holds the clause unenforceable under Missouri law and the fee ineligible for secured status under section 506(b) as well; Skyler Ridge had discussed but declined to decide the latter point. The second case, In re Financial Center Associates, involved a clause that, like that in Skyler Ridge, employed a Treasury security reference rate, but unlike Skyler Ridge provided for discounting of the lender's lost interest stream to present value. The court held that even though the formula in the prepayment clause (which produced a fee of nearly twenty-five percent of the principal being prepaid) might overestimate the lender's loss, it was good enough to satisfy the prospective reasonableness test for liquidated damages under New York law:

There is, and there should be, a wide spectrum of available formulas that are designed to estimate, in any specific case, the possible actual damages. Actual damages in complicated and sophisticated transactions do not lose their character as difficult to ascertain just because formulas may serve as a useful tool to estimate them. The court only cursorily analyzed section 506(b), which it regarded as a "safety valve which must be used cautiously and sparingly."

The borrower had made no effort to prove the extent of the lender's

124. A similar approach was suggested by the borrower's expert witness in First Nat'l Bank v. Philadelphia Nat'l Bank, No. 87-2829, 1989 WL 79789 at *10 n.7 (E.D. Pa. July 10, 1989), aff'd, 897 F.2d 521 (3d Cir. 1990). This expert, however, suggested using the published prime rate rather than the Treasury bond rate. The bond rate seems preferable, since it is by nature a long-term rate, while the prime represents principally intermediate-term commercial loans.


127. Id. at 837.

128. Id. at 839.
actual loss from prepayment, a failure that the court considered fatal to its reliance on section 506(b). The opinion almost seemed to take the position that any fee enforceable under state law will constitute a secured claim under section 506(b) as well.

What do all these cases, beginning with United Merchants, signify in practical terms? First, prepayment fee clauses are fair objects for attack as invalid penalties in the bankruptcy courts. Second, the bankruptcy decisions purport to apply state law as an initial matter; but that statement has little meaning, since in most jurisdictions the state law of prepayment is unclear. Third, even if state law is not considered adequate to strike down a prepayment fee clause, the bankruptcy courts can always reach substantially the same result by relying on Bankruptcy Code section 506(b), under which they usually employ an *ex ante* test of reasonableness. Although that section technically refers only to allowance of the fee as a secured claim, as a practical matter denial under section 506(b) will usually have the effect of giving the lender only a small portion of the fee or none at all. Fourth, whether operating under state law or section 506(b), the bankruptcy courts are likely (although not certain, as Financial Center Associates illustrates) to strike down prepayment fee clauses that are so constructed as to inevitably overcompensate lenders (like the Type III-plus clause in Skyler Ridge) or that appear to impose fees of an arbitrary amount (Type I and Type II clauses) which in fact overcompensate the lender. Hence, the only sorts of clauses that one can confidently predict will survive in bankruptcy are Type III “yield maintenance” clauses that correct the deficiencies of the Skyler Ridge clause, and that compute the lender’s loss with reasonable (although not necessarily perfect) accuracy.

As of this writing, there seem to be no published non-bankruptcy cases dealing with Type III yield maintenance prepayment clauses. However, two cases have been decided in a closely related context—clauses fixing a lender’s damages for failure of a borrower to honor a binding mortgage loan commitment. The analogy is obvious: a borrower’s failure to draw down the loan funds under a commitment gives the lender precisely the same sort of reinvestment problem as does a prepayment. In a sense, the borrower’s breach of the loan commitment is the ultimate prepayment, one that occurs even before the loan is made.
In the first of these cases, Teachers Insurance & Annuity Ass’n of America v. Butler, the language of the damages clause in the loan commitment was fairly general, giving the lender “all provable damages, including loss of bargain, sustained by us as a result of such default.” The court, acting under New York law, fleshed out this language by awarding the lender the difference between the contracted interest (14.25%) and interest at the lender’s current loan rate at the time of the breach (12.25%), discounted to present value. The lender argued that it was entitled to six months of interest differential based on a lower short-term index, on the ground that it would require that period to find a suitable replacement loan. The court rejected the argument, noting that the lender had offered no concrete evidence that it had taken six months to close a replacement loan. The borrower, on the other hand, offered no evidence to contradict the lender’s testimony that 12.25% was its current mortgage loan rate, and the court accepted it at face value. In essence, in computing the lender’s damages, the court reached the same result that it would have reached under a Type III yield maintenance clause that did not suffer from the sorts of defects criticized by the Skyler Ridge court. The court used a mortgage rate, rather than a short-term rate, as an index, and it discounted the differential in interest to present value. Hence, the decision strongly suggests that a similar yield maintenance prepayment clause would be upheld.

Another case involving a borrower’s breach of a loan commitment, New England Mutual Life Insurance Co. v. Stuzin, involved a more specific and more questionable damages clause. The clause applied by its terms to both failure of the borrower to draw down the loan and to prepayment after closing, but the breach was of the former type. The clause called for a discounting to present value of the difference between interest at the contract rate and the equivalent interest at the current yield on U.S. Treasury obligations of a maturity and coupon rate closest to those of the mortgage loan. From the Skyler Ridge viewpoint, the use of the Treasury note index would be objectionable, but the court upheld it under Massachusetts law and enforced the clause, finding it to constitute a reasonable forecast of damages as of the time the contract was formed.

130. Id. at 1236.
132. The court also sustained language requiring the borrower to reimburse the lender for its full out-of-pocket expenses in reinvesting the amount prepaid or not
To date, the only nonbankruptcy case deciding the validity of a Type III yield maintenance clause is an unpublished opinion by the federal district court for the Eastern District of Pennsylvania in First National Bank v. Philadelphia National Bank.\textsuperscript{133} The court enforced the clause under Pennsylvania law despite its use of the yield on Treasury obligations as the reference rate for fixing the prepayment fee. The court conceded that “a formula like the lender’s when used industry-wide over a long time tends to give lenders excessive recoveries.”\textsuperscript{134} Nevertheless, it found that Pennsylvania law imposed the burden of proving unreasonableness on the party attacking a liquidated damages clause, and it was not satisfied that the borrowers had sustained their burden by showing that the lender could readily have reinvested the funds at a rate higher than the Treasury rate. The court specifically declined to follow Skyler Ridge, which in effect adopts a contrary presumption.

While New England Mutual Life and First National Bank are hardly overwhelming authority, they do suggest that a yield maintenance clause will be enforced under state law outside the bankruptcy context, even if the clause seems designed to overstate the lender’s damages systematically. This may not seem surprising in light of the virtually uniform enforcement of Type I and Type II clauses in state courts discussed earlier in this Article. But the sort of Type III clause found in New England Mutual Life, First National Bank, and Skyler Ridge is different because the prepaying borrower will almost always be forced to overcompensate the lender. The Type I and Type II clauses, however, permit a possibility that the clause will work to the borrower’s benefit if interest rates have fallen so sharply that the lender’s loss on prepayment exceeds the figure dictated by the clause. Whether this difference warrants a different judicial treatment is the subject of the following section.


\textsuperscript{134} \textit{Id.} at *11.
A. Economic Analysis of the Type III-Plus Clause

A Type III clause is, in a sense, not a liquidated damage clause at all, but rather a purported formula for computing the lender's actual damage. However, if the formula used is designed to overstate the damages (thus, a “Type III-plus” clause, since an additional liability over and above actual damages is certain to exist), the Skyler Ridge court, at least, would refuse to enforce it. The analogy drawn earlier in this Article, treating the prepayment fee clause as a species of insurance contract, is helpful here. The Type I or Type II clause is tantamount to insurance, albeit perhaps with a slightly arbitrary premium. The lender's damages may turn out to be either more or less than the fee agreed upon, depending on the subsequent behavior of interest rates; either way, the borrower has the benefit of knowing that the liability is capped. But with the Type III clause no insurance function is being served. Instead, the clause in effect requires the borrower to pay actual damages, and, in a Type III-plus clause, an additional sum flowing from the clause's "faults" as outlined above. The borrower would always be better off with no prepayment clause at all, and instead with the obligation to pay the lender's actual loss.

The economic analysis of prepayment fees presented earlier in this Article attempted to justify their enforcement on two grounds: first, that they represent an efficient voluntary shifting of the risk of prepayment, and second, that they do not produce inefficiency by discouraging borrowers' pursuit of lower-interest refinancing. As noted in the preceding paragraph, the risk-shifting process does not occur with a Type III clause; the borrower still incurs the entire risk of loss from prepayment, and in a Type III-plus clause, a further liability as well. Thus the first rationale suggested earlier for enforcement of the clause has no application here. The one advantage to a Type III-plus clause is its simple formula for computing the fee, which avoids the need for litigation to measure the mortgagee's damages.

A "straight" Type III clause that accurately computes the lender's damages should, of course, be unexceptionable and routinely upheld. But the case for enforcement of a Type III-plus clause is obviously weaker. Analyzing the clause according to the second economic rationale just mentioned reveals that a court should sustain the clause. The clause does no harm in terms of economic efficiency, and whatever sum in excess of actual damages it forces the borrower to pay the lender is, in practical effect, merely a
further form of compensation to the lender for having made the loan.

This is an acceptable situation because, as this Article demonstrates, no matter how great the apparent overcompensation that the clause gives the lender, the practical amount of overcompensation in any voluntary prepayment case will be limited to some portion of present value of the borrower's opportunity to refinance at a below-market rate. As was shown above, if the borrower must pay that entire present value or more, she or he will simply forego refinancing altogether; it isn't worth doing. Hence the Type III-plus clause merely represents a bargain under which the lender exacts a share of the value of the borrower's below-market refinancing opportunity. Although such opportunities are not very common, when they do exist these clauses force borrowers to "cough up" part of their value to lenders.

Type III-plus clauses thus result in a cross-subsidization among borrowers, with those who find attractive below-market refinancing opportunities inevitably subsidizing those who do not. If Type III-plus clauses were declared unenforceable by all courts, lenders as a class would forego the revenue these clauses would otherwise generate, and (assuming an efficient market in mortgage loans) would raise interest rates or front-end loan fees on all loans to compensate for that loss. Thus all borrowers would pay a bit more in order to ease the burden on the select class of borrowers who have below-market refinancing opportunities. This cross-subsidization seems to have no efficiency implications, nor can it be reasonably attacked on grounds of inequity. Hence, one must conclude that, at least where prepayment is voluntary, even a Type III-plus clause should be enforced under state law.

When the borrower is in bankruptcy there is a further factor to consider. A trustee in bankruptcy or a debtor in possession who prepay a mortgage loan is representing not merely himself or herself, but in most cases a host of subordinate mortgagees and unsecured creditors as well. If the prepayment fee is allowed as a secured claim, that much additional value in the security property will be consumed to pay the fee and hence will be unavailable for distribution to the unsecured creditors. It is they, not merely the debtor, who will be harmed by the debtor's poor judgment or improvidence in entering into an unduly onerous prepayment fee clause.

If the bankruptcy proceeding is under Chapter 11, there are additional considerations. Chapter 11's purpose is to save a failing
business. The managers of firms in Chapter 11 have typically made many poor business decisions, and signing a mortgage containing a Type III-plus prepayment clause may have been one of them. But the goal of Chapter 11 is to help the firm survive for the benefit not only of its owners but also of its employees, suppliers, creditors, and all others who do business with it. The very existence of Chapter 11 in the Bankruptcy Code reflects a federal policy decision that this goal is sufficiently important to warrant modification of some of the contractual rights of some of these parties in order to benefit all of them in the aggregate. The goal may be debatable, but it is so firmly entrenched in American law that any debate is not of much interest.

Whether these objectives of bankruptcy are sufficient to warrant a bankruptcy court's disallowance of a Type I or Type II fee is doubtful. As noted earlier, those fees are a type of insurance premium. The premium may have been too high, and the debtor may have been foolish to have agreed to it, but it was at least potentially less than the lender's actual damages, and it did avoid the necessity of litigation to establish those damages. Bankruptcy courts should not engage in a post hoc re-evaluation of the debtor's insurance policies, refusing to pay the premiums already due on those that appear burdensome. Except in the most extreme cases involving fees at outrageous levels, the bankruptcy courts ought to let Type I and Type II fees stand under section 506(b).

But with a Type III-plus clause—one that is consciously designed to overstate the lender's damages in every instance—a much stronger argument for bankruptcy court intervention can be made. When the borrower is in bankruptcy, the debtor's transfer of wealth under the prepayment fee clause ultimately diminishes the junior lienholders and unsecured creditors, and in Chapter 11 the employees, suppliers, and other contractors. In theory, they might have gone to the public records, reviewed the clause in the mortgage, and made their business decisions accordingly, but the transaction costs of this behavior would obviously be far in excess of its benefits in most cases, and it is wholly impractical to expect ordinary trade creditors, for example, to engage in it. Hence, they are entitled to a restoration to the bankruptcy estate of the unearned fee charged by the mortgage lender.135 It is one thing for unsecured

135. A rough analogy can be drawn to the fraudulent transfer concept of § 548 of the Bankruptcy Code, which authorizes the court to set aside transfers given by an insolvent debtor within one year of bankruptcy for less than "reasonably equivalent value." 11 U.S.C. § 548 (1988 & Supp. III 1991). Of course, the prepayment fee is not,
creditors to live with a business decision of the debtor that was potentially an unnecessary and unearned expense; it is another to impose upon them a decision that was inevitably such an expense. The bankruptcy courts may reasonably conclude that the debtor can throw away his or her own money, but not money owed to the subordinate and unsecured creditors. Hence, the economic freedom ordinarily allowed to borrowers can properly be curtailed to serve the policy objectives of bankruptcy.

On the other hand, a bankruptcy court's refusal to allow the full prepayment fee as a secured claim under either state law or section 506(b) should not mean that the lender gets no fee at all. Although some bankruptcy cases have reached this result, it is legally unnecessary and unfair to the lender if an actual loss exists. Ordinarily under state law, denial of enforcement of a liquidated damages clause leaves the party who suffered the breach with a claim for actual damages. Similarly, section 506(b) states that reasonable fees "shall be allowed." Unless a court wants to punish the lender for being a pig, it ought to take evidence of the lender's actual damages and allow them as a secured claim.

In general, then, the courts are doing just what ought to be done with clauses imposing fees for voluntary prepayment. They enforce them routinely, regardless of their amount, except when the borrower is in bankruptcy and the clause is designed to accomplish a systematic overcompensation of the lender. Principles of economic efficiency support the results actually being reached.

V. THE INTERACTION OF PREPAYMENT AND ACCELERATION CLAUSES

Virtually all commercial mortgages contain clauses providing for acceleration of the debt under certain circumstances. The most universal of these clauses permits the lender to accelerate the loan, making the entire balance immediately due and payable, in the event of a default by the borrower in payment or in performance of other covenants. At least three other types of events are com-

136. See supra note 113 and accompanying text.
138. The documents may provide for a notice to the borrower of the nature of the default, and a brief grace period within which the default may be cured, prior to accel-
monly made grounds for debt acceleration. One is the occurrence of insured physical damage to the improvements on the real estate. While some residential loan clauses may allow the mortgagor to apply the insurance proceeds to repair the damage,\textsuperscript{139} most commercial mortgages give the lender the option to apply the entire proceeds against the debt instead.\textsuperscript{140} Another is a taking of the property by eminent domain; a mortgage clause will usually provide that the entire governmental award will, at the lender's option, be applied toward the mortgage balance.\textsuperscript{141} A third basis for acceleration is a transfer of the security property, which can trigger an acceleration under a due-on-sale clause.\textsuperscript{142}

When acceleration occurs in any of these four situations, the lender requires the borrower to make a prepayment (in whole or in part) of the debt. The lender may compel payment by action on the debt, foreclosure, suit for a deficiency, or some combination of these. The lender will often demand, in addition, any prepayment fee provided for in the mortgage documents. Borrowers naturally resist the collection of the fee, often arguing that because the prepayment is involuntary, the fee clause does not apply. The following material will examine whether, in each of these four prepayment cases, the fee should be collectible.

\textsuperscript{139} See, e.g., FNMA/FHLMC MORTGAGE, SINGLE FAMILY, Nonuniform Covenant 21 (Sept. 1990), which grants a 30-day period to cure; Nelson & Whitman, supra note 1, §§ 7.6-7.8.

\textsuperscript{140} See, e.g., FNMA/FHLMC MORTGAGE, SINGLE FAMILY, Uniform Covenant 5 (Sept. 1990), which permits the borrower to apply the insurance proceeds to repair or restore if such is economically feasible and the lender's security is not lessened.

\textsuperscript{141} See, e.g., FNMA/FHLMC UNIFORM INSTRUMENT, MULTIFAMILY DEED OF TRUST, Uniform Covenant 5 (Jan. 1977), which authorizes the lender, at its sole option, to hold insurance proceeds for reconstruction of the property or to apply them toward payment of the balance owing on the debt.

\textsuperscript{142} See, e.g., id. Uniform Covenant 11. If only a partial taking occurs, the clause may provide that less than the entire award must be paid on the debt. See also, e.g., FNMA/FHLMC MORTGAGE, SINGLE FAMILY, Uniform Covenant 10 (Sept. 1990), which requires payment of only a fraction of the award, defined as (a) the loan balance immediately prior to the taking, divided by (b) the fair market value of the property immediately prior to the taking. The objective, of course, is to maintain the loan-to-value ratio that the lender enjoyed before the taking, but to allow the borrower to have the funds not needed by the lender for this purpose. It is doubtful that many mortgages on commercial real estate make even this concession to the borrower.

\textsuperscript{142} See supra text accompanying note 3.
A. **Contract Construction: Is Acceleration Governed by the Prepayment Clause?**

Prior to the mid-1980s, it was rare for the prepayment clauses in commercial mortgages to deal specifically with prepayment incident to acceleration. Hence, lenders who claimed prepayment fees upon acceleration had only a slender contractual basis for doing so. They could argue that the loan was indeed being paid prior to its scheduled maturity and hence that the fee had been earned, but they could point to no contract language so stating. They usually lost these cases, typically on the grounds that the clause was not intended to cover "involuntary" prepayments; having been accelerated by the lender, the loan was now mature, and thus that payment was not "pre-


145. For cases involving acceleration for default, see *In re LHD Realty Corp.*, 726 F.2d 327, 331 (7th Cir. 1984); 3C Assocs., 524 N.Y.S.2d at 702; George H. Nutman, Inc. v. Aetna Business Credit, Inc., 453 N.Y.S.2d 586 (Sup. Ct. 1982). *But see* Mutual Life Ins. Co. v. Hilander, 403 S.W.2d 260 (Ky. 1966) (lender does not waive right to prepayment fee merely by threatening acceleration).

For a case involving acceleration under a due-on-sale clause, see McCausland v. Bankers Life Ins. Co., 757 P.2d 941, 946 (Wash. 1988) ("It is only fair that the lender be
These cases were not free of conceptual difficulty. For example, a problem was raised when the borrower prepaid under the threat or prospect of acceleration for default or under a due-on-sale clause, even though no formal notice of acceleration had been given by the lender. The courts, perhaps wishing to avoid the need to delineate the various gradations of expectation of acceleration that might exist in borrowers' minds, usually held that only payment under an *actual* acceleration was free of the duty to pay the fee. \(^{146}\) Another problem was created by borrowers who were tempted to engage in conduct that would cause their lenders to accelerate, precisely in order to prepay while avoiding the fee that would ordinarily be due on a voluntary acceleration. Hazard insurance payoffs and eminent domain awards do not, as a practical matter, present this sort of opportunity to borrowers, but defaults and sales of the property plainly do. After some equivocal language in the earlier cases, \(^{147}\) the courts finally began to announce rather forcefully that prohibited from demanding prepayment fees upon acceleration of the debt since . . . it is the lender who is insisting on prepayment.").

See also Greenhouse Patio Apartments v. Aetna Life Ins. Co., 868 F.2d 153 (5th Cir. 1989), in which the lender, in order to protect its claim to the prepayment fee under the cases cited above, went to great and successful lengths not to accelerate the debt.

\(^{146}\) For cases concerning acceleration for default, see *In re Adu-Kofi*, 94 B.R. 14, 15 (Bankr. D.R.I. 1988) (lender may rescind acceleration unless borrower has relied to its detriment, and prepayment after rescission requires payment of fee); *Bell Bakeries, Inc. v. Jefferson Standard Life Ins. Co.*, 96 S.E.2d 408, 417 (N.C. 1957); *West Portland Dev. Co. v. Ward Cook, Inc.*, 424 P.2d 212, 214 (Or. 1967) (lender accelerated because of the borrower's default, but subsequently rescinded the acceleration at the borrower's request; borrower then prepaid the loan; held: since the acceleration was no longer in effect, the lender was permitted to collect the prepayment fee); *Berenato v. Bell Sav. & Loan Ass' n*, 419 A.2d 620, 622 (Pa. Super. Ct. 1980) (same).

For cases involving acceleration under a due-on-sale clause, see *First Nat'l Bank v. Equitable Life Assur. Soc'y*, 510 N.E.2d 518, 523 (Ill. App. Ct. 1987); *First Ind. Fed. Sav. Bank v. Maryland Dev. Co.*, 509 N.E.2d 253, 257 (Ind. Ct. App. 1987) (where lender had refused to approve sale of property, but had not accelerated under due-on-sale clause, lender could demand prepayment fee when loan was prepaid; the prepayment was not "involuntary"). *But see* *Wide Scope, Inc. v. Freedom Fed. Sav. & Loan Ass'n*, 520 N.E.2d 35 (Franklin County Mun. Ct. Ohio 1987) (lender was barred from collection of prepayment fee, where lender told borrower that it would not approve transfer of mortgaged property, despite fact that lender had not instituted foreclosure proceedings and apparently had not accelerated).

\(^{147}\) See, e.g., *LHD Realty*, 726 F.2d at 331 ("[S]hould such intentional defaults become a problem, . . . courts could [deny] the acceleration exception in appropriate cases."). See also the dicta in *Eyde Bros.*, 697 F. Supp. at 1436, and *Rodgers*, 757 F.2d at 978–79, both of which imply that an intentional default would permit collection of the fee.
such bad faith actions by borrowers would simply fail to gain the desired result; the prepayment fee would have to be paid.\textsuperscript{148}

I have described these cases in the past tense, although many of them are recent, because they are shortly destined to become largely irrelevant as a result of changes that have already occurred in commercial mortgage practice. Lenders’ counsel followed with acute interest the development of the case law denying prepayment fees to borrowers whose payments were a result of acceleration of the debt. By the mid-1980s they were busy redrafting their mortgages to make their clients’ contractual right to prepayment fees in these circumstances very clear. The 1988 FNMA/FHLMC Rider to Multi-family Instrument is illustrative:

\begin{quote}
Borrower shall pay the prepayment premium . . . whether the prepayment is voluntary or involuntary (in connection with Lender’s acceleration of the unpaid principal balance of the Note) or the Instrument is satisfied or released by foreclosure . . . , deed in lieu of foreclosure or by any other means. Borrower shall not pay any prepayment premium with respect to any prepayment occurring as a result of the application of insurance proceeds or condemnation awards under the Instrument.\textsuperscript{149}
\end{quote}

The clauses that many commercial lenders currently use do not exclude insurance and condemnation awards, as does the FNMA/FHLMC form; instead, they state that \textit{all} payments prior to scheduled maturity will give rise to prepayment fee liability. Thus far, these clauses are having precisely their desired effect; the courts are enforcing them literally.\textsuperscript{150}

\textsuperscript{148} Florida Nat'l Bank v. BankAtlantic, 589 So. 2d 255, 259 (Fla. 1991). The line between a default intended to induce an acceleration and a default caused by the borrower's financial problems is not an easy one to draw. Borrowers who engage in alleged “bad faith” defaults are often in financial distress as well; indeed, it is usually their hope that an acceleration by the lender will permit them to pay off the loan (without a prepayment fee, of course) and to refinance at a lower interest rate, thus improving the project’s cash flow and placing it in a financially viable posture. \textit{See id.} at 259 (Grimes, J., dissenting).

\textsuperscript{149} FNMA/FHLMC RIDEr TO MULTIFAMILY Instrument, COVEnANT A(3) (Apr. 1988). Very similar language was employed by Connecticut General Life Insurance Co. in the loan litigated in \textit{In re Schaumburg Hotel Owner Ltd. Partnership}, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989). Perhaps the earliest similar language discussed in a reported case (albeit not involving a mortgage loan) is found in \textit{In re United Merchants & Mfrs.}, 674 F.2d 134, 140 (2d Cir. 1982): “upon default: then at the option of the holder of any Note . . . the principal of such Note shall forthwith become due and payable, together with the interest accrued thereon, and, to the extent permitted by law, an amount equal to the prepayment charge that would be payable if [borrower] were prepaying such Note at the time.”

\textsuperscript{150} At this point most of the cases involve acceleration for default, rather than under a due-on-sale clause. \textit{See Schaumburg Hotel}, 97 B.R. at 953 (“Because this right was specifically bargained for and agreed to by the Debtor, [the lender] is entitled to
B. An Economic Analysis of Prepayment Resulting from Acceleration

This Article has described the prepayment clause as a form of insurance, permitting the borrower (for a fee) to shift the financial risk of prepayment to the lender. I now propose to use this insurance model to evaluate prepayments that result from acceleration by the lender. The analysis is vitally dependent on a clear definition of the "insured event"—that is, the occurrence for which the prepayment fee is designed to compensate. As I have already argued, that event is prepayment resulting from the borrower's actions or from other causes beyond the lender's control. If a prepayment is the lender's "fault"—that is, if it is triggered by a lender who has no legitimate need to demand it to protect the security or to avoid default, it is not the sort of prepayment against which the parties intended to insure.

The familiar insurance law principle of "moral hazard" explains this conclusion. That phrase typically describes situations in which the insured party is tempted, because of the existence of the insurance coverage, to reduce the degree of care that he or she would otherwise take to prevent the occurrence of the insured event. For example, the insured under a fire insurance policy may enforce its liquidated damages clause."); see also Parker Plaza West Partners v. UNUM Pension & Ins Co., 941 F.2d 349, 355-56 (5th Cir. 1991); United Merchants, 674 F.2d at 143; in re Financial Center Assocs., 140 B.R. 829, 835 (Bankr. E.D.N.Y. 1992); Golden Forest Properties v. Columbia Sav. & Loan Ass'n, 248 Cal. Rptr. 316, 318-19 (Ct. App. 1988); Meisler v. Republic Sav. Ass'n, 758 S.W.2d 878, 884 (Tex. Ct. App. 1988).

Warrington 611 Assocs. v. Aetna Life Ins. Co., 705 F. Supp. 229 (D.N.J. 1989), upheld in dictum a combination of prepayment and due-on-sale clauses. However, the loan was in fact locked in and nonprepayable at the time of the proposed sale of the property, and the lender did not actually accelerate the loan, but merely indicated that it would demand a yield maintenance fee if the loan were paid off in connection with the sale. The court held that the lender's position was warranted and gave rise to no liability for damages. Id. at 236. The due-on-sale clause was largely irrelevant, as the borrower desired to pay off the loan.

The enforceability of mortgage language specifically imposing a prepayment fee upon an acceleration by the lender was predicted in dictum in several additional cases. See Eyde Bros., 697 F. Supp. at 1436 ("If parties to a contract wish to avoid the general rule of LHD Realty, it is incumbent upon them to more clearly express their intent in their agreement."); Village of Rosemont v. Maywood-Proviso State Bank, 501 N.E.2d 859, 862 (Ill. App. Ct. 1986) (eminent domain award); Rodgers, 757 P.2d at 979 (acceleration for default).

The only decision refusing to enforce specific mortgage language providing for collection of a prepayment fee upon an acceleration for default is Clinton Capital Corp. v. Straeb, 589 A.2d 1363 (N.J. Super. Ct. Ch. Div. 1990), discussed infra notes 178-179 and accompanying text.

151. See supra notes 56-57 and accompanying text.
pay less attention to the presence of flammable chemicals or other combustible materials on the premises, thinking, "Why worry? I'm covered by insurance anyway." The most extreme form of moral hazard is the situation in which the insured has full control over the insured event. The whole point of insurance is to shift the risk of events that are *outside* the beneficiary's control. Both the drafters of insurance policies and the courts go to great lengths to prevent enforcement of insurance claims when the beneficiary causes or controls the loss.152 Thus, for example, the beneficiary under a life insurance policy cannot collect if he or she murders the insured; the insured under a fire insurance policy who burns down his or her own house is not entitled to make a claim; and so on. There is a good economic reason for this restriction: insurance is efficient because it permits shifting risk from one who is more risk-averse to one who is less risk-averse. This principle is inapplicable when the party who is shifting away the risk has control of whether a loss will eventuate. A contract of this sort is not insurance at all. It is merely an agreement to transfer wealth from the insurer to the insured upon demand.

In some contexts a mortgage clause providing for a prepayment fee upon acceleration takes on the characteristics of an insurance contract in which the insured (the mortgagor) controls whether or not the insured event will occur. In the mortgage contract there is an additional feature: as a precursor to acceleration, some triggering action must occur. That trigger—a governmental taking, a casualty loss, or a transfer of the property—is itself outside the mortgagor's control. But under some conditions the triggering occurrence may impose no cost or risk on the lender. When an occurrence gives rise to no business or economic necessity for the lender to accelerate, it is a mere fortuity. Under such circumstances, the lender's decision to accelerate actuates the "moral hazard" principle discussed above, and the lender should, in insurance terms, be "denied coverage." It is as if no insured event has occurred. Because the "insurance" contract represented by the prepayment fee clause has the peculiar feature that the "premium" (the fee) is not due from the mortgagor until an insured event occurs, it should not be payable under these circumstances. Indeed, to enforce the prepayment fee when there is no business necessity for the prepayment is analogous to enforcement of a gambling contract. In

substance, the mortgagee says, "If a triggering occurrence, such as a taking, a casualty loss, or a sale of the property occurs, it may or may not affect my position in terms of security and credit risk. But even if it does not affect me in those ways, I still have the right to accelerate, and to charge you, the borrower, a prepayment fee." There is no economic or public policy rationale for enforcement of the fee in these conditions.

The description of moral hazard above does not apply to all accelerations resulting from condemnation, casualty loss, or property sale. In many cases the lender has a legitimate business need to accelerate when one of these events occurs. In those cases, the prepayment fee, if provided in the mortgage documents, should be readily enforced. Hence, we need to examine carefully each of the common events that triggers mortgage acceleration, and to consider when each of those events gives the lender a business need to accelerate. I will begin with the easiest case, acceleration resulting from eminent domain takings, and proceed to the case that I regard as the most difficult, acceleration for default.

1. Takings in Eminent Domain

When the mortgaged property is taken in eminent domain, the lender's security is either entirely lost (in a total taking) or reduced in value (in a partial taking). In either case, both the common law and most commercial mortgages give the lender the right to insist that the award be applied toward the debt. In the case of a total taking the judicial rule allots the entire award (up to the amount of the debt) to the lender. When only part of the land is taken, some cases give the lender the entire award, but most of the modem decisions allocate to the lender, for payment toward the debt, only so much of the award as is necessary to maintain the loan-to-value ratio that existed before the taking. This approach is seen as preventing impairment of the lender's security, while at the same time preserving as much of the loan principal as possible for the borrower's use.

153. See Hatch v. Minot, 369 So. 2d 974, 977 ( Fla. Dist. Ct. App. 1979); Nelson & Whitman, supra note 1, § 4.12 (pointing out that in partial taking cases the authorities are divided between giving the mortgagee the entire award and giving it only enough to protect its security); Harold D. Teague, Condemnation of Mortgaged Property, 44 TEX. L. REV. 1535, 1537 (1966).

The cases disagree as to whether language in the mortgage documents can effectively override the majority rule preserving the loan-to-value ratio and give the lender a claim for the entire award in a partial taking case.\textsuperscript{155} The courts that permit this contractual modification of the judicial rule allow the eminent domain clause to act as a peculiar sort of due-on-sale clause, with the "sale" in question being the governmental taking. Since such takings are relatively rare and are usually unpredictable at the time the loan is made, it is doubtful that such a clause, even if enforceable, has much economic value to the lender. Indeed, language in the mortgage may take an even more heavy-handed approach, authorizing an acceleration of the entire debt (and not merely the amount of the condemnation award) when a partial taking occurs. But this language may be too much for a court to swallow. In \textit{Sessler v. Arshak Corp.},\textsuperscript{156} the Florida District Court of Appeal dealt with such a clause in a foreclosure action triggered by the taking in eminent domain of such a small portion of the property that its security value was not impaired. The court refused to recognize the acceleration or to order foreclosure, holding that to do so would be "inequitable and unjust."

Now consider a mortgage that provides for a prepayment fee when a paydown of the debt of the sort described above occurs. If the paydown is really necessary to protect the lender's security after a governmental taking, and if the mortgage documents clearly state that the prepayment fee is chargeable in these circumstances, the courts should enforce that language. The risk of a necessary prepayment resulting from eminent domain is one of the risks the parties agreed to cover under the clause, and it is efficient (as discussed earlier) to give effect to their agreement. The government's decision to engage in a taking under its power of eminent domain is ordinarily a "neutral" occurrence because the lender has no influence. There need be no concern that the lender will attempt to manipulate

\textsuperscript{155} Compare \textit{INA/Oldfather}, 700 P.2d at 879 ("[W]hen the deed of trust or mortgage has a provision determining the disposition of such proceeds, it governs.") with \textit{Redwood Baseline}, 149 Cal. Rptr. 11, 16 n.7 (construing \textit{CAL. CIV. PROC. CODE} § 1265.225 to mean that a "lienholder is entitled to share in the award only to the extent of the impairment of his security notwithstanding any agreement to the contrary entered into at the time of the creation of the indebtedness on which the lien is based").

\textsuperscript{156} 464 So. 2d 612, 612-13 (Fla. Dist. Ct. App. 1985) (only a small portion of the property was taken, and security was not impaired; hence, foreclosure would be "inequitable and unjust").
the matter in order to collect an unwarranted prepayment fee. Lenders will naturally and correctly point out that a prepayment resulting from a governmental taking imposes on the lender precisely the same burden and potential financial loss as the borrower's voluntary prepayment.

However, the paydown of the mortgage may not be necessary for protection of the lender's security. Obviously the real estate or some portion of it is gone and can no longer serve as security. But if the lender demands and can enforce a paydown that does not merely maintain, but actually improves, its loan-to-value ratio, the excess portion of that paydown above that necessary to maintain the ratio is ordinarily unnecessary for protection of the security. Moreover, a paydown or payoff may be unnecessary even in the case of a total taking of the real estate. Suppose the mortgagor asks the lender to leave the full loan outstanding and offers to substitute collateral—say, an unconditional letter of credit from a bank of great financial strength—that is indisputably as good or better security than the real estate, and further offers to pay all transaction costs associated with the substitution. Further assume that the mortgagor has sources of cashflow sufficient to cover the debt service payments, so that the loss of the real estate as a cash generator will not increase the risk of default. Under these circumstances, the mortgagor might well argue, by analogy to Sessler v. Arshak Corp.,\(^{157}\) that the security has not been impaired and that no acceleration of the debt should be recognized. Professor Frank Alexander has advanced this argument,\(^{158}\) and it has considerable force, although no court seems yet to have adopted it.

Thus, a court might reject the mortgagor's offer of substitute collateral as a basis for denying acceleration of the loan. But even if the acceleration is enforced, the mortgagor's offer should suffice to establish that the prepayment which ensues is not attributable to the borrower, but rather to the lender. If the mortgagor makes the offer of substitution and the lender rejects it, it is the lender's "fault" that prepayment occurs. Even if the substitution is a fully adequate replacement for the real estate, the lender might object if he or she desires repayment because the combination of the prepayment fee and the value of relending the funds at market interest rates exceeding the contract rate on the existing loan make the prepayment

\(^{157}\) 464 So. 2d 612.

\(^{158}\) See Alexander, supra note 1, at 320.
profitable. The lender's calculation (ignoring transaction costs) is a simple one:

* The amount of the condemnation award (potentially to be prepaid);
* Plus the prepayment fee;
* Minus the future stream of payments the lender will earn on the amount of the condemnation award, discounted to present value at the current market rate.

If the sum of these factors is positive, the lender will be better off financially to insist on prepayment of the condemnation award, even if it has no need to do so in terms of protection of its security because the borrower has offered fully adequate substitute security. On these facts, the lender's actions are the sole cause of the prepayment. It is outside the scope of "insured events" which the prepayment fee clause covers, and no fee should be awarded. Perhaps cases in which a condemnee/mortgagor can and will offer such satisfactory substitute security will not be very common, but where they occur the courts should refuse to enforce the prepayment fee even if they permit the prepayment itself. The same reasoning should be followed in partial taking cases in which the courts allot to the lender so much of the condemnation award that the lender's loan-to-value ratio is improved; no prepayment fee should be collectible on the excess portion of the allotment.

2. Hazard Insurance Proceeds and Due-on-Sale Accelerations

Prepayments of hazard insurance proceeds are much the same as those resulting from government condemnation actions, but with one important difference. When the real estate has been damaged by a fire or other insured hazard, application of the insurance proceeds will frequently restore the damage. Often the borrower will prefer this use of the insurance proceeds, since the borrower needs the property in a useable state, and the only alternative means of financing a restoration may be by means of a subordinate mortgage loan at a relatively high interest rate. But the lender may have an incentive to discourage use of the insurance proceeds to restore the premises. If its mortgage permits it to demand that the insurance proceeds be applied on the debt, the lender may look at current interest rates and conclude that prepayment is financially advantageous despite the fact that restoration of the damaged real estate could readily be accomplished with the insurance proceeds and that after restoration the premises would be as acceptable security as before the damage occurred. If the mortgage also provides for an enforceable prepayment fee, the lender's incentive to capture the in-
surance payment is stronger yet. The lender’s calculation is analogous to that used above to analyze the capture of eminent domain awards:

- The amount of the hazard insurance proceeds (potentially to be prepaid);
- Plus the prepayment fee;
- Minus the future stream of payments the lender will earn on the amount of the insurance proceeds, discounted to present value at the current market rate.

If the sum of these factors is positive, it will be to the lender’s advantage to insist on prepayment of the insurance funds although it has no need to do so for protection of its security.\textsuperscript{159} While the California courts have refused to countenance this result even if the mortgage purports to give the lender the right to insist upon it,\textsuperscript{160} virtually all other jurisdictions routinely enforce such mortgage clauses, and most hold for the lender even if there is no clause.\textsuperscript{161}

Prepayment caused by an acceleration under a due-on-sale clause is analogous to that under a casualty insurance clause. Due-on-sale clauses are designed to address two distinct issues. The first is the risk that the real estate will be transferred to someone who has a weak credit history, an inadequate income to carry the mortgage debt service, a history of “milking” or committing waste on

\textsuperscript{159} This sort of calculation and decision is by no means hypothetical. It is quite clear that the mortgagees went through precisely this process (and hence demanded prepayment) in Starkman v. Sigmond, 446 A.2d 1249 (N.J. Super. Ct. App. Div. 1982). No prepayment fee was involved in the case, but because market interest rates had risen significantly since the loan was made, the mortgagees were still better off with a prepayment of the insurance proceeds.

\textsuperscript{160} See Kreshek v. Sperling, 204 Cal. Rptr. 30 (Ct. App. 1984); Schoolcraft v. Ross, 146 Cal. Rptr. 57 (Ct. App. 1978). Where the mortgage does not explicitly give the mortgagor control of the insurance proceeds, some additional jurisdictions have recognized the mortgagor’s right to use them for restoration of the premises. See Cottman Co. v. Continental Trust Co., 182 A. 551, 554-55 (Md. 1936); \textit{Starkman}, 446 A.2d at 1253.

\textsuperscript{161} See, \textit{e.g.}, Pearson v. First Nat’l Bank, 408 N.E.2d 166, 169-70 (Ind. Ct. App. 1980) (lender breached no duty to borrower by applying proceeds to mortgage debt); English v. Fischer, 660 S.W.2d 521, 523 (Tex. 1983); \textit{see also} \textit{NELSON \& WHITMAN}, \textit{supra} note 1, § 4.15. In \textit{General G.M.C. Sales, Inc. v. Passarella}, 481 A.2d 307 (N.J. Super. Ct. App. Div. 1984), the court held that the lender may capture insurance proceeds in absence of a mortgage clause, and disagreed with \textit{Starkman}, 446 A.2d 1249:

There may be cases in which the mortgagor will be adequately protected by a holding that allows the mortgagor to use the fire insurance proceeds to rebuild. But there will be times when the mortgagor will be placed at risk by having his mortgage on an existing building converted to a construction mortgage for a new building. The holding creates too much potential for dispute and litigation.

\textit{General G.M.C. Sales}, 481 A.2d at 312.
real estate, or who for some other reason is an objectively unacceptable borrower. In effect, the due-on-sale clause permits the lender to say, "If this proposed grantee of the property lacks the personal and financial qualities that we would find acceptable in a new borrower, we don't have to permit him or her to take the property subject to our mortgage loan." Even prior to the Garn Act, the courts universally agreed that this use of the due-on-sale clause was legitimate.\(^\text{162}\)

The second function of the clause has nothing to do with the qualifications of the proposed purchaser of the real estate. It is to give the lender an opportunity to adjust the yield on its mortgage loan portfolio upward, taking advantage of increased interest rates since the loan was initially made. Prior to passage of the Garn Act, this use of the clause was controversial, but the Garn Act legitimized it.\(^\text{163}\)

The analogy between the eminent domain and insurance clauses and the due-on-sale clause should now be clear. All of these clauses may have two possible objectives: first, to protect the lender against unacceptable risks of default and loss (in the insurance and eminent domain cases, flowing from a loss in value of the security, and in the due-on-sale case, flowing from the substitution of a borrower of unacceptable quality); and second, to give the lender an opportunity to raise its portfolio yield in a period of rising rates. If, under applicable law and mortgage language, the lender can enforce the due-on-sale clause and also insist on collection of a prepayment fee, the lender's decision whether to do so (assuming that the proposed purchaser of the real estate is acceptable) will be based on precisely the same sort of calculation given above in connection with condemnation and hazard insurance proceeds:

- The loan balance;
- Plus the prepayment fee;
- Minus the future stream of payments the lender would earn on the existing loan, discounted to present value at the current market rate.

If the result is positive, the lender has an incentive to accelerate the loan and collect the fee.

Under what conditions should the prepayment fee be collectible? If we think of the prepayment fee clause as a device for shifting risk to the lender in return for the borrower's payment to the lender of a prepayment fee that represents an "insurance premium," the

\(^\text{162}\) See sources cited supra note 3.

\(^\text{163}\) See supra text accompanying notes 3–10.
question becomes: What risks are being insured? In mortgages in which the prepayment fee clearly applies to accelerations based on hazard insurance payments and due-on-sale accelerations, the risks of default and loss that are caused by irremediable reductions in value due to eminent domain, fire, or other casualty, or by the substitution of a property owner with poor credit-worthiness are precisely within the ambit of the prepayment clause. In essence, takings, casualty losses, and property transfers may change the loan equation in ways that may be detrimental to the lender, and if they are detrimental, the lender need not accept them. Hence the lender is entitled to demand a payoff. And because that payoff will force the lender to seek reinvestment opportunities, with their attendant cost and risk of rate loss, the lender should be fully empowered to collect the prepayment fee that represents the value, as agreed by the parties, of the lender's absorption of that risk of loss.

Consider, however, an eminent domain taking in which the security is preserved or a fully acceptable substitute is provided, a fire or other casualty loss that can readily be restored by expenditure of the insurance proceeds, or a sale to a new owner whose credit, income, and other qualities are at least as acceptable as the original borrower's. In these circumstances, the lender's sole purpose in accelerating the loan is to improve the yield on its mortgage portfolio. There may be nothing wrong with that; the Garn Act establishes the lender's right to accelerate upon a sale of the property, and acceleration upon eminent domain or casualty is at least arguably permissible, with the caveats expressed earlier. The question is whether the prepayment fee should also be collectible. On these facts, I suggest that it should not be because it is a pure windfall to the lender, consequently reducing the clause to a mere gambling contract. Under the circumstances stated at the beginning of this paragraph, if there is no prepayment fee the lender will accelerate only when the market rate is higher than the loan's contract rate. The existence of an enforceable prepayment fee, however, may give the lender an incentive to accelerate even if current market rates are equal to or lower than the contract rate. In this situation, payoff of the loan is unnecessary either to protect the lender's security or to permit it to take advantage of increased market rates—the two legitimate purposes of the hazard insurance and due-on-sale clauses.164

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Of course, it can be argued that the clause compels a wealth transfer from borrower to lender, one bargained for at the inception of the loan. The feature that makes it objectionable, however, is its fortuitous character. The clause does not merely have the lender say, "Borrower, if you suffer a taking or fire, or sell your property, you must protect me from security loss"; nor does it merely say, "if you suffer a taking or a fire, or sell your property, I am entitled to realize on market rate increases." Rather it says, "If you suffer a taking or a fire, or sell your property, you must pay me a windfall profit, even if your actions have caused me no harm and I have lost no financial opportunity." The lender who accelerates when there is no harm to its security and no increased risk of default does so only because it expects to gain rather than lose by reinvesting the funds. Such a lender has not experienced the "insured event" that makes the prepayment fee due.

Enforcing the prepayment fee incident to a sale of the property raises an additional policy objection, for it may actually prevent the sale from occurring. The buyer and seller must together share the cost of paying the fee to the lender, and the fee may be large enough to discourage the transaction. When the fee acts to compensate the lender for a genuine risk, a situation that only arises when the proposed buyer's credit or other qualities are objectionable, it is legitimate. As we have already seen, it is not the amount of the fee that determines this legitimacy, but the nature of the risk that it is intended to compensate; hence, a fee that exceeds the dollar amount

If a lender elects to accelerate the debt upon sale because interest rates have increased, the lender should not also be allowed to collect a prepayment fee. The function of the prepayment fee or prohibition is to protect lenders from borrower refinancing in times of falling interest rates and should not be used to penalize borrowers who refuse to accept lender's increased interest rates at resale in times of rising rates. It is only fair that the lender be prohibited from demanding prepayment fees upon acceleration of the debt since, in that instance, it is the lender who is insisting on prepayment.

See also Nelson & Whitman, supra note 1, § 6.5.

165. The situation is analogous to the "insurable interest" requirement of insurance law, which holds that one may not insure property in which one has no ownership rights. See Jerry, supra note 152, § 40; Robert S. Pinzur, Insurable Interest: A Search for Consistency, 46 Ins. Couns. J. 109, 111 (1979). An insurance contract not founded on an insurable interest is objectionable on two grounds: that the insured may be tempted to cause the loss, since he or she has nothing to lose and a great deal to gain by doing so, and that the contract is merely a wager, and thus morally offensive. In the context of the unearned prepayment fee, the first ground is irrelevant; there is nothing the lender can do to cause the borrower to sell the real estate, and lenders are most unlikely to cause fires or other casualty losses to the property securing their loans. But the prepayment fee clause, in the present context, is indeed a wager.
of the lender's loss can be perfectly acceptable. But where the lender has no risk of loss, and triggers the acceleration for the very purpose of reinvestment of the funds at a profit, the fee constitutes a windfall to the lender. It is not a restraint on alienation in the technical sense, 166 but the burden it places on real estate sales is difficult to justify.

This analysis leads to the following conclusions. When a court is asked to enforce a prepayment fee incident to acceleration under a condemnation or casualty insurance clause or a due-on-sale clause, it should first inquire whether the lender has a legitimate objection to leaving the loan in place, based on the characteristics of the proposed new owner, the property, and any collateral offered in substitution for it. If the answer is negative, the acceleration of the loan may go forward if the mortgage and local law so dictate, but the prepayment fee should not be enforced. This approach will permit the fee to serve the proper purpose of compensating the lender for the risk of being compelled by business necessity to accept prepayment in adverse interest market conditions, but will prevent the lender from using the prepayment clause to exact a fortuitous advantage where there is no legitimate need for the prepayment to occur. 167

Some may object that this approach is a throwback to the pre-Garn Act period, during which many courts enforced due-on-sale clauses only when the lender's security was placed at greater risk by the transfer. 168 That rule was quite properly rendered a dead letter by the Garn Act, and it is now national policy to permit lenders to use the fortuity of a sale of the property (even a sale to a fully qualified buyer) as a means of gaining the advantage of upward shifts in interest rates. The approach I advocate here merely ensures that they cannot use that fortuity to gain a further advantage beyond that necessary to bring their yield to a market level.

3. Lender Refusal to Respond Under the Due-on-Sale Clause

The structure of due-on-sale clauses raises a further problem. The clauses are usually worded so that the lender has an option to

166. See supra text accompanying note 48.
167. It might be argued that an attempt by the lender to enforce the prepayment fee when it has no business need to demand the prepayment reflects a lack of good faith and should not be recognized under the law of contracts. See Eric G. Andersen, Good Faith in the Enforcement of Contracts, 73 IOWA L. REV. 299 (1988); Steven J. Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 HARV. L. REV. 369 (1980).
168. See sources cited supra note 3.
accelerate the loan unless the lender gives consent to the transfer. The problem arises if the lender does neither. The facts of *First Indiana Federal Savings Bank v. Maryland Development Co.*, somewhat simplified, illustrate the situation well. The borrower's mortgage contained both a due-on-sale clause and a prepayment fee clause. The borrower informed the lender that it had negotiated a sale of the property, and asked whether the lender wished to consent to the sale or to accept prepayment. However, the lender gave no specific response to the inquiry for nearly four months. The proposed purchaser considered going ahead with the sale and then waiting to see if the lender would accelerate. But apparently concluding that such a course was too risky, the purchaser instead completed the sale and paid off the loan, including the prepayment fee. The purchaser then sued for a refund of the fee, basing its action on earlier cases denying enforcement of prepayment fees in connection with acceleration. The lender's response was that it had never accelerated the loan, and thus that these cases were inapposite. The court, rather remarkably, agreed; it characterized the prepayment as "voluntary" and refused to order the lender to return the fee.

The court's attitude was unrealistic. A purchaser of real estate cannot be expected to close a sale without knowing whether the lender has consented or not. Doing so would expose the purchaser to the risk that the lender might finally decide to accelerate some months or even years after the sale, forcing a refinancing by the purchaser in much more adverse mortgage market conditions than existed on the date of the sale. Few buyers would willingly assume such a risk. Hence, as a practical matter, if a lender simply refuses to either give or deny consent under the due-on-sale clause within a reasonable time, and if the borrower then prepays the loan in order to consummate the proposed sale, the lender ought to be regarded as having accelerated, whether or not it has issued a for-

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170. See cases cited supra notes 143–145.
172. After the passage of some substantial time a court might hold that the lender had waived the due-on-sale clause or was estopped from enforcing it, especially if the lender had accepted payments from the new owner. See, e.g., Rakestraw v. Dozier Assocs., 329 S.E.2d 437, 438 (S.C. 1985) (lender accepted payments for 17 months; held to have waived due-on-sale clause); Cooper v. Deseret Fed. Sav. & Loan Ass'n, 757 P.2d 483, 486 (Utah Ct. App. 1988) (lender's delay of 5 years in enforcement of clause was unreasonable, and clause had become unenforceable). But it is impossible to predict with certainty how long a time is necessary to activate these doctrines.
mal notice of acceleration. Whether the prepayment fee is then collectible should depend on an analysis of the characteristics of the new owner and the collateral as discussed above.

The Federal Home Loan Bank Board recognized this fact in its regulation prohibiting the collection of prepayment fees by lenders who accelerate under due-on-sale clauses. Because this regulation applies only to loans on owner-occupied homes, it has little direct relevance to the present discussion. But the Board dealt astutely with the problem created by the lender that refuses to respond to a request for consent to transfer. Its regulation prohibits collection of a prepayment fee if the lender

fails to approve within 30 days the completed credit application of a qualified transferee of the security property to assume the loan in accordance with the terms of the loan, and thereafter the borrower transfers the security property to such transferee and prepays the loan in full within 120 days after receipt by the lender of the completed credit application.

Courts dealing with cases involving income-producing property should follow the regulation's lead. Whenever a lender fails to give a reasonably prompt response to a borrower's request for consent to a proposed sale, if the purchaser and the property qualify under the lender's ordinary credit and underwriting standards, the prepayment fee should be considered uncollectible.

4. Acceleration for Default

The final sort of acceleration with which we must deal is acceleration for default. In this setting there can be no serious question that the prudent lender is entitled to accelerate the loan. The documents say so, and a lender on a commercial mortgage loan certainly does not have any obligation to nurse a defaulted borrower along, unless there exists some defense to acceleration, such as a waiver by the lender or a breach of some duty owed to the borrower. The acceleration is a business necessity. Nevertheless, it gives rise to precisely the risk of reinvestment that prepayment fees are designed to compensate. Hence, the fee should be enforced if the documents so provide.

This sort of involuntary acceleration differs in one important respect from the voluntary prepayment discussed earlier in this Ar-

174. Id. § 591.5(b)(3).
There is an intrinsic limitation on voluntary fees: whatever the stated amount of the fee, it will never exceed the present value of the savings that the borrower expects to realize by paying off the loan since no borrower will be willing to pay a fee larger than this. But in the present context, a prepayment fee incident to an acceleration for default, the borrower has no choice. The default is usually a consequence of financial conditions beyond the borrower’s control, and he or she cannot simply refrain from making the prepayment, no matter how high the fee. Nonetheless, state law should enforce the fee, for it represents the risk premium to which the parties agreed. This approach has the added benefit of avoiding for the courts the difficult and tenuous distinction, already recognized in a few cases, between “good faith” defaults caused by the borrower’s financial exigency and “bad faith” defaults in which the borrower engaged intentionally for the purpose of inducing an acceleration by the lender and thereby avoiding the prepayment fee.

Only one case based on state law dissents from this view. In *Clinton Capital Corp. v. Straeb*, the mortgage provided for a prepayment premium of ten percent of the amount prepaid, and stated that “[t]he premium shall be paid whether prepayment is voluntary or involuntary, including any prepayment made after exercise of any acceleration provision contained in this Note or any documents or instrument executed in connection therewith.” The court, in an extraordinary exercise of contractual distortion, held:

> In the setting of this case, the court construes the word “involuntary” to mean actions taken by third parties which force the payment of the mortgage prematurely. That is not the situation that exists on the facts in this case. Based upon what is in the record of this case none of the defendants [borrowers] have taken action to force Clinton Capital Corporation to accelerate the mortgage in order to pay it off so that they could avoid a prepayment penalty.

The lesson to be learned from this little episode is that lenders who expect to collect prepayment fees upon acceleration for default must

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177. See cases cited *supra* notes 147–148.
179. *Id.* at 1364.
180. *Id.* at 1371.
be exceedingly clear in stating that intent. But this aspect of the case must surely be viewed as an aberration.

5. Clogging the Equity of Redemption

Of much greater interest is the Clinton Capital court's apparent alternative holding: that enforcing the prepayment fee would constitute a "clog" on the equity of redemption. This argument must be taken seriously. The clogging doctrine, which is of ancient origin, holds that the mortgagor has the right to redeem the mortgage if the debt has matured, and that any agreement in or created contemporaneously with a mortgage that impairs that right is unenforceable. It is based on the notion that mortgagors are usually incorrigible optimists at the time they sign the mortgage documents, and hence may well be willing to waive the right to redeem. Such waivers, if legally enforceable, would probably find their way into the vast majority of mortgages, effectively eliminating the equity of redemption, which is considered an important and salutary debtor protection. Hence such waivers are held unenforceable.

Is a prepayment fee payable upon acceleration for default a violation of the clogging doctrine? Obviously it does not prohibit redemption, but just as obviously it makes redemption more difficult and burdensome. A similar clogging issue is raised by a provision for a late fee or an increased rate of interest upon default; such clauses also employ default as a triggering event to increase the amount of the debt secured by the mortgage. There is remarkably little case law on the matter. Professor George Osborne thought that the courts should hold an interest rate increase upon default unenforceable as a clog if it produced an additional liability so huge that the debtor could not possibly pay it. He also suggested that the courts should view more leniently a clause providing for a high interest rate with a discount or reduction for timely payment, as distinct from a clause providing for a low rate with an increase for default. But Osborne's ideas were based largely on speculation derived from case law dealing with theories other than the clogging doctrine. Unfortunately, none of the modern cases dealing with late

183. See id. at 147.
charges and with clauses providing for increased interest upon default or acceleration discuss the clogging doctrine; they treat the clauses under other theories. Some cases uphold clauses increasing interest upon default, subject only to whatever restrictions result from usury statutes; others uphold them if reasonable or "not unconscionable." The most common approach is the liquidated damage/penalty analysis discussed and critiqued earlier in this Article. Much the same description is applicable to cases challenging the validity of late fees. These tests are notoriously imprecise and malleable, and their results are widely variable and unpredictable. None of them consider the clogging issue, and they provide no useful guidance for our consideration of clogging in the context of prepayment fees triggered by default and acceleration.

Despite the lack of case law guidance, the clogging issue raised by prepayment fees on accelerated mortgage loans can be handled simply. The question should be whether the prepayment fee is serving in a default situation the same function it serves in a voluntary prepayment: to compensate for the lender's reinvestment risk. That


187. See supra text accompanying notes 78–97.

risk to the lender is, of course, precisely the same whether the prepayment results from the borrower’s default or the borrower’s decision to pay off the debt. If the fee is the same amount in both contexts (as it usually is, being governed by the same clause), a court should almost certainly find that the same function is being served and should uphold the fee for the reasons discussed earlier in connection with voluntary prepayments. After all, a requirement that the borrower in default pay exactly the same amount to redeem that would be demanded of a borrower not in default can hardly be a clog. On the other hand, if the mortgage provides for a prepayment fee upon default and acceleration that is significantly greater than the fee due on a voluntary prepayment, a serious question can be raised as to its legitimacy, and it might well be regarded as a clog on the equity of redemption. In *Clinton Capital Corp. v. Straeb*, discussed above, the prepayment clause treated prepayment in default and nondefault situations identically, and the court was incorrect in suggesting that the clause violated the clogging doctrine.

6. The Impact of Bankruptcy on Prepayment Incident to Default

The intervention of bankruptcy should affect enforceability of a prepayment fee clause triggered by the borrower’s default in precisely the same way that bankruptcy affects nondefault prepayments as discussed earlier in this Article. Once the bankruptcy court has crossed the hurdle of state law enforceability, it must still grapple with the application of section 506(b) of the Bankruptcy Code. The prepayment fee is plainly a “fee” within the meaning of that section, whether triggered by a default or the borrower’s voluntary decision to prepay. If the policy considerations underlying that section—protection of subordinate and unsecured creditors against the depletion of the collateral by excessive and unwise fee obligations entered into by the debtor—are sufficient to warrant limitations on enforcement of prepayment fees when the payment is voluntary (and I have already suggested that they are), the same is true when prepayment results from the borrower’s default.

CONCLUSION

I have suggested in this Article that to comport with economic efficiency, changes are needed in the law governing “locked-in” mortgage loans. First, courts should abandon the “perfect tender in

time" rule and mortgage loans should be freely prepayable if the documents make no mention of prepayment. This change will impose no burden on commercial mortgage lenders, who routinely insert clauses covering the matter in their documents, and it will avoid the occasional case in which the mortgagor naturally but erroneously believes that the loan can be prepaid because the documents are silent. Second, the courts should refuse to enforce the absolute lock-in of a mortgage loan, but under the concept of "efficient breach" should instead permit prepayment if the borrower is willing to pay the lender's damages, either as determined by a trial if necessary or as fixed by a prepayment fee clause.

In general, courts should enforce prepayment fee clauses without reference to their amount or supposed reasonableness. Except in transactions involving unsophisticated borrowers who are not represented by counsel, or for some other reason lack the ability to understand and bargain over the clause, "protection" of borrowers by the courts is not needed or warranted, and indeed may interfere with economic efficiency. When the borrower is in bankruptcy, however, a court may be warranted in limiting the amount of the prepayment fee to the lender's actual damages as a means of avoiding the depletion of the debtor's estate at the expense of junior and unsecured creditors. Intervention of this sort is particularly appropriate when the clause is one that seems designed not merely to liquidate the lender's damages, but to overstate them in a systematic manner.

In most cases, enforcement of prepayment fee clauses is justified even when the prepayment results from an "involuntary" acceleration of the debt by the lender, provided that the mortgage documents so state. However, the lender should not be privileged to collect the fee if the acceleration was done with no business justification other than the lender's desire to obtain prepayment of the loan. Such unjustified accelerations are a real possibility when an eminent domain taking or insured casualty loss occurs but the property can be restored with no loss of security value or the borrower offers adequate substitute security, or when the borrower's transfer of the property triggers a due-on-sale clause. Courts should scrutinize the lender's conduct in such cases carefully.

Finally, the courts should not permit a prepayment fee clause to obstruct the borrower's equitable right of redemption. The simplest way to prevent this is to refuse enforcement of a clause providing for a larger fee for acceleration for default than for a voluntary prepayment. But where the documents merely impose the same fee
whether prepayment is voluntary or a result of acceleration for default, the clause should be fully enforceable.

I have attempted to use the perspective of economics to examine prepayment restrictions and fees. Some may argue that economic analysis embodies too restrictive a view of the world, and that it fails to account for normative considerations, such as the morality of the parties' agreement and the fairness of enforcing it. There may be situations in which these factors should predominate, but I think they are rare in commercial mortgage transactions. In the absence of a bargaining failure (as occurs often in consumer adhesion contracts but seldom in commercial mortgage loans), some overriding policy (such as the protection of subordinate and unsecured creditors in bankruptcy), or an attempt to enforce in bad faith (as when the lender has no business need to demand an "involuntary" acceleration), the parties' agreement concerning prepayment fees should be enforced. A court that refuses to do so substitutes its own judgment for that of the parties, and its judgment will usually be inferior in quality and economically inefficient in result.

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