Swords and Shields – Prepayment Premiums In and Out of Bankruptcy

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Introduction

Current interest rates are at historic lows. Commercial borrowers benefit from low rates not only by taking out new loans but also by refinancing old loans at new, lower rates. To refinance, these borrowers use new low-interest loans to pay off their old higher-interest loans. However, many commercial loans impose a premium on prepayment. Several legal issues have arisen in this situation.

First, can a borrower avoid the prepayment premium so that it can voluntarily refinance and take full advantage of the lower interest rates? Borrowers sometimes prepay loans not to benefit from reduced interest rates but because they have no choice—the lender has accelerated the loan. The lender may accelerate a loan for many reasons, but almost all accelerations are triggered by the borrower's payment default. Ironically, these defaulting borrowers are usually the least able to prepay the principal and accrued interest, let alone an additional prepayment premium. Second, can the borrower avoid paying the prepayment premium triggered solely by the lender's acceleration? Third, in either case, does bankruptcy shield the debtor from the lender's prepayment premium sword?

Not surprisingly, the answer to the first question is usually no, since borrowers may not unilaterally breach their loan agreements to benefit from lower interest rates without paying a reasonable prepayment premium, especially when such a premium is provided for in the loan agreement. Surprisingly, the answer to the second question is often yes, but only if the prepayment premium is unreasonably excessive.[1] Predictably, the answer to the third question depends not only on the economics of the transaction but also on the willingness of the particular bankruptcy judge to balance the prebankruptcy expectations of the parties with the reorganizational bias accorded to commercial debtors.

Either in or out of bankruptcy, unreasonable or excessive prepayment premiums are much less likely to be enforced, especially where the prepayment results from the lender's acceleration. Furthermore, if the lender drafts an excessive prepayment premium in its loan agreements, it risks winding up with no prepayment premium at all. Thus, the larger the prepayment sword wielded by the lender, the more likely a court is to fully shield the borrower from its thrust.

Description of Prepayment Premiums and Their Economic Function

Economic Rationale of Prepayment Premiums

Prepayment premiums are typically intended to protect lenders against a drop in interest rates. They compensate lenders if the loan is prepaid when the market interest rate is lower than the loan agreement's interest rate.[2]

Lenders require protection from decreasing interest rates because otherwise a borrower would always refinance and prepay whenever interest rates fall. For example, a hypothetical lender bargains for a loan agreement at 10 percent interest for an eight-year term. If the interest rates decrease and the borrower prepays, the lender could relend those funds for a similar term at only 7 percent. The 3 percent interest rate differential over the eight-year loan term represents the primary component of the lender's damages incurred because of the prepayment.[3] Thus, prepayment premiums are designed to compensate a lender for the difference in the interest rate to which it is entitled under the loan agreement and the interest rate it could obtain on a similar loan after prepayment.

A lender may claim additional damages resulting from the delay between receiving

the prepaid loan proceeds and relending those proceeds to a new borrower, as well as attendant administrative costs. While these costs should be compensable, they are usually nominal relative to the size of the loan and most prepayment premiums.[4] In addition, these costs are usually covered not by prepayment premiums but by late fees and default interest rates.[5]

Prepayment premiums can be viewed as shifting the risk of decreasing interest rates from the lender to the borrower.[6] Consequently, under a loan with a reasonable prepayment premium, the borrower assumes the risk of declining interest rates, and the lender retains the risk of rising interest rates.[7]

Reasonable prepayment provisions can benefit both the lender and the borrower. The lender benefits from the protection that a reasonable prepayment premium provides from decreasing interest rates. Theoretically (in a perfectly competitive market), the money saved by the lender is passed on to the borrower in the form of lower loan rates. The borrower also benefits from lowered transaction costs associated with the easy determination of the cost of prepaying the loan, as opposed to litigating the lender's damages.[8]

The prepayment premium sword is an important weapon in the lender's arsenal.

Types of Prepayment Premiums

Fixed Premiums

Fixed premiums are not only prepayment premiums based on fixed dollar amounts but also those based on formulas that depend *only* on information contained in the loan documents themselves. In other words, the loan documents "fix" the amount of the prepayment premium without reference to any extrinsic sources. Some of the more common prepayment premiums that fall under this definition of a "fixed fee" include premiums demanding the value of interest payments for a certain number of months after prepayment, either fixed or dependent of the remaining loan term, and premiums demanding a certain percentage of the principal balance remaining on the loan at the time of prepayment.

Fixed prepayment fees typically have the virtue of easy calculation. However, they are inherently arbitrary estimates of a lender's damages resulting from the prepayment. They fail to account for changes in interest rates and will thus either over- or undercompensate the lender.[9]

Yield Maintenance Premiums

In general. A yield maintenance premium is a prepayment premium set by a formula designed to approximate actual damages by incorporating market interest rates as of the time of prepayment. A lender's damages resulting from decreased interest rates can be accurately estimated using a yield maintenance premium: the lender's damages equal the interest payments the lender would have received under the loan agreement minus the interest payments that the lender could expect to receive by relending the money in a similar loan at the current market rate, discounted to present value.[10]

The market rate of interest. The most controversial element of this yield maintenance formula is the manner in which the market rate of interest is determined. If a continuously creditworthy borrower refinances a loan, the refinancing rate could be considered as the presumptive market rate. If the lender has not exited the relevant market, the lender should know the market rate of interest on similar loans at the time of prepayment. Alternatively, the borrower could also sample other lenders' rates offered for similar loans.

Many lenders base the yield maintenance rate on a U.S. Treasury bill yield with the same or similar maturity. However, a Treasury bill yield is always lower than commercial loan yield due to the risk differential between the two investments.

Yield maintenance premiums designed to overcompensate lenders. Yield maintenance premiums are not always designed to provide an accurate measure of damages; often, they are designed to overcompensate the lender. Typically, this is done by utilizing one or more of four distortions.[11]

(1) *Presuming a loss.* Many lenders draft their yield maintenance premium provisions so the formula will always require a premium payment to the lender, even if interest rates have risen. However, the lender benefits whenever a loan is prepaid after interest rates have risen. The lender can reinvest the prepaid funds at a higher interest rate, resulting in greater gain for the lender. Thus, the lender is not damaged by prepayment, and enforcement of the premium creates a windfall for the lender.

(2) *Calculating the market rate based on a standard rate inherently lower than the market for loans similar to the prepaid loan.* To increase the differential between the contract rate and the market rate, some lenders will define the market rate in relation to a low-risk security with a yield that always trails the yield for the relevant commercial loan market. Lenders will often define the market rate as a Treasury bill rate with a similar maturity date. Because a commercial lender lends money at a rate greater than the Treasury bill rate of comparable maturity in the first place, basing the prepayment premium on the Treasury bill rate assumes that the lender will not be able to relend the money at a rate greater than the Treasury bill rate—an assumption that is almost always false.[12] Once again, the difference between the contract rate and the current market (Treasury bill) rate overcompensates the lender.

(3) *Failing to discount to present value.* The receipt of money today is more valuable than its receipt in the future. Accordingly, if a yield maintenance premium requires the borrower to presently prepay the interest due on the loan, minus the interest the lender will be able to obtain by relending the money, the lender is overcompensated. In the absence of prepayment, the lender would receive the interest payments over time. The immediate payment of the interest creates a windfall to the lender. Therefore, a reasonable yield maintenance premium must discount the prepaid interest to present value, preferably at the current market rate in the industry for similar loans.

(4) *Failing to account for amortization.* Typically, a loan will require payment of at least a portion of the principal during the loan term. Thus, the size of the interest payments at the end of the loan will be less than those at the beginning. A yield maintenance premium that does not account for the decrease in interest payments over the life of the loan again overcompensates the lender.[13]

The Preservation of Damages Clause

Occasionally, loan agreements will not specify a fixed prepayment fee or an express formula for determining a prepayment premium but will merely provide that in the event of prepayment, the lender is entitled to all damages resulting from such prepayment.[14] In the face of such a provision, it is the authors' opinion that the courts should establish a rebuttable presumption that the lender's damages should be based on a yield maintenance formula: the lender's damages equal the difference between the contract rate of interest and the market rate of interest on a similar loan, measured at the time of prepayment and discounted to the present value.

Treatment of Prepayment Premiums Under State Law

In General

A prepayment premium that is unenforceable under state law is unenforceable in bankruptcy.[15] Therefore, before discussing the treatment of prepayment premiums under the Bankruptcy Code, we must discuss prepayment premiums under state law.[16]

Prepayments and Acceleration

The Perfect Tender in Time Rule

In most jurisdictions in the United States, a commercial borrower does not have a right to prepay a loan unless the right is expressly supplied in the loan documents.[17] This is called the perfect tender in time rule. The borrower must pay the precise amount precisely when due. Most courts will not force a lender to accept a borrower's tendered prepayment.[18]

The perfect tender in time rule makes sense because a loan agreement actually consists of multiple separate promised performances.[19] If a breach occurs, unless the lender accelerates under an acceleration provision, the lender may sue to recover only the missed payments and not the payments due in the future because the borrower has not yet breached those promises of future performance.

However, if a borrower does prepay, the lender should be entitled to demand any damages resulting from the prepayment as a condition to its acceptance of the prepayment. This follows from general principles of contract law. A contracting party is entitled to receive the benefit of its bargain. The lender typically bargains to receive a fixed monthly payment based on a set rate of interest. When that bargain is breached and when the lender is unable to relend the pre-

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paid money in a comparable loan at an equal rate of interest, the lender is damaged.

However, the lender is not entitled to a return of the principal plus all the interest that the loan would have generated during its term, since the revenue stream the loan would have generated must be discounted to the present value.

The lender should also have a duty to mitigate its damages by reinvesting the money in a similar investment with the highest possible yield.[20] Accordingly, the lender's compensation should be based on the yield maintenance formula discussed earlier in this article. The lender's damages are reduced by the lender's duty to mitigate its losses. In other words, the lender's compensation should equal the interest the loan would have earned at the contract rate, minus the interest the prepaid funds will earn at the market rate at the time of prepayment, discounted to the present value.

In most jurisdictions in the United States, a commercial borrower does not have a right to prepay a loan unless the right is expressly supplied in the loan documents.

Under this analysis, a yield maintenance premium simply restates the concept of expectation damages, the legal remedy for breach of the loan agreement designed to place the nonbreaching party in as good a position as if the loan agreement was never breached.

Acceleration

In response to the transaction costs associated with litigating separate payment breaches, lenders almost always include acceleration clauses in their loan agreements. These clauses allow a lender to accelerate the principal amount due under the loan. Once the lender elects to accelerate the loan, the principal becomes immediately due and owing, along with any accrued interest, charges, and fees.

However, by electing to accelerate, the lender should lose its right to claim or receive damages resulting from the prepayment. Once the lender accelerates the loan, the balance becomes immediately due and owing. The maturity date is accelerated. The borrower cannot possibly prepay amounts that are presently due. Rather, payment of the accelerated principal is necessarily payment at maturity due to the nature of acceleration. Since nothing is prepaid, the lender should not be entitled to a prepayment premium.[21]

Further, the prepayment occurred not by the choice of the borrower but through the lender's election of remedies. The lender could have retained its original bargain by electing not to accelerate and instead by filing suit to recover for each breach of the loan agreement.

The Loan Agreement May Expressly Preserve Prepayment Premiums on Acceleration

In response to the cases denying that prepayment premiums are caused by a lender's acceleration, lenders now typically draft their loan agreements to expressly preserve the right to receive prepayment premiums after loan acceleration. Courts regularly enforce such preservation provisions after an acceleration resulting from the borrower's default.[22]

Prepayment Premiums as Alternative Performance

Express prepayment premiums are usually characterized by the courts either as (1) an alternative method of performance under the loan agreement or (2) a liquidated damages provision. The first is a charge intended as consideration for permission to prepay the loan, and the second is a remedy for the borrower's default.

Some courts have decided that loan prepayments, especially voluntary prepayments, are simply an alternative performance of the loan contract.[23] Often, this is a matter of contract interpretation and may also turn on whether the borrower made a voluntary prepayment.

Courts following the alternative performance theory interpret the loan agreement as providing the borrower with two options: (1) repaying the loan principal according to the schedule and at the rate of interest set out in the loan agreement or (2) prepaying the principal along with all accrued interest and paying the prepayment premium. Under this theory, the prepayment premium is simply a bargained-for consideration for the right to prepay the loan. Thus, if a borrower makes the choice to prepay, there is no breach of the contract and the prepayment premium is fully enforceable, even if excessive.[24]

Courts should apply this theory to situations only where the prepayment is, in fact, voluntary.[25] As persuasively argued by Professor Whitman, even excessive prepayment premiums may result in efficient outcomes where the two parties are able and willing to negotiate.[26] If the borrower would

save more by prepaying than the lender would lose, the parties should be able to reach a settlement making both parties better off.[27]

However, once the borrower breaches the contract, the lender is entitled only to its damages. Damages are designed to put the nonbreaching party in the same position as if no breach had occurred. Under the alternative performance theory, had no breach occurred, the lender would have received either (1) payments as scheduled by the loan agreement or (2) the prepayment of the entire principal amount of the loan coupled with a prepayment premium. The lender has no choice of what performance it receives. Therefore, the lender is put in the same position as if no breach had occurred if it receives damages designed to compensate it for *either* alternative performance.

In other words, the lender has bargained for one of two performances by the borrower. The borrower chooses which performance to deliver. If the borrower fails to deliver either, then the lender must be compensated so that it receives damages for one of the two performances. Thus, the borrower may choose to compensate the lender *either* for not paying the scheduled payments *or* for not prepaying and paying the prepayment premium. The lender receives the benefit of its bargain if it receives damages based on either of these alternative performances.[28]

Prepayment Premiums as Liquidated Damages

Many courts refuse to follow the alternative performance theory and hold that prepayment premiums should be construed as a liquidated damages provision subject to state law.[29] This is especially true in cases where prepayment or defaults are clearly not voluntary.

The Restatement (Second) of Contracts states that a liquidated damages provision is enforceable where the damages are difficult to prove and the liquidated damages provision is reasonable in amount.[30] The more difficult the proof of damages, the more leeway is provided on the reasonableness requirement, and vice versa.[31]

Michigan follows the general rule that liquidated damages may be awarded if (1) the liquidated damages provision is a reasonable estimate of what damages will be in the event of breach and (2) the amount of damages is of a type impossible or exceedingly difficult to calculate at the time of breach. As the Michigan Supreme Court stated in *Curran v Williams*,

> The purpose in permitting a stipulation of damages as compensation is to render certain and definite that which appears to be uncertain and not easily proven. The courts recognize that the parties, particularly at the time of execution of the instrument, are in as good a position as anyone to arrive at a fair amount of damages for a subsequent breach. In the event they are not unconscionable or excessive courts will not disturb it. Just compensation for the injuries sustained is the principle at which the law attempts to arrive. Courts will not permit parties to stipulate unreasonable sums as damages, and where such an attempt is made have held them penalties and therefore void and unenforceable.[32]

Where a liquidated damages provision is found to be unenforceable, the loan is read as if the provision never existed. Therefore, a lender retains any rights to compensation for prepayment that it has in the absence of an express prepayment premium.[33]

Many jurisdictions, including Michigan, focus on the reasonableness and ease of proof of liquidated damages *ex ante*, that is, at the time the contract was executed rather than at the time of breach.[34] Accordingly, prepayment premiums must be difficult to prove and reasonable in amount at the time the loan is entered into. Alternative approaches require that liquidated damages be (1) reasonable at the time of breach[35] or (2) reasonable either *ex ante* or at the time of breach.[36]

Damages resulting from prepayment premiums are relatively easy to determine at the time of breach using a yield maintenance formula. However, they cannot be accurately estimated at the time of contracting. This is because the market rate of interest at the time of breach cannot be known *ex ante*. Accordingly, prepayment premiums usually satisfy the requirement that damages must be difficult to determine in states, such as Michigan, that have adopted the *ex ante* approach.

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Prepayment premiums have more difficulty passing the reasonable estimation of damages test. Under this test, the court must be satisfied that the amount of the prepayment premium is designed to compensate the lender, rather than penalize the borrower.

It is questionable whether fixed premiums should ever be considered to be reasonable. By failing to take into account future interest rate changes, the fixed fee, no matter its amount or how it is calculated, will always be arbitrary.[37] It might even turn out that the fixed fee was a precisely accurate measurement of actual damages. However, at the time of contracting, the fixed fee was, at best, a guess of the potential damages, if any, which the lender would incur because of prepayment.[38] While making reasonable guesses as to potential damages is the essence of liquidated damages, the purpose of a fixed fee as compensation rather than as premium is questionable where compensation can easily be more accurately calculated with a yield maintenance premium.

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In contrast, yield maintenance premiums are calculated based directly on the interest rate in place at the time the prepayment premium is imposed and can, therefore, be designed to estimate damages very accurately. For this same reason, it is also easy to design prepayment premiums to overcompensate the lender by presuming a loss, using an inherently low standard, failing to discount to present value, or failing to account for amortization.[39] A prepayment premium designed to overcompensate the lender abandons the concept of compensation and works as a penalty.[40]

Although a creditor generally may prove its damages after a liquidated damages clause is rejected as an unenforceable penalty, this should not be allowed in the case of prepayment premiums triggered by the lender's own acceleration. Because the lender elected to accelerate the loan, the loan matures and no prepayment occurs. The lender, therefore, may collect a prepayment penalty after accelerating the loan only if the loan agreement specifically provides that the prepayment premium is enforceable after acceleration. However, if that prepayment premium is determined to be an unenforceable penalty and is rejected, enforcement of the premium after acceleration should also be denied.[41]

Other State Law Defenses to Prepayment Premiums

Borrowers might also successfully shield themselves from prepayment premiums under state law by arguing that the premium is usurious, an unreasonable restraint on alienation, or unconscionable and inequitable. For a court to find that a prepayment premium is usurious, it must first find that the premium constitutes interest that exceeds the lawful rate allowed in that jurisdiction.[42] In many jurisdictions, including Michigan, there is rarely a real danger that a loan may become usurious. Not only are the usury statutes generous,[43] but commercial lenders typically include usury savings clauses that cap interest rates before they become usurious.[44]

The combination of a prepayment premium with a due on sale provision has been held to be an unreasonable restraint on alienation.[45] However, this argument has been severely weakened in the state of Michigan by the holding in *Eyde Bros Dev Co v Equitable Life Assurance Soc'y of the United States*.[46] This case held that because Michigan has expressly approved of due on sale clauses by statute in MCL 445.1622, the combination of a due on sale clause and a prepayment premium is not an unreasonable restraint on alienation.

Finally, a prepayment premium may be so excessive that a court will refuse to enforce it because it is unconscionable. However, between sophisticated parties to a commercial loan, courts should not refuse to enforce a prepayment premium because of unconscionability except under highly unusual circumstances where enforcement would create highly inequitable results that shock the court's conscience.

Prepayment Premiums in Bankruptcy

In General

Two primary goals of bankruptcy are to reorganize businesses and to maximize the value of the assets for distribution to creditors. Rewarding a lender with an excessive prepayment premium squarely conflicts with these goals. Enforcement of the prepayment premium takes funds out of the bankruptcy estate which otherwise would be used to reorganize the debtor's business and make

distributions to creditors. Thus, from a policy standpoint, where the prepayment premium is reasonable and compensates the lender only for actual damages, the premium should be allowed as part of the lender's claim. However, where the prepremium is excessive and would generate a windfall to the lender, it should be disallowed.

Bankruptcy courts typically employ a two-prong test to determine whether a prepayment premium is enforceable in bankruptcy: is the premium (1) enforceable under state law and (2) enforceable under 11 USC 506(b).[47] This article has already discussed enforceability under state law, so now we turn to section 506(b).[48]

Section 506(b) and Oversecured Creditors

Section 506(b) states:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

Section 506(b) allows an oversecured creditor in a bankruptcy case to collect fees, costs, or charges to which it would be entitled outside of bankruptcy, but only if reasonable and only if provided for under the agreement between the creditor and the debtor. The fees, costs, or charges are, in effect, added to, and become a part of, the creditor's secured claim. "Oversecured" means that the value of the collateral securing the creditor's claim exceeds the amount of the claim.[49]

For example, a lender that holds a first mortgage on a building worth $500,000 securing a debt of $300,000 is oversecured by $200,000. Consequently, the lender is entitled to receive in the bankruptcy case any reasonable fees, costs, or charges provided for in the loan agreement, such as attorney fees, late charges and prepayment premiums. In contrast, had the building been worth only $250,000, the lender would have been undersecured and not entitled to any of these charges in the bankruptcy case.

Section 506(b) Applies to Prepayment Premiums in Bankruptcy

The initial question is whether section 506(b) applies at all to prepayment premiums. The vast majority of courts have concluded that prepayment premiums are charges under section 506(b), regardless of whether the prepayment is voluntary or involuntary.[50]

At least one court has questioned whether a prepayment premium is subject to section 506(b) where the loan documents provide that the prepayment premium is due on acceleration and the lender has accelerated before the bankruptcy filing.[51] The rationale is that because the prepayment premium was triggered before bankruptcy, the premium already became part of the lender's claim as of the petition date under section 502[52] and part of the secured claim under section 506(a). This argument is flawed, however, because the premium is a claim that arises when the borrower prepays, not when the lender accelerates.

Liquidated damages mature at the time of breach.[53] Here, the breach that a prepayment premium is designed to remedy is neither the breach of the loan agreement nor the lender's acceleration of the loan (which is not itself a breach but a remedy for a prior breach) but the breach of the perfect tender in time rule—the actual prepayment. [54] This breach occurs when the borrower prepays the loan but fails to pay the prepayment premium at that time. Only then can the lender maintain an action for breach of the prepayment premium obligation.[55]

On the other hand, if the loan documents do clearly provide that the premium is triggered by the lender's acceleration and determined at the date of acceleration, then the premium is, in fact, an acceleration premium.[56] Such a premium should not be enforced as a matter of state law. The lender's damages, if any, must result from the borrower's act of prepayment, not from the lender's election to accelerate.[57]

This point is proved by the consequences of deceleration. The lender and the borrower can always agree to decelerate the loan. If the loan is decelerated, there will be no prepayment. As a result, the lender suffers no damages from prepayment. The prepayment premium, therefore, has no relation to acceleration but only to actual prepayment. Accordingly, any claim arising from acceler-

[A] prepayment premium may be so excessive that a court will refuse to enforce it because it is unconscionable.

ation, as opposed to arising from prepayment, is an unreasonable estimation of the damages resulting from acceleration and should, therefore, be regarded as an unenforceable penalty under state liquidated damages law.

Section 506(b) Should Be Read to Strictly Limit Prepayment Premiums

In General

The next, and more controversial question, is how to apply section 506(b) to prepayment premiums that have, presumably, already passed the reasonableness test incorporated in the applicable state's liquidated damages law.

Section 506 Requires Analysis of Prepayment Premiums Independent from the State Law Analysis

Courts are also split on whether an unreasonable prepayment premium in violation of section 506(b) should be allowed to the extent of the lender's actual damages or simply denied in its entirety.

Too many bankruptcy courts have accepted the tempting but incorrect notion that if a prepayment premium is reasonable under state law, it must therefore be reasonable under federal law. Although bankruptcy courts generally claim to conduct separate analyses under both state and federal law, the standard used to determine a prepayment premium's reasonableness often parallels the standard used by the state courts.[58] Section 506(b) then becomes nothing but a repetition of state law. This is incorrect because section 506(b) is a federal statute, wholly independent of state law. If section 506(b) merely parroted state law, section 506(b) would be subject to fifty different interpretations based on each state's idea of what is reasonable. The better conclusion is that section 506(b) is a federal standard that must be interpreted based solely on federal law.[59]

State standards should also not be relied on because state law typically accepts liquidated damages as reasonable if they were reasonable estimates of potential damages at the time the contract was entered into. Section 506(b) is not so generous. Section 506(b) requires that each item of fees, costs, and charges be reasonable and not merely a reasonable estimate. The most natural reading and, arguably, the plain meaning of the statute require that the charge be reasonable on the date it is imposed. While reasonable estimates at the time of contract may pass muster as enforceable liquidated damages under state law, only fees, costs, and charges proven to be reasonable at the time of imposition satisfy section 506(b).

Section 506(b) Should Require Prepayment Charges to Closely Approximate Actual Damages as Measured by the Yield Maintenance Formula

The standard for determining reasonableness should be either the lender's actual loss or the lender's estimated damages using a yield maintenance formula.[60] The lender bears the burden of proof under section 506(b).[61] Therefore, if the lender believes the yield maintenance formula underestimates its actual damages, it is the lender's burden to prove its damages.

Accordingly, the argument against enforcing fixed-fee type prepayment premiums becomes much stronger in bankruptcy. Even if a fixed fee was a reasonable estimate of a lender's damages at the time the contract is executed, it may prove to be excessive as of the date of prepayment, based on the market conditions at that time. An excessive prepayment might be enforceable in state courts under these circumstances but should not be enforced in bankruptcy. If a prepayment premium overcompensates a lender, the premium should be deemed unreasonable.[62]

In contrast, state-liquidated damages laws in jurisdictions that look primarily to the time of contracting may reject a prepayment premium that was an unreasonable estimate when agreed to but later proves to be accurate. Because prepayment premiums are enforceable in bankruptcy only if enforceable under state law and only if reasonable under section 506(b), a borrower certainly could argue that for a lender to receive a prepayment premium in bankruptcy, the premium must be reasonable both at the time the contract was entered into and at the time the premium is assessed.

Bankruptcy courts should also impose a strict standard on yield maintenance premiums included in the loan agreement. The yield maintenance provision used by a lender should not have to exactly match what the judge considers to be the most accurate formula. However, a lender should be expected to use a yield maintenance formula that is not designed to overcompensate the lender through distortions that (1) presume a loss, (2) use an inherently low interest rate standard, (3) fail to discount to pres-

ent value, or (4) fail to account for amortization.[63] Inclusion of such distortions constitutes an intentional departure from the principle of fair compensation and should not be tolerated.

If the Prepayment Premium Is Unreasonable Under Section 506(b), Courts Should Refuse to Enforce the Premium in Its Entirety

Courts are also split on whether an unreasonable prepayment premium in violation of section 506(b) should be allowed to the extent of the lender's actual damages or simply denied in its entirety.[64] Bankruptcy courts may be willing to rewrite an unreasonably high prepayment premium provision to reach a reasonable amount. Lenders, however, would then be encouraged to inflate their prepayment premiums knowing that the bankruptcy courts will still enforce them to the extent that they are determined to be reasonable.

In contrast, if the premium is denied in its entirety, some good-faith lenders may be denied compensation for actual losses. Striking the entire prepayment premium impairs the benefit that the lender bargained for as part of the initial transaction. This approach is likely to result in more flexible standards of reasonableness because courts will be reluctant to void the entire charge in cases where the lender suffered obvious damage. Accordingly, policy arguments point in both directions.

The issue, however, may best be resolved through statutory construction. Did Congress enact section 506(b) with the intent of allowing only reasonable charges and disallowing unreasonable charges, or did Congress intend to allow all charges but only to the extent that they are reasonable?

We believe the better answer is that if the loan agreement fails to provide for a reasonable charge, no charge should be allowed under section 506(b). The statute allows only "reasonable fees, costs, or charges provided for under the agreement . . . ." If a charge is excessive, it is not allowed. If a charge is reasonable but not provided for in the parties' agreement, it is not allowed. A loan agreement that provides for an excessive prepayment premium does not also provide a reasonable prepayment premium. Thus, once an excessive premium is struck as unreasonable, the loan no longer contains any enforceable provision for a prepayment premium.[65]

A court should think twice about invoking equitable powers to allow the charges to the extent that they are reasonable.[66] There is no equitable reason why a lender that drafted an unreasonable prepayment premium should be allowed to recover its actual damages while a lender that included no prepayment provision in its loan agreement is allowed to recover nothing.[67]

Other Possible Defenses to Prepayment Premiums

Unmatured Interest

Under section 502(b)(2), claims in bankruptcy are not allowed to the extent that they represent unmatured interest. At least one court has held that a prepayment premium should not be allowed pursuant to section 502(b)(2) because the purpose of the prepayment premium is to compensate a lender for anticipated interest lost through prepayment.[68] According to the *Ridgewood Apts* decision, the prepayment premium as compensation for lost interest constitutes unmatured interest.

However, courts that have determined that prepayment premiums are liquidated damages provisions will probably not apply section 502(b)(2), because liquidated damages mature at the time of breach.[69] They therefore constitute damages and not interest.

Unconscionable or Inequitable Consequences

As with state courts, bankruptcy courts occasionally deny a prepayment premium for the reason that enforcing the premium will have unconscionable or inequitable consequences.[70] However, it is doubtful whether prepayment premiums that are otherwise enforceable under state law and are found to be reasonable under section 506(b) should ever be disallowed because of equitable considerations.[71]

Reinstatement of the Loan

Section 1124(2)[72] allows a debtor in Chapter 11 (business reorganization) to reinstate a loan on its preacceleration terms after curing any defaults.[73] Consequently, a Chapter 11 debtor can often simply avoid prepaying the loan. Actual prepayment is a prerequisite to a lender's entitlement to a prepayment premium.[74] Therefore, by avoiding prepay-

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ment, the debtor avoids the prepayment premium.[75]

Conclusion

The prepayment premium sword is an important weapon in the lender's arsenal. It enables the lender to obtain the benefit of its bargain even if a borrower refinances after a decrease in interest rates. Too often, however, the lender wields a sword too large for its proper purposes in an attempt to not simply protect its bargained-for rights but also to gain a windfall at the expense of a borrower who has fallen on hard times.

A reasonable prepayment premium, which accurately estimates the lender's damages from prepayment, can be beneficial to all parties and should be enforced. However, an excessive prepayment premium only provides a windfall to the lender and should not be enforced. This is especially true in bankruptcy, where the lender would obtain its windfall to the prejudice of the debtor's other creditors and tend to frustrate the ability of the debtor to reorganize.

[T]he larger the prepayment sword wielded by the lender, the more likely a court is to fully shield the borrower from its thrust.

Yield maintenance provisions can also accurately, or overly, estimate a lender's damages from prepayment. In determining whether a yield maintenance provision is enforceable, courts should blunt provisions that overcompensate lenders and shield the debtor from them. Bankruptcy courts especially should never allow lenders to receive more than their actual damages and, at least in some circumstances, should foil enforcement of excessive prepayment premiums in toto.

NOTES

1. *Atlantic Ltd P'ship-XI v John Hancock Mut Life Ins Co*, 95 F Supp 2d 678, 681 (ED Mich 2000); *Eyde v Empire of America Fed Sav Bank*, 701 F Supp 126, 128 (ED Mich 1988) ("There is no dispute that reasonable prepayment premiums are enforceable.").

2. *See, e.g., In re Skyler Ridge*, 80 BR 500, 504–05 (Bankr CD Cal 1987); Seth D. Gould, *Conflicting Approaches to Recovery of Prepayment Premiums Under § 506(b)*, Am Bankr Inst J 22 (Oct 18, 1987).

3. *In re AJ Lane & Co*, 113 BR 821, 829 (Bankr D Mass 1990).

4. *Id*.

5. Late fees and default interest rates have many of the same characteristics as prepayment premiums and are subject to many of the same defenses discussed in this article.

6. *See* Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L Rev 851, 873–875 (1993) (discussing prepayment premiums as a form of insurance).

7. It may sound odd to talk of a borrower risking lower interest rates and lenders risking higher interest rates, but this is the economic reality. In entering into a long-term loan at a fixed interest rate, the borrower takes the risk that interest rates may fall in the next quarter, allowing its competitors to receive financing at lower rates. Similarly, a lender risks rising interest rates because of the additional money the lender would have received had it waited to make the loan at those higher rates.

8. *Compare* Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 Cornell L Rev 288, 328–331 (1987), *with AJ Lane & Co*, 113 BR at 830.

9. Fixed premiums could be reasonable estimates of a lender's administrative costs and the loss associated with the delay between receipt of a prepayment and reinvesting the prepaid funds. However, they are not typically designed for such limited purposes.

10. *AJ Lane & Co*, 113 BR at 829. For examples of yield maintenance provisions, see Patrick A. Randolph, Jr., *Yield Maintenance and Defeasance: Two Distinct Paths to Commercial Mortgage Prepayment*, 478 PLI/Real 871, Apps B–D (2002).

11. As Professor Whitman has pointed out, each of these built-in bonuses was present in the prepayment premium that the Travelers Insurance Company attempted to enforce in *In re Skyler Ridge*, 80 BR 500 (Bankr CD Cal 1987). 40 UCLA L Rev at 895–897.

12. It has been suggested that a Treasury bill with the same maturity could be properly used by adjusting the rate upward to estimate the market rate.

13. 40 UCLA L Rev at 896–897.

14. Some loan documents also allow for defeasance, the replacing of the lender's collateral with substitute collateral of at least equal investment quality to the original collateral. For an example of a defeasance provision and how such provisions can turn against the lender, see 478 PLI/Real at 893–904.

15. *Noonan v Fremont Fin (In re Lappin Elec Co)*, 245 BR 326, 329 (Bankr ED Wisc 2000)*In re 433 South Beverly Drive*, 117 BR 563, 568 (Bankr CD Cal 1990); . *But see AJ Lane*, 113 BR 821 at 824–825 (applying only a federal standard).

16. The authors have found no published decisions from Michigan state courts discussing the enforceability of prepayment premiums. *See Atlantic Ltd P'ship-XI*, 95 F Supp 2d at 681 (stating that there appears to be no Michigan case law addressing the enforceability of prepayment premiums).

17. *See* 478 PLI/Real 871 at 872–875.

18. *Houston North Hosp Props v Telco Leasing, Inc*, 680 F2d 19, 22 (5th Cir 1982) (holding that where the borrower wished to prepay loan, the lender had the right to refuse prepayment or negotiate for a prepayment premium, even where such a premium was not included in the loan documents); *McCae Mgmt Corp v Merchants Nat'l Bank & Trust Co*, 553 NE2d 884, 888 (Ind Ct App 1990).

19. *Sparta State Bank v Covell*, 197 Mich App 584, 495 NW2d 817 (1992) (stating that if an installment contract does not contain an acceleration provision, a separate cause of action accrues as each installment falls due); *SLMSoft.Com, Inc v Cross Country Bank*, No 00C-09-163-JRJ, 2003 Del Super LEXIS 112, (Apr 2, 2003).

20. *Shiffer v Board of Ed of Gibraltar Sch Dist*, 393 Mich 190, 197, 224 NW2d 255 (Mich 1974) (citing McCormick, *Damages* § 33, at 127, for the proposition that the duty to mitigate damages is unqualified and applies through the entire jurisprudence).

21. *See, e.g., In re LHD Realty Corp*, 726 F2d 327, 330–331 (7th Cir 1984); *but see*, e.g., *Westmark Commerce Mortgage Fund IV v Teenform Assocs, LP*, 362 NJ Super 336, 345–347, 827 A2d 1154 (NJ Super Ct App Div 2003) (disagreeing with the result of LHD Realty, but without discussing the effect of a specific contract provision allowing for enforcement of the prepayment premium after acceleration).

22. *See, e.g., United States v Harris*, 246 F3d 566, 572

(6th Cir 2001); *Empire of America Fed Sav Bank*, 701 F Supp. at 129–130; *In re Schaumberg Hotel Owner Ltd P'ship*, 97 BR 943, 953 (Bankr ND Ill 1989).

23. *Atlantic Ltd P'ship-XI*, 95 F Supp 2d at 683–684; *Carlyle Apartments Joint Venture v AIG Life Ins Co*, 333 Md 265, 635 A2d 366 (1994); *Renda v Gouchberg*, 4 Mass App Ct 786, 343 NE2d 159 (1976). *But see AJ Lane*, 113 BR at 826–827 (discussing and rejecting the alternative performance theory).

24. *See Atlantic Ltd P'ship-XI*, 95 F Supp 2d at 683–684.

25. Courts have also enforced prepayment premiums as an alternative performance against borrowers who breached the loan agreement to evade the prepayment premium. *Empire of America Fed Sav Bank*, 701 F Supp at 130 (remanding for a determination of whether the borrower intentionally defaulted to escape the prepayment provision); *Florida Nat'l Bank of Miami v Bankatlantic*, 589 So 2d 255 (Fla 1991). *But see In re LHD Realty Corp*, 726 F2d at 333 (refusing to "enmesh courts in unnecessary hunts for the 'true' cause of a loan repayment"); *Eyde Bros Dev Co v Equitable Life Assurance Soc'y of the United States*, 697 F Supp 1431, 1436 (WD Mich 1988), *aff'd without opinion*, 888 F2d 127 (6th Cir 1989) (finding that even though the default was intentional, equities did not favor the award of prepayment premium).

26. 40 UCLA L Rev at 876–881.

27. *Id*. at 878 n65, 67 (citing Ronald Coase, *The Problem of Social Cost*, 3 JL & Econ 1 (1960), and Robert Cooter, *The Cost of Coase*, 11 J Legal Stud 1 (1982)).

28. Lenders could respond by drafting the loan agreements to limit the damages for breach to the prepayment premium. However, the loan would then no longer allow alternative performances but would revert to a typical liquidated damages clause.

29. *See, e.g., In re Hidden Lake Ltd P'ship*, 247 BR 722 (Bankr SD Ohio 2000); *Lappin*, 245 BR at 329.

30. Restatement (Second) of Contracts §356.

31. *Id*.

32. *Curran v Williams*, 352 Mich 278, 283 (1958); *see also Wilkinson v Lanterman*, 314 Mich 568, 22 NW2d 827 (1946); *HF Campbell Co v Country Builders, Inc*, No 224735, 2001 Mich App LEXIS 293 (Dec 18, 2001) (unpublished) (invalidating a liquidated damages provision as being "unconscionable and disproportionate to any possible injury that could have been suffered from a breach of these contracts"); *UAW-GM Human Res Ctr v KSL Recreation Corp*, 228 Mich App 486 579 NW2d 411 (1998).

33. *Colonial at Lynnfield, Inc v Sloan*, 870 F2d 761, 765 (1st Cir 1989); *Lake River Corp v Carborundum Co*, 769 F2d 1284, 1287 (7th Cir 1985); *HF Campbell Co*, No 224735, 2001 Mich App LEXIS 293.

34. *In re Vanderveer Estates Holdings, Inc*, 283 BR 122, 129 (Bankr EDNY 2002) (applying New York law); *In re Schaumberg*, 97 BR at 953–954 (applying Illinois law); *UAW-GM Human Res Ctr*, 228 Mich App at 508–509.

35. *Colonial at Lynnfield, Inc*, 870 F2d at 765 (stating that Massachusetts law does provide for a retrospective appraisal of liquidated damages).

36. Restatement (Second) of Contracts § 356.

37. *Lake River Corp*, 769 F2d at 1291 ("When a contract specifies a single sum in damages for any and all breaches even though it is apparent that all are not of the same gravity, the specification is not a reasonable effort to estimate damages . . . .").

38. The use of hindsight to judge the reasonableness of liquidated damages is allowed in some jurisdictions.

39. See the section titled "The Market Rate of Interest" on p. 30.

40. *Lake River Corp*, 769 F2d at 1291 ("[W]e conclude that the damage formula in this case is a premium and not a liquidation of damages, because it is designed always to assure Lake River more than its actual damages.").

41. See the section titled "Acceleration" on page 32.

42. *In re Abramoff*, 92 BR 698, 705 (Bankr WD Tex 1988) (finding that a "prepayment premium" was actually interest because it was imposed because of default and not actual prepayment). *But see CC Port, Ltd v Davis-Penn Mortgage Co*, 61 F3d 288 (5th Cir 1995); *Lappin*, 245 BR at 330 (stating that the prepayment premium could not be characterized as interest).

43. MCL 450.1275; *see also* MCL 438.61(2); *Kleanthous v First of Chelsea Corp*, 201 Mich App 440, 507 NW2d 2 (1993). *But see* MCL 438.41 (providing that charging interest at more than 25 percent per annum may be a violation of Michigan's criminal laws).

44. *See Mims v Fid Funding, Inc (In re Auto Int'l Refrigeration)*, 275 BR 789, 819–820 (Bankr ND Tex 2002) (holding that a usury savings clause prevented the loan in question from being usurious).

45. *Abramoff*, 92 BR at 702–703; *see also LaFond v Rumler*, 226 Mich App 447, 574 N.W. 2d 40 (1997) (discussing the enforceability of restraints on alienation in Michigan); *Teltow v Tiger Dev, LLC*, No 223070, 2001 WL 1699711, *3 (Mich App Dec 28, 2001) (unpublished) (stating that, in Michigan, a restraint will not be enforced unless found to be reasonable).

46. 697 F Supp at 1434–1435.

47. *Lappin*, 245 BR at 329. *But see AJ Lane*, 113 BR at 824–825 (applying only a federal standard).

48. Unless otherwise specified, all statutory citations in the remainder of this article are to the United States Bankruptcy Code, 11 USC 101 et seq References to the "debtor" refer to a borrower in bankruptcy.

49. Section 506(a).

50. *AJ Lane*, 113 BR at 824.

51. *Vanderveer*, 283 BR at 131–132.

52. *Id*. at 131.

53. *Skyler Ridge*, 80 BR at 508.

54. *In re Ridgewood Apartments*, 174 BR 712, 720 (Bankr SD Ohio 1994) ("Whether the prepayment is voluntary or involuntary . . . 'prepayment' is the initial condition to be satisfied.").

55. Often, the lender will bring an action to foreclose on its collateral. Receipt of the proceeds from the foreclosure sale constitutes prepayment. The lender might alternatively argue that the breach of a prepayment premium obligation is really an anticipatory breach triggered by the initial breach of the loan agreement and seek to liquidate its entire claim at once.

56. The court in *Hidden Lake*, 247 BR at 730, found that the prepayment premium became due as of the date of acceleration and that actual prepayment was unnecessary. We contend that this is, in fact, an acceleration premium.

57. The lender may incur some administrative costs through accelerating the loan. However, such costs would be relatively nominal in large commercial loans.

58. *In re United Merchants & Mfrs, Inc*, 674 F2d 134, 141 (2d Cir 1982); *Vanderveer Estate Holdings, Inc*, 283 BR at 133 (applying the same test under § 506(b) as under the state law for liquidated damages); *In re Schwegmann Giant Supermarkets P'ship*, 264 BR 823, 832 (Bankr ED La 2001) (holding that a prepayment charge must "effectively estimate actual damages"); *See AJ Lane*, 113 BR at 828 (citing the Restatement (Second) of Contracts §356(1) as the federal standard for §506(b)); *In re Skyler Ridge*, 80 BR at 507 (holding that a prepayment charge was unreasonable under §506(b) for the same reasons that it was an invalid liquidated damages provision).

59. *See In re Outdoor Sports Headquarters, Inc*, 161 BR 414, 424 (Bankr SD Ohio 1993); *AJ Lane*, 113 BR at 828; *see also In re 268 Ltd*, 789 F2d 674, 675–677 (9th Cir 1986) (holding that reasonableness is governed by federal law, not state law).

60. *In re Imperial Coronado Partners, Ltd*, 96 BR 997, 1001 (9th Cir 1989) (holding that §506(b) limits prepayment premiums to "the difference between (1) the market rate of interest on the prepayment date, and (2)

the contract rate, for the remaining term of the loan"); *In re Kroh Bros Dev Co*, 88 BR 997, 1001 (Bankr WD Mo 1988) (determining that charges under §506(b) are limited to actual costs).

61. *Schwegmann Giant Supermarkets*, 264 BR at 829 (holding that the party objecting to a proof of claim bears an initial burden of producing evidence to rebut the claim but that the claimant always bears the burden of proof); *In re Carr Mill Mall Ltd P'ship*, 201 BR 415, 423 n10 (Bankr MDNC 1996).

62. *Outdoor Sports Headquarters, Inc*, 161 BR at 424; *In re Duralite Truck Body & Container Corp*, 153 BR 708, 714–715 (Bankr Md 1993); *In re 433 South Beverly Dr*, 117 BR at 569.

63. See the section titled "Yield Maintenance Premiums" on p. 30.

64. *In re Schwegmann Giant Supermarkets P'ship*, 264 BR at 832 (holding that an unreasonable prepayment premium should be disallowed in its entirety); *Skyler Ridge*, 80 BR at 507 (noting, in dicta, that a court may be permitted to allow reasonable fees even if a prepayment premium is unreasonable).

65. *See In re White*, 88 BR 498, 511–512 (Bankr D Mass 1988) (asserting that a contract including an unreasonable default interest rate could not be reformed to contain a lesser, reasonable default interest rate).

66. *Norwest Bank Worthington v Ahlers*, 485 US 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); *Outdoor Sports Headquarters, Inc*, 161 BR at 426.

67. If the agreement does not provide for the charge, it is not allowed under § 506(b), regardless of whether a state court would have allowed for prepayment damages in the absence of a specific provision.

68. *Ridgewood Apartments*, 174 BR at 721.

69. *Skyler Ridge*, 80 BR at 508; *see also Lappin*, 245 BR at 330 (finding that prepayment premiums do not constitute unmatured interest).

70. *Sachs Elec Co v Bridge Info Sys* (*In re Bridge Info Sys*), 288 BR 556, 564 (Bankr ED Mo 2002); *White*, 88 BR at 510–511.

71. *See supra* n66. Section 510(c) does allow for equitable subordination, but only if the lender has committed inequitable conduct.

72. Section 1124(2) provides that a debtor does not impair a class of claims notwithstanding applicable law allowing the holders of such claim to receive accelerated payment if the debtor cures the default (with certain exceptions), reinstates the original maturity date, compensates the claim holder for certain damages, and does not otherwise alter the claim holders' rights. The effect of this section is to allow the Chapter 11 debtor to decelerate a loan.

73. The debtor is not required to cure the defaults listed in § 365(b)(2).

74. *Ridgewood Apartments*, 174 BR at 720.

75. *See LHD Realty Corp*, 726 F2d at 332; *Carr Mill Mall Ltd P'ship*, 201 BR at 422–423.

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