


Fall 1989

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Recommended Citation

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WHAT YOU SEE IS NOT ALWAYS WHAT YOU GET: THE ENFORCEABILITY OF LOAN PREPAYMENT PENALTIES

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INTRODUCTION

Commercial real estate loan documents often restrict the borrower's right to prepay the loan prior to maturity. Through these restrictions, a lender seeks to ensure its investment stream over the life of the loan. Where, as in the case of many insurance company lenders today, the lender borrowed the funds it is lending and guaranteed the original source of those funds a fixed rate of return for a definite period, a prepayment by the ultimate borrower is especially problematic. Upon prepayment, since the lender is still obligated to provide the original source of funds with its guaranteed fixed return, the lender must find an alternative investment which will generate a sufficient return to allow the lender to pay that guaranteed return and still make a profit on the override. In a market with interest rates lower than rates in effect when the original loan was made, a lender's search for such an alternative investment often is futile.

This article explores the enforceability in Illinois of provisions in commercial real estate loan documents which preclude or restrict prepayment unless the prepayment is accompanied by a stated prepayment premium - whether the prepayment is a voluntary prepayment or follows an acceleration of the loan prior to its state maturity date. First, various forms of prepayment clauses will be discussed; second, judicial interpretations of these clauses will be described; and finally, drafting suggestions and alternative remedies for lenders will be presented.¹

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1. For a very complete discussion of prepayment restrictions in commercial loans, see Stark, *Enforcing Prepayment Charges: Case Law and Drafting Suggestions*, 22 REAL PROP., PROB. & TR. J. 549 (Fall 1987).

I. ANALYSIS

A. Forms of Prepayment Clauses

Clauses limiting prepayment sometimes establish a period at the beginning of the loan term during which the borrower is prohibited from prepaying any portion of the outstanding loan balance. This absolute prohibition is often followed by a subsequent period coinciding with the latter part of the loan terms during which the borrower may prepay the loan if it pays a specified prepayment premium. Another common form of prepayment restriction allows prepayment from the beginning of the loan term if the borrower pays the stated prepayment premium.

The prepayment premium was traditionally stated as the product of a specified percentage multiplied by the principal balance of the loan being prepaid. The specified percentage often decreased annually over the life of the loan. Such a provision was at issue in *In Re LHD Realty Corp.*,² a leading case in this area. In that case, the promissory note provided that the prepayment premium was to be calculated as follows:

No prepayment of principal may be made during the first ten (10) loan years. After [the] tenth (10th) loan year, the right is reserved . . . to prepay on any interest payment date all or any portion of the note principal by paying a premium on the amount prepaid as follows: During the eleventh (11th) loan year at five (5%) percent, declining one (1%) percent per year thereafter to a minimum of par.

In the event of prepayment in full only, and in addition to the foregoing, an additional prepayment premium will be payable in the amount computed as follows: The average "additional interest" payments for the three (3) preceding years capitalized at thirty-three and one-third (33 ⅓%) percent.³

Another typical provision allows prepayments from the beginning of the loan term, requiring a premium on any prepayment which exceeds a certain percentage of the original principal amount of the loan. Such a clause was at issue in another leading Illinois case, *Slevin Container Corp. v. Provident Federal Savings & Loan of Peoria*,⁴ where the promissory note provided:

[Borrowers] reserve the right to prepay this note in whole or in part at any time, but [Lender] may require payment of note more than six (6) months advance interest on that part of the aggregate amount of all prepayments on the note in one year, which exceeds twenty percent (20%) of the original principal amount of the loan.⁵

2. 726 F.2d 327 (7th Cir. 1984).

3. *Id.* at 329.

4. 98 Ill. App. 3d 646, 424 N.E.2d 939 (1981).

5. *Id.* at 646, 424 N.E.2d at 939.

A prepayment premium also may be expressed as an approximation of the unrealized interest the lender will forfeit as a result of the prepayment.⁶ This approximation is often calculated by determining the present value of the difference between the interest payments the lender would have received pursuant to the loan but for the prepayment and the product of the amount of principal prepaid multiplied by the market interest rate prevailing at the time of the prepayment. Theoretically, the lender may reinvest the principal upon prepayment and the present value of the difference between its anticipated return under the prepaid note and its actual return at the market rate should represent the lender's direct damages as a result of the prepayment. Such a provision might be as follows:

The premium (herein called the "Premium") to be paid in connection with a prepayment hereof shall be an amount calculated as follows:

(a) There shall first be determined, as of the date fixed for prepayment (herein called the "Prepayment Date"), the amount, if any, by which the Interest Rate hereunder exceeds the yield to maturity percentage (herein called the "Current Yield") for the United States Treasury Note (herein called the "Treasury Note") closest in maturity to the Maturity Date hereof as published in *The Wall Street Journal* on the first (1st) business day preceding the Prepayment Date (if (i) publication of *The Wall Street Journal* is discontinued or (ii) publication of the Current Yield of the Treasury Note in *The Wall Street Journal* is discontinued, the Holder shall, in its sole discretion, designate some other daily financial or governmental publication of national circulation); and

(b) The premium shall be the remainder of (x) minus (y) where (x) is the present value of all unpaid installments of principal and interest due under this Note from the date of prepayment to and including the original maturity date of this Note, discounted at the Current Yield and (y) is the outstanding principal balance of this Note as of the prepayment date; provided that Borrower shall not be entitled in any event to a credit against, or a reduction of, the indebtedness evidenced hereby to be prepaid if the Current Yield exceeds the Interest Rate, or for other reason.

B. Judicial Interpretations of Prepayment Clauses

It has been generally acknowledged that a borrower is not entitled to prepay a loan unless the borrower has reserved the right to do so in the loan documents.⁷ As a result, it has long been assumed that a lender may condition a borrower's right to make a voluntary prepayment, including requiring the borrower to pay a specified pre-

6. *Id.* at 647, 424 N.E.2d at 939.

7. *Missouri, K & T R.R. Co. v. Union Trust Co.*, 156 N.Y. 592, 51 N.E. 309 (1898). See generally 55 AM. JUR. 2d § 397 (1971).

mium upon prepayment. Case law is sparse regarding the enforceability of clauses establishing such a condition of prepayment.

In those cases where a court addressed a loan clause which required payment of a premium as a condition of allowing a prepayment, the court usually focused on the nature of the prepayment in determining the enforceability of the clause. Courts appear to distinguish four types of prepayments. First, a prepayment may be precipitated by the borrower's request, such as where the borrower requests a payoff letter and proceeds to pay the balance of the loan (including the prepayment premium) pursuant to that letter or where the borrower simply tenders a lump sum payment to lender which is greater than the required scheduled principal payment under the loan. Second, a prepayment may be occasioned by a monetary default of the borrower combined with an acceleration of the indebtedness by the lender pursuant to rights given to the lender under the loan documents (this type of default is subsequently referred to in this article as a Monetary Default). Third, a prepayment may be based upon a non-monetary default by the borrower combined with an acceleration of the indebtedness by the lender, such as where the borrower transfers or sells the property which is security for the loan in violation of the loan documents (this type of default is subsequently referred to in this article as a Non-monetary Default). Finally, a prepayment may be the result of the occurrence of an event other than a default which is not directly or indirectly within the borrower's control combined with an acceleration of the indebtedness by the lender permitted by the loan documents by reason of the specific event, such as where the property which is security for the loan is destroyed by a fire or condemned (this fourth event is subsequently referred to in this article as a Force Majeure Default). Courts often refer to the first category of prepayment above as voluntary prepayments and the second, third and fourth categories of prepayments above as involuntary prepayments. Those categories will be similarly referred to as Voluntary Prepayments and Involuntary Prepayments subsequently in this article.

As a threshold matter, whether the prepayment is a Voluntary Prepayment or Involuntary Prepayment, the amount of the premium due must be reasonable for the clause to be enforceable.⁸ If

8. In *In re Skyler Ridge*, 80 Bankr. 500 (Bankr. C.D. Cal. 1987), the Court considered the reasonableness of the amount of the required prepayment. The case involved the Voluntary Prepayment of a construction loan, and the bankruptcy court applied principles pertaining to the enforceability of liquidated damages clauses in considering the enforceability of the prepayment clause. The prepayment clause provided:

The privilege is reserved to pre-pay all of the outstanding principal balance, all accrued interest and all other sums due on this Note on any installment payment date . . . provided the holder of this Note has been paid a prepayment

the amount of the premium equals or closely approximates the actual damages which the parties calculate at the time the loan is made that the lender may suffer as a result of a prepayment, it would probably be considered reasonable.⁹

In *In re Schaumburg Hotel Ownership Limited Partnership*,¹⁰ the bankruptcy court discussed the reasonableness of a prepayment clause, stating: "In determining the validity of a prepayment clause, the court must look to the damages the parties could anticipate at the time the parties contracted [I]f the damages are easily calculable [at the time of contracting] or the prepayment premium will be disallowed."¹¹ In reaching its conclusion that the prepayment clause was enforceable, the court applied principles of law often used in determining the enforceability of liquidated damages provisions. It should be noted that the court estimated that the lender's actual damages at the time of, and as a result of the prepayment, were \$2,510,557 and that the prepayment premium amounted to only \$1,721,216.¹²

premium equal to the greater of (a) the product obtained by multiplying (i) the difference obtained by subtracting from ten and 75.100 percent (10,75%) the yield rate of 11-½% U.S. Treasury Notes due November, 1995 (as such yield is reported in *The Wall Street Journal* or similar publication on the fifth business day preceding the prepayment date) and (ii) the number of whole and fractional years remaining between the prepayment date and the scheduled maturity date of this Note, and (iii) the prepaid amount

Id. at 11.

The court refused to enforce the prepayment premium, holding that the amount of the premium was unreasonable. The court based its conclusion on the findings that the yield on U.S. Treasury notes "is systematically lower than the interest rate on first mortgages for construction loans on apartment buildings, because the risk is lower" and that the promissory note did not contain an adjustment for the difference in rates. The court further observed that the formula was deficient because it did not contain a discount for present value. "Application of the formula would permit [the lender] to recover its entire lost interest at the time of prepayment, rather than over the life of the loan." *Id.*

Although the court's ruling in *In re Skyler* seems harsh on lenders, it must be considered against the backdrop of that particular bankruptcy proceeding. In that case, several other creditors had agreed to accept a plan of reorganization if the bankruptcy estate were distributed without an allowance of the prepayment premium. The court appeared to weigh this factor heavily in its consideration of the reasonableness of the prepayment premium, stating that: "The court has equitable power to avoid the enrichment of certain creditors at the expense of subordinate creditors, where such a result would be unfair." *Id.* at 30. It is possible that in a non-bankruptcy context, a court might more liberally compare the lender's return under the loan and the lender's return under an alternative investment vehicle, such as U.S. Treasury obligations, provided that any payments to the lender are adjusted for present value purposes.

9. See the Drafting Suggestions, *infra* notes 51 through 52 and accompanying text for a further discussion of the formulation of prepayment premiums.

10. 97 Bankr. 943 (Bankr. N.D. Ill. 1989).

11. *Id.* at 953-54 (citing *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289-90 (7th Cir. 1985)).

12. For a further discussion of this case, see *infra* notes 22 through 25 and accompanying text. See also *In re Kroh Brothers Development Co.*, 88 Bankr. 997

For the purpose of the following discussion it is assumed that the amount of the stated prepayment premium due is commensurate with the actual loss which the lender would suffer as a result of the borrower's prepayment, and calculated accordingly at the time the loan was made.

1. *Voluntary Prepayments*

Courts usually allow prepayment premiums sought by lenders as a result of a Voluntary Prepayment. In *In First National Bank of Springfield v. The Equitable Life Assurance Society of the United States*,¹³ for example, the borrower desired to sell land which secured a loan from Equitable Life Assurance Society of the United States ("Equitable"). In order to consummate the sale, the borrower sought to pay off the loan to Equitable at closing. The borrower tendered payment of all amounts owed to Equitable other than the prepayment premium, but Equitable refused to release its mortgage. The borrower then paid the prepayment fee, Equitable released its mortgage and the borrower brought suit challenging the enforceability of the prepayment clause and seeking a refund of the premium paid.

In considering the enforceability of the prepayment clause, the court stated that "[r]esolution of this matter . . . turns on whether the 'prepayment' by the [borrower] was voluntary, or whether in fact it was the result of an acceleration of the indebtedness by Equitable."¹⁴ In determining that the clause was enforceable, the court stated that the borrower was allowed the privilege of paying off the balance of the loan" by voluntarily maturing the debt In return, the mortgagee is authorized to collect [the prepayment premium] [S]uch provisions have been routinely upheld and enforced where the [borrower's] election to call the loan to maturity was voluntary."¹⁵

2. *Involuntary Prepayments*

Relying on various theories which are discussed below, courts have often denied a prepayment premium sought by a lender which is predicated upon an involuntary prepayment.¹⁶

(Bankr. W.D. Miss. 1988) (prepayment clause analyzed as liquidated damages and found enforceable because premium failed to provide discount to present value).

13. 157 Ill. App. 3d 408, 510 N.E.2d 518 (1987).

14. *Id.* at 414, 510 N.E.2d at 523.

15. *Id.*

16. *Teachers Ins. & Annuity Ass'n of America v. Butler*, 62 F. Supp. 1229 (S.D.N.Y. 1986); *Village of Rosemont v. Maywood Proviso State Bank*, 149 Ill. App. 3d 1087, 501 N.E. 2d 859 (1987); *LaSalle Nat'l Bank v. I.H.D.A.*, 148 Ill. App. 3d 158,

a. *Monetary Defaults*

A difficult issue for a court, and possibly the most troublesome situation for a lender, arises where the borrower is in default under a note or mortgage and the lender seeks to accelerate the indebtedness and collect the prepayment premium called for by the loan documents.¹⁷ Some courts have found that since a lender's acceleration of a loan advances the maturity date of the debt, a payment after acceleration is not a prepayment but rather a payment made after maturity and, therefore, no premium is due.¹⁸ The lender thus must make a choice of remedies. If the lender exercises its right to accelerate the indebtedness following a default, it waives the right to require a prepayment premium when the accelerated indebtedness is paid.

In *In re LHD Realty Corp.*, for example, the borrower missed several monthly payments under the promissory note, and the lender accelerated the indebtedness. The court first noted that prepayment premiums serve the valid purpose of compensating a lender for the anticipated interest that it will not receive as a result of a prepayment of the loan and second, a lender loses its right to a prepayment premium when it accelerates the loan because acceleration "advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."¹⁹ In response to the argument that such a *per se* rule would prompt borrowers to default intentionally (rather than prepay loans) in order to avoid paying the prepayment premium, the court stated that a borrower is unlikely to default because of the adverse effect on its credit rating and because a lender always has the option to sue the borrower for payments as they mature.²⁰ Finally, the court stated that if intentional defaults become commonplace, courts in appropriate cases will refuse to enforce the acceleration ex-

498 N.E. 2d 697 (1986); *Pacific Trust Co. v. Fidelity Fed. Sav. & Loan*, 229 Cal. Rptr. 269, 184 Cal. App. 3d 817 (1986); *General Motors Acceptance Corp. v. Uresti*, 553 S.W. 2d 660 (Tex. App. 1977).

17. *Slevin Container Corp. v. Provident Fed. Sav. & Loan of Peoria*, 98 Ill. App. 3d 646, 424 N.E.2d 939 (1981).

18. One might ask if in *First National Bank of Springfield v. Equitable Life Assurance Soc'y of the United States*, 157 Ill. App. 3d 408, 414, 510 N.E. 2d 518, 523 (1987), the borrower had sold the land which secured the loan but had not tendered payment of the balance of the loan and Equitable had exercised its rights under the due on sale clause under the mortgage, whether the prepayment would have been deemed involuntary and the prepayment clause unenforceable. *Id.* Specifically, the court stated: "We believe *Slevin* is factually inapposite from the matter presently under consideration. . . . Equitable never invoked its rights under the due-on-sale clause, an event which would have triggered payment of the entire balance [of the loan] without penalty." *Id.*

19. 726 F.2d 327, 330 (7th Cir. 1984).

20. *Id.* at 331.

ception to the allowance of prepayment premiums.²¹

A recent Illinois bankruptcy case involving a Monetary Default, *In re Schaumburg Hotel Ownership Limited Partnership*,²² appears to be an exception to the above rule. In that case, the borrower defaulted on its payment obligations and the lender accelerated the balance of the loan. The loan documents called for a ten percent premium payable on the indebtedness prepaid. As previously discussed herein, the court first determined that the amount of the premium was reasonable.²³ The court then determined that the premium was due because the loan documents explicitly provided that the premium was owed "upon prepayment due to default or acceleration."²⁴ The court distinguished *Slevin* and *Matter of LHD Realty Corp.*, stating: "In both [of those cases], the loan documents provided that the debtor would incur a prepayment fee if it repaid the amount before maturity. In neither case did the loan documents provide that upon default, the lender could both accelerate the debt and collect the prepayment fee."²⁵ Although the court's factual distinction is correct, it is not clear (based on the *Slevin* court's comments discussed below) that such distinction would have rendered a different result in *Slevin* since the premium was due as a result of the lender's acceleration of the maturity date of the loan.

b. Non-Monetary Defaults

In *Slevin*, a case involving a Non-monetary Default, the borrower sold its interest in the property which secured the loan, thus triggering the lender's right to accelerate because of the due on sale clause contained in the mortgage. In reasoning nearly identical to that of the court in *In re LHD Realty Corp.*, the *Slevin* court stated that "we believe that where the discretion to accelerate the maturity of the obligation is that of the obligee, the exercise of the discretion renders the payment made pursuant to the election one made after maturity and by definition not prepayment."²⁶ The court reasoned that although the event which ultimately led to the acceleration was the borrower's intentionally selling the property, the lender's choice of acceleration was the lynch pin to the denial of the prepayment premium: "if [the lender] so elected, the mortgage payments could have been continued as in the past."²⁷

21. *Id.*

22. 97 Bankr. 943 (Bankr. N.D. Ill. 1989).

23. See *supra* note 10 through 11 and accompanying text.

24. *In re Schaumburg*, 97 Bankr. at 954.

25. *Id.* at 953.

26. *Slevin Container Corp.*, 98 Ill. App. 3d at 648, 424 N.E.2d at 941.

27. For a discussion of this situation in the context of *First Nat'l Bank of Springfield*, see *supra* note 18.

The courts' rulings in *In re LHD Realty Corp.* and *Slevin* place a lender in a precarious position. The protections afforded the lender by these decisions are illusory. The court's rationale that a borrower will hold so sacred its credit rating that it will not default on a loan is misguided. A borrower's decision whether to default in its obligations under the loan documents in an attempt to force an acceleration and avoid the payment of a prepayment premium, is probably more a function of the amount of savings the borrower will enjoy as a result of the prepayment premium being disallowed rather than the sanctity of a good credit rating. The court's suggested solution in *In re of LHD Realty Corp.*,²⁸ that a lender continually sue a borrower for late payments and late charges is surely palatable to only the most litigious of lenders and is especially troublesome in light of the concern whether the new Illinois Foreclosure Act preserves the remedy of partial foreclosure.²⁹

Finally, the contention that a lender may simply collect mortgage payments under the note in lieu of accelerating the indebtedness contradicts the agreement of the parties and denies the lender one of the benefits of the parties' bargain. This applies in the case of Monetary Defaults and in the case of Non-Monetary Defaults which imperil the lender's security (such as the borrower's failure to pay taxes and insurance premiums). It also applies where the expertise of the borrower in operating the mortgaged property was a significant factor in the lender's original approval of the loan, but the borrower attempts to sell the property in violation of the loan documents. Even under *In re LHD Realty Corp.* where the court addressed, but gave little or no weight, to the borrower's state of mind³⁰ as a factor in whether a prepayment premium is due, the lender is faced with burdensome and usually costly litigation to prove that the borrower intentionally defaulted on the loan in order to enforce the prepayment premium agreed to in the loan documents.

c. *Force Majeure Default*

Where a lender seeks to collect a prepayment premium based upon a payment of the indebtedness after a Force Majeure default such as a casualty or condemnation, courts usually deny the lender the right to collect a prepayment premium. Although courts have not established a bright line test in these Force Majeure cases, what appears to underlie most courts' reasoning is a strange combination of principles of equity and contract law combined with an obvious

28. 726 F.2d 327 (7th Cir. 1984).

29. See generally ILL. REV. STAT. ch. 110, ¶ 15-1501 (f) (1986) (allowing separate actions).

30. 726 F.2d 327, 333 (7th Cir. 1984).

reluctance to enforce the prepayment clause in these cases.

For example, in *Jala Corp. v. Berkeley Savings & Loan*,³¹ where the lender sought and was denied a prepayment premium occasioned by a condemnation of the property securing the loan, the condemnation proceeds were used to prepay the loan. Similarly, in *Chestnut Corp. v. Bankers Bond & Mortgage Co.*,³² the lender sought and was denied a prepayment premium when, following a fire in the property securing the loan, the insurance proceeds were used to prepay the loan as opposed to repair the improvements destroyed. In both cases, the court reasoned that requiring a prepayment premium would work an inequity on the borrower.³³ In other cases, such as *Village of Rosemont v. Maywood Proviso State Bank*,³⁴ the court applied principles of contract law and found the prepayment clause ambiguous, and therefore unenforceable. In that case, the prepayment clause provided that:

[i]f, during the term of the note [borrower] shall (whether voluntarily or by operation of law) sell, convey, assign, mortgage, hypothecate, or otherwise transfer or encumber the mortgaged premises [the lender shall collect a prepayment premium].³⁵

The mortgaged premises were condemned and the lender sought to apply the condemnation proceeds in prepayment of amounts owed under the loan. The lender argued that the prepayment premium was due according to the terms of the loan documents because the condemnation constituted a transfer of the property.³⁶ The court determined that although condemnation constitutes a transfer by operation of law, the prepayment clause interpreted as a whole, was ambiguous because the phrases "mortgagor shall [transfer]" and "[transfer] by operation of law" were contained by the same sentence.³⁷ The court's holding appears more based on semantics than logic and reason.

Many contract purists would argue that if the loan documents clearly provide that a prepayment premium is due from the borrower in the case of prepayment, whether such a prepayment is due by reason of Force Majeure Default or as a result of the lender's acceleration of the debt following a Monetary Default or Non-Monetary default, courts should enforce the prepayment clause in any of these situations since the loan documents are valid contracts. In *In Re LHD Realty Corp.*, after citing the above noted condemnation

31. 104 N.J. Super. 394, 250 A.2d 150 (1969).

32. 395 Pa. 153, 149 A.2d 48 (1959).

33. *Jala Corp.*, 104 N.J. Super. at 402-03, 250 A.2d at 155; *Chestnut Corp.*, 395 Pa. at 156-57, 149 A.2d at 50.

34. 149 Ill. App. 3d 1087, 501 N.E.2d 859 (1986).

35. *Id.* at 1089, 501 N.E.2d at 860.

36. *Id.* at 1091, 501 N.E.2d at 861-62.

37. *Id.* at 1089, 501 N.E.2d at 860.

and casualty exceptions to the enforceability of prepayment clauses, the court noted that "[t]hese exceptions have been read into contracts by courts and could presumably be modified by the parties through appropriate contractual provisions."³⁸ The court in *Village of Rosemont* made similar observations.³⁹ However, notwithstanding these observations, and unlike the approach which courts usually employ in interpreting contract provisions, in cases involving Force Majeure Defaults, courts often search for the slightest ambiguity as a basis for declaring the entire prepayment clause ambiguous, construing it in the most restrictive manner, and often striking it from the loan documents.⁴⁰

d. Trends

As demonstrated above, Illinois courts have strained to allow borrowers to prepay loans without paying prepayment premiums in cases of a loan prepayment following a Monetary Default. Notwithstanding the current state of the law in Illinois, however, one California court has held that a prepayment premium is collectable even after the lender's acceleration based upon the borrower's default under a promissory note and deed of trust. In *Pacific Trust Co. v. Fidelity Savings & Loan Association*,⁴¹ the promissory note in question provided, in part:

Borrower may prepay the principal amount outstanding in whole or in part . . . on the condition that, in the event that the aggregate amount of any prepayments during any calendar month period preceding and including the date of the latest prepayment, exceeds twenty percent (20%) of the original principal amount of the loan [the borrower will pay a prepayment premium. *The borrower*] agrees that such [prepayment premium] shall be due and payable whether said prepayment is voluntary or involuntary, including any prepayment effected by the holder's exercise of the Acceleration Clause hereinafter set forth.⁴²

The court considered whether by accelerating the indebtedness due under the note the lender waived its right to the prepayment premium.⁴³ Citing *In re LHD Realty Corp*, the court stated that

38. 726 F.2d 327, 331 n.5 (7th Cir. 1984).

39. 149 Ill. App. 3d 1087, 501 N.E.2d 859.

40. In *Chestnut Corp v. Bankers Bond & Mortgage Co.*, the court stated: "Neither the bond nor the mortgages specifically or expressly provides for the exact situation which has arisen, namely, a prepayment of the entire principal [of the] loan with interest during the premium period, due not to a voluntary election of prepayment but to a fire. If defendant (the obligee - mortgagee) believed it should be entitled to the premium under these circumstances it could easily and should have so provided on the bond and/or mortgage."³⁹⁵ Pa. at 155, 149 A.2d at 50 (emphasis added).

41. 184 Cal. App. 3d 817, 229 Cal. Rptr. 269 (1986).

42. *Id.* at 819, 229 Cal. Rptr. at 271 (emphasis added).

43. *Id.* at 823-24, 229 Cal. Rptr. at 273.

prepayment premiums are valid.⁴⁴ The court rejected the argument that *Slevin* and its progeny should control and the lender should be denied the prepayment premium because it accelerated the indebtedness.⁴⁵ The court reasoned that in *Slevin*, *In re LHD Realty Corp.*, and similar cases from other jurisdictions, the provisions restricting prepayment were ambiguous and could be reasonably interpreted as requiring the borrower's payment of a prepayment premium only if the borrower exercised its option to prepay the loan as distinguished from a payment after the lender accelerated the indebtedness.⁴⁶ In those cases, the courts had construed the ambiguity against the lenders because the lender presumably drafted the loan documents and was responsible for the ambiguity.⁴⁷ In this case, however, the note explicitly stated that the prepayment premium was payable not only if the borrower voluntarily prepaid the loan, but also in the event that the lender accelerated the indebtedness.⁴⁸

Whether the California court's decision in *Pacific Trust Co.*, and the bankruptcy court's decision in *In re Schaumburg Hotel Ownership Limited Partnership* will stand as precedents allowing subsequent Illinois courts to distinguish *Slevin* and its line of cases remains to be seen. For lenders, the hope is that those cases are not a temporary aberration but rather the beginning of a realization by the courts that reasonable prepayment premiums serve to protect the lender from potentially economically disastrous consequences which arise from early prepayment following acceleration.

It is a maxim of Illinois contract law that a court, in interpreting a contract, should seek to determine and fulfill the intent of the parties.⁴⁹ Where a contract is found to be unambiguous by a court, "the intentions of the parties must be determined solely from the language read in the agreement."⁵⁰ Certainly in case where the loan documents clearly require a prepayment premium if the loan is accelerated by reason of a Monetary Default or Non-Monetary Default, it is inequitable for the court to read out the stated intent of

44. *Id.* at 823, 229 Cal. Rptr. at 273.

45. *Id.* at 824, 229 Cal. Rptr. at 274.

46. *Id.*

47. *See, e.g.*, *Village of Rosemont v. Maywood Proviso State Bank*, 149 Ill. App. 3d 1087, 501 N.E.2d 859. Note, however, that even in *Rosemont* the court implied that a clearly stated intent of the parties that a prepayment penalty was due notwithstanding the fact that prepayment was prompted by a condemnation of the mortgaged premises might lead a court to allow the lender to collect a premium following condemnation. *Id.* at 1090, 501 N.E.2d at 862.

48. *Pacific Trust*, 184 Cal. App. 3d at 820, 229 Cal. Rptr. at 271.

49. *Wheeling Trust & Sav. Bank v. Citizens Nat'l Bank of Downers Grove*, 142 Ill. App. 3d 333, 491 N.E.2d 866 (1986).

50. *LaSalle Nat'l Bank v. I.H.D.A.*, 148 Ill. App. 3d 158, 162, 498 N.E.2d 697, 700 (1986) (quoting *Nitrin, Inc. v. Bethlehem Steel Corp.*, 35 Ill. App. 3d 577, 594, 342 N.E.2d 65, 78 (1976)).

the parties and require the lender to bear the actual loss which results to the lender when it is deprived of the yield on the loan for the balance of the stated loan term. Further, in the case of a Force Majeure Default followed by an acceleration under rights granted to the lender in loan documents which were negotiated by sophisticated parties represented by competent counsel, the allocation of loss resulting from a Force Majeure Default in the form of a reasonable prepayment premium should be respected by Illinois courts.⁵¹ In either case, the courts would only be enforcing the stated intent of the parties, expressed in the loan documents when the transaction was entered into.

II. DRAFTING SUGGESTIONS AND ALTERNATIVE REMEDIES FOR LENDERS

Although most Illinois cases have been quite explicit on the point that if a lender accelerates a loan it waives its right to collect a prepayment premium, *In re Schaumburg Hotel Ownership Limited Partnership* leave lenders a glimmer of hope that careful draftsmanship of a prepayment premium clause may persuade an Illinois court to enforce the clause, even where a lender seeks to collect the premium predicated upon its acceleration of the indebtedness after a Monetary Default or Non-monetary Default or the occurrence of a Force Majeure Default.

A prepayment clause should clearly set forth that:

(i) a prepayment premium is due from the borrower if (a) the loan is prepaid voluntarily by the borrower or, for any reason, is paid off prior to the stated maturity date following a Force Majeure Default pursuant to rights granted to the lender in the loan documents; or (b) the stated maturity date of the loan is accelerated by the lender (in whole or in part) following the borrower's Monetary or Non-monetary Default and the loan is then repaid, whether voluntarily or following action by the lender to enforce its rights under the loan documents;

(ii) the borrower's payment of the prepayment premium in the

51. In *Trident Center v. Connecticut General Life Ins. Co.*, 847 F.2d 564 (9th Cir. 1988), the court made the following comments:

The parties to this transacted are, by any standard, highly sophisticated business people: Plaintiff is a partnership consisting of an insurance company and two of Los Angeles' largest and most sophisticated law firms; defendant is another insurance company, dealing at arm's length and from positions of roughly equal bargaining strengths In an economy where interest rates fluctuate, it is all but certain that one side or the other will be dissatisfied with a long-term loan at some time. Mutuality calls for enforcing the contract as written no matter whose ox is being gored.

Id. at 565, 568.

event of a payment of the loan prior to the stated maturity date predicated upon the occurrence of any of the above events is the essence of the transaction and is necessary to prevent the lender from suffering an actual loss by reason of the early payment (with the nature of the lender's loss being described as specifically as possible) and, but for the lender having the right to demand and collect the prepayment premium in such event, the lender would not have entered into the transaction; and

(iii) the borrower is sophisticated in commercial matters and has been represented by competent counsel.

Consideration should be given to referring to the premium as a "loan fee" as opposed to "prepayment premium," the latter of which seems to invite the *Stevin* inquiry whether payment after acceleration is a "prepayment."

Predicating the lender's right to collect a prepayment premium on the occurrence of a Voluntary Prepayment or Involuntary Prepayment makes it imperative that the loan document clauses governing such prepayments, including the default, condemnation, casualty and any total or partial acceleration clauses, are carefully drafted and ironclad. Based upon the actions of Illinois courts to date, the result of an ambiguity in those clauses may well be that a court would construe the ambiguity against the lender, regardless of the negotiation which transpired in finalizing any of those clauses.

Lenders should also take steps to avoid a judicial finding that the amount of the prepayment premium is unreasonable. Perhaps the best formulation for this purpose is to make the amount of the prepayment premium a function of the loss which the parties contemplate when the loan is made that the lender will suffer as a result of the prepayment rather than an arbitrary percentage which may in fact result in a windfall to the lender. One such formula is the amount of interest the lender would forfeit as a result of the prepayment, mitigated by the amount the lender would earn by investing the prepaid principal amount in alternative investment vehicles (such as United States treasury instruments) which are available at the time of prepayment, with an appropriate adjustment for present value. At least one case suggests that the amount of the prepayment premium should be adjusted to reflect the difference in risk between an investment such as the loan and the alternative investment vehicle.⁵²

Finally, lenders in Illinois might avoid the quagmire of the existing law regarding the enforceability of prepayment premiums after a lender's acceleration of the loan by opting to partially foreclose

52. See *In re Skyler Ridge*, 80 Bankr. 500 (Bankr. C.D. Cal. 1987).

the loan (to the extent it is permitted under the Illinois Mortgage Foreclosure Act) or exercise its other remedies under the loan documents such as an assignment of rents and leases. Armed with a remedy which is an alternative to accelerating the indebtedness under a loan, a lender may put additional pressures on a borrower that intentionally defaults under the loan in order to prompt the lender's acceleration of the indebtedness. In this manner, a borrower may be inclined to prepay a loan voluntarily rather than default in order to prompt the lender to accelerate the indebtedness. Thus, a lender may transform what would otherwise, in a court's interpretation be an Involuntary Prepayment into a Voluntary Prepayment, rendering the prepayment clause enforceable.

CONCLUSION

Although many commercial real estate loan documents contain a clause prohibiting the payment of the loan prior to maturity and imposing a prepayment premium on the borrower in the event of a prepayment, such clauses are often interpreted in a manner detrimental to a lender. As a result, a lender may find itself in the unenviable position of having its loan prepaid and the anticipated interest stream thereunder cut short, while being required to make guaranteed payments to the original source of its funds.

In determining whether to enforce a prepayment premium, courts usually consider whether the prepayment was voluntary, in which case prepayment premiums of a reasonable amount usually are allowed, or involuntary, in which event prepayment premiums usually are denied and the issue of reasonableness of the amount of the premium is not considered. In distinguishing the two, courts have held those prepayments which the borrower elects to make prior to the maturity of the loan through acceleration or otherwise are voluntary, and have held those prepayments which are made as a result of a declared acceleration by the lender (based upon either a Monetary Default or Non-monetary Default by the borrower) or of the condemnation or destruction of the encumbered property are involuntary.

In Illinois, it appears that when a prepayment is predicated upon the borrower's default and the lender's acceleration of the indebtedness, regardless of whether the default was intentional on the part of the borrower, the payment is deemed made after maturity. In declaring an acceleration of the principal balance of the loan, the lender is deemed to have waived its right to a prepayment premium. In one Illinois bankruptcy case and in one California case, however, the courts distinguished a prepayment clause from the prepayment clauses which were held unenforceable under the traditional Illinois

line of cases. The clauses in those cases specifically stated that a prepayment premium would be due in the event of the lender's acceleration of the indebtedness under the note. Those cases suggest that carefully and unambiguously drafted prepayment clauses may be enforced, even where the prepayment is deemed involuntary or a payment made after maturity.

Finally, where the lender has reason to believe that a borrower defaulted under a loan in order to prompt the lender to accelerate the indebtedness, it may be to that lender's advantage to forego acceleration and continue to collect monthly payments under the note or, pursuant to the assignment of rents and leases, collect rents due the borrower. In this manner, a lender may pressure a borrower to make voluntary prepayment of the loan, in which event a reasonable prepayment premium probably would be collectable.