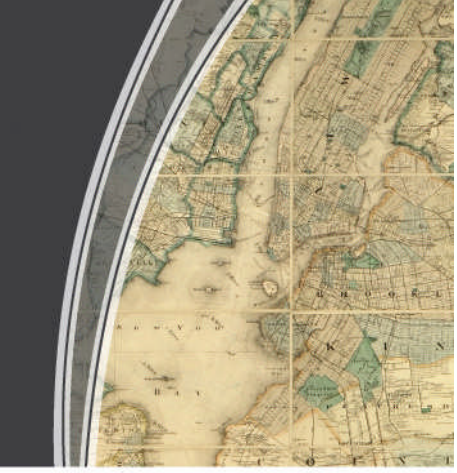

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LENDING & RESTRUCTURING ALERT
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Prepayment Premiums: Lenders Must Avoid This Mistake

Prepayment provisions are intended, in part, to protect lenders in a depressed market from losses resulting from the costs of replacing their loans sooner than expected and having to relend at rates lower than those originally charged. A New York federal district court recently upheld a bankruptcy judge's ruling denying a lender's claim for a $7.5 million prepayment premium against a borrower-debtor.[1] The lender must have been both surprised and disappointed to learn from the courts' decisions that this result could have been avoided had the lender's loan documents included a provision making the prepayment premium due upon default and acceleration of the loan.

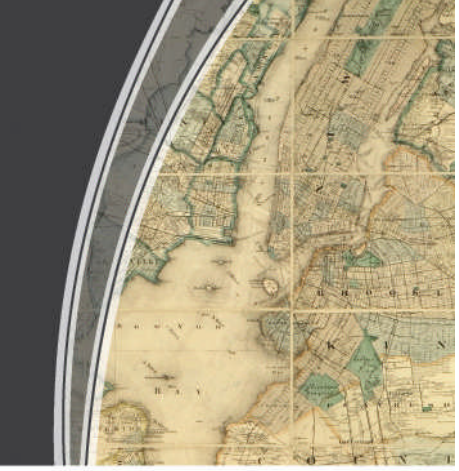
Background

Debtor owned and operated a mixed-use residential and commercial building located in Brooklyn that it mortgaged in April 2007 in return for a $29 million loan. Debtor defaulted under its loan documents by failing to make monthly payments due in November 2008 and thereafter. Lender accelerated the debt, commenced a foreclosure action in federal court and won summary judgment. In late April 2009, Debtor filed its bankruptcy case, staying the foreclosure proceedings.

Lender filed a proof of claim in Debtor's bankruptcy case for over $36.8 million, and later amended it to include a claim for prepayment consideration of approximately $7.5 million. Lender's mortgage (the "Mortgage") contained a voluntary prepayment provision that allowed the debtor to prepay the unpaid principal balance of the note two years after the loan was made, provided that the debtor paid principal, accrued interest, certain other sums, and a prepayment consideration equal to the greater of one percent of the outstanding principal balance or a specified yield maintenance premium. The Mortgage also contained the following provision that governed prepayment of the loan after default and acceleration:

> Following an Event of Default and acceleration of the Debt, if Borrower or anyone on Borrower's behalf makes a tender of payment of the amount necessary to satisfy the Debt at any time prior to foreclosure sale . . . the tender of payment shall constitute an evasion of Borrower's obligation to pay any prepayment consideration or premium due under the Note and such payment

[1] U.S. Bank N.A. v. South Side House LLC, 2012 WL 273119 (E.D.N.Y. Jan. 12, 2012).



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> shall, therefore, . . . include a premium equal to the prepayment consideration or premium that would have been payable on the date of such tender had the Debt not been so accelerated . . . .

Debtor objected to Lender's claim. Though the bankruptcy court upheld portions of the claim, it disallowed that portion of the claim seeking the prepayment premium. Lender appealed to the United States District Court for the Eastern District of New York. The District Court affirmed.

The District Court's Reasoning

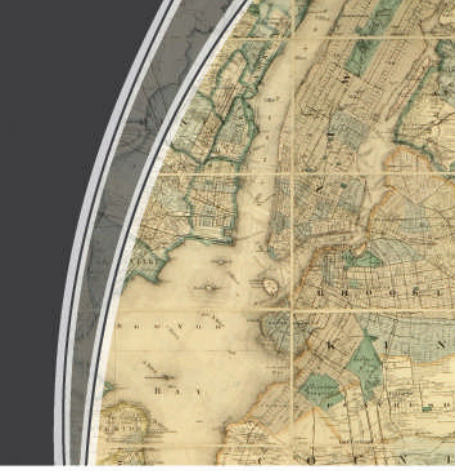
The District Court observed that, "[g]enerally, a lender forfeits the right to a prepayment consideration by accelerating the balance of the loan. The rationale commonly cited for this rule is that acceleration of the debt advances the maturity date of the loan, and any subsequent payment by definition cannot be a prepayment." 2012 WL 273119 at *4 (internal citations omitted). The Court recognized two exceptions to this rule: "(1) where the debtor intentionally defaults in order to trigger acceleration and evade the prepayment premium; and (2) when a 'clear and unambiguous clause . . . calls for payment of the prepayment premium.'" *Id.* at *5 (citation omitted).

The District Court then reviewed the relevant language in the Mortgage governing prepayment. It ruled that this language, by its terms, merely protected Lender from Debtor's intentional evasion of its prepayment obligation, if Debtor had defaulted and then tendered payment after acceleration. The Court stated: "[T]he agreement gives the lender the right to demand immediate payment of the principal and the amount otherwise due under the note, and, if the borrower chooses to satisfy the entirety of the debt, the borrower must furnish the prepayment consideration." *Id.* at *6. But the Debtor did not choose to tender payment.

The District Court noted that a creditor holds a "claim" under the Bankruptcy Code if it has a pre-petition right to payment under relevant non-bankruptcy law. The District Court concluded, however, that Lender's loan documents did not include a clear and unambiguous clause requiring payment of the prepayment premium in the event of a default and acceleration. Accordingly, it held that Lender did not hold a valid claim for the prepayment premium in the bankruptcy case.

Notably, the District Court surveyed decisions that recognized lenders' claims for prepayment premiums in bankruptcy cases, including *In re Vanderveer Estates Holdings, Inc.*,[2] a case in which Herrick, Feinstein represented the lender and that is often cited by lenders in prepayment premium disputes in bankruptcy. The District Court observed that, "[i]n all these cases, the lender's right to a prepayment premium unambiguously arises as a consequence of the default and provision. The prepayment premium, instead of being forfeited by the acceleration of the note, becomes a form of liquidated damages that the lender

[2] *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122 (Bankr. E.D.N.Y. 2002).



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may demand after accelerating the debt . . . . These cases make clear that if the parties intended to create an actual right to payment of the prepayment consideration upon default and acceleration, the parties could easily have so contracted." *Id.* at *7.[3]

Conclusion

The *South Side* case provides an important lesson to lenders who rely upon prepayment premiums as integral components of their financing strategy. To be sure, not all prepayment premium provisions, even if drafted to address the concern raised by *South Side*, will be allowed. A prepayment premium provision may be unenforceable if the borrower files for bankruptcy unless the lender can satisfy other requirements. For example, the case law on prepayment premiums demonstrates that the courts will also assess whether the provision in question is enforceable under applicable non-bankruptcy law. But as a threshold matter, lenders should be certain when they make their loans that their loan documents permit them to collect the prepayment premium after default and acceleration, even if the borrower does not tender repayment.

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[3] The note at issue in *Vanderveer* contained provisions requiring payment of a yield maintenance premium if the loan were repaid, "'whether the prepayment is voluntary or involuntary (in connection with holder hereof's acceleration of the unpaid principal balance of this Note) or the Instrument is satisfied or released by foreclosure (whether by power of sale or judicial proceeding), deed in lieu of foreclosure or by any other means.'" 283 B.R. at 126 (quoting language from note).