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EXPOSING THE MYTH OF MORTGAGE PREPAYMENT PENALTIES IN THE AFTERMATH OF *RIVER EAST*

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Editors' Synopsis: In this Article, the Author analyzes the uncertain and unpredictable judicial treatment of mortgage prepayment fees in commercial mortgages in light of a recent Seventh Circuit decision that reaffirms judicial deference to such fees. The Article illustrates the result of the judicial deference—when compared to the actual loss the mortgagor suffers as a result of commercial mortgage prepayment, often the enforced prepayment fee results in a windfall for the mortgagor. In light of the broad range of judicial approaches to the analysis of mortgage prepayment fees, the Author calls for a requirement of increased disclosure of prepayment fees as a solution to this prepayment penalty problem.

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I. INTRODUCTION

> *The ablest judges have declared that they felt themselves embarrassed in ascertaining the principle on which the decisions [distinguishing liquidated damages from penalties] . . . were founded.*
>
> Judge Charles H. Ruggles[1]

The issue of the enforceability of voluntary mortgage prepayment fees highlights the inherent conflict between lenders and borrowers in the commercial context, and between lenders and regulators in the residential setting. When borrowers attempt to voluntarily prepay a mortgage in order to refinance at lower interest rates or to sell the underlying property, lenders often demand the enforcement of contractual provisions requiring the payment of additional fees—the mortgage prepayment penalties.[2]

It is important to distinguish residential and commercial mortgage prepayment fees because they often differ in their calculations and prevalence. For residential loans, prepayment fees had nearly disappeared in the 1980s as a result of regulatory changes,[3] only to resurge in connection with the growth of the securitized subprime mortgage market that emerged outside of the heavily regulated markets.[4] Studies conducted at the peak of the subprime boom estimated that between 71% and 98% of subprime mortgages carried a prepayment fee.[5] These fees often force residential borrowers to

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[1] Cotheal v. Talmage, 9 N.Y. 551, 553 (1854) (Ruggles, J.).

[2] *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 6.1 (5th ed. 2007) ("Contrary to what is probably pervasive popular belief, in the absence of a specific provision in the note or mortgage so permitting, there is by the majority view no right to pay off a mortgage debt prior to its maturity.").

[3] *See id.*, § 6.2 ("Both Fannie Mae and Freddie Mac, the two principal federally sponsored corporations that purchase mortgages on the secondary market, dropped the prepayment fee clauses from their standard home mortgage forms in 1980, and most home lenders followed suit.").

[4] *See* Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?*, 15 HOUSING POLICY DEBATE 715, 734 & n.30 (2004), *available at* http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_engel.pdf (citing earlier studies finding that between 64% and 98% of subprime mortgages had prepayment penalties). This resurgence was predicted as early as 1987. *See* Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense,* 72 CORNELL L. REV. 288, 289 (1987).

[5] *See* Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments 22-23, 32 tbl.6 (Jan. 25, 2005) (unpublished), *available at*

pay a flat fee of thousands or tens of thousands of dollars.[6] Given that these fees had nearly disappeared for decades and are often quite small in comparison to multi-million dollar fees often demanded in commercial prepayment, little prepayment litigation involving residential borrowers exists.[7] Rather, government regulations serve as the primary protective framework for residential borrowers.

In contrast, most loans to commercial borrowers contain prepayment fee clauses that calculate the fee as an estimate of the lender's lost profits if interest rates drop.[8] When borrowers attempt to challenge commercial prepayment fees, the vast majority of courts have found these fees enforceable under the principle that borrowers and lenders should enjoy freedom of contract when drafting the terms of a mortgage.[9] However, a minority of

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http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf (finding that among subprime refinance mortgages, 14.6% have prepayment penalties that can be triggered within the first three years of the loan and another 57.2% have prepayment penalties for terms that exceed three years, thus totaling 71.8%); Engel & McCoy, *supra* note 4, at n.30 (finding that between 64% and 98% of subprime mortgages have prepayment penalties).

[6] *See, e.g.* John Hechinger, *Prepayment Penalties Trap Many Borrowers,* WALL ST. J. ONLINE, Aug. 6, 2001, *available at* http://www.realestatejournal.com/buysell/mortgages/20010806-hechinger.html; Ruth Simon, *The Unpleasant Surprise of Prepayment Penalties*, WALL ST. J. ONLINE, Dec. 18, 2001, *available at* http://www.realestatejournal.com/buysell/mortgages/20011218-simon.html.

[7] *See* NELSON & WHITMAN, *supra* note 2, § 6.2. Addressing the fact that commercial borrowers are at the center of most prepayment litigation, the treatise notes:

> [V]irtually all of the recent [prepayment] cases involve mortgages on income-producing properties rather than owner-occupied homes. . . . As a result, nearly all modern prepayment litigation is between parties who were relatively sophisticated and had access to counsel when they entered into the mortgage.

Id. For a discussion of the extensive history of commercial prepayment fee litigation highlighting the enforcement of such clauses and the multi-million dollar fees often at issue in such litigation, see John C. Murray, Enforceability of Prepayment-Premium Provisions in Mortgage Loan Documents (2008), http://www.firstam.com/ekcms/uploadedFiles/firstam_com/References/Reference_Articles/John_C_Murray_Reference/Mortgages_and_Financing/prepaymentarticle.pdf.

[8] *See* Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis,* 40 UCLA L. REV. 851, 856, 871 (1993) ("Most mortgages on income-producing real estate (as distinct from owner-occupied housing) contain clauses restricting early payment of the loan."); Murray, *supra* note 7 (demonstrating the dominance of the yield-maintenance clause in commercial mortgage lending).

[9] *See* Whitman, *supra* note 8, at 860 (noting that "attacks by borrowers nearly always fail"); Murray, *supra* note 7, at 20 (Numerous cases have upheld such clauses after concluding that "some state and federal courts . . . find such clauses enforceable under a

courts have applied a "liquidated damages analysis"—an approach that opens the door to inquiry as to whether the damages reasonably estimate the lender's actual loss.[10] Applying this analysis, a handful of bankruptcy courts broke from the majority by refusing to enforce early formulations of commercial prepayment clauses with crude calculations that unreasonably overestimated the lender's loss.[11]

Instead of using the crude formulas that were occasionally rejected by courts, modern commercial lenders commonly use a yield-maintenance prepayment fee clause.[12] These clauses are so named because lenders claim that the clauses maintain the lender's yield, or profit, when interest rates drop after the mortgage is originated.[13] The yield-maintenance calculation requires the borrower to pay the present value of the interest due on the loan, discounted by the interest that the lender will receive if the prepaid principal is reinvested at the "reinvestment rate," as defined by the mortgage documents.[14]

In a 2006 decision that had a broad impact on both residential and commercial mortgages,[15] an Illinois federal district court sided with a borrower who voluntarily prepaid in *River East Plaza, L.L.C. v. Variable An-*

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liquidated damages analysis, and hold that the parties should be free to contract for the payment of any premium that is not clearly inequitable or unconscionable.").

[10] *See, e.g.*, *In re* Kroh Brothers Dev. Co., 88 B.R. 997 (Bankr. W.D. Mo. 1988); *In re* Skyler Ridge, 80 B.R. 500 (Bankr. C.D. Cal. 1987).

[11] *See, e.g.*, *In re* A.J. Lane & Co., 113 B.R. 821 (Bankr. D. Mass. 1990); *In re* Kroh Brothers Dev. Co., 88 B.R. 997; *In re* Skyler Ridge, 80 B.R. 500.

[12] *See* Whitman, *supra* note 8, at 871 (describing the yield-maintenance clause as having "come into common use since the early 1980s"); Murray, *supra* note 7, at 117–51 (listing of prepayment privilege clauses consisting mainly (ten of twelve exhibits) of various types of yield-maintenance clauses).

[13] *See* Whitman, *supra* note 8, at 871 ("The accuracy of this method of measuring the lender's loss may be open to serious criticism; but it does approximate that loss, at least in rough terms."); Sam W. Galowitz, *The Myth of the Yield Maintenance Formula*, 15 REAL EST. FIN. J. 27 (1999) (discussing the attempt to accurately calculate the lender's loss and disputing its accuracy).

[14] *See* Galowitz, *supra* note 13, at 27.

[15] *See* Robert Boyle, Comment, *The Enforceable Prepayment Penalty*, 6 DEPAUL BUS. & COM. L.J. 585, 609 (2008):

> Although the court considered a prepayment provision in the context of a commercial mortgage, the court's analysis was relevant to residential mortgages as well. Ultimately, whether or not to subject a prepayment provision to a liquidated damages analysis turns on the similarity of the prepayment provision to a liquidated damages provision. The analysis has nothing to do with whether the mortgage was commercial or residential.

nuity Life Ins. Co. [hereinafter *River East Plaza*].[16] The borrower objected to the common treasury-flat yield-maintenance prepayment clause that defined the reinvestment rate as the rate on U.S. treasuries.[17] This *River East Plaza* decision garnered nationwide attention from lenders, borrowers, and mortgage attorneys.[18] Using a liquidated damages analysis, the district court held that the provision was unenforceable because the clause was an unreasonable estimate of the lender's actual loss.[19]

Less than a year later, the Seventh Circuit reversed, holding that a treasury-flat yield-maintenance clause is not subject to a liquidated damages analysis because prepayment is not a contractual breach, but is instead an alternative form of performance under the terms of the contract.[20] Courts may be able to extend *River East* to future residential and commercial fee disputes and treat prepayment penalty and associated fees as nothing more than an alternative form of performance under the contract and avoid analyzing when a "fee" crosses the line and becomes an unenforceable penalty.[21]

While the Seventh Circuit was correct that a liquidated damages analysis is appropriate, the appellate court's dicta failed to acknowledge that

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[16] No. 03-C-4354, 2006 WL 2787483 (N.D. Ill. Sep. 22, 2006), *rev'd and remanded*, 498 F.3d 718 (7th Cir. 2007). Voluntary prepayment occurs when the borrower chooses to pay rather than being forced to prepay for reasons such as bankruptcy or when the loan is in default. *See infra* note 93 and accompanying text.

[17] *River East Plaza*, 2006 WL 2787483. For further explanation of the treasury-flat yield-maintenance prepayment clause, see *infra* note 86 and accompanying text.

[18] *See, e.g.*, Gregory A. Thorpe, River East Plaza: *Liquidated Damages Analysis Applies to Prepayment Premium*, 42 REAL PROP. PROB. & TR. J. 41 (2007); Michelle McAtee and Kristen Boike, River East—*A Tale of Caution for Lenders and Borrowers*, REAL ESTATE CLIENT ADVISORY (Jenner & Block L.L.P.), Apr. 2, 2007, at 1, *available at* http://www.lawdragon.com/impages/uploads/pdf/Jenner_Advisory_040307.pdf; Kate Schuler, River East Plaza *Case: A New Challenge to the Enforceability of Prepayment Premiums*, REAL ESTATE NEWSLETTER (Bingham McCutchen, L.L.P.), Summer 2007, at 11, http://www.bingham.com/Media.aspx?MediaID=5377; *Seventh Circuit Clarifies Enforceability of Yield Maintenance Clause in* River East, RPTE E-REPORT (A.B.A. Section of Real Prop. Tr. and Est. Law), Oct. 2007, http://www.abanet.org/rppt/publications/ereport/2007/5/TEClement.html; *Treasury-flat Voluntary Prepayment Premiums Survive Attack*, Legal Alert (Bingham McCutchen, L.L.P.), Aug. 23, 2007, http://www.bingham.com/Media.aspx?MediaID=5572.

[19] *River East Plaza*, 2006 WL 2787483, *8–*11.

[20] River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718 (7th Cir. 2007), [hereinafter *River East*]; *see also* Boyle, *supra* note 15 (reviewing *River East* and the subprime mortgage crisis).

[21] Within this Article, all analysis of prepayment clauses is based on the assumption that the borrower voluntarily prepaid.

treasury-flat yield-maintenance prepayment fees create a windfall for the lender by overestimating damages.[22] The court's holding appears to rely on an assumption that proves false when Treasury securities are used as the reinvestment rate—that a yield-maintenance clause accurately maintains or reflects the lender's yield. In reality, a systematic gap exists between the higher interest rates on risk-bearing commercial mortgages and the lower interest rates on virtually risk-free Treasury securities.[23] This gap accounts for what is known in finance as a "risk premium," which is the premium rate of return that lenders and investors expect to receive in exchange for their willingness to make riskier investments.[24] Thus, the yield-maintenance prepayment clause systematically guarantees the lender the rewards of a higher yield commercial mortgage without the corresponding higher risks that would normally accompany such high-yield mortgages,[25] since the lender simply will reinvest the prepayment in a similar mortgage and double-collect on the risk premium while avoiding the greater risk of borrower's non-payment.

In focusing on voluntary mortgage prepayment fees, this Article will first provide an introduction to relevant mortgage law principals, contractual prepayment clauses, and seminal judicial interpretations. Second, this Article will review the recent *River East* Seventh Circuit decision. Third, this Article will provide an analysis of *River East* and related jurisprudence of prepayment fees, with a particular focus on the borrower's underestimation of the risk of prepayment. Finally, this Article will offer proposals for reform—namely more rigorous disclosure requirements to residential borrowers and the use of alternative reinvestment rates for commercial borrowers—that more accurately reflect the risk-yield substance of these loans.

II. HISTORY

Lenders have traditionally garnered favorable mortgage prepayment treatment under the law, beginning with the judicial presumption that lenders may refuse prepayment altogether.[26] Courts commonly side with lenders who advocate treating a mortgage as an investment that produces a stream

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[22] *See infra* notes 163–91 and accompanying text.

[23] *See* Galowitz, *supra* note 13, at 27; s*ee also infra* notes 78–89 and accompanying text.

[24] *See id. See generally* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE (2008).

[25] *See* Galowitz, *supra* note 13, at 27.

[26] *See* Whitman, *supra* note 8, at 858 n.19 ("American law has presumed that in the absence of a clause permitting prepayment, the lender is under no duty to accept it.").

of income for a fixed period of time that cannot be shortened by a borrower simply through prepayment of the principal.[27] Instead, lenders often codify the terms of prepayment through a clause that requires an additional fee if the borrower prepays. The vast majority of courts have enforced these prepayment fees.[28]

A. The Lender's Right to Refuse Prepayment

Although nearly all modern mortgages permit a borrower to prepay the principal, the default rule is the "perfect tender in time" rule, which states that mortgage lenders have the right to receive payment from the borrower according to the mortgage schedule in the absence of a prepayment provision in the loan or opposing statutory authority.[29] The common law acceptance of this rule has been attributed to the nineteenth century decisions of *Brown v. Cole* and *Abbe v. Goodwin*.[30] These seminal cases established the majority rule that prepayment is a privilege to be granted by the lender. This presumption has come under attack in recent years by numerous scholars,[31] legislatures,[32] and courts.[33] Arguably, the most significant attack came in 1980 when federally-chartered home loan corporations Federal National

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[27] *See id.* at 858 (discussing the "standard doctrine" that "a mortgage loan whose documents are entirely silent on the subject is not prepayable as a matter of right.").

[28] *See id.* at 859 ("The general reaction of state courts has been to enforce [prepayment fees] routinely.").

[29] *See* NELSON & WHITMAN, *supra* note 2, § 6.1; Vicki A. Huffman, Annotation, *Construction and Effect as to Interest Due of Real Estate Mortgage Clause Authorizing Mortgagor to Prepay Principal Debt,* 86 A.L.R. 3D 599 (1978 & Supp. 2009); Murray, *supra* note 7, at 61 noting also that "Mutuality and freedom of contract are the principal philosophical underpinnings for the '[perfect tender in time] rule.'").

[30] *See* Whitman, *supra* note 8, at 858, n.19 (citing Abbe v. Goodwin, 7 Conn. 377, 384 (1829); Brown v. Cole, 14 Sim. 427 (Chancery), 60 E.R. 424 (1845)).

[31] *See, e.g.*, Alexander, *supra* note 4 (arguing that these cases were wrongly decided and are contrary to common sense); Rebecca C. Dietz, *Silence is Not Always Golden: Mortgage Prepayment in the Commercial Loan Context*, 22 U. BALT. L. REV. 297, 328 (1993).

[32] *See, e.g.*, DEL. CODE ANN. tit. 5, § 2234 (2001 & Supp. 2008) ("A borrower may prepay a loan in full at any time."); FLA. STAT. ANN. § 697.06 (West 1994 & Supp. 2008) ("Any note which is silent as to the right of the obligor to prepay the note in advance of the stated maturity date may be prepaid in full by the obligor or his successor in interest without penalty."); 41 PA. CONS. STAT. ANN. § 101, 405 (West 1999 & Supp. 2009). *See generally* Whitman, *supra* note 8, at 863 ("Several states have enacted statutes in recent years granting a right to prepay, but they are usually limited to mortgages on owner-occupied homes."); Nelson & Whitman, *supra* note 2, § 6.4.

[33] *See, e.g.*, Hatcher v. Rose, 407 S.E.2d 172 (N.C. 1991); Spillman v. Spillman, 509 So.2d 1207 (La. 1987), *writ denied,* 513 So.2d 442 (La. App.1987); Mahoney v. Furches, 468 A.2d 458, 461 (Pa. 1983).

Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) prohibited prepayment fees in their standard form contract.[34] While this prohibition initially caused prepayment restrictions virtually to disappear from owner-occupied loans, prepayment fees were reintroduced for such loans in the late 1990s and early 2000s. Many have attributed this resurgence to the growth of subprime mortgages and private mortgage markets, which are beyond the direct influence of Fannie Mae and Freddie Mac.[35]

Whether the judicial presumption exists may be merely academic because lenders often address the perfect tender in time rule by explicitly restricting prepayment through what is known alternatively as a "lock-in" or "lock-out" clause.[36] The clause is known by these alternate terms because it locks-in the loan payments and locks-out prepayment.[37] While courts traditionally uphold prohibitions on prepayment,[38] the practical effect is that lenders can waive enforcement of the clause in negotiations when the bor-

[34] *See* Nelson & Whitman, *supra* note 2, §§ 6.2 & 6.4. The current Fannie Mae and Freddie Mac Multistate Fixed Rate Note allows borrowers to "make a full Prepayment or partial Prepayments without paying a Prepayment charge." Form 3200: Multistate Fixed Rate Note, § 4, Fannie Mae, *available at* https://www.efanniemae.com/sf/formsdocs/documents/notes/pdf/3200.pdf; Form 3200: Multistate Fixed Rate Note, § 4, Freddie Mac, *available at* http://www.freddiemac.com/uniform/doc/3200-MultistateFRNote.doc.

[35] *See infra* notes 63–70 and accompanying text.

[36] For example, the Ninth Circuit upheld one lock-in/lock-out clause that stated the borrower "shall not have the right to prepay the principal amount hereof in whole or in part" for the first twelve years of the loan. Trident Ctr. v. Conn. Gen. Life Ins. Co., 847 F.2d 564, 568–70 (9th Cir. 1988).

[37] *See generally* Whitman, *supra* note 8, at 863–69.

[38] *See, e.g.*, Houston N. Hosp. Props. v. Telco Leasing, Inc., 680 F.2d 19, 22–23 (5th Cir. 1982) (upholding the results of such a negotiation and noting: "Having a good investment that did not require acceptance of prepayment, [the lender] could use market tactics to exact a profit."), *aff'd on reh'g*, 688 F.2d 408 (5th Cir. 1982); Tyler v. Equitable Life Assur. Soc'y, 512 So. 2d 55 (Ala. 1987); *see also* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.2 (1997) ("[A]n agreement that prohibits payment of the mortgage obligation prior to maturity is enforceable."); *c.f.* Mahoney v. Furches, 468 A.2d 458, 461 (Pa. 1983) (refusing to enforce lock-out where the note was silent on the issue); Cont'l Sec. Corp. v. Shenandoah Nursing Home P'ship., 193 B.R. 769, 776 (D. Va. 1996) (refusing to enforce "the lockout provision, completely uncoupled from some sort of damages provision"). *See generally* Gavin L. Phillips, *Validity and Construction of Provision of Mortgage or Other Real-Estate Financing Contract Prohibiting Prepayment for a Fixed Period of Time,* 81 A.L.R. 4TH 423 (1990).

rower requests to prepay the loan.[39] This strategy might facilitate efficient bargaining to exact a prepayment fee from the borrower that exceeds the lender's actual losses, so long as the borrower simultaneously profits by refinancing at a lower rate or selling the property.[40]

B. Economic Purpose of Mortgage Prepayment Fees

With judicial presumptions and contracts authorizing the right to refuse prepayment altogether, lenders have developed clauses that work to their financial benefit by allowing borrowers to prepay their loan upon the payment of a fee (borrowers call such a fee a "penalty").[41] Borrowers usually voluntarily prepay a mortgage to refinance at a lower interest rate,[42] which is widely recognized by scholars and courts as a risk to lenders.[43] The pri-

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[39] *See* Whitman, *supra* note 8, at 863 ("The lender may well be amenable to accepting prepayment during [the lock-in/lock-out] period but may negotiate a sizeable fee as the price of doing so.").

[40] *See id.* Professor Whitman noted that:

> These clauses are designed to protect the lender's investment in situations in which market rates have fallen at the time of a proposed prepayment; if rates have risen instead, the lender will normally be eager to waive the prohibition and accept the prepayment. Even if rates have fallen, so that the prepayment will produce loss to the lender, the lender may well be amenable to accepting prepayment during this period but may negotiate a sizeable fee as the price of doing so.

Id.; *see also* Nelson & Whitman, *supra* note 2, § 6.1 ("[M]ost mortgagees permit prepayment but exact a fee or 'prepayment penalty' for the 'privilege' of prepaying the loan.").

[41] Charges for prepayment are variously characterized in the cases and articles as "prepayment fees," "prepayment premiums," "prepayment penalties," "prepayment charges," "make whole premiums," and other terms.

[42] *See* Jerry Green & John B. Shoven, *The Effects of Interest Rates on Mortgage Prepayments*, 18 J. MONEY, CREDIT, & BANKING 41 (1986) (demonstrating the relationship between market rates and the probability of prepayment of an existing mortgage); Whitman, *supra* note 8, at 856 (1993) ("When rates fall, borrowers frequently wish to prepay their mortgage loans by obtaining new and cheaper financing from other sources."). *But see* Anthony Pennington-Cross, *Credit History and the Performance of Prime and Nonprime Mortgages*, 27 J. REAL EST. FIN. ECON. 279, 283 (2003) (adding that while a majority of prepayments occur because of refinancing, moving is also a common motive for residential borrowers to prepay a mortgage).

[43] *See* Whitman, *supra* note 8, at 860 ("Both lender and borrower recognize at the time of contracting that in the event the borrower pays the loan prior to maturity, the lender may suffer damage as a consequence. The predominant element of that damage is, of course, the lender's loss of an advantageous interest rate in a market in which rates may have declined since the loan was made."); George Lefcoe, *Yield Maintenance and Defeasance: Two Distinct Paths to Commercial Mortgage Prepayment,* 28 REAL EST. L.J. 202, 202 (2000). A number of courts have concurred. *See, e.g., In re* LHD Realty Corp., 726 F.2d 327, 330 (7th

mary damage to the lender that results from the prepayment is the lower yield that the lender must accept when reinvesting the prepaid principal in a new loan. Assuming interest rates have dropped, the spread between the higher interest rate paid by the borrower who prepaid and the lower interest rate on the new loan by the lender represents lost profit to the lender.[44] Additionally, the lender will incur increased overhead[45] and lost interest during the time it takes to find a reinvestment opportunity.[46]

Prepayment fees have found support from Seventh Circuit Judge Richard Posner[47] as well as prominent mortgage-prepayment scholar Dale A. Whitman based on the principals of law and economics.[48] These proponents have argued that prepayment fees encourage "efficient breaches"—the

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Cir. 1984); *In re* Ridgewood Apts. of Dekalb County, Ltd., 174 B.R. 712, 720–21 (Bankr. S.D. Ohio 1994); Westmark Com. Mortg. Fund IV v. Teenform Assocs., 362 N.J. Super. 336, 344 (2003) (citing U.S. v. Harris, 246 F.3d 566, 573 (6th Cir. 2001)).

[44] *See* Whitman *supra* note 8, at 860. In discussing both the potential gains and losses in prepayment, Professor Whitman has also noted:

> If the prepayment occurs at a time when market rates have risen, the lender will be able to relend the funds more profitably than under the old loan and will experience a gain. However, voluntary prepayments under such circumstances are relatively uncommon, since from the borrower's viewpoint a prepayment "at par" (that is, for the face amount of the loan's balance rather than at a discount) on these facts simply throws away the benefit of an advantageous contract.

Id. at 860 n.29. Interestingly, there seem to be no mortgage contracts that provide for a specified financial inducement to borrowers who prepay when interest rates have risen, thereby allowing the lender to gain a yield higher than the yield on the prepaid loan.

[45] *See id.* at 862 ("The lender may also incur some transaction cost in relending the funds, and in some cases an additional tax liability.").

[46] *See id.* ("Of course, the lender will not hide the money in a mattress . . .; it will be invested in short-term commercial paper, short-maturity United States government obligations, or similar cash-equivalent instruments. These investments will typically carry interest rates a bit lower than commercial mortgage rates—perhaps two to three percent lower.").

[47] *See* Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) (Posner, J.) ("Penalty clauses provide an earnest of performance" and can enhance the debtor's credibility.).

[48] Whitman, *supra* note 8, at 874 n.58 ("It can be argued that liquidated damages clauses which produce awards in excess of actual damages may introduce inefficiencies, since a contracting party who might breach and pay actual damages might not be willing to breach and pay the higher liquidated sum") (citing James A. Weisfield, Note, *"Keep the Change!": A Critique of the No Actual Injury Defense to Liquidated Damages*, 65 WASH. L. REV. 977, 990–91 (1990)); *see also* Debora L. Threedy, *Liquidated and Limited Damages and the Revision of Article 2: An Opportunity to Rethink the U.C.C.'s Treatment of Agreed Remedies*, 27 IDAHO L. REV. 427, 447–48 nn.93–95 (1990).

theory that a party "should be allowed to breach a contract and pay damages, if doing so would be more economically efficient than performing under the contract."[49] Thus, prepayment fees are more advantageous than lock-in/lock-out clauses because the borrower will only pay the fee when the borrower also receives a benefit.[50]

However, opponents of prepayment fees allege that the law and economics arguments fall flat when applied in the consumer context, particularly in the subprime market.[51] While law and economics scholars insist that prepayment fees can be traded for lower interest rates, many borrowers may be unsophisticated and thus unaware of this potential.[52] Even if borrowers are aware, they may be willing to accept the suboptimal choice of a prepayment fee in exchange for the lower interest rate needed to reduce their monthly payments to qualify for the loan altogether.[53] In addition, prepayment fees increase the transaction costs of refinancing, thereby decreasing the probability that the borrower will take advantage of the opportunity, until the benefits of a lower interest rate outweigh the cost of the prepayment fee.[54] This problem can be exacerbated when a borrower in a high-

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[49] BLACK'S LAW DICTIONARY 712 (8th ed. 2004). *See generally* Charles Goetz & Robert Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: A Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977). Some have argued that prepayment is not breach, but rather an alternative form of performance under the terms of the contract. *See infra* text at Part IV.A.

[50] As Professor Whitman explains:

> The borrower who wishes to prepay, and who concludes that prepayment will be advantageous even though he or she must pay full damages as well, should be permitted to do so. If the borrower's calculation of advantage is correct (and nobody is in a better position to judge it), an efficient result will ensue, and society as a whole will be better off.

Whitman, *supra* note 8, at 864–65. For a full discussion on lock-in/lock-out clauses, see *supra* Part II.A.

[51] *See e.g.*, Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 501 (2005) (citing U.S. DEPT. OF HOUSING AND URBAN DEV. CURBING PREDATORY HOME MORTGAGE LENDING 28-30 (2000), *available at* http://www.huduser.org/publications/hsgfin/curbing.html).

[52] *See id.*

[53] *See id.*

[54] *See* JP MORGAN N. AM. CREDIT RESEARCH, GLOBAL STRUCTURED FINANCE RESEARCH: OPTION ONE ISSUER PROFILE AND PREPAYMENT STUDY at 18 (2005), *available at* http://www.securitization.net/pdf/JPMorgan/OptionOne_19Jan05.pdf ("The presence of a prepayment penalty raises the refinancing threshold by increasing the transaction cost of refinancing the loan. On average, the presence of a prepayment penalty reduces the incentive by about 4.0% CRR [conditional repayment rates]."). In practical terms, this disincentive to refinance serves as an impediment to consumers who seek to shop around for the lowest

interest loan later qualifies for a lower interest mortgage because their credit has improved but cannot take advantage of the new rate because of the prepayment fee.[55]

C. Prepayment Fee Clauses: Types and Prevalence

While the debate about the validity and utility of prepayment fees continues, the judicial acceptance of prepayment fees has encouraged their use in the mortgage industry.

The two most prevalent types of prepayment today[56] are the fixed-fee clause for residential mortgages[57] and the yield-maintenance clause for commercial mortgages.[58]

1. Residential Prepayment: The Fixed Fee

In the residential setting, prepayment fees are just one of many disadvantageous terms that affect borrowers.[59]

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interest rate in the market. A rational borrower will not refinance at the lower interest rate unless the advantage of the lower interest rate on the new mortgage exceeds the prepayment fee on the existing mortgage.

55 *See id.*

56 Estimates regarding the prevalence of prepayment fees vary greatly due to the lack of comprehensive data. Pennington-Cross, *supra* note 42, at 300 n.1.

57 The term *residential* is used throughout this Article to refer to non-income-producing properties. The term *commercial* is used to refer to income-producing properties, though such properties may be residential buildings such as apartments or rental homes.

58 *See generally* Whitman, *supra* note 8, at 856. For examples of modern prepayment fee clauses, see Murray, *supra* note 7, at 110–44.

59 During the real-estate boom of the mid-2000s, lenders often used "creative financing" techniques such as adjustable-rate mortgages with "teaser" rates in which an initially low loan payment would greatly increase at a later date. For an in-depth discussion of adjustable-rate mortgages and other alternative financing techniques, for example, Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1096–1102 (2009). When facing foreclosure, borrowers have alleged that they did not "understand the loan structure—and the escalating payments." Veena Trehan, *The Mortgage Market: What Happened?*, NPR, Apr. 26, 2007, http://www.npr.org/templates/story/story.php?storyId=9855669. Further evidence suggests that the growth of subprime lending—lending to borrowers with riskier credit histories than other "prime" borrowers—was rife with deceptive practices. *See* Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, *available at* http://www.nytimes.com/2007/08/26/business/yourmoney/26country.html. Notably, Countrywide Financial, formerly the nation's largest subprime lender, used practices that directed borrowers away from lower-cost loans into loans that were more expensive to homeowners and more profitable to the lender. *See id.*

The most commonly-used, the "fixed fee" clause, calculates the prepayment fee as either a flat-dollar amount or a percentage of the principal remaining on the loan at the time of prepayment.[60] The costs of these fees can vary widely.[61]

The prevalence of prepayment fees has been the subject of extensive discussion. Some have argued that the growth of prepayment fees is tied to the growth of the secondary mortgage market. Historically, the prevalence of residential prepayment fees largely has been the result of the conflicts between lenders and regulators. Notably, prepayment fees nearly disappeared in the 1980s due to regulatory changes at Fannie Mae and Freddie Mac, which eliminated the clauses from their standard forms.[62] Subsequently, however, with the growth of the private, securitized subprime residential mortgage market, which exists outside of the heavily-regulated markets, the use of residential prepayment fees increased.[63] This connection was predicted at least as far back as 1987, when Professor Frank Alexander argued that these two factors would rise concurrently because of the needs of the secondary mortgage market for predictable loan payments.[64] Not surprisingly, evidence suggests that prepayments decrease as prepayment fees increase.[65] However, the process of securitization passes off loans to servicers, who often have no ability to waive prepayment fees, thereby locking borrowers into loans that may simply end up in default.[66]

Others also have attributed the rise of prepayment fees to the growth of the subprime mortgage industry.[67] According to a 2001 Standard and Poor's

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[60] *See* Whitman, *supra* note 8, at 870.

[61] Anecdotal evidence suggests that fees can range from $3,000 to more than $13,000. *See* Simon, *supra* note 6.

[62] *See* NELSON & WHITMAN, *supra* note 2, § 6.1.

[63] Mortgage securitization is the process of aggregating numerous mortgages into securities to be sold to investors who expect regular dividend payments throughout the duration of the mortgage. *See generally* NELSON & WHITMAN, *supra* note 2, § 11.3. Because prepayment interrupts the flow of payments, prepayment is a risk for the lender. This risk has been shown to decrease through the use of prepayment fees. *See infra* note 73 and accompanying text.

[64] *See* Alexander, *supra* note 4, at 330–36.

[65] *See id.*

[66] *See* Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2078–79 (2007).

[67] The reintroduction of prepayment fees has caused an unpleasant surprise for many borrowers. *See* Simon, *supra* note 6. A subprime mortgage is provided to a borrower with a high credit risk. Conversely, a prime mortgage is provided at a lower interest rate to a

survey, 80% of subprime mortgages carried prepayment fees in 2000, up from a mere 50% in 1997.[68] This figure pales in comparison to the measly 2% of loans that carry a prepayment penalty on prime loans issued to low-risk borrowers.[69] Consumer activists allege that the connection between subprime lending and prepayment fees demonstrates a predatory lending practice that works to the detriment of less-financially-sophisticated borrowers who have fewer options.[70]

In response, lenders argue that subprime borrowers trade prepayment fees for lower interest rates and that prepayment fees are necessary to reduce prepayment risk, which is higher among subprime borrowers.[71] However, predatory-lending activists allege that borrowers receive no added benefit in exchange for the disadvantageous term.[72] Instead, these opponents allege that lenders use prepayment penalties to disincentivize borrowers from refinancing at lower interest rates, a correlation demonstrated by a 2005 JP Morgan report.[73] Predatory-lending opponents also allege that lenders require that cash-poor borrowers add prepayment and refinancing fees of a pre-paid loan to the principal financed by a new loan rather than paying the fees in cash, thus drawing down the equity of the homeowner in an action known as "equity stripping."[74] In light of the meltdown in the

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borrower with a low credit risk. In the middle, an Alt-A borrower carries a risk in between a subprime and prime borrower. *See generally* Pennington-Cross, *supra* note 42.

[68] *See* Hechinger, *supra* note 6. *But cf.* Joe Mattey, *Mortgage Interest Rates, Valuation, and Prepayment Risk*, FRBSF ECON. LETTER 98-30, Oct. 9, 1998, *available at* http://www.sf.frb.org/econrsrch/wklyltr/wklyltr98/el98-30.html (finding that between 1992 and 1996, "conventional mortgages [were] prepayable at the option of the borrower.").

[69] *See* Engel & McCoy, *supra* note 4, at 734 & n.30.

[70] *See, e.g.*, Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002).

[71] *See* Richard F. DeMong & James E. Burroughs, *Prepayment Fees Lead to Lower Interest Rates* (Univ. of Va. McIntire Sch. of Com.) (unpublished working paper), http://www.commerce.virginia.edu/faculty_research/faculty_homepages/DeMong/PrepaymentsandInterestRates.pdf (last visited Oct. 7, 2009); Pennington-Cross, *supra* note 42; *see also* Henry C. McCall III & Len Blum, *Evolution of the B&C Home Equity Loan Securities Market*, ASSET BACKED SECURITIES 137–46, 141 (Anand K. Bhattacharya & Frank J. Fabozzi eds., Wiley 1996); JOHN C. WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT (1997).

[72] *See* KEITH ERNST, NO INTEREST RATE BENEFITS FROM SUBPRIME PREPAYMENT PENALTIES (Cent. for Responsible Lending Research Report) (2005), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/rr005-PPP_Interest_Rate-0105.pdf.

[73] *See supra* note 54, at 18.

[74] As Professor McCoy explained:

subprime mortgage market in 2007, even Federal Reserve Chairman Ben Bernanke has admitted that "misaligned incentives" between borrowers, lenders, and the intermediaries have created perverse results.[75]

2. Commercial Prepayment: The Yield-Maintenance Fee

Despite the numerous problems that residential prepayment fee clauses present, the vast majority of recent prepayment litigation is driven by the commercial prepayment clauses.[76]

In the commercial sector, the "yield-maintenance" clause has become the industry standard.[77] The clause purports to approximate the actual damages suffered by the lender attributable to the prepayment.[78] The damages are calculated as the lower yield the lender will receive because the prepaid

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> Asset-based lending often spawns another abusive practice known as "loan flipping," in which lenders persuade homeowners to refinance their mortgages repeatedly at extremely short intervals, up to three or four times a year. Since the victims are usually cash-poor, any prepayment penalties and "refinancing" charges are wrapped into the old principal and then financed. Predatory lenders manufacture these situations by making asset-based loans in the first place with payments that the borrowers cannot meet. When the borrowers default, as is sure to happen, the lenders offer them an opportunity to escape foreclosure by refinancing. Flipping offers borrowers temporary relief in the form of lower monthly payments by extending the loan maturities. Ultimately, however, the borrowers end up owing higher total principal and interest to the lenders. Thus, "loan flipping" results in "equity stripping," as owners' home equity declines with each refinancing. As equity vanishes and total loan balances rise, the borrowers' ability to refinance with legitimate lenders drops.

McCoy, *supra* note 70, at 1263.

[75] Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, The Subprime Mortgage Market (May 17, 2007), http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm (focusing on the perverse incentives of brokers that erode credit underwriting standards). However, researchers suggest that the long-term effects of unscrupulous lending practices will be detrimental to the mortgage broker because the broker risks receiving no compensation from a borrower who simply walks away or chooses a lender with lower fees. *See* Amany El Anshasy, Gregory Elliehausen & Yoshiaki Shimazaki, Mortgage Brokers and the Subprime Mortgage Market, (May 2004), at 5 (unpublished draft), http://www.ftc.gov/be/seminardocs/0405elliehausen.pdf.

[76] *See* Whitman, *supra* note 8.

[77] *See supra* note 8 and accompanying text.

[78] *See* Whitman, *supra* note 8, at 871 ("[T]he accuracy of this method of measuring the lender's loss may be open to serious criticism; but it does approximate that loss, at least in rough terms."); *cf.* Galowitz, *supra* note 13 (disputing the accuracy of the treasury-flat yield-maintenance formula).

principal must now be reinvested at a lower interest rate.[79] From a financial perspective, this figure is known as the market value of a loan, which is defined as "the amount that [must] be loaned so that the remaining payments on the loan would give the lender a return equal to the current market rate of interest."[80] The market value of a loan differs from the contract or book value of a loan, since a decline in interest rates would require the new loan to have a greater principal than the original loan to receive the same stream of cash flow.[81] Thus, an accurately calculated prepayment fee properly returns this principal deficiency to the lender, thereby making the lender indifferent to prepayment. From an economic perspective, the yield-maintenance clause compensates the lender for the risk-sharing in fixed-rate mortgages, whereby the lender benefits if prevailing interest rates drop, while the borrower benefits if interest rates rise.[82] Thus, a prepayment fee that accurately calculates the lender's actual loss forces the borrower to share with the lender the benefits of the borrower's new loan secured at a lower interest rate.[83]

However, the accuracy of this calculation depends on the reinvestment rate.[84] Lenders often align the reinvestment rate with U.S. Treasury securities with a maturity in relative proximity to the maturity of the prepaid loan.[85] Clauses that simply use the Treasury securities rate are commonly referred to as "treasury-flat" yield-maintenance clauses.[86] While lenders favor the U.S. Treasury rate, in part, because it easily enables the borrower and lender to calculate the appropriate reinvestment rate,[87] some clauses add points to the U.S. Treasury securities rate, likely a byproduct of an informed

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[79] *See* Whitman, *supra* note 8, at 871. A simplified version of a yield-maintenance clause may seek to "fix the fee as the difference between the loan interest rate and the then-current yield on U.S. Treasury notes closest in maturity to the remaining loan term, multiplied by the loan balance and then by the number of years remaining on the loan term." *Id.*

[80] WILLIAM B. BRUEGGEMAN & JEFFERY D. FISHER, REAL ESTATE FINANCE & INVESTMENTS 156 (2008).

[81] *See id.*

[82] *See* Whitman, *supra* note 8.

[83] *See id.* at 871–72.

[84] *See id.*

[85] *See id.*

[86] *See* River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 719 (7th Cir. 2007) (referencing the clause at issue as "treasury-flat"); *see also Treasury-flat Voluntary Prepayment Premiums Survive Attack*, *supra* note 18.

[87] *See id.*

borrower who negotiates for these added points.[88] This latter approach is fairer to the borrower because the additional points narrow the systematic gap between the lower interest Treasury securities and higher interest commercial mortgage.[89]

While prepayment is only a potential outcome during loan origination, if it occurs, it forces borrowers to pay the fees required by the prepayment clause. When commercial borrowers are faced with multi-million dollar prepayment fees from a lender with whom they likely will have no future relationship, challenging the prepayment fee becomes a possibility.[90] Whatever the underlying reasoning, borrowers have proffered various arguments to resist prepayment fees, but these arguments almost always have fallen flat—lenders have dominated decades of prepayment litigation.

D. Judicial Treatment of Prepayment Fee Clauses in Voluntary Prepayment

Prepayment fee clauses are highly controversial,[91] and borrowers often oppose their enforcement.[92] Although courts are hesitant to side with the lender in instances of involuntary prepayment,[93] when the borrower elects to

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[88] Galowitz, *supra* note 13, at 27.

[89] *See id.*

[90] *See* Robert Axelrod & William D. Hamilton, *The Evolution of Cooperation,* 221 SCIENCE (N. S.) 1390 (1981). Given the large number of commercial lenders, it is probably safe to assume that a commercial real estate borrower believes it can find a lender for future transactions other than the lender involved in the current transaction. However, it is possible that a borrower could develop a reputation because of resulting litigation that could follow it into future transactions with other lenders. It is also possible that the borrower foresees no future borrowing whatsoever. *See id.*

[91] *See, e.g.*, RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.1 (1997); Jack F. Bonnano, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U. S.F. L. REV. 267 (1972); Thomas C. Homburger & Matthew K. Phillips, *What You See is Not Always What You Get: The Enforceability of Prepayment Penalties*, 23 J. MARSHALL L. REV. 65, 65 (1989); Debra P. Stark, *Enforcing Prepayment Charges: Case Law and Drafting Suggestions*, 22 REAL PROP. PROB. & TR. J. 549, 557, 559–60 (Fall 1987).

[92] Whitman, *supra* note 8, at 852–56.

[93] Involuntary payment is outside the scope of this Article. For more information on involuntary prepayment, see generally Whitman, *supra* note 8, at nn.138–89 and accompanying text. Reasons for involuntary prepayment include acceleration of debt due to default, acceleration pursuant to a due-on-sale clause, casualty insurance loss, or eminent domain. These mitigating factors and Bankruptcy Code provisions demanding reasonableness of fees for creditors diminish the success of lenders.

voluntarily prepay, courts will generally uphold prepayment fees.[94] Lenders generally argue that the freedom of contract requires that "parties . . . have a broad right to stipulate in their agreement the amount of damages recoverable in the event of a breach" or if the borrower chooses an alternative course of performance.[95] Conversely, borrowers most commonly argue that the prepayment "fee" represents an unenforceable penalty because the amount is an unreasonable estimate of the lender's loss under a liquidated damages analysis.[96]

1. *Prepayment Fees as Unenforceable Penalty Under Liquidated Damages*

While parties are generally free to enter into a contract containing whatever terms they may wish under freedom of contract principles, the penalty doctrine represents a narrow exception that limits the parties' freedom to determine damages in the case of a breach of contract.[97] The penalty doctrine "originated in equity as a means to deal with unfairness and overreaching in the bargaining process."[98] Courts have a long history of applying the penalty doctrine to prepayment fees through application of a liquidated damages analysis.[99] Most commonly, courts apply the liquidated damages

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[94] *See* Whitman, *supra* note 8, at 860 ("attacks by borrowers nearly always fail"). For examples, see *id.* and Murray, *supra* note 7, at 20.

[95] Richard A. Lord**,** *Validity of Provisions for Liquidated Damages, Generally*, *in* 24 WILLISTON ON CONTRACTS § 65:1 (4th ed. 2007). *See generally* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT (1997); P. S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT (Oxford Univ. Press, 1985).

[96] *See infra* notes 177–90 and accompanying text. Some borrowers have argued that the size of the fee or its percentage in relation to the outstanding balance is unconscionable usury. This argument has had only limited success. *See* Whitman, *supra* note 8, at 926.

[97] *See generally* JOHN CALAMARI & JOSEPH M PERILLO, THE LAW OF CONTRACTS § 14-31 (4th ed. 1998).

[98] HOWARD O. HUNTER, MODERN LAW OF CONTRACTS: BREACHES AND REMEDIES § 10.02[1] (1986).

[99] The court in *Goodyear Shoe Machinery Co. v. Selz, Schwab & Co.*, 51 Ill. App. 390 (Ill. App. Ct. 1893), *aff'd*, 41 N.E. 625 (Ill. 1894) held that prepayment provisions are analyzed as liquidated damages clauses. The court explained:

> There are few subjects upon which there have been more apparently conflicting decisions than on the subject of whether an agreement to pay or deduct a fixed sum as a compensation for prepayment . . . is to be considered as liquidated damages, an agreed reward, or as a penalty. This arises from the fact that in all this class of cases there has been an attempt by courts of law to shape their rulings so as to, while enforcing a legal right, take into consideration the principles by which a court of equity would be guided in arriving at a conclusion in the same manner. So now, in respect to

analysis provided in the Restatement (Second) on Contracts, which allows parties to specify damages in the contract, "but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss."[100] This analytical framework further provides that a "term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."[101]

However, numerous courts,[102] legal scholars,[103] and economists have criticized this distinction between liquidated damages and penalties.[104] Over a century ago, New York Court of Appeals Judge Charles H. Ruggles admitted that "[t]he ablest judges have declared that they felt themselves embarrassed in ascertaining the principle on which the decisions [distinguishing liquidated damages from penalties] . . . were founded."[105] This distinction has also troubled courts attempting to analyze mortgage

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> undertakings for the payment of so-called liquidated damages for the doing or not doing of certain things, courts of law will take into consideration the intent of the parties and the reasonableness of the contract and, whenever it appears that the stipulated damages were the subject of calculation and adjustment between the parties, and a certain sum was agreed upon and intended as compensation, and is in fact reasonable in amount, such sum will be allowed by the court as liquidated damages.

Id.; see also In re AE Hotel Venture, 321 B.R. 209, 220–21 (Bankr. N.D. Ill. 2005) ("The relevant question under Illinois law, however, is not the size of the liquidated damages amount standing alone. The question is the *relation* between that amount and the projected actual loss.").

[100] RESTATEMENT (SECOND) OF CONTRACTS § 356 (1979).

[101] *Id.*

[102] *See, e.g.*, Evans v. Moseley, 114 P. 374, 375 (Kans. 1911) ("There is no branch of the law on which a unanimity of decision is more difficult to find, or on which more illogical and inconsistent holdings may be found."); Callanan Road Improvement Co. v. Colonial Sand & Stone Co., 72 N.Y.S.2d 194, 196 (1947) ("Many more complex and intrinsically less tractable subjects have been reduced to order; this one, from the struggles of the English judges with it before the Revolution to the present time, remains oddly elusive.").

[103] *See, e.g.*, 11-58 CORBIN ON CONTRACTS § 58.18 (2007); Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351, 366–72 (1978).

[104] *See* Robert Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970) ("Repudiation of obligations should be encouraged where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered"); Charles Goetz & Robert Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

[105] Cotheal v. Talmage, 9 N.Y. 551, 553 (1854) (Ruggles, J., for the court).

prepayments, with several courts[106] citing Professor Whitman's assessment that "[e]ssentially, prepayment fees are nothing more than liquidated damages clauses."[107]

In the 1987 bankruptcy case, *In re Skyler Ridge*,[108] the court analyzed prepayment fees as liquidated damages. Applying Kansas law, the court refused to enforce a yield-maintenance prepayment clause because the calculation failed to reasonably estimate the lender's actual damages as required under a liquidated damages analysis.[109] The early yield-maintenance prepayment calculation at issue in the case subtracted the yield rate on comparable U.S. Treasury securities from the mortgage note rate, and then multiplied this yield spread by the number of years remaining on the loan and by the principal amount being prepaid.[110] The court took particular issue with the reasonableness of the fee upon finding that the yield on the U.S. Treasury securities as a reference point is "systematically lower" than the lender's actual interest rate for a comparable loan.[111] The court did note, however, that U.S. Treasury securities can be used as a reference point "provided that some appropriate adjustment to bring this rate up to the first

[106] *See* River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 721 (7th Cir. 2007); Carlyle Apartments Joint Venture v. AIG Life Ins. Co. 635 A.2d 366, 372 (Md. 1994); Westmark Com. Mortg. Fund IV v. Teenform Assocs., 827 A.2d 1154, 1158–59 (N.J. Super. Ct. App. Div. 2003); s*ee also* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.2 1997.

[107] Whitman, *supra* note 8, at 871. As Professor Whitman explained:

> Two facts in the prepayment context lead inexorably toward this conclusion: first, it is payment on time, rather than early payment with a fee, that the lender primarily desires and for which the lender bargains; and second, prepayment may cause the lender substantial damage, and the fee's obvious purpose is to compensate for that damage. A prepayment is simply a breach of the borrower's primary promise—to pay the loan on schedule—and a court ought not permit the drafter of the documents to disguise that fact.

Id. at 871–72. However, Professor Whitman notes that outside of bankruptcy, "a freely-bargained prepayment fee clause ought to be enforced against the borrower who makes a voluntary prepayment, irrespective of the amount of money that the lender's clause demands." *Id.* at 890.

[108] 80 B.R. 500 (Bankr. C.D. Cal. 1987).

[109] *See id.* at 511–12.

[110] *See id.* at 502. The clause also contained a 1% "floor" fee, though the floor was not at issue since the yield-maintenance calculation was the higher fee demanded by the lender. *See id.* at 505.

[111] *See id.* at 505 ("The interest rate 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.").

mortgage rate were included."[112] The court also was critical of the lender's failure to reduce the interest payments due upon prepayment to their present value.[113]

Similarly, the 1988 bankruptcy decision, *In re Kroh Brothers Development Co.*,[114] held an identical yield-maintenance clause unreasonable under Missouri liquidated damages analysis.[115] Unlike the court in *Skyler Ridge*, which only rejected the prepayment fee under state liquidated damages law, the *Kroh Brothers* court also declared the fee ineligible for status as a secured lien under the Bankruptcy Code.[116] However, the *Kroh Brothers* holding is distinguishable from any case that arises out of a voluntary prepayment dispute because a voluntary prepayment likely will not be subject to the Bankruptcy Code and its section 506(b) reasonable requirement for secured liens.[117] In addition, scholars have criticized *Skyler Ridge* and *Kroh Brothers*, arguing that the court required too strict of a "reasonableness" standard under a liquidated damages analysis.[118] Numerous courts have expressly rejected the reasoning used in both cases.[119]

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[112] *Id.*

[113] *See id.*

[114] 88 B.R. 997 (Bankr. W.D. Mo. 1988).

[115] *See id.* at 1000 ("The MBL prepayment formula is identical to the formula used by the parties in *Skyler Ridge.*").

[116] *See id.* at 1002. The court also noted that the prepayment fee at issue was a 25% charge and therefore unreasonable "under a guideline established by the cases [that] . . . at most a 10% prepayment charge could be considered within the realm of reasonable." *Id.*

[117] *See* 11 U.S.C.A. § 506(b) (2005) ("To the extent that an allowed secured claim is secured by property the value of which. . . is greater than the amount of such claim, there shall be allowed to the holder of such claim. . . any reasonable fees, costs, or charges provided for under the agreement. . . ."). *See generally* Murray, *supra* note 7, at 1–29.

[118] For example, Debra Pogrund Stark, a professor of law at The John Marshall Law School of Chicago and attorney who represents lenders, has become a leading critic of these cases. She argues that the courts ignored judicial precedent and applied a requirement that was too strict on lenders, requiring them to perfectly, rather than reasonably, estimate damages. *See* Debra P. Stark, *New Developments in Enforcing Prepayment Charges After an Acceleration of a Mortgage Loan*, 26 REAL PROP. PROB. & TR. J. 213, 234 (1991) ("[B]oth bankruptcy and nonbankruptcy courts have recently repudiated the flawed *Skyler Ridge* analysis, which in essence required a perfect estimate of the lender's damages rather than a reasonable one."); *see also* Debra P. Stark, *Prepayment Charges in Jeopardy: The Unhappy and Uncertain Legacy of In re* Skyler Ridge, 24 REAL PROP. PROB. & TR. J. 191, 201 (1989) ("A perfect calculation cannot be achieved because, contrary to the court's assumption, a standard first mortgage interest rate on commercial loans does not exist and, even if it did, utilization of such a standard might not make the lender whole.").

[119] *See generally* Murray, *supra* note 7.

2. Prepayment Fees as Enforceable Penalty Under Freedom of Contract

While the cases that use a liquidated damages analysis to reject prepayment fees present an interesting viewpoint, the majority of courts have upheld voluntary prepayment fees.[120] The reasoning behind these disparate cases highlights the conflict between those legal doctrines that are invoked by borrowers seeking to avoid prepayment fees under a liquidated damages analysis and those invoked by lenders to defend their practices under freedom of contract principals.

One of the earliest important cases to uphold a prepayment fee under the freedom of contract principle was the 1971 decision in *Lazzareschi Investment Co. v. San Francisco Federal Savings & Loan Ass'n*.[121] In that case, a California state court upheld a prepayment fee in a commercial loan despite the fact that interest rates had risen since the signing of the mortgage.[122] While not foreclosing the possibility that a prepayment fee could be exorbitant, the court noted that:

> [A] prepayment case does not fall into a simple calculation at any one point of time of the difference between the interest rate on the repaid loan and that which might be available to the lending institution on a new loan of about the same size made to a new borrower.[123]

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[120] *See* Murray, *supra* note 7, at 25–26 (citing, among others, *In re* LHD Realty Corp., 726 F.2d 327, 330 (7th Cir. 1984); In re United Merchs. & Mfrs., Inc., 674 F.2d 134, 143–44 (2d Cir. 1982); Continental Secs. Corp. v. Shenandoah Nursing Home P'ship, 193 B.R. 769, 775 (W.D. Va. 1996); *In re* Duralite Truck Body & Container Corp., 153 B.R. 708, 713 (Bankr. D. Md. 1993); Travelers Ins. Co. v. 100 LaSalle Assoc., No. 90-C-4778, 1991 U.S. Dist. Lexis 1903, at *8–*9 (Bankr. N.D. Ill. 1991); *In re* 433 S. Beverly Drive, 117 B.R. 564, 568 (Bankr. C.D. Cal. 1990); *In re* Schaumburg Hotel Owner Ltd. P'ship, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989)).

[121] 99 Cal. Rptr. 417 (1971).

[122] The clause at issue read:

> Privilege is reserved to make additional payments on the principal of this indebtedness at any time without penalty, except that as to any such payments made which exceed twenty percentum (20%) of the original principal amount of this loan during any successive twelve (12) month period beginning with the date of this promissory note, the undersigned agrees to pay, as consideration for the acceptance of such prepayment, six (6) months advance interest on that part of the aggregate amount of all prepayments in excess of such twenty percentum (20%).

Id. at 418.

[123] *Id.* at 421.

The *Lazzareschi* court did not address directly whether the damages were an accurate calculation of the lender's true loss.[124]

Later cases upheld prepayment fees under the freedom of contract principle by treating the fees as something other than damages. For example, in the 1990 bankruptcy case, *In re A.J. Lane & Co., Inc.*,[125] the court refused to treat prepayment fees as a penalty for breach, holding that prepayment is simply an alternative form of performance under the terms of the contract. The court reasoned that "[u]nder a true alternative contract, performance does not, of itself, constitute a breach of the other alternative promise. Yet that is what prepayment constitutes. An alternative contract, moreover, is one in which either alternative is equally open to the promissor."[126]

In another example, the 1992 bankruptcy decision, *In re Financial Center Associates*,[127] upheld a prepayment fee in a commercial mortgage. The court expressly refused to follow the liquidated damages analysis in *Skyler Ridge*, in part because "*Skyler Ridge* appears to limit the freedom of contract of the parties by replacing the parties' judgment regarding the appropriate discount rate with the court's view of the appropriate discount rate."[128]

One court even applied an economics rationale in upholding a prepayment fee under the freedom of contract principle. In the 1994 decision of *Carlyle Apartments Joint Venture v. AIG Life Insurance*,[129] the court treated a voluntary prepayment as ineligible for a liquidated damages analysis because the prepayment was permitted by the mortgage documents. Quoting Professor Whitman's economic and legal analysis that prepayment fees encourage efficient breach, the court found that "no matter how great the apparent overcompensation that the clause gives the lender, the practical amount of overcompensation in any voluntary prepayment case will be limited to some portion of present value of the borrower's opportunity to refinance at a below-market rate."[130]

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[124] *Lazzareschi* was decided before *Kroh Brothers* and *Skyler Ridge* declared a prepayment fee to be an unenforceable penalty.

[125] 113 B.R. 821 (Bankr. D. Mass. 1990).

[126] *Id.* (citing WILLISTON ON CONTRACTS § 781 (3d ed. 1961)).

[127] 140 B.R. 829 (Bankr. E.D. N.Y. 1992).

[128] *Id.* at 837.

[129] 635 A.2d 366 (Md. 1994). ("This is not a case in which prepayment was merely conceivably possible when the contract was formed. Carlyle demonstrated by its conduct that alternative performance by prepayment became 'more desirable.'") (citing WILLISTON ON CONTRACTS § 781(3d ed. 1961)).

[130] *Id.* at 372 (quoting Whitman, *supra* note 8, at 904).

These cases represent the dominance of lenders in enforcing prepayment fees through the freedom of contract principle—a dominance that, until 2006, had been undisturbed by a borrower who voluntarily prepaid the mortgage.[131]

III. THE ATTACK ON PREPAYMENT FEES IN *RIVER EAST*

The long history of conflict over prepayment fees was revisited in *River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co*.[132] The case was watched closely precisely because the voluntary prepayment at issue is so common.[133] In 1999, River East Plaza, L.L.C. (REP)[134] borrowed $12.7 million from Variable Annuity Life Insurance Company (VALIC)[135] to finance the purchase of a share of a Chicago development at an interest rate of 8.02%.[136] At the time the loan was originated, the interest rate was 127 points (one basis point equals 0.01%) above the interest rate on Treasury securities.[137] The mortgage contained a treasury-flat yield-maintenance prepayment clause that calculated the lender's loss as "the difference between what VALIC *would have* received in interest over the life of the loan and what VALIC *could receive* by investing the prepaid principal into Treasuries."[138] Four years after the loan was originated, REP sold the prop-

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[131] *See* Thorpe, *supra* note 18.

[132] No. 03-C-4354, 2006 WL 2787483 (N.D. Ill. 2006), *rev'd and remanded*, 498 F.3d 718 (7th Cir. 2007).

[133] For examples highlighting how closely lenders and attorneys watched the *River East* case, see *supra* note 18. For a discussion of the prevalence of the yield-maintenance clause prepayment, see *supra* notes 56–89 and accompanying text.

[134] River East Plaza, L.L.C. was known as MCL Clybourn Square South, L.L.C. at the time of contracting. *See River East,* 2006 WL 2787483 at *1–*2.

[135] VALIC is a subsidiary of American International Group (AIG), Inc.

[136] *See River East*, 498 F.3d at 722.

[137] The interest rate at the time the loan was originated was 6.75%. *See River East Plaza,* 2006 WL 2787483 at *6. The rate of 127 points "is the amount, referred to as the differential or discount rate, that would be added to the rate at that date to make VALIC financially 'indifferent' to the proposed prepayment [under the yield maintenance clause] because VALIC would be fully compensated as though the loan had been paid over the entire term." *Id*.

[138] River East, 498 F.3d at 720 (emphasis in original). The Seventh Circuit explained that this would be the result "[i]f River East decided to exercise the privilege of prepayment and interest rates had fallen since the time that the loan was funded," and continued:

> Assuming that VALIC placed the unexpected principal into Treasuries and received the prepayment fee from River East, the expected yield that VALIC bargained for would be "maintained" by River East supplementing the interest on the reinvested funds with the prepayment fee. If, however,

erty to Costco and opted to voluntarily prepay the outstanding principal of $12.3 million.[139] Since interest rates on Treasury securities had dropped 200 basis points to 4.75%,[140] REP paid the $3.8 million required by the prepayment clause in addition to the remaining principal on the loan.[141]

REP brought suit in the United States District Court for the Northern District of Illinois to recover the prepayment fee, alleging that the yield-maintenance prepayment calculation was an unenforceable penalty under a liquidated damages analysis.[142] Siding with REP the district court applied the Illinois liquidated damages analysis[143] to find that the treasury-flat calculation was "not reasonable at the time of contracting and did not bear some relation to the damages which might have been sustained."[144] Accordingly, the district court ruled in favor of REP declaring that the yield-maintenance clause at issue was an unenforceable penalty.[145]

On appeal to the Seventh Circuit, VALIC argued that the district court erred by applying a liquidated damages analysis altogether, or that in the

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> River East prepaid the loan and interest rates had risen substantially in the interim, the interest on the Treasuries would presumably exceed the interest rate called for in the loan and the prepayment fee would equal the minimum fee of one percent of the outstanding principal. But in no case would the fee exceed the maximum interest rate allowed by law.

Id. The yield-maintenance clause also provided a minimum prepayment fee of 1% of the then outstanding principal. *See id.* at 719.

139 *See River East Plaza,* 2006 WL 2787483 at *5, *13.

140 *See id.* at *5.

141 *See River East*, 498 F.3d at 726. As the Seventh Circuit admitted, "the math is perplexing." *Id.* The $3,886,679.00 prepayment premium seems to represent 31.58% of the then outstanding principal ($3,886,679.00 prepayment premium divided by the outstanding principal of $12,301,215.38). While the District Court found the percentage to be important, the Seventh Circuit did not mention the percentage as a factor in their analysis. *Compare River East Plaza*, 2006 WL 2787483 at *5 ("The Statement included a prepayment premium due of $4,713,601.27, an amount equal to approximately 38.32% of the outstanding principal balance of the Loan (which then was $12,301,215.38)") *with River East*, 498 F.3d 718 (containing no reference to the percentage of prepayment in relation to the principal).

142 First Amended Complaint at *1, *River East Plaza*, 2006 WL 2787483 (No. 03-C-4354).

143 Illinois law applies the Restatement Second of Contracts analysis for liquidated damages. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356(1) cmt. a (1981).

144 *River East Plaza*, 2006 WL 2787483, at *12.

145 *See id.* ("[T]he amount provided in the [treasury-flat yield-maintenance] prepayment provision . . . was not reasonable at the time of contracting and did not bear some relation to the damages which might have been sustained . . . . Accordingly, this part of the prepayment provision based on the yield-maintenance clause is a penalty and is unenforceable.").

alternative, by finding the clause unreasonable under that analysis.[146] VALIC asserted that instead, freedom of contract principles should control because "Illinois would consider the [prepayment fee] clause to be a bargained-for form of alternative performance."[147]

The Seventh Circuit applied Illinois state law, which does not enforce "some liquidated damages clauses [that] cross the line and become penalty clauses in disguise."[148] However, to determine whether the prepayment clause represented liquidated damages, or simply an alternative form of performance under the contract, the circuit court compared "the relative value of the alternatives" of performance to determine whether the prepayment clause served solely to assure contract performance and thus, is "punitive in nature."[149] To distinguish between penalties and alternative forms of performance under the contract, the "relative value of the alternatives may be decisive."[150]

In comparing the alternatives—prepaying with a fee or continuing to pay as scheduled under the loan—the Seventh Circuit failed to accept REP's argument that the prepayment results in a windfall to the lender. REP attempted to point out the windfall by arguing that VALIC can "reinvest the returned principal and eventually get an even greater income stream from somebody else than it would have received from River East."[151] The court

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[146] *See River East*, 498 F.3d at 721. If the court were to find the clause enforceable, the court also planned to address "whether the amount refunded by VALIC was the correct amount" and "whether River East or McLean owes costs and fees to VALIC." *Id.* This Article focuses largely on the enforceability addressed by the first issue on appeal.

[147] *Id.* (*citing* Brief of Appellant at 16–19, *River East,* 498 F.3d 718 (No. 06-3856), 2007 WL 185876.

[148] *River East,* 498 F.3d at 722 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981)).

[149] *River East*, 498 F.3d at 722 ("[W]hen the sole purpose of the clause is to secure performance of the contract, the provision is an unenforceable penalty") (quoting Checkers Eight Ltd. P'ship v. Hawkins, 241 F.3d 558, 562 (7th Cir. 2001)).

[150] *Id.* at 723 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt c).

[151] *River East,* 498 F.3d at 723. *Id.* at 722–23. The circuit court compared the $13 million in interest that would be due as compared to the $3.9 million that REP paid, stating:

> Even assuming, due to the time value of money, that the $3.9 million was worth more in 2003 than it would have been worth over the course of the loan, River East seems to have benefited from this bargain. . . . This hardly seems to be a clause whose "sole purpose is to secure performance of the contract."

Id. (quoting *Checkers Eight*, 241 F.3d at 562).

The court went on to note:

> Reality, we might suspect, will be different. One might believe, and expert testimony at trial supported this belief, that interest rates on commercial real

rejected this assertion, and opined that "River East seems to have benefited from this bargain."[152] The court then compared REP's benefits to the three options that VALIC could pursue with REP's prepaid principal and prepayment fee:

> (1) reinvest it in Treasuries (in which case it would be no worse off), (2) hold it as cash (in which case its income would be less than bargained for from River East), or (3) invest it in additional real estate mortgages with their attendant higher risks of default. The relative value of the alternatives for both parties leads us to believe that the clause is not punitive in nature.[153]

Thus, the court dismissed a liquidated damages analysis by finding that "under any ordinary view of the contract's unambiguous terms, the prepayment is not a breach: the parties explicitly provided that River East would be allowed to prepay."[154] Although the Seventh Circuit admitted that some

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> estate loans will almost always exceed the interest rates on Treasuries. This spread in interest rates gives VALIC a chance to profit from the prepayment. The argument goes that sophisticated lenders like VALIC will not invest the returned principal in Treasuries, but will simply line up a new commercial real estate loan. But there is an irony to this argument. In trying to argue that the prepayment clause is a penalty, which by definition is a clause whose sole purpose is to secure the performance of the contract, River East argues that VALIC would have been effectively worse off if the contract had been repaid over the term of the loan instead of prepaid.

Id.

[152] *Id.* at 722–23. The circuit court compared the $13 million in interest that would be due as compared to the $3.9 million that REP paid, stating:

> Even assuming, due to the time value of money, that the $3.9 million was worth more in 2003 than it would have been worth over the course of the loan, River East seems to have benefited from this bargain. . . . This hardly seems to be a clause whose "sole purpose is to secure performance of the contract."

Id. (quoting *Checkers Eight*, 241 F.3d at 562).

[153] *River East*, 498 F.3d at 724.

[154] *Id.* The court continued, "[t]he fee for prepaying seems a long stretch from damages for a breach if both parties entered the contract believing that the contract allowed River East to prepay." *Id.* The court quoted Professor Whitman:"'[S]tate courts have ignored the law of liquidated damages (perhaps appropriately) when faced with the issue of the validity of prepayment fee clauses. . . . [A] freely-bargained prepayment fee clause ought to be enforced against the borrower who makes a voluntary prepayment, irrespective of the amount of money that the lender's clause demands.'" *Id.* (quoting Whitman, *supra* note 8, at 890).

The court also rejected the bankruptcy and acceleration cases that had applied liquidated damage analyses to declare a prepayment fee unenforceable, finding that involuntary prepayment analysis is irrelevant for a voluntary prepayment. *River East*, 498 F.3d at 724–25 lenders have added twenty-five to fifty basis points to the Treasury-based yield-maintenance calculation to increase the fairness to the borrower, the court ultimately observed that under REP's argument, even such lenders "would have made an 'unreasonable' fee . . . because the fee would allow them to recover more from their future investments than they would have from the original borrower."[155]

Accordingly, the Seventh Circuit reversed the lower court, holding that the prepayment fee was enforceable.[156] This declaration is followed by dicta that suggests the court sought to take a conservative path.[157] Abdicating their power as a federal court, the Seventh Circuit concluded that the "responsibility for making innovations in the common law of Illinois rests with the [state] courts of Illinois . . . ."[158]

IV. ANALYSIS OF PREPAYMENT FEES IN THE AFTERMATH OF *RIVER EAST*

The decision in *River East* has far-reaching effects for both commercial and residential borrowers who seek judicial protection from disadvantageous prepayment penalties.

As the court in *River East* demonstrated, no matter how gross the overcompensation to the lender, courts simply can declare the prepayment clause to be an alternative course of performance not subject to liquidated damages scrutiny. This judicial side-step is so powerful that even the

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(noting that a case the district court relied upon, Automotive Fin. Corp. v. Ridge Chrysler Plymouth, 219 F. Supp. 2d 945 (N.D. Ill. 2002), is irrelevant because it in turn relied upon precedent in *In re* LHD Realty Corp, 726 F.2d 327, 330 (7th Cir. 1984), an Indiana bankruptcy case that involved lender acceleration of the note rather than voluntary borrower prepayment).

[155] *Id.* at 725. The Seventh Circuit observed:

> River East considers the clause unreasonable because the lender will almost always be able to re-lend the principal at a rate higher than the Treasury rate, because commercial real estate loans frequently carry a rate higher than the treasury rate.

Id.

[156] *See id.* at 725 ("In short, we hold that VALIC is entitled to judgment as a matter of law on River East's first count of the complaint.").

[157] "[A] contrary result would have broad implications for both lenders and borrowers of mortgage-secured loans in Illinois, and might inadvertently effect a wide-ranging alteration of the law of real estate financing in Illinois." *Id.* at 725–26. *See* Boyle, *supra* note 15, at 608. Interestingly, the Seventh Circuit did not certify the question to be answered by the Supreme Court of Illinois.

[158] *River East*, 498 F.3d at 726 (citing Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985)).

Seventh Circuit was able to feign ignorance of the gross overcompensation hidden within the treasury-flat yield-maintenance calculation. *River East* also begs the question of why borrowers continue to agree to disadvantageous prepayment fee clauses.

A. Residential and Commercial Prepayment Fees Are an Alternative Course of Performance Not Subject to Liquidated Damages Analysis

As the Seventh Circuit made clear, the judicial dominance of lenders arguing for the freedom of contract principles is appropriate when applied to prepayment fees, which continue to be viewed as an alternative course of performance. The freedom of contract principles were reinforced by that court's unwillingness to assess whether the prepayment clause amounted to a penalty, and preference to let the written agreement of a borrower and lender supersede the court's judgment.[159] Unless courts are willing to question the wisdom of the perfect tender in time rule or a lock-in/lock-out clause, there seems to be no public policy rationale for courts to interfere with lenders who charge a fee to solvent debtors for the waiver of the lender's right to refuse prepayment.

There is also little reason to believe that *River East* is limited to commercial borrowers. Rather, the unreasonable estimate of the lender's actual damages, found when the *River East Plaza* district court applied a liquidated damages analysis, equally could apply to residential borrowers.[160] Thus, the Seventh Circuit reversal of the district court's liquidated damages approach and declaration that prepayment is an alternative course of performance has significance for future litigation for both commercial and residential borrowers alike.[161]

B. *River East* Perpetuated the Myth that the Yield-Maintenance Clause Accurately Measures the Lender's Loss

The primary flaw in the Seventh Circuit's decision is its perpetuation of the myth that the treasury-flat yield-maintenance clause accurately calculates the lender's loss.[162] Experts in finance unequivocally have found that the calculation always results in a windfall to the lender.[163]

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[159] *See River East*, 498 F.3d at 724.

[160] *See* Boyle *supra* note 15, at 609.

[161] *Id.*

[162] *See supra* Part III.

[163] *See* Galowitz, *supra* note 13, at 28 (describing the "built in gap" between the lenders true loss and the treasury-flat yield-maintenance calculation).

1. Seventh Circuit's Comparison of Lender's Possible Reinvestment Strategies Conflicts with Principles of Finance

The court's unwillingness to expose the myth that prepayment accurately calculates the lender's loss is highlighted by the court's analysis of the relative values of the lender's possible reinvestment strategies.[164]

First, the court reviewed the lender's option of reinvesting the prepayment in Treasuries, finding that the lender "would be no worse off."[165] This statement is in direct contradiction to the teachings of finance, which assume that between two investments that produce the same return, lenders always prefer the investment with lowest risk.[166] The risk premium on a given investment is calculated as the spread between the interest rate on the given, riskier investment and the interest rate on a risk-free investment, which finance generally defines as the interest rate on virtually risk-free U.S. treasury securities.[167] This spread will vary depending primarily upon the risk that the borrower will default on repayment and the possibility that foreclosure of the underlying collateral will yield less than the debt owed.[168] This relationship is known as the "risk-return-tradeoff," which describes the principle that "invested money can render higher profits only if it is subject to the possibility of being lost."[169] By investing in risk-free Treasuries and receiving the income stream that accompanies higher-risk commercial mortgages, the lender has reduced its risk without reducing the return.[170] Contrary to the Seventh Circuit's assessment, the lender does benefit by eliminating the various lending risks.

Second, the court reasoned that the lender could hold the prepayment as cash, in which case the lender's income would be less than what was bargained for from the borrower.[171] While the court is correct that the lender would suffer a loss in this situation, the idea that a sophisticated lender

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164 *See River East*, 498 F.3d at 724.

165 *Id.*

166 *See supra* note 24 and accompanying text.

167 *Id.* Any disagreement over the characterization of Treasuries as "risk-free" is outside the scope of this Article.

168 *See, e.g.*, River East Plaza L.L.C. v. Variable Annuity Life Ins. Co., No. 03-C-4354, 2006 WL 2787483 at *6 (N.D. Ill. Sept. 22, 2006). ("A CREM loan compensates the lender for taking the comparatively higher risks of default and impairment to collateral by receiving a premium interest rate.")

169 *Risk-Return Tradeoff*, INVESTOPEDIA: A FORBES DIGITAL COMPANY, http://www.investopedia.com/terms/r/riskreturntradeoff.asp (last visited Oct. 6, 2009).

170 *See* Galowitz, *supra* note 13, at 27.

171 *See id.*

would be holding a multi-million dollar prepayment as cash for the duration of a multi-year loan ignores the realities of commerce.

Finally, the court assessed the most likely scenario, in which the lender would invest the prepayment in additional real estate mortgages, explaining that the lender would thus be subject to the "attendant higher risks of default."[172] In reality, this scenario results in a windfall to the lender because the risk premium that accompanies the higher risk has already been paid by the first borrower and will be paid again by the second borrower.[173] The first portion of this double recovery of the risk premium comes when the original borrower prepays the mortgage and the required prepayment fee, which allows the lender to collect the risk premium, calculated as the spread between risk-free treasuries and the higher risk commercial mortgage that is then being prepaid.[174] The lender then recovers the risk premium a second time by reinvesting that payment in a second loan, thereby charging a second borrower an interest rate that exceeds the rate on risk-free treasuries.[175] This risk premium is incorporated into the second loan even though the previous borrower paid that risk premium in the yield-maintenance prepayment.[176] By creating a higher return without higher risk, this highly likely scenario results in a windfall to the lender.

2. *Scholarly Rejection of Treasury-Flat and* River East*'s Analysis*

Scholars in the field concur that the Seventh Circuit's analysis of the relative values missed the mark in its failure to recognize the realities of the treasury-flat prepayment clause. Notably, leading real estate finance scholar Dale A. Whitman commented that the Seventh Circuit was "disingenuous" in finding no difference between the relative values of prepayment and payment over the duration of the loan.[177] Rather, he concluded that "without doubt, if the loan had stayed in place, the lender would have made less profit overall than they got from the prepayment."[178] Professor Whitman's anal-

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[172] *River East*, 498 F.3d at 724.

[173] *See* Galowitz, *supra* note 13, at 28 (describing the "built in gap" between the lenders true loss and the treasury-flat yield-maintenance calculation). *See generally* BREALEY, MEYERS & ALLEN, *supra* note 24.

[174] *See* Galowitz, *supra* note 13, at 28.

[175] *See id.*

[176] *See id.*

[177] *See* Teleconference: Prepayment Fees in the Aftermath of *River East*, ABA Section of Real Property, Trust & Estate Law, Mortgage Lending Committee, Oct. 10, 2007 (audio recording on file with author).

[178] *Id.*

ysis should be given extraordinary weight, considering that the borrower, lender, and Seventh Circuit in *River East* all cited his leading law review article on prepayment fees under the belief that his article supported their conclusions.[179]

Professor Whitman does not stand as the lone scholar to criticize the treasury-flat analysis. On a broader level, Sam W. Galowitz insightfully described in *The Myth of the Yield Maintenance Formula* that “the yield maintenance . . . technique . . . will provide a far higher yield to the lender in the event of a prepayment than the lender would have received had the loan been paid as agreed.”[180]

3. Alternatives to Treasuries to Measure of Yield Spread

In light of the Seventh Circuit’s analysis and scholarly discussion on the topic, courts should consider changes in the measurement of prepayment fees. Courts should not continue to accept the legal fiction that a lender in the business of commercial mortgages will invest the prepayment fees in Treasury securities, thereby receiving the same yield that it would have on the mortgage. Instead, courts should assess the more likely possibility that the lender will invest in another loan of comparable risk.

The Seventh Circuit missed an opportunity to advance legal thought when it failed to recognize that the treasury-flat calculation results in the likely double-recovery of the risk premium without the lender actually accepting the risk. Courts should be willing to review the fairness of the reinvestment-rate calculation by comparing the treasury-flat rate to other easily-accessible indices such as the prime rate at major commercial banks, LIBOR, federal discount, or thirty-day commercial paper.[181] These indices track the interest rates being offered on investments that have risks similar to those associated with commercial mortgages.[182] However, such a change would require lenders and courts to accept mortgage documents that track rates unknown at the time of contracting.

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[179] Both of the parties and the court cited Whitman’s 1993 analysis, *supra* note 8, in support of their reasoning. *See* River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 721, 724 (7th Cir. 2007); Brief of Appellee at 20, 28, 29, 43; *River East*, 498 F.3d 718 (2007) (No. 06-3856), 2006 WL 4085661; Brief of Appellant, *supra* note 147, at 23–26, 42, 43. In its reply brief, the lender claimed that the borrower’s usage of Whitman in its brief was “demonstrably false” and that, in fact, “Whitman agree[s]” with the lender’s argument. Reply Brief of Appellant at 18, *River East*, (No. 06-3856), 2007 WL 701212.

[180] Galowitz, *supra* note 13 at 27.

[181] *See id.* at 31.

[182] *See id.*

4. *Timing the Measurement of the Yield Spread*

Even if courts accept that a yield spread above Treasuries increases the fairness to the borrower, it creates another issue about the appropriate time to determine this spread. The general rule, as defined by the *Restatement (Second) of Contracts*, demands that courts determine reasonableness at the time of contract formation.[183] However, Gregory A. Thorpe, in his article on the *River East* district court decision, argued that the yield spread is best measured at the time of prepayment.[184] Thorpe reasoned that the spread between Treasury rates and mortgage loans varies over time, thus "[a] lender attempting to craft a reasonable spread at the time of entering into the loan might specify a spread based upon the lender's current spreads for similar properties that might be completely different than spreads for such properties at the time of actual prepayment."[185]

The parties should ameliorate this valid concern by utilizing a prepayment clause that measures the spread more accurately in two ways. First, a prepayment clause should measure the spread based on an index that accurately tracks the commercial real estate market.[186] Second, the time that the spread is measured should be based on the time of prepayment, rather than the time of contract formation. Such an approach likely would require courts to utilize a standard outside of that set forth in the *Restatement (Second) of Contracts*.[187]

5. *Courts Should Allow Borrowers to Show that a "Comparable" Loan Would Be Unreasonable, Despite Lenders' Assertions that No "Identical" Loan Will be Made*

Lenders and scholars have resisted the idea that any prepayment formula could accurately measure the lender's future losses because of the unique nature of each loan and inability to forecast the need for a comparable loan at the time of prepayment. For example, in the oral arguments for *River East*, Eric Brunstad, on behalf of the insurer-lender, argued that "at the time of the loan [origination], we do not know in the future if the insurers are going to be able to reinvest in anything other than Treasuries" because of governmental regulations requiring them to keep a balanced portfolio and

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183 *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981); *supra* note 100 and accompanying text.

184 *See* Thorpe, *supra* note 18, at 60–61.

185 *Id.* at 61.

186 For examples of these measures, see *supra* note 181 and accompanying text.

187 *See supra* note 183 and accompanying text.

match their assets to liabilities, "including the riskiness of their assets."[188] Thus, Brunstad argued that insurers need to match their income stream with what they must pay out in the future.[189] This concern was echoed by Thorpe's scholarly dissent to the district court decision, in which he argued that "all commercial real estate is different and that no two loans (and the required underwriting considerations) are identical (the lender may not even be in the loan market at that time)."[190] Thorpe further argues that a lender cannot find the "exact same investment at any time" because:

> Spreads vary depending on the type of property, the location of the property, the property's current leasing status, the current market for mortgage loans in general, the availability of funds, and a wide variety of other factors that lenders take into consideration in setting rates and spreads on their loans, all of which continually vary.[191]

While Thorpe's argument that real estate loans are unique may be true, Brundstad's argument reveals the true desire of the lender: a stream of income. Thus, while a subsequent loan may not be identical, to argue that two loans could never be comparable seems disingenuous considering that the lender desires money, not unique commercial real estate.

Courts should not continue to uphold the legal fiction that prepayment fees are universally enforceable because an identical loan did not exist.[192] Rather, courts should allow borrowers to present evidence that the lender easily could have found a comparable stream of income that would have systematically compensated the lender. Upon shifting the burden, the lender should be free to proffer evidence to dispute the accuracy of the borrower's assessments. Directly addressing whether the litigated prepayment clause is overcompensatory would produce a legal system that reflects financial reali-

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[188] Recording of Oral Argument, River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718 (7th Cir. 2007) (No. 06-3856), http://www.ca7.uscourts.gov/fdocs/docs.fwx?submit=showbr&shofile=06-3856_028.mp3.

[189] *See id.*

[190] Thorpe, *supra* note 18, at 61.

[191] *Id.*

[192] While this Article primarily proposes increased disclosure in combination with the free market to allow borrowers and lenders to decide when prepayment fees should be used, it is worth noting that circumstances such as those in *River East* would still require judicial intervention. As a result, this Article presents a possible model for such judicial interference with privately negotiated prepayment fees.

ties while also creating predictable results based on potential prepayment situations.

Thorpe and others likely would counter that the downside to such an approach would be increased litigation over the financial market and prepayment clause. This argument likely would be valid in the short term, but such an approach might actually decrease litigation if precedent creates predictability. If so, the certainty with which lenders and borrowers could predictably forecast results would reduce transactional legal fees and subsequent litigation. However, if such predictability did not result and litigation merely increased, it would indicate that the market was a better arbiter of the true value of the right to refuse prepayment. Given the valid concerns about this approach in the commercial context, it might be more appropriate to limit such an approach to residential mortgage prepayment fees.[193] In addition, such a proposal would not foreclose the possibility that courts only would provide relief in the minority of situations when the prepayment clause was grossly overcompensatory, barring relief when the prepayment is arguably a reasonable forecast. In any event, this approach would provide an alternative to the current judicial side-step.

C. Questioning the Assumption that Prepayment Fees are a Bargained-for Exchange

Assuming that prepayment fees in both residential and commercial mortgages create a windfall to the lender, the strongest argument for prepayment-fee enforcement is that the fees are a bargained-for exchange.[194] If so, prepayment fee clauses allow borrowers to receive a lower interest rate on the front end by allowing borrowers who voluntarily prepay to provide a fee on the back end that is highly profitable to the lender.[195] An underlying assumption of this argument is that the parties have perfect information—or at least are in a similar position to know the relevant information. In reality,

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[193] It is worth noting that residential fees may be more difficult to justify because the current flat-fee residential clause frequently ignores the lender's actual losses, while the commercial yield-maintenance clause often at least attempts to track the lender's actual damages.

[194] *See* Alexander, *supra* note 4, at 330–31. While there is little data in the commercial sector, other data is in conflict as to whether borrowers benefit by receiving a lower interest rate in exchange for a prepayment fee clause (which benefits the lender). *Compare* Ernst, *supra* note 72 (finding that subprime prepayment penalties conferred no interest rate benefits to borrowers), *with* DeMong & Burroughs, *supra* note 71 (finding that prepayment penalties result in financial benefits to the borrower).

[195] No reliable data exists on the rates of prepayment in the commercial market. For the sake of argument, this Article assumes that the majority of borrowers do not prepay.

information asymmetry favors lenders because they can best calculate the probability of prepayment over a pool of mortgages.[196] They are also in a better position to calculate the cost of the fee, even when there are sophisticated borrowers who are represented by counsel.[197]

To the contrary, borrowers are in the worst position to calculate the true probability of prepayment, and thus, the real cost that they should "bargain for." For example, lenders are aware of how often borrowers in the residential and commercial sectors sell their property or refinance their mortgage based on historical data—information that may be difficult for a borrower to determine. The bargained-for-exchange argument also assumes that the parties are willing to bargain for the term—an assumption that evidence suggests is not always true in the residential sector. In the consumer sector, prepayment fee clauses sometimes are implemented as the result of the classic "signing without reading" problem.[198] For borrowers who fail to read or comprehend these clauses, the assumption that borrowers rationally entered into the contract or bargained for other terms withers away.[199] Even Judge Posner would admit that this situation presents an exception to the freedom of contract principles, in which paternalistic rules may be necessary to curb overreaching in the bargaining process.[200]

D. Psychological Overoptimism and Overconfidence in Borrower Underestimation of Prepayment Risk

Assuming that borrowers are aware that prepayment fees are a windfall for the lender, psychology helps explain why borrowers would be willing to

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[196] This Article presumes that lenders conduct research into the probability of prepayment based on the extensive literature on the subject. *See, e.g.*, Peter Chinloy, *The Probability of Prepayment*, 2 J. REAL EST. FIN. & ECON. 267 (1989).

[197] As seen in *River East*, prepayment calculations are so difficult to compute that an agent for the lender made an error of nearly one-million dollars in the lender's favor that was not noticed by the borrower until long after litigation had commenced. *See River East Plaza L.L.C. v. Variable Annuity Life Ins. Co.*, 498 F.3d 718, 721 (7th Cir. 2007) ("The parties agree that, due to a mathematical error, VALIC's agent had overcharged River East by nearly one million dollars when it computed the prepayment fee. VALIC returned the overcharge, with interest . . .").

[198] GERRIT DE GEEST & FILIP WUYTS, *Penalty Clauses and Liquidated Damages*, 4610 THE ENCYCLOPEDIA OF LAW AND ECONOMICS 141, 147 (1999), *available at* http://users.ugent.be/~gdegeest/4610book.pdf; *see also* EJAN MACKAAY, ECONOMICS OF INFORMATION AND LAW (Kluwer Academic Publishers 1982).

[199] *Id.*

[200] *See* ANTHONY T. KRONMAN AND RICHARD A. POSNER, THE ECONOMICS OF CONTRACT LAW 274 (Little Brown 1979).

agree to such a disadvantageous clause. In particular, the overconfidence and overoptimism cognitive biases cause decision-makers to discount risk and, instead, overestimate the probability that positive results will occur.[201] These psychological biases plague individuals in business, who may be in the market for commercial mortgages, and individuals in general, who may be in the market for residential mortgages.

For both consumers and business decision-makers, the result may be the same. If a borrower believes that the disadvantageous result of prepayment will not happen to them because they are overconfident and overoptimistic, they may be more likely to focus on other terms, such as a lower monthly payment.[202] Thus, these biases undercut the rationale underlying the law and economics argument that prepayment fees represent a bargained-for exchange.

Given these numerous legal, economic, and psychological hurdles to understanding the modern system of prepayment fees, the mortgage system may be ripe for reform to bring regulation in line with reality.

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[201] *See, e.g.*, Neil D. Weinstein, *Optimistic Biases About Personal Risks*, 246 SCIENCE 1232, 1232 (1989); Paul Slovic, *Do Adolescents Know the Risks?,* 47 DUKE L. J. 1133, 1137 (1998) ("Optimistic biases are greatest for hazards judged to be controllable by personal action, such as lifestyle risks."); Paul Slovic, Baruch Fischoff & Sarah Lichtensetin, *Facts Versus Fears: Understanding Perceived Risk*, in JUDGMENTS UNDER UNCERTAINTY 463, at 468–70 (Cambridge Univ. Press, 1982) (describing people's belief in the face of a risk of injury that "it won't happen to me"). As one scholar notes, "What is characterized here, and in much of the law and behavioral science literature, as overoptimism, might more accurately be called denial. Rather than being overoptimistic about their ability to control their finances, people may be in denial about their inability to do so." Lauren E. Willis, *Decisionmaking & the Limits of Disclosure: The Problem of Predatory Lending* (*Working Paper*), 54 American Law & Econ. Ass'n Ann. Meetings, n.117 (2005), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=1525&context=alea.

[202] *See* Willis, *supra* note 201, at n.28.

> Risk impacts pricing on the seller's side because sellers attempt to price loans so as to ensure at least a competitive (if not higher) rate of return, over a pool of loans, based on default and prepayment likelihood (i.e., risk from the seller's perspective) and cost of origination and servicing. Generally, loans with higher probabilities of default should be priced higher to cover the probabilistically anticipated losses of both principal and future interest payment stream caused by default, although equity obtainable at foreclosure can also cover these losses in whole or in part.
>
> From the borrower's perspective, inflated opportunistic price terms can create higher risk terms to the extent that a borrower, who might have a high likelihood of being able to make payments on fair terms, is less likely to be able to afford the monthly payments on an overpriced loan, and therefore is placed at high risk of default.

Id.

E. Review and Prediction of Judicial Treatment in the Aftermath of *River East*

1. Federal Court Decisions Since River East

Since the *River East* decision, the federal courts have addressed prepayment penalties in one notable case, the 2008 Eighth Circuit decision, *Great Plains Real Estate Development, L.L.C. v. Union Central Life Insurance Co*.[203] Applying Iowa law, the court upheld a prepayment penalty in a commercial mortgage document.[204] At the outset, the Eighth Circuit noted that Iowa courts will "ordinarily enforce" the type of commercial mortgage prepayment at issue where the parties are commercial entities represented by counsel.[205] First, the court concluded that prepayment under the terms of the contract is not a breach, but rather an alternative course of performance.[206] Second, the court assessed whether the clause would pass a liquidated damages analysis (though without admitting that such scrutiny is appropriate) by assessing whether the prepayment clause was reasonable at the time of contact formation.[207] The court distinguished the mortgage at issue in the bankruptcy opinion of *In re A.J. Lane & Co.*,[208] which held that a prepayment fee could become an unenforceable penalty if the clause "presumed that a loss would occur, regardless of whether interest rates rose or fell."[209] The *Great Plains* court found that the prepayment clause at issue "did not presume a loss and was calculated based upon prevailing market rates" in an attempt to calculate the lender's actual damages.[210] Thus, the clause would be enforceable "[e]ven if . . . treated as a liquidated damages provision. . . because it constituted a reasonable assessment of the actual or anticipated loss caused by the breach."[211]

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[203] 536 F.3d 939 (8th Cir. 2008). For commentary on the decision, see, for example, *Mortgages: Prepayment Premium Upheld*, 38-Oct Real Est. L. Rep. 5 (2008) and Dan Schechter, *Prepayment Premium in Commercial Promissory Note Is Not Invalid as Liquidated Damages Provision Because It Reflects Lender's Actual Loss Resulting from Prepayment*, 2008 Comm. Fin. News. 68 (Aug. 11, 2008).

[204] *See Great Plains*, F.3d 939 at 944–45.

[205] *See id.* at 945.

[206] *See id.* at 945.

[207] *See id.*

[208] 113 B.R. 821 (Bankr. D. Mass.1990).

[209] *Great Plains*, 536 F.3d at 945.

[210] *Id.*

[211] *Id.*

Interestingly, while the logic tracked the major concepts of *River East*, the *Great Plains* court did not cite that case. Notably, the court came to the same primary conclusion that prepayment is not a breach, but is instead an alternative course of performance provided for in the contract.[212] Also, as in *River East*, the *Great Plains* court assessed whether the clause passed a liquidated damages analysis without admitting that such an analysis would be inappropriate given that there are no damages when there is no breach.[213] This outcome could be a sign that courts recognize that prepayment fees seem particularly appropriate for a liquidated damages analysis, despite the judicial side-step of declaring such prepayment an alternative course of performance under the contract. The failure to cite *River East* even as persuasive authority in a case directly on point could be seen as a sign that the federal courts have not yet accepted *River East Plaza* as a watershed decision.

2. *State Court Decisions Since* River East

The state courts have reached several decisions that shed light on the current state of mortgage prepayment law and the relative importance of *River East Plaza*.

In the state case most analogous to *River East*, *Santa Rosa KM Associates Ltd. v. Principal Life Insurance Co.*,[214] the Kansas Court of Appeals upheld a treasury-flat mortgage prepayment fee when the borrower voluntarily prepaid.[215] At the outset, the court noted that when competent adults freely enter into contracts, parties are generally bound notwithstanding that the bargain may have been unwise or disadvantageous to one of the parties.[216] In addition, the court noted the economic reasoning underlying prepayment fee clauses—that they provide stability and predictability to loan transactions, particularly commercial transactions involving parties represented by counsel.[217]

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[212] *See Great Plains*, 536 F.3d at 945 (quoting Am. Soil Processing, Inc. v. Iowa Underground Storage Tank Fund Bd., 586 N.W.2d 325, 334 (Iowa 1998)).

[213] *See Great Plains*, 536 F.3d at 945.

[214] 206 P.3d 40 (Kan. Ct. App. 2009).

[215] *See id.* at 46–51. *See generally* Alvin L. Arnold, *Loans: Prepayment Fee Upheld,* REAL EST. L. REP., June 2009, at 3.

[216] *See* Santa Rosa KM Assocs. Ltd., 206 P.3d at 47.

[217] *See id.* at 48.

The court then addressed two arguments made by the borrower.[218] First, the borrower argued that the "make whole premium" provision was an unenforceable penalty because it used Treasuries, which are lower risk and lower yield, to calculate the yield spread, thereby creating a windfall because the lender would actually reinvest the loan proceeds at a higher rate of return.[219] The court summarily dismissed this argument noting that courts have already rejected this argument[220] and reasoned that Treasuries are "easily verifiable and consistently predictable market indicators that are commonly used in prepayment premium provisions."[221] In contrast, the interest rate on the reinvested proceeds would be too unique for the court to quantify or speculate to determine if the lender received a windfall.[222] Because Treasuries were found to be a "reasonable substitute for trying to find a loan transaction that precisely replaces the investment opportunity lost with the borrower's prepayment," the court did not further scrutinize the inclusion of Treasuries in the calculation.[223]

Second, the borrower argued that the make whole premium provision is unenforceable because it creates a windfall by failing to account for the lender reinvestment of the make whole premium.[224] The court admitted that

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[218] *See id.* at 46–51. The borrower made other arguments that are either outside the scope of this Article or not addressed by the court.

[219] *See id.* at 48.

[220] *See* Santa Rosa KM Assocs. v. Principal Life Ins. Co., 206 P.3d 40, 48 (Kan. Ct. App. 2009).

[221] *See id.* at 49.

[222] *See id.* In *Santa Rosa*, the borrower's statement of uncontroverted facts did not quantify the new return on investment it argued that the lender would receive. *Id.* This omission may have added to the court's unwillingness to address the lender's reinvestment, though it is unclear if the court would have done so even if the borrower had attempted to quantify the lender's reinvestment return.

[223] *Id.*

[224] *See id.* at 49. This argument is fairly complex. As the court stated:

> [U]nder the formula the "make whole premium" is that portion of the present value of the future stream of note payments that is greater than the principal balance of the note being paid off by the borrower. However, the formula does not take into account the fact that the lender is not only receiving the outstanding principal balance on the loan which it can then reinvest, but also the "make whole premium" itself which can also be invested. Accordingly, the "make whole premium" would be smaller if the formula took into account the "make whole premium" itself together with the future stream of interest income Principal will realize from prepayment.

Id.

this issue is "more troubling."[225] Applying Kansas state precedent, the court held that the "the reasonableness of a liquidated damages clause should be determined as of the time the contract was executed, not with the benefit of hindsight."[226] The court used this approach with the prepayment provision at issue, despite the fact that there had been no default on the note,[227] but found that a presumption in favor of the reasonableness of a commercial mortgage prepayment penalty is proper, absent evidence to the contrary.[228] Although the borrower, despite this presumption, convinced the court that the "formula is not the best estimation of [lender's] anticipated loss from prepayment of the loan,"[229] the court found that the borrower did not show that, at the time of contracting, the term was "so unreasonable as to render it unenforceable."[230]

The *Santa Rosa* decision evidences the continued judicial deference to lenders. First, the challenge to the use of Treasuries as the reinvestment rate failed despite the borrower's assertions that there are more comparable "readily available market investments that pay a stated and reported interest rate."[231] The court also evinced the longstanding unwillingness to consider the reasonableness of the liquidated damages clause by looking retrospectively and instead only looked prospectively at the time of contract formation.[232] Further, the court demonstrated the continued deference to lenders by demanding precision from the borrower in alleging the reinvestment will produce a windfall but uncritically accepting Treasuries as a "reasonable substitute."[233] Additionally, the court's failure to consider the compounding

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[225] *Id.*

[226] *Id.* (quoting TMG Life Ins. Co. v. Ashner, 898 P.2d 1145, 1160 (Kan. App. 1995)).

[227] *Santa Rosa K.M.*, 206 P.3d at 49.

[228] *Id.* The court held that:

> In the absence of clear evidence to the contrary, when parties of equal sophistication negotiate a loan agreement, courts should presume that the creditor gave value, in the form of some other term of the agreement or otherwise, for terms favorable to the creditor in calculating the discount rate and formula to be used in computing the prepayment premium.

Id. (quoting TMG Life Ins. Co., 898 P.2d at 253–54).

[229] *Id.*

[230] *Id.* at 50.

[231] Brief of Appellant at 28, *Santa Rosa*, 206 P.3d 40 (2009) (No. 100,041), 2008 WL 2337236.

[232] In contrast, the borrower proposed that a reasonable clause could have been devised at the time of contract formation that precisely measured damages based on a reinvestment rate determined at the time of prepayment. *Id.*

[233] *Santa Rosa*, 206 P.3d at 49

interest revealed further deference by replacing the requirement for "reasonableness" of liquidated damages with a requirement that the clause not be "so unreasonable."[234]

In *Atrium View, L.L.C. v. Eastern Savings Bank, FSB* (*In re Atrium View, LLC*),[235] a Pennsylvania bankruptcy court declared that a commercial mortgage prepayment fee that demanded six months' interest was an unreasonable estimate of the lender's damages under bankruptcy law.[236] The court applied section 506(b) of the Bankruptcy Code, which allows an over-secured creditor to only claim reasonable fees (such as a mortgage prepayment fee). The court defined reasonableness as "how accurately [a prepayment penalty] predicts actual losses that will be incurred by the creditor if the obligation is paid before the end of the term."[237] The court further demanded that the creditor bear the burden to demonstrate reasonableness.[238] The court found the prepayment fee unreasonable because it was a flat fee for six months regardless of how many months of interest were lost and had no relation to the market interest.[239] The court noted that the lender's only justification was that a typical prepayment premium in the subprime mortgage industry was six months' interest,[240] and found that routine enforcement of these premiums outside of bankruptcy did not make the fee enforceable in a bankruptcy context.[241] Although the court sided with the borrower, the impact on prepayment-clause jurisprudence is limited because

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[234] *Compare* RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981) ("A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."), *and Santa Rosa,* 206 P.3d at 49 (discussing the courts role in assessing "the reasonableness of a liquidated damages clause"), *with id.* at 49–50 (declaring the clause enforceable, stating "[the borrower] fails to show that the formula is so unreasonable as to render it unenforceable.").

[235] No. 1:07-BK-02478MDF, 2008 Bankr. LEXIS 3441, 2008 WL 5378293 (Bankr. M.D. Pa. Dec. 24, 2008); *see also* Harris Ominsky, *Mortgage Prepayment Fee: Found Invalid*, REAL EST. L. REP., Apr. 2009, at 7.

[236] *See Atrium View* at *4 (citing 11 U.S.C. § 506(b) (2006)).

[237] *Atrium View*, 2008 Bankr. LEXIS 3441, at *4 (citing, e.g., *In re* Imperial Coronado Partners, Ltd., 96 B.R. 997, 1001 (9th Cir. 1989)).

[238] *See Atrium View*, 2008 Bankr. LEXIS 3441, at *4 (citing, e.g., *In re* Schaumburg Hotel Owner Ltd. P'ship, 97 B.R. 943, 950 (Bankr. N.D. Ill. 1989)).

[239] *See Atrium View*, 2008 Bankr. LEXIS 3441, at *9.

[240] *See id.*

[241] *See id.*

the decision occurred in the bankruptcy context and involved involuntary prepayment.[242]

In *Feinstein v. Ashplant*,[243] another involuntary prepayment case, the Florida state appellate court enforced a prepayment fee due upon the lender's acceleration of the debt due under a note.[244] The promissory note contained a provision that an acceleration of debt constitutes involuntary prepayment for which a prepayment fee shall be due and payable.[245] The trial court denied the prepayment fee based upon consideration of the "timeliness of default, the voluntary nature of the tender of full payment of the note and the involuntary nature of the lender's action to accelerate the note."[246] However, the appellate court reversed, finding that the trial court had no discretion to balance such considerations where the clause at issue specifically provides that a prepayment fee shall accompany acceleration.[247]

3. *Assessment of the Effect of* River East

A review of recent cases suggests that the effect of *River East* may be limited. Most damning is the fact that *River East* was not mentioned in any of the cases discussed in this Section, including *Great Plains*[248] and *Santa Rosa*,[249] the two most significant cases to address the subject of voluntary prepayment penalties since the *River East* decision. In fact, only two reported cases mentioned *River East* on prepayment issues,[250] and one did so in a manner unrelated to a yield-maintenance clause[251] while the other did so only in passing.[252] In contrast, practitioners and scholars have extensively

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242 *See id.* (holding that the lender "has not shown that the prepayment premium is reasonable, and, therefore, it is disallowed under § 506(b)" of the Bankruptcy Code).

243 961 So. 2d 1074 (Fla. Dist. Ct. App. 2007).

244 *See id.* at 1076.

245 *See id.* at 1075.

246 *Id.* (quoting Fla. Nat'l Bank v. Bankatlantic, 557 So. 2d 596, 598 (Fla. Dist. Ct. App. 1990); citing Fla. Nat'l Bank v. Bankatlantic, 589 So. 2d 255, 258–59 (Fla.1991)).

247 *See Feinstein*, 961 So. 2d at 1076.

248 *See* Great Plains Real Estate Dev. L.L.C. v. Union Central Life Ins. Co., 536 F.3d 939 (8th Cir. 2008).

249 *See* Santa Rosa KM Assocs. v. Principal Life Ins. Co., 206 P.3d 40 (Kans. Ct. App. 2009).

250 Citing references to *River East* were checked on Lexis and WestLaw as of August 2009.

251 *See* WestWacker K-Parcel, LLC v. Pac. Mut. Life Ins. Co., No. 05 C 4988, 2008 WL 597451, at *1 (N.D. Ill. Mar. 03, 2008).

252 *See* Paciwest, Inc. v. Warner Alan Props., LLC, 266 S.W.3d 559, 569 (Tex. App. 2008).

discussed the potential impact of *River East*.[253] Courts may have been hesitant to cite *River East* in light of the shaky economic reasoning supporting the case.[254] While Courts may have found that treasury-flat prepayment fees are enforceable because the payment seems close enough to the actual loss upon a cursory analysis, a court undertaking an in-depth analysis may reveal that the prepayment is a windfall.[255] Given that only a few years have passed since the ruling in *River East*, it is too soon to fully know the legacy of the Seventh Circuit's decision.

V. PROPOSALS FOR BORROWER PROTECTION THROUGH DISCLOSURE IN THE AFTERMATH OF *RIVER EAST*

In light of the courts' unwillingness to declare prepayment fees to be an unenforceable penalty (as highlighted by the *River East* decision), borrowers should seek various protections. While the clause at issue in *River East* involved a commercial prepayment, the case has broad implications for both the residential and commercial sectors because of the lack of judicial review inherent in its holding that a prepayment clause was ineligible for review under the penalty doctrine.

A. Residential Borrower Protections: Increased Disclosure of Fees and Risk

In light of strong public policy concerns, protection from mortgage prepayment fees should be available to residential borrowers. The protections currently available for consumers are largely a result of the battle between lenders and regulators on the state and federal level, with consumers rarely waging the judicial fights that are more common in the commercial sector.[256] Public policy favors an increase in home ownership, yet this goal has been undermined by the rising use of prepayment fees in the subprime lending industry.[257] This problem was illustrated in a University of North Caro-

[253] *See supra* note 18.

[254] The courts in *Great Plains* and *Santa Rosa* offered only a cursory explanation of why treasury-flat is enforceable while avoiding the extensive comparison of the lender's options made in *River East*. *See* Great Plains Real Estate Dev., L.L.C. v. Union Cent. Life Ins. Co., 536 F.3d 939, 945 (8th Cir. 2008); Santa Rosa KM Assocs. v. Principal Life Ins. Co., 206 P.3d, 40, 43, 49 (Kans. Ct. App. 2009).

[255] *See supra* Part IV.B.1.

[256] Prepayment litigation rarely involves residential borrowers. *See supra* note 7 and accompanying text.

[257] *See, e.g.*, *supra* note 4 and accompanying text; *infra* notes 259–81 and accompanying text.

lina study on the effect of predatory lending prices in the subprime mortgage market.[258] The study found that subprime refinance loans with prepayment penalties were about 20% more likely to experience a fore-closure than loans without prepayment penalties.[259]

Although various agencies have attempted to curb the consequences of deceptive lending,[260] predatory mortgage lending practices are particularly problematic in the growing secondary mortgage market.[261] The practice by lenders of convincing borrowers to accept disadvantageous prepayment penalty terms in exchange for supposedly more-advantageous interest rates has come under scrutiny as deceptive.[262] Borrowers are often willing to accept this trade-off because a lower interest rate will equate to a lower monthly payment, which increases the ability of the borrower to qualify for the loan.[263] A 2004 report published by the Fannie Mae Foundation recognized that "secondary market . . . discipline on the subprime home loan market . . . is not enough to bring predatory lending to a halt."[264] Allegations of fraud have led to numerous lawsuits from cities[265] and securities litigation.[266] These studies and lawsuits have demonstrated that residential borrowers need greater protections against the use of prepayment penalties.

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[258] *See* Quercia, Stegman & Davis, *supra* note 5.

[259] *See id.* at 26.

[260] *See, e.g.*, Consumer Information: Credit and Loans: Mortgages/Real Estate, Federal Trade Commission, http://www.ftc.gov/bcp/menus/consumer/credit/mortgage.shtm.

[261] The secondary mortgage market includes any loan that is not originated by the party that plans to collect on the mortgage throughout the duration of the loan. Instead, mortgage originators add a one-time origination fee to the cost of the mortgage and subsequently sell the mortgage to a third party who assumes the risks of the loan. *See generally* NELSON & WHITMAN, *supra* note 2, § 11.3.

[262] *See* Engel & McCoy, *supra* note 4, at 735 ("[A]nalysts contend . . . that subprime borrowers are able to trade prepayment penalties for lower annual percentage rates."). However, research has demonstrated that "subprime prepayment penalties are positively correlated with an *increase* in interest rates . . . after controlling for other loan terms." *Id.* at 737 (emphasis in original) (citing John Farris, Christopher Richardson, & Yu Shai, Quantifying the Economic Costs of Prepayment Penalties to Subprime Mortgage Borrowers, at 18 (working paper) CTR. FOR RESPONSIBLE LENDING 2003).

[263] *See id.* at 722.

[264] *Id.* at 715.

[265] *See, e.g.*, Gretchen Morgenson, *Baltimore is Suing Bank Over Foreclosure Crisis,* N.Y. TIMES, Jan. 8, 2008, at A12 *available at* http://www.nytimes.com/2008/01/08/us/08baltimore.html?em&ex=1199941200&en=f69b5d8df2e6a884&ei=5087%0A.

[266] *See, e.g.*, Martha Graybow*, US Litigation Seen Growing on Subprime Turmoil*, REUTERS, Jan. 22, 2008, http://www.reuters.com/article/companyNewsAndPR/idUSN2254558220080122?sp=true. The fraud also has had racial implications, according to a study

Legislators have become acutely aware of the problems posed by residential prepayment penalties and are particularly well-situated to expand borrower protections.[267] While many states have introduced laws limiting predatory lending,[268] the attempt to define "predatory lending" is a recurring problem. Lenders often argue for laissez-fair principles—that borrowers should not be subjected to restrictions because of their less-than-perfect financial history,[269] but some restrictions are necessary to ensure that the borrowers are given the information necessary to assess their loan options.

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by the Center for Responsible Lending, which found that African-Americans were 31%–34% more likely to enter into a subprime loan than their Caucasian counterparts, even when income and credit risk were accounted for. DEBBIE GRUENSTEIN BOCIAN, KEITH S. ERNST & WEI LI, CTR. FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES, 4 (May 31, 2006), http://www.responsiblelending.org/mortgage-lending/research-analysis/rr011-Unfair_Lending-0506.pdf). This practice is known as "steering," whereby "borrowers are influenced to accept a loan with a higher-cost [sic] than that for which they are qualified." WEI LI & KEITH S. ERNST, CTR. FOR RESPONSIBLE LENDING, THE BEST VALUE IN THE SUBPRIME MARKET: STATE PREDATORY LENDING REFORMS, 7 (Feb. 23, 2006), http://www.responsiblelending.org/mortgage-lending/research-analysis/rr010-State_Effects-0206.pdf. In its suit against the nation's top subprime lender, the NAACP alleged that the lenders disproportionately issued subprime loans to African-Americans that were laden with disadvantageous "prepayment penalties which effectively prohibit borrowers from refinancing at a fairer rate." Complaint at 3, N.A.A.C.P. v. Ameriquest Mortgage Co., No. SACV 07-0794 AG (ANX), 2009 WL 2031671 (C.D. Cal. Jan. 12, 2009), *available at* http://www.naacp.org/pdfs/NAACP_Complaint_lending_00033487-3.pdf (alleging violations of the Fair Housing Act, the Equal Credit Opportunity Act and racial discrimination under 42 U.S.C. §§ 1981, 1982).

[267] The 2008 presidential election highlighted the need for increased scrutiny of lender practices in the residential mortgage market—both leading Democratic candidates, Hillary Clinton and Barack Obama, openly expressed their opposition to prepayment penalties. *See* Seth Gitell, *Clinton, Veering Left, Lashes Out at Lenders*, N.Y. Sun, Aug. 8, 2007; Press Release, Sen. Barack Obama, Obama Demands Investigation into Subprime Loan Discrimination (Oct. 18, 2007).

[268] Thirty-seven states have enacted legislation that bans some form of prepayment penalties, flipping, negative amortization, or financing credit insurance, while encouraging consumer credit counseling and high income to debt ratio protections. *See generally,* National Conference of State Legislatures, *Predatory Mortgage Lending*, http://www.ncsl.org/programs/banking/predlend_intro.htm (last visited Sept. 14, 2009).

[269] For example, the Community Financial Services Association of America (CFSA) promotes such arguments in favor of payday lending, a service that can be compared to the subprime mortgage industry due to the lending provided to high-risk consumers. *See generally* Community Financial Services Association of America, http://www.cfsa.net/ (last visited Sept. 14, 2009).

The Truth in Lending Act (TILA)[270] was amended in 2008 to further restrict the use of prepayment fees.[271] When such fees are permitted, the Act requires lenders to disclose prepayment fees to borrowers.[272] In practice, however, this disclosure amounts to nothing more than a checkbox next to small print that informs the borrower that they either "may" or "will not" have a prepayment penalty.[273] The form then directs borrowers to "[s]ee [their] contract documents for any additional information. . . ."[274] Notably absent from the form is the cost of the prepayment penalty,[275] arguably the most important term in a prepayment disclosure.[276] The probability of triggering the prepayment clause is also absent from the standard disclosure form,[277] a statistic that psychology suggests consumers are likely to under-

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[270] 12 C.F.R. § 226 (2009). For an extensive discussion of the federal attempts to regulate prepayment fees, see Boyle, *supra* note 15.

[271] *See* Truth in Lending, Regulation Z, 12 C.F.R. § 226 (2008). Beginning October 1, 2009, some high-cost mortgages will be restricted entirely from containing a prepayment penalty. *See* 12 C.F.R. § 226.32(d)(6) (2009). However, exceptions do exist. *See* 12 C.F.R. § 226.35(b)(2) (2009).

[272] *See* 12 C.F.R. § 226.18 (2009). The Act requires that the creditor disclose the following information:

> (1) When an obligation includes a finance charge computed from time to time by application of a rate to the unpaid principal balance, a statement indicating whether or not a penalty may be imposed if the obligation is prepaid in full.
>
> (2) When an obligation includes a finance charge other than the finance charge described in paragraph (k)(1) of this section, a statement indicating whether or not the consumer is entitled to a rebate of any finance charge if the obligation is prepaid in full.

Id.

[273] *See e.g.*, Truth In Lending Disclosure Statement, Ellie Mae, Inc., http://www.tilamortgage.com/UploadFiles/DefaultFiles/regz.pdf (applying Regulation Z, Truth in Lending Act); *see also* 12 C.F.R. Pt. 226, App. H (2009) (model disclosure forms); COMPTROLLER OF THE CURRENCY, ADM'R OF NAT'L BANKS, DEPT. OF TREAS., TRUTH IN LENDING: COMPTROLLER'S HANDBOOK (2008), http://www.occ.treas.gov/handbook/til.pdf.

[274] Truth in Lending Disclosure Statement, *supra* note 273.

[275] If the prepayment penalty is a flat fee, the form only requires the lender to list the amount. However, if the prepayment penalty changes based on the time or balance remaining, the form may require a more detailed disclosure showing various potential scenarios relating to those factors.

[276] Rather than being nominal amounts, the penalties can be surprisingly high to unsuspecting consumers. *See* Heckinger, *supra* note 6.

[277] Disclosure of the probability of prepayment might present difficult challenges due to the unique nature of each mortgage. However, it is likely that lenders are making such calculations already given the extensive literature on the subject. *See, e.g.*, Chinloy, *supra* note 196.

estimate.[278] As the Federal government looks to rewrite these rules in light of recent turmoil in the residential sector, added disclosure regarding the cost of prepayment fees is necessary to ensure that borrowers are better informed.[279]

Some states have provided additional consumer protections. However, some federal regulations expressly preempt state laws, even if those laws provide stronger borrower protections.[280] Of those state laws that are not preempted, the protections vary widely, depending on which state the borrower resides in.[281] For example, Illinois requires borrowers seeking nontraditional mortgages to attend a two-hour training session to explain terms such as the adjustable rate, prepayment penalties, and interest-only payments.[282] Looking forward, legislators should focus on ensuring that lenders disclose both the fees and potential costs that will arise if the borrower prepays.[283]

If residential loan disclosure laws were stronger, borrowers could more fairly assess the value of prepayment fees and the risks involved. This assessment would allow borrowers either to negotiate out of prepayment fees

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[278] *See supra* Part IV.D.

[279] Assuming prepayment fees continue in the marketplace, disclosure of those fees may also encourage competition among lenders, thereby driving down the cost of prepayment fees.

[280] *See* 12 C.F.R. § 560.2 (1996). The regulation states:

> OTS hereby occupies the entire field of lending regulation for federal savings associations. OTS intends to give federal savings associations maximum flexibility to exercise their lending powers in accordance with a uniform federal scheme of regulation. Accordingly, federal savings associations may extend credit as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of this section . . . .
>
> [T]he types of state laws preempted by paragraph (a) of this section, include, without limitation, state laws purporting to impose requirements regarding: . . .
>
> (5) Loan-related fees, including without limitation, initial charges, late charges, prepayment penalties, servicing fees, and overlimit fees . . . .

Id.

[281] *See* LI & ERNST, *supra* note 266, at 6–7.

[282] *See, e.g.*, Amy Merrick, *Illinois Tries New Tack Against Predatory Loans*, THE WALL ST. J. ONLINE, Aug. 22, 2007, *available at* http://www.realestatejournal.com/buysell/mortgages/20070822-merrick.html.

[283] *Cf.* Jack M. Guttentag, *Disclosure Rules on Mortgage Prepayment Penalties*, MORTGAGE PROFESSOR (Jan. 9, 2008), http://www.mtgprofessor.com/A%20-%20Mandatory%20Disclosure/disclosure_of_prepayment_penalty.htm.

or to assess more rationally the value of prepayment fees weighed against other terms of the loan, such as the interest rate. Lenders also would gain the benefit of being able to assure courts that borrowers were aware of the terms of the prepayment fee, thereby enhancing the enforceability of such fees.

B. Commercial Borrower Protections: Increased Disclosure and Point-Spread Fairness

In contrast to the need to protect residential borrowers who often have little knowledge of finance or the law, judicial interference with prepayment fees in the commercial setting is unnecessary because the typical commercial borrower has business experience and is represented by legal counsel. Instead, commercial borrowers should encourage lenders to disclose the true cost of prepayment, not simply the formula, and bargain for a prepayment fee that accurately calculates the lender's potential loss. Borrower disclosures for a yield-maintenance clause could quite easily include all potential prepayment situations and their related fees. While some yield-maintenance clauses can accurately calculate a lender's loss,[284] the calculations nonetheless may be confusing for borrowers. Even the Seventh Circuit noted that "the math is perplexing" while attempting to account for the district court's award of damages.[285] To clarify the costs, a lender could calculate the prepayment fee given differing potential reductions in Treasury rates and reductions in the principal remaining on the loan. By converting the complicated yield-maintenance form into a simplified potential cost to the borrower, the bargaining process would be more fair. Lenders also may find such full and simplified disclosure beneficial if a borrower later attempts to allege that the prepayment fee is not enforceable, as the borrower did in *River East*.[286]

In addition, borrowers should negotiate prepayment fees to better reflect the lender's loss. Parties can accomplish this goal quite simply through the use of a reinvestment rate that accurately tracks the market for comparable commercial mortgages[287] and includes the spread in basis points between the Treasury securities rate and the commercial mortgage that existed at the

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[284] *See supra* note 181 and accompanying text.

[285] River East Plaza, LLC v. Variable Annuity Life Ins. Co., 498 F.3d 718, 726 (7th Cir. 2007). For full quotation, see *supra* note 141.

[286] *See River East*, 498 F.3d at 720; *see also Teleconference on Prepayment Fees* in the Aftermath of *River East*, *supra* note 177 (question and answer session included numerous techniques to increase enforceability of a yield-maintenance clause).

[287] For examples, see Galowitz, *supra* note 13.

time of loan origination. These techniques would accurately calculate the lender's loss by eliminating the built-in gap that exists in the treasury-flat calculation.[288]

Given that yield-maintenance clauses are under attack—as evidenced by *River East*—lenders should find these proposed methods of calculation useful because they better assess the actual damages suffered by the prepayment and are therefore more likely to survive a liquidated damages analysis. By bargaining for the basis-point spread, lenders also would have an easier time showing that the prepayment fee represents a bargained-for exchange rather than a product of unfairness in the bargaining process.

By following these proposals, lenders and borrowers in residential and commercial settings could reduce the expense of litigation while preserving the underlying economic purpose of prepayment fees.

VI. CONCLUSION

The law of prepayment penalties reveals the golden rule: Those with the gold make the rules. The combination of the perfect tender in time rule and lock-in/lock-out clauses allow lenders to reject prepayment altogether. With the power in the hands of lenders and minimal judicial interference with contracts, modern prepayment fees such as the treasury-flat yield-maintenance clause result in a clear windfall to the lender when borrowers voluntarily prepay. The psychological biases of overconfidence and overoptimism reveal that borrowers may be underestimating the likelihood that the term will affect them after the loan is originated. Government interference with prepayment fees may be inappropriate given the economic role that these clauses continue to play. Rather, the proper role of government should be to require increased disclosure that reveals the likelihood and cost of prepayment for residential borrowers. In the commercial sector, borrowers should become aware of the likelihood of prepayment and demand that lenders use reinvestment rates that more accurately track the market for comparable commercial mortgages. Through increased disclosure, prepayment fees can continue to play an economic role in the mortgage market while enhancing fairness to borrowers and decreasing litigation costs for all.

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[288] *See* Galowitz, *supra* note 13, at 28 (explaining the "built in gap" between the lender's true loss and the treasury-flat yield-maintenance calculation).