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Prepayment Penalties: A Survey and Suggestion

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NOTES

Prepayment Penalties: A Survey and Suggestion

I. INTRODUCTION

Borrowers often wish, for various reasons, to satisfy their indebtedness prior to the maturity of the loan agreement. Conversely, lenders often wish to prevent early payment of the debt or, alternatively, to exact a fee from the borrower for the privilege of prepaying the debt. Between seven and ten percent of the approximately thirty-two million loans secured by mortgages on real estate are prepaid each year.[1] At least seventy percent of these loans contain a provision in the loan agreement calling for a penalty in the event of prepayment.[2] This Note discusses the rights of lenders and borrowers when a borrower prepays a debt and suggests a resolution of those rights that is more appropriate than the resolution provided by current law.

Part II A of this Note examines the rights of borrowers when they choose to or are compelled to pay their debts prior to maturity.[3] Part II B examines a lender's right to refuse an early tender of payment or to exact a fee or premium, known as a prepayment penalty, from the borrower in return for allowing prepayment. Part II C discusses the arguments supporting the validity of prepayment penalties. Parts II D-G discuss the various ways in which courts, state legislatures, and federal regulatory bodies have attempted to adjust the rights of lenders and prepaying borrowers. Finally, Part III suggests an approach to these issues that is consistent with basic principles of law and justice and that recognizes and protects the legitimate interests of both borrowers and lenders.

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1. These statistics have been provided by the Mortgage Bankers Association of America.

2. *Id.*

3. Many, if not most, of the statutes and cases cited in this Note pertain specifically to loans secured by a mortgage on real property because most disputes over the right to prepay and the enforceability of a prepayment penalty arise in the context of a note secured by a mortgage on residential real estate. Two reasons explain this fact. First, the nature of the real estate market itself gives rise to this type of dispute with greater frequency than otber types of loans. It is common for an owner of real estate to wish to convey the property before the note matures and pay off the mortgage, thereby absolving the owner of any continuing obligation. A continuing obligation would exist if, for example, the vendee merely took subject to the note. Additionally, the lender often will not consent to an assumption or "subject to" arrangement. This is perhaps less likely to occur in other contexts, such as when the note is not for as long a period of time as the typical 30-year mortgage or when the debtor is less likely to attempt to dispose of the security and retire the debt before maturity. Second, commercial borrowers usually possess more sophistication and bargaining power than the typical residential home buyer. Therefore, commercial borrowers are able to better anticipate future problems and receive more favorable terms in the note, thus reducing the likelihood of a dispute ending up in court. The latter point also may explain why state legislatures have been more inclined to afford statutory protection for residential home buyers than for other classes of borrowers.

Notwithstanding these facts, the principles developed in this Note should apply with equal force to loans that are not secured by real estate, with the exception of those principles relating to some legal aspect unique to realty. Thus, for example, an argument against allowing the collection of a prepayment penalty because it constitutes an unreasonable restraint on alienation of real property obviously would not have application outside the real estate mortgage context.

II. The Rights of Borrowers and Lenders in Prepayment Situations

A. *The Borrower's Right to Prepay*

Most unsophisticated borrowers do not consider whether they have the right to satisfy their debt prior to the time specified in the loan agreement and, of those who do, many simply assume they have a right to prepay. This assumption, however, is not necessarily accurate. *Brown v. Cole,*[4] an early English case, held that a real estate mortgagor, prior to the maturity date specified in the agreement, had neither the right to compel the mortgagee to accept an early tender of the mortgage payment nor the right to compel the mortgagee to reconvey the property to the mortgagor.[5] The *Brown* court declared that "[i]f mortgagors were allowed to pay off their mortgage money at any time after the execution of the mortgage, it might be attended witb extreme inconvenience to mortgagees, who generally advance their money as an investment."[6] An additional reason cited by other courts in support of this rule is simply that a contract should be strictly enforced according to its terms.[7]

Various states[8] adopted the common law rule announced in *Brown,* and many states[9] adhere to this rule even today.[10]

4. [1845] 14 L. J.-Ch. (n.s.) 167 (V.C.).

5. This notion of the mortgagee executing a reconveyance of the mortgaged property to the mortgagor is comparable to a release of the property in the context of a modern mortgage. Although most jurisdictions currently grant the mortgagee only a security interest in the land securing the debt, at early common law the mortgagee actually received legal title and the right to possess the property on the condition that the property be reconveyed to the mortgagor upon satisfaction of the debt on the specified date. *See generally* G. Nelson & D. Whitman, Real Estate Finance Law § 1.2 (2d ed. 1985).

6. *Brown,* 14 L. J.-Ch. (n.s.) at 168.

7. *See* Smiddy v. Grafton, 163 Cal. 16, 19, 124 P. 433, 435 (1912). In *Smiddy* the court stated that the mortgagee could not be compelled to accept payment of a mortgage not yet due. The court adopted that rule without discussion or citation, but the context of the holding indicates that the reason the mortgagee did not have to accept payment was simply because it was not yet due according to the terms of the instrument. *See also* Chapman v. Ford, 246 Md. 42, 227 A.2d 26 (1967) (justifying a 10% prepayment penalty because the terms of the note clearly called for it); Kruse v. Planer, 288 N.W.2d 12 (Minn. 1979) (strictly enforcing the terms of the note and holding that the borrower had no right to prepay because the note conferred no such right); Peryer v. Pennock, 95 Vt. 313, 115 A. 105 (1921).

8. *See, e.g.,* Saunders v. Frost, 22 Mass. (5 Pick.) 259 (1827); Porten v. Peterson, 139 Minn. 152, 166 N.W. 183 (1918); Pyross v. Fraser, 82 S.C. 498, 64 S.E. 407 (1909); *see also* Smiddy v. Grafton, 163 Cal. 16, 124 P. 433 (1912); Peryer v. Pennock, 95 Vt. 313, 115 A. 105 (1921).

9. *See, e.g.,* Dugan v. Grzybowski, 165 Conn. 173, 332 A. 2d 97 (1973); Kruse v. Planer, 288 N.W. 2d 12 (Minn. 1979); Boyd v. Life Ins. Co., 546 S.W.2d 132 (Tex. 1977) (allowing a prepayment penalty in a situation in which the note was silent as to prepayment, thereby

Nevertheless, the borrower has the right to prepay its debt in many situations. The right to prepay may be created by state statute,[11] judicial decision,[12] or provision in the note.[13] Additionally, a federal statute or regulation may bestow prepayment privileges on the debtor in certain limited situations.[14] Unless the common law has been abrogated in one of these manners, however, the debtor cannot compel a creditor to accept an early tender of payment.

B. The Lender's Right to Charge a Penalty for Permitting Prepayment

Lenders often are willing to surrender their right to insist on strict compliance with the contract's payment terms and timing if the borrower is willing to compensate the lender for the surrender. The fee that a lender charges for allowing the borrower to satisfy all or a portion of the debt before maturity is known as a "prepayment penalty."

Prepayment penalties take two forms, "option" and "non-option."[15] In the option prepayment penalty situation, the note contains a prepayment clause delineating the borrower's right to prepay, any limitations thereon, and the fee to be exacted if the borrower exercises that right. A prepayment clause may prohibit prepayment altogether or may provide for severe penalties in the early life of the loan, with only moderate or completely abolished penalties after a certain time period has elapsed.[16] The penalty

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impliedly affirming that the borrower has no right to prepay).

10. One court stated the rule as follows:

> A creditor can no more be compelled to accept payments on a contract before, by the terms thereof, they are due, than can a debtor be compelled to make such payments before they are due. The time of payment fixed by the terms of a pecuniary obligation is a material provision, and each party has the right to stand on the letter of the agreement and perform accordingly.

Preyer, 95 Vt. at 315, 115 A. at 105.

11. *See infra* text accompanying notes 98-139.

12. *See, e.g.*, Mahoney v. Furches, 468 A.2d 458, 461 (Pa. 1983) (holding that when a note is silent as to prepayment, a presumption arises that it may be prepaid).

13. *See, e.g.*, *infra* notes 16, 18 & 141.

14. *See infra* notes 140-55 and accompanying text.

15. Williams v. Fassler, 110 Cal. App. 3d 7, 10-11, 167 Cal. Rptr. 545, 547 (1980).

16. For example, in DeKalb County v. United Family Life Ins. Co., 235 Ga. 417, 219 S.E.2d 707 (1975), the note in question contained the following provision:

> No right to prepay for five years; privilege to prepay in full or in part beginning in the fifth year at a 5% penalty declining ½ of 1%. Penalty shall be calculated on the unpaid principal balance of the loan. In any case, thirty days notice of intent to make prepayment must be given in writing.

Id. at 418, 219 S.E.2d at 709.

may be a percentage of the prepaid principal or a percentage of the original loan amount.[17] Other prepayment clauses permit, within a given time period, prepayment without penalty up to a stated maximum, which may be a percentage of the loan's total original balance, but impose a penalty for the amount prepaid within the specified time period in excess of that limit.[18]

In the non-option prepayment penalty situation the instrument creating the debt is silent concerning prepayment and the borrower, if it wishes to prepay, must negotiate with the lender for that privilege. Unless the common-law rule has been abrogated, the lender is free to refuse the early tender of payment. Typically, however, the lender will agree to accept the prepayment, conditioned upon the borrower's willingness to pay a penalty. The amount of the penalty may depend on many factors.[19] However,

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Thus, while the borrower could not prepay before the fifth year and would be subject to a substantial penalty immediately thereafter, by the fifteenth year of the note the penalty would be only ½ of 1% of the outstanding principal and the borrower could prepay without charge after that time.

17. *See, e.g.*, Camellia Apartments, Inc. v. United States, 334 F.2d 667, 669 (Ct. Cl. 1964) (measuring the prepayment penalty as one percent of the original face amount of the loan); Landohio Corp. v. Northwestern Mut. Life Mortgage & Realty Investors, 431 F. Supp. 475, 477 (N.D. Ohio 1976) (measuring the penalty as 3½% of the balance of the loan at the time of prepayment).

18. An example of tbis type of provision is found in Powell v. Phoenix Fed. Sav. & Loan Ass'n, 434 So. 2d 247 (Ala. 1983). The provision in tbe mortgage read:

> Borrower may prepay the principal amount outstanding in whole or in part. The Note holder may require that any partial prepayments (i) be made on the date monthly installments are due and (ii) be in the amount of that part of one or more monthly installments wbich would be applicable to principal. Any partial prepayment shall be applied against the principal amount outstanding and shall not postpone the due date of any subsequent monthly installments or change the amount of such installments, unless the Note holder shall otherwise agree in writing. If, within five years from the date of this Note, Borrower make(s) any prepayments in any twelve month period beginning with tbe date of this Note or anniversary dates thereof ('loan year') with money lent to Borrower by a lender other than the Note holder, Borrower shall pay the Note holder (a) during each of the first three loan years 5.5 percent of the amount by which the sum of prepayments made in any such loan year exceeds twenty percent of the original principal amount of this Note and (b) during the fourth and fifth loan years 3 percent of the amount by which the sum of prepayments made in any such loan year exceeds twenty percent of the original principal amount of this Note.

Id. at 248 n.1.

19. Theoretically, a lender will consider the following factors: (1) any fixed costs associated witb the loan that have not been recovered yet; and (2) the rate of interest at which the lender can reinvest the prepaid loan as compared to the rate on the loan being prepaid. *See infra* text accompanying notes 24, 25, 28 & 29. The lender may wish to maximize the amount of the penalty to generate revenue. *See infra* text accompanying note 45. Finally, the amount of the penalty may be limited by applicable statutes or regulations. *See infra* text accompanying notes 98-155.

some states prohibit, either judicially or statutorily, the collection of a prepayment penalty if the note does not contain an explicit provision permitting a prepayment penalty.[20]

C. *Reasons Supporting the Validity of Prepayment Penalties*

The *Brown v. Cole*[21] court observed that a rule allowing borrowers to satisfy their obligations prior to the time stipulated in the note would be detrimental to lenders, "who generally advance their money as an investment."[22] This rationale remains sound and continues to provide one of the strongest arguments for allowing lenders to refuse to accept an early tender of payment or, alternatively, to exact a prepayment fee to ameliorate the attendant negative consequences.[23] Among the various reasons supporting the validity of prepayment penalties are the following: (1) the need for lenders to recoup their fixed administrative costs; (2) the need to protect lenders from the detrimental effects of borrower refinancing; (3) the revenue concerns of lenders; and (4) tax considerations.

The first argument supporting prepayment penalties recognizes that every loan entails certain fixed administrative costs, such as time spent reviewing and approving the loan application, investigating the loan applicant, and executing the necessary documents.[24] Assuming that the administrative costs are amortized fully over the duration of the loan, an early satisfaction of the note would deprive the lender of the opportunity to recover these costs.[25] At least one commentator, however, has argued that this reasoning ignores modern lending practices, whereby lenders recoup their administrative costs at the loan's inception[26] by charg-

20. *See, e.g.*, Mahoney v. Furches, 468 A.2d 458 (Pa. 1983); *infra* notes 98, 99 & 103.

21. [1845] 14 L.J.-Ch. (n.s.) 167 (V.C.).

22. *Id.* at 168.

23. *See infra* text accompanying notes 28-44.

24. *See, e.g.*, Sacramento Sav. & Loan Ass'n v. Superior Court, 137 Cal. App. 3d 142, 145-46, 186 Cal. Rptr. 823, 825 (1982) (allowing a prepayment penalty because of the administrative costs associated with making the loan and the time lag between receipt of the prepayment and the lender's reinvestment of those funds); Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 905 (Tex. 1976) (citing expenses incurred in making the loan, including appraisals, inspection costs, and attorney's fees).

25. *See* Mid-America Dev. Corp. v. Arkansas Sav. & Loan Ass'n, 257 Ark. 850, 852, 520 S.W. 2d 238, 239 (1975) (citing expenses incurred by the lender in making the loan as justification for allowing a prepayment penalty); Arkansas Farm Prods., Inc. v. Ford Motor Credit Co., 267 Ark. 653, 654-55, 590 S.W.2d 48, 50 (Ct. App. 1979).

26. Bonanno, *Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives*, 6 U.S.F. L. Rev. 267, 295 (1972).

ing "points," loan commissions, and fees, all of which effectively force the borrower to pay for the loan's administrative expenses at the outset.[27] To the extent that lenders are compensated for their administrative costs at the inception of the loan, this reason no longer justifies retaining the common-law rule endorsing prepayment penalties. Fixed administrative cost compensation, however, is not the only argument supporting the legality of prepayment penalties.

A second argument for permitting prepayment penalties is that lenders must be able to charge a penalty in order to insulate themselves from the devastating effects of wholesale debt refinancing by borrowers in times of falling interest rates.[28] By charging a prepayment premium, lenders discourage prepayment and "lock in" loans at higher interest rates. This strategy helps to maintain a profitable loan portfolio, especially when used in conjunction with a due-on-sale clause. A due-on-sale clause, which commonly is included in real estate mortgages, is a provision that gives the mortgagee the right to call the entire debt due if the mortgagor conveys the property.[29]

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27. *Id.*

28. *See, e.g.*, Sacramento Sav. & Loan Ass'n v. Superior Court, 137 Cal. App. 3d 142, 146, 186 Cal. Rptr. 823, 825-26 (1982); Occidental Sav. & Loan Ass'n v. Venco, 206 Neb. 469, 479, 293 N.W.2d 843, 848 (1980).

29. Similarly, a due-on-encumbrance clause allows a mortgagee to accelerate the debt whenever the mortgaged property is encumbered. An example of a due-on-sale clause, the one contained in the standard form approved by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), is found in Powell v. Phoenix Fed. Sav. & Loan Ass'n, 434 So. 2d 247 (Ala. 1983). The clause reads as follows:

> If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to this mortgage, (b) the creation of a purchase money security interest for household appliances, (c) a transfer by devise, descent or by operation of law upon the death of a joint tenant, or (d) the grant of any leasehold interest of three years or less not containing an option to purchase, Lender may, at Lender's option, declare all the sums secured by this Mortgage to be immediately due and payable. Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender and that the interest payable on the sums secured by this Mortgage shall be at such rate as Lender shall request. If Lender has waived the option to accelerate provided in this paragraph 17, and if Borrower's successor in interest has executed a written assumption agreement accepted in writing by Lender, Lender shall release Borrower from all obligations under this Mortgage and the note.
>
> If Lender exercises such option to accelerate, Lender shall mail Borrower notice of acceleration in accordance with paragraph 14 hereof. Such notice shall provide a period of not less than 30 days from the date the note is mailed within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the expiration of

A lender, therefore, can use a prepayment penalty in conjunction with a due-on-sale clause to accelerate a particular note or mortgage, thereby calling the whole debt immediately due and payable, then exact a fee from the debtor for allowing the debtor this dubious "privilege."[30] Although this practice may seem patently unfair to borrowers, it must seem too good to be true from a lender's perspective. In fact, it no longer is true in certain contexts. First, several states have enacted statutes that prohibit a lender from accelerating a note pursuant to a due-on-sale clause and then demanding a prepayment penalty.[31] Almost universally, however, these statutes apply only if the mortgaged property is residential property.[32] Second, several courts have held that lenders may not exact a prepayment penalty in a due-on-sale situation.[33] A recurring rationale among these holdings is that the lender, by accelerating the debt, has rendered the entire principal amount due, thereby making it impossible for any subsequent payment to be characterized as a prepayment.[34] Finally, the Federal Home Loan Bank Board (FHLBB), pursuant to the Garn-St. Germain Depository Institutions Act of 1982,[35] has promulgated a regulation forbidding all lenders, not just federally chartered lenders, from accelerating a loan under a due-on-sale clause and then demanding

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such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 18 hereof.

Powell, 434 So. 2d. at 249.

30. *See, e.g.*, Chapman v. Ford, 246 Md. 42, 227 A.2d 26 (1967).

31. *See infra* notes 128-30.

32. *See id.* and accompanying text.

33. *See, e.g.*, Tan v. California Fed. Sav. & Loan Ass'n, 140 Cal. App. 3d 800, 809, 189 Cal. Rptr. 775, 782 (1983); Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 98 Ill. App. 3d 646, 648, 424 N.E.2d 939, 941 (1981); American Fed. Sav. & Loan Ass'n v. Mid-America Serv. Corp., 329 N.W.2d 124, 125-26 (S.D. 1983). *But see* Chapman v. Ford, 246 Md. 42, 227 A.2d 26 (1967).

34. *See, e.g.*, *Tan*, 140 Cal. App. 3d at 809, 189 Cal. Rptr. at 782; *Slevin Container Corp.*, 98 Ill. App. 3d at 648, 424 N.E.2d at 941; *American Fed. Sav. & Loan Ass'n*, 329 N.W.2d at 125-26. The statement of the *American Federal* court is typical of these cases: "Where the discretion to accelerate the maturity of the obligations is that of the obligee, the exercise of the election renders the payment made pursuant to the election one made after maturity and by definition not prepayment." *Id.* at 126.

General Motors Acceptance Corp. v. Uresti, 553 S.W.2d 660 (Tex. Civ. App. 1977), concerned not a mortgage on real estate, but a vehicle lien that the lender had accelerated. The court stated that "[o]nce the maturity date is accelerated to the present, it is no longer possible to prepay the debt before maturity. Any payment made after acceleration of the maturity date is made *after* maturity, not before." *Id.* at 663 (emphasis in original).

35. Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified in scattered sections of 12 U.S.C.).

payment of a prepayment fee.[36] This prohibition, however, applies only if the mortgaged property is a home in which the borrower lives or will live.[37]

Lenders should be prohibited from accelerating a debt and then collecting a prepayment penalty for various reasons other than the inherent unfairness of the practice. First, the justifications for enforcing prepayment penalties are wholly inapplicable in a due-on-sale clause acceleration context. The lender cannot contend convincingly that prepayment of the debt will work to its detriment by preventing recovery of the loan's costs when it is the lender who insists on early payment. Moreover, the second justification for enforcing prepayment penalties, that of locking in loans at higher interest rates in times of declining interest rates, also is irrelevant. If interest rates were truly at a level lower than that of the note, the lender would not accelerate except in very limited circumstances, such as when failure to accelerate would increase the risk of default to an unacceptable level or leave the lender unsecured or under-secured. Instead, the lender would consent to the conveyance of the property, with the vendee assuming or taking subject to the mortgage, and continue to collect payments at the higher rate of interest. The due-on-sale clause serves almost exclusively to call due loans made at a rate of interest lower than the current rate, thus allowing the lender to reinvest the funds at the higher current rate.[38] A due-on-sale clause helps the lender maintain a profitable portfolio in times of rising interest rates[39] and, therefore, is most effective when used in tandem with a prepay-

36. 12 C.F.R. § 591.5(b)(2) (1986); *see* Comment, *Prepayment Penalties After Garn-St. Germain: A Minor Coup for Consumers*, 3 DET. C.L. REV. 835 (1985). Commentators have suggested that the FHLBB may have exceeded the scope of its statutory authority by promulgating this regulation and, therefore, that it may be attacked successfully as ultra vires. *See* G. NELSON & D. WHITMAN, *supra* note 5, at § 6.5.

37. 12 C.F.R. § 591.5(b)(2) (1986).

38. G. NELSON & D. WHITMAN, *supra* note 5, at § 5.21. Even if the lender does not demand payment in full and thereafter reinvest the funds at the market rate, the lender may use the threat of acceleration to exact a higher rate of interest from the vendee who assumes the mortgage. *Id.* at n.3; *see, e.g.*, Lake v. Equitable Sav. & Loan Ass'n, 105 Idaho 923, 674 P.2d 419 (1983); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976).

39. *See* Redd v. Western Sav. & Loan Co., 646 P.2d 761, 767 (Utah 1982) (sanctioning the enforcement of a due-on-sale clause because it was "justified by legitimate interests of the parties [and recognizing that] lenders must be able to compete with inflation or they will not long remain in existence"); *see also* Fidelity Fed. Sav. & Loan Ass'n v. De La Cuesta, 458 U.S. 141, 169 n.21 (stating that over 40% of the losses suffered by savings and loan associations in California in 1981 resulted from that state's restrictions on the use of due-on-sale clauses).

ment penalty, which insulates the lender during times of falling interest rates. However, because these two provisions serve to maintain the profitability of the lender's portfolio only during times of directly opposing market conditions, the lender's interest in maintaining a profitable loan portfolio cannot justify the concurrent use of both the prepayment penalty and the due-on-sale clause. Thus, when a lender accelerates a debt during times of rising interest rates pursuant to a due-on-sale clause, the lender benefits from the early payment because then it can reinvest the money at the higher rate. Consequently, the lender cannot claim that a prepayment penalty is needed to maintain a profitable portfolio by locking in the loan at the old rate.[40]

Lenders' use of prepayment penalties and due-on-sale clauses to maintain profitable yields is not totally unjustified. The point is merely that their use, at the same time and with respect to the same loan, is neither legitimate nor logical. In a broader sense, lenders' use of either the due-on-sale or prepayment penalty clause as an overall strategy to achieve higher yields during times of fluctuating interest rates, but without enforcing both provisions simultaneously, presents a much less objectionable scenario. A lender can use the due-on-sale clause to increase its overall yield in times of increasing interest rates[41] and the prepayment penalty to maintain its yield when interest rates decline. Even this scenario, however, seems to give the lender a two-edged advantage with no concomitant concession to the borrower. When interest rates increase, a borrower wishing to sell its real estate will have its low-interest loan accelerated and, thus, will not be able to benefit from that lower rate by commanding a higher price for its property.[42] Conversely, when interest rates decrease, the borrower cannot benefit from that decrease by refinancing at the lower rates because the prepayment penalty has locked the borrower in at the higher rate.

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40. The FHLBB has recognized this and, in discussing the use of a prepayment penalty in conjunction with a due-on-sale clause, has stated, "While the ability to impose a prepayment or equivalent fee upon due-on-sale acceleration may be of some economic benefit to the lender, it is in no sense essential to effective use of the due-on-sale clause for the purpose of raising portfolios yields to current market rates." 48 FED. REG. 21,560 (1983).

41. *See supra* notes 38-39 and accompanying text.

42. *See* Powell v. Phoenix Fed. Sav. & Loan Ass'n, 434 So. 2d 247 (Ala. 1983). "With the due-on-sale clause in a fixed rate mortgage, the borrower is free from the effects of rising interest rates until he decides to sell . . . . At this point he may experience some difficulty in selling the home without a considerable reduction in the sale price." *Id.* at 253; *see also* Lake v. Equitable Sav. & Loan Ass'n, 105 Idaho 923, 929, 674 P.2d 419, 425 (1983) (Shepard, J., dissenting).

The lender enjoys a "heads I win, tails you lose" situation, while the borrower seemingly bears an unduly disproportionate share of the risk associated with fluctuating interest rates.[43] Nevertheless, courts frequently cite the need for lenders to lock in loans at higher rates as support for permitting enforcement of prepayment penalties.[44]

A third, though not often articulated, reason for lenders' desire to collect a prepayment penalty is that penalties produce revenue. One informal survey designates the prepayment penalty as the third most significant source of income for lending institutions, behind only interest collections and loan fees.[45]

The final justification that has been advanced in support of the validity of prepayment penalties concerns the tax consequences to the lender of a borrower's prepayment. At least one court has enforced a provision providing for a penalty of fifty percent of the prepaid principal.[46] The justification for such a harsh penalty was that the lender would incur a significant increase in federal income tax liability if the borrower, in any given year, repaid more than the amount called for in the note.[47]

D. Judicial Treatment of Attacks on Prepayment Penalties

Prepayment penalties have been attacked frequently in court. Generally, however, borrowers challenging the enforceability of these penalties have not been successful. This section discusses the

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43. *See* Lake v. Equitable Sav. & Loan Ass'n, 105 Idaho 923, 674 P.2d 419 (1983) (Sbepard, J., dissenting). In *Lake* the dissent argued as follows:

> Here, it is asserted that such institutions need have no concern for anything but their own profitability and that whatever results flow from these transactions are risks to be assumed by the public. I disagree. In a time of increasing interest cost, the borrower finds himself unable to convey unless an interest premium is paid. In a time of falling interest, a borrower is prevented from refinancing by obtaining a loan at lower interest and paying off the original loan without likewise paying the original lender a premium/penalty for prepayment. The home owner is placed at the mercy of forces he does not understand and cannot control or plan against. I find it nothing short of incredulous that such practices and procedures can be viewed as in the "public interest."

Id. at 931, 674 P.2d at 427.

44. *See, e.g.*, Camellia Apartments, Inc. v. United States, 334 F.2d 667, 672 (Ct. Cl. 1964); *Sacramento Sav. & Loan Ass'n*, 137 Cal. App. 3d at 145-46, 186 Cal. Rptr. at 825-26; *Lazzareschi Inv. Co.*, 22 Cal. App. 3d at 309, 99 Cal. Rptr. at 421; Bell Bakeries v. Jefferson Standard Life Ins. Co., 245 N.C. 418, 96 S.E.2d 415 (1957).

45. *See* Comment, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CALIF. L. REV. 923, 924 n.10 (1963).

46. Williams v. Fassler, 110 Cal. App. 3d 7, 167 Cal. Rptr. 545 (1980).

47. *Id.* at 12-13, 167 Cal. Rptr. at 548-49; *see also* Miller v. Berkoski, 297 N.W.2d 334, 336 (Iowa 1980) (discussing the effect of prepayment on tax liability).

various legal theories advanced by borrowers attacking the legality of prepayment penalties.

Borrowers often have attacked prepayment penalties as violative of state usury statutes.[48] This argument appears valid when the total amount paid, including principal, interest, and prepayment penalty, combines to give the lender a higher return on its investment, up to the time of prepayment, than is allowable under the applicable usury statute. This reasoning, however, assumes that the penalty amount is interest for purposes of the usury laws. Most courts, however, have held that a prepayment penalty is not interest within the meaning of the usury statutes and, therefore, that the stated maximum allowable interest rate does not prevent the collection of a prepayment penalty.[49]

In the non-option penalty situation—when the note is silent as to the amount of the penalty—courts have analyzed the penalty as consideration for the lender surrendering its right to refuse an early tender of payment.[50] Because the penalty is not interest, the usury statutes may not be invoked to prevent the lender from col-

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48. *See, e.g.*, Travelers Ins. Co. v. Kernachan, 283 Ala. 96, 214 So. 2d 447 (1968); Winkle v. Grand Nat'l Bank, 267 Ark. 123, 601 S.W.2d 559 (1980); Mid-America Dev. Corp. v. Arkansas Sav. & Loan Ass'n, 257 Ark. 850, 520 S.W.2d 238 (1975); Eldred v. Hart, 87 Ark. 534, 113 S.W. 213 (1908); Arkansas Farm Prods., Inc. v. Ford Motor Credit Co., 267 Ark. 653, 590 S.W.2d 48 (Ct. App. 1979); Williams v. Fasler, 110 Cal. App. 3d 7, 167 Cal. Rptr. 545 (1980); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971); Abbot v. Stevens, 133 Cal. App. 2d 242, 284 P.2d 159 (1955); McCarty v. Mellinkoff, 118 Cal. App. 11, 4 P.2d 595 (1931); Dezell v. King, 91 So. 2d 624 (Fla. 1956); Webb v. Southern Trust Co., 227 Ky. 79, 11 S.W.2d 988 (1928); B.F. Saul Co. v. West End Park N., Inc., 250 Md. 707, 246 A.2d 591 (1968); Jackson Inv. Co. v. Bates, 366 So. 2d 225 (Miss. 1978); Hanson v. Acceptance Fin. Co., 270 S.W.2d 143 (Mo. Ct. App. 1954); Bloomfield Sav. Bank v. Howard S. Stainton & Co., 60 N.J. Super. 524, 159 A.2d 443 (1960); Redmond v. Ninth Fed. Sav. & Loan Ass'n, 147 N.Y.S.2d 702 (N.Y. App. Div. 1955); Lyons v. Nat'l Sav. Bank, 280 A.D. 339, 113 N.Y.S.2d 695 (N.Y. App. Div. 1952), *rev'g* 200 Misc. 652, 110 N.Y.S.2d 564 (1951); Feldman v. Kings Hwy. Sav. Bank, 278 A.D. 589, 102 N.Y.S.2d 306 (N.Y. App. Div.), *aff'd*, 303 N.Y. 675, 102 N.E. 2d 835 (1951); Bell Bakeries v. Jefferson Standard Life Ins. Co., 245 N.C. 408, 96 S.E.2d 408 (1957); Marley v. Consolidated Mortgage Co., 102 R.I. 200, 229 A.2d 608 (1967); Reichwein v. Kirschenbaum, 98 R.I. 340, 201 A.2d 918 (1964); Luchesi v. Capitol Loan & Fin. Co., 83 R.I. 151, 113 A.2d 725 (1955); Bearden v. Tarrant Sav. Ass'n, 643 S.W.2d 247 (Tex. Ct. App. 1982); Boyd v. Life Ins. Co., 546 S.W.2d 132 (Tex. Civ. App. 1977).

49. *See, e.g., Arkansas Farm Prods., Inc.*, 267 Ark. at 656, 590 S.W.2d at 50; *Williams*, 110 Cal. App. 3d at 11, 167 Cal. Rptr. at 547; *McCarty*, 118 Cal. App. at 13, 4 P.2d at 596; *Webb*, 227 Ky. at 83, 11 S.W.2d at 989; *Feldman*, 278 A.D. at 589-90, 102 N.Y.S. 2d at 307-08; *Lyons*, 280 A.D. at 340-41, 113 N.Y.S.2d at 696; *Bearden*, 643 S.W.2d at 249-50; *Boyd*, 546 S.W.2d at 133.

50. *See, e.g., Abbot*, 133 Cal. App. 2d at 247, 284 P.2d at 162; *McCarty*, 118 Cal. App. at 13, 4 P.2d at 596; *Webb*, 227 Ky. at 83, 11 S.W.2d at 989; *Bloomfield Sav. Bank*, 60 N.J. Super. at 531-32, 159 A.2d at 447; *Feldman*, 278 A.D. at 589-90, 102 N.Y.S. 2d at 307-08; *Lyons*, 280 A.D. at 340-41, 113 N.Y.S.2d at 696.

lecting the prepayment fee. Similarly, in the option penalty situation—when the terms of prepayment and the amount of the penalty are specified in the note—courts have not viewed the penalty as interest. Instead, the penalty is a fee exacted by the lender for allowing the borrower the privilege of prepaying, or for creating an alternative method of performance in the note.[51] Courts have tended to focus attention on the fact that it is the borrower who decides if and when prepayment will be made and, therefore, it is the borrower who triggers the penalty.[52] Courts conclude that the borrower should not be allowed, through its voluntary and unilateral act of prepaying the loan, to render usurious a loan that otherwise would be lawful if carried to maturity.[53]

Several problems plague this analysis. Foremost is the inconsistency between this approach, which defines prepayment as something other than interest, and the frequently implied assumption that the loan would be usurious if the prepayment provision operated to give the lender a return on its investment in excess of the maximum lawful rate when calculated to the date of maturity instead of the date of prepayment.[54] If the prepayment penalty were truly consideration for the prepayment privilege rather than interest, the loan should not be considered usurious even when the combination of prepayment penalty and interest exceeds the maximum rate when calculated to maturity. One commentator has suggested that this inconsistency is a result of the courts' attempt to deal with the following dilemma:

> Had the courts not suggested some limit to the penalties, they would have endorsed a relatively simple means for circumventing the usury laws. On the other hand, had they held the prepaid loan usurious, the full sanctions of the

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51. *See, e.g., Arkansas Farm Prods., Inc.*, 267 Ark. at 656, 590 S.W.2d at 50; *Williams*, 110 Cal. App. 3d at 11, 167 Cal. Rptr. at 547; *Marley*, 102 R.I. at 205-08, 229 A.2d at 611-13; *Bearden*, 643 S.W.2d at 249; *Boyd*, 546 S.W.2d at 133.

52. *See, e.g., Winkle*, 267 Ark. at 139-C, 601 S.W.2d at 568; *Eldred*, 87 Ark. at 539, 113 S.W. at 215; *Arkansas Farm Prods., Inc.*, 267 Ark. at 655-67, 590 S.W.2d at 50; *Abbot*, 133 Cal. App. 2d at 246, 284 P.2d at 162; *Bloomfield Sav. Bank*, 60 N.J. Super. at 532, 159 A.2d at 447; *Redmond*, 147 N.Y.S.2d at 703; *Bell Bakeries*, 245 N.C. at 418, 96 S.E.2d at 417; *Marley*, 102 R.I. at 208, 229 A.2d at 612; *Bearden*, 643 S.W.2d at 249; *Boyd*, 546 S.W.2d at 133.

53. *See, e.g., Winkle*, 267 Ark. at 139-C, 601 S.W.2d at 568; *Eldred*, 87 Ark. at 539, 113 S.W. at 215; *Abbot*, 133 Cal. App. 2d at 247-48, 284 P.2d at 162; *Dezell*, 91 So. 2d at 627; *Hanson*, 270 S.W.2d at 148.

54. *See, e.g., Winkle*, 267 Ark. at 139-C, 601 S.W.2d at 568; *Eldred*, 87 Ark. at 539, 113 S.W. at 215; *Dezell*, 91 So. 2d at 627; *B. F. Saul*, 250 Md. at 719, 246 A.2d at 599; *Hanson*, 270 S.W.2d at 148; *Feldman*, 278 A.D. at 590; *Redmond*, 147 N.Y.S.2d at 703; *Marley*, 102 R.I. at 208, 209 A.2d at 612-13; *Bearden*, 643 S.W.2d at 249.

usury laws would have been brought to bear on the lenders.[55]

Even the courts' adopted limitation on prepayment penalties, however, is of little practical benefit to the borrower for two reasons. First, usury statutes in some jurisdictions do not apply to all lenders or classes of loans.[56] Second, this judicial limitation will not save the prepaying borrower any money because the maximum allowable penalty will be greater than or equal to the entire amount of unearned interest on the note when calculated to maturity.[57] Thus, it would be no more expensive, and perhaps even less expensive, for the borrower to forego prepayment and simply pay the note off according to its terms.

Another problem arises when the prepayment is involuntary. Analysis of the usury law challenge to prepayment penalties is based on the premise that the fee is merely consideration for allowing the borrower to exercise the privilege of prepayment.[58] This analysis, therefore, breaks down when the prepayment is involuntary or compelled by circumstances beyond the borrower's control, such as condemnation or destruction of the property, acceleration by the lender pursuant to a due-on-sale or encumbrance clause, or involuntary default by the borrower.[59] Despite breakdowns in this analysis, courts generally do not appear receptive to usury law challenges to prepayment penalties.[60]

A second avenue of attack against prepayment penalties is the argument that they are an invalid penalty because they bear no reasonable relationship to the damages actually sustained by the lender because of the prepayment.[61] This argument fails when the penalty is minimal or the damage to the lender is quite severe.

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55. *See* Comment, *supra* note 45, at 927.

56. *See, e.g., id.* at 928. *See generally* 45 AM. JUR. 2d *Interest & Usury* § 9 (1969); 47 C.J.S. *Interest & Usury; Consumer Credit* § 92 (1982).

57. If, as this approach permits, the penalty is calculated to give the lender a sum that represents a return on its investment equal to the maximum allowahle interest rate on the loan calculated to maturity, this penalty amount cannot be less than the penalty derived if the actual interest rate is used; the interest rate on the note cannot, by definition, exceed the maximum allowable rate.

58. *See supra* notes 51-53 and accompanying text.

59. *But see* Jackson Inv. Co. v. Bates, 366 So.2d 225 (Miss. 1978) (allowing a prepayment penalty despite a usury law challenge when the lender demanded prepayment after destruction of the security).

60. *See supra* notes 49-53 and accompanying text.

61. *See, e.g.,* Sacramento Sav. & Loan Ass'n v. Superior Court, 137 Cal. App. 3d 142, 186 Cal. Rptr. 823 (1982); Williams v. Fassler, 110 Cal. App. 3d 7, 167 Cal. Rptr. 545 (1980); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971); Century Fed. Sav. & Loan Ass'n v. Madorsky, 353 So.2d 868 (Fla. Dist. Ct. App. 1977), *cert. denied*, 359 So. 2d 1217 (Fla. 1978).

Even when the penalty charged far exceeds any damages sustained by the lender, however, many courts have continued to enforce the penalty.[62] The reasoning espoused by these courts is somewhat analogous to the rationale used to reject usury statute challenges to prepayment penalties: the prepayment is merely an alternative means by which the borrower can perform its obligation under the contract.[63] For example, in *Lazzareschi Investment Co. v. San Francisco Federal Savings & Loan Association*[64] the court upheld a penalty of six months interest against an attack on the validity of the penalty. The court declared that prepayment is not a breach of contract for which the law demands actual damages to be reasonably related to the penalty.[65] Thus, the court held inapplicable the principle forbidding the collection of a penalty that does not approximate the actual damages caused by the breach of contract.[66] Other courts have approached this issue in a similar manner.[67]

Borrowers also have challenged the enforceability of prepayment penalties by characterizing them as invalid liquidated damages provisions.[68] The *Lazzareschi* court, however, held that the prepayment penalty was not a provision for liquidated damages.[69] The court found that the note's prepayment provision was not made in contemplation of a breach, but instead merely created an alternative method of performance for the borrower.[70] Other courts have used this theory to reach the same conclusion.[71]

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62. *See supra* note 61.

63. *Williams*, 110 Cal. App. 3d at 11-13, 167 Cal. Rptr. at 547-48; *Lazzareschi Inv. Co.*, 22 Cal. App. 3d at 307, 99 Cal. Rptr. at 420.

64. 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971).

65. "[T]here has been no breach. The borrower had the option . . . of making one or more prepayments. He . . . availed himself of the option . . . . [T]here is no penalty in the sense of retribution for breach of an agreement." *Lazzareschi Inv. Co.*, 22 Cal. App. 3d at 307, 99 Cal. Rptr. at 420.

66. *Id.* Nevertheless, the court assumed that palpably exorbitant penalties would be unenforceable. The court concluded that because this particular penalty provision exceeded neither the usual penalty nor the one authorized by FHLBB regulations, and because it protected the lender's legitimate interests, it was not unreasonable. *Lazzareschi Inv. Co.*, 22 Cal. App. 3d at 308-11, 99 Cal. Rptr. at 420-23.

67. *See Sacramento Sav. & Loan Ass'n*, 137 Cal. App. 3d at 146, 186 Cal. Rptr. at 826; *Williams*, 110 Cal. App. 3d at 11-13, 167 Cal. Rptr. at 547-49; *Century Fed. Sav. & Loan Ass'n*, 353 So.2d at 869 (dismissing the borrower's claim that a prepayment penalty of 12 months interest constituted unjust enrichment).

68. *See* Williams v. Fassler, 110 Cal. App. 3d 7, 167 Cal. Rptr. 545 (1980); Meyers v. Home Sav. & Loan Ass'n, 38 Cal. App. 3d 544, 113 Cal. Rptr. 358 (1974).

69. *Lazzareschi Inv. Co.*, 22 Cal. App. 3d at 307, 99 Cal. Rptr. at 420.

70. *Id.*

71. *See Williams*, 110 Cal. App. 3d at 12-13, 167 Cal. Rptr. at 548 (holding a 50% prepayment penalty enforceable because it was an alternative means of performance and

Finally, prepayment penalties in notes secured by mortgages on real estate also have been assailed as an unreasonable restraint on alienation.[72] Again, courts generally have been unreceptive to this line of attack.[73] The *Lazzareschi* court began with the proposition that restraints on alienation that are not absolute and that serve to protect a "justifiable interest" are not inherently illegal. The court summarized its prepayment discussion by stating that "[t]he prepayment charge by no means constitutes an absolute restraint and because we do not regard it as an exorbitant burden . . . and because there are legitimate interests of the lender to be protected, . . . we do not discern an unlawful restraint on alienation."[74] At least one court has relied on *Lazzareschi* to reach the same conclusion concerning an identical prepayment provision.[75]

E. *Special Considerations in Involuntary Prepayment Situations*

Special considerations concerning the validity of a prepayment penalty come into play when the prepayment is not a voluntary act on the part of the borrower. For example, the lender may accelerate a note pursuant to a due-on-sale clause.[76] Other examples of involuntary prepayment situations in the context of a note secured by real estate occur when the mortgaged premises are condemned or destroyed and a provision in the note allows the lender to accelerate the debt.[77]

Applying the basic justifications for allowing a prepayment penalty does not necessarily resolve involuntary prepayment issues, but it may help focus attention on the parties' real interests and, thus, point toward an equitable solution. If the prepayment

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because, at the time of making the contract, it was a reasonable approximation of actual damages); *Meyers*, 38 Cal. App. 3d at 545-47, 113 Cal. Rptr. at 359-60 (holding a prepayment penalty not to be an invalid liquidated damages clause because it did not envision a breach of the contract, but rather provided an alternative means of performance).

72. Sacramento Sav. & Loan Ass'n v. Superior Court, 137 Cal. App. 3d 142, 186 Cal. Rptr. 823 (1982); Lazzareschi Inc. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971); Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969); *see also* Hartford Life Ins. Co. v. Randall, 283 Or. 297, 583 P.2d 1126 (1978) (upholding a provision in the note prohibiting prepayment for 11 years against borrower's allegation that it constituted an unreasonable restraint on alienation).

73. *See supra* note 72.

74. *Lazzareschi Inv. Co.*, 22 Cal. App. 3d at 311, 99 Cal Rptr. at 422.

75. *Sacramento Sav. & Loan*, 137 Cal. App. at 145-47, 186 Cal. Rptr. at 825-26.

76. *See supra* notes 29-30.

77. *See, e.g.*, Jackson Inv. Co. v. Bates, 366 So. 2d 225 (Miss. 1978); Knoxville Hous. Auth., Inc. v. Bush, 56 Tenn. App. 464, 408 S.W.2d 407 (1966).

penalty is necessary to compensate the lender for the loan's fixed costs, which have been amortized over the life of the loan, no reason justifies not allowing the lender to collect this penalty even if prepayment is involuntary. Under modern practices, however, a lender arguably recovers its fixed costs at the inception of the loan.[78] Therefore, to the extent that this is true, the collection of any prepayment penalty, especially in involuntary prepayment situations, is unjustified. Furthermore, the argument that lenders must charge a prepayment penalty to avoid or mitigate the devastating effects on their portfolio yields that would result if borrowers were free to refinance their debts whenever interest rates dropped is not applicable when circumstances beyond the mortgagor's control force prepayment. This is especially true because the lender, instead of calling the debt due immediately, could allow the borrower, in the case of destruction, to apply the insurance proceeds toward rebuilding the structure,[79] or could allow the mortgagor, in the case of condemnation, to use the condemnation award to purchase or build another structure.[80] In both cases, the process can be carried out under the lender's supervision or subject to its

78. *See supra* notes 26-27 and accompanying text.

79. Most of the mortgage forms used today provide for the disposition of insurance proceeds in the event of the mortgaged property's destruction. G. NELSON & D. WHITMAN, *supra* note 5, at § 4.15. For example, the Federal National Mortgage Association/Federal Home Loan Mortgage Corporation Uniform Mortgage-Deed of Trust Covenants-Single Family Form contains the following provision:

> Unless Lender and Borrower otherwise agree in writing, insurance proceeds shall be applied to restoration or repair of the Property damaged, if the restoration or repair is economically feasible and Lender's security is not lessened. If the restoration or repair is not economically feasible or Lender's security would be lessened, the insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with any excess paid to Borrower. If Borrower abandons the Property, or does not answer within 30 days a notice from Lender that the insurance carrier has offered to settle a claim, then Lender may collect the insurance proceeds. Lender may use the proceeds to repair or restore the Property or to pay sums secured by this Security Instrument, whether or not then due. The 30-day period will begin when the notice is given.

Id. at § 14.3, para. 5.

80. Commentators have pointed out that a condemnation situation is not necessarily analogous to a situation in which the security is destroyed because, in the latter instance, if the mortgagee allows the mortgagor to rebuild, the mortgagee's security is unimpaired, while in the former, allowing the mortgagor to keep the condemnation award would result in an unsecured loan. G. NELSON & D. WHITMAN, *supra* note 5, at § 6.3. There is no reason, however, why the mortgagee could not allow the mortgagor to keep the condemnation award on the condition that the mortgagor purchase or build on another piece of property, thereby securing the debt. This would not differ substantially from the common practice of allowing the mortgagor to keep the insurance proceeds in cases of destruction, conditioned on the rebuilding of a structure that would not impair the security. *See also supra* note 79.

approval, thereby ensuring that the new structure will secure the debt adequately. The lender, therefore, could abstain from accelerating the debt and allow the original loan to survive according to its terms in both destruction and condemnation situations.[81] If the lender does accelerate, the prepayment is especially involuntary because the borrower does not wish to dispose of the property or prepay the debt.

A common mortgage provision allows the mortgagee to collect a prepayment penalty whether prepayment is voluntary or involuntary.[82] Arguably, the mortgagor's signing of a note containing a prepayment penalty provision constitutes a waiver of its right to make the above arguments. The equities of the situation, however, may demand relief.[83] These situations naturally provoke sympathy for the mortgagor and, indeed, some courts have shown a willingness to intervene and prevent the collection of prepayment penalties.[84]

In *Chestnut Corp. v. Bankers Bond & Mortgage Co.*[85] the court refused to allow the lender to collect a prepayment penalty on a loan that was prepaid with insurance proceeds after fire destroyed the property. The court balanced the parties' interests and concluded that the equities weighed against enforcement of the penalty.[86] It is unclear whether the court would have applied this

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81. In the destruction context several courts have been willing to require the mortgagee to allow the mortgagor to apply the insurance proceeds toward rebuilding when the note does not state otherwise and when the security will not be impaired because this result is deemed more equitable. G. Nelson D. Whitman, *supra* note 5, at § 4.15. Because the same equities are present when the security is condemned, a similar result should follow.

82. For example, the prepayment penalty provision in the note at issue in Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 305, 99 Cal. Rptr. 417, 418 (1971), contained the following language: "The undersigued agree that such six (6) months advance interest shall be due and payable whether said prepayment is voluntary or involuntary, including any prepayment effected by the exercise of any acceleration clause provided for herein."

83. *See* G. Nelson & D. Whitman, *supra* note 5, at § 6.3 (suggesting that the inclusion of a penalty provision in the debt instrument, while perhaps precluding the debtor from challenging the collection of the prepayment penalty, may constitute an invalid penalty for the breach of an obligation); *see also* Cal. Civ. Code § 2985.6(b) (West Supp. 1987) (stating that any provision in a land sale contract waiving a vendee's statutory right to make prepayment shall be void as against public policy).

84. *See infra* notes 85-89.

85. 395 Pa. 153, 149 A.2d 48 (1959).

86. The court discussed the interests of the parties as follows:

The question posed is a difficult one. A prepayment clause is ordinarily inserted to compensate a mortgagee for the cost and expenses attendant in making a new long term mortgage loan. The obligor-mortgagor was clearly given the right or privilege *at its election* to pay the balance of principal in full before maturity. Plaintiff (who is the reasoning if the note had called for a prepayment penalty regardless of whether the prepayment was voluntary.[87]

When the mortgaged property has been condemned, courts also have been unwilling to sanction the collection of a penalty.[88] These courts reason that when the property is condemned, prepayment is involuntary and outside the scope of the note's prepayment provision, which only applies to voluntary prepayments.[89] At

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owner and who stands in the shoes of the obligor-mortgagor) correctly contends (a) that the prepayment was not voluntary on its part, and (b) that no prepayment was made *by it*, and (c) that no 30 days prior written notice of an intention to prepay the unpaid principal debt was ever given as required by the bond. The mortgagee was paid the entire unpaid principal balance of the mortgage plus accrued interest not because of any desire on the part of the plaintiff to prepay the debt, nor in compliance with the exact terms of the Rider, but solely because of the fire and the provisions with respect thereto in the fire insurance policies. Nevertheless, at least in theory, defendant would be put to some cost and expense to make a new mortgage loan. On the other hand, plaintiff, while it has received the full net amount of the fire insurance, bas lost its building, and if it desired to rebuild it would have to obtain a new mortgage loan, and in the meantime it would be without a building and would lose whatever contracts and/or leases it had made. In such a situation both parties suffer, but the owner suffers most.

Id. at 155-56, 149 A.2d at 50 (emphasis in original); *see also* Jackson Inv. Co. v. Bates, 366 So. 2d 225 (Miss. 1978) (invoking equitable principles to order refund to debtor of unearned precomputed interest when loan was accelerated after destruction of security).

87. The *Chestnut Corp.* court placed heavy emphasis on the fact that the note was silent as to tbis particular contingency. The court stated:

Neither the bond nor the mortgage specifically or expressly provides for the exact situation which has arisen, namely, a prepayment of the entire principal loan with interest during the premium period, due not to a voluntary election of prepayment but to a fire. If defendant (the obligee-mortgagee) believed it should be entitled to the premium under these circumstances it could easily and should have so provided in the bond and/or mortgage. In the absence of such a provision we believe that defendant who received the entire unpaid principal and accrued interest of its mortgage is not entitled to the prepayment premium.

Chestnut Corp., 395 Pa. at 156-57, 149 A.2d at 50. *Compare* Chestnut Corp. v. Banker's Bond & Mortgage Co., 395 Pa. 153, 149 A.2d 48 (1959) *with In re* Brooklyn Bridge Southwest Urban Renewal Project, 46 Misc. 2d 558, 260 N.Y.S.2d 229 (N.Y. Super. Ct.), *aff'd*, 24 A.D.2d 710, 262 N.Y.S.2d 1020 (1965) (holding a provision in the note expressly providing for tbe collection of a prepayment penalty in the event of condemnation to be enforceable).

88. *See, e.g.*, Associated Schools, Inc. v. Dade County, 209 So. 2d 489 (Fla. Dist. Ct. App. 1968); DeKalb County v. United Family Life Ins. Co., 235 Ga. 417, 219 S.E.2d 707 (1975); Jala Corp. v. Berkeley Sav. & Loan Ass'n, 104 N.J. Super. 394, 250 A.2d 150 (N.J. Super. Ct. App. Div. 1969); Silverman v. State, 48 A.D.2d 413, 370 N.Y.S.2d 234 (1975); Landohio Corp. v. Northwestern Mut. Life Mortgage & Realty Investors, 431 F. Supp. 475 (N.D. Ohio 1976); *see also* Knoxville Hous. Auth., Inc. v. Bush, 56 Tenn. App. 464, 408 S.W.2d, 407 (1966) (holding that mortgagor could not recover amount of prepayment penalty from condemnor, but reserving judgment on whether a prepayment penalty should be effective as between the mortgagor and mortgagee). *See generally* Annotation, *Compensation for interest prepayment in emminent domain proceedings*, 84 A.L.R.3d 946 (1978).

89. For example, the *Jala Corp.* court stated:

Thus, in the instant case we find that plaintiffs did not voluntarily exercise any "right" least two states have statutorily forbidden the collection of a prepayment penalty when prepayment is occasioned by condemnation of the mortgaged property.[90] Other states have taken a different approach and require the agency taking the property to include in the condemnation award all "expenses [the owner] necessarily incurred [as] . . . penalty costs for prepayment for any preexisting recorded mortgage."[91] The Uniform Relocation Assistance Policies Act[92] requires this approach for federally funded projects.[93]

Some courts also have prevented the lender from collecting a prepayment penalty after accelerating the debt in response to the borrower's default.[94] The court's rationale in *In re LHD Realty Corp.*, that "acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity," is typical of these decisions.[95] Other courts have recognized, either implicitly or explicitly, the validity of this reasoning in decisions permitting the collection of a prepayment penalty when the lender only has threatened acceleration or rescinded a prior acceleration.[96] If the rule were

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> or "privilege" to prepay the unpaid balance of the mortgage, as was contemplated by the prepayment clause contained in the mortgage. Rather, the mortgage was prepaid by reason of the fact that the State pursuant to its paramount right of eminent domain took the property for public use . . . . We cannot construe the language of the prepayment clause to make it applicable to the instant situation. Rather, we hold that the parties in inserting tbis clause did not contemplate a taking of the premises by eminent domain . . . . "If defendant (the obligee-mortgagee) believed it should be entitled to the premium under these circumstances it could easily and should have so provided in the bond and/or mortgage. In the absence of such a provision we believe that defendant who received the entire unpaid principal and accrued interest of its mortgage is not entitled to the prepayment premium."

Jala Corp., 104 N.J. Super. at 400-01, 250 A.2d at 154 (quoting Chesnut Corp. v. Bankers Bond & Mortgage Co., 395 Pa. 153, 158, 149 A.2d 48, 59 (1959)); *see also In re* Brooklyn Bridge Southwest Urban Renewal Project, 46 Misc. 2d 558, 260 N.Y.S.2d 229 (N.Y. Sup. Ct.), *aff'd*, 24 A.D. 710, 262 N.Y.S.2d 1020 (1965) (holding enforceable a provision in the note expressly providing for the collection of a prepayment penalty in the event of condemnation).

90. CAL. CIV. PROC. CODE § 1265.240 (West 1982); MASS. GEN. LAWS ANN. ch. 183, §57 (West 1977).

91. ARIZ. REV. STAT. ANN. § 11-965 (1977); *see also* CONN. GEN. STAT. ANN. § 8-282 (West Supp. 1986); OKLA. STAT. ANN. tit. 27, § 10 (West 1976); S.C. CODE ANN. § 28-11-30 (Law. Co-op 1977).

92. 42 U.S.C. §§ 4601-4655 (1982). The Uniform Relocation Assistance Policies Act is federal legislation.

93. *Id.* §§ 4653 & 4655.

94. *In re* LHD Realty Corp., 726 F.2d 327 (7th Cir. 1984); Kilpatrick v. Germania Life Ins. Co., 183 N.Y. 163, 75 N.E. 1124 (1905); Nutman, Inc. v. Aetna Bus. Credit, Inc., 115 Misc.2d 168, 453 N.Y.S.2d 586 (N.Y. Sup. Ct. 1982).

95. *In re* LHD Realty Corp., 726 F.2d at 330-31.

96. *See, e.g.*, Bell Bakeries, Inc. v. Jefferson Standard Life Ins. Co., 245 N.C. 408, 96

adopted, however, that a lender cannot collect a prepayment penalty when it has accelerated the debt because of a borrower's breach, an unscrupulous debtor wishing to prepay without incurring a penalty only would have to intentionally default or otherwise provoke the lender into accelerating the debt. Clearly, this is not a result that the courts should sanction.[97]

F. Legislative Activity Concerning Prepayment Penalties

1. General Legislation

Because courts have been reluctant to abrogate the common-law rule giving borrowers no right to prepay or to limit the permissible amount of prepayment penalties, state legislatures have been forced to protect the interests of borrowers. Legislation ranges from prohibitions on prepayment penalties to mere codifications of existing practices.

For example, Florida legislation grants the borrower the privilege of prepaying the debt without penalty if the loan instrument does not explicitly state otherwise.[98] A North Carolina statute produces an identical result.[99] Legislation of this kind eliminates the non-option prepayment penalty. Tennessee, instead of following the Florida and North Carolina approach of abrogating the common-law rule, enacted legislation preventing judicial modification or abrogation of the common law.[100]

S.E.2d 408 (1957) (holding penalty collectible when prepayment occurred after lender insisted on strict compliance with terms of note and threatened to exercise rights under note. The court, however, recognized that the lender would have no right to enforce the penalty if the note actually had been accelerated); West Portland Dev. Co. v. Cook, Inc., 246 Or. 67, 424 P.2d 212 (1967) (holding penalty collectible because lender rescinded prior acceleration and reinstated note before prepayment); Berenato v. Bell Sav. & Loan Ass'n, 276 Pa. Super. 599, 419 A.2d 620 (1980) (holding penalty collectible when lender, before prepayment, stayed foreclosure sale and indicated intent to reinstate note after payments were brought up to date); Cook v. Washington Mut. Sav. Bank, 143 Wash. 145, 254 P. 834 (1927) (holding penalty collectible on prepayment made after lender merely threatened to accelerate the debt).

97. *See infra* note 168 and accompanying text.

98. FLA. STAT. ANN. § 697.06 (West Supp. 1986). The Florida statute, which applies in all situations, provides that "[a]ny 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." *Id.*

99. N.C. GEN. STAT. § 24-2.4 (1986).

100. TENN. CODE ANN. § 47-14-108 (1984). Tennessee's statute provides that "the privilege of prepayment of a loan, in whole or in part, and any refunds or premiums with respect thereto, shall be governed by contract between the parties." *Id.*

2. Mortgage Loans: Prohibitions Against and Limitations Upon Prepayment Penalties

Most legislation on prepayment penalties is neither as comprehensive nor as definitive as the legislation discussed in the preceding subsection, but instead applies only to certain classes of lenders or certain types of loans. For example, many states have enacted statutes targeting residential real estate mortgages.[101] In the residential real estate context there are almost as many approaches to regulating prepayment penalties as there are statutes. Some states have enacted legislation that reverses the common-law rule and forbids the lender from collecting a penalty.[102] Conversely, at least one other state statute requires merely that the loan agreement "expressly and clearly state . . . any maximum prepayment privilege penalty."[103] This statute applies to any loan secured by a mortgage on real estate of a duration exceeding three years.[104] A violation of this requirement nullifies the prepayment provision.[105] Iowa's statute, while not specifically granting the right of prepayment to the borrower, forbids the lender from collecting a penalty if prepayment occurs.[106] The Iowa statute does not state explicitly whether a lender may refuse the borrower's early tender of payment.[107] Illinois achieves a result similar to Iowa by forbidding collection of a prepayment penalty on a residential mortgage in which

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101. States have adopted different definitions of the real estate covered by this type of statute. Pennsylvania's statute covers only "[r]esidential mortgage obligations." 41 PA. CONS. STAT. ANN. § 405 (Purdon Supp. 1986). Many statutes are more specific. California regulates "loan[s] for residential property of four units or less," CAL. CIV. CODE § 2954.9 (West Supp. 1986), while New York's statute applies to "a bond or note, or the mortgage on real property, improved by a one to six family residence, occupied by the owner," N.Y. REAL PROP. LAW § 254-a (McKinney Supp. 1987). Similarly, Massachusetts applies its statute to "[a]ny mortgage note secured by a first lien on a dwelling house of three or less separate households occupied or to be occupied in whole or in part by the mortgagor." MASS. GEN. LAWS ANN. ch. 183, § 56 (West 1977). Iowa prohibits prepayment penalties in loans "used for the purpose of purchasing real property which is a single-family or a two-family dwelling occupied or to be occupied by the borrower." IOWA CODE ANN. § 535.9 (West Supp. 1986). Interestingly, Iowa's prohibition also applies to loans used to purchase agricultural land. *Id.*

102. For example, New Jersey's statute states that "[p]repayment of a mortgage loan may be made by or on behalf of a mortgagor at any time, without penalty." N.J. STAT. ANN § 46:10B-2 (West Supp. 1986). Pennsylvania has a similar statute, but it is limited in application to residential mortgages. PA. CONS. STAT. ANN. § 405 (Purdon Supp. 1986).

103. OR. REV. STAT. § 86.150(1) (1984).

104. *Id.*

105. *Id.* § 86.150(2).

106. IOWA CODE ANN. § 535.9 (West Supp. 1986).

107. The language of subsection 2, however, seems to suggest that the borrower bas the right to make prepayment and that the lender may do no more than require 30 days notice and collect earned interest. *Id.* § 535.9(2).

the interest rate exceeds eight percent per year.[108] Similarly, Minnesota forbids the collection of a prepayment penalty on loans secured by a mortgage on residential real estate when the loan is made by a credit union or certain other commercial lenders, or when the loan is insured or guaranteed by the Veteran's Administration (VA), the Federal Housing Authority (FHA), the Federal Home Loan & Mortgage Corporation (FHLMC), or the Federal National Mortgage Association (FNMA).[109] Additionally, several states have created the specific right to prepay, without penalty, second mortgages made by certain lenders.[110]

Some legislation regulating prepayment penalties on residential real estate mortgages does not prohibit completely the collection of prepayment penalties. Instead, many of these laws establish a maximum allowable prepayment penalty during the various stages of the life of the loan, with several statutes also granting the borrower the right to prepay without penalty after a certain period of time has elapsed. Ohio, for example, provides that any residential real estate mortgage may be prepaid without penalty after five years and provides a maximum penalty of one percent of the original principal if the loan is prepaid before five years.[111] Similarly, Missouri[112] and Mississippi[113] allow a prepayment penalty only during the first five years of the loan. Missouri establishes a maximum penalty of two percent of the loan balance at the time of prepayment, whereas Mississippi allows a penalty of five percent of the loan balance during the first year, declining one percent per year until, in the fifth year, the maximum penalty is reduced to

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108. ILL. ANN. STAT. ch. 17, § 6404(2)(a) (Smith-Hurd Supp. 1986).

109. MINN. STAT ANN. § 47.20(5) (West Supp. 1987).

110. *See, e.g.*, DEL. CODE ANN. tit. 5, § 3125 (1985); MO. ANN. STAT. § 408.234.(3) (Vernon Supp. 1987); N.J. STAT. ANN. § 17:11A-50 (West 1984); N.C. GEN. STAT. § 24-14(e) (1986); OHIO REV. CODE ANN. § 1321.57. (Page Supp. 1985); *see also* CONN. GEN. STAT. ANN. § 36-224(j)(West 1981) (creating the right to prepay, without penalty, a second mortgage after three years and establishing a maximum penalty of five percent of the unpaid balance before that time); N.H. REV. STAT. ANN. § 398-A:2 (Supp. III 1986) (granting the borrower the right to prepay and forbidding the imposition of a penalty unless the loan documents clearly provide for a penalty).

111. OHIO REV. CODE ANN. § 1343.011(3)(c) (Page 1979).

112. MO. ANN. STAT. § 408.036 (Vernon Supp. 1987). Compare the standard used in this statute to establish the amount of the penalty with that used in the Ohio statute, *supra* note 111. Whereas Missouri calculates the penalty as a percentage of the outstanding principal at the time of prepayment, Ohio allows a penalty to be calculated as a percentage of the original loan balance. California, on the other hand, measures the penalty as six months interest on the amount of prepayment. *See infra* note 127.

113. MISS. CODE ANN. § 75-17-31 (Supp. 1985). This section applies only to lenders subject to the usury statute.

one percent. Rhode Island permits prepayment after one year, but permits a penalty of two percent of the remaining balance before one year.[114] Massachusetts also prohibits the collection of a prepayment penalty if prepayment is made after one year, setting the maximum allowable penalty for prepayment within the first year of the loan as the lesser of the balance of the first year's interest or three months interest.[115] New York law permits prepayment of residential real estate mortgages and limits the right of the lender to exact a penalty.[116] Under New York law no penalty may be collected unless the instrument expressly provides for it and, in any case, no prepayment penalty may be charged after one year from the date of the loan's inception.[117] Michigan forbids the lender to refuse to allow a mortgagor of property containing a single family residence to prepay at any time and allows only a penalty of one percent of the prepaid principal during the first three years, with no penalty afterwards.[118] Likewise, Virginia limits prepayment penalties on loans secured by a borrower-occupied residence[119] and in various other contexts.[120] Additionally, at least two states have statutes that specifically address prepayment penalties in residential real estate mortgage loans made by savings and loan associations.[121]

Two states also have enacted legislation regulating the use of prepayment penalties in alternative mortgage instruments. Connecticut forbids the imposition of a prepayment penalty in this context,[122] while Indiana allows the borrower to prepay a variable rate mortgage, without penalty, for sixty days after receiving noti-

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114. R.I. GEN. LAWS § 34-23-5 (1984).

115. MASS. GEN. LAWS ANN. ch. 183, § 56 (West 1977). Interestingly, this statute provides for an additional penalty not in excess of three months interest if the prepayment is made within three years solely for the purpose of refinancing the debt through another institution. Thus, this statute enables lenders to protect their interests by discouraging refinancing in times of declining interest rates.

116. N.Y GEN. OBLIG. LAW §§ 5-501 (3) & (6) (McKinney Supp. 1987).

117. *Id.*

118. MICH. COMP. LAWS ANN. § 438.31c(2)(c) (West Supp. 1986). This statute applies to land leases, installment land contracts, and real estate mortgages.

119. VA. CODE § 6.1-330.29 (1983).

120. *Id.* §§ 6.1-330:27:1—6.1-330:33 (1983 & Supp. 1986). These sections limit the permissible amount of prepayment penalties on loans made by a wide variety of lenders, including credit unions (§ 6.1-330.28), industrial loan associations (§ 6.1-330.30), and unlicensed lenders (§ 6.1-330.31).

121. *See* KAN. STAT. ANN. § 17-5512 (1981); *see also id.* § 17-5512(a) (pertaining to mortgage loans made by savings and loan associations other than residential loans); N.Y. BANKING LAW § 393(2) (McKinney Supp. 1987).

122. CONN. GEN. STAT. ANN. § 36-9g(c) (West 1981).

fication that the rate has risen above the initial loan rate.[123] Indiana permits the borrower to prepay roll-over mortgages at the time of adjustment without penalty.[124]

California's legislation[125] is more advantageous to lenders than many of the statutes previously mentioned. California law prohibits lenders from charging prepayment penalties on loans secured by a mortgage on residential property of four units or less after five years.[126] Before that time, however, borrowers must prepay in accordance with any provision in the note calling for a penalty.[127] At least three states—New York, Virginia, and California—prohibit the collection of prepayment penalties on loans secured by residential real estate mortgages if the lender accelerates the debt pursuant to a due-on-sale clause. The New York statute applies to all loans secured by a mortgage on an owner-occupied residence containing one to six family units, and only forbids collection of a prepayment penalty if the lender refuses the borrower's request to allow the purchaser to assume the note or take subject to the mortgage.[128] Virginia has enacted similar legislation.[129] California's statute applies to all real estate mortgages; the debtor, however, may waive its rights by a provision in the mortgage if the mortgage is not on residential property containing four or fewer living

123. IND. CODE ANN. § 28-1-13.5-2(5)(C) (Burns 1986).

124. *Id.* § 28-1-13.5-3(3) (Burns 1986).

125. CAL. CIV. CODE § 2954.9 (West Supp. 1987).

126. *Id.* § 2954.9(3)(b). Purchase money mortgages are exempt from this restriction if the lender takes back four or less mortgages per year. *Id.* § 2954.9(3).

127. *Id.* The penalty may not exceed 6 months interest on that amount prepaid in any 12 month period exceeding 20% of the original loan balance. Identical restrictions govern loans negotiated by real estate brokers, except that lenders may charge a penalty during the first 7 years of the note. CAL. BUS. & PROF. CODE § 10242.6 (West Supp. 1987). Theoretically, these statutes permit the borrower to pay off the entire mortgage in 5 years, without incurring a penalty, by prepaying 20% of the original balance each year. This possibility is of little practical value to mortgagors, however, because the majority of prepayments coincide with a sale of the property and, consequently, must be made in a single large payment. If a sale of the property occurs in the first 5 years of the debt, the mortgagor may face a penalty of 6 months interest on the amount of prepaid principal exceeding 20% of the original balance. This potential penalty is a harsher result than allowed in most states with limited prepayment penalties. For example, if a mortgagor borrowed $100,000 at 12% and reduced the outstanding balance to $95,000 at the end of the first year, at which time the borrower wanted to sell the property and prepay the note, the California law permits a maximum penalty calculated as follows: $75,000 (the amount prepaid in excess of 20% of the original loan balance) multiplied by 12% (the loan's interest rate) and divided by 2 (to ascertain 6 months interest), or $4,500. Compare this result with the result reached under the Michigan statute, *supra* note 118, which limits the prepayment penalty to 1% of the original loan balance, or, in this case, $1,000.

128. N.Y. REAL PROP. LAW § 254-a (McKinney Supp. 1987).

129. VA. CODE § 6.1-330.33 (1983).

units.[130]

At least one state has passed legislation granting the vendee in an installment land contract the right to prepay its debt. This right, however, is subject to a provision in the debt instrument prohibiting prepayment for up to twelve months following the sale.[131] Finally, several states have enacted legislation addressing the problem of prepayment penalties when condemnation of the mortgaged property forces prepayment.[132]

3. Nonmortgage Debt

Many states have enacted legislation permitting the borrower to prepay or limiting the amount of the prepayment penalty in a wide variety of contexts other than residential real estate loans. Minnesota, for example, forbids state and national banks from refusing early payment or collecting a prepayment penalty on certain small installment notes,[133] while Oregon strictly limits the availability of prepayment penalties.[134] Iowa has a statute similar to Oregon's, but it applies only to state banks.[135] New Jersey restricts prepayment penalties on small business loans.[136]

The remainder of legislative activity in this area has targeted mostly consumer credit situations, including installment sales arrangements and licensed lenders.[137] Specifically, many statutes

130. CAL. CIV. CODE § 2954.10 (West Supp. 1987).

131. CAL. CIV. CODE § 2985.6 (West Supp. 1987); *see also* MICH. COMP. LAWS ANN. § 438.31c(2) (West Supp. 1986).

132. *See supra* notes 90-91 and accompanying text.

133. MINN. STAT. ANN. § 48.154 (West Supp. 1987).

134. OR. REV. STAT. § 708.480 (1985). The Oregon statute provides that upon prepayment of a loan made by a bank, the lender must refund to the borrower all unearned interest except 10% of the principal amount of the loan or $75, whichever is less. Thus, while the statute does not explicitly mention prepayment penalties, it limits penalties, at least to the extent that the penalty is in the form of unearned interest, to the amounts permitted in the statute.

135. IOWA CODE ANN. § 524.906(5) (West 1970).

136. N.J. STAT. ANN. § 17:9A-59.28(c) (West 1984).

137. The 1974 version of the UNIF. CONSUMER CREDIT CODE § 2.509 (1974 Act), 7A U.L.A. 96 (1985), provides that "[s]ubject to the provisions on rebate (Section 2.510), the consumer may prepay in full the unpaid balance of a consumer credit transaction, except a consumer lease, at any time without penalty." Section 2.510 sets forth two alternative methods of calculating the refund amount of unearned interest. *Id.* § 2.510. The original version contained similar provisions. UNIF. CONSUMER CREDIT CODE §§ 3.209-3.210 (1968 Act), 7 U.L.A. 738 (1985). At least 11 states - Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, and Wyoming - have adopted the 1974 Act in some form. AM. JUR. DESK BOOK, Item 124 (Supp. 1985). The 1974 Act defines "consumer credit transaction" broadly to include loans and credit sales, but does not include credit sales of interests in land unless the interest rate exceeds 12% per year. *See* 1974 Act §§

permit prepayment and require a refund of any unearned interest when a precomputed debt is paid before maturity.[138]

Finally, at least two states—Illinois and South Dakota—specifically provide that the borrower may prepay at any time and also is entitled to a refund of the unearned interest in an

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1.301(12)-(15).

Even states that have not adopted the Uniform Consumer Credit Code have enacted legislation delineating a debtor's right to prepay and the creditor's right to charge a penalty or retain a portion of the unearned interest. The following statutes, for example, address prepayment in the context of retail installment sales: ILL. ANN. STAT. ch. 121½, § 507 (Smith-Hurd Supp. 1986); MASS. GEN. LAWS ANN. ch. 255D, § 13 (West Supp. 1986); MONT. CODE ANN. § 31-1-242 (1985); NEB. REV. STAT. § 451-1342 (1984); NEV. REV. STAT. § 97.225 (1986); N.J. STAT. ANN. § 17:16C-41 (West 1984); OR. REV. STAT. § 83.620 (1985); TENN. CODE ANN. § 47-11-103(h) (1984). Other statutes regulate prepayment of loans made by various lenders. MISS. CODE ANN. §§ 75-67-41 & 75-67-127(c) (Supp. 1986); MO. REV. STAT. §§ 408.130(7) & 408.170 (Vernon 1979); NEB. REV. STAT. §§ 45-135—45-137 (1984); N.H. REV. STAT. ANN. § 399-A:5 (1983); N.J. STAT. ANN. §§ 17:9A-54—17:9A-56 (West 1984); N.M. STAT. ANN. § 58-7-5 (1978); N.D. CENT. CODE § 13-03-14(2) (1981); PA. STAT. ANN. tit. 7, § 6214(D) (Purdon Supp. 1986); R. I. GEN. LAWS § 19-25.3-25 (1982); VT. STAT. ANN. tit. 8, § 2225(3) (1984).

138. Typically, the refund is calculated as follows:

> The portion to he refunded shall be that proportion of the interest or discount which the sum of the monthly balances originally scheduled to be outstanding during the full months following such prepayment in full hears to the sum of all monthly balances originally scheduled to be outstanding, both sums to be determined by the schedule of payments in the original contract [except that no refund of less than a dollar need be made].

PA. STAT. ANN. tit. 7, § 6214(D) (Purdon Supp. 1985). Other statutes measure the refund by the Rule of 78ths. *See, e.g.*, MISS. CODE ANN. § 75-67-12g (Supp. 1985); N.J. STAT. ANN. § 17:9A-56 (West 1984); N.M. STAT. ANN. § 58-7-5 (1978). The Rule of 78ths is described in VA. CODE § 6.1-330.32 (1983) as follows:

> A. The Rule of 78 is so named because the months of one year, i.e., one through twelve added together, total seventy-eight.
>
> B. To determine the amount of tbe rebate of unearned interest under the Rule of 78 on a loan where payment is anticipated:
>
> 1. Determine the number of months over which the loan is to be repaid according to its terms. Write the numbers in sequence and add (for example, for a four-year loan write the numbers one through forty-eight). The total will be the denominator of a fraction to be determined below.
>
> 2. Determine the number of months remaining on the loan after payment is anticipated. Write in inverse sequence and add (for example, for a four-year loan anticipated after the third month, write the numbers forty-five back to one). The total will be the numerator of the fraction of which subparagraph 1 above is the denominator.
>
> 3. Multiply the original amount of interest that would have been paid over the life of the loan by the fraction derived as above, such figure, so determined, is the amount to be rebated.
>
> Payment anticipated between scheduled payment dates shall not be considered but instead the succeeding scheduled payment date shall be used in the above determination, notwithstanding any contrary provision of law.

VA. CODE § 6.1-330.32 (1983).

installment sales contract for the purchase of a motor vehicle.[139]

G. Federal Regulation of Prepayment Penalties

Federal regulation of prepayment penalties affects primarily the residential mortgage market. The impact of federal regulation in the residential mortgage market is significant because certain quasi-federal entities trading on the secondary mortgage market will not purchase mortgages that do not conform to federal policies.[140] The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) have approved a standard note form permitting the borrower to prepay and prohibiting the collection of a penalty.[141] In loans guaranteed by the Federal Housing Administration[142] or the Veteran's Administration,[143] the borrower has the same right to prepay, without penalty, at any time. The right of prepayment also exists for any loan made by a federally chartered credit union.[144]

Additionally, the Federal Home Loan Bank Board (FHLBB), which regulates all federally chartered savings and loan associations, promulgated a regulation in 1966 permitting prepayment, without penalty, unless the loan agreement expressly provided otherwise.[145] This regulation, which was rescinded in 1980, also limited any penalty to six months interest on any amount prepaid in excess of twenty percent.[146] Because of the volume of lending carried out by lenders subject to its control, this regulation tended to set national standards for prepayment penalties.[147] Federal regula-

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139. The Illinois statute, ILL. ANN. STAT. ch. 121½, para. 567 (Smith-Hurd Supp. 1986), effectively permits a penalty of $25, while the South Dakota statute, S.D. CODIFIED LAWS ANN. § 54-7-40 (Supp. 1985), does not make such an allowance.

140. G. NELSON & D. WHITMAN, *supra* note 5, at § 6.4.

141. The FNMA/FHLMC Multistate Fixed Rate Note is reprinted in G. NELSON & D. WHITMAN, *supra* note 5, at § 14.2. The Note provision reads: "I have the right to make payments of principal at any time before they are due . . . . I may make a full prepayment or partial prepayments without paying any prepayment charge." *Id.* at para. 4.

142. 24 C.F.R. § 203.22(b) (1986).

143. 38 C.F.R. § 36.4310 (1986).

144. 12 C.F.R. § 701.21(c)(6) (1986).

145. 12 C.F.R. § 545.6-12(b) (1979), *rescinded*, 45 Fed. Reg. 76,102 (1980). The FHLBB's regulations still require tbat a note clearly provide for the collection of a prepayment penalty in order for the penalty to be enforceable. 12 C.F.R. 545.34(c) (1986).

146. 12 C.F.R. § 545.6-12(b) (1979). This regulation was identical to California's legislation. *See supra* note 123. The *Lazzareschi* court cited tbis federal regulation in support of its holding that the challenged prepayment provision was neither unreasonable nor exorbitant. Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 309-10, 99 Cal. Rptr. 417, 421-22 (1971).

147. *See* G. NELSON & D. WHITMAN, *supra* note 5, at § 6.4. Furthermore, states are

tion of alternative mortgage instruments also permits prepayment, without penalty, in a variety of adjustable rate mortgages.[148]

Finally, while not aimed directly at the right to prepay or the collection of prepayment penalties, two acts of the federal government nevertheless have an indirect effect. The Federal Truth in Lending Act[149] and the regulations promulgated pursuant to it[150] require full disclosure of any conditions on prepayment and the manner in which any penalty will be calculated.[151] Additionally, the Uniform Relocation Assistance Policies Act[152] requires the federal government to compensate the owner of condemned property for any incidental expenses, including prepayment penalties, incurred in the process of transferring title to the government.[153] Furthermore, the Act prohibits federal assistance to any state project unless the state provides similar compensation for expenses incurred.[154] Several states have enacted laws to conform with this requirement.[155]

III. A Suggested Approach

Any approach that courts, legislatures, or regulatory bodies adopt in adjusting the rights of parties involved in prepayment situations should recognize and protect the legitimate interests of both lenders and borrowers. Although the interests of lenders and borrowers have been discussed throughout this Note, they are restated briefly below. First, lenders have a legitimate interest in recouping the fixed expenses they incur in originating a loan.[156] Sec-

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preempted from placing more severe restrictions on the collection of prepayment penalties hy federally chartered savings and loan associations. Toolan v. Trevose Fed. Sav. & Loan Ass'n, 501 Pa. 477, 462 A.2d 224 (1983).

148. *See* G. Nelson & D. Whitman, *supra* note 5, at § 6.4; *see also* 12 C.F.R. 545.34(c) (1986) (allowing prepayment, without penalty, of an adjustable rate mortgage within 90 days following notice of adjustment).

149. 15 U.S.C. § 1601-1693(r) (1982).

150. *See* 12 C.F.R. § 226.18(k)(1) (1986).

151. Regulation Z, 12 C.F.R. § 226 (1986), which enforces the Federal Truth in Lending Act, provides:

> For each transaction, the creditor shall disclose the following information as applicable: . . . 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.

Id. § 226.18(k)(1).

152. 42 U.S.C. §§ 4601-4655 (1982).

153. *Id.* § 4653.

154. *Id.* § 4655.

155. *See supra* note 91.

156. *See supra* notes 24-25.

ond, lenders have a legitimate interest in taking reasonable measures to ensure the maintenance of a profitable loan portfolio by protecting themselves against debtor refinancing when interest rates fall.[157] However, the fact that prepayment penalties represent a source of income to lenders is not a legitimate concern supporting the validity of prepayment penalties. If it were, the revenue concern also would justify any penalty or fee that one party to a contract could extort from another. This view is disfavored because of the bargaining power disparity that often exists between lender and borrower and because of the law's disfavor of penalties.

Conversely, borrowers should be able to borrow money without being shackled with the unilateral disadvantage of being forced, through the operation of various acceleration and prepayment clauses, to bear most of the risk associated with interest rate fluctuations.[158] In addition, borrowers should not have to pay penalties that are far in excess of any damages sustained by the lender. Furthermore, society benefits economically from the availability of capital provided through the lending process; society, therefore, should act to maximize economic benefits by removing impediments to the fair and efficient operation of the lending process. Society has a stake in ensuring that the rights of lenders and borrowers are protected fairly so that neither receives an undeserved advantage over the other. Thus, lenders should not be allowed to exact exorbitant penalties from borrowers. At least one court, however, has recognized that a one-sided approach favoring individual borrowers ultimately could make it more difficult and expensive for future borrowers to receive loans if lenders, because their interests are not protected adequately, are forced to bear all the losses resulting from prepayment.[159] Many of the approaches adopted by various legislatures and regulatory bodies do not recognize or afford adequate protection to the legitimate interests of lenders and borrowers. For example, those statutes and regulations[160] granting the borrower the unqualified right to prepay at any time, without penalty, do not recognize lenders' interests in profiting on the transaction. In contrast, jurisdictions that sanction the collection of severe penalties, either by placing a high maxi-

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157. *See supra* text accompanying notes 28-37.

158. *See supra* notes 42-43; *see also supra* notes 38-41, 44 and accompanying text.

159. Occidental Sav. & Loan Ass'n v. Venco, 206 Neb. 469, 477, 293 N.W.2d 843, 847 (1980).

160. *See supra* notes 98-99 & 102.

mum limit on penalties[161] or by retaining the common-law rule allowing enforcement of any penalty the lender demands,[162] do not protect the borrower sufficiently.

Commentators have suggested that, in the context of real estate mortgages, the best approach is that of the Mississippi statute, whereby a prepayment penalty of five percent is allowed in the first year, decreasing one percent per year until after the fifth year, at which time prepayment may be made without penalty.[163] This statute may be more effective than most others in protecting the parties' interests and providing a penalty that will approximate roughly the lender's damages upon prepayment. The Mississippi statute permits more substantial penalties in the early life of a loan, when the lender is less likely to have recovered completely the fixed costs associated with the loan's origination; the statute also discourages refinancing by the borrower during this time period. In addition, the statute recognizes the borrower's interest in being able to transfer the property and retire the debt after a certain period of time has elapsed. Even this comparatively flexible approach, however, can produce results that are inequitable and unnecessary to protect the parties' legitimate interests because it does not distinguish between different types of prepayment situations.[164] An ideal approach to prepayment penalties would be an adaptable one that affords each party the degree of protection demanded by its legitimate interests regardless of the circumstances. An approach recognizing that the consideration afforded the parties' interests varies with the circumstances surrounding the prepayment can avoid the rigidity of some of the present approaches that produce undesirable results.

When a borrower voluntarily prepays a loan made at a rate of interest equal to or less than the rate at which the lender could reinvest the money at the time of prepayment, the prepayment penalty should be limited in order to compensate the lender only for any unrecovered fixed costs associated with the loan's origination and for the interest it will not collect between prepayment

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161. *See, e.g., supra* notes 125-27 & 145.

162. *See, e.g., supra* note 100.

163. *See* G. NELSON & D. WHITMAN, *supra* note 5, at § 6.4.

164. For example, this approach, absent some further provision of law, would allow a lender to demand a penalty when the prepayment is involuntary. Furthermore, the borrower, even in voluntary prepayment situations, would be subject to a penalty within the first five years even if interest rates increased. Therefore, the lender would profit from the prepayment by reinvesting those funds at a higher rate of interest. In these instances, the penalty serves no justifiable purpose.

and reinvestment. Arguably, many lenders recover their fixed costs entirely at the inception of the loan.[165] To the extent that this is untrue, however, the lender should be allowed to charge a penalty. This determination entails no difficult issues of proof because, presumably, the lender's expenses and fees will be documented and easily ascertained. Additionally, this approach recognizes the "turnaround" time between receipt of prepayment and reinvestment by the lender and compensates the lender accordingly. While at least one court has questioned the feasibility of tracing particular funds from prepayment to reinvestment,[166] tracing actually is unnecessary. The legislature could fix a reasonable time, such as "X" number of business days, as an estimate of the average time required for a diligent lender to reinvest the funds. Thus, a portion of the penalty would be determined by allowing the lender to collect a sum equal to the amount of prepaid principal multiplied by the annual rate of interest called for in the prepaid loan, pro-rated to represent the stipulated turnaround time. While a stipulated turnaround time would not always correspond exactly to the actual turnaround time, the stipulated turnaround time element would compensate the lender for most, if not all, of its lost interest profits and motivate the lender to mitigate its damages by promptly reinvesting.

These two factors, unrecovered fixed costs and lost profits due to turnaround time, represent the lender's only real damages. The lender has no legitimate interest in discouraging prepayment in order to maintain the profitability of its loan portfolio when interest rates have risen or remained constant merely because reinvestment will yield equal or greater returns.

A more troublesome situation arises when the interest rate at the time of voluntary prepayment is lower than the interest rate on the note. As when interest rates have risen or remained constant, and for the same reasons, the lender should be allowed a penalty that represents its unrecovered fixed costs and lost profits. Furthermore, the lender's need to maintain profitable yields in this situation by discouraging prepayment demands some additional penalty. The issue is how to measure this penalty. Arguably, the lender has suffered damages to the extent that the interest that would have been paid over the life of the loan, when calculated to

165. *See supra* note 26.

166. *See* Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 309, 99 Cal. Rptr. 417, 421 (1971).

maturity, exceeds the interest that the lender will be able to receive in that same period of time by reinvesting the funds. If the penalty were measured in this manner, the lender certainly would be protected fully, but the borrower could be forced, depending on the degree to which interest rates declined and the length of time remaining until maturity of the original debt, to pay a very substantial penalty. Indeed, this penalty could remove any economic incentive for the borrower to refinance or otherwise prepay the loan.

The lender, however, does not require such a drastic penalty to protect its interests. In formulating a policy to govern prepayment penalties, the goal should not be to insulate completely the lender from all effects of declining interest rates, but merely to protect the lender from the full impact of debtor refinancing as interest rates drop. The fact that lenders currently are not allowed to charge such a drastic penalty, but only one that shifts some of the negative effects to the prepaying borrower, lends support to the idea that the goal of prepayment penalty regulation is not, and should not be, to shield lenders completely from the effects of declining interest rates, but, instead, is to equitably distribute the risks among lenders and borrowers. The borrower in the real estate mortgage context already bears some of the risks associated with fluctuating interest rates through the operation of due-on-sale clauses that prevent the borrower from benefiting from an increase in interest rates.[167] Protection of the lender's interests does not warrant a penalty that also would render it impossible for the borrower to benefit from decreases in interest rates. A penalty limited to a small percentage of the prepaid principal would protect adequately the lender without being unduly harsh on the borrower.

There is no reason to forbid the collection of this type of penalty after a fixed period of time has elapsed. The lender's interests will be no less compelling, and the borrower's no more compelling, in the sixth year of the loan than in the fifth year. In addition, allowing a prepayment penalty in the later life of the loan would not be as harsh on borrowers because, when measured as a percentage of the prepaid principal, penalties will decrease siguificantly—to the point of being minimal near the end of the loan's life.

Thus, lenders should be able to charge a penalty determined by the three elements discussed above. Again, no difficult problems

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167. *See supra* notes 42-43 and accompanying text.

of proof should arise because lenders' unrecovered fixed costs, if any, should be easily ascertainable and the turnaround time would be fixed by statute, as would the amount of penalty allowed to protect lenders' profitability. In the interest of further certainty and simplification, legislatures could establish a single penalty formula to compensate lenders for all these elements. Such a formula would not be unlike several statutory formulas now existing, except that it would apply only when the rate of interest on the prepaid loan is higher than the current rate. A single penalty formula would not apply when interest rates rise or remain constant between the time the loan is made and the time of its prepayment.

The final prong of this suggested approach would forbid the collection of a penalty when prepayment is involuntary, either because of destruction or condemnation of the security or because of acceleration by the lender. In the involuntary prepayment situation a penalty will not protect the lender's interests. To permit a penalty merely would penalize the borrower for circumstances beyond its control. First, a penalty will not help maintain the lender's profitability by discouraging prepayment because, by definition, the borrower has no choice in the matter. No amount of penalty could dissuade the borrower from prepaying. Second, there appears to be no reason to allow the lender to compel the borrower to compensate the lender for its unrecovered fixed costs. When a lender accelerates a debt, the lender is the cause of any harm it suffers and, consequently, should bear the expense. Additionally, when prepayment is involuntary for some other reason, such as condemnation, no valid reason exists to force the borrower to bear the lender's loss of potential interest revenue.

An exception to this suggested approach should be fashioned to deal with unscrupulous borrowers who might provoke a lender into accelerating the debt as a way to avoid a prepayment penalty.[168] When a lender is able to prove bad faith on the part of a borrower, the lender should be allowed to charge a penalty, calculated according to the principles established above.

IV. CONCLUSION

Both borrowers and lenders have legitimate interests meriting protection when a debt is prepaid. Neither a prohibition against all penalties nor an across-the-board allowance of substantial penal-

168. *See In re* LHD Realty Corp., 726 F.2d 327, 331 (7th Cir. 1984) (discussing this potential abuse and the various means of dealing with it).

ties adequately recognizes or protects these legitimate interests. Additionally, statutes that attempt to compromise between these two extremes are not likely to protect adequately lenders and borrowers in the various circumstances surrounding prepayment. An approach is needed, such as the one set forth in this Note, that is sufficiently flexible to protect the concerns of both parties in various circumstances. The suggested approach would allow the money lending market to function more fairly, thus benefiting not only lenders and borrowers, but also society as a whole.

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