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Keeping the Benefit of Your Bargain: Strengthening Your Right to Prepayment Premiums

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Anyone involved in commercial lending transactions is familiar with provisions of loan agreements that provide for compensation to the lender in the event the indebtedness is paid in advance of the contemplated due date. These provisions are heavily litigated, particularly in bankruptcy proceedings. The title used for such provisions often reflects the arguments the respective parties will take during litigation. From the lending perspective, these provisions are usually emphasized to be "prepayment premiums" to reflect their purpose. These premiums are designed to prevent a borrower from attempting to refinance at a lower interest rate in a market where the lender will not be able to obtain the same benefit of its bargain because it will likely be re-lending the funds at the same lower interest rate. From the borrowing perspective, these provisions are usually emphasized to be "prepayment penalties," with the borrower asserting that the payment is unreasonable or punitive in nature.

While there are many cases involving prepayment premiums, a recent decision from the United States Bankruptcy Court for the Northern District of Illinois reminds us of the importance of exercising remedies as soon as they are available, and strengthening your protections when the opportunity presents itself. *In re Doctors Hospital of Hyde Park, Inc.*, 508 B.R. 697 (Bank. N.D. Ill. 2014), dealt with an objection to recovery of a yield maintenance premium in a proof of claim as either an unenforceable penalty or a claim for unmatured interest subject to 11 U.S.C. § 502(b)(2). The Court applied New York law, which favors freedom of contract through enforcement of stipulated damages provisions between sophisticated parties, to find that the premium was not an unenforceable penalty. 508 B.R. 703-705.

The Court did find that the compensation provided in the yield maintenance premium was unmatured interest. *Id.* at 705. The court reviewed the economic realities of the transaction to determine that the premium provided for recovery of interest. *Id.* The Court next determined that it fell under the purview of Section 502(b)(2) as unmatured interest based on the terms of the loan documents. Under the terms of the loan documents, the premium was due on acceleration, not default. *Id.* at 706 The parties agreed that the event that triggered the acceleration was the foreclosure of collateral owned by an affiliate of the debtor that occurred three months after the debtor's petition date. *Id.* at 702. Accordingly, even though the lender had the right to declare acceleration prior to the bankruptcy filing, it did not. *Id.* at 706. Because the trigger for recovery of the premium had not occurred as of the petition date, the interest was not matured and earned at that time. *Id.* While the Court denied summary judgment based on a factual dispute as to whether the lender was oversecured or undersecured, the issue may have been avoidable through earlier acceleration.

Even if a lender has already bargained for a prepayment premium, it should evaluate any provisions that can be added to strengthen its position if the opportunity to amend arises. For example, a lender can provide that it is entitled to receive, and borrower must pay, a prepayment premium in the event of default (including default and acceleration based on a bankruptcy filing). Additionally, it can be expressly stated that a premium must be paid whether acceleration is automatic or optional, or whether the prepayment is voluntary or involuntary. Further, the loan documents could expressly acknowledge the right to include a prepayment premium in the calculation of any claim filed in a bankruptcy proceeding. While there is clear logic behind prepayment premiums, additional acknowledgments from borrowers as to their effectiveness will very rarely hinder a lender's position and should be considered.