Prepayment Penalties and Due-on-Sale Clauses in Commercial Mortgages: What Next?*

I. Introduction

In 1981, new-home mortgage yields climbed as high as 16.38%, while the prime rate charged by banks stood at 20.50%.[1] At the same time, outstanding commercial mortgage debts totaled approximately 277.5 billion dollars.[2] By the close of 1986, new home mortgage yields dropped to 9.69%, while the prime rate plummeted to 7.50%.[3] This significant decline in interest rates marked a coterminous increase in commercial lending. The outstanding commercial mortgage debt at the close of 1986 was nearly 525 billion dollars.[4]

Two common provisions in mortgage documents in the commercial mortgage industry are due-on-sale clauses and prepayment penalties.[5] The due-on-sale clause is a contractual provision that permits a lender to declare the entire balance of a loan immediately due and payable if the mortgaged real estate is transferred without the lender's consent.[6] A prepayment penalty is a penalty imposed upon the borrower for his exercise of the privilege of paying a loan before the loan's scheduled date of maturity.[7] The use of these two clauses in tandem has generated much of the interest prompting the writing of this Note.

The lender's imposition of a prepayment penalty pursuant to the exercise of a valid due-on-sale clause in the commercial mortgage context can be seen as a bargained for commercial cost of doing business.[8] However, when present interest rates are higher than interest rates at the date of the loan's inception, the use of these two clauses together

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*The author of this Note assisted in the preparation of Appellee's brief in First Indiana Federal Savings Bank v. Maryland Development Co., Inc., 509 N.E.2d 253 (Ind. App. 1987). The case involves several of the issues addressed in this Note.

[1]Council of Economic Advisors, Economic Report of the President Together with the Annual Report of the Council of Economic Advisors 324 (1987).

[2]*Id.* at 328.

[3]*Id.* at 325.

[4]*Id.* at 328.

[5]*See* Comment, *Prepayment Penalties After Garn-St. Germain: A Minor Coup for Consumers*, 1985 Det. C. L. Rev. 835 [hereinafter *Prepayment Penalties*].

[6]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 145 (1982).

[7]G. Nelson & D. Whitman, Real Estate Finance Law § 6.1 (2d ed. 1985) [hereinafter Real Estate Finance].

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

results in "double-dipping"[9] by the lender and inequitable circumstances can result.[10]

The issue faced by both state and federal courts and legislatures today is the propriety of allowing these clauses to be exercised in tandem in the commercial mortgage context. The United States Supreme Court's decision in *Fidelity Federal Savings & Loan Association v. de la Custa*[11] providing for the enforceability of due-on-sale clauses in mortgages held by federal lending associations,[12] along with Congress' passage of section 341 of the Garn-St. Germain Depository Institutions Act[13] (Act), extending the ability to enforce due-on-sale clauses to both state and federal lenders,[14] have greatly settled questions concerning the validity and enforceability of due-on-sale clauses.

The enforceability of prepayment penalties by commercial lenders is not quite so settled. Presently there are no real "rules" concerning a commercial lender's ability to exercise a prepayment penalty provision.[15] However, under the power of the Home Owners' Loan Act[16] (HOLA), the Federal Home Loan Bank Board[17] (Board) has passed regulations

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[9]"Double-dipping" occurs when the lender exercises a due-on-sale clause, receiving the entire balance of the loan debt immediately, while also collecting a prepayment penalty because of the borrower's early payment of the loan.

[10]*See* George H. Hutman, Inc. v. Aetna Business Credit, Inc., 115 Misc. 2d 168, 453 N.Y.S.2d 586 (1982). The inequity of "double-dipping" results from the lender's ability to reinvest loan proceeds collected by the exercise of a due-on-sale clause at presently higher rates of interest, while also collecting a prepayment penalty from the borrower.

[11]458 U.S. 141 (1982).

[12]"Federal association" is defined as "[a] savings and loan association or savings bank chartered by the Board under section 5 of the [Garn-St. Germain Depository Institutions] Act and, except as the Board may otherwise provide, any building and loan, savings and loan, building or homestead association, organized or incorporated under the laws of the District of Columbia." 12 C.F.R. § 541.8 (1986).

[13]Pub. L. No. 97-320, Title III, § 341, 96 Stat. 1505 (1982) (codified as amended at 12 U.S.C. § 1701j-3 (1982 & Supp. 1985)).

[14]Under the Act, a "lender" is defined as "a person or government agency making a real property loan or any assignee or transferee, in whole or in part, of such a person or agency." 12 U.S.C. § 1701j-3(a)(2) (1982).

[15]*See infra* notes 170–210 and accompanying text.

[16]Home Owners' Loan Act, 12 U.S.C. §§ 1461-1470 (1982 & Supp. 1985).

[17]The Federal Home Loan Bank Board is an independent federal regulatory agency founded in 1932 and is vested with authority to administer HOLA. 12 U.S.C. §§ 1421-1449 (1982 & Supp. 1985). The role of the Board is stated explicitly in HOLA:

> In order to provide thrift institutions for the deposit or investment of funds and for the extension of credit for homes and other goods and services, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as Federal savings and loan associations, or Federal savings banks, and to issue charters therefor, giving primary consideration to the best practices of thrift institutions in the United States. The lending and investment authorities are conferred by this section to provide such

limiting a lender's right to collect a prepayment penalty in residential mortgages under certain circumstances, including the lender's election to accelerate the balance of the mortgage debt pursuant to the exercise of a due-on-sale clause.[18]

Some states have also imposed limitations upon a lender's ability to collect a prepayment penalty;[19] however, the effect of these state law limitations upon federal lenders is unclear. The Board has passed regulations purportedly preempting all state law addressing "the subject of the operations of a Federal association."[20] However, the Court in *de la Cuesta* refused to decide whether the preemption of contradictory state law governing the validity and enforceability of due-on-sale clauses also included preemption of state law regarding the enforcement of prepayment penalties.[21] Even if the Board's regulations do preempt state laws restricting a federally-chartered lender's ability to enforce a prepayment penalty, it is unclear whether a federally-chartered lender may enforce a prepayment penalty upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause.[22]

This Note will analyze, by analogy to residential loan rules, the propriety of commercial "double-dipping." It will propose that action by Congress, the Board, or both is warranted to clear the confusion surrounding the collection of prepayment penalties in the commercial mortgage context. Finally this Note will show that while commercial lenders may easily protect themselves under present law, policy considerations compel the conclusion that commercial borrowers should be afforded the same protections as residential borrowers through statutory and/or regulatory action by Congress or the Board.

II. Due-on-Sale Clauses

A. Background

In order to understand fully the result of allowing lenders to utilize both acceleration and prepayment penalty clauses, it is necessary to examine the judicial treatment of such clauses in the residential context. As mentioned, the due-on-sale clause[23] is a contractual provision that

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institutions the flexibility necessary to maintain their role of providing credit for housing.

12 U.S.C. § 1464(a) (1982).

[18]12 C.F.R. § 591.5(b)(2), (3) (1986). *See also infra* notes 162-64 and accompanying text.

[19]*See infra* notes 145-61 and accompanying text.

[20]12 C.F.R. § 545.2 (1986).

[21]458 U.S. at 159 n.14. *See also infra* notes 174-75 and accompanying text.

[22]*See infra* notes 203-10 and accompanying text.

[23]A commonly used due-on-sale clause is found in ¶ 17 of the uniform mortgage

permits a lender to declare the entire balance of a loan immediately due and payable if the mortgaged real estate is transferred without the lender's consent.[24] The major purpose of the clause is to enable lenders to recall lower than market interest rate loans during periods of rising interest rates,[25] although the clause has been used to protect lenders against transfers that threaten mortgage security or increase the risk of default.[26]

Prior to 1930, due-on-sale clauses were not common in mortgages or deeds of trust,[27] although clauses of a similar nature were often

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instrument developed by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. This clause provides:

> 17. Transfer of the Property; Assumption. 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 Deed of Trust, (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 a 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 Deed of Trust 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 Deed of Trust 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 Deed of Trust and the Note.
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> 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 notice is mailed within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the execution of such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 18 hereof.

Fidelity Fed. Sav. & Loan Ass'n. v. de la Cuesta, 458 U.S. at 145-46 n.2 (Emphasis supplied).

This clause has been criticized as incomprehensible to all but trained lawyers. Many residential borrowers may be unaware of its import. *See* Squires, *A Comprehensible Due on Sale Clause*, 27 PRAC. LAW. 67 (1981). One court has implied that this clause may be inadequate to permit due on sale clause enforcement in the installment land sale contract situation. *See* Boyes v. Valley Bank of Nevada, 101 Nev. 287, 292 n.4, 701 P.2d 1008, 1012 n.4 (1985).

[24]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. at 145.

[25]Volkmer, *The Application of Restraints on Alienation Doctrine to Real Property Security Interest*, 58 IOWA L. REV. 747, 769 (1973).

[26]*See* REAL ESTATE FINANCE, *supra* note 7, § 5.21.

[27]A deed of trust is a device normally involving a conveyance of realty to a third person in trust to hold as security for the payment of a debt to a lender. Deeds of trust often contain a power of sale in the trustee and are thus similar to mortgages with a power of sale. *See id.*

included in land sales contracts.[28] In recent years, the clause has been the subject of a great deal of scholarly commentary[29] and has become a great source of controversy as a result of the inflationary economic climate of the 1970's and early 1980's.[30] The adverse economic conditions, including periods of rising interest rates, have tended to pit lenders against borrowers and real estate buyers thereby intensifying the economic, political, and legal aspects of the issues.[31]

Traditionally, due-on-sale clauses have been attacked as unreasonable restraints upon alienation.[32] These attacks have taken different approaches. Under one approach, the clause is deemed reasonable per se absent a showing of duress, fraud, or unconscionable or inequitable conduct on the part of the lender.[33] The lender need not establish that a proposed sale would endanger security under this approach.[34] Another approach maintains that enforcement of due-on-sale clauses must be reasonable under the circumstances, necessitating a case by case deter-

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[28]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, 271 (1972).

[29]*See generally* Ashley, *Use of "Due-On" Clauses to Gain Collateral Benefits: A Common Sense Defense*, 10 Tulsa L.J. 590 (1975); Gorinson & Manishin, *Garn-St. Germain: A Harbinger of Change*, 40 Wash. & Lee L. Rev. 1313 (1983); Maxwell, *The Due-on-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 UCLA L. Rev. 197 (1980); Nelson & Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act*, 35 Hast. L.J. 241 (1983); Segreti, *The Borrower as Servant to the Lender: Enforcement of Mortgage Due-on-Sale Clauses*, 51 U. Cin. L. Rev. 779 (1982).

[30]The economic climate of the 1970's and early 1980's was characterized by double-digit inflation, rising prices and wages, dollar devaluation, long term unfavorable balances of trade, high unemployment, and large federal budget deficits. *See* Comment, *An Update of the Law Governing Prepayment Clauses*, 17 San Diego L. Rev. 1047 (1980) [hereinafter *Update*].

[31]*See* Real Estate Finance, *supra* note 7, § 5.21.

[32]Restatement of Property § 404 (1944) defines restraints on alienation as

> an attempt by an otherwise effective conveyance or contract to cause a later conveyance (a) to be void [disabling restraint]; or (b) to impose contractual liability on the one who makes the later conveyance when such liability results from a breach of an agreement not to convey [promissory restraint]; or (c) to terminate or subject to termination all or a part of the property interest conveyed [forfeiture restraint].

[33]*See* Baker v. Loves Park Sav. & Loan Ass'n, 61 Ill. 2d 119, 333 N.E.2d 1 (1975) (exercise of due-on-sale clause reasonable and not an invalid restraint on alienation absent proof the lender acted fraudulently, inequitably, or unconscionably). *Accord* Martin v. Peoples Mut. Sav. & Loan Ass'n, 319 N.W.2d 220 (Iowa 1982); Dunham v. Ware Sav. Bank, 394 Mass. 63, 423 N.E.2d 998 (1981); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 224 S.E.2d 580 (1976); Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 633 S.W.2d 811 (Tex. 1982).

[34]Baker v. Loves Park, 61 Ill. 2d at 124, 333 N.E.2d at 5.

mination.[35] The burden of establishing reasonableness is imposed upon the lender under this approach, and he usually must show that the sale or transfer would result in a threat to security or an increased danger of default.[36]

In several cases where courts upheld a due-on-sale clause, the absence of a prepayment penalty was held to be dispositive. Thus, in *Century Federal Savings & Loan Association v. Van Glahn*,[37] the court enforced a contractual acceleration clause where the borrower enjoyed a statutory privilege of prepayment with only a slight penalty.[38] The court reasoned that the only way to give the lender the benefit of the bargain was to allow acceleration of the loan upon transfer.[39] The North Carolina Supreme Court, in *Crockett v. First Federal Savings & Loan Association*,[40] employed similar reasoning when it found "noteworthy [the fact that] . . . under the loan agreement entered into in this case, [the borrower] could prepay at any time without penalty."[41] The court concluded that "in order to balance the ability of lender and borrower to take advantage of fluctuations in interest rates, equities favor the limited adjustment permissible by the due-on-sale clause."[42] In *Dunham v. Ware Savings Bank*,[43] the Supreme Judicial Court of Massachusetts recognized that the borrower's ability to benefit through early payment of the loan during periods of falling interest rates was not equal in value to the lender's ability to benefit through acceleration of the loan during periods of rising interest rates.[44] However, the court held that equity favored enforcing the lender's rights where a Massachusetts statute permitted the borrower to prepay with little or no penalty.[45] A different analysis was used in *Baltimore Life Insurance Co. v. Harn*,[46] where an Arizona

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[35]*See* Baltimore Life Ins. Co. v. Harn, 15 Ariz. App. 78, 486 P.2d 190 (1971) (exercise of due-on-sale clause reasonable since it did not "absolutely" restrict the mortgagors' ability to dispose of their property); Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978) (enforcement of due-on-sale clause improper absent lender's showing that "enforcement is reasonably necessary to protect against impairment to its security or the risk of default"); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977) (due-on-sale clause not enforced absent lender's showing that the clause was reasonable in the particular case).

[36]Wellenkamp v. Bank of Am., 21 Cal. 3d at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

[37]144 N.J. Super. 48, 364 A.2d 558 (1976).

[38]*Id.* at 51, 364 A.2d at 562.

[39]*Id.*

[40]289 N.C. 620, 224 S.E.2d 580 (1976).

[41]*Id.* at 625, 224 S.E.2d at 585.

[42]*Id.*

[43]384 Mass. 63, 423 N.E.2d 998 (1981).

[44]*Id.* at 69, 423 N.E.2d at 1002.

[45]*Id.*

[46]15 Ariz. App. 78, 486 P.2d 190 (1971).

appellate court observed that when a lender invokes an acceleration clause along with a prepayment penalty, the result could be unconscionably harsh.[47] In concluding, the court noted that "[c]ourts of equity may refuse to enforce these clauses where they will work a hardship on the [borrower] and the [lender] is not prejudiced by the breach."[48]

In 1976, the Board became concerned about the increasing controversy as to a federal savings and loan association's authority to exercise a due-on-sale clause included in a residential mortgage contract.[49] The Board listed several adverse effects that could result from restrictions upon a savings and loan's ability to accelerate upon transfer of the security: (1) "the financial security and stability of Federal associations would be endangered if . . . the security property is transferred to a person whose ability to repay the loan and properly maintain the property is inadequate," (2) "elimination of the due-on-sale clause will cause a substantial reduction of the cash flow and net income of Federal associations, and . . . to offset such losses it is likely that the associations will be forced to charge higher interest rates and loan charges on home loans generally," and (3) "elimination of the due-on-sale clause will restrict and impair the ability of Federal associations to sell their home loans in the secondary mortgage market, by making such loans unsalable or causing them to be sold at reduced prices, thereby reducing the flow of new funds for residential loans which otherwise would be available."[50] The Board concluded that elimination of the due-on-sale clause would benefit only a limited number of home sellers, while generally causing economic hardship to the majority of home buyers and potential home buyers.[51]

In order to resolve the controversy surrounding a federal savings and loan association's authority to exercise a due-on-sale clause included in a residential mortgage contract, the Board issued a regulation in 1976 authorizing due-on-sale clauses in real estate loan instruments.[52] In the

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[47]*Id.* at 81, 486 P.2d at 193.

[48]*Id.*

[49]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 145 (1982).

[50]*Id.* at 145-46 (citing 41 Fed. Reg. 6283, 6285 (1976)).

The secondary mortgage market is that market where lenders who have originated loans sell or assign the loans to investors or government sponsored agencies which will hold the loans for the long term. *See* REAL ESTATE FINANCE, *supra* note 7, § 11.1. Among the government agencies participating in the secondary mortgage market are the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Government National Mortgage Association (GNMA). *Id.* § 11.3.

[51]*de la Cuesta*, 458 U.S. at 146.

[52]12 C.F.R. § 545.8-3(f) (1983) (originally codified at 12 C.F.R. § 545.6-11(f) (1976)) provides that a federal savings and loan association

> continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instrument whereby the association may,

preamble to this regulation, the Board expressed its intent that the due-on-sale practices of federal savings and loans be governed solely by federal law, thus preempting any state laws imposing different requirements.[53] This interpretation did not receive unanimous acceptance, and the following six years were marked by an extraordinary volume of litigation challenging the preemption of state due-on-sale clause law.[54] While the federal courts tended to conclude that the Board regulation preempted state due-on-sale clause law,[55] several state courts reached contrary results.[56]

Those state courts finding no congressional intent for the Board to pass due-on-sale clause regulations preempting contradictory state law often pointed to the lack of express language in HOLA regarding the Board's power to pass such preemptory regulations. For example, the court in *Holiday Acres v. Midwest Federal Savings & Loan Association*[57] relied heavily upon the argument that mortgage law was traditionally the domain of the states as a reason for not inferring congressional intent to preempt state due-on-sale clause law.[58] That court also interpreted narrowly the authority granted to the Board under section 5(a) of HOLA, holding that HOLA was merely intended as an expedient cure for the Depression.[59] Interestingly, the court did not take notice of the preamble to the Board's due-on-sale clause regulation, which manifested an unequivocal intent to preempt conflicting state law.[60] Another case reaching a similar conclusion was *First Federal Savings &*

> at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent . . . . Exercise . . . of such option . . . shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract.

This regulation was amended subsequent to the passage of the Act, and now includes both federal lenders and non-federal lenders. *See* 12 C.F.R. § 591.3, § 591.4 (1986).

[53]41 Fed. Reg. 18,287 (1976).

[54]*See generally Prepayment Penalties*, *supra* note 5.

[55]*See e.g.*, Baily v. First Fed. Sav. & Loan Ass'n, 467 F. Supp. 1139 (C.D. Ill. 1979); Glendale Fed. Sav. & Loan Ass'n v. Fox, 459 F. Supp. 903 (C.D. Cal. 1978).

[56]*See e.g.*, Panko v. Pan Am. Fed. Sav. & Loan Ass'n, 119 Cal. App. 3d 916, 174 Cal. Rptr. 240 (1981), *vacated*, 458 U.S. 1117 (1982); First Fed. Sav. & Loan Ass'n of Englewood v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981).

[57]308 N.W.2d 471 (Minn. 1981).

[58]*Id.* at 477-79.

[59]*Id.* at 479.

[60]The preamble provides in relevant part: "It was and is the Board's intent to have . . . due-on-sale practices of Federal associations governed exclusively by Federal law . . . Federal associations shall not be bound by or subject to any conflicting State law which imposes different . . . due-on-sale requirements." 41 Fed. Reg. 18,286 (1976).

Loan Association of Englewood v. Lockwood,[61] where the court concluded that equity rather than the Board regulation was the overriding factor in determining the enforceability of due-on-sale clauses.[62]

B. Resolution of the Due-On-Sale Controversy

The controversy concerning the Board's authority to preempt state law that prohibited or restricted the enforcement of due-on-sale clauses by federal associations was finally resolved by the Supreme Court in *de la Cuesta*.[63] The Court upheld the Board's 1976 regulation against a preemptive state law challenge, concluding that the Board intended to preempt state law.[64] Interpreting the 1976 regulation, the Court held that the regulation in fact conflicted with state law, despite the fact that it merely authorized, without requiring, the use of due-on-sale clauses by federal associations.[65] The Court also held that the Board acted within its statutory authority under section 5(a) of HOLA, concluding that HOLA clearly empowered the Board to promulgate rules for the operation and regulation of federal associations,[66] including the use of due-on-sale clauses in loan contracts.[67] The majority observed that the wisdom of the Board's regulation was not uncontroverted, but concluded that the Board's exercise of authority was reasonable and therefore valid.[68]

While *de la Cuesta* validated the enforcement of due-on-sale clauses by federal savings and loan associations, that decision did not apply to lenders not covered by the Board's regulation. In order to extend the *de la Cuesta* protection to all lenders, Congress passed the Garn-St. Germain Depository Institutions Act.[69] This Act has been described as "signal[ing] the dawn of a new era for due-on-sale clause enforcement."[70]

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[61]385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

[62]*Id.* at 160.

[63]458 U.S. 141 (1982). Justice Blackmun delivered the opinion of the Court, joined by Chief Justice Burger and Justices Brennan, White, Marshall, and O'Connor. Justice O'Connor filed a concurring opinion. Justice Rehnquist dissented, joined by Justice Stevens. Justice Powell took no part in the consideration or decision of the case. *Id.*

[64]*Id.* at 158-59. The Court noted the Board's intent that "[f]ederal associations . . . not be bound by or subject to any conflicting State law which imposes different . . . due-on-sale requirements." *Id.* at 158.

[65]*Id.* at 154-55.

[66]*Id.* at 159-61.

[67]*Id.* at 167.

[68]*Id.* at 169-70.

[69]Pub. L. No. 97-320, Title III, § 341, 96 Stat. 1505, (1982) (codified as amended at 12 U.S.C. § 1701j-3 (1982 & Supp. 1985)).

[70]*See* REAL ESTATE FINANCE, *supra* note 7, § 5.24. President Reagan hailed the Act as "the most important legislation for financial institutions in the last fifty years." *Garn-St. Germain Financial Reform Bill Signed by President Reagan*, Wash. Fin. Rep. (BNA) No. 39, at 743 (Oct. 25, 1982).

The Act affirmed the federal preemption of state law restrictions upon due-on-sale clause enforcement and extended that preemption to all lenders holding commercial or residential real property loans.[71] The legislative history of the Act reveals Congress' recognition that the practice of borrowing short and lending long,[72] at fixed rates, combined with high and volatile interest rates resulted in the financial depression experienced by many lenders.[73] The Act was primarily intended by Congress to be of aid to those economically troubled institutions.[74]

The Act covers any "person or government agency making a real property loan."[75] The Board has emphasized that the list of lenders included within this definition is "intended to be representative and not exclusive."[76] The Act also covers every "loan, mortgage, advance, or credit sale secured by a lien on real property, the stock allocated to a dwelling unit in a cooperative housing corporation, or a residential manufactured home, whether real or personal property."[77]

Congress limited the broad reach of the Act in several important respects. Responding to effective lobbying by the real estate brokerage industry and related interests,[78] Congress softened the impact of the Act in many states by creating exceptions to the preemption on loans assumed

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[71]50 Fed. Reg. 46,746 (1985).

[72]The practice of borrowing short and lending long occurs when lenders lend large sums of money at fixed rates of interest for long periods of time while market interest rates continue to rise. This practice leads to a scenario where the cost of funds for lenders rises faster than the yield on their assets, rendering lenders unable to cover their operating expenses. *See* S. REP. No. 536, 97th Cong., 2d Sess. (1982), *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 3059.

[73]*Id.* Congress observed that "the cost of funds has increased rapidly, while slow repayment of old mortgages had led to an extremely sluggish increase in the gross asset yields." *Id.*

[74]*Id.*

[75]12 U.S.C. § 1701j-3(a)(2) (Supp. 1985). Under the present regulation, this definition includes

> without limitation, individuals, Federal associations, state-chartered savings and loan associations, national banks, state-chartered banks and state-chartered mutual savings banks, Federal credit unions, state-chartered credit unions, mortgage banks, insurance companies and finance companies which make real property loans, manufactured home retailers who extend credit, agencies of the Federal government, [and] any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act.

12 C.F.R. § 591.2(g) (1986).

[76]48 Fed. Reg. 21,555 (1983).

[77]12 U.S.C. § 1701j-3(a)(3) (Supp. 1985).

[78]*See generally Mortgage Assumption Plan Approved*, 40 CONG. Q. 2126 (1982); *Savings and Loan Aid Package Boosts Powers of Banks, Thrifts*, 40 CONG. Q. 2423 (1982); *Senate Passes Comprehensive Financial Institutions Bill*, Hous. & Dev. Rep. (BNA) No. 10, at 356 (Sept. 27, 1982).

or originated during a "window period."[79] Congress also expressly enumerated several types of transfers that could not be used as the basis for due-on-sale acceleration.[80] However, these insulated transfers were immune from acceleration only if the mortgaged real estate contained "less than five dwelling units."[81] Congress cited the policy basis behind the exclusions as the protection of consumers "by prohibiting the enforcement of due-on-sale clauses where such enforcement would be inequitable."[82]

The Supreme Court's decision in *de la Cuesta* validating federal preemption of state laws concerning a federal savings and loan association's ability to include and enforce due-on-sale clauses, along with

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[79]Congress exempted certain loans ("window period loans") from coverage under the Act until three years from its effective date (October 15, 1985) based upon a recognition that complete federal preemption of state laws seeking to limit due-on-sale clauses could have an unfair impact upon home buyers attempting to assume existing mortgages in reliance upon state law. *See* S. REP. No. 536, 97th Cong., 2d Sess. (1982), *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 3076. The concept of "window period loans" is complex and is not clearly defined in the Act or subject to easy explanation. "Window period loans" exist only in states that prohibited the exercise of due-on-sale clauses prior to the passage of the Act. 12 U.S.C. § 1701j-3(c)(1) (Supp. 1985). Under the "window period" concept, state law applicable to due-on-sale clauses is not preempted until three years after the Act's enactment. *Id.* The "window period" may vary from state to state or be nonexistent in a state, depending on the state's treatment of due-on-sale clauses prior to the passage of the Act. *Id.*

The Board declined to identify the states qualifying for "window period" treatment, although requested to do so, on the grounds that Congress intended "window period" determinations to be left to "state interpretation and state judicial decision." 48 Fed. Reg. 21,555 (1983). Only states that previously "prohibited the exercise of due-on-sale clauses" qualify for "window period" treatment. 12 U.S.C. § 1701j-3(c)(1) (Supp. 1985).

[80]This list includes: (1) the creation of a lien or other encumbrance subordinate to the lender's security instrument that does not relate to a transfer of rights of occupancy in the property; (2) the creation of a purchase money security interest for household appliances; (3) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety; (4) the granting of a leasehold interest of three years or less not containing an option to purchase; (5) a transfer to a relative resulting from the death of a borrower; (6) a transfer where the spouse or children of the borrower become an owner of the property; (7) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property; (8) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and occupant of the property. 12 C.F.R. § 591.5(b)(1) (1986).

[81]Pub. L. No. 98-181, tit. IV, § 473, 473 Stat. 1237 (1983) (codified at 12 U.S.C. § 1701j-3(d) (1982 & Supp. 1985)). This language, absent from the original Act, was added on November 30, 1983, in response to concerns that the insulated transfers would prevent due-on-sale clause enforcement in a variety of commercial and non-residential settings. *See* REAL ESTATE FINANCE, *supra* note 7, § 5.24. The Board sought to alleviate fears by limiting application of the insulated transfers to mortgage loans made "on the security of a home occupied . . . by the borrower." 12 C.F.R. § 591.5(b) (1986).

[82]S. REP. No. 536, 97th Cong. 2d Sess. (1982), *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 3079.

Congress' passage of the Act, have largely settled questions concerning the validity and enforceability of due-on-sale clauses.[83] Yet to be resolved by action of the Supreme Court or Congress is whether a commercial lender may collect a prepayment penalty pursuant to the exercise of a valid due-on-sale clause. Resolution of this issue must commence with an examination of prepayment penalties.

III. Prepayment Penalties

A. Background

1. Justification for Prepayment Penalties.—Since at least 1845, courts have recognized that there is no common law right to discharge a mortgage debt prior to its maturity.[84] Under the common law, the ability to prepay depended upon a specific provision in the mortgage or note providing for prepayment.[85] As a result, the lender has the right to refuse an early tender of principal and interest and will not be judicially compelled to discharge the mortgage prematurely.[86] The common law

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[83]Excepting the so-called "window period loans" 12 U.S.C. § 1701j-3(c)(1) (Supp. 1985), and excepting certain state courts that have refused to apply the Act to transactions occurring before the date of the Act's enactment. *See* North Community Bank v. Northwest Nat'l Bank, 126 Ill. App. 3d 581, 467 N.E.2d 1094 (1984); Central Nat'l Bank of Greencastle v. Shoup, 501 N.E.2d 1090 (Ind. Ct. App. 1986); Viereck v. Peoples Sav. & Loan Ass'n, 343 N.W.2d 30 (Minn. 1984); Stinger v. Great S. Sav. & Loan Ass'n, 677 S.W.2d 376 (Mo. Ct. App. 1984); Boyes v. Valley Bank of Nevada, 101 Nev. 287, 701 P.2d 1008 (1985); Home Sav. Bank v. Baer Properties, Ltd., 92 A.D.2d 98, 460 N.Y.S.2d 833 (1983); Morris v. Woodside, 101 Wash. 2d 812, 682 P.2d 905 (1984). These courts reason that because they are not subject to the Act's "window periods," and because the Act expresses no clear manifestation of retroactivity, the Act does not apply to transactions occurring before the effective date of the Act.

[84]This rule derives from the early case of Brown v. Cole, 60 Eng. Rep. 424 (1845), where the court surmised that if borrowers were allowed to pay off their mortgage money at any time after the execution of the mortgage, it might be attended with extreme inconvenience to lenders, who generally advance their money as an investment.

[85]Real Estate Finance, *supra* note 7, § 6.1.

[86]*See* Smiddy v. Grafton, 163 Cal. 16, 124 P. 433 (1912); Peter Fuller Enter., Inc. v. Manchester Sav. Bank, 102 N.H. 117, 152 A.2d 179 (1959). This rule was applied in an inequitable fashion by the Fifth Circuit in Houston N. Hosp. Properties v. Telco Leasing, Inc., 680 F.2d 19 (5th Cir. 1982). In that case, the borrower offered to pay the outstanding balances on two loans held by the lender. The lender refused the offer, informing the borrower that it would accept full payment of the loans (approximately $797,000) only if the borrower agreed to pay an additional $160,000. *Id.* at 20-21. Rejecting the borrower's appeal of a summary judgment granted to the lender upon the borrower's suit to recover the $160,000, the court recognized the lender's right to reject prepayment in the absence of a contractual right of prepayment by the borrower in the loan documents. *Id.* at 22. The court concluded: "Having a good investment that did not require acceptance of prepayment, [the lender] could use market tactics to exact a profit. Our entrepreneurial economic system does not exact moral scruples in deals between parties of equal bargaining power." *Id.* at 22-23.

rule has been rejected in a variety of modern day contexts.[87] Currently, most lenders permit prepayment, but often exact a "prepayment penalty."[88] The modern practice has often been to include the borrower's right to prepay as an express condition in the loan agreement.[89]

Although numerous theories have been commonly advanced in support of prepayment penalties, three primary theories are cited most often.[90] The first of these has been labeled the "recapture rationale."[91] Lenders argue that the costs to them of making loans are not recouped at the time the loan is made. Rather, the costs are amortized over the entire length of the loan period and would be lost absent a penalty for early payment.[92] This theory has been criticized by the Board and numerous commentators who argue that closing costs and other charges collected by lenders at the inception of the loan more than compensate for such fixed costs.[93]

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[87]In Pennsylvania, the presumption is that a loan may be prepaid unless the mortgage documents refute the presumption. Mahoney v. Furches, 503 Pa. 60, 468 A.2d 458 (1983).

[88]*See* REAL ESTATE FINANCE, *supra* note 7, § 6.1. The phrase "prepayment penalty" has been labeled "prepayment privilege" by lenders and others who favor the imposition of a charge by the lender in the event of prepayment by the borrower. *See* Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971). By contrast, opponents of the charge characterize it as a "prepayment penalty." *See* American Fed. Sav. & Loan Ass'n of Madision v. Mid-America Serv. Corp., 329 N.W.2d 124 (S.D. 1983); Comment, *Secured Real Estate Loan Prepayments and the Prepayment Penalty*, 51 CALIF. L. REV. 923 (1963) [hereinafter *Secured Real Estate Loan Prepayments*]. Others have utilized more neutral expressions such as "prepayment premium" or "prepayment fees." *See In re* L.H.D. Realty Corp., 726 F.2d 327 (7th Cir. 1984); 1 *H. Miller & M. Starr, Current Law of California Real Estate* 444 (1965).

[89]The modern practice of expressly providing for the borrower's right to prepay in the loan agreement is referred to as the "option" situation. *See Update*, *supra* note 30, at 1049. A different situation occurs where the loan agreement omits any mention of prepayment. When the borrower desires to prepay, he must negotiate with the lender and is in the undesirable position of having the lender determine the amount of the penalty. *See* Houston N. Hosp. Properties v. Telco Leasing, Inc., 680 F.2d 19 (5th Cir. 1982), where the court upheld the lender's determination of the charge for the borrower's right to prepay. This situation is referred to as the "non-option" type and may result in the lender being unable to collect a penalty because some states prohibit collection of a penalty unless specifically provided for in the loan documents. *See* Burks v. Verschuur, 35 Colo. App. 121, 532 P.2d 757 (1975); *Update*, *supra* note 30, at 1049.

[90]Another theory for upholding prepayment penalties is that they serve the purposes of both the lender and the borrower. For example, the borrower is enabled to save interest or to have his property released from the lien early, while the lender is able to protect his investment income. *See generally* Annotation, *Construction and Effect as to Interest Due of Real Estate Mortgage Clause Authorizing Mortagor to Prepay Principal Debt*, 86 A.L.R. 3d 599, 604 (1978).

[91]*See Prepayment Penalties*, *supra* note 5, at 847.

[92]*See Bonanno*, *supra* note 28, at 295.

[93]Criticizing the theory, the Board has commented that "this rationale seems debatable because the closing costs and other charges collected by the lender upon origination may

A second theory advanced by lenders in support of prepayment penalties is the "income" argument.[94] Lenders argue that prepayment penalties constitute a substantial portion of their annual income, the loss of which would not only endanger existing loans but would restrict the availability of loans to future borrowers.[95]

The third justification commonly advanced in support of prepayment penalties is the "economic complement" argument.[96] According to this theory, the due-on-sale clause enables lenders to avoid being locked into loans at rates below current market levels. The lender is able to refuse assumptions and, by accelerating the unpaid balance of the loan, is able to reinvest its funds at higher market interest rates.[97] The prepayment penalty clause is employed by lenders to "lock in" loans at interest rates higher than current market rates by discouraging refinancing by borrowers when market interest rates drop below those of the borrower's loan.[98]

The use of prepayment penalty and acceleration clauses in tandem has been described as "another imperfect method for achieving a higher long term return on the [lender's] loan portfolio"[99] and as a method to reduce the risk associated with fixed rate lending.[100] The Board has noted that "[p]roperly used, [prepayment and acceleration clauses] can

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more than compensate it for its fixed costs." 49 Fed. Reg. 32,081 (1984). One commentator argued

> that lenders also charge 'points' (which is actually a form of discounting the borrower's rate), for making a new loan or for accepting an assumption of an outstanding loan. In addition, they require payments for such present and future expenses as credit reports, ALTA title insurance, and even reconveyance fees. Consequently, the traditional justification hardly seems credible any more.

Bonanno, *supra* note 28, at 295.

[94]*Prepayment Penalties*, *supra* note 5, at 848.

[95]One commentator has noted that lenders argue that prepayment penalties comprise anywhere from twelve to thirty-eight percent of their annual net incomes. *See id.* at 848-49.

[96]*See* REAL ESTATE FINANCE, *supra* note 7, § 6.1; *Prepayment Penalties*, *supra* note 5, at 849.

[97]*See Prepayment Penalties*, *supra* note 5, at 849. The alternative use of the due-on-sale and prepayment penalty clauses by lenders is distinguishable from the variable interest rate situation. When variable interest rates are used, interest rates on long term mortgages rise or fall in conjunction with some index that is related or tied to market interest rates. When the lender employs the due-on-sale and prepayment penalty clauses together, the prepayment penalty is used to keep the lender's portfolio interest return from dropping while the due-on-sale clause is applied to reloan money at higher market rates. Thus, the lender is able to protect itself from the adverse economic effects of dropping interest rates, an impossible result with variable interest rates. *See* REAL ESTATE FINANCE, *supra* note 7, § 6.1.

[98]*See* REAL ESTATE FINANCE, *supra* note 7, § 6.1.

[99]*Id.*

[100]*See Prepayment Penalties*, *supra* note 5, at 830.

help lenders in preserving both original contract terms and anticipated yields as a means of matching the durations of their assets and liabilities."[101]

2. Attacks on Prepayment Penalties.—Borrowers have unsuccessfully attacked prepayment penalties upon numerous grounds. For example, it has been asserted that a prepayment penalty should be unenforceable as usurious when the sum of the actual interest paid plus the prepayment amount exceeds the maximum lawful interest rate calculated to the date of prepayment.[102] Courts have rejected this argument on the ground that the voluntary payment of the loan by the borrower was not a charge for the use of the money, but instead a charge for the privilege of repaying the loan before maturity.[103] The penalty may also be upheld when the payment by the borrower does not exceed the interest that would have been collected had the debt continued to its maturity, because the borrower is not required to pay more interest than it contractually agreed to pay.[104]

Another argument commonly rejected by the courts is premised upon the theory that the damages imposed do not bear a reasonable relationship to the injury caused by the prepayment.[105] This argument, whether framed in terms of invalid liquidated damages,[106] invalid penalty,[107] or unjust enrichment,[108] has proved unsuccessful in the voluntary payment situation. One court rejected the argument in part because the purpose of the prepayment penalty was to give the borrower the option to prepay.[109] Another court, in a commercial mortgage situation, based its decision

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[101]49 Fed. Reg. 32,082 (1984).

[102]*See Secured Real Estate Loan Prepayment*, *supra* note 88, at 926.

[103]*See* Boyd v. Life Ins. Co. of the Southwest, 546 S.W.2d 132 (Tex. Civ. App. 1977).

[104]*See* Redmond v. Ninth Fed. Sav. & Loan Ass'n, 147 N.Y.S.2d 702 (N.Y. Sup. Ct. 1955).

[105]*See Update*, *supra* note 30, at 1055.

[106]*See* Meyers v. Home Sav. & Loan Ass'n, 38 Cal. App. 3d 544, 113 Cal. Rptr. 358 (1974).

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

[108]*See* Century Fed. Sav. & Loan Ass'n v. Madorsky, 353 So. 2d 868 (Fla. Dist. Ct. App. 1978). In this case, the court engaged in little analysis, instead quoting extensively from *Lazzareschi* as the justification for its decision. *Id.* at 869.

[109]Meyers v. Home Sav. & Loan Ass'n, 38 Cal. App. 3d at 546, 113 Cal. Rptr. at 359. This case is also interesting in that its companion case, Meyers v. Beverly Hills Federal Savings & Loan Association, 499 F.2d 1145 (9th Cir. 1974), concerned the same issue although with a federal savings and loan association chartered under HOLA, rather than a state lender. The court in the latter case did not reach the issue of the validity of the prepayment penalty under state law, instead basing its holding on the conclusion that state law was preempted by federal law. This case is discussed *infra* notes 186-88 and accompanying text.

on the fact that the prepayment penalty at issue did not exceed Board limitations upon the collection of prepayment penalties in the residential mortgage context.[110] Still another court upheld a prepayment penalty of fifty percent of the amount prepaid on the basis that the charge was reasonably related to the lender's risk.[111]

Prepayment penalties have also been attacked on the ground their use constitutes an invalid restraint on alienation.[112] Some courts have rejected this argument by refusing to view the prepayment charge as an exorbitant burden.[113] Other courts have viewed the assessment of the prepayment penalty as reasonably related to protecting the legitimate interest of the lender.[114] Some commentators, however, dispute that prepayment penalties do not constitute an invalid restraint on alienation.[115] Instead, they argue that when a lender invokes a prepayment penalty along with its exercise of the due-on-sale clause, alienation is restrained because of the increased cost of the conveyance.[116]

B. Limitations upon Prepayment Penalties

1. Judicial Treatment of Prepayment Penalties.—Although courts have often upheld prepayment penalties in the context of voluntary prepayments,[117] many courts have refused to enforce the penalties when the breach of the loan agreement resulted from an involuntary act on

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[110]*Lazzareschi*, 22 Cal. App. 3d at 309-10, 99 Cal. Rptr. at 421. The court noted that the prepayment clause in the subject commercial loan was the same as those permitted by the Board in home loans, and implied that the prepayment penalty of $9,130.02 would have been valid even if a greater amount had been charged because of the commercial nature of the loan. *Id.* The present day limitations imposed by the Board upon the collection of prepayment penalties in the residential mortgage context are found at 12 C.F.R. § 591.5(b) (1986).

[111]Williams v. Fassler, 110 Cal. App. 3d 7, 13, 167 Cal. Rptr. 545, 549 (1980).

[112]One commentator has classified prepayment penalty clauses and due-on-sale clauses as indirect rather than direct restraints upon alienation because they penalize transfers rather than prohibit them. *See Update*, *supra* note 30, at 1051.

[113]*See, e.g.*, *Lazzareschi*, 22 Cal. App. 3d at 311, 99 Cal. Rptr. at 422.

[114]Sacramento Sav. & Loan Ass'n v. Superior Court, 137 Cal. App. 3d 142, 186 Cal. Rptr. 823 (1982) (lender has a justifiable interest in imposing a prepayment penalty to cover his costs due to potential lag time and administrative processing prior to making a new loan); Hellbaum v. Lytton Sav. & Loan Ass'n, 274 Cal. App. 2d 546, 79 Cal. Rptr. 9 (1971) (lender has justifiable interest in imposing a prepayment penalty because of administrative costs incurred in issuing loans and setting up provisions for their servicing), *rev'd on other grounds sub. nom.* Wellenkamp v. Bank of Am., 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

[115]*See Update*, *supra* note 30, at 1051.

[116]*Id.* The author argued further that "there is no justification in law or public policy for the imposition of a penalty-type restraint upon alienation of the security." *Id.* at 1057.

[117]*See supra* notes 102-16 and accompanying text.

the part of the borrower.[118] As one commentator observed, "[W]here circumstances other than the [borrower's] deliberate exercise of the prepayment clause arguably have caused prepayment of the loan, the courts have examined the factual situations presented and have denied enforcement of the penalty where the [borrower] did not voluntarily mature the indebtedness."[119]

The rule prohibiting the collection of prepayment penalties upon the borrower's involuntary payment of the loan is applicable in several different situations. One situation occurs when the mortgaged premises are destroyed and the insurance proceeds are used to pay off the debt. In *Chestnut Corp. v. Bankers Bond & Mortgage Co.*,[120] the borrower's mortgaged premises were completely destroyed by fire. The loan documents provided that the debt could be prepaid at any monthly installment as long as the borrower paid an additional two percent penalty.[121] The court reasoned that the loan documents contemplated a voluntary prepayment by the borrower, and held that the lender was not entitled to the penalty when the mortgage debt was paid from the insurance proceeds after the premises were destroyed by fire.[122] The court noted that the lender could have protected itself by providing for a more explicit prepayment penalty in the loan documents.[123]

Another common situation in which courts have refused to authorize the collection of a prepayment penalty upon the involuntary payment of the loan, absent specific language in the mortgage or note, is when prepayment results from condemnation or the threat of condemnation of the mortgaged premises.[124] Thus, in *Jala Corp. v. Berkely Savings & Loan Association*,[125] the court held that the prepayment clause contemplated the borrower's voluntary exercise of its right to prepay the

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[118]*See, e.g.*, *In re* L.H.D. Realty Corp., 726 F.2d 327 (7th Cir. 1984).

[119]Annotation, *Construction and Effect as to Interest Due of Real Estate Mortgage Clause Authorizing Mortgagor to Prepay Principal Debt*, 86 A.L.R.3d 599, 605 (1978).

[120]395 Pa. 153, 149 A.2d 48 (1959).

[121]*Id.* at 155, 149 A.2d at 49.

[122]*Id.* at 156-57, 149 A.2d at 50.

[123]*Id.* The problems experienced by the lender in this case could have been avoided by drafting similar to that noted *infra* notes 221-24 and accompanying text. This is in fact what the court in *Chestnut* suggested.

[124]*See* Shavers v. Duval County, 73 So. 2d 684 (Fla. 1954); 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), *on remand*, 136 Ga. App. 822, 222 S.E.2d 664 (1975); LandOhio Corp. v. Northwestern Mut. Life Mortgage & Realty Investors, 431 F. Supp. 475 (N.D. Ohio 1976); *cf. In re* Brooklyn Bridge Southwest Urban Renewal Project, 46 Misc. 2d 558, 260 N.Y.S.2d 229 (N.Y. Sup. Ct. 1965) (court held prepayment penalty was enforceable in the condemnation situation because the parties had expressly provided for such a happening in the loan documents).

[125]104 N.J. Super. 394, 250 A.2d 150 (1969).

balance of the mortgage and did not embrace prepayment by reason of eminent domain.[126] The court also found persuasive the argument advanced in *Chestnut* regarding the lender's ability to protect itself by express drafting.[127]

A third situation wherein courts have refused to enforce a prepayment penalty is the so-called "acceleration exception."[128] This situation arises when the lender exercises a due-on-sale clause and also attempts to collect a prepayment penalty upon the borrower's early payment of the loan.[129] Courts have commonly analyzed the lender's exercise of the due-on-sale clause as an advancement of the maturity date of the loan to the present.[130] Thus, a payment by the borrower upon the debt is not a prepayment, but rather a payment made after maturity, thereby precluding the lender's right to collect a prepayment penalty.[131]

The "acceleration exception" was recognized in *In re L.H.D. Realty Corp.*,[132] a case involving commercial property and a non-federally chartered lender. The loan documents provided for collection of a penalty in the event the loan was "prepaid."[133] The court began its analysis of the lender's attempt to impose a prepayment penalty after the lender had elected to accelerate the balance of the loan by recognizing that

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[126]*Id.* at 401, 250 A.2d at 154.

[127]The court reiterated the argument that had the lender believed itself entitled to a prepayment penalty in the event of condemnation, it could have provided for such an occurrence in the loan documents. *Id.*

[128]*See In re* L.H.D. Realty Corp., 726 F.2d 327 (7th Cir. 1984).

[129]Courts have upheld the lender's right to collect a prepayment penalty in situations related to the "acceleration exception." When the lender accelerates the balance of the loan, declaring it due, and then waives or rescinds its acceleration, courts have held that the lender may regain the right to collect a prepayment penalty. *See* Arend v. Great S. Sav. & Loan Ass'n, 611 S.W.2d 381 (Mo. Ct. App. 1981); West Portland Dev. Co. v. Ward Cook, Inc., 246 Or. 67, 424 P.2d 212 (1967); Berenato v. Bell Sav. & Loan Ass'n, 276 Pa. Super. 599, 419 A.2d 620 (1980). Thus, the lender's election to accelerate the loan need not be irrevocable. However, the lender's ability to rescind its election exists only where the borrower has not changed its position in reliance upon the lender's acceleration. *See* Van Vlissingen v. Lenz, 171 Ill. 162, 49 N.E. 422 (1898); *cf.* Great S. Sav. & Loan Ass'n v. Jefferson Properties, Inc., 661 S.W.2d 68 (Mo. Ct. App. 1983) (court rejected borrower's argument that waiver of acceleration had occurred as a matter of law).

[130]*See* Grubbs v. Houston First Am. Sav. Ass'n, 718 F.2d 694, 697 (5th Cir. 1983). *But cf. Update*, *supra* note 30, at 1050, where the author concluded that acceleration of the loan debt through use of a due-on-sale clause generates a "prepayment" for which a penalty is charged under the prepayment penalty clause.

[131]*See* General Motors Acceptance Corp. v. Uresti, 553 S.W.2d 660 (Tex. Civ. App. 1977) (holding that a "prepayment" is a payment made before maturity and "acceleration" is a change in the date of maturity from the future to the present).

[132]726 F.2d 327 (7th Cir. 1984). This case was somewhat complicated by the fact the borrower was in a Chapter 11 bankruptcy proceeding.

[133]*Id.* at 329.

reasonable prepayment penalties were enforceable.[134] It noted an exception to this general rule where the lender elects to accelerate the debt "because acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."[135] Noting that the lender had in fact accelerated the loan debt, the court held that payment of a prepayment penalty by the borrower would clearly be improper because the loan debt was presently due and the loan documents provided for a penalty only if the loan were "prepaid."[136] The court concluded that the lender's attempted collection of a penalty, in lieu of forgone interest, was improper because the lender had "voluntarily waived the unpaid interest in the expectation of accelerated payment of the remaining principal."[137]

Other cases involving commercial loan situations and non-federal lenders have applied similar reasoning to conclude the lender was not entitled to a prepayment penalty upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause.[138] However, in *George H. Nutman, Inc. v. Aetna Business Credit, Inc.*,[139] another case involving commercial property and a non-federal lender, the court employed a different analysis in refusing to uphold the lender's right to collect a prepayment penalty after acceleration of the balance of the loan. The court analogized to the involuntary exceptions of "eminent domain" and "payment of the mortgage debt through insurance proceeds" mentioned previously.[140] It reasoned that the lender's election "to treat the mortgage debt as due was not a voluntary act by the [borrower] sufficient to bring the prepayment penalty into operation."[141] Accordingly, the lender was not entitled to a prepayment penalty.[142]

Courts have also refused to allow federal savings and loan associations to collect a prepayment penalty upon acceleration of the mortgage

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[134]*Id.* at 330.

[135]*Id.* at 330-31.

[136]*Id.* at 331.

[137]*Id.*

[138]*See* Martin v. Southern Atl. Inv. Corp., 160 Ga. App. 852, 287 S.E.2d 692 (1982) (court held non-federally chartered lender was not entitled to collect a prepayment penalty upon commercial property when it exercised a due-on-sale clause). *Accord* Casey v. Business Men's Assurance Co., 706 F.2d 559 (5th Cir. 1983); McCarthy v. Louisiana Timeshare Venture, 426 So. 2d 1342 (La. Ct. App. 1982), *cert. denied*, 433 So. 2d 163 (La. 1983); *cf.* Grubbs v. Houston First Am. Sav. Ass'n, 718 F.2d 694 (5th Cir. 1983) (court held non-federally chartered residential lender should not collect a prepayment penalty upon acceleration of the balance of the loan because acceleration caused the loan debt to become immediately due).

[139]115 Misc. 2d 168, 453 N.Y.S.2d 586 (N.Y. Sup. Ct. 1982).

[140]*See supra* notes 118-27 and accompanying text. .

[141]115 Misc. 2d at 169, 453 N.Y.S.2d at 587.

[142]*Id.*

debt pursuant to the exercise of a due-on-sale clause.[143] The decisions, which have employed reasoning similar to that previously discussed, make no mention of Board limitations upon the collection of a prepayment penalty in the residential mortgage context.[144]

2. State Legislative Treatment of Prepayment Penalties.—State legislatures have also addressed the issue of prepayment penalties, and several have enacted legislation regulating and often limiting their collection.[145] However, these statutes are limited to residential loans and do not attempt to regulate prepayment penalties in the commercial mortgage context.[146] The New Jersey statute forbids prepayment penalties in residential mortgages.[147] Pennsylvania's statute is similar.[148] Illinois prohibits prepayment penalties on residential loans with interest rates exceeding eight percent per annum.[149] Other legislation is not quite as restrictive. For example, Missouri allows prepayment penalties on residential mortgages during the first five years of the loan, but limits the penalty to two percent of the balance at the time of prepayment.[150] After five years, prepayment penalties may not be charged.[151] Mississippi also forbids prepayment penalties on residential mortgages after five years.[152] If prepayment is made during the first year of the mortgage, the prepayment charge is five percent of the unpaid balance.[153] The charge then decreases one percent per year.[154] California forbids prepayment penalties upon residential mortgages after five years as well.[155]

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[143]*See* Tan v. California Fed. Sav. & Loan Ass'n, 140 Cal. App. 3d 800, 189 Cal. Rptr. 775 (1983) (held that in residential mortgage context, federal lender could not collect a prepayment penalty upon its acceleration of the loan because the loan documents provided for a penalty only in the event borrower voluntarily prepaid the loan; court chose to ignore pertinent Board regulations); Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 98 Ill. App. 3d 646, 424 N.E.2d 939 (1981) (held that in commercial mortgage context, federal lender could not collect a prepayment penalty under the loan documents because borrower's payment upon lender's acceleration of the loan was not a prepayment; pertinent Board regulations not analyzed); American Fed. Sav. & Loan Ass'n v. Mid-America Service Corp., 329 N.W.2d 124 (S.D. 1983) (held that in mortgage upon "certain real property," federal lender could not collect prepayment penalty upon acceleration of the loan; Board regulations ignored).

[144]*See supra* note 143.

[145]These states include Illinois, Massachusetts, Mississippi, Missouri, New Jersey, New York, Pennsylvania, and West Virginia.

[146]*See infra* notes 147-61 and accompanying text.

[147]N.J. STAT. ANN. § 46:10B-5 (West 1986).

[148]PA. STAT. ANN. tit. 41, § 405 (Purdon 1986).

[149]ILL. ANN. STAT. ch. 17, para. 6404(2)(a) (Smith-Hurd 1986).

[150]MO. ANN. STAT. § 408.036 (Vernon 1986).

[151]*Id.*

[152]MISS. CODE ANN. § 75-17-31 (Supp. 1986).

[153]*Id.*

[154]*Id.*

[155]CAL. CIVIL CODE § 2954.9(b) (West 1986).

Within five years, it imposes limitations similar to those of previous Board regulations.[156] Virginia provides that a borrower from a credit union may prepay at any time without penalty.[157] Virginia's statutes also provide that in the residential mortgage situation, the lender is not entitled to a prepayment penalty greater than two percent of the amount of the prepayment,[158] and may not collect a penalty at all if the payment results from the exercise of a due-on-sale clause.[159] New York also prohibits collection of prepayment penalties where the lender exercises a due-on-sale clause in a residential mortgage.[160] Massachusetts prohibits prepayment penalties where a residential mortgage is paid pursuant to the state's exercise of its eminent domain powers.[161]

3. Board Treatment of Prepayment Penalties.—The Board, which governs all federally-chartered savings and loan institutions, imposes restrictions on the enforcement of prepayment penalties upon residential mortgages in several situations. The lender may not impose a penalty if: (1) it declares by written notice that a loan is due pursuant to a due-on-sale clause;[162] (2) it initiates a judicial or nonjudicial foreclosure proceeding to enforce a due-on-sale clause;[163] or (3) it fails to consent within thirty days to the written request of a qualified purchaser to assume the loan according to its terms and thereafter the borrower sells or transfers the property and prepays the loan in full.[164]

In the preamble to the final publication of the Board's recent amendment of the above provisions,[165] the Board noted several pertinent justifications for limiting a lender's right to collect a prepayment penalty pursuant to the exercise of a due-on-sale clause. The Board stated that "equity demands that no prepayment penalty be permitted if a lender does not wish to allow a loan to remain outstanding by approving its assumption by a qualified obligor."[166] The Board effectively rebuffed

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[156]The statute provides:

> A prepayment charge may be imposed on any amount prepaid in any 12-month period in excess of 20 percent of the original principal amount of the loan which charge shall not exceed an amount equal to the payment of six months' advance interest on the amount prepaid in excess of 20 percent of the original principal amount.

Id.

[157]VA. CODE ANN. § 6.1-330.28 (1983).

[158]*Id.* § 6.1-330.29

[159]*Id.*

[160]N.Y. REAL PROPERTY LAW § 254-a (McKinney 1986).

[161]MASS. GEN. LAWS. ANN. ch. 183, § 57 (West 1977).

[162]12 C.F.R. § 591.5(b)(2)(i) (1986).

[163]*Id.* § 591.5(b)(2)(ii).

[164]*Id.* § 591.5(b)(3).

[165]50 Fed. Reg. 46,744 (1986).

[166]*Id.* at 46,746.

the lender's arguments in favor of the practice by noting "that the ability to impose a prepayment penalty is not essential to the effective use of due-on-sale clauses for the purposes of raising portfolio yields to current market interest rates."[167]

The Board's limitations upon the collection of prepayment penalties are limited to "loan[s] on the security of a home occupied or to be occupied by the borrower."[168] The Board imposes no limitations upon a lender's right to exercise a due-on-sale clause and collect a prepayment penalty in a commercial mortgage situation. However, many of the Board's justifications for restrictions upon the collection of a prepayment penalty in the residential mortgage situation seem equally applicable to the commercial situation. Neither commercial nor residential lenders should be allowed to engage in unequitable practices, especially when the practices are not required to bring their portfolio yields to current rates.[169]

IV. Application of Board Regulations, State Law and Policy Considerations to Commercial Lenders

A. Board Regulation of Prepayment Penalties: Does Preemption Apply?

De la Cuesta and the Act have, for the most part, settled questions as to a lender's ability to enforce a due-on-sale clause. However, the lender's ability to enforce a prepayment penalty in commercial mortgages, especially upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause, is not quite so settled.

Several Board regulations may apply to commercial mortgages. One such regulation, 12 C.F.R. § 545.34(c), provides that "an association

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[167] *Id.* at 46,745.

[168] 12 C.F.R. § 591.5(b) (1986).

[169] A future problem may exist in the Board's enforcement of the limitations upon collection of a prepayment penalty. The regulations purport to limit the rights of "lenders" to collect prepayment penalties in certain situations. *See id.* § 591.5(b)(2), (3). Under 12 C.F.R. § 591.2 (1986), "lender" is defined as "a person or government agency making a real property loan, including without limitation, individuals, Federal associations, state-chartered savings and loan associations, national banks, state-chartered banks and state-chartered mutual savings banks . . . ." Thus, the Board attempts to prohibit all lenders, whether federally chartered or not, from collecting prepayment penalties pursuant to exercise of a due-on-sale clause. However, the Act upon which the Board relied for authority contains no language granting the Board authority to extend prepayment penalty enforcement limitations to non-federally chartered lenders. For the Board's purported source of authority, see Senate Comm. on Banking, Housing and Urban Affairs Report on S. 2879, S. Rep. No. 536, 97th Cong., 2d Sess., at 21 (1983).

may impose a penalty on prepayment of a loan as provided in the loan contract."[170] Another regulation provides:

> Section 545.34(c) makes clear that, with the exception of certain instances enumerated therein, the charging of a prepayment penalty is a matter of contract between a Federal association and a borrower, and that the borrower may wholly or partly prepay the loan without penalty unless the loan contract contains an express provision imposing a prepayment penalty. Thus, in view of the controlling Federal regulation, a Federal association may include a prepayment provision in the loan contract up to the maximum limitation of § 545.34(c) regardless of conflicting State law which sets a lower limit or imposes a different type of prepayment penalty, but it may not charge a prepayment penalty exceeding the limit in § 545.34(c) even if State law allows a higher charge.[171]

The effect of these regulations upon the ability of a federal association to collect a prepayment penalty is unclear. In particular, because 12 C.F.R. § 545.34(c) is entitled "Limitations for home loans secured by borrower-occupied property,"[172] its application to commercial mortgages seems questionable.

Pursuant to its "plenary and exclusive authority . . . to regulate all aspects of federal associations," the Board has expressed its intention to preempt "any state law purporting to address the subject of the operations of a Federal association."[173] However, in *de la Cuesta*, the Supreme Court narrowly limited the effect of its decision to the due-on-sale clause context. Specifically, the Court stated that "[b]ecause we find an actual conflict between federal and state law, we need not decide whether the HOLA or the Board's regulations occupy the field of due-

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[170]The full text of the regulation provides:

> (c) Loan payments and prepayments. Except for loans to natural persons secured by borrower-occupied property and on which periodic advances are being made, payments on the principal indebtedness of all loans on real estate shall be applied directly to reduction of such indebtedness, but prepayments made on an installment loan may be reapplied from time to time wholly or partly to offset payments which subsequently accrue under the loan contract. Subject to the disclosure provisions of § 545.33(f)(2), an association may impose a penalty on prepayment of a loan as provided in the loan contract. Notwithstanding the above, for any home loan secured by borrower-occupied property and on which the yield may be adjusted pursuant to § 545.33(e), an association may not impose a penalty on any prepayment made within 90 days following notice of an adjustment.

12 C.F.R. § 545.34(c) (1986).

[171]*Id.* § 555.15.

[172]*Id.* § 545.34(c).

[173]*See id.* § 545.2.

on-sale law or the entire field of federal savings and loan regulation."[174] The Court also hinted that the Board's preemptive powers were limited when it observed that "[a]lthough the Board's power to promulgate regulations excepting federal savings and loans from the requirements of state law may not be boundless, in this case we need not explore the outer limits of the Board's discretion."[175]

These statements must be contrasted with several seemingly contradictory statements in the Court's opinion. At one point, the Court observed that "[t]he Board's extensive regulations govern . . . loan payments and prepayments."[176] In another footnote, the Court cited approvingly *Meyers v. Beverly Hills Federal Savings & Loan Association*,[177] a decision holding that Board regulations preempted the entire field of prepayments of real estate loans to federal associations.[178]

In what could be characterized as an attempt to clarify the majority's contradictory indications, Justice O'Connor concurred separately emphasizing "that the authority of the Federal Home Loan Bank Board to preempt state laws is not limitless."[179] Conceding that the Board's powers were indeed broad, Justice O'Connor refused to recognize that HOLA allowed the Board to preempt all state and local laws applicable to federally-chartered savings and loan institutions.[180]

Justices Rehnquist and Stevens dissented. Arguing that contract and real property law were traditionally state law questions,[181] and that Congress had not intended to create a federal common law of mortgages,[182] Justice Rehnquist concluded his dissent by noting that "[d]ischarge of its mission to ensure the soundness of federal savings and loans does not authorize the . . . Board to intrude into the domain of state property and contract law that Congress has left to the States."[183] The only clear conclusion from the above discussion seems to be that a federal lender's ability to collect a prepayment penalty in the commercial mortgage context, absent specific language so providing, is unsettled.[184]

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[174]458 U.S. at 159 n.14.

[175]*Id.* at 167.

[176]*Id.* at 167 n.20.

[177]499 F.2d 1145 (9th Cir. 1974) *cited in de la Cuesta*, 458 U.S. at 152 n.9.

[178]499 F.2d at 1147.

[179]458 U.S. at 171 (O'Connor, J., concurring).

[180]*Id.* at 172.

[181]*Id.* at 174 (Rehnquist, J., dissenting).

[182]*Id.*

[183]*Id.* at 175.

[184]In contrast to the confusion surrounding the issue of whether the regulation of prepayment penalties is preempted by federal law, several examples exist of congressional action clearly preempting state law. The first of these is the previously mentioned Act, which preempted state law restrictions upon the enforcement of due-on-sale clauses. Another is the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C.

Only two lower court decisions address the Board's preemptive powers regarding prepayment penalties; however, both of these decisions involved residential mortgages.[185] The first of these, *Meyers*, cited approvingly by the Supreme Court in *de la Cuesta*,[186] involved a class action on behalf of borrowers holding "real estate loans" who sought to have prepayment penalty provisions in their loan contracts with federal lenders declared void as invalid liquidated damage clauses under a California statute.[187] The Ninth Circuit, while required by the circumstances of the case to determine only whether a specific federal regulation providing for prepayment penalties in fact conflicted with and therefore preempted a specific state statute, instead chose to base its holding upon much broader grounds. The court held that federal law preempted the entire field of prepayment penalties to federal lenders in "real estate loans" and, because of this, that all state laws were inapplicable.[188]

A second case interpreting the Board's preemptive powers over the collection of prepayment penalties by federal lenders in residential mortgages is *Toolan v. Trevose Federal Savings & Loan Association*.[189] In *Toolan*, the Pennsylvania Supreme Court employed a preemption analysis similar to that used by the Supreme Court in *de la Cuesta* to determine whether a state statute prohibiting prepayment penalties in residential mortgages was preempted by contradictory federal regulations providing for prepayment penalties.[190] Focusing upon statements in *de la Cuesta* supportive of prepayment penalty preemption,[191] and ignoring the Supreme Court's expressions of doubt upon the issue,[192] the *Toolan* court held that the regulation of prepayment penalties was within the Board's power and that the Board regulations did preempt the contradictory state statutes.[193]

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§ 1735f-7 (1982 & Supp. 1985), which preempted state usury laws for all "federally-related" loans secured by first liens on residential real estate. The Board regulations issued under the authority of this statute may be found at 12 C.F.R. §§ 590.1-590.101 (1986). A third example of a clearly preemptive statute is the Alternative Mortgage Transactions Parity Act of 1982, 12 U.S.C. §§ 3801-3805 (1982 & Supp. 1985), which authorized state chartered financial institutions to make alternative forms of mortgage loans approved by federal financial regulatory agencies, even though the loans might be contrary to state law.

[185]While both of these decisions address the preemption issue in the residential mortgage context, undoubtedly commercial lenders will apply similar reasoning in litigation involving prepayment penalties assessed in the commercial mortgage context.

[186]*See supra* notes 177-78 and accompanying text.

[187]499 F.2d at 1146.

[188]*Id.* at 1147.

[189]501 Pa. 477, 462 A.2d 224 (1983).

[190]*Id.* at 481-83, 462 A.2d at 226-27.

[191]*See supra* notes 176-78 and accompanying text.

[192]*See supra* notes 174 and 175 and accompanying text.

[193]501 Pa. at 484, 462 A.2d at 227.

Undoubtedly, federally-chartered savings and loan associations will argue that the reasoning of *Meyers* and *Toolan* should be extended to include the collection of prepayment penalties in the commercial mortgage context as well. Should future courts conclude that state laws concerning the collection of prepayment penalties by federal lenders are preempted by federal law, it is still not clear that federal lenders will be entitled to per se collection of a prepayment penalty pursuant to the exercise of a due-on-sale clause. If the Board regulations providing that prepayment penalties are "a matter of contract between a Federal association and a borrower"[194] and that prepayment penalties may be imposed "as provided in the loan contract"[195] apply to commercial loans, and if the Board's limitations upon the collection of prepayment penalties in residential mortgages[196] do not, may any other limitations upon the collection of prepayment penalties apply?[197]

The only applicable comment by the Board about prepayment penalties in commercial mortgages was included in the preamble to the final publication of the Board's amendment to 12 C.F.R. § 591.5(b).[198] There, responding to a query from an Indianapolis-based lender,[199] the Board stated that "[f]ederal associations may include prepayment penalty clauses in any loan they make and, except for limitations imposed by Board regulations, enforce such clauses according to their terms, state law—including equitable principles—notwithstanding."[200] If courts chose to view this statement by the Board as preemptive of state law,[201] it would seem that a federally-chartered lender could collect a prepayment penalty in a commercial mortgage situation even if the loan were paid as the result of a nonvoluntary payment by the borrower. The nonvoluntary exceptions to enforcement of prepayment penalties have been termed "equitable applications" of the law[202] and would likely fall within the category of state laws preempted under the Board's interpretation.

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[194]12 C.F.R. § 555.15 (1986).

[195]*Id.* § 545.34(c).

[196]*Id.* § 591.5(b)(2), (3).

[197]Of course, these types of questions will not arise under present law if the lender has effectively drafted its loan documents to preclude such problems. *See infra* notes 221-24 and accompanying text.

[198]*See* 12 C.F.R. § 591.5(b) (1986), as amended at 50 Fed. Reg. 45,749 (1985).

[199]*See* Office of General Counsel Opinion Letter (Oct. 9, 1985) (construing 12 C.F.R. §§ 545.34(c), § 591.5(b)(2) (1985)).

[200]50 Fed. Reg. 46,745 (1985).

[201]*See* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 159 n.13 (1982); Indiana Bell Telephone Co. v. Boyd, 421 N.E.2d 660 (Ind. Ct. App. 1981).

[202]*See* American Fed. Sav. & Loan Ass'n of Madison v. Mid-America Service Corp., 329 N.W.2d 124 (S.D. 1983).

B. The "Acceleration Exception"

While the above discussion may seem to preclude objections to a lender's imposition of a prepayment penalty pursuant to the exercise of a due-on-sale clause in the commercial mortgage context, the "acceleration exception" may still provide borrowers some hope. Under the reasoning employed by the Seventh Circuit in *In re L.H.D. Realty Corp.*,[203] acceleration of the loan by the lender pursuant to the exercise of a due-on-sale clause advances the maturity date of the loan so that payment thereafter is not prepayment but rather is payment made after maturity.[204] If the loan documents in a given case call for the payment of a prepayment penalty when the loan is "prepaid"[205] or when the loan is "paid before maturity," it would seem that even a federal lender would be precluded from collecting a prepayment penalty. This is because the Board regulations provide that collection of a prepayment penalty is "a matter of contract"[206] and that a prepayment penalty may be imposed "as provided in the loan contract."[207] If the loan documents provide for a penalty when the loan is paid before maturity, then under the contract, no penalty would be due because the loan may no longer be paid before maturity. The lender's acceleration of the loan pursuant to its exercise of the due-on-sale clause renders the loan presently due and makes payment of a prepayment penalty impossible.[208] Depending upon whether the court chooses to view the "acceleration exception" as an application of the involuntary exceptions to the collection of prepayment penalties or as a matter of contractual interpretation of the loan documents, a federally-chartered lender may be precluded from enforcing a prepayment penalty upon acceleration of the loan debt pursuant to the exercise of a due-on-sale clause.

Regardless of how courts resolve the problems applicable to federal lenders mentioned above, it appears those lenders not chartered under HOLA[209] and therefore not subject to Board regulation remain subject to state law limitations upon the collection of prepayments penalties. Therefore, the involuntary exceptions to prepayment penalty enforcement, along with the "acceleration exception," may still prevent non-federally

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[203]726 F.2d 327 (7th Cir. 1984).

[204]*Id.* at 330-31.

[205]*See* McCarthy v. Louisiana Timeshare Venture, 426 So. 2d 1342 (La. Ct. App. 1983) (providing for a penalty in the event the loan is "prepaid"), *cert. denied*, 433 So. 2d 163 (La. 1983).

[206]12 C.F.R. § 555.15 (1986).

[207]*Id.* § 545.34(c).

[208]*See L.H.D.*, 726 F.2d at 330-31.

[209]*See supra* notes 12 and 16.

chartered commercial lenders from imposing a prepayment penalty in some situations.[210]

V. What Next?

A. Policy Considerations

The Board regulations limiting the lender's right to collect a prepayment penalty in the residential mortgage context were prompted by consumer protests against unfair "double-dipping" practices of lenders.[211] While lenders often impose large prepayment penalties to discourage early payments of loans when market interest rates drop, they also exercise due-on-sale clauses when market interest rates rise above interest rates on existing mortgages.[212] The unfairness occurs when the lender elects to accelerate the balance of the loan debt pursuant to a due-on-sale clause, while also imposing a prepayment penalty.

This practice seems particularly unfair when the interest rate upon the existing mortgage is lower than the current market interest rates and when the lender's security interest is not endangered because a qualified borrower desires to assume the loan.[213] The lender's imposition of a prepayment penalty in this situation is unsupportable by any justification. The Board advanced similar reasoning when it "noted that the ability to impose a prepayment penalty is not essential to the effective use of due-on-sale clauses for the purpose of raising portfolio yields to current market interest rates."[214] While this comment was included in the preamble to the Board's amendment of regulations concerning the collection of prepayment penalties in residential mortgages, it is equally applicable to the commercial situation as well.

Regulation by the Board or, more preferably, legislation by Congress is warranted to clarify the confusion surrounding a federally-chartered lending association's ability to collect a prepayment penalty upon acceleration of the loan debt pursuant to the exercise of a due-on-sale clause in the commercial mortgage situation. Future legislation should closely consider the policy arguments against the exercise of a prepayment penalty pursuant to the exercise of a due-on-sale clause in the residential mortgage situation.

The lack of need by lenders to employ prepayment penalties to make due-on-sale clauses effective for raising portfolio yields to current market

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[210]*See* Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 98 Ill. App. 3d 646, 424 N.E.2d 939 (1981).

[211]*See Prepayment Penalties*, *supra* note 5, at 850.

[212]*See* Real Estate Finance, *supra* note 7, § 6.1.

[213]Under Board regulations, a borrower desiring to assume a residential mortgage is qualified if he "qualifies for the loan under the lender's applicable underwriting standards and . . . occupies or will occupy the security property." 12 C.F.R. § 591.5(b)(3) (1986).

[214]50 Fed. Reg. 46,745 (1986).

interest rates is one consideration.[215] Another argument advanced in the residential mortgage situation is that the prepayment penalty clause is not freely bargained for by substantially equal contracting parties.[216] Residential borrowers may not even be aware of what a prepayment penalty clause is, or they may be unable sufficiently to digest unintelligible loan documents to recognize its existence, much less be in a position to negotiate with lenders as to its inclusion within a mortgage. This argument would seem to be weakened in the commercial mortgage context because, arguably, parties to a commercial transaction freely contract. Both the borrower and the lender are often represented by counsel in commercial situations.[217] While representation by counsel might preclude a non-bargaining argument by borrowers, this is not necessarily so. Lenders are often in a financially superior position when negotiations commence, especially in today's economic climate of low market interest rates.[218] Many lenders have mortgages with high rates of interest on their books.[219] A borrower may possess little or no power to negotiate as to the existence or non-existence of prepayment penalties. Though the transaction be commercial, the prepayment penalty provision may not be "freely bargained for."

The collection of a prepayment penalty upon acceleration of the loan debt pursuant to the exercise of a due-on-sale clause may create an inequitable windfall for the lender, whether in the residential or commercial mortgage context. If part of the justification for due-on-sale clauses is that they enable lenders to call in loans with below market interest rates so that lenders may loan the funds at currently higher rates of interest, it seems fair and just that a borrower should be permitted to prepay its loan without penalty when market interest rates drop below previous levels.[220] This argument is further strengthened by the fact that the borrower's early payment of the loan is not voluntary, but results from the lender's command that the loan be paid off. This "double-dipping" practice by lenders is unfair and should be limited by Board or Congressional action.

B. Express Drafting to Avoid Problems

Notwithstanding the above discussion, and absent a non-preempted state statute providing to the contrary, lenders may employ express drafting to avoid many of the problems associated with collection of a

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[215] *Id.*

[216] *See Prepayment Penalties*, *supra* note 5, at 851.

[217] One might question the business sense of either a borrower or lender entering into a major commercial transaction without the benefit and assistance of competent counsel.

[218] *See supra* text and accompanying notes 1-4.

[219] *See supra* text and accompanying notes 1-4.

[220] 49 Fed. Reg. 32,082-83 (1984).

prepayment penalty upon acceleration of the loan, if they do not do so already. Express drafting was successfully employed by a commercial lender in *Lazzareschi Investment Co. v. San Franscisco Federal Savings & Loan Association*.[221] In *Lazzareschi*, the lender imposed a penalty of $9,130.02 upon the borrower's early payment of the loan.[222] Although the lender was able to reloan the recovered funds at higher market interest rates, the court upheld a prepayment clause that provided: "The undersigned 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."[223] Another express clause that has been upheld stated: "[I]f the loan is paid in full prior to maturity then in addition to the interest due, the holder hereof shall have the right to charge a sum equal to three months advance interest on the principal balance."[224]

Thus in situations where the loan documents expressly provide for a prepayment penalty, the court is more likely to uphold the penalty against possible restrictions upon collection based upon grounds of involuntary payment or other policy considerations. This is especially so in the commercial mortgage situation, because arguably the parties have freely contracted.

VI. Conclusion

Under present Board regulations, a lender may not collect a prepayment penalty upon acceleration of the mortgage debt pursuant to the exercise of a due-on-sale clause in the residential mortgage context. The residential lender is also precluded from imposing a prepayment penalty when he refuses to allow a "qualified transferee" to assume the loan in accordance with the loan's terms. A commercial lender's ability to enforce a prepayment penalty under the same circumstances is unclear in light of vague Board regulations and the Supreme Court's failure in *de la Cuesta* to address the issue of broad federal preemption of savings and loan law. Many of the equitable considerations prompting the Board's limitations upon collection of prepayment penalties in residential mortgages are equally applicable to the commercial mortgage situation.

Action by Congress, the Board, or both is warranted to eliminate this confusion. In view of the numerous policy considerations discussed previously, any action should be formulated such that commercial bor-

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[221]22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971).

[222]*Id.* at 306, 99 Cal. Rptr. at 419.

[223]*Id.* at 305, 99 Cal. Rptr. at 418.

[224]Arend v. Great S. Sav. & Loan Ass'n, 611 S.W.2d 381, 382 (Mo. Ct. App. 1981).

rowers are afforded the same protections against inequitable imposition of prepayment penalties by lenders as residential borrowers are afforded under present Board regulations. Thus, commercial lenders should be prohibited from imposing a prepayment penalty pursuant to the exercise of a due-on-sale clause.

Regardless of any future action by Congress or the Board, lenders must be conscious of the pitfalls awaiting carelessly or loosely drafted loan documents. Under present law, careful thought and express drafting may easily avoid the problems mentioned in this Note.

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