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Research on Intentional Default and Enforceability of Prepayment Premium

Introduction

A bond is issued in exchange for $1,000. Issuer must pay the bondholder a certain percent each year until maturity, whereupon the bondholder gets the $1,000 back. The issuer may pay back the bond early (before maturity), but because that would extinguish the bondholder's steady stream of interest income, the parties agree that the issuer must pay a premium if the issuer redeems the bond prematurely. In order to evade having to pay the premium for buying off the bond prematurely, the issuer has intentionally defaulted on its obligation to pay the annual interest on the bond. This forces the bondholder to declare a breach and accelerate the entire debt so that the principal and accrued interests are due immediately. The bondholder can then go to court to collect this money, and the bond will have been extinguished (prematurely) without the issuer ever having paid the premium.

Question Presented

1. Does the bondholder have a right to the premium for prepayment when the issuer has intentionally defaulted to force an acceleration of the debt prior to maturity in the absence of a clause that provides for this?

Short Answer

1. Possibly yes. Courts in other jurisdictions have recognized a right to the prepayment premium when the debtor intentionally defaults to force acceleration, even in the absence of a clause that provides for it, and New York courts would likely follow suit. In order to overcome the general rule that acceleration of a debt precludes prepayment, the bondholder would have to prove that the default was intentionally contrived in order to avoid the prepayment premium.

DISCUSSION

New York courts have not directly addressed a case of an intentional default manufactured to force acceleration and evade a prepayment penalty. In dicta, a trial court has stated that if a Court concludes that the borrower has defaulted intentionally in order to trigger acceleration, and thereby avoid or evade a prepayment premium, the prepayment clause may be enforced, notwithstanding substantial authority which requires an explicit agreement to allow a premium after acceleration. *Northwestern Mut. Life Ins. Co. v. Uniondale Realty Assoc.*, 2006 NY Slip Op 26072 (N.Y. Misc. 2006). This case was an action for foreclosure in which the underlying note provided for payment of a prepayment premium, and specifically provided that an acceleration due to default would be deemed a voluntary prepayment so that the prepayment premium would apply. After examining the history and examples of premium collection clauses, the Court found that the language in the clause did no more than anticipate and thwart any attempt by a mortgagor to intentionally trigger acceleration in order to secure the benefits of prepayment in a favorable market while at the same time avoiding the bargained for premium. The court concluded that the clause was relevant solely where there was an attempt at prepayment after a default and acceleration but prior to commencement of a foreclosure action. Thus, the prepayment premium was not recoverable by the insurer.

The Court held:

> A prepayment premium will not be enforced under default circumstances in the absence of a clause which so states. In the event that a court concludes that the borrower has defaulted intentionally in order to trigger acceleration and thereby avoid or evade a prepayment premium, the prepayment clause may be enforced, notwithstanding substantial authority which requires an explicit agreement to allow a premium after acceleration. (internal citations omitted)

Id. at 26077, 26078.

According to the court in *Northwestern*, in the case of default, a prepayment premium will be enforced only if the bond has a clause that so states. However, if the court has reason to conclude that the default was intentional, the prepayment clause will be enforced even in the absence of such a clause. Because of the lack of New York cases addressing the intentional-default situation, the Court cited cases from other jurisdictions in support of the proposition. It is likely that New York would follow the reasoning of these cases, discussed below.

The general rule is that prepayment clauses are inapplicable to debts that have been accelerated following a breach. Courts will not depart from this rule without clear evidence that the default was an intentional attempt to evade the prepayment premium. For example, in *Eyde Bros. Dev. Co. v. Equitable Life Assurance Soc*., 697 F. Supp. 1431 (D. Mich. 1988), plaintiff Development Company borrowed six million dollars, in 1978, from defendant Equitable Life Assurance Society to finance construction of an apartment building complex. The promissory note provided for repayment over a 30-year period and restricted plaintiff's right to prepay, prohibiting prepayment of the whole principal within the first ten years. The plaintiff defaulted, and Equitable elected to accelerate the debt and initiate litigation. Soon after, plaintiff paid to Equitable the entire amount demanded, including the prepayment penalty, under protest. The plaintiff contended that Equitable was not entitled to assess a prepayment penalty since prepayment was a function of Equitable's decision to accelerate the debt. The Court held that the general rule precludes a prepayment penalty when the debt has been accelerated:

> Reasonable prepayment premiums are enforceable . . .There are, however, some limitations upon the right to receive a prepayment premium. For one, **the lender loses its right to a premium when it elects to accelerate the debt**. . . . this is so 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.

Id. at 1436. (emphasis added)

Equitable urged the Court to depart from the general rule so as not to reward plaintiff in its attempt to avoid the prepayment penalty through intentional default. The Court held that in appropriate cases, the courts could enforce a prepayment penalty even where the lender had accelerated the debt and that although the Court does not condone plaintiff's intentional default, nor the manner in which it was accomplished, neither does the Court believe the equities weigh so heavily in favor of Equitable as to warrant award of both default interest and a prepayment penalty. *Id.*

The general rule stated in *Eyde Bros.* was first enunciated in *In re LHD Realty Corp.*, 726 F.2d 327 (7th Cir. 1984), where the issue before the court was a contest over a mortgage holder's right to receive a stipulated premium in exchange for accepting a borrower's repayment of a loan before maturity. The mortgage agreement in *LHD* provided that early payment of the balance due on the underlying loan was permissible, but would subject the mortgagor to a prepayment premium. *Id.* at 329. After filing its

Chapter 11 petition, *LHD* made several late monthly mortgage payments under the mortgage agreement. The mortgage holder, National Life Insurance Company ("National"), responded by filing a complaint seeking relief from the automatic stay in order to foreclose its lien. *LHD* countered by seeking court authorization to sell the mortgaged property. After several hearings on each of these requests, the court denied the relief sought by National and approved the sale of the property by *LHD*. *Id*. at 329, 330. It was at that point that National asserted its right to a prepayment premium pursuant to the terms of the mortgage agreement. Although the Seventh Circuit acknowledged the enforceability of reasonable prepayment premiums, it cited several limitations on the right to receive them. One limitation is that a lender waives its right to a prepayment premium when it chooses to accelerate the underlying debt. *Id*. at 330.

National argued that a per se rule that prepayment premiums are unenforceable after acceleration would lead to intentional defaults by debtors seeking to avoid paying prepayment premiums. The Seventh Circuit suggested two solutions to this potential problem. First, "the lender could sidestep the debtor's ploy by suing only for overdue payment as they mature, together with attorney's fees." *Id*. at 331. Second, a lender, even after acceleration, could "regain the right to its premium by revoking its acceleration and reinstating the mortgage prior to detrimental reliance by the borrower on the acceleration." *Id.* at 331, n.4. In addition to these suggested lender tactics, the court also opened a potentially wide back-door to the *LHD* acceleration exception, concluding that "should such intentional defaults become a problem, however, we believe courts could deal with the difficulty by denying the acceleration exception in appropriate cases." *Id.* at 331. However, the court held:

> It is not appropriate, under these circumstances, for the lender to receive a prepayment premium in lieu of the interest foregone since it has voluntarily waived the unpaid interest in the expectation of accelerated payment of the remaining principal.

Id. The Court found no suggestion that *LHD* had implemented a strategy to intentionally default in order to evade the premium. *Id.*

Similarly, where there was no evidence of an intentional default, the Court in *Rodgers v. Rainier Nat'l Bank*, 111 Wn.2d 232 (Wash. 1988) refused to supply a penalty incident to an acceleration upon default when the terms of the agreement between the parties did not provide for one. In *Rodgers*, debtors on a promissory note defaulted and the lender accelerated the maturity date pursuant to a default-acceleration provision. The Note prohibited prepayment in the first four loan years. It stipulated that thereafter the loan may be prepaid only in full and only by paying a prepayment fee and also that, in the event of any default, the entire principal sum and accrued interest would immediately become due and payable at the option of the holder. The debtors had made a request for reduction in the interest rate, and when the lender refused, the debtors stopped monthly payments. Thereafter, lender sent borrowers notice of nonjudicial foreclosure and sale, and demanded interest from the date of tender, full payment of principal to the end of the fourth loan year, and the prepayment fee that would have been due upon prepayment during the fifth loan year. The debtor paid this amount under protest and initiated the suit. According to the court, the note merely provided an *option* for the lender, in the event of default, to declare due and payable the entire principal sum and accrued interest. *Id*. at 236. The lender unilaterally chose to exercise that option and in so doing negated the prohibition against prepayment and obliterated the fifth loan year prepayment fee. *Id.* The court held that “[t]he inevitable factual and legal consequence of lender's acceleration was to establish a new maturity date, *i.e*., unpaid principal and accrued interest were due and payable *now*." *Id*. Because the maturity date had been accelerated, the payment could no longer be considered *pre*payment and the prepayment penalty was inapplicable. The Court held that the "promissory note does not provide for any penalty incident to an acceleration upon default. The court cannot supply a provision which the parties omitted." *Id.* at 238.

Though the lender argued that the default was intentional, the Court held that there was no evidence of this. The lender had other remedies available, but instead chose to accelerate debt, and the loan documents failed to provide for a prepayment charge incident to acceleration upon default. *Id*. at 237

While in the above cases there was insufficient evidence of intentional default, where such evidence exists, courts will deny the acceleration exception and find liability for the prepayment penalty. This is because a party to a contract should not be allowed to profit from his own, intentional default. For example, in *Florida Nat'l Bank v. Bankatlantic*, 589 So. 2d 255 (Fla. 1991), Petitioner borrowers built an apartment project as a tax shelter and, after completion of construction in 1976, executed a note and mortgage turning the construction loan into a permanent twenty-five-year loan due June 1, 2001. The note and mortgage contained both a prepayment clause and a default acceleration clause. The prepayment clause read as follows:

> In addition to the regular monthly installments herein provided for, the makers may, without penalty of any kind, make prepayments of the principal aggregating, in any loan year, 20% or less of the principal amount of this note. The makers may also prepay greater principal amounts than said 20% in any loan year, upon payment of 12 months interest on the amount by which such prepayments shall cause, in such

> loan year, an excess above the maximum free prepayments herein established.

Id. at 256.

Petitioners defaulted on the note, but later, unbeknownst to respondent, executed a purchase and sale agreement. Respondent initiated foreclosure proceedings. While the foreclosure proceeding was pending, Petitioner sold the mortgaged property and tendered payment of the entire principal balance, default rate interest, attorney's fees, and costs to Respondent. Petitioner agreed to escrow an amount equal to the prepayment penalty and anticipated attorney's fees. The mortgage was then satisfied and the sale was closed.

The only issue before the trial court was whether a provision in the mortgage note imposing a penalty for prepayment was applicable after Respondent elected to declare the note due and payable in full, pursuant to a separate, optional, default-acceleration clause. Respondent presented evidence to substantiate that petitioner's intention was to evade the prepayment penalty. The Supreme Court of Florida held that because the borrower deliberately defaulted, forcing the lender to accelerate the debt, the borrower should not be rewarded with a better outcome than that of a non-defaulting borrower:

> Where a borrower deliberately defaults on a note and the lender is forced to accelerate the note in order to protect its rights and to avoid bringing a separate action each month to enforce the note the borrower cannot obtain greater rights than a borrower who timely pays his debts as they come due. If the loan is prepaid, in the first instance the borrower should not be exempted from paying the penalty while the second borrower is required to pay it. This is a logical conclusion which clearly finds support in the principles and policies applied by the Courts.

Id. at 258.

Relying on the cases discussed above (*Rodgers* and *LHD Realty*), Petitioner argued that "prepayment" is payment before maturity and once a lender accelerates maturity, "prepayment" is, by definition, not possible. The Court noted that *LHD Realty* acknowledged that there is an exception to the general rule where the court finds an intentional default. *Id*. at 258. The Court did affirm the general rule that, unless otherwise specifically provided for in the note, the lender cannot upon the lender's acceleration also collect the prepayment penalty. But such a rule is based on the premise that it was the lender's voluntary choice of exercising the option to collect full payment, rather than waiting, that accelerated the maturity date of the loan. The rule will not be applied when the borrower purposefully defaults in order to force an acceleration and defeat the lender’s contractual right to a premium:

> However, it is axiomatic that a party to a contract should not profit from his own intentional default. We feel that courts should deal with the difficulty of intentional defaults by denying the acceleration exception and finding liability for the prepayment penalty in appropriate cases. In commercial settings, under scenarios such as the instant case, courts should be allotted the discretion to consider the question of timeliness of default, the voluntary nature of the tender of full payment of the note and the involuntary nature of the lender's action to accelerate the note and make exceptions to the general rule. The trial court weighed these considerations and we affirm its finding of liability.

Id. at 258,259.

The Court further held that equity courts have been granted the discretion and authority to do justice between the parties, particularly in circumstances where one party is attempting to profit from his own intentional misconduct. *Id.* at 259.

In an analogous case, the Supreme Court of Minnesota ruled that bondholders may seek their prepayment premium in a breach contract action, where the issuer improperly acted to defeat the right. In *In Re: Hennepin County 1986 Recycling Bond Litigation*, 50 N.W.2d 494 (1995), the county issued bonds, which were secured by a letter of credit, to fund a recycling facility. The indenture agreement gave the County the right to prematurely redeem the bonds, but only upon payment of a premium. However, the agreement also provided that if the County failed to renew the letter of credit, an immediate, mandatory redemption of the bonds would be triggered. Because the County concluded that it would be financially beneficial to reissue bonds at a lower interest rate, it intentionally refused to extend the letter of credit in order to trigger the mandatory redemption and avoid having to pay the premium it otherwise would have for early redemption. *Id*. at 496.

The Court found it illogical that the parties would painstakingly negotiate an economic risk allocation in the form of the prepayment premium, but allow the County to freely evade it merely by allowing the letter of credit to expire. *Id.* at 500-01. "In effect, when the County intentionally foreclosed extension of the Letter of Credit, it opted to redeem the bonds. Because the bonds were redeemed 'at the option of the County,' it is arguable at the very least, that the County must comply with… the Trust Indenture requiring the payment of a premium for the right to redeem the bonds prior to maturity." *Id.* The Court saw through the transaction and deemed it an optional redemption masquerading as a mandatory redemption. *Id*. at 501. In accordance with the rule that "a party who has entered into an obligation to pay will not be permitted to set up his own voluntary default to defeat the same, unless such intention clearly and unequivocally appears in the contract," the Court ruled that the contract was ambiguous as to whether the County could evade the premium and that the bondholders could sue for express breach of contract. *Id.* Furthermore, because every contract has an implied covenant of good faith and fair dealing that prohibits a party from "unjustifiably hindering" the other party's performance, the bondholders could also go forward with their suit for the premium and interest based on breach of the implied covenant. *Id.* at 502-03.

Although the New York Courts have not confronted the intentional-default issue, it is likely that they would follow the lead of other jurisdictions. This was strongly implied in the dicta of *Northwestern*, discussed above, which relied on cases from other jurisdictions. In *Law Research Service, Inc. v. Franklin Corp*., 26 A.D.2d 478 (N.Y. App. Div. 1966), where the construction of a particular clause was at issue the lender argued that unless its construction was adopted, the Plaintiff would have the power to destroy defendant's rights under the particular clause by committing an intentional default. The Court held that "the argument would base contract interpretation on the assumption that the parties will act in bad faith and it underestimates the ability of courts to frustrate acts of bad faith should one occur." *Id.* at 481. The courts of New York do have power to frustrate such acts of intentional default, and would likely do so under the facts of the hypothetical.

CONCLUSION

The general rule is that an acceleration following a default makes the debt mature immediately and therefore prepayment provisions do not apply in the absence of a provision specifically making them applicable upon acceleration. When there is no evidence that the default was intentionally manufactured to avoid the premium, courts follow the general rule. However, in cases in which issuers have contrived to purposefully deprive bondholders of their contractual premium right through an intentional default, courts in other jurisdictions have ruled that the premium provision is enforceable. New York courts would likely follow suit.