ENFORCEABILITY OF PREPAYMENT PREMIUMS – LANGUAGE DOES MATTER!

By John C. Murray

Introduction

The Circuit Court of Cook County, Illinois recently entered an interesting ruling on the enforceability of a commercial-loan prepayment provision. *See Cornerstone Leased Drugstores LLC v. Wells Fargo Bank Northwest, NA*, Circuit Court of Cook County, Illinois, No. 07 CH 04352 (June 19, 2009). The case was decided solely on the basis of the meaning of the contractual language regarding prepayment contained in the (identical) mortgage notes executed by Cornerstone Leased Drug Stores LLC ("Cornerstone") in connection with forty-two 25-year mortgages on properties located in 16 states. The Court agreed with the defendant, Wells Fargo Bank Northwest ("Wells Fargo," which served as trustee for the five institutional lenders who actually loaned the money and were designated as trust-beneficiaries) with respect to its calculation, under each of the notes, of the Reinvestment Yield under the prepayment provision and the conversion to a monthly yield as provided by the provision. This article will summarize and analyze the court's decision and discuss its relevance for commercial mortgage lenders.

Analysis of Decision

The court summarized the issues as follows:

> There are two portions of [the prepayment provision] that are critical to the resolution of the dispute between the parties. The first is part (i) of the definition of "Reinvestment Yield," and in particular the parenthetical statement: "(or such other display as may replace such displays on the Bloomberg service or any other generally available service)." The second is contained within the definition of "Prepayment Consideration" providing the method of calculating the total amount of the remaining payments due under the note: "such sum to be determined by discounting (monthly on the basis of a 360-day year composed of twelve 30-day months).

Id. at p.3.

The prepayment premium was to be calculated (pursuant to the applicable provision) by reference to the "Reinvestment Yield," which, as stated in the provision,

> means the yield to maturity of either (i) the yield reported as of 11:00 A.M. (New York City time) on the date of calculation on the display designated USD on the Bloomberg Financial Markets Screen (or such other display as may replace such displays on the Bloomberg service or any other generally available service) for actively traded U.S. Treasury securities having a constant maturity equal to the remaining average life of the Note, or (ii) if such yields shall not be reported as of such time or the yields reported as of such time shall not be ascertainable (including by way of interpolation), the Treasury Constant Maturity Series yields reported for the latest day for which such yields shall have been so reported as of

> the Business Day next preceding the Determination Date in Federal Reserve Statistical Release H-15 (519) (or any comparable successor publication) for U.S. Treasury securities having a constant maturity equal to the remaining average life of the Note as of the Determination Date: provided however, if no maturity exactly corresponding to the remaining average life of the Note shall appear therein, yields for the two most closely corresponding reported maturities (with one being shorter and the other longer) shall be calculated pursuant to the foregoing sentence and the Reinvestment Yield shall be interpolated from such yields on a straight-line basis (rounding in each of such relevant periods, to the nearest month). All such prepayments must occur on a Business Day.

Cornerstone subsequently refinanced the loan and exercised its right to prepay in the summer of 2006. However, on the stipulated date for calculation of the prepayment premium (August 16, 2006), a "matched" Treasury security that would mature on the maturity date of the loan (March 3, 2019) did not appear on the Bloomberg USD screen. The parties then agreed, as per the language in the prepayment provision, to interpolate the prepayment consideration using the two most closely corresponding reported U.S. securities, one shorter than March 3, 2019 and one longer. But the parties disagreed on whether they could only look to the Bloomberg USD screen to ascertain such interpolation based on the U.S. Treasury securities most closely corresponding to March 2019 (as argued by Wells Fargo), or whether the parties could look to different screens for such purpose (as argued by Cornerstone). The court ruled in favor of Wells Fargo, noting that "Paragraph 6 [the prepayment provision] of the Notes, while admittedly complex, is not ambiguous." *Id*. at p. 5. The court further noted that: "The plain language of the note anticipates the possibility that changes might occur over the course of those 25 years, but does not provide the parties with an alternate financial markets screen from which to obtain information on the interest rate borne by U.S. Treasury securities." *Id*. at p. 7.

Cornerstone also argued that the Reinvestment Yield should have been calculated on a semi-annual, rather than a monthly basis. But after carefully reviewing the language in the prepayment provision, the court agreed with Wells Fargo that in order to be consistent with the terms of the Notes the Reinvestment Yield had to be calculated on a monthly basis. According to the court:

> Since the discount factor is comprised of the "Reinvestment Yield plus 50 basis points," the Notes direct the parties to apply the Reinvestment Yield as if it accrued monthly, and then to add 50 basis points to that number. The word monthly in this section of the note provides the clear and unambiguous direction for that calculation. As such, there is no issue of material fact . . . and Wells Fargo's Motion for Summary Judgment is granted.

Id. at p. 7.

The basic purpose of a yield-maintenance prepayment provision in a commercial real-estate loan document is to provide a fee to the lender that will compensate it for the difference between the original interest on the loan and the yield available from U. S. Treasury instruments at the time of prepayment. The prepayment clause in the *Cornerstone* case provided that "the Notes direct the parties to apply the Reinvestment Yield as if it accrued monthly, and then to add 50 basis points to that number." This adding of basis points, which is not all that common any

more in connection with prepayment premium provisions in commercial mortgage-loan documents, was probably done by the lender to blunt any argument that prepayment based on U.S. Treasury instruments without the addition of such basis points would constitute a "windfall" for the lender. But this specific language (certainly not a bad idea) had no bearing on the court's ruling, which was based strictly on contractual interpretation. This was not a true "yield maintenance" case where the validity or enforceability of such a clause in general was questioned. For years, institutional lenders such as insurance companies have used "yield maintenance" clauses to calculate prepayment premiums, and such clauses are considered the industry norm.

See Richard F. Casher, *Prepayment Premiums: Hidden Lake is a Gem,* 19-9 ABI J. 1 (Nov. 1, 2000):

> A yield-maintenance clause typically assumes that the prepayment premium and the prepaid principal will be invested in U.S. Treasury securities (Treasuries) that will mature at the same time as the prepaid loan and that the dollars so invested will return the same yield that the insurance company would have realized had its loan not been prepaid. Treasuries are used as the reinvestment norm because there exists no standard commercial mortgage loan rate, given the uniqueness of each commercial loan and the inherent difficulty (if not impossibility) of identifying an identical or similar loan; in contrast, the market for treasuries is deep and highly liquid.

See also Restatement (Third) of Property: Mortgages § 6.2 comment a (1997):

> The primary purpose of [prepayment] clauses is to protect the mortgagee against the loss of a favorable interest yield . . . . Prepayment may also result in further losses, such as the administrative and legal costs of making a new loan . . . and in some cases additional tax liability.

Conclusion

The *Cornerstone* case (at least at the trial level) once again clearly illustrates the importance of clarity in the drafting of a mortgage prepayment provision, and in this case it would appear the lenders (and their counsel) did it right. The borrower had contended that it was overcharged by $2,260,000 based on the defendant's calculation (the total prepayment amount paid to Cornerstone, pursuant to Wells Fargo's calculation, was $20,621,812). The court noted in its ruling that there was no ambiguity and therefore no need to examine parol evidence. (*See also Friedman v. LaSalle Nat'l Bank*, 2004 Ohio 2205 (Ohio App. 2004), at P21 ("[t]he prepayment provision is clear on its face and unambiguous. Therefore we will not consider the parol evidence [the borrower] advances")). The court's ruling in *Cornerstone* highlights the fact that a mortgage prepayment provision should be carefully, clearly, and comprehensively drafted so that its meaning is clear and there is no ambiguity that may open the door to a challenge by a clever borrower. The general rule is that any ambiguity will be construed by a court in the borrower's favor when the lender has drafted the loan documents. *See, e.g., Littlejohn v. Parrish*, 163 Ohio App. 3d 456, PP 27-28 (2005) (holding that mortgage, which provided that there was no prepayment penalty but that any prepayment was subject to the mortgagee's approval, imposed duty of good faith and fair dealing "when one party has discretionary authority to determine

certain terms of the contract"; court refused summary judgment for mortgagee and remanded case for further proceedings). The moral of the *Cornerstone* case: Language does matter! [Note: The judgment entered in favor of Wells Fargo in the *Cornerstone* case was fully dispositive of the case, and Cornerstone had 30 days in which to file a Notice of Appeal (unless a post-trial motion was filed within that time, in which event the notice of appeal would be due 30 days after disposition of the post-trial motion). The author is uncertain, as of the date of this article, whether either such event has occurred or will occur.]