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COMMENTS

SILENCE IS NOT ALWAYS GOLDEN: MORTGAGE PREPAYMENT IN THE COMMERCIAL LOAN CONTEXT

Carl Adams owns a small hardware store in Baltimore County. Through much hard work, he has been able to establish a reputation for knowledge, service, and dependability, which has resulted in the steady growth of his business despite the recent slump in the construction and housing industries. After renting space for several years, Carl now has the opportunity to purchase his store building. As his attorney, you are able to negotiate what you believe is an excellent arrangement for Carl. The owner of the building, John Walker, has agreed to take back a purchase money mortgage for all but a minimal down payment at a favorable interest rate. The twenty-year term you have convinced the owner to accept will keep Carl's payments relatively low, which is important to Carl. Using a standard form note and mortgage you obtain from the library, the deal closes. Carl is pleased and speaks highly of your work to his friends and customers. You close the file on the transaction, satisfied that you have served Carl well.

But have you? It is now eight years later, and Carl speaks of your service with a different tone. The economy is flourishing, and along with it, Carl's hardware store. Carl has the opportunity to expand his store into the adjoining building. Interest rates have decreased significantly, and Carl's bank is willing to lend him enough to refinance the existing loan and purchase the new space. He will be able to save a substantial amount in monthly payments by structuring the financing in this manner rather than taking out a mortgage only on the second building. Carl is shocked and angry when John Walker tells him that he will refuse to accept early payoff of his loan. Carl calls your office insisting that you immediately write Walker a letter informing him that he has no choice but to accept the payoff. You set up an appointment with Carl for the next day and begin to research the issue. As you review the form note you used, a knot develops in your stomach. You sleep very little that night, thinking of Carl's reaction to the answer you must give him.

In *Promenade Towers Mutual Housing Corp. v. Metropolitan Life Insurance Co.*,¹ the Court of Appeals of Maryland adopted the

1. 324 Md. 588, 597 A.2d 1377 (1991) (*Promenade II*).

rule of "perfect tender in time," under which, absent statute, contractual provisions, or agreements to the contrary, a mortgagor does not have the right to pay off a mortgage loan prior to the maturity date specified within the loan contract.² Although for years generally considered to be the common law in Maryland,³ the rule had never been expressly adopted by the court.

The note that you used for Carl's loan from John Walker did not contain a prepayment clause.⁴ This silence is fatal to Carl's desire to pay the loan off early unless Walker cooperates. Carl may be able to make payoff more attractive to Walker by offering to pay an additional lump sum amount, commonly called a prepayment premium or penalty. You could have included such a provision in the original note. At that time, Walker's primary concern was to sell his building; he probably would not have objected to a reasonable prepayment option. Unfortunately for Carl, at this time Walker is most concerned with maintaining the income stream he has become dependent on, and Walker now has bargaining superiority.

The concept that one does not inherently have the right to payoff debt at will may be foreign to many people. Consumer lending laws⁵

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2. *Id.* at 603, 597 A.2d at 1384. The rule of "perfect tender in time" is the general or majority rule in this country. *See, e.g.*, 3 RICHARD R. POWELL, POWELL ON REAL PROPERTY ¶ 460[3][f] (1993); 55 AM. JUR. 2D *Mortgages* § 397 (1971); 59 C.J.S. *Mortgages* § 447(a) (1949). The converse of this rule is referred to as the civil law rule or as a presumption of prepayment. The civil law rule considers the maturity date to be for the benefit of the debtor only, and allows the debtor to prepay at will, thus creating a presumption that the debtor may prepay the loan unless the contract specifies otherwise. *Promenade II*, 324 Md. at 600, 597 A.2d at 1383.
 3. *Promenade II*, 324 Md. at 602, 597 A.2d at 1384 (citing HYMAN GINSBERG & ISIDORE GINSBERG, *MORTGAGES AND OTHER LIENS IN MARYLAND* 236 (1936); HERBERT TIFFANY, *A TREATISE ON THE MODERN LAW OF REAL PROPERTY* § 537, at 1235 n.276 (1912)).
 4. Such a clause sets forth the right, if any, of the borrower to prepay, along with any charges or penalties due in the event that right is exercised. If no prepayment clause is included, leaving the loan contract silent on the issue of prepayment, the rule of "perfect tender in time" will apply unless a statute grants the right to prepay.
 5. *E.g.*, MD. CODE ANN., COM. LAW § 12-505(e) (1990) ("A buyer may prepay at any time, without penalty, all or any part of the outstanding balance of a closed end [retail credit] account."); *id.* § 12-612(b) ("A buyer may prepay at any time, without penalty, all or part of the outstanding balance payable under an installment sale agreement relating to consumer goods."); *id.* § 12-620(a) ("[A] buyer may prepay at any time, without penalty, all or any part of the unpaid balance payable under the installment sale agreement if such agreement is for the retail sale of personal property purchased primarily for personal, family, or household purposes. . . ."); *id.* § 12-635(a) ("A sales finance company shall permit a buyer to prepay in full or in part at any time, without penalty, the outstanding balance payable under a renewal, extension, or refund

and the policies of many purchasers of residential mortgage loans⁶ serve to insulate most lending transactions from the common law rule. Within a transaction subject to the rule, laymen and lawyers not familiar with commercial real estate and lending law may likely be under the impression that negotiation of a prepayment clause is in furtherance of the lender's desire to limit the borrower's right to prepay, rather than the creation of that right for the borrower.

This Comment first reviews the *Promenade Towers* opinion, which involves an examination of an interesting line of Revolutionary War era cases. The Comment then explores the legal bases for the rule of perfect tender in time and the arguments both in support of and critical of its operation. Finally, the Comment discusses issues related to the validity and enforcement of contractual agreements providing for prepayment limitations and penalties.

I. PROMENADE TOWERS MUTUAL HOUSING CORP. v. METROPOLITAN LIFE INSURANCE COMPANY

Metropolitan Life Insurance Company (Metropolitan) was the holder of a consolidated note and deed of trust securing indebtedness of approximately \$23 million on The Promenade, an apartment complex in Montgomery County, Maryland.⁷ At the time of suit,

agreement."); *id.* § 12-1009(a) ("A consumer borrower may prepay a loan in full at any time.").

As a result of the *Promenade Towers* decision, the General Assembly of Maryland enacted § 12-126 of the Commercial Law Code, which, in regard to a loan "secured by a mortgage or deed of trust on the borrower's primary residence" that "is not a commercial loan," provides that "[e]xcept to the extent provided otherwise in the loan contract, a borrower may prepay all or part of the outstanding unpaid indebtedness under [the] loan at any time." MD. CODE ANN., COM. LAW § 12-126 (Supp. 1993).

6. No prepayment penalty may be charged on FHA and VA loans. See 24 C.F.R. § 203.22(b) (1993) (requiring FHA mortgages to allow prepayment in whole or in part without payment of a prepayment charge); 38 C.F.R. § 36.4211(c) (1993) (requiring that the debtor on a VA loan have the "right, without penalty or fee, to prepay all or not less than one installment of the indebtedness at any time"). FHLMC and FNMA do not purchase loans that contain prepayment penalty provisions. See ROBERT KRATOVL & RAYMOND J. WERNER, MODERN MORTGAGE LAW & PRACTICE § 34.04(c) (2d ed. 1981).
7. This note and deed of trust represented the consolidation of two prior notes and deeds of trust. *Metropolitan Life Ins. Co. v. Promenade Towers Mut. Hous. Corp.*, 84 Md. App. 702, 706, 581 A.2d 846, 848 (1990) (*Promenade I*). The original parties to the lending transactions were Landcon Associates Phase One and Continental Illinois Realty. At the time of consolidation in 1975, Continental's interest had been assigned to Metropolitan R. Extract at E2-E3, *Promenade Towers Mut. Hous. Corp. v. Metropolitan Life Ins. Co.*, 324 Md. 588, 597 A.2d 1377 (1991) (*Promenade II*) (No. 91-2) [hereinafter *Record Extract*].

The Promenade was owned by Promenade Towers Mutual Housing Corporation (PTMHC). The consolidated note and deed of trust had been modified in 1980 (the First Modification) and in 1986 (the Second Modification).⁸ The First Modification established an interest rate of 14%, expressly prohibited prepayment until July 1, 1989, and allowed prepayment without penalty after that date.⁹ The Second Modification reduced the interest rate to 11.875%, with payments to be made until September 1996, at which time the remaining balance would be due in full. There was no mention of prepayment in the Second Modification.¹⁰ The entire note was completely restated as amended within each Modification.¹¹ The Second Modification additionally recited that the “[b]orrower hereby confirms and reaffirms the terms, covenants and conditions of the Consolidated Note, as amended hereby.” Paragraph eight of the Second Modification states the following:

That except as amended hereby, nothing herein contained invalidates or shall impair or release any covenant, condition, agreement or stipulation in the Consolidated Note as previously amended and Consolidated Deed of Trust as previously amended, and the same, except as amended hereby, shall continue to be in full force and effect¹²

In January 1989, PTMHC informed Metropolitan of its intent to exercise the prepayment privilege granted in the First Modification.¹³ In response, Metropolitan asserted that the Second Modifi-

The facts as presented here are a compilation of information provided by the opinions of the Court of Special Appeals of Maryland, *Promenade I*, 84 Md. App. at 705-07, 581 A.2d at 848-49, and the Court of Appeals of Maryland, *Promenade II*, 324 Md. at 590-92, 597 A.2d at 1378-79. This information is supplemented with information provided in the Complaint, *Record Extract, supra*, at E1-E8, that was not contested in the Answer, *Record Extract, supra*, at E47-E52.

8. *Promenade I*, 84 Md. App. at 706, 581 A.2d at 848. The First Modification was between Promenade Associates, successor to Landcon Associates, and Metropolitan; the Second Modification was between PTMHC, successor in title to Promenade Associates, and Metropolitan. *Record Extract, supra* note 7, at E4.
9. *Promenade II*, 324 Md. at 590, 597 A.2d at 1378. The interest rate was fixed until June 1990. *Id.* From July 1990 until maturity in June 2005, the rate was adjustable, subject to a 14% floor. *Id.* The prepayment privilege required an irrevocable 60 day written notice and payment of interest through the date of prepayment. *Id.*
10. *Id.* at 591, 597 A.2d at 1378.
11. *Id.*; see also *Record Extract, supra* note 7, at E9-E44 (providing a copy of each Modification).
12. *Promenade II*, 324 Md. at 591, 597 A.2d at 1378.
13. *Id.* at 591, 597 A.2d at 1379.

cation extinguished that privilege.¹⁴ PTMHC then sought a declaratory judgment and an injunction requiring Metropolitan to accept prepayment after July 1989.¹⁵

The issue presented to the trial court was whether the prepayment terms of the First Modification were incorporated by reference into the Second Modification through the use of the reaffirmation and continuance clauses, or whether the terms of the Second Modification completely superseded those of the First, leaving the contract silent on the issue of prepayment and thereby precluding PTMHC from prepayment at will. Although both parties recognized that there was no statutory or case law on point in Maryland, the initial pleadings and motions did not challenge the applicability of the general rule as to silence on the issue of prepayment.¹⁶ Thus, the initial question presented to the court was one of pure contract interpretation.

The trial court granted summary judgment to PTMHC, holding that the First Modification was "not extinguished, but rather by specific language in the second modification survive[d] and [was] incorporated by reference" to the extent that there was not conflict, and that silence in the Second Modification did not eliminate the right of prepayment granted in the First Modification.¹⁷ Acknowledging the gap in Maryland law and desiring to preserve all issues for appeal, the court additionally held that even if the Second Modification did not incorporate the prepayment privilege of the First Modification, there is a right to prepay absent language in the contract precluding prepayment.¹⁸

The Court of Special Appeals of Maryland reversed the trial court on both issues.¹⁹ The court first addressed the issue of contractual silence as to prepayment. The court reviewed the majority

14. *Id.* at 591-92, 597 A.2d at 1379.

15. *Id.*

16. Metropolitan acknowledged the lack of a Maryland statute or case law and placed weight on the fact that a "majority of neighboring jurisdictions" follow the majority rule with only one nearby jurisdiction, Pennsylvania, holding to the contrary. *Record Extract, supra* note 7, at E77, E79 (citing case law from New York, Connecticut, Massachusetts, New Hampshire, Delaware, and the United States Court of Appeals for the District of Columbia to support the majority rule). While agreeing that Metropolitan accurately stated the majority rule, PTMHC maintained that the rule was inapplicable because the prepayment provisions in the First Modification survived the Second Modification. *Id.* at E115.

17. *Id.* at E150-E151 (ruling of the court).

18. *Id.* at E151-E153. The judge chose to rule in this fashion to "eliminate the necessity of cross appeals in order to preserve that issue," despite the fact that he considered the decision to be "adverse[] to what I believe the law is and is going to be." *Id.*

19. *Metropolitan Life Ins. Co. v. Promenade Towers Mut. Hous. Corp.*, 84 Md. App. 702, 581 A.2d 846 (1990) (*Promenade I*).

rule of perfect tender in time²⁰ and the minority rule granting the right to prepay absent express preclusion.²¹ The few Maryland cases relating to the prepayment issue, although not directly on point, were discussed and determined to be consistent with the majority rule.²² Finally, quoting a Washington State opinion to the effect that changes in this area were more appropriately handled by the legislature than the judiciary, the court adopted the majority rule.²³ The court then quickly dealt with the issue of contract interpretation. The court found that the Second Modification was not ambiguous and that the terminology used should be given its ordinary meaning. The Modification stated that "[t]he Consolidated Note is hereby modified and amended . . . [and] shall read *and be deemed to read in full*" as set forth. As "amended" includes deletion and "in full" means "complete," the prepayment provision of the First Modification was excluded from the Second Modification.²⁴

The Court of Appeals of Maryland affirmed the decision of the court of special appeals.²⁵ After reviewing the application of the rule of perfect tender in time to both mortgage and land installment contracts throughout the United States, the court discussed the precedential value of three cases decided by the court of appeals in the 1790's in favor of a defendant named Whetcroft.²⁶

In the first two of these cases, two creditors, McHard and Quynn, sued for payment on bonds issued by Whetcroft on September 24, 1778 in the amounts of 442 pounds and 10 shillings, plus interest, due "at or upon" September 1, 1788.²⁷ Whetcroft pleaded that the debt had been paid²⁸ based upon his tenders on March 7,

20. *Id.* at 708-10, 581 A.2d at 849-50.

21. *Id.* at 710-13, 581 A.2d at 850-52.

22. *Id.* at 714-15, 581 A.2d at 852-53.

23. *Id.* at 715-16, 581 A.2d at 853.

24. *Id.* at 716-18, 581 A.2d at 853-54.

25. *Promenade Towers Mut. Hous. Corp. v. Metropolitan Life Ins. Co.*, 324 Md. 588, 597 A.2d 1377 (1991) (*Promenade II*).

26. *Id.* at 592-602, 597 A.2d at 1380-84. These three cases are *McHard v. Whetcroft*, 3 H. & McH. 85 (Md. Gen. Ct. 1791) (*Whetcroft I*); *Quynn v. Whetcroft*, 3 H. & McH. 136 (Md. Gen. Ct. 1793) (*Whetcroft II*); and *Quynn v. Whetcroft*, 3 H. & McH. 352 (Md. Gen. Ct. 1795) (*Whetcroft III*). Cases in *Harris & McHenry* are reported based upon the date the case was heard in the General Court (trial level). The trial and appellate decisions are combined. The amount of information provided varies, but usually includes some factual background, the decision, and sometimes an opinion of the general court, and the arguments presented before the appellate court. Often, an appellate court opinion is not provided. Thus, the holding of the appellate court must be inferred based upon the judgment rendered and the arguments presented.

27. *Whetcroft I*, 3 H. & McH. at 85; *Whetcroft II*, 3 H. & McH. at 136; *see also Promenade II*, 324 Md. at 599, 597 A.2d at 1382.

28. *Whetcroft I*, 3 H. & McH. at 85; *Whetcroft II*, 3 H. & McH. at 136; *see also Promenade II*, 324 Md. at 599, 597 A.2d at 1382.

1781 of \$1,175.67 payment on each bond in the form of bills of credit issued by the State of Maryland, which had been refused by the creditors.²⁹ The general court rendered a verdict for the creditors in both cases.³⁰ On appeal, the creditors' attorney argued that the court should apply the common law rule that a payment or tender made by the debtor before the date specified by contract is ineffectual unless accepted by the creditor.³¹ Whetcroft's attorney argued for application of the civil law rule that a distant day of payment is for the benefit of the debtor, not the creditor.³² The court of appeals, deciding both cases in the June term of 1794, reversed both general court judgments.³³

Believing these reversals to signify that the court of appeals allowed prepayment, Professor Frank S. Alexander cited the *Whetcroft* line of cases in his seminal article on mortgage prepayment³⁴ to support his thesis that the rule of perfect tender in time is of relatively recent development without settled historical foundation.³⁵ In turn, PTMHC asserted that the cases represented undisturbed precedent establishing that Maryland follows the minority rule.³⁶ Both Alexander's treatment and PTMHC's assertion rely upon the decisions in the first two *Whetcroft* cases (*Whetcroft I* and *Whetcroft II*), and are based on the premise that decisions in the defendant's favor mean that the court adopted the defendant's argument. That Maryland follows the minority rule and permits prepayment is a logical conclusion drawn from reading *Whetcroft I* and *II*.

The court of appeals, however, looked to the third *Whetcroft* case (*Whetcroft III*) and developed an equally plausible alternative explanation for the *Whetcroft* decisions.³⁷ The court first established the historical context in which these *Whetcroft* cases were decided. An act of the February 1777 session of the Maryland General

29. *Promenade II*, 324 Md. at 599-600, 597 A.2d at 1382-83.

30. *Whetcroft I*, 3 H. & McH. at 85; *Whetcroft II*, 3 H. & McH. at 137; see also *Promenade II*, 324 Md. at 599, 597 A.2d at 1382.

31. *Whetcroft I*, 3 H. & McH. at 87-88; see also *Promenade II*, 324 Md. at 599-600, 597 A.2d at 1382-83.

32. *Whetcroft I*, 3 H. & McH. at 88-90; *Whetcroft II*, 3 H. & McH. at 137-38; see also *Promenade II*, 324 Md. at 600, 597 A.2d at 1382-83.

33. *Whetcroft I*, 3 H. & McH. at 91; *Whetcroft II*, 3 H. & McH. at 139; see also *Promenade II*, 324 Md. at 600, 597 A.2d at 1382-83.

34. Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 CORNELL L. REV. 288, 302-03 (1987).

35. *Id.* at 290-308. Alexander ends his historical analysis with the conclusion that "[c]ontrary to traditional wisdom, the common law prior to 1825 did not clearly deny the debtor the right to prepay his mortgage." *Id.* at 308. For Alexander's discussion of the *Whetcroft* cases, see *id.* at 302-03, 305-06.

36. *Promenade II*, 324 Md. at 595, 597 A.2d at 1380.

37. *Id.* at 601-02, 597 A.2d at 1383-84.

Assembly (the 1777 Act) provided that as of April 20, 1777, bills of credit issued by Congress or by the state would be legal tender within the state for payment of all types of debt.³⁸ In addition, the 1777 Act provided that a creditor refusing bills of credit tendered in payment of a debt would be barred from suit on that debt and the debt would be extinguished.³⁹ A debtor, having tendered and been refused, was entitled to plead payment and introduce the 1777 Act as evidence.⁴⁰ Acts such as these were passed by many states to help stabilize economies hard hit by inflation during the Revolutionary War.⁴¹ Unfortunately, the bills of credit legalized by the 1777 Act were just as susceptible to inflation as the currency they replaced; thus, during the October 1779 legislative session the bills were ordered out of circulation as of March 20, 1781.⁴² This 1779 Act provided for exchange of the old bills of credit for new currency at a rate of forty to one.⁴³ Whetcroft's March 7, 1781 tenders to his creditors were made with the old, devalued bills of credit.⁴⁴

The evidence provided in *Whetcroft III* established that Whetcroft had tendered, in succession, the exact same bills to creditor Quynn as payment for each of three bonds held by Quynn; each tender was refused.⁴⁵ Plaintiff Quynn argued that the tenders should be valid against the first bond only and should not operate to extinguish more debt than money tendered.⁴⁶ The general court ruled that because refusal of tender operated as payment so as to extinguish the debt, the same money might then be used again to tender on the second debt, and if again refused, to tender on the third—each tender and refusal operating to discharge the debt tendered against with no further obligation to the creditor.⁴⁷

On appeal, Luther Martin,⁴⁸ representing Quynn, contended that the 1777 Act “established a new principle” in that it “made a tender

38. *Id.* at 596-97, 597 A.2d at 1381.

39. *Id.* at 597, 597 A.2d at 1381.

40. *Id.*

41. *Id.* at 598, 597 A.2d at 1382.

42. *Id.*

43. *Id.*

44. *Id.* at 599, 597 A.2d at 1382.

45. *Quynn v. Whetcroft*, 3 H. & McH. 352, 352-53 (Md. Gen. Ct. 1795) (*Whetcroft II*); see also *Promenade II*, 324 Md. at 600, 597 A.2d at 1383.

46. *Whetcroft III*, 3 H. & McH. at 353; see also *Promenade II*, 324 Md. at 600, 597 A.2d at 1383.

47. *Whetcroft III*, 3 H. & McH. at 353; see also *Promenade II*, 324 Md. at 600, 597 A.2d at 1383.

48. Luther Martin was one of the preeminent Maryland lawyers of the time. His career has been summarized as follows:

MARTIN, Luther. 1748?-1826. American lawyer and public official, b. near New Brunswick, N.J. Practiced in Maryland (from c. 1772); first

of money, and a refusal to receive, a payment . . . of the same effect as if the money had been received," thus depriving the creditor of his debt.⁴⁹ Martin then argued that, having had the debt extinguished upon tender, the creditor should now be entitled at least to the money previously tendered and refused, "which by law has been forced upon him as an equivalent for [the debt] which was his due."⁵⁰ Without recorded opinion, the court of appeals reversed the judgment of the general court.⁵¹

The (modern) court of appeals posited that the reversals in *Whetcroft I* and *II* may not have represented the adoption of the civil law rule allowing prepayment at the debtor's will. These reversals instead could indicate the court's decision that a refused tender would have the effect of payment and would consequentially operate as the creditor's acceptance of prepayment, which under the common law extinguished a debt whether or not the debtor had the right to prepay.⁵²

attorney general of Maryland (1778-1805). Member, Continental Congress (1785) and Federal Constitutional Convention (1787); opposed plan of strong central government and adoption of Constitution. Defended Samuel Chase in impeachment trial before U.S. Senate (1804) and Aaron Burr in treason trial in Richmond, Va. (1807). Chief judge, court of oyer and terminer, Baltimore (1813-16); again attorney general of Maryland (1818-22); losing prosecutor in *McCulloch v. Maryland* case (1819).

WEBSTER'S NEW BIOGRAPHICAL DICTIONARY 659 (1988).

49. *Whetcroft III*, 3 H. & McH. at 355; see also *Promenade II*, 324 Md. at 600, 597 A.2d at 1383.
50. *Whetcroft III*, 3 H. & McH. at 356; see also *Promenade II*, 324 Md. at 601, 597 A.2d at 1383.
51. *Whetcroft III*, 3 H. & McH. at 356; see also *Promenade II*, 324 Md. at 601, 597 A.2d at 1383.
52. *Promenade II*, 324 Md. at 601-02, 597 A.2d at 1383-84. In a footnote, the court observed that *Whetcroft II* seemed to involve a parol evidence issue that cast little light on the issue at hand. *Id.* at 596 n.2, 597 A.2d at 1381 n.2. *Whetcroft II* does, however, appear to fit well with the hypothesis of the court. The *Whetcroft II* general court report indicates that Whetcroft offered to prove a tender made in bills of credit before the date of payment specified in the bond, and that such tender was a legal tender under the Act. *Quynn v. Whetcroft*, 3 H. & McH. 136, 136-37 (Md. Gen. Ct. 1793) (*Whetcroft II*). The general court held that evidence would not be admitted to prove the facts proffered because "no tender is legal, or can be admitted to be proved, before the day of payment mentioned in the condition of the bond." *Id.* at 137. The general court further held that the Act of October 1780 was of "no relation to continental contracts, where the date of payment was after the continental money was called out of circulation." *Id.*

On appeal, Whetcroft's attorney argued for the application of the civil law on prepayment; Luther Martin, for Quynn, argued against the admission of parol evidence. *Id.* at 137-39. The court of appeals reversed and remanded. *Id.* at 139. The remand proceedings and subsequent appeal are reported as

The court of appeals thus held that the *Whetcroft* cases did not represent adoption of the civil law rule in Maryland, leaving Maryland's case law devoid of appellate precedent directly addressing the issue of a mortgagor's right to prepay.⁵³ The court noted, however, that authorities on Maryland law, in accord with general treatises, have long espoused perfect tender in time as the applicable rule in Maryland.⁵⁴ The court further found the holding in a 1950 case involving a disputed land sale contract to imply that Maryland followed the common law rule.⁵⁵ The court also cited the recent enactment of Commercial Law section 12-126, which grants the right to prepay on non-commercial loans secured by the borrower's primary residence, as representing the legislature's acknowledgement that Maryland follows the rule of perfect tender in time.⁵⁶ On these bases,

Whetcroft III. On remand, the general court instructed the jury that the same money, tendered and refused on three different debts, operated to extinguish each debt. *Whetcroft III*, 3 H. & McH. at 353. *Whetcroft*'s invocation of the Act in *Whetcroft II*; the significant change in the rulings of the general court between *Whetcroft II* and *Whetcroft III*; and Luther Martin's focus upon the effect of the Act in arguments before the court of appeals in *Whetcroft III*, combine to lend credibility to the theory that the decisions of the court of appeals in *Whetcroft I* and *II* were based upon interpretation of the Act rather than upon an adoption of the civil law rule on prepayment.

53. *Promenade II*, 324 Md. at 602, 597 A.2d at 1383-84.

54. *Id.* at 602, 597 A.2d at 1384.

55. *Id.* at 602-03, 597 A.2d at 1384. *Meinecke v. Goedeke*, 195 Md. 373, 73 A.2d 445 (1950), involved a sale of 20 acres of land for \$5000, at 6% interest, with payments of \$50/month. Upon payment in full, the sellers were to execute a deed to the purchasers. *Id.* at 378, 73 A.2d at 446. Apparently there was neither a maturity date, nor a provision for prepayment in the contract. The contract was voidable at the sellers' option on 30 days default by the sellers. *Id.* After having fallen several months behind in payment, the buyers gave the sellers' attorney sufficient funds to bring the contract current. *Id.* at 380, 73 A.2d at 447. The attorney held the money while the parties argued about whether the contract had been voided. The buyers sued for specific performance, requiring the sellers to accept either the remaining monthly payments or the full remaining balance. *Id.* at 380-81, 73 A.2d at 447.

The court of appeals affirmed a circuit court decree ordering performance of the contract as written, citing the sellers' refusal of the lump sum. *Id.* at 382-83, 73 A.2d at 448. The *Promenade II* court read this holding to mean that "[i]mplicitly, the purchasers had no right to prepay." *Promenade II*, 324 Md. at 603, 597 A.2d at 1384.

56. *Promenade II*, 324 Md. at 603, 597 A.2d at 1384 (citing MD. CODE ANN., COM. LAW § 12-126 (Supp. 1991)). This statute was introduced in direct response to the court of special appeals decision in the *Promenade I* case. See Act of May 14, 1991, ch. 409, 1991 Md. Laws 2499, 2499 (deleted "Whereas" clause). This timing somewhat weakens the court of appeals' use of the statute to support its finding that Maryland has long followed the common law rule of perfect tender in time. Regardless of the opinions of various authorities as to the state of Maryland law prior to the court of special appeals' ruling in *Promenade I*, the law in Maryland became the rule of perfect tender in time

the court held that "under Maryland common law, a mortgagor or grantor under a deed of trust payable at a fixed date or dates in the future, does not have a right to prepay, absent a provision for prepayment in the loan contract."⁵⁷ The court declined PTMHC's invitation to change Maryland common law by adopting the minority rule. The court was neither persuaded by the reasoning of jurisdictions that have done so, nor willing to extend the presumption of prepayment beyond the line so recently drawn by the legislature in its enactment of Commercial Law section 12-126.⁵⁸

II. PERFECT TENDER IN TIME

The rule of "perfect tender in time," considered to be the general or majority rule⁵⁹ regarding mortgage prepayment. It is recognized⁶⁰ as having its documented roots in two mid-nineteenth century cases, *Abbe v. Goodwin*,⁶¹ an 1829 American case, and *Brown v. Cole*,⁶² an 1845 English case. The *Abbe* court rested its refusal to allow early payment of two notes secured by a mortgage on the premises that allowing the prepayment would amount to a reformation of the mortgage contract, and that allowing the mortgagor to compel the mortgagee to accept early payment would be akin to allowing the mortgagee to require the mortgagor to make payment before maturity.⁶³ The *Brown* court based its decision to deny the mortgagor of a leasehold interest the right to repay a one year note four months early upon the "inconvenience" such a practice would impose upon mortgagees, who, the court said, "generally advance their money as an investment."⁶⁴ Neither court cited precedent to support its reasoning or holding. Subsequently, other courts throughout this country began to make similar determinations, either citing to *Abbe* and *Brown*,⁶⁵ or, as did the courts in those cases,

after that decision. The enactment of § 12-126 might then be viewed as a reaction to what the legislature perceived as a change in the law.

57. *Promenade II*, 324 Md. at 603, 597 A.2d at 1384.

58. *Id.* at 604-06, 597 A.2d at 1384-85. The court also affirmed the court of special appeals on the issue of contract interpretation, finding that the prepayment clause of the First Modification was not incorporated into the Second Modification. *Id.* at 606-10, 597 A.2d at 1386-87.

59. See *Promenade Towers Mut. Hous. Corp. v. Metropolitan Life Ins. Co.*, 324 Md. 588, 597 A.2d 1377 (1991) (*Promenade II*).

60. See GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* 422 (2d ed. 1985); Alexander, *supra* note 34, at 291.

61. 7 Conn. 377 (1829).

62. 14 L.J.-Ch. 167 (1845).

63. *Abbe*, 7 Conn. at 384.

64. *Brown*, 14 L.J.-Ch. at 168, *quoted in* Alexander, *supra* note 34, at 292; NELSON & WHITMAN, *supra* note 60, at 422.

65. See cases cited in Alexander, *supra* note 34, at 292 n.19.

after a general discussion without support of authority.⁶⁶ By the early twentieth century, the rule of perfect tender in time was well established as common law in America.⁶⁷

The *Abbe* and *Brown* decisions reveal a dichotomy in the rationales used to support the rule of perfect tender in time. *Abbe* represents a contract interpretation approach; *Brown* represents a policy approach. Under either position, advocates of the rule view the note as an investment vehicle for the lender.

There are two facets to the contract-based rationale. The first operates upon the premise that a loan contract that specifies loan amount, interest rate, term, and payments, is complete.⁶⁸ The note is a contract under which the borrower, who has been advanced an amount of money by the lender, agrees to repay that money under certain conditions, generally over a certain period of time during which interest on the unpaid balance must be paid. Time is thus an important part of the creditor's expectation.⁶⁹ The borrower has received the benefit of the bargain—the use of the creditor's money. A presumption of prepayment would deprive the creditor of his benefit—the interest income for the term of the loan. A presumption of prepayment in essence gives the debtor the right to unilaterally change the term provision.⁷⁰ Any right, such as the right to prepayment, which gives one party the right to alter the contract at will without approval of the other party, should be expressly given, not implied in law.⁷¹

66. See, e.g., *Missouri, Kan. & Tex. Ry. Co. v. Union Trust Co.*, 51 N.E. 309, 312 (N.Y. 1898) (denying a petition for early retirement of a bond issue secured by a mortgage on the basis that as "[t]he outstanding bondholders have a right to receive their debt only as provided by the contract . . . [t]he obligation of the debtor is to pay the principal when it becomes due, and he has no right to compel the creditor to accept payment until it becomes due" without citing to authority); see also Ellis J. Harmon, Comment, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CAL. L. REV. 923, 924 n.7 (1963) (indicating that the prohibition against payment of a mortgage debt prior to maturity "apparently based on the principle that a contract is enforceable according to its terms, seems to have been adopted by the California Supreme Court without discussion or citation of authority").

67. See Alexander, *supra* note 34, at 290-93, 308-10.

68. See *F.D.I.C. v. Rusconi*, 808 F. Supp. 30, 41-42 (D. Me. 1992) (finding that absence of prepayment provision does not create ambiguity).

69. See, e.g., *Peryer v. Pennock*, 115 A. 105, 105 (Vt. 1921) ("The time of payment fixed by the terms of a pecuniary obligation is a material provision, and each party has the right to stand on the letter of the agreement and perform accordingly."). By contrast, the civil law rule presumes that the term provision of a note is for the benefit of the obligor, and thus may be waived by the obligor, in the absence of evidence to the contrary. *Spillman v. Spillman*, 509 So. 2d 442 (La. Ct. App. 1987).

70. *Arthur v. Burkich*, 520 N.Y.S.2d 638, 639 (N.Y. App. Div. 1987).

71. See *Metropolitan Life Ins. Co. v. Promenade Towers Mut. Hous. Corp.*, 84

The second contract-based rationale is grounded in the concept of reciprocity.⁷² In Whetcroft's time, the investment risk was a fluctuating currency. McHard's attorney stated the creditor's argument well:

[Y]ou [the debtor] shall not tie my hands and be at liberty to speculate on me and pay me at the lowest state of depreciation to which paper money may be reduced; but as you take the chance of a fall, give me the chance of its rising in value.⁷³

The modern investment risk in a long term lending transaction is fluctuating interest rates. The creditor takes the chance that interest rates will rise, the debtor that interest rates will fall. Absent an express contractual provision, the creditor is not permitted to demand payment before it is due. On the same basis, the debtor should not be allowed to anticipate the maturity date unless this right has been provided in the note.⁷⁴

Other rationales for allowing the lender to refuse prepayment, focus on policy considerations.⁷⁵ One argument for permitting the lender to refuse prepayment is that the interest rate charged is, in part, calculated to recoup the lender's up-front costs over the term of the loan, so that early repayment would prevent the lender from fully recovering these up-front costs.⁷⁶ Further, prepayment could result in additional unexpected costs related to reinvesting the funds

Md. App. 702, 714, 581 A.2d 846, 852 (1990) (*Promenade I*) (citing Vincent v. Palmer, 179 Md. 365, 372, 19 A.2d 183, 188-90 (1941), for the proposition that "a party to a contract does not have any unilateral right to modify, and courts may not redraft, an agreement merely because it turns out to be disadvantageous").

72. See Alexander, *supra* note 34, at 307-08, 317-19; see also Alan M. Weinberger, *Neither an Early Nor a Late Payor Be?—Presuming to Question the Presumption Against Mortgage Prepayment*, 35 WAYNE L. REV. 1, 5 (1988).
73. McHard v. Whetcroft, 3 H. & McH. 85, 86-87 (Md. Gen. Ct. 1791) (*Whetcroft I*); see also Brown v. Cole, 14 L.J.-Ch. 167 (1845) (acknowledging that allowing prepayment "might be the cause of much loss to the [mortgagee], by the funds falling during the time"), quoted in Alexander, *supra* note 34, at 292 n.18.
74. Alexander argues that the modern concept of reciprocity of contract terms is actually a misconstruction of early decisions requiring reciprocity of remedies, whereby upon payment, the mortgagor has the right to redeem his property, and upon failure of payment, the mortgagee has the right to foreclose. Alexander, *supra* note 34, at 307-08.
75. These economic arguments are also advanced to justify the imposition of prepayment charges. See NELSON & WHITMAN, *supra* note 60, at 423; Robert K. Baldwin, Note, *Prepayment Penalties: A Survey and Suggestion*, 40 VAND. L. REV. 409, 414-15 (1987); Michael T. McNelis, Comment, *Prepayment Penalties and Due-on-Sale Clauses in Commercial Mortgages: What Next?*, 20 IND. L. REV. 735, 747-48 (1987).
76. Weinberger, *supra* note 72, at 14-15.

received prior to maturity.⁷⁷ This type of argument generally is not well received, due to the usual lending practice of charging origination and processing fees to cover these costs.⁷⁸

Other economic arguments center on the lender's management of its loan portfolio. Generally, an institutional lender, such as a bank, savings and loan, or insurance company, ties the interest paid by the institution on its obligations, such as savings, certificates of deposit, and annuities, to the income received by the institution on its investments, including its mortgage portfolio. It is argued that without the ability to control prepayments, the lender will lose the ability to effectively maintain its portfolio yield.⁷⁹ As noted by one commentator, "[p]resumptive nonprepayment and prepayment premiums protect and compensate lenders if they lose their anticipated and bargained-for rate of return when borrowers prepay high interest rate loans during low interest rate periods."⁸⁰

Conversely, decisions and arguments supporting a presumptive right to prepay tend to focus on a property analysis. In *Mahoney v. Furches*,⁸¹ the Supreme Court of Pennsylvania reviewed the relevant policy considerations and determined that, in view of the importance of free alienability of property, there should be a presumptive ability to prepay, which could be refuted only by contract provisions or a manifestation of mutual intent to the contrary.⁸² The implication that

77. *Weinberger, supra*; note 72, at 14-15; *Alexander, supra* note 34, at 311-12.

78. *Weinberger, supra* note 72, at 14.

79. *See Weinberger, supra*, note 72 at 15-18; *Alexander, supra* note 34, at 312-17.

80. *Weinberger, supra* note 72, at 15. It could be argued that use of sophisticated prepayment clauses that calculate a prepayment premium based upon current market conditions would allow lenders to address this risk without resorting to a presumptive prohibition against prepayment. Such provisions "calculate the prepayment premium based on the prevailing market interest rate at the time of prepayment, and the remaining term of the loan prior to maturity." *Weinberger, supra*, note 72, at 17. By using such clauses, the lender is able to protect itself against the portfolio-management risk without relying upon an absolute prohibition against prepayment. This argument that the lender should use a prepayment premium that is tailored to the market interest rate to some extent begs the question because it does not address the issue of the silent document. What the argument implies, however, is that the lender should be responsible for including such a clause, and should be the party to suffer if omitted. At least one recent decision recognized that the mortgagee is the usual drafter of the instruments in question; and thus, a presumption of a right to prepayment "would not work a hardship on the mortgagee." *Mahoney v. Furches*, 468 A.2d 458, 461 (Pa. 1983).

81. 468 A.2d 458 (Pa. 1983).

82. *Id.* at 460-61. The court considered that the effect on alienability of land was the "dominant" consideration, as "the fundamental purpose of the mortgage note in most instances is to secure a debt incurred in the purchase of land from which the debt arises rather than to secure investment income for the mortgagee." *Id.* at 461. Obviously, this concern about the alienability of land

prepayment may be prohibited by agreement weakens the alienability argument because, as pointed out by the Court of Special Appeals of Maryland in *Promenade I*, "an invalid restraint on alienation is generally determined by the nature of the restraint, not by the manner in which the restraint is created [and] the unreasonableness, if any, of a restraint exists whether it is written or presumed."⁸³ The alienability argument is also undermined by the fact that although the prepayment prohibition may make the transfer of the property less economically feasible or less attractive to potential purchasers, it does not actually prevent alienation.⁸⁴

focuses upon the debtor's perspective rather than upon the lender's, and ignores the fact that these two purposes of a mortgage note, to secure a debt and to secure investment income, may exist concurrently. See *Promenade Towers Mut. Hous. Corp. v. Metropolitan Life Ins. Co.*, 324 Md. 588, 604, 597 A.2d 1377, 1385 (1991) (*Promenade II*).

83. *Metropolitan Life Ins. Co. v. Promenade Towers Mut. Hous. Corp.*, 84 Md. App. 702, 712, 581 A.2d 846, 851 (1990) (*Promenade I*). The Pennsylvania court's apparent deference to the parties' agreement is diminished by its approving reference to a lower court's conclusion

that, consistent with the policy against restraints on alienation, even where the mortgage explicitly states there is no right to prepay the note, if the mortgagor can provide the mortgagee with the benefit of his bargain under the terms of the note, he will be allowed to have a release of his land following the substitution of security or other arrangement.

Mahoney, 468 A.2d at 461 n.1. The alienability argument highlights the security aspect of the mortgage transaction. Although the debt is often created in order to facilitate the acquisition of the property, the debt is technically separable from the property given as security. This severability of the debt from the property is the basis for a "simple solution," proposed by Professor Alexander to resolve the prepayment issue: The mortgagor obtains a release from a mortgagee refusing prepayment by purchasing an annuity guarantying the payments specified in the note. Alexander, *supra* note 34, at 336-41. Two problems with Alexander's solution are that the loan is transformed from a secured to an unsecured status, and the creditworthiness of the annuitant is substituted for that of the mortgagor. That recourse to the property is an integral facet of the mortgage transaction is not addressed by Alexander's proposal.

84. See *Warrington 611 Assocs. v. Aetna Life Ins. Co.*, 705 F. Supp. 229, 236 (D.N.J. 1989) (citing to cases holding "prepayment restrictions in the commercial context [are] enforceable and not violative of the policy against restraints on alienation"); *Connolley v. Harrison*, 23 Md. App. 485, 490-91, 327 A.2d 787, 790 (1974) (finding that neither a clause preventing prepayment for two years, nor a clause requiring a prepayment penalty after that time "violated the purpose for the rule against invalid restraints on alienation, i.e.,: neither clause made the property 'extra commercium'"); *Patterson v. Tirollo*, 581 A.2d 74 (N.H. 1990) ("[T]he only restrictions placed on the plaintiffs were that they were unable to prepay their note, and they were prevented from having a subsequent grantee freely assume the mortgage held by the defendant. Nothing, however, precluded the plaintiffs from selling their property in fee

III. BREACH BY PREPAYMENT

When the loan documents are silent on the issue of prepayment, or prohibit or limit prepayment, a borrower subject to the rule of perfect tender in time who wishes to prepay may find himself in a curious situation if the lender is not receptive to early payoff. The generally accepted remedy for breach of a loan contract by prepayment is specific performance, that is, the borrower is required to continue payment according to the terms of the note.⁸⁵ Thus, although it is a legal axiom that equitable relief is available only when there is an inadequate remedy at law,⁸⁶ and a loan contract, being a contract for the payment of money, allows for a calculation of damages having a virtual identity to performance, the borrower is not allowed to breach. Two Maryland cases, although not exactly on point, illustrate the risks to the borrower of non-existent, short-sighted, or unartfully crafted prepayment rights.

*Abell v. Safe Deposit & Trust Co.*⁸⁷ involved 1000 serially numbered bonds with a par value of \$1000 each, issued in January 1910 by the A.S. Abell Company (the Company), and secured by an indenture of mortgage for \$1,000,000 to Safe Deposit and Trust Company of Baltimore as Trustee. The mortgage provided for redemption of twenty bonds a year in serial number order, with redemption beginning in January 1915 and continuing each January thereafter until the last bonds matured in 1965.⁸⁸ The redemption clause specifically mandated that "*the Company shall have no right to pay any other bonds prior to maturity, except those hereafter provided to be redeemed out of the unused proceeds of insurance.*"⁸⁹ The insurance clause of the mortgage allowed the Company to apply proceeds "*to the payment and redemption of said bonds in the order of their serial numbers.*"⁹⁰

Over the years, in addition to redemption according to the mortgage, the Company also purchased a number of bonds, so that

simple at any time to whomever they chose. They would just not be able to give a warranty deed free from all encumbrances until after the two-year promissory note became due without the consent of the mortgagee."); *see also* Baldwin, *supra* note 75, at 424 (discussing restraint on alienability challenges to prepayment premiums).

85. *See* Weinberger, *supra* note 72, at 35 ("By enforcing the lender's right to refuse tender, the traditional common law rule grants the lender specific performance.").

86. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 359(1) ("Specific performance or an injunction will not be ordered if damages would be adequate to protect the expectation interest of the injured party.").

87. 192 Md. 438, 64 A.2d 722 (1949).

88. *Id.* at 441, 64 A.2d at 723.

89. *Id.*

90. *Id.* at 442, 64 A.2d at 724.

by the middle of 1947 there were only ninety-nine bonds outstanding.⁹¹ At that time, approximately \$108,000 in insurance proceeds from a fire in late 1946 were deposited with the Trustee.⁹² These funds were used to purchase an additional sixty-four bonds, leaving only thirty-five bonds outstanding, the majority of which were held by the plaintiffs, individuals of the Abell family.⁹³ The Company attempted to redeem these remaining bonds under the insurance clause of the mortgage. Although the plaintiffs refused to surrender their bonds for redemption, the Trustee released the mortgage.⁹⁴

The court held that the Company did not have the right to redeem the plaintiffs' bonds, and that the Trustee's release of the mortgage was a violation of its fiduciary duty to the bondholders.⁹⁵ The mortgage was very specific on the terms of redemption and allowed for no deviation—the timing and order of redemption was controlled by the serial numbers on the bonds. The Company's purchase of bonds did not alter the scheme for redemption, and the purchased bonds could not be ignored in determining which bonds were eligible for redemption under either the redemption or the insurance clause of the mortgage.⁹⁶ The court refused to reinstate the \$1,000,000 mortgage to secure the plaintiffs' remaining thirteen bonds, however, stating that the injury to the defendants from such a remedy far outweighed the benefits to the plaintiffs.⁹⁷

Of interest is the court's discussion regarding an appropriate remedy. The court emphasized that the plaintiffs were seeking specific performance of the mortgage contract, and that "courts of equity will not specifically enforce a contract unless . . . the circumstances surrounding a given case appeal to the conscience of the court."⁹⁸ In clearly identified dicta, the court ruminated on possible remedies of which the plaintiffs might avail themselves to enforce their contractual right to hold their bonds until maturity and receive interest when due. A suggested approach was an action at law or in foreclosure for damages for breach of contract, "measured by the present value of a bond of the same quality, e.g., a U.S. bond, and the

91. *Id.* at 443, 64 A.2d at 724.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.* at 446, 64 A.2d at 726.

96. *Id.* at 444, 64 A.2d at 725. The last of plaintiffs' bonds would mature in January 1957. *Id.* at 446, 64 A.2d at 726. While sufficient to cover payment of all outstanding bonds, the insurance proceeds apparently were not sufficient to reach the plaintiffs' bonds when the approximately 200 intervening purchased but unredeemed bonds held by the company were considered. *Id.*

97. *Id.* at 447-48, 64 A.2d at 726-27.

98. *Id.* at 447, 64 A.2d at 726.

same 'yield' and maturity."⁹⁹ But, the court said, "a court of equity will not devise a remedy by injunction, or in the nature of specific performance, which will harass or injure the Company and is not necessary to protect bondholders against any actual threatened impairment of their security."¹⁰⁰

The *Abell* case was referred to in *Pierson v. Pyles*,¹⁰¹ a case involving an installment land sales contract with payment provisions structured in such a fashion that despite fifteen years of payments, the contract balance was nearly \$300 more than the original contract amount.¹⁰² As the *Pierson* court was deciding a complaint for a declaratory interpretation of a contract that had not been breached, however, it applied the equity principle that a court may not permit redrafting of the provisions of a contract in order to alleviate a bad bargain by one of the parties.¹⁰³ The court held that the purchasers must continue the monthly payments per the terms of the contract even though it would take an additional thirty-seven years to achieve unencumbered ownership.¹⁰⁴ The defendant, Pyles, was trustee for the estate of the seller, and the court cited the *Abell* case for the proposition that were Pyles to agree to a prepayment, he might be breaching a fiduciary duty to the estate.¹⁰⁵

Thus, it seems that in Maryland, as the cooperation of either the lender, in which case there is no breach,¹⁰⁶ or the trustee, who risks suit for breach of fiduciary duty for accepting an unauthorized prepayment, is required in order to breach, and the assistance of the court cannot be drawn upon prior to an actual breach, the borrower, subject to the rule of perfect tender in time, is in the unusual position of being unable to breach the contract by prepayment. The alterna-

99. *Id.* at 448, 64 A.2d at 727.

100. *Id.*

101. 234 Md. 119, 197 A.2d 890 (1964).

102. *Id.* at 121, 197 A.2d at 891. The contract, dated June 13, 1946, provided for a starting balance \$14,935, interest at 4%, monthly payments of \$65, with no right to anticipate payments. *Id.* Once the balance had decreased by \$5000, a deed would be executed and a mortgage taken back on the same terms. *Id.* On these terms, the buyers would have been entitled to a deed in seven and one-half years, and the full balance would have been paid in slightly over 36 years. However, the contract also provided for payment of taxes and insurance from the monthly payment. *Id.* Over the years, the tax assessment increased to the point that there was no amortization of the balance. *Id.* at 121-22, 197 A.2d at 891.

103. *Id.* at 123, 197 A.2d at 892. The court did affirm the lower court ruling that the contract could be interpreted to allow the separate payment of taxes and insurance. *Id.* at 123-24, 197 A.2d at 892.

104. *Id.* at 123, 197 A.2d at 892.

105. *Id.* at 125, 197 A.2d at 893.

106. *See* *Carlyle Apartments Joint Venture v. AIG Life Ins. Co.*, 333 Md. 265, 274, 635 A.2d 366, 370 (1994).

tives are to breach the contract through default or other violation and then pay the loan when the creditor accelerates (assuming that the creditor would choose to accelerate rather than sue on each individual payment); purchase the property in foreclosure; or forfeit the property. The disadvantages of these options are obvious. From the borrower's standpoint there is harm to his credit rating and a risk of losing his investment and appreciation in the property.¹⁰⁷ From the creditor's standpoint, there is the likelihood that, if forced to recognize the default, recovery would be limited to the principal balance, accrued interest, and costs, not the expectation damages he would have received had a breach by prepayment been allowed.¹⁰⁸

IV. THE PREPAYMENT CLAUSE

The *Promenade Towers* decision and the inherent difficulty in breaching a loan contract by prepayment make negotiation of prepayment terms essential for the non-residential borrower¹⁰⁹ in Maryland. Careful planning of prepayment provisions is also important for the lender, however, as the case law¹¹⁰ presents a strange paradox. Despite the general rule that there is no prepayment unless provided for in the loan documents, courts have tended to subject prepayment clauses to exacting standards, and on occasion, have not been hesitant to strike a negotiated clause, leaving the borrower with an unhindered right to prepay.

107. See, e.g., *Trident Ctr. v. Connecticut Gen. Life Ins. Co.*, 847 F.2d 564, 568 (9th Cir. 1988) ("[D]efaults are messy things; they are supposed to be.").

108. Clearly it is to the benefit of both parties to negotiate and come to terms when the mortgagor wishes to prepay. One commentator has noted, however, that although the rule of perfect tender in time prevents prepayment at the mortgagor's initiative when the loan documents are silent, some states statutorily prohibit collection of a prepayment fee unless provided for in the loan contract. The lender is thus left with no compromise position. Baldwin, *supra* note 75, at 413-14.

109. Maryland's Commercial Law Code, § 12-126, enacted in reaction to the *Promenade Towers* decision, provides that on a non-commercial loan secured by a borrower's primary residence, the borrower may prepay all or part of the unpaid balance at any time "except to the extent expressly provided otherwise in the loan contract." MD. CODE ANN., COM. LAW § 12-126 (Supp. 1993). A commercial loan is defined as a loan "made solely to acquire or carry on a business or commercial enterprise" or made "to any business or commercial organization." *Id.* § 12-101(c) (1990). Thus, the protection of the statute does not reach loans made to individuals for business purposes, or loans secured by properties other than the borrower's primary residence, such as second or vacation homes. In these instances, the borrower must negotiate prepayment rights or be subject to the rule of perfect tender in time.

110. Except as previously discussed, there is no Maryland case law addressing the interpretation and enforcement of prepayment clauses. The discussion that follows surveys cases from across the country in an effort to highlight the national trends and some of the more predominant approaches to analysis.

Generally, prepayment clauses establish if and when prepayment is to be permitted, and how the prepayment premium, if any, is to be calculated.¹¹¹ The drafting of prepayment clauses has evolved over the years. Initially, such clauses tended to restrict prepayment for a number of years, and then allowed prepayment upon payment of an additional percentage of either the original loan amount or the then outstanding balance. Often the required percentage was decreased over time.¹¹² The arbitrary nature of these clauses earned them the nomenclature of "prepayment penalties." The penalty was not calculated to have any relation to the harm to the lender in the event of prepayment; the percentage fee was stated within the loan documents and did not vary according to the prevailing market. Thus, a lender would collect the fee even though interest rates had risen and the lender was actually advantaged by the prepayment.

The modern trend is to use instead what has been termed a "yield equivalent" or "make whole" formula.¹¹³ In this type of clause, the prepayment fee is tied to an objective measurement of current interest rates, such as United States Treasury Bonds. In the event of prepayment, the borrower is required to provide the lender with the amount that is necessary to purchase bonds providing the same yield and maturity as the prepaid loan.¹¹⁴ An alternative formula calculates the difference between the contract yield and the current yield on a specified investment, such as United States Treasury Notes, of the same maturity, and requires the borrower to pay the present value of the interest differential applied to the outstanding balance.¹¹⁵ Under either of these formulas, the borrower pays only if interest rates have fallen below the contract rate; a penalty is not extracted if the lender benefits from the prepayment.¹¹⁶

111. The silent loan contract has been referred to as a "non-option" prepayment, as distinguished from the "option" prepayment where the prepayment terms are specified in the loan documents. *Williams v. Fassler*, 167 Cal. Rptr. 545, 547 (Cal. Ct. App. 1980).

112. Thomas C. Homburger & Matthew K. Phillips, *What You See Is Not Always What You Get: The Enforceability of Loan Prepayment Penalties*, 23 J. MARSHALL L. REV. 65, 66 (1989); Debra P. Stark, *Enforcing Prepayment Charges: Case Law and Drafting Suggestions*, 22 REAL PROP., PROB. & TR. J. 549, 552-53 (1987); Weinberger, *supra* note 72, at 16-17.

113. See Chester L. Fisher, III, *Make-Whole Prepayment Premiums Under Attack*, 45 BUS. LAW. 15, 17-18 (Nov. 1989); Homburger & Phillips, *supra* note 112, at 67; Stark, *supra* note 112, at 553; Weinberger, *supra* note 72, at 17-18.

114. See Stark, *supra* note 112, at 553; see also *Warrington 611 Assocs. v. Aetna Life Ins. Co.*, 705 F. Supp. 229, 234 (D.N.J. 1989) (defining "yield maintenance fee").

115. See Weinberger, *supra* note 72, at 17.

116. There has been some criticism of the selection of U.S. Government obligations as the measuring standard. See, e.g., *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987) (stating that because government securities are lower risk

Challenges to loan contract clauses providing for a fee in the event of prepayment have generally focused on two elements: the validity of the imposition of any prepayment premium at all, and, if allowed, the validity of the method used to calculate the prepayment fee.

A. The Validity of the Imposition of a Prepayment Premium

Objectively, the lender should receive the negotiated prepayment charge regardless of the circumstances of prepayment. Courts, however, have utilized both contract interpretation and equity principles to deny the lender the charge when prepayment is deemed beyond the borrower's control. There are four general situations which lead to prepayment: (1) condemnation of the property; (2) receipt of insurance proceeds upon destruction of the improvements; (3) the lender's acceleration of the loan under the terms of the contract; and (4) a prepayment initiated by the borrower due to a refinance or sale of the property. Of these, the lender's position is sound only in the last instance.¹¹⁷ The lender is least likely to collect a prepayment fee in the event of prepayment as a result of condemnation or insurance compensation, and the ability to collect in the event of acceleration is dependent upon careful drafting of the prepayment provisions.

1. Condemnation

In condemnation or eminent domain proceedings, the government is required to reimburse the landowner for the property taken based upon an appraisal of the fair market value of the property.¹¹⁸ Under Maryland law, mortgagees are parties to the condemnation suit.¹¹⁹ Mortgage contracts ordinarily require the application of condemnation proceeds to the principal balance of the loan on the theory that the security for the loan has been reduced.¹²⁰ The reported cases

investments commanding lower rates, calculations based upon these securities overcompensate the lender); *see also infra* note 177. *But see* Debra P. Stark, *Prepayment Charges in Jeopardy: The Unhappy and Uncertain Legacy of In re Skyler Ridge*, 24 REAL PROP., PROB. & TR. J. 191, 196-97 (1989) (addressing the *Skyler Ridge* court's criticism).

117. *See* Homburger & Phillips, *supra* note 112, at 70.

118. *See* MD. CODE ANN., REAL PROP. §§ 12-104(a), 12-105(b), 12-207(c) (1988). *See generally* RICHARD A. REID, CONDEMNATION & EMINENT DOMAIN (1988).

119. A proceeding for condemnation is to be brought against all parties who have an interest in the property to be condemned. MD. R. U4(b) (1993). If such a party is not designated in the petition for condemnation, there is no transfer of that party's interest to the condemner. Department of Nat. Resources v. Welsh, 308 Md. 54, 521 A.2d 313 (1986).

120. *See* KRATOVIL & WERNER, *supra* note 6, § 6.07; *see also* JACOB RABKIN & MARK H. JOHNSON, CURRENT LEGAL FORMS, Form 21.78, at 21-5101 (1993).

show a reluctance to enforce prepayment charges in this situation.¹²¹ *Jala Corp. v. Berkeley Savings & Loan Ass'n*¹²² is an excellent example. The prepayment clause at issue in that case, which provided for a prepayment fee if the loan was prepaid during the first five years of the loan, spoke of the mortgagor's "right and privilege" to prepay.¹²³ Condemnation proceeds were released to the first mortgagee, who paid the second mortgagee, retained an amount sufficient to cover the outstanding balance, accrued interest, and a prepayment fee, and forwarded the remainder to the mortgagor.¹²⁴ The mortgagor sued for recovery of the prepayment charges withheld.¹²⁵ The court held that the prepayment occurred by operation of law rather than by exercise of a right or privilege by the mortgagors.¹²⁶ The prepayment clause, as worded, was found not to contemplate prepayment due to condemnation; the court indicated that the mortgage should specifically provide for this event.¹²⁷

The mortgagee in *Village of Rosemont v. Maywood-Proviso State Bank*¹²⁸ thought it was providing for this contingency with a mortgage clause that gave the mortgagor the right to either prepay, including a prepayment fee, or provide substitute security in the event the mortgagor "shall (whether voluntarily or by operation of law) sell, convey, assign, mortgage, hypothecate, or otherwise transfer or encumber the mortgaged premises."¹²⁹ The court found the clause to be ambiguous because although it provided for payment upon transfer by operation of law, it was prefaced by operative words requiring mortgagor action. The court concluded that "in the event of condemnation, performance of a prepayment penalty clause will be

121. See generally Vicki A. Huffman, Annotation, *Compensation for Interest Prepayment Penalty in Eminent Domain Proceedings*, 84 A.L.R.3d 946 (1978 & Supp. 1993).

122. 250 A.2d 150 (N.J. Super. Ct. App. Div. 1969).

123. *Id.* at 151-52.

124. *Id.* at 151.

125. *Id.* at 152.

126. *Id.* at 154.

127. *Id.* at 154-55. *Accord Shavers v. Duval County*, 73 So. 2d 684 (Fla. 1954) (denying mortgagee interest for remaining term of note upon condemnation payoff of loan without prepayment privilege, as condemnation law existed at time of contracting and could have been provided for in loan contract); *Associated Schs., Inc. v. Dade County*, 209 So. 2d 489 (Fla. Dist. Ct. App. 1968) (relying upon *Shavers* to deny contractual prepayment penalty where property was taken by eminent domain).

128. 501 N.E.2d 859 (Ill. App. Ct. 1986). The caption of the case refers to the condemnation action. *Maywood-Proviso State Bank*, in a trustee capacity, was the owner/mortgagor in this instance; the appeal was brought by the mortgagee, Lyons Savings and Loan Association, which was contesting the court-ordered distribution of the condemnation proceeds. *Id.* at 860.

129. *Id.*

excused unless there is clear language which expressly delineates payment of a premium upon condemnation."¹³⁰ Thus, to be certain of the ability to collect a prepayment premium in condemnation cases, lenders should not rely upon blanket provisions, but should require that the mortgage documents expressly state that such a fee is payable in the event of condemnation.¹³¹

Arguments that the condemning government should be liable for the prepayment premium, either to the mortgagee directly or as part of the mortgagor's just compensation award as a loss incidental to the condemnation, have been unsuccessful. The court in *Jala Corp.* found such a claim to be "frivolous A prepayment charge as here claimed is not a factor to be considered in arriving at fair value nor is it an element of damage incidental to the taking."¹³² Similarly, on the grounds that just compensation is based upon the fair market

130. *Id.* at 862. The court further found that the prepayment provision of the note "evinces an intent to enforce the penalty only if Maywood chooses to prepay." *Id.* A similar approach was used in *Landohio Corp. v. Northwestern Mut. Life Mortgage & Realty Investors*, 431 F. Supp. 475 (N.D. Ohio 1976), to hold that prepayment resulting from a sale under threat of condemnation did not amount to the mortgagor's exercise of a "privilege" to prepay.

In the case of *DeKalb County v. United Family Life Ins. Co.*, 219 S.E.2d 707, 710 (Ga. 1975), the court's approach was less logical. The note in question prohibited prepayment during the first five years of the loan and provided for a sliding percentage premium for prepayments thereafter. *Id.* at 708-09. The court held that no premium was payable on a prepayment due to condemnation during the prohibition period, stating that "it cannot be contended that [the lender] is claiming a premium for the exercise of a right bargained for with the [borrower, as the borrower] had no right whatsoever to prepay for a period of five years from the date of the making of the note." *Id.* at 710. The resulting inference, that had the condemnation occurred in year six the lender would have been entitled to the prepayment premium, directly contradicts the relative rights of the parties at the times involved.

131. Only one case involving a contractual provision for prepayment due to condemnation is noted in Huffman's annotation. Huffman, *supra* note 121, at 951 (citing *In re Brooklyn Bridge Southwest Urban Renewal Project*, 260 N.Y.S.2d 229 (N.Y. Sup. Ct. 1965)). That case involved, not a prepayment premium per se, but a contract provision specifying that the mortgagor would be responsible for payment of the difference between the 6% note rate and the 4% interest rate which the condemning body was required to pay by statute. *Brooklyn Bridge*, 260 N.Y.S.2d at 231. As the contract provision did not involve an increased payment by the condemnor, but merely determined the apportionment of the condemnation proceeds between the property owner and the mortgagee, the court declined to interfere with the contract. *Id.* at 232-33.

132. *Jala Corp. v. Berkeley Sav. & Loan*, 250 A.2d 150, 154-55 (N.J. Super. Ct. App. Div. 1969). The court, in *Jala Corp.*, cited *Knoxville Hous. Auth., Inc. v. Bush*, 408 S.W.2d 407 (Tenn. Ct. App. 1966), for the proposition that a prepayment charge should not be considered in arriving at fair value or damage incidental to the taking. *Jala Corp.*, 250 A.2d at 155. It should be noted that in *Bush*, the Court of Appeals of Tennessee clearly limited the issue to one of statutory interpretation. *Bush*, 408 S.W.2d at 410-11.

value of the condemned property and is not related to apportionment of the condemnation award, the court in *Village of Rosemont* rejected the mortgagee's assertion that it had been deprived of the ability to protect its right to the prepayment premium by its exclusion from an agreement reached by the mortgagor and the Village.¹³³

2. Insurance Proceeds

In *Chestnut Corp. v. Bankers Bond & Mortgage Co.*,¹³⁴ a case influencing the decision in *Jala Corp.*,¹³⁵ a clause attaching a premium to the "right" to prepay was given a narrow construction to deny the premium when the mortgage was paid according to the terms of an insurance policy following destruction of the improvements by fire.¹³⁶ Assessing the position of both the lender and the owner of the property, the court concluded that "[i]n such a situation both parties suffer, but the owner suffers most."¹³⁷ As such, given that "[n]either the bond nor the mortgage specifically or expressly provide[d] for the exact situation which ha[d] arisen," the mortgagee was not entitled to the prepayment premium.¹³⁸ Thus, courts generally hold that when outside forces, such as condemnation or fire, cause early repayment of the loan, the loss of expected interest income on the contract should be borne by the mortgagee, unless that risk has been unequivocally assigned to the mortgagor within the loan contract.

3. Acceleration

When prepayment is due to the mortgagee's acceleration¹³⁹ of the loan, the cases are less settled. Although the recent trend is otherwise, courts have generally viewed an acceleration as a voluntary act of the mortgagee. When acceleration is optional rather than self-executing, the mortgagee has been held to forfeit the right to a prepayment premium when the right to accelerate is exercised.¹⁴⁰ The

133. *Village of Rosemont v. Maywood-Proviso State Bank*, 501 N.E.2d 859, 862 (Ill. App. Ct. 1986).

134. 149 A.2d 48 (Pa. 1959).

135. See *Jala Corp.*, 250 A.2d at 153.

136. *Chestnut Corp.*, 149 A.2d at 50.

137. *Id.*

138. *Id.*

139. Most mortgage loans provide for acceleration when the mortgagor transfers the property, commonly known as a due on sale clause, or when the mortgagor defaults. When a loan is accelerated the full balance of the loan is due and payable immediately, rather than on the stated maturity date.

140. The primary theory behind denying prepayment premiums upon acceleration is that there is technically no prepayment because the full balance is presently due.

rationale that the mortgagee forfeits the prepayment premium upon acceleration has been applied even when the loan is accelerated as a result of the borrower's failure to abide by the terms of the contract.

An early case, holding that the mortgagee forfeits the prepayment premium, was *Kilpatrick v. Germania Life Insurance Co.*,¹⁴¹ in which the mortgagee began foreclosure proceedings after the mortgagor's default. When the mortgagor, who was able to secure other financing, subsequently tendered the full balance, the mortgagee halted the foreclosure proceedings, but refused to accept the payment unless the contractual prepayment 'bonus' was included.¹⁴² The court stated that the mortgagee's election to consider the debt due became irrevocable upon the mortgagor's assumption of other legal obligations in reliance on the mortgagee's actions.¹⁴³ The prepayment was thus found to have been involuntary, and the court allowed the mortgagor to recover the amount of the bonus.¹⁴⁴

Later cases place little or no emphasis upon the mortgagor's reliance. In addition to a prepayment clause, the mortgage in *Slevin Container Corp. v. Provident Federal Savings & Loan Ass'n*¹⁴⁵ contained a due on sale clause that prohibited the sale of the property without the mortgagee's approval. In the event of such a sale, the mortgagee had the option to increase the interest rate, accelerate the loan, or implicitly, continue to accept monthly payments.¹⁴⁶ After learning of an unapproved sale, the mortgagee chose to accelerate the loan.¹⁴⁷ The court, finding acceleration to have been the mortgagee's voluntary decision, held that the payment was a payment made after maturity; therefore, the mortgagee was not entitled to a prepayment premium.¹⁴⁸ This rationale was also applied in *In re LHD Realty Corp.*¹⁴⁹ to deny a prepayment premium to a mortgagee whose acceleration of the mortgage debt took the form of a petition for relief from the bankruptcy automatic stay to allow foreclosure proceedings.¹⁵⁰

141. 75 N.E. 1124 (N.Y. 1905).

142. *Id.* at 1125.

143. *Id.*

144. *Id.* at 1125-26.

145. 424 N.E.2d 939 (Ill. App. Ct. 1981).

146. *Id.* at 939-40.

147. *Id.* at 940.

148. *Id.* at 940-41; see also Baldwin, *supra* note 75, at 415-19 (discussing the combination of due on sale and prepayment clauses).

149. 726 F.2d 327 (7th Cir. 1984).

150. *Id.* at 331. Filing a petition for relief from the automatic stay is a voluntary acceleration of the debt by the creditor distinct from the automatic acceleration of the debt upon the filing of bankruptcy. See *In re Skyler Ridge*, 80 B.R. 500, 507 (Bankr. C.D. Cal. 1987) ("The automatic acceleration of a debt upon the filing of a bankruptcy case is not the kind of acceleration that eliminates the right to a prepayment premium.").

In *Imperial Coronado Partners v. Home Federal Savings & Loan Ass'n*,¹⁵¹ however, the court allowed the mortgagee to collect the prepayment fee, reasoning that the mortgagor had failed to exercise options available to halt the acceleration.¹⁵² Under California law, the mortgagor had the right to reinstate the loan by curing the default; under federal Bankruptcy law, the mortgagor could decelerate the loan.¹⁵³ Because the mortgagor made a conscious decision instead to sell the property, the court found that the payoff was voluntary.¹⁵⁴

In this same vein, courts have emphasized that a mortgagor cannot avoid a contractual prepayment fee on the basis that the loan was paid off in anticipation of an expected acceleration. In *First Indiana Federal Savings Bank v. Maryland Development Co.*¹⁵⁵ the court established a standard of requiring a clear and unequivocal exercise of the acceleration option by the lender before the prepayment fee is forfeited.¹⁵⁶ A refusal to consent to an assumption is not sufficient,¹⁵⁷ nor is a voluntary payoff prior to sale of the mortgaged property made involuntary by the lender's expressed intention to accelerate the loan in exercise of a due on sale clause.¹⁵⁸

Recent cases reflect a willingness to enforce prepayment premiums when the draftsmanship manifests attention to the concerns expressed in earlier decisions.¹⁵⁹ When the prepayment provision is specific as to applicability upon acceleration, the premium has been upheld.¹⁶⁰ Failure to be precise can be fatal, however. For instance, despite strong evidence of a deliberate default, the court in *Ferreira v. Yared*¹⁶¹ required the refund of a prepayment premium paid upon

151. 96 B.R. 997 (Bankr. 9th Cir. 1989).

152. *Id.* at 1000.

153. *Id.*

154. *Id.*

155. 509 N.E.2d 253 (Ind. Ct. App. 1987).

156. *Id.* at 257.

157. *Id.*

158. *First Nat'l Bank of Springfield v. Equitable Life Assurance Soc'y of United States*, 510 N.E.2d 518, 523 (Ill. App. Ct. 1987).

159. See Debra P. Stark, *New Developments in Enforcing Prepayment Charges After an Acceleration of a Mortgage Loan*, 26 REAL PROP., PROB. & TR. J. 213, 215-16, 224-26 (1991).

160. See, e.g., *Travelers Ins. Co. v. Corporex Properties, Inc.*, 798 F. Supp. 423, 428 (E.D. Ky. 1992) (finding prepayment provision entitling lender to premium upon default and acceleration "computed as if a voluntary prepayment had been made on the date of such acceleration" enforceable); *In re Schaumburg Hotel*, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989) (enforcing prepayment premium due "whether said payment is voluntary or the result of prepayment created by the exercise of any acceleration clause after a default").

161. 588 N.E.2d 1370 (Mass. App. Ct. 1992).

a refinance to avoid foreclosure. As to the equities involved, the court stated:

It is not lost on us that a borrower may evade a lawfully agreed to prepayment penalty by embarking on a course of conduct which provokes acceleration of the note. Indeed, that may have occurred here. There are, however, often risks and costs attendant upon default in a mortgage note and, on balance, it strikes us as the better course to adopt the majority view that, unless the note otherwise provides, a holder of a note cannot simultaneously accelerate the note and collect a prepayment penalty.¹⁶²

B. The Validity of the Amount of the Prepayment Premium

Evaluation of the amount of the prepayment premium will depend upon the characterization of the nature of the premium. There are three approaches that may be taken: The premium can be treated as consideration for relinquishment of the right to insist upon payment as scheduled, as a bargained-for contractual term, or as liquidated damages. How the premium is viewed depends, in part, upon the structure of the prepayment right. Where the loan contract provides no right at all, a later agreement reached between the parties to allow prepayment generally results in treatment of the prepayment premium as consideration in exchange for the contract modification.¹⁶³ Where the loan contract provides the right to prepay in

162. *Id.* at 1371-72; see also Stark, *supra* note 159, at 229-31 (discussing intentional default). *But see* Trident Ctr. v. Connecticut Gen. Life Ins. Co., 847 F.2d 564, 567 (9th Cir. 1988) (rejecting argument that mortgagor can precipitate a default and insist on acceleration by tendering balance due plus prepayment fee where note prevented prepayment for initial 12 years of loan, but provided for 10% prepayment premium for prepayment resulting from default).

Another example of strained reasoning to reach a result favorable to the mortgagor is Clinton Capital Corp. v. Straeb, 589 A.2d 1363 (N.J. Super. Ct. Ch. Div. 1990), where in disallowing a prepayment premium to be paid "whether prepayment is voluntary or involuntary, including any prepayment made after exercise of any acceleration provision," *id.* at 1364, the court construed "involuntary" to mean "actions of third parties which force the payment of the mortgage prematurely." *Id.* at 1371. In a non sequitur, the court then stated that "[this] is not the situation that exists on the facts in this case . . . none of the defendants have taken action to force [the lender] to accelerate the mortgage [to] avoid a prepayment penalty." *Id.* The court's primary concern seems to be the effect of the 10% prepayment premium, when combined with a default interest rate of 24%, upon the mortgagor's ability to redeem the property. *Id.* A liquidated damages analysis would have been the more appropriate approach to reach the equitable result the court desired, while avoiding a convoluted construction of the prepayment provision.

163. See Baldwin, *supra* note 75, at 420.

exchange for a specified premium, the premium usually will be treated as a bargained-for contractual term when prepayment is voluntary.¹⁶⁴ Under either of these evaluations, the premium generally is subject to nullification only if it is determined to be unconscionable.¹⁶⁵

When the premium becomes due upon a prepayment occasioned by the mortgagor's default, however, courts often subject the premium to a liquidated damages analysis.¹⁶⁶ Under this analysis, if the premium is considered to be a penalty for breach, rather than a reasonable estimate of damages, the prepayment clause will not be enforced.¹⁶⁷ In decisions which caused some controversy,¹⁶⁸ the bankruptcy courts of the central district of California and the western district of Missouri used a liquidated damages approach to invalidate two yield maintenance clauses.¹⁶⁹ Although it should be noted that

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164. See Baldwin, *supra* note 75, at 421-23 (citing court characterizations of option prepayment clauses as giving the mortgagor the ability to choose between alternative performances); see also *West Raleigh Group v. Massachusetts Mut. Life Ins. Co.*, 809 F. Supp. 384, 391 (E.D.N.C. 1992) (rejecting claim that yield differential prepayment clause was unenforceable liquidated damages provision as the prepayment premium was "bargained-for consideration for the option to prepay, and as such it is enforceable as a matter of contract law and not as a measure of damages"); *Renda v. Gouchberg*, 343 N.E.2d 159, 160 (Mass. App. Ct. 1976) (rejecting liquidated damages analysis as "the plaintiffs' prepayment constituted a voluntary election on their part").
165. See Stark, *supra* note 112, at 550 n.7 and accompanying text. *But see In re A.J. Lane Co.*, 113 B.R. 821, 827-28 (Bankr. D. Mass. 1990) (arguing that prepayment is not a "true" alternative performance, and that liquidated damages analysis is, therefore, the proper approach for all prepayment clauses).
166. Baldwin, *supra* note 75, at 423.
167. See RESTATEMENT (SECOND) OF CONTRACTS § 356(1) ("Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."); see also *Holloway v. Faw, Casson & Co.*, 319 Md. 324, 354, 572 A.2d 510, 525 (1990); *Schrier v. Beltway Alarm Co.*, 73 Md. App. 281, 289-90, 533 A.2d 1316, 1320 (1987). It should be noted that the common characterization of the prepayment fee as a "prepayment penalty" is not related to a liquidated damages analysis, and the parties' choice of terminology within the document should not be determinative. See *West Raleigh Group v. Massachusetts Life Ins. Co.*, 809 F. Supp. 384, 390-91 (E.D.N.C. 1992); see also *Traylor v. Grafton*, 273 Md. 649, 661, 332 A.2d 651, 660 (1975) (stating that nomenclature used by the parties is not determinative of whether payment is a penalty).
168. See Fisher, *supra* note 113; Stark, *supra* note 116.
169. See *In re Kroh Bros. Dev. Co.*, 88 B.R. 997 (Bankr. W.D. Mo. 1988); *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987). In *Skyler Ridge*, the court invalidated a yield maintenance clause which required payment of the differential between the note rate and a comparable U.S. Treasury note yield, with a floor payment of 1% of the principal balance. *Skyler Ridge*, 80 B.R. at 505. The court found the failure to adjust for the normal difference in rate between first mortgages and Treasury notes; the lack of a discount for present value;

in each of these cases the mortgagee was to receive full payoff of the principal balance owed, and as the courts frankly admitted, payment of any prepayment premium would have either frustrated the implementation of an otherwise feasible plan of reorganization,¹⁷⁰ or would have precluded the claims of other secured creditors against the proceeds of the property,¹⁷¹ the willingness of the court to invalidate a negotiated prepayment charge in a contract between two sophisticated parties is significant.

A clause calling for a fixed one percent prepayment premium has also been invalidated under a liquidated damages analysis.¹⁷² The court in *In re A.J. Lane & Co.* found the clause to be unreasonable both in light of the lender's anticipated loss, because a loss was presumed, and in light of the lender's actual loss, because interest rates at the time of prepayment were in fact higher than the note rate.¹⁷³ Although it seems that the answer to the court's concerns would be to use a properly formulated yield maintenance clause. The court also stated that the prerequisite finding of difficulty of proof of loss necessary to uphold a liquidated damages provision could not be made in the prepayment situation because the common usage of such formulas demonstrates that the damage formula is "simple and well-established."¹⁷⁴ This characterization has been subsequently criticized as being over-simplistic.¹⁷⁵

The Court of Appeals of Maryland recently addressed a mortgagor's challenge of the validity of a premium charged in connection with the mortgagor's voluntary prepayment of its commercial loan

and the failure to amortize the floor payment, which the lender justified as recoupment of transaction costs over the life of the loan to be unreasonable, and thus totally unenforceable under the common law. *Id.* at 506. The *Kroh Brothers* court, using *Skyler Ridge* as precedent, invalidated a similar provision on the same grounds.

170. *Skyler Ridge*, 80 B.R. at 503.

171. *Kroh Bros.*, 88 B.R. at 999.

172. *In re A.J. Lane & Co.*, 113 B.R. 821 (D. Mass. 1990).

173. *Id.* at 829. *But see In re Schaumburg Hotel Owner Ltd. Partnership*, 97 B.R. 943 (Bankr. N.D. Ill. 1989) (upholding 10% prepayment premium as reasonable estimate of damages where actual losses exceeded that amount).

174. *A.J. Lane*, 113 B.R. at 829. The court characterized the formula as "the difference in the interest yield between the contract rate and the market rate at the time of prepayment, projected over the term of the loan and then discounted to arrive at present value." *Id.*

175. *See In re Financial Ctr. Assoc. of East Meadow, L.P.*, 140 B.R. 829, 836-37 (Bankr. E.D.N.Y. 1992) (finding the *A.J. Lane* formula to be "a general description of the factors to be included in a proper approach which at best may only provide an appropriate range within which a particular result may be considered appropriate," and answering the query "does the mere existence of a workable formula mandate a conclusion that damages are easily determinable" in the negative).

in *Carlyle Apartments Joint Venture v. AIG Life Insurance Co.*¹⁷⁶ The loan documents permitted the mortgagor to prepay the loan in full after the first year of the five-year term and provided for a prepayment premium "equal to the difference in yield between the Loan . . . and a Treasury Note in the amount of the prepayment proceeds with a term equal to the remaining term of the Loan."¹⁷⁷ The mortgagor sought to have the court declare the prepayment premium clause void as a liquidated damages clause that imposed a penalty.¹⁷⁸ The court of appeals did not reach the liquidated damages question, however, because it rejected the premise that the mortgagor's prepayment, made in accordance with the terms of the loan contract, was a breach.¹⁷⁹ As there was no breach, there was "no occasion to consider damages . . . much less to alter the contract."¹⁸⁰ The Maryland answer to the question of whether a liquidated damages analysis would be appropriate when prepayment results from the lender's acceleration of the loan following the mortgagor's default will "await a case presenting those facts."¹⁸¹

V. CONCLUSION

The *Promenade Towers* decision settled the issue of whether Maryland follows the rule of perfect tender in time. Although the process began with *Carlyle Apartments*, a comprehensive judicial approach to the enforcement of that rule and to the interpretation of negotiated prepayment arrangements has yet to develop in Mar-

176. 333 Md. 265, 635 A.2d 366 (1994). This opinion was issued in response to questions certified to the court by the United States District Court for the District of Maryland. *Id.* at 265 n.1, 635 A.2d at 366 n.1.

177. *Id.* at 267, 635 A.2d at 366-67. For a discussion of yield equivalent prepayment premium calculations see *supra* notes 113-16 and accompanying text. This case illustrates a common criticism of the use of government securities as the index investment for yield equivalent calculations. See *supra* note 116. The selection of Treasury Notes as the yield against which the prepayment fee was to be calculated apparently was the catalyst to this mortgagor's challenge to the prepayment premium, as the mortgagor was not attempting to avoid the prepayment fee altogether. *Carlyle Apartments*, 333 Md. at 280, 635 A.2d at 373. The note rate on the loan was 10.25%. At the time the mortgagor requested payoff figures from the lender the Treasury Note Yield was 4.136%, while the "FHFB Nat'l Mortgage Contract Rate" was approximately 7.49%. *Id.* at 269 n.2, 635 A.2d at 367 n.2. The yield difference was thus over 3% higher than had a mortgage-related interest rate index been chosen, a significant difference on a loan exceeding \$3 million.

178. *Carlyle Apartments*, 333 Md. at 280, 635 A.2d at 373; see *supra* notes 116 & 177.

179. *Carlyle Apartments*, 333 Md. at 270-74, 635 A.2d at 368-70; see *supra* note 164.

180. *Carlyle Apartments*, 330 Md. at 279, 635 A.2d at 373.

181. *Id.* at 278 n.4, 635 A.2d at 372 n.4.

yland. When faced with these issues, however, Maryland judges will have the advantage of starting with a clean slate and will, if care is taken, be able to avoid some of the inconsistencies and contradictions that have developed in other jurisdictions.

First, the rule of perfect tender in time should mean that a prepayment not provided for in the loan documents is a *breach*, not that it is prohibited absolutely. Maryland courts should be willing to abrogate or distinguish the limited case law that supports specific performance of a loan contract,¹⁸² and allow mortgagors, even where the contract is silent, to breach by prepayment. As in any other breach of contract action, the mortgagor should then be held liable for all damages proved by the lender.¹⁸³ The modern use of yield maintenance clauses and other such prepayment options has shown that the expectation interest of the lender is quantifiable; the lender should not be able to use silence in order to circumvent the usual contract remedies. Silence should represent the decision of the lender to pursue actual damages in the event of a breach by prepayment instead of establishing a predetermined approximation that may not, in fact, result in full recompense for the effects of an early repayment.

Second, where the cost of the right to prepay is predetermined and specified in the loan documents, Maryland judges should be willing to enforce the clauses as drafted. Drafters of loan documents and parties involved in loan negotiations have a responsibility to clearly define the intention of the parties regarding loan prepayment rights. Once those rights are established, however, the agreement reached by the parties should be respected, especially in commercial settings involving sophisticated parties with equivalent bargaining power. Where the mortgagor has agreed to pay a prepayment premium regardless of the event precipitating the prepayment, that agreement should be honored.

182. The *Carlyle Apartments* court quoted *Pierson v. Pyles*, 234 Md. 119, 124, 197 A.2d 89, 893 (1964), for the following proposition: "We do not think the situation here calls for a result which would defeat valuable contractual rights of the [lender]." *Carlyle Apartments*, 333 Md. at 279, 635 A.2d at 373. There is a significant difference, however, between the court's upholding of a contractual clause providing for a premium in exchange for the right to prepay in *Carlyle Apartments* and the court's *de facto* grant of specific performance of the installment land sales contract in *Pierson*. See *supra* notes 102-06. Hopefully, the court's use of an appropriate quote from *Pierson* does not represent an unwillingness to reexamine the conclusion reached in that case.

183. This is thus not a suggestion that the effect of *Promenade Towers* be lessened or that the balance of rights between the lender and borrower established by that case be changed. Damages should include costs incurred as a result of a borrower's attempts to frustrate the lender's pursuit of actual damages, and the lender's security interest in the property should extend to the borrower's liability for damages.

Finally, if a liquidated damages analysis is applied to evaluate a prepayment premium when the prepayment is prompted by the lender's acceleration of the loan following a mortgagor default, the courts should take care to consider all relevant factors when determining the effect of the prepayment on the lender. In addition to the contract-to-market interest rate differential, tax ramifications, the cost of reinvestment, and the relative risks of the investment options foreseeably available to the lender in comparison to the loan being prepaid should be evaluated. Where the calculation specified by the prepayment clause is reasonable, even though not exact, the negotiated amount should be awarded. Where the amount determined by the prepayment clause is clearly unreasonable or exorbitant, the courts should either modify the award to eliminate the unreasonable feature, or allow the lender to prove actual damages. Striking the prepayment clause altogether ignores the relative rights of the parties prior to negotiation and inverts the rule of "perfect tender in time" to give the borrower the absolute right to prepay without charge.

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